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Fragility

January 3, 2016 — It was a wild ride for stocks in 2015. In May, the S&P 500 stock index set a record high, only to be followed by an 11% collapse over an eight-day period in August. In the end, the index lost 0.71% on the year. However, if we include dividends the total return was in the black at 1.4%, the weakest one-year performance since the disaster of 2008 (down 37% in one year).

Similarly, the Dow Jones Industrial Average lost 2.23% for the year. The Nasdaq Composite gained 5.73%.

Low oil prices account for some of the weakness in equity returns during the year, as eight of the ten worst performers were in the energy sector. From 2011 through 2014 the average price of a barrel of oil in the U.S. was $95.05. That fell to an average price of $48.86 per barrel in 2015, closing the year at under $40.

Conventional wisdom suggests that the price collapse resulted from the surge of oil production in the U.S., accompanied by OPEC's decision not to reduce their output, creating a worldwide glut. In fact, in order to maintain their cash flow at lower prices, some countries *increased* production at the lower prices, fueling additional oversupply.

The minority view is that shrinking demand also has played a significant role in driving down prices. The world economy has not been growing robustly, and so low oil prices are not a temporary aberration but may last for years. Much of the world's oil production is unprofitable at these price levels. Accordingly, spending on new production has been deferred or delayed, and this has led to significant unemployment in the oil sector.

Interest rates

In December the Federal Reserve Board took its first tentative steps to raise interest rates, by 0.25%. This has been an unprecedented period of very low interest rates. However, a downward rate trend has been evident since the 1980s, when Paul Volcker broke the back of inflation. Studies of interest rates over the long term suggest that the high rates of the 1970s were the anomaly, and the current situation is closer to the norm of the last two centuries.

Market observers expect the Fed to continue nudging rates higher in 2016, but do not expect a dramatic move. The economy, still recovering, may not be able to withstand a big rate hike. For example, the Atlanta Fed projected that the growth of gross domestic product in the fourth quarter was an anemic 0.7%. Should that prove accurate, total GDP growth in all of 2015 was just 1.8%.

Construction

The Census Bureau announced that construction spending declined 0.4% in November 2015, which was a big surprise. The consensus expectation was an increase of 0.6%. Buried in the fine print of the report was the startling revelation that a "processing error" meant that all the tabulations from 2005 through 2015 had to be reworked. Each data point from April through October 2015 had to be revised downward, indicating that construction had been slowing most of the year. What other government data sets are due for material revision?

The larger point is that, despite the low unemployment numbers and the long period of expansion, the economy remains somewhat fragile, vulnerable to sudden shocks. What shocks may be in store for us in 2016?

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