Pinnacle Capital Management, LLC

January, 2016

COMMENTARY

ECONOMIC STATISTICS					
	4th Qtr (12/31/15)	3rd Qtr 9/30/15)	*% Change*	1 Yr Ago (12/31/14)	*% Change*
S&P 500 Index	2,043.94	1,920.03	*6.5%*	2,058.9	*-0.7%*
10 Year Treasury Yield	2.27%	2.04%		2.17%	
Gold Spot ($ / oz)	$1,061.42	$1,115.07	*-4.8%*	$1,184.86	*-10.4%*
WTI Crude Oil (next future)	$37.04	$45.09	*-17.9%*	$53.27	*-30.5%*
GDP Qtr / Qtr	N/A	2.0%		2.1%	
CPI Y / Y	0.5% (Nov)	0.0%		0.8%	
Unemployment Rate	5.0%	5.1%		5.6%	

2015 was a year of dichotomies. And it was a year of sudden turns and reversals. Perhaps the greatest reversal was the price of oil. Hovering in a range between roughly $90 and $110 per barrel, the price of West Texas Intermediate (WTI) slid abruptly in 2014. Bottoming just below $45 in March 2015, there was an initial rebound. By June oil was just above $60 per barrel. Then the bottom fell out once more. As we write this Commentary, the price is hovering around $30. We highlight this price movement because it is intertwined with so much else in the economy. We'll start with the positive.

The decline in oil prices represents a massive tax cut for individuals across the economy. As a simple exercise, let's we assume a typical vehicle is driven 12,000 miles per year and gets 20 mpg. Between June 2014 and early January 2016, the average price of gasoline has fallen by $1.70 per gallon. The net savings amounts to $1,020 per driver per year. We haven't even considered savings related to heating, air conditioning, power generation, or commercial transportation. Nor have we considered the impact of decreased hydrocarbon prices as inputs to other products (e.g. chemicals and plastics). We hope you get the picture.

Of course the fall in prices is bad for one industry... the energy industry. Yet we've seen the markets act skittish with each drop in the price of oil. Why is that so? There are two reasons as far as we can see. First, while debt is generally not the problem it was a few years back, there is a bit of debt in the oil sector. Companies borrowed to finance drilling on a global basis assuming $100+ per barrel prices. As interest rates have been extremely low, investors have chased the higher returns available in the energy sector. Whoops! Suddenly, all debt funds look suspicious. Fears of a debt rout accelerate. Perhaps the markets might be more forgiving but we have reason #2.

At the same time that oil is falling, the growth in China is slowing down. Remember 10% Chinese economic growth? That's a thing of the past now. We're looking at numbers around 6.5% GDP growth. However, all numbers coming out of China have to be taken with a grain of salt. And a portion of their growth (no one knows exactly how much) has been the result of debt funded construction spending. So when economic growth slows down, there is a glut of real estate; and we have another debt problem on the other side of the world.

Exacerbating the problems is a misconception, in our opinion, about the nature of the fall in the price of oil. The fall in price, in our opinion, is mostly a result of the U.S. led shale oil boom. According to the laws of economics, too much supply leads to falling prices. However, perceptions are that the problem is actually weak demand, primarily in China. This leads to further fears of weak economic growth everywhere. Therefore the price of oil falls further. All this fear leads to a rush of investors to U.S. Treasuries. The rush from overseas leads to upward pressure on the dollar (one can't buy U.S. Treasuries with foreign currency). This in turn leads to weaker profits of U.S. companies as their foreign sales and profits translate into fewer dollars. Earnings fail to grow reinforcing fears about a weak global economy.

Some of this becomes self fulfilling. Yet we take issue with the markets not treating currency induced earnings reductions as anything other than a temporary phenomenon. If the expectation is that the U.S. dollar will perpetually rise, then yes, there is a fundamental problem. While we won't rule out a further rise in the U.S. dollar, we don't see the recent gains as something that will persist into perpetuity. Still, the argument is that U.S. firms will become less competitive. While there is truth to that, the argument ignores improvements in productivity and improved purchasing power in the U.S. Lengthy papers have been written on this subject. Suffice it to say that we think that 1) there will be a near term hit to corporate profits due to the rising dollar (we've already seen the initial hits), 2) competitive issues will slow sales and profit growth going forward, but 3) after a brief respite, the upward trend of corporate sales and profits will resume.

Now enter stage left, the Federal Reserve. We bet you thought we had forgotten about them. The Fed is not ignorant to all of these issues. Part of the reason that it had been mostly unwilling to raise interest rates is that it was afraid, we think, of two things. First, it saw the weakness that the markets see. It was afraid that raising interest rates would add to economic weakness. After all, U.S. economic growth has not been robust. Second, because the European Union (EU) is currently committed to monetary easing and low interest rates, any increase in interest rates might further fuel the rush to the dollar, as global fixed income investors find U.S. investments even more attractive. This in turn hurts the profitability of U.S. exports and, potentially, U.S. competitiveness.

Nonetheless, the Fed in December raised its targeted Fed Funds rate. To put this in perspective, rates are still near historical lows. Additionally, the Fed typically begins raising rates within a year of an economic recession. When did the last recession end? March, 2009.... hmmmmm. Don't fool yourselves. The Fed is still being incredibly accommodative. Then again, it is a move in the right direction. As we've stated many times in these Commentaries, we believe the over accommodative stance of the Fed has actually hurt economic growth.

So in summary, economic growth advances, albeit at a slower pace than we'd like. Corporate profitability is being hindered by the strong dollar. Oil prices have plunged, putting more dollars in consumers' wallets. And most everyone fears what's occurring in China. For now, China rules the direction of the markets. But, we invest for the long term - not the short term. As frustrating as it might be, fear creates opportunities. We hope to capitalize on it.

Thank you, and we wish all a happy, healthy, and prosperous New Year!