Insights: March 2015

Market Overview and Performance

In somewhat surprising fashion, February proved to be the opposite of January this year. During the first thirty days of the year, U.S. stocks fell by 3 percent, while international equities mostly tracked sideways. In contrast, during February, U.S. indexes raced almost six percent higher, as did non-U.S. markets, with developed international equities in particular notching a 6.5 percent gain for the year. This seems like a far cry from the volatile days of January when a "risk-off" persuasion dominated the markets amidst a parade of headlines about the European Central Bank's quantitative easing program, other global central banks slashing interest rates and the prospect of the difficulties in Greece potentially resulting in that country's exit from the Eurozone. In that uncertain environment, bonds, gold and volatility were all up smartly, yet we saw a complete reversal of that performance in February. So, what changed? The shift towards a more bullish view was largely predicated on three things: the stabilizing of the price of oil, a decrease in the likelihood of a shock to the system from either Greece or Russia, and unexpectedly strong economic recovery data being generated out of Europe. So its back to "risk-on" in the markets for the time being, but there were some noteworthy new details to the narrative that we think merit some discussing in this month's Insights.

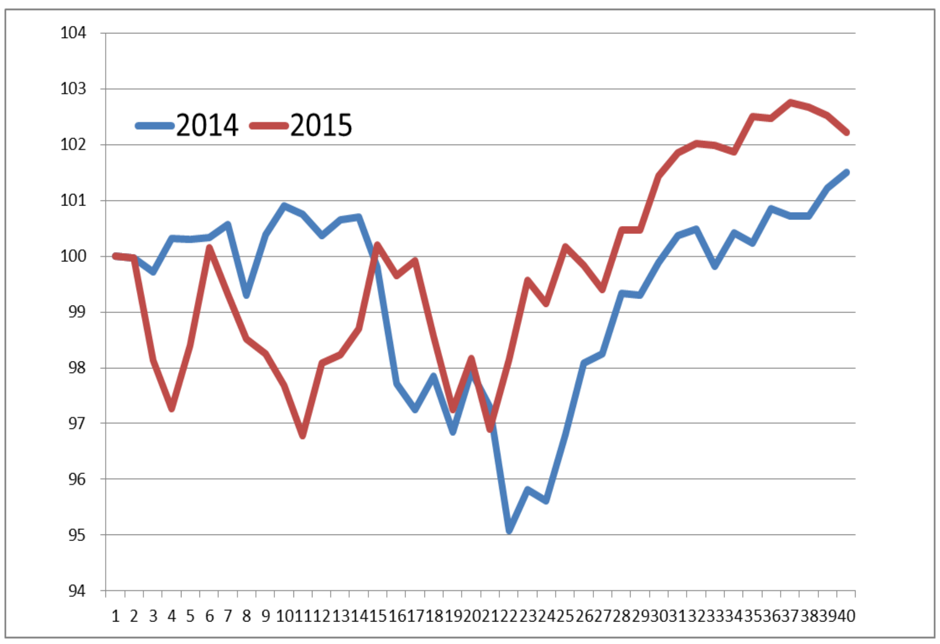
We hope you enjoy what we have to say and we look forward to hearing from you soon.

	Month to Date	Year to Date
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	***5.75***	2.22
Russell 2000 Index	***5.94***	2.53
MSCI EAFE Index	***5.98***	***6.50***
MSCI Emerging Markets Index	3.10	***3.71***
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.94	1.14
Barclay's U.S. Credit Index	-1.27	1.33
Barclay's Corporate High Yield Index	***2.41***	***3.09***
Barclay's Municipal Bond Index	1.03	0.72
Macro Measures		
Gold	***-5.17***	2.45
Crude Oil	3.15	***-6.59***
CBOE Volatility Index	***-36.39***	-30.52
USD Dollar Index	0.42	***5.51***

February Themes – Risk Back On and Maybe the U.S. Really Isn't the Only Game in Town

If the tale of a January filled with uncertainty followed by a strong February rally sounds familiar to you, that is because it is exactly what we experienced last year too. Below is a chart of the performance of the S&P 500 Index during January and February of 2014 and 2015 indexed back to 100. As you can clearly see, both years have followed a very similar path.

S&P 500 Index January and February Performance

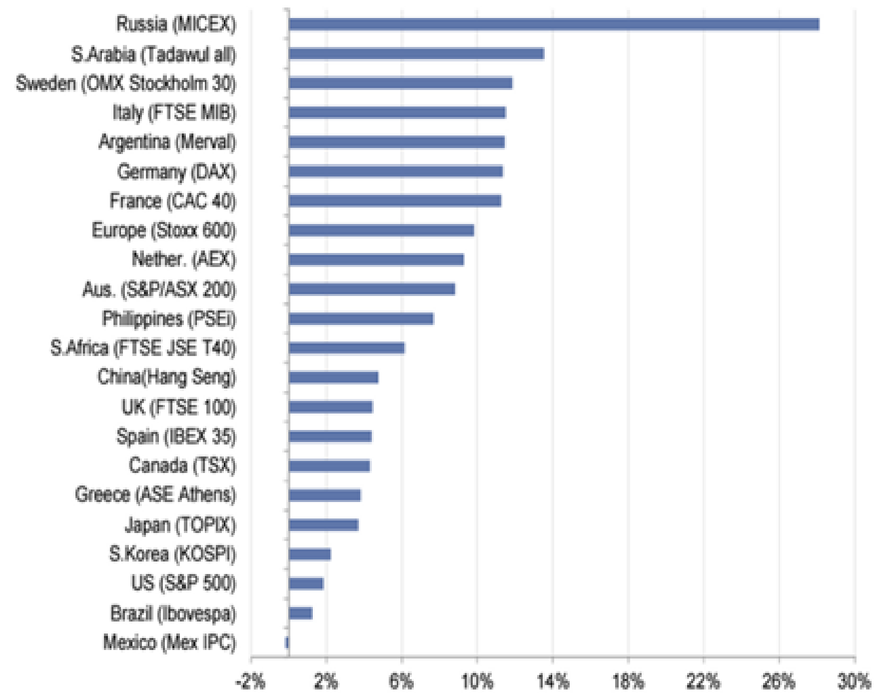


Source: Thomson One; S&P Dow Jones

What was perhaps different from last year was the sentiment going into a new calendar year. In 2014, most strategists and investors generally felt that the U.S. was the best opportunity available from a risk/reward perspective, but there still was not a tremendous amount of conviction in that positioning. Fast forward through a twelve month period in which the U.S. economy continually showed signs of strong improvement, and now by January of 2015, the common wisdom, firmly held this time, was that the U.S. was the only place to have your money right now.

So pundits and average investors alike found it curious that the following is what actually occurred so far in 2015.

2015 Global Stock Index Returns – US Near the Bottom



Source: Goldman Sachs, Bloomberg

It is surprising that the Russian stock market would be pushed up over 20 percent to its 2011 levels in the face of what appears to be a certain recession, however, with oil stabilizing and European crisis issues seemingly moderating, risk assets got the "all clear" signal. It is worth noting though, that in addition to the outlier of Russia, most global markets have bested the U.S. stock market through February of this year.

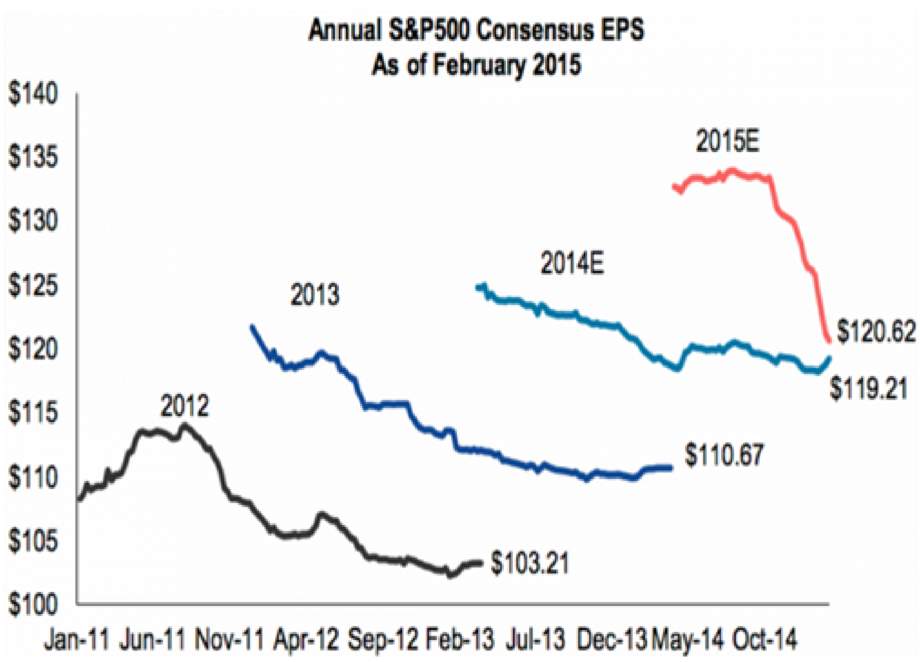
We will talk about the reasons behind the strength in the Eurozone later, but first, we will spend some time on why the enthusiasm for the U.S. investment thesis has been more muted even though the case is still very much in tact.

Earnings and the U.S. Economy – Still Strong

In what should be a good development, investors have focused quite a bit of attention on fundamentals this quarter and particularly on earnings. It is a good sign for markets when investment decisions are not based solely on macro events, so when looking at company results, the key question for many has been, "Can corporate America continue the consistent earnings growth that has helped propel this six year bull-run?"

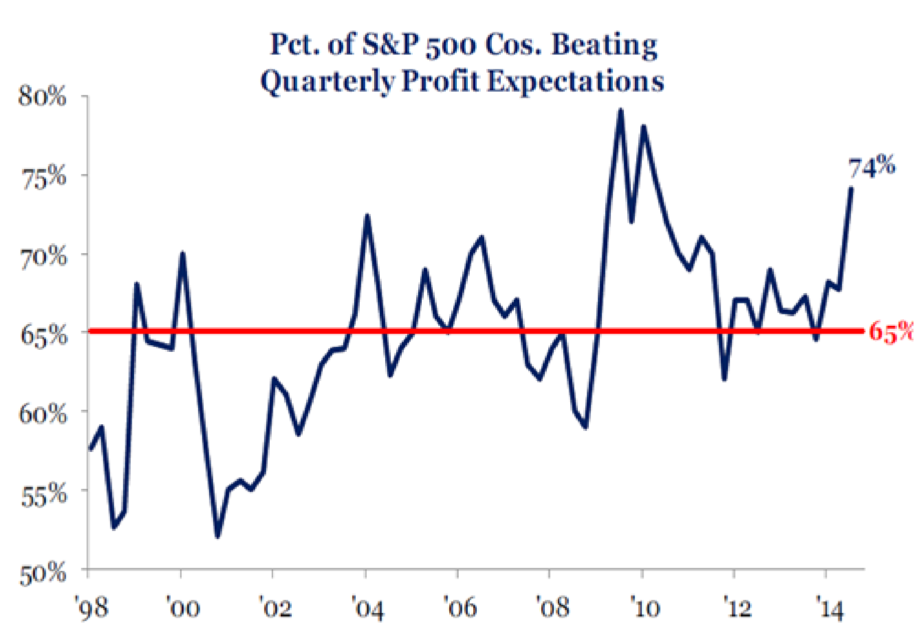
We would suggest that the answer to this question has been somewhat misunderstood. It is true that earnings estimates in aggregate have been revised down during the month, but we think those who would categorize this as a sign of deterioration in the market need to look just one small layer deeper. As the charts below highlight, estimates for S&P 500 earnings in 2015 have come in sharply, perhaps too much so given that companies have been able to beat estimates handily. More importantly though, is the reasoning behind the estimate cuts which as the last graph from Ed Yardeni clearly points out, as coming from the energy complex.

2015 S&P Earnings Estimates Have Been Cut…



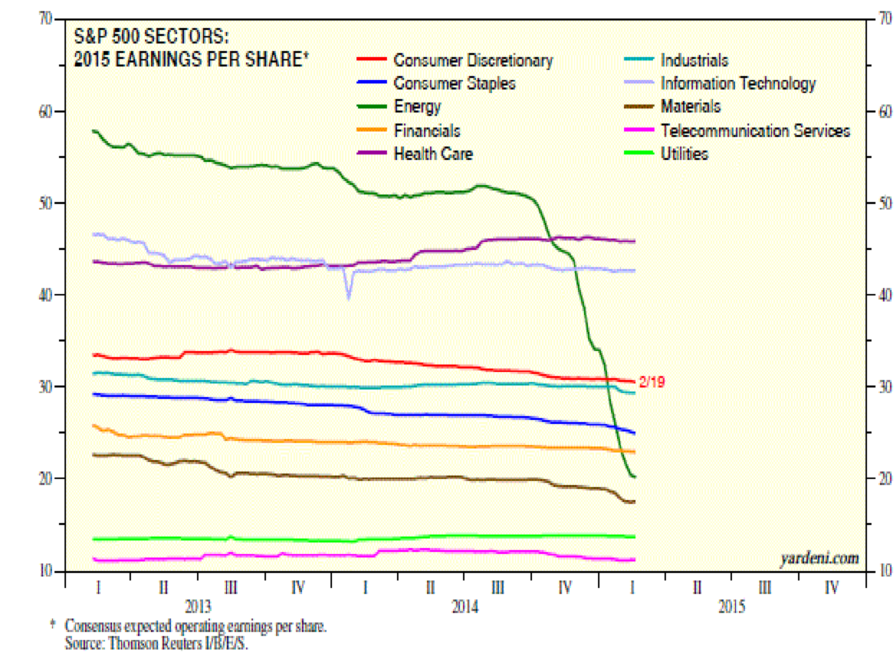
Source: Fidelity, Morgan Stanley

But Results Have Continued to Outpace Expectations…



Source: Fidelity, Strategas.

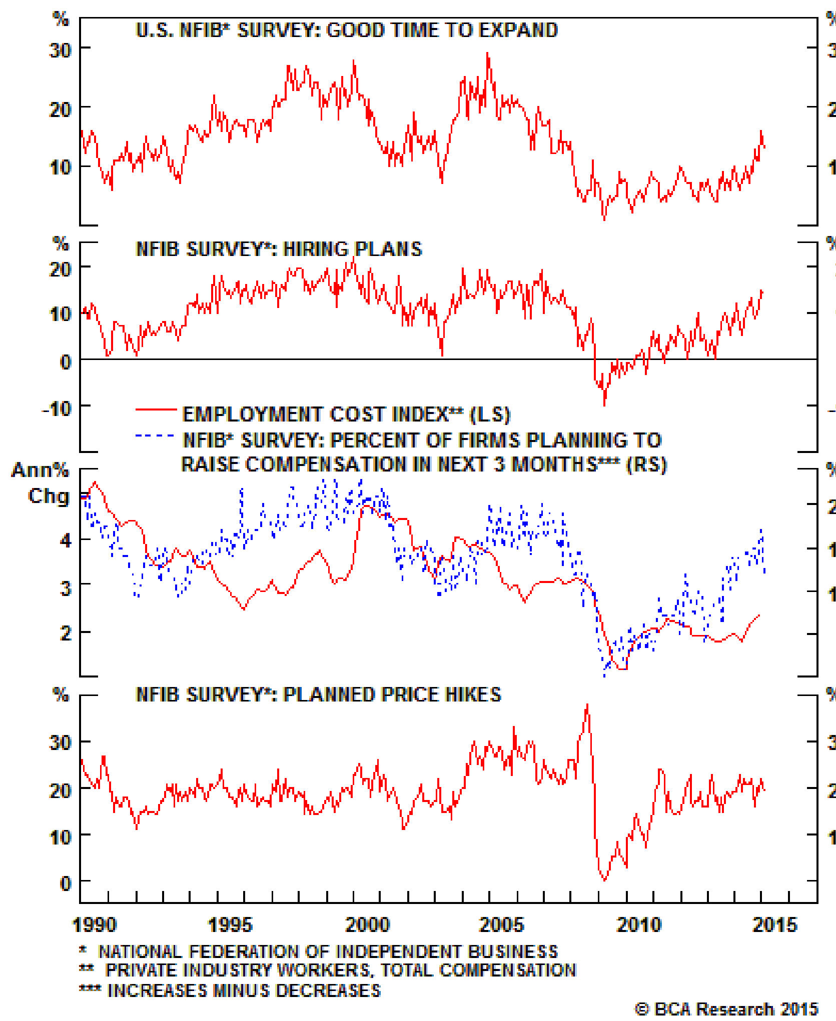
And Negative Impact Has Come Almost Entirely From The Energy Sector



If the price of oil has in fact stabilized as Mr. Yardeni and others have proposed, it would suggest that this adjustment period for earnings is largely complete which allows investor attention to once again fall on the progress of the U.S. economy.

It has been well documented that the U.S. is further along in its recovery than many other regions and February brought further evidence to support this case. In particular, the February employment report showed that 257,000 jobs were created in January and that over 1,000,000 jobs were created over the prior three months in total. That was the highest reading since November of 2008. Additionally, small business hiring and sentiment continued to build momentum as seen in the chart from BCA Analytics. This is important because in a very quiet way, small businesses have been driving the employment gains during the most recent part of the recovery. As evidence of that, small businesses actually accounted for 83 percent of new hires according to Fortune Magazine.

Small Businesses Feeling Good About the Future

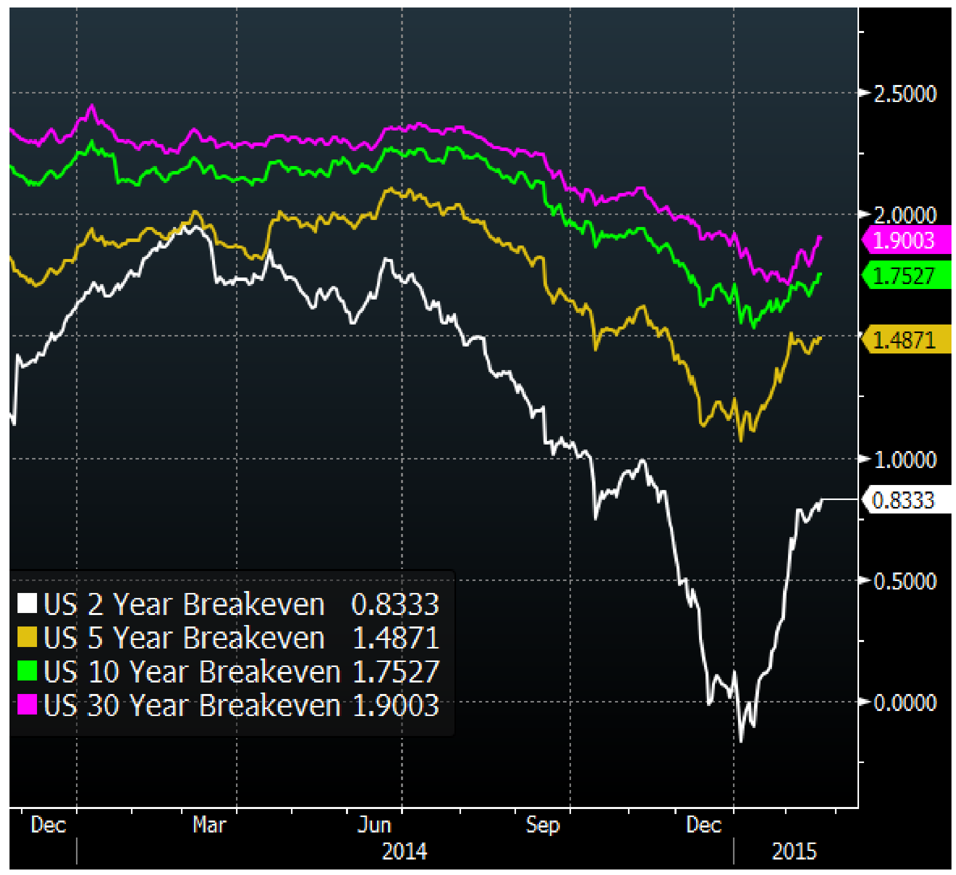


So if the employment situation is becoming increasingly stable, what about the Federal Reserve's other measure of the pace of economic development, inflation? Despite job gains, inflation levels have been frustratingly low, however, February began to show signs of a shift. Average hourly earnings showed a marked increase in February, suggesting more upward pressures to come.

Wage Inflation Making Its Long Awaited Return

This, combined with what appears to be a reprieve from the deflationary pressure of declining oil prices, has finally given the Fed what it wants – higher inflation expectations in the market – as illustrated in the chart below. Anticipated inflation levels have moved higher since the start of the year after falling for much of 2014.

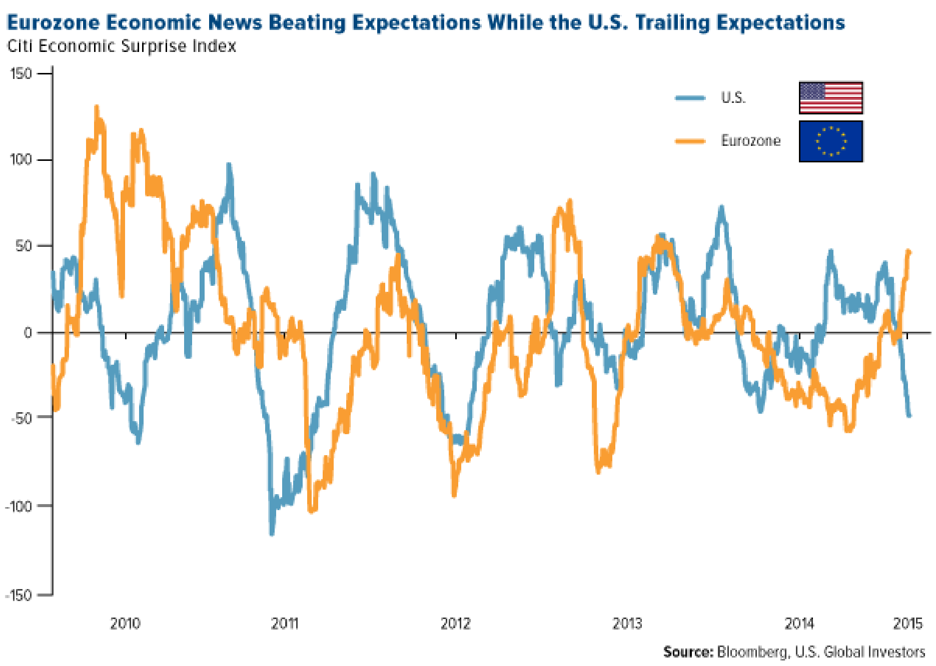
Inflation Expectations Have Moved Higher in 2015



Source: Charlie Bilello, @MktOutperform

So if U.S. earnings are solid, employment gains are continuing and inflation trends look to moving higher, why wouldn't investors just have all of their money in the U.S. and why wouldn't the Fed just raise rates in June? The answer to that question, and to the one posed earlier about global markets outperforming, we believe lies in expectations and opportunities. Within the U.S., most of the positive news has been priced in, and in hindsight, seems to have gotten ahead of itself somewhat. Conversely, Europe is still facing massive challenges, so any improvement is largely unexpected. The chart below reflects this theme well.

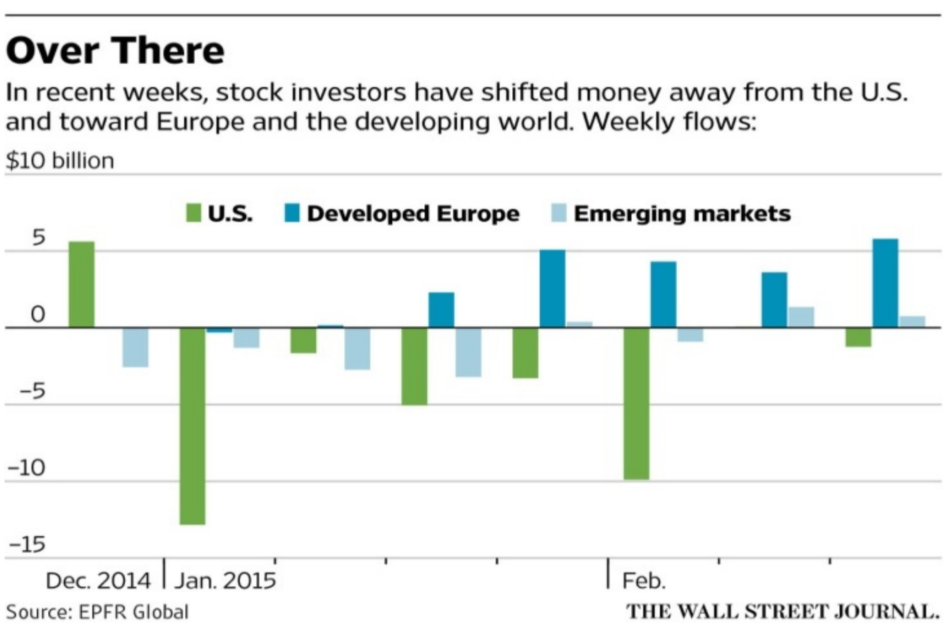
Positive Economic Surprises in the Eurozone Have Been Unexpected



"Risk On" Flow Winds its Way Outside of the U.S.

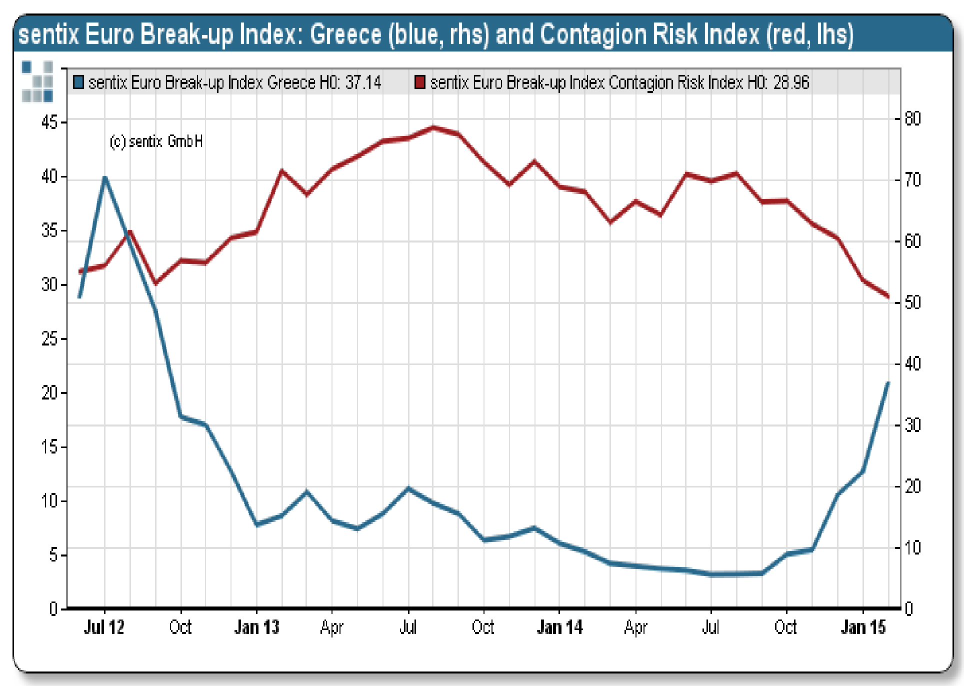
As we mentioned at the outset, the investment world is in "risk on" mode right now, so investors, in a measured degree, are looking to go where "the money" will be going and not where it's been. That translated into dollars, taken from gains in U.S., moving to other markets, most notably Europe, but also Japan and emerging markets. The chart below details this weekly migration so far in 2015.

Money Has Been Shifting from U.S. to Abroad



This was certainly not anticipated in any meaningful way at the start of the year, but several things happened in late January and February that changed the conversation. First, the Greek drama had to be resolved. So far, it has for the most part gone according to script with the Greek leadership largely acquiescing after much grandiose talk. But as the chart below points out, concern over contagion from a Greek exit faded even as the perceived likelihood of an exit increased. This was a significant change from January.

Market Views a Greek Exit as Possible But Contagion Unlikely



Source: www.sentix.de

Beyond a Greek resolution, and a peace accord between Ukraine and Russia, the fundamentals outside the U.S. also showed signs of unexpected improvement as well. Japan and India have improved on pre-2015 forecasts, while Europe in particular has benefitted from a very low bar set by the market combined with surprisingly strong indicators of a healthy recovery such as an increasing activity in the manufacturing sector, much higher retail sales and strengthening consumer confidence. But make no mistake, these recovery levels are not better or higher than those in the U.S. It is simply a case of money being attracted to the greatest rate of change.

Going Forward

The month of February, and the whole of 2015 in fact, has been a wonderful reminder that diversification plays a large role in prudent portfolio management. It is precisely the unexpected moves, like those we have seen outside the U.S. this year, which prove why we advocate a well diversified portfolio for our clients. You simply cannot time the markets and it is very difficult to recover, either on the up or downside, from the impacts of unnecessary portfolio risk.

Within equities, we continue to favor the large cap segment of the U.S. market. We would prefer to gain our exposure through cyclical areas of the market such as the technology, health care and consumer discretionary sectors which stand to benefit the most from a strong U.S. economy and a strong dollar.

Given the movements in markets outside of the U.S., we have gained increased confidence in adding to our exposure in the energy space, emerging markets and Japan and have begun shifting allocations slightly to reflect those opportunities.

We remain underweight traditional fixed income. As the employment and inflation levels move closer to the Fed's target, it appears as though they will raise interest rates in the second half of 2015, so we continue to advocate an emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus.

As we stated previously, traditionally diversifying assets in the commodities area such as gold remain challenged as the combined headwinds of a stronger dollar and rising rates do not look to be abating anytime soon.

Thank you for taking the time to read some of our thoughts from this month. As always, we hope you found our ideas valuable and insightful and we would be happy to discuss any items in greater detail with you in the future.