
# Quarterly Update & Economic Commentary—December 31, 2014

## Quarter in Review

The domestic markets had another solid year in 2014. The S&P 500 TR (TR stands for total return, which includes both appreciation and dividend reinvestment) finished the year positive by 13.69 percent, which marked the sixth straight calendar year with a positive return. The cumulative return of the S&P 500 over this six year time period has been 159.43 percent. The 2014 returns of the S&P 500 were led by defensive sectors, Utilities (28.98 percent) and Health Care (25.34 percent). The Energy sector was the lone broad sector to post a calendar year loss, falling 7.78 percent. The Energy sector lost over 10 percent during the fourth quarter due to falling oil prices. Small and mid- sized domestic stocks also finished the year positive, but not quite as high as the S&P 500. The S&P MidCap 400 TR returned 9.77 percent, and the S&P 600 SmallCap 600 TR returned 5.76 percent. For U.S. investors, a strengthening dollar hurt performance of foreign investments. In U.S. dollar terms, the MSCI EAFE lost 4.90 percent for 2014, but in local currency terms, the return was 5.92 percent. There was a similar, though less severe, situation in the broad emerging markets category. The MSCI Emerging Markets index lost 2.19 percent in U.S. dollar terms, but in local currency it was up by 5.17 percent.

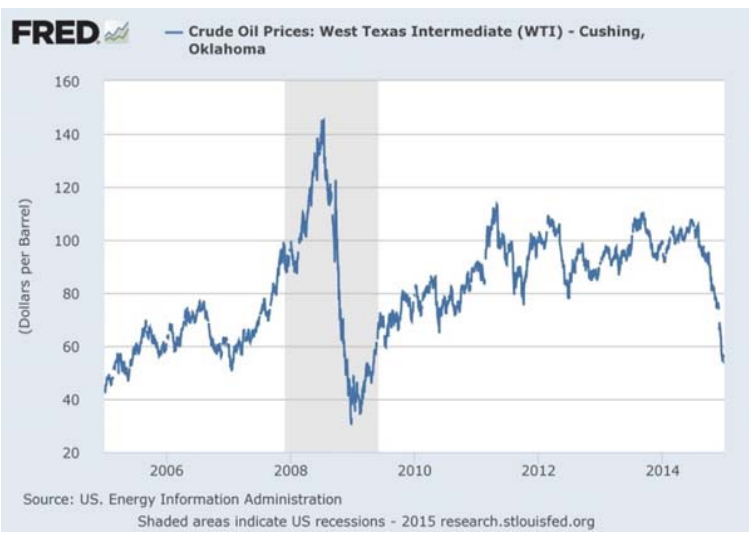
Over the last year, the yield curve flattened as shorter-term interest rates rose slightly and longer-term interest rates fell. Short-term interest rates rose in anticipation of a Fed rate increase next year, while longer-term rates fell as inflation expectations declined and because of an increase in demand for longer-term bonds as a result of perceived relative value versus other sovereign debt. The 10-year treasury yield fell from 3.04 percent at the beginning of the year to 2.17 percent at the end of the year. The drop in rates surprised many but was beneficial to fixed income holders. The Barclays US Aggregate Bond index rose 5.97 percent for the year. Low-quality bonds suffered losses during the fourth quarter mainly due to the relatively large exposure to the energy sector. The Barclays US Corporate High Yield index lost one percent during the fourth quarter, finishing 2014 with a gain of 2.45 percent.

Commodity headlines were dominated by the drop in energy prices, most notably oil prices. Oil prices fell over 47 percent during 2014, with the most dramatic drop occurring near the end of the year. Oil fell over 17 percent in December and almost 39 percent during the fourth quarter. The calendar year loss for oil was its worst loss since 2008. Gold and silver suffered back-to-back calendar year losses. Gold lost 1.51 percent for 2014 after falling 28.26 percent in 2013; silver's losses were more significant, falling 19.47 percent in 2014 and 35.92 percent in 2013. Coffee led commodities in 2014 as prices rose 50.50 percent for the year.

The major headlines throughout the fourth quarter focused on the fall in oil prices and the strengthening U.S. dollar. Although there will be some negatives to the drop in oil prices — such as loss in jobs, deflation, lower earnings for companies in the energy sector, and potential defaults, among others — we believe lower oil prices will be a net positive for the U.S. economy. Oil prices have fallen as a result of excess supply. New technology has allowed for increased oil production in the U.S. and in the rest of the world. In addition to the additional supply being brought to the market, slow global economic growth has also kept demand for oil stable. More supply and stable demand translates into lower prices. The lower oil prices will help U.S. consumers; the U.S. Energy Information Administration has estimated that U.S. households will save an average of $550 on gas in 2015 because of lower gas prices and more fuel-efficient cars.

Oil exporting countries like Russia, Iran and Venezuela have been among the hardest hit by the drop in oil prices. Revenue from energy makes up a significant part of the Russian government's budget. The value of the Russian Ruble declined significantly during the year, causing the Russian government to raise interest rates to 17 percent from 10.5 percent; the government has also been selling its currency reserves to the market in an attempt to stabilize the currency. Russia's currency reserves fell below $400 billion for the first time since 2009.

The U.S. dollar has strengthened as other developed regions like Europe and Japan continue to fight slow economic growth, high unemployment and growing risks of deflation. Japan's central bank has been aggressively buying government bonds and other financial assets, while the European Central Bank (ECB) continues to "talk" about some sort of quantitative easing — though it has stopped short of implementing any such measure. Further, the U.S. has been regarded as the most likely to raise interest rates in the near future.




The economic readings in the U.S. continued to show signs that the economic recovery is picking up steam. The third quarter gross domestic product reading showed the U.S. economy grew at a rate of five percent, the most since 2003. Before getting too excited over such a great reading, it is important to remember that the first quarter reading in 2014 was negative 2.1 percent. We believe both of these readings are outliers, but nonetheless, it is comforting to see the economy growing at a pace that is around three percent. Another sign of a strengthening U.S. economy is the improving jobs picture. The unemployment rate has steadily fallen throughout the year. The current rate is 5.8 percent, which is down from 7.0 percent at the last reading of last year. The four-week moving average of initial jobless claims has consistently remained below 300,000, a trend not seen since before the financial crisis.

Housing data throughout the year has been mixed. Housing prices rose modestly, which contributed to the rise in consumer confidence. Despite the recovery seen in the housing market over the last few years, many individuals continue to rent as opposed to purchasing a home. The demand for rental properties has pushed rental prices higher; making purchasing a home more attractive. Part of the reason why renting has become the chosen path is that recent college grads prefer the flexibility of renting and lending standards are more strict today than before the financial crisis. This new dynamic has caused developers to increase the production of apartments and condominiums.

As expected, the Republicans took control of the Senate and added to their majority in the House of Representatives. What was surprising was the number of seats the Republicans won, which the markets perceived as a positive. While it's unlikely to come to fruition, there is a chance that the new Congress could tackle tax reform.

While the U.S. economy looks to be in full recovery mode, other countries around the world have not been as fortunate; many central banks have been forced to cut rates or keep them low in an effort to stimulate their economies. The People's Bank of China and The Bank of Korea cut interest rates in October, Japan continues to be committed to low interest rates, and more accommodative policies may be coming from Thailand and Australia.

Much remains the same in Europe: economic growth is anemic, unemployment is too high and the risk of deflation is a real threat. Adding to the concerns, fears of a possible Greek exit of the Euro, or Grexit, resurfaced at the end of the year. The Greek parliament failed to elect a president, forcing a snap election to be held on January 25th. Many fear that an anti-Euro politician could win the election and attempt to remove Greece from using the Euro as the country's currency.

## A Look At The Numbers

| Name | 4th Quarter 2014 (%) | Year-to-Date (%) |
|---|---|---|
| DJ Industrial Average TR USD | 5.20 | 10.04 |
| S&P 500 TR USD | 4.93 | 13.69 |
| S&P MidCap 400 TR | 6.35 | 9.77 |
| S&P SmallCap 600 TR USD | 9.85 | 5.76 |
| NASDAQ Composite TR USD | 5.70 | 14.75 |
| MSCI EAFE NR USD | -3.57 | -4.90 |
| Barclays US Agg Bond TR USD | 1.79 | 5.97 |
| Wilshire US REIT TR USD | 15.13 | 31.78 |
| IA SBBI US 30 Day TBill TR USD | 0.00 | 0.02 |

## Forecast In Brief

As we look ahead into 2015, we expect to see many of the same trends that started in 2014.

Oil prices were a major story during the second half of 2014 and we think the oil story will remain in headlines this year. Low energy prices will act like a massive tax cut for many households that depend on automobiles. Americans have proved over and over again that they will spend money, and having more discretionary dollars translates into more money for consumers to spend. Although we believe lower oil prices are a net positive for the overall American economy, it will have a negative impact on certain areas of the economy. Two of the leading states for job growth in recent years have been Texas and North Dakota, both benefiting from the U.S. energy boom. However, with oil prices falling, profitability will fall, leading to less hiring and more lay-offs. There are a number of oil production companies in the U.S. that carry substantial debt that requires interest payments. As revenue of these companies fall, the ability to pay the interest will become more difficult and in some cases, may result in defaults. The high yield bond market may see higher levels of volatility, as the energy sector makes up around 18 percent in the broad indices.

Another trend in 2014 that is expected to continue into the New Year is the strengthening U.S. dollar. As other central banks are either conducting quantitative easing, talking about implementing quantitative easing or lowering interest rates, the U.S. Federal Reserve has stopped quantitative easing and has at least discussed the possibility of raising interest rates in 2015. We do not believe a rate hike is guaranteed for 2015, but given the relative strength of the U.S. economy and higher bond yields compared to other developed countries, inflows to the U.S. are likely, which would cause the dollar to strengthen due to the increase in the demand. The consensus is that the U.S. dollar will strengthen further in 2015, much like the consensus a year ago was that U.S. interest rates would go higher, proving that consensus trades are not always a sure thing and that there are no guarantees.

The falling yield on the 10-year treasury surprised many investors in 2014. We would not be surprised to see the 10-year stay at current levels and potentially even continue to fall. With a low threat of inflation, especially with the drastic decline in energy prices, the 10-year treasury may fall lower in 2015. Even if the Fed decides to begin raising rates in 2015, we still believe long-term interest rates can remain at current levels and may even fall. The Fed can directly impact the short end of the yield curve but they may not be able to move the intermediate-to-longer-end of the yield curve. Low energy prices and capital inflows will be the main drivers of stable or falling interest rates in 2015. Even given the potential of rates to fall further, it continues to remain important to manage interest rate risk.

It will be entertaining to watch the political scene this year. In one breath, both sides have indicated that they will compromise on important issues to avoid getting nothing accomplished in the next two years. The president has voiced his intentions to continue to use Executive Orders to further his agenda when needed. Republicans have also contributed to the stalemate, as some continue to dig in against any presidential initiatives and vow to repeal Obamacare. This year, we should gain more insight into who the key players will be in the 2016 presidential race.

Foreign markets have lagged the U.S. in recent years, but, as expected, gains in the U.S. are being lowered, valuations are looking stretched, and investors are looking for opportunities overseas. Investors are eyeing European markets, particularly in anticipation of the beginning of quantitative easing in the Eurozone. The ECB has been suggesting aggressive quantitative easing (QE) for some time, but has yet to take formal action. Some believe that QE in Europe may have little impact, as banks have plenty of liquidity and rates are already at historical lows. The problems Europe faces are structural and could require much more attention than QE. Another concern investors need to be cognizant of, however unlikely, is an attempt by Greece to leave the Euro, which could increase volatility over the short-term. U.S. investors looking for exposure overseas also need to consider the currency impact; if European stocks rise but the dollar strengthens, all gains could be wiped out unless the currency exposure is hedged.

Many of the threats that caused increased volatility last year continue to exist. Many of these "known" risks, like an attack from ISIS, the spread of Ebola, a European recession, a "Grexit", Russian military aggression, and a rate increase by the Fed remain viable in 2015. Despite their persistence, however, we believe that the risks, which are more significant in terms of their impact, have a lower probability of occurring. That said, however, it is often the unknown risks that tend to shake the market when they appear. The event that causes the next stock market meltdown is likely not being closely monitored today.

Our forecasts have been consistent over many previous quarters, with the driving theme being we remain bullish on domestic equities. We see a majority of equity returns being driven by corporate earnings growth, outside of the energy sector. Investors will also continue to see returns from corporate buybacks and dividends, as well as from some multiple expansion. Buybacks and dividends will be driven by healthy corporate balance sheets; we believe multiples can expand as a result of increased consumer confidence. Although we believe domestic equities continue to offer an attractive potential return, we also believe fixed income assets can provide diversification benefits and may continue to appreciate in value if interest rates continue to drop. Domestic equities have outperformed many foreign markets in recent years, but we do not think international markets should be ignored by all investors. The recent troubles have created some potential opportunities. We continue to believe investors should be well diversified and make investment decisions based on personal goals and objectives.

If anything in your financial situation has changed, please let us know so we can determine whether a change in your portfolio is necessary.

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