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Known unknowns and unknown unknowns: the complexity of financial markets

The Dow and the S&P 500 pushed to new highs in 2014, extending a bull run that is now older than most kindergarteners. Yet their strength has also masked the weakness present in many other markets, as well as the risks lying hidden in the financial markets as a whole.

2013 and 2014: One Last Glance Back

When the markets closed on December 31st, 2013, they did so with some of the best yearly returns since the days of the Clinton Presidency[1]. The S&P 500 and the Dow[2] climbed to new highs as both indices notched gains of over 25%.

Foreign stock markets showed similar strength with the German, British and French markets posting gains in excess of 15%[3]. Japan's Nikkei 225 Index soared 57% in 2013, its best annual gain since 1972[4]. The economic situation in Europe seemed to have stabilized with countries pulling out of recession.

As 2013 drew to an end, investor sentiment was at its most optimistic level since early 2010 when the market was rebounding after the financial crash[5]. In September 2013, the cover of *Time* magazine showed a picture of a bull in a party hat, with the caption "How Wall Street Won"[6].

At the end of 2013, the general consensus among major market prognosticators was that 2014 would not be "as good" as 2013. But the forecasts still mostly leaned toward the positive side[6].

Wall Street has a bad habit of attempting to oversimplify complexity, encouraged by a financial media that speaks in sound bites and headlines. However, 2014 would turn into a stark reminder of the intricacies that are possible in the financial markets. With the benefit of hindsight we will attempt to explain some of the factors that weighed on the markets last year.

As it turned out, Wall Street's predictions were mixed. Blue-chip U.S. stocks continued to show strength in 2014 – but many of the other major asset classes performed poorly.

	2014 Return*
U.S. Stocks	13.36%
Emerging Markets	-2.19%
Developed Markets excluding the U.S.	-4.90%
World Markets excluding the U.S.	-3.47%
United Kingdom	-5.35%
Europe	-5.68%
Japan	-3.72%
China	8.26%
Latin America	-12.03%

	2014 Return*
Commodities	-33.06%
Oil	-42.56%
Precious Metals	-6.47%
Gold	-2.19%
Silver	-19.51%

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One factor was the political chaos abroad. By summer, unrest in Ukraine had boiled over into an armed conflict and the Middle East was sinking further into chaos. In September, the Ebola virus had made its way onto American soil. In Europe, stagnating economic growth once again called into question the future of the Eurozone.

By July, oil had started to fall from a peak of over $100 per barrel[7]. The major Wall Street banks failed to predict the depth of the oil crash – J.P. Morgan had predicted an average price of $112 in 2014[8,9]. Instead, oil collapsed to just above $50 by the end of the year. The tumble in oil prices led to a general decline in the stock markets of oil-exporting countries across the world. The currencies of those countries fell as a result, leading to a strengthening U.S. dollar. In turn, a strong U.S. dollar weighs on the prices of commodities (such as gold).

Yet despite this turbulence, the U.S. stock market remained relatively strong. The U.S. economy grew 3.7% in 2014[10] even as the rest of the developed world struggled to generate any positive growth at all. Corporate profits continued to notch record highs[11]. As a net importer of oil, the American economy benefited from falling oil prices with consumers having more money to spend.

With the financial media focusing on blue-chip American stocks and oil prices, the weakness in other markets went largely unnoticed. Last year's results show that record highs measured by blue-chip indices, such as the Dow, don't always reflect broad or total market strength.

To illustrate the point, let's look at some well-known market strategies with origins from some of the historically most popular investment strategists. These names and numbers have been provided by the American Association of Individual Investors[12].

1. David Dreman's Contrarian Screen +7.7%
2. "Dogs of the Dow" High Dividend Strategy +6.8%
3. John Neff's Value Strategy +5.1%
4. Warren Buffet's Sustainable Growth Strategy +3.2%
5. Motley Fool's Small Cap Strategy -2.1%
6. Peter Lynch's Bottom-up Strategy -7.2%
7. Ben Graham's Defensive Investor Screen -13.1%
8. Marty Zweig's Growth Strategy -14.6%
9. Joel Greenblatt's Magic Formula -16.5%
10. Ben Graham's Enterprising Investor Screen -20.6%

What happened in 2014 also demonstrates the limits of diversification. Those who spread their money away from American blue-chip stocks saw their portfolios lag the Dow and the S&P 500.

2015: Risk Factors Remain

Global economic weakness remains a concern as we make our way through 2015. Once again, the crisis in the Eurozone has started to weigh on stock markets. There is now a very real possibility that Greece may break away from the Eurozone, as a result of the Greeks electing a government led by the political party SYRIZA (a Greek acronym meaning *the Coalition of the Radical Left*). European investors are fleeing to bonds with some European government bonds now having negative yields (in other words, they're *paying* the government to own those bonds!)[13].

Major oil exporters in the Middle East, Latin America and Russia could see continued high volatility in their stock markets as the price of oil fluctuates.

Economic growth in East Asia is also a significant concern. Chinese GDP growth is at its lowest level since 1990, when they were hit by international sanctions for the Tiananmen Square crackdown[14]. Repeated attempts to revive Japan's stagnant economy seem to have failed with Japanese GDP remaining below its 1995 level[15].

The effect of a global economic slowdown on U.S. companies may be significant. Yet it's also possible that foreign investors, seeking to protect their money from financial turmoil in their home countries, invest in American financial markets instead. That would likely provide a boost to the U.S. stock market.

Here in the U.S., Federal Reserve policy is another risk factor we are monitoring closely. The possibility of an interest rate hike in June has been raised[16]. An increase in interest rates – the first since the financial crisis 7 years ago[17] – could have significant effects on the financial markets, and may have detrimental effects on bonds and dividend-paying stocks.

Conclusion

Former Secretary of Defense Donald Rumsfeld once said the following[18]:

> *As we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know.*

"Known unknowns" are things that we know we don't know. Some of these risk factors we discussed previously – the health of Europe, the price of oil, and Federal Reserve policy – are things that we know are risk factors, even though we don't know how they will turn out. They are "known unknowns". Our investment strategies are the tools we employ to manage these risks. While these risks cannot be eliminated or perfectly mitigated, they can be planned and prepared for.

"Unknown unknowns" are risks we don't know that we don't know. An example is the Ebola outbreak last year – before it started, investors didn't even know that it was something to consider as a risk factor. One way to manage these "unknown unknowns" is through constant monitoring of your portfolios and the markets. As your financial advisor, we monitor and react to the risk factors that are revealed through changing prices. That is one way we attempt to add value to your portfolios and your financial life.

To discuss this or any other financial matter, please don't hesitate to call.

My very best,

Derrick

*The following indices are used as proxies for the first table, in descending order: MSCI USA Index, MSCI Emerging Markets, MSCI EAFE, MSCI ACWI ACWI Ex USA IMI, MSCI United Kingdom, MSCI Europe, MSCI Japan, MSCI China, MSCI Latin America. All data for the first table has been provided by MSCI Inc. The following indices and ETFs are used as proxies for the second table, in descending order: S&P GSCI, S&P GSCI Crude Oil, PowerShares DB Precious Metals ETF, SPDR Gold Shares ETF, iShares Silver Trust ETF. The S&P GSCI and the S&P GSCI Crude Oil performance data has been retrieved from Standard & Poor's.

[1] All price and return data for the S&P 500 and the Dow Jones Industrial Average in this letter have been retrieved from Morningstar, Inc.
[2] References to "Dow" in this letter refer to the Dow Jones Industrial Average.
[3] Rooney, Ben, 2013. *CNN Money*. "Stocks: Stellar year ends on a high note" http://money.cnn.com/2013/12/31/investing/stocks-markets/
[4] Nikkei Inc., 2015 "Historical Data (Nikkei 225)". Retrieved from http://indexes.nikkei.co.jp/en/nkave/archives/data.
[5] "Investor sentiment" here is measured by the AAII Investor Sentiment Survey's percent bullish minus percent bearish spread.
[6] Pelberg, Steven, 2014. *Business Insider*. "Here's What 14 Top Wall Street Strategists Are Predicting For The Stock Market In 2014".
[7] All oil price data in this letter refer to the spot price of Brent Crude Oil. U.S. Energy Information Administration, 2015. "Spot Prices"
[8] MacDonald, Elizabeth and Evan Falk, 2014. *Fox Business News*. "Oil Plunge: Who on Wall Street Got it Right?"
[9] Reuters, 2014. "POLL-U.S. shale to keep lid on oil prices next year".
[10] U.S. Bureau of Economic Analysis, 2015. "Gross Domestic Product [GDP]".
[11] U.S. Bureau of Economic Analysis, 2015. "Corporate Profits After Tax (without IVA and CCAdj) [CP]".
[12] Throp, Wayne, 2015. *AAII Journal*: January 2015. "AAII Stock Screens 2014 Review: Active Strategies Lag".
[13] Cox, Josie and Emese Bartha, 2015. *The Wall Street Journal*. "Negative Yields on Eurozone Sovereign Bonds Becoming New Normal".
[14] Yao, Kevin and Pete Sweeney, 2015. Reuters. "China's 2014 economic growth misses target, hits 24-year low".
[15] Japanese Cabinet Office, 2015. "Gross Domestic Product for Japan© [JPNNGDP]".
[16] Lockhart, Dennis, 2015. Federal Reserve Bank of Atlanta. "Considerations on the Path to Policy Normalization".
[17] Federal Reserve Bank of New York, 2015. "Historical Changes of the Target Federal Funds and Discount Rates".
[18] U.S. Department of Defense, 2002. "DoD News Briefing - Secretary Rumsfeld and Gen. Myers".
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