Market Commentary

Fourth Quarter 2014

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The fourth quarter of 2014 was a fitting coda to the full year. Equity markets witnessed significantly increased volatility during the most recent quarter, yet rebounded from large early losses to register its seventh consecutive quarterly gain. Despite two sharp pullbacks of 5% or more during the quarter, stock prices rebounded in "V-shaped" fashion on both occasions, setting all-time record highs in the last few trading days before pulling back in the final days of the quarter. The benchmark S&P 500 index rose by 4.9% during the quarter on a total return basis. This brought the full-year total return for 2014 to 13.69%. The benchmark 10-year US Treasury note yielded 2.17% on December 31, down from the 2.49% yield at the start of the quarter, and 3.00% at the start of 2014.

Economic and Market Outlook

The Federal Reserve has completed its final round of Quantitative Easing (QE). With the Fed no longer participating as a buyer of debt securities, we believe interest rates will begin to seek out more normalized levels. Based on current inflation expectations, this may be very close to current levels, at least on the longer end of the interest rate curve. In fact, during the past several months, we have seen yields on shorter maturities rise while maturities of 10 years and longer have continued to decline. As for most of the past six years, capital markets have been driven by the actions of central banks. We believe this will continue into 2015. While interest rates are very low around the globe, we ponder how and why 10-year Italian and Spanish notes provide lower yields than 10-year US Treasuries. In fact, the 10-year US Treasury note has one of the highest yields among developed nations, as shown in the nearby table. This flies in the face of the risk/reward mantra in Capital Markets 101. Either US Treasuries are far too cheap, or many other nations' debt is too expensive. We strongly believe it is the latter. Thus, international fixed income investors may seek the stability of the US Treasury market if foreign fixed income markets re-price (sell off) based on relative risk levels.

Country	10-Year Yield
United States	2.17%
Germany	0.54%
Italy	1.89%
Spain	1.61%
UK	1.72%
France	0.78%
Ireland	1.24%

On the economic front, the most significant factor is the price of oil. With the sharp decline of over 45% from its June peak, there will be negative effects to the energy industry, but far more positive effects to the consumer and spending. The American consumer is in the best financial shape since the 2007 downturn began. Having de-levered personal balance sheets, the consumer is finally seeing home values increase, wages are finally growing modestly, and now energy prices have been slashed by a third since the summer. This sets up the consumer to increase spending in 2015, supporting GDP growth forecasts in the 3.0-3.5% range.

The combination of minimal wage growth, very low interest rates, and a weaker dollar has helped US companies post record margins. All three of these have begun to reverse, meaning top-line growth will be necessary to continue driving corporate profits in the next few years. We believe the US economy will show continued strength throughout 2015 with tailwinds coming from lower energy prices, a rebounding consumer and continued low inflationary pressures. Economic strength aside, we believe

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investors need to be prepared for more volatility and the increased chances of a 10% stock market correction at some point in 2015. This will not signify the end of the bull market, but rather a healthy and well-needed pause. Markets are driven by fear and greed. These emotions, combined with shorter investment time horizons for many and the laser focus on the latest headlines is what drives volatility higher. We believe modest equity returns are likely during the next 12-18 months, although equities may still be the preferred asset choice over that time period.

Portfolio Positioning

As we near the six-year anniversary of the current bull market, we believe prudence and capital preservation become more important. We have said many times that bull markets do not die solely due to age, but rather from changes in economic forecasts along with meaningful increases in interest rates. We do not see reasons to believe the US economy will face the risk of recession – in fact, the sharply lower price of oil should provide a boost to consumer spending and disposable income. We are less certain on the path of interest rates. The Federal Reserve very much wants to raise interest rates, but is being held back by deflationary fears. With markets at all-time highs, and modest signs of speculation re-emerging, we counsel investors to hold high-quality equities in the coming months. The time to increase overall risk profiles occurs early in bull markets, after a meaningful decline has washed out many risk-takers. We are well beyond that and are holding companies and industries with financial strength, low leverage, and high returns on capital with high levels of free cash flow in client portfolios. These are the companies that should outperform during volatile markets.

Conclusion

2014 was yet another year where any strategy other than "Buy the Dips" lagged. This will not always be the case, and investors who fight the last war are the ones who get burned. If we had known that Russia would invade Ukraine and annex the Crimea, oil prices would decline by 50%, and the Federal Reserve would complete its Quantitative Easing during the year, we would have been hard pressed to predict mid-teens returns for equities and healthy fixed income returns for 2014. This supports the fallacy of short-term market predictions. We are known to say that our "crystal ball" is much more accurate six years hence rather than six months. Long-term trends are easier to ascertain and follow rather than short-term blips. Prudent investors look past the current headlines and focus on valuations and long-term trends. This is what ultimately rewards sensible portfolio construction and proper asset allocation.

As we look to 2015, we wish each of you a healthy, joyous and prosperous year. Please contact us if you have any questions or comments.

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