Insights: January 2015

Market Overview and Performance

The overall investment environment in December was somewhat reflective of what had occurred all year long – global macro concerns flared up, driving volatility higher and stock prices lower. Inevitably however, investors concluded that nothing was fundamentally broken and buyers stepped in to take advantage of the discounted prices. In December's case, that pattern translated into a -4.5% decline in the S&P 500 during the first two weeks of the month, followed by the first back-to-back up 2% days since March of 2009 and an all-time high for the Index on December 29th. For the year, the S&P 500 experienced five notable pullbacks, but the trend higher continued, propelling stocks almost 14% higher over the 12-month span as the conviction in an improving U.S. economy strengthened.

Since it is the end of the calendar year, we will focus this month's *Insight* on a review of some of the key themes that shaped 2014, and then shift our emphasis toward outlining what we believe will be among the main drivers of market dynamics for 2015. Our hope is not to give predictions for what lies ahead, but rather to provide a guideline of what we view as the opportunities and risks on the horizon for 2015.

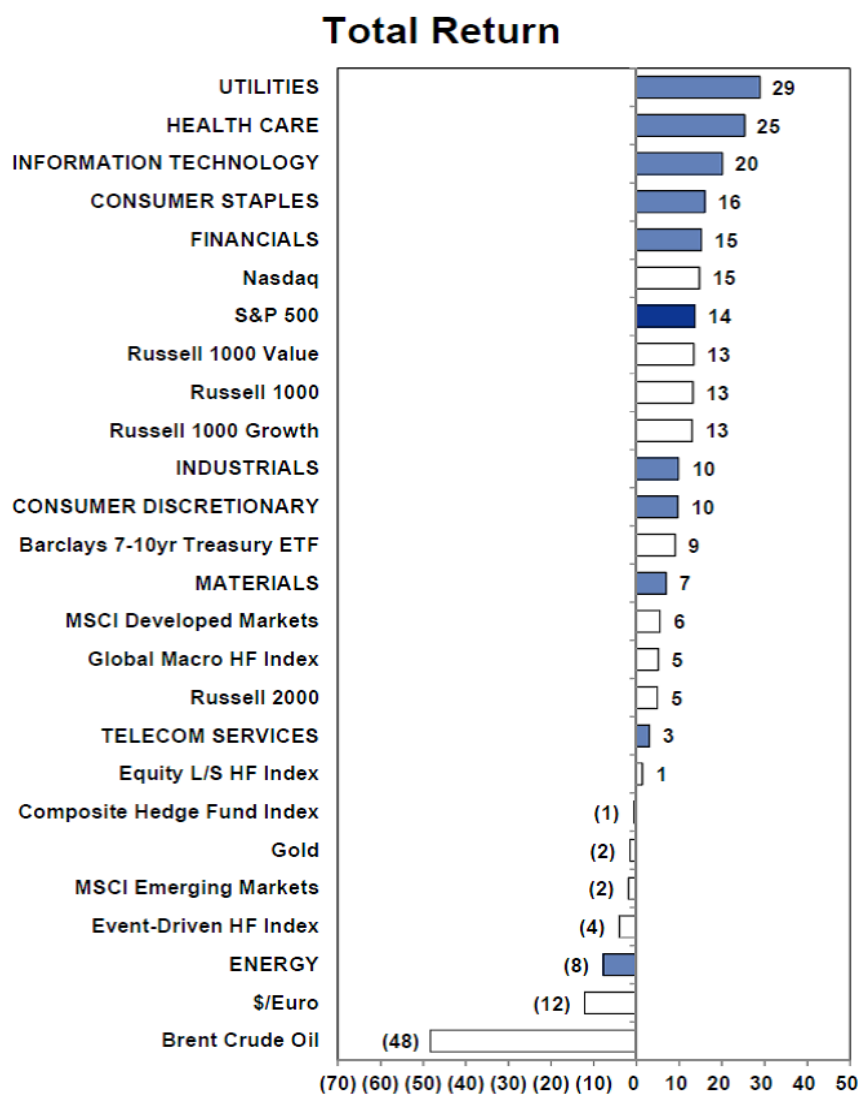
As always, we hope you find our ideas to be thought provoking and insightful and we look forward to hearing from you in the New Year.

	Month to Date	***Year to Date***
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	-0.25	***13.69***
Russell 2000 Index	***2.85***	4.89
MSCI EAFE Index	-3.46	***-4.90***
MSCI Emerging Markets Index	-4.61	***-2.19***
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.09	5.97
Barclay's U.S. Credit Index	0.01	7.53
Barclay's Corporate High Yield Index	-1.45	2.45
Barclay's Municipal Bond Index	0.50	***9.05***
Macro Measures		
Gold	0.07	-1.87
Crude Oil	***-19.69***	***-41.59***
CBOE Volatility Index	***44.04***	39.90
USD Dollar Index	2.34	***12.79***

2014 Themes- US Divergence, Strong Dollar, Crashing Oil, and Falling Interest Rates

To sum up the year in one sentence, investors would have been well served to simply put their money into an equity / fixed income blend of the S&P 500 and government bonds at the beginning of the year and not look at their portfolio again until December 31st.

Asset Class Returns in 2014



Source: Goldman Sachs

The S&P 500 Index rose in fairly orderly fashion during the year resulting in a roughly 14% return and mid-duration government bonds unexpectedly produced gains of 9%, outperforming almost all other asset classes for the year.

In hindsight then, in a period when our first theme, U.S Divergence, was such a dominant presence, investment strategy and capital allocation should have proved fairly straightforward. However, investors as a group rarely have the fortitude to resist questioning their investment thesis, particularly during times of stress. This certainly proved true in 2014. As the year progressed, it became increasing clear that the U.S. economy was undeniably improving, but events occurring outside the U.S., whether in the form of disruptions in Japan, China, Europe or elsewhere, periodically shook market confidence.

As the chart below highlights, spikes in volatility coincided with downdrafts in equities several times throughout the year. In fact, there were three occasions in 2014 when the CBOE Volatility Index known as the VIX, shot 20% higher during one day's trading period. Despite these knee jerk reactions, 2014 overall was a year of historically lower volatility with an average index level of just 14 compared to the longer term average of 20.

S&P 500 Index and Volatility in 2014

Source: S&P Dow Jones; Chicago Board of Options

What's clear from the above chart as well is the manner in which the S&P 500 sharply recovered from any declines. These "V Pattern" recoveries can only occur in an environment where there is evidence that the future will be better than conditions today might suggest, and that is precisely what investors received in droves from U.S. economic data during the year. The foundation of confidence came in the form of a steadily improving U.S. job market, strong manufacturing data and retail sales, a declining trade balance , increased business and consumer confidence measures, and finally, a third quarter GDP reading of 5%.

As a result, buyers were encouraged to take advantage of any weakness, propelling the S&P 500 to 58 new highs over the period and concluding with its six consecutive year of gains.

The strength in the U.S. was even more impressive given the fact that every other region in the world seemed to be heading in the opposite direction. As the chart below illustrates, the global stock market actually declined in 2014 while the U.S. marched upward. It's not hard to understand the divergence given the fact that the U.S. successfully transitioned into an expanding economy with a strong currency while other major regions like Europe and Japan are facing the exact opposite scenario.

U.S. Equities Dominated in 2014

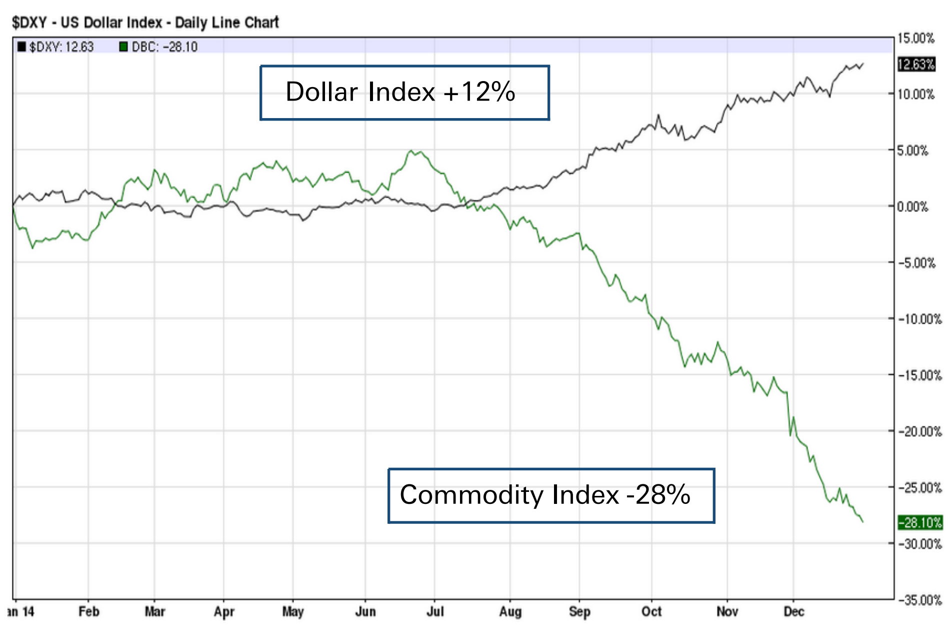
Source: Bloomberg

Europe's challenges can largely be attributed to a lack of action by the European Central Bank who is now seven years behind their U.S. counterpart in enacting quantitative easing, failing not only to spark inflation, but actually pushing the region to the brink of a prolonged Japan-like period of extended deflation. As Europe and Japan entered a regime of monetary easing in 2014, the U.S. has begun to exit theirs. As a result, the Dollar strengthened against all major global currencies for the first time this century, our second major market theme that was not well anticipated at the beginning of the year.

The ramifications of a strong U.S. Dollar are particularly severe for emerging markets countries, where an increase in the currency generally translated into higher borrowing costs for them. However, the one-two punch for emerging markets in 2014 was the combination of their currencies losing value while demand for many of their exports, in the form of commodities fell dramatically throughout the year.

The third major theme for the year, the sharp unexpected drop in the price of oil, is tied up within the commodity complex, however, there was weakness in demand for virtually all commodities in 2014, reflecting the slowdown in growth virtually everywhere outside of the U.S. As the chart below highlights, the Dollar Index and the Commodity Index were trading tightly together until July. As a matter of fact, commodities as a group were actually up roughly 5% for the year in June while the Dollar was flat. However, since that time, the Dollar Index appreciated 12% while commodities fell by over 28%.

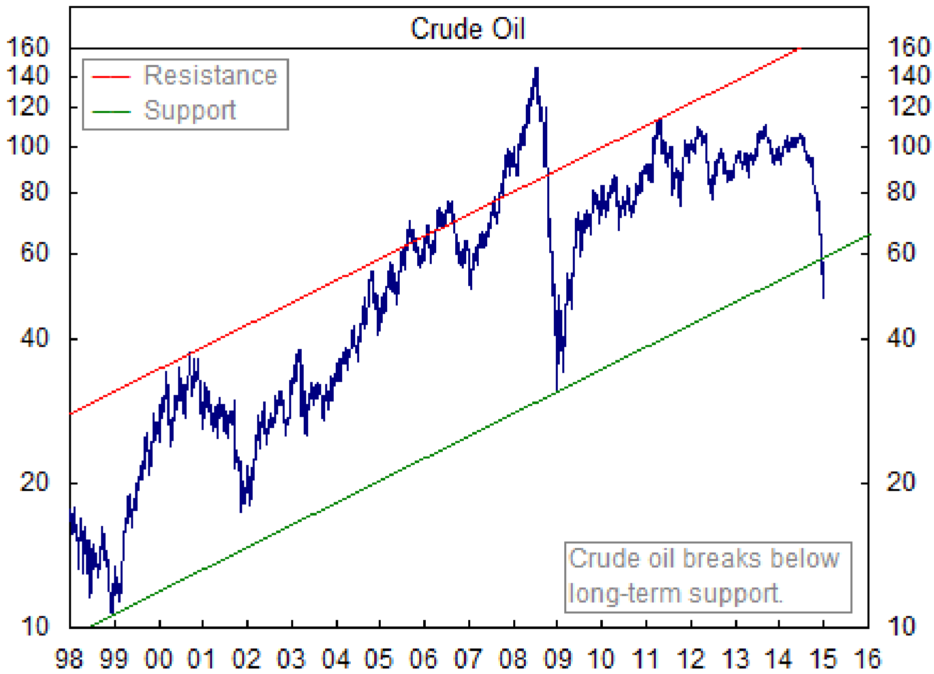
U.S. Dollar Strengthened While Commodities Faltered



Source: Barcharts.com

With regards to the decline in oil in particular, the astounding 50% spiral downward has been well covered in the media. We will not add any more to that conversation, however, what we would like to highlight is the fact that the dynamics of the oil market have shifted dramatically. The following two charts help explain what has occurred. First, the fall in oil, while shocking, is not unprecedented. What is different this time is the disruption of the bull trend in oil prices that has been in place since the late 90's.

Oil Broke a 17 year Trend in 2014

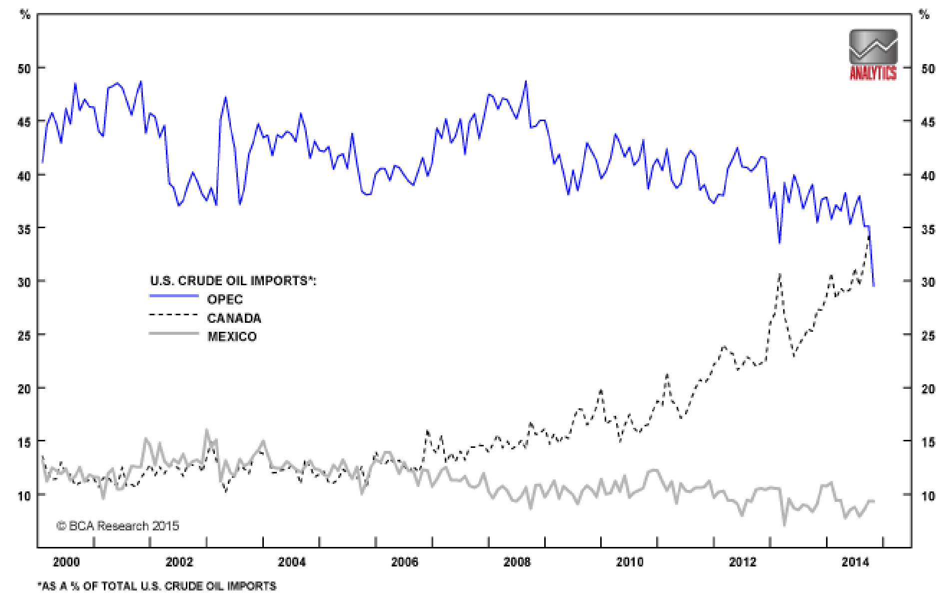


Source: ChartofTheDay.com

A chart in and of itself does not tell you what will happen next, so it helps to understand the fundamentals involved. In this case, we are witnessing another massive shift. While global demand for oil has declined, and at the same time supply has increased, OPEC, the once dominant arbiter of price levels, has lost its grip. The U.S. continues to rapidly increase its oil production and reduce its reliance on foreign sources. Most notably, it no longer relies heavily on the Middle East for much of the oil it does import. As the chart below illustrates, Canada has quietly overtaken OPEC as the largest provider of oil to the U.S. These factors have perhaps permanently altered the way the oil market works, and quite simply, OPEC can no longer act in the manner to which it has become accustomed.

As a recent Bloomberg article stated, $50 oil changes everything, from household budgets to airlines to restaurants. While those effects are beneficial, protracted lower prices could be harmful. However, anecdotal evidence (like China adding to their strategic reserves and traders chartering oil tankers in hopes of selling stored oil at higher levels in the future), suggests we might be closer to the bottom in the cycle.

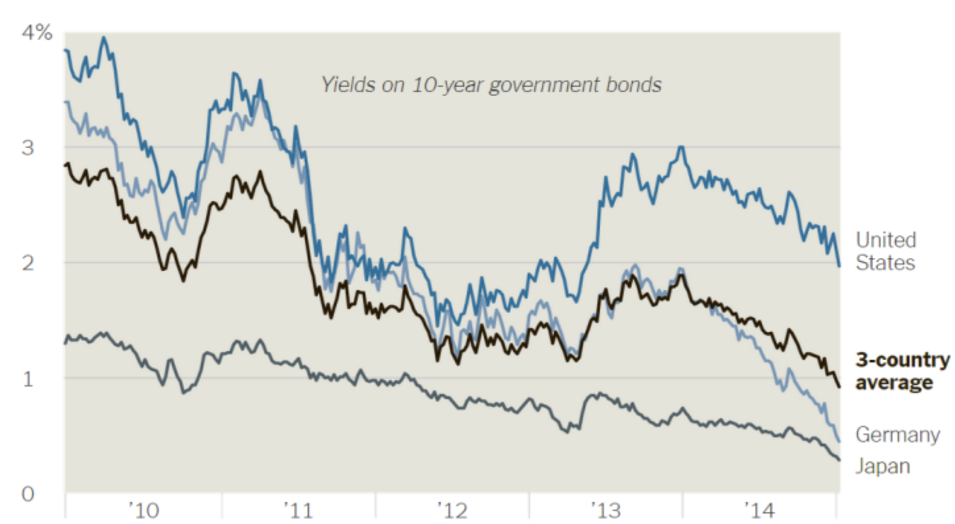
OPEC No Longer the Main Supplier of U.S. Oil



Source: BCA Research

Our fourth theme for 2014 was the falling rate environment. As we noted in our October *Insights*, a Bloomberg survey from the beginning of 2014 showed that 100% of economists polled believed that interest rates would rise in 2014. In fact, they fell across the globe. As the chart below illustrates, the average 10-Year yields of U.S., German and Japanese government bonds fell below 1% for the first time ever.

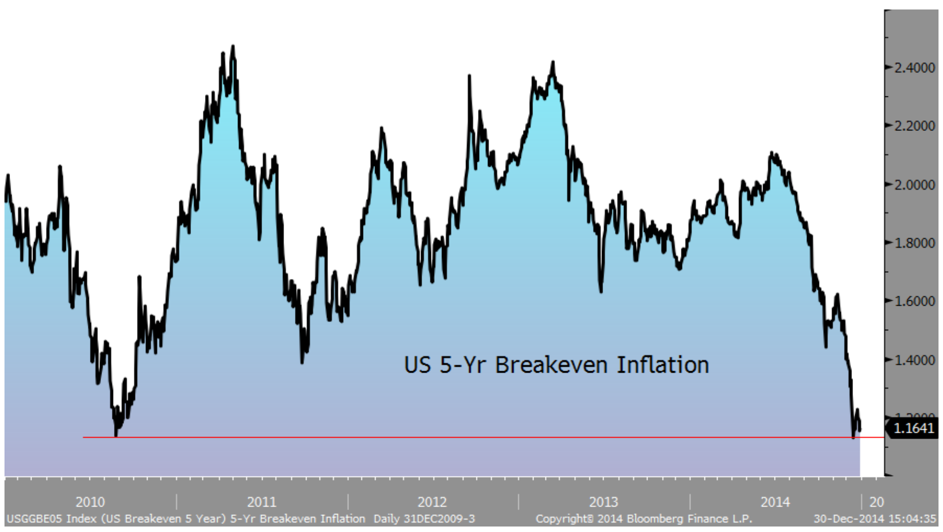
Average Global 10 Year Yields Have Fallen Below 1.00%



Source: Bloomberg; The New York Times

In conjunction with declining interest rates throughout the year, market expectations for inflation also fell sharply which we discussed at length in our October *Insights*. This has a lot to do with the price of oil, but historically, a measure like this might give the Fed pause before they begin what is widely anticipated to be rate increases in 2015.

Inflation Expectations Have Fallen to 2010 Levels

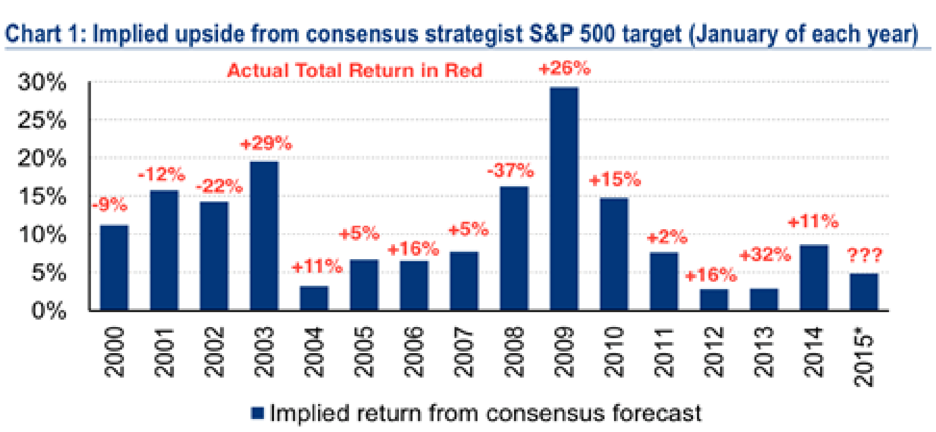


Source: Pension Partners; Bloomberg

Going Forward

Turning our attention to 2015, we believe that many of the forces in place at the end of 2014 will continue into the first half of 2015. U.S. exceptionalism will persist, volatility is likely to increase and the Dollar looks to continue its march higher. With those themes as a backdrop, we will outline our positioning, but as the graph below demonstrates, forecasting markets is folly, and we remain especially vigilant during a period such as this when the consensus view is so widely shared.

12 Month Forecasts Are Rarely On Target



Source: The Reformed Broker; BoA ML US Equity and Quantitative Strategy

As we have stated in previous Insights, we are still very constructive on the U.S. economy and believe it will continue to dominate its peers in 2015. Broadly speaking then, we would favor the U.S. with a preference for equities over bonds.

Within equities, we 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 strong dollar. We do also believe that the energy sector is compelling on a long-term basis. Given our U.S. focus, there is an argument to be made for small-cap stocks which are domestically focused and more levered to the U.S. economy. However, given the likelihood of rising rates in the coming year, we do not believe the risk/reward profile is compelling enough to overweight the sector at this time.

As we have stated in earlier *Insights*, we are assessing the opportunities in Europe, Japan and Emerging Markets. Although challenges exist for each, we like to focus on "where the money will be going" and not on where it's been. To this end, the combination of attractive valuation levels and accommodative fiscal policies could provide attractive entry points in 2015 as the U.S. will likely move from being fairly valued currently to richly valued. We feel that greater surprise opportunities to the upside exist outside the U.S. but we are patient, and would look for further confirmation.

We still remain underweight traditional fixed income. In all likelihood, the Fed will raise rates at some point 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. We would not favor the high yield market at this time given the vulnerabilities related to energy space which we discussed in November. Additionally, we would advise an underweight in emerging markets debt at this point given the increased default risk in areas like Venezuela and Russia.

As we stated last month, traditionally diversifying assets in the commodities area such as oil and gold remain challenged as the combined headwinds of a stronger dollar and rising rates do not look to be abating anytime soon. However, with oil down more than 50% at this point, we are now more inclined to consider adding exposure to the sector in 2015.

That said, we are believers in a long-term investment horizon and the necessity for diversification. So our positioning refers to tilts rather than absolutes. The chart below on the rotation of market leadership argues for both ideas. It is not new, but it highlights the fact that last year's winners are seldom at the front of the pack the following year, and provides particularly good perspective given the strong consensus view in place today.

In parting, we wish you the best in 2015 and welcome the opportunity to work with you more closely in the coming year.

The Power of Diversification

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Annualized
Emerging Mkts 32.6%	REITs 35.1%	Emerging Mkts 33.1%	Aggregate Bonds 7.6%	Emerging Mkts 68.9%	REITs 28.3%	TIPS Bonds 13.3%	Emerging Mkts 19.1%	Small Cap 41.0%	REITs 30.1%	Mid Cap 9.4%
Comdty 21.4%	Emerging Mkts 31.4%	Comdty 14.9%	Cash 2.1%	Small Cap 41.6%	Small Cap 27.2%	REITs 8.5%	Int'l Stocks 18.8%	Mid Cap 33.1%	Large Cap 13.7%	Small Cap 9.4%
Int'l Stocks 13.3%	Int'l Stocks 25.9%	TIPS Bonds 11.9%	TIPS Bonds -0.5%	Mid Cap 37.6%	Mid Cap 26.3%	Aggregate Bonds 7.7%	Mid Cap 17.8%	Large Cap 32.2%	Mid Cap 9.4%	REITs 8.4%
Mid Cap 12.5%	Small Cap 17.0%	Int'l Stocks 9.9%	Mid Cap -36.4%	REITs 29.6%	Emerging Mkts 16.5%	Large Cap 2.1%	REITs 17.5%	Int'l Stocks 21.4%	Aggregate Bonds 6.0%	Emerging Mkts 7.6%
REITs 11.9%	Large Cap 15.6%	Mid Cap 7.1%	Small Cap -37.6%	Int'l Stocks 26.9%	Comdty 16.2%	Cash 0.1%	Large Cap 15.8%	REITs 2.3%	TIPS Bonds 3.6%	Large Cap 7.6%
Small Cap 7.7%	Mid Cap 10.0%	Aggregate Bonds 6.7%	Comdty -37.4%	Large Cap 25.9%	Large Cap 14.8%	Small Cap 1.1%	Small Cap 15.7%	Cash 0.1%	Small Cap 3.0%	Aggregate Bonds 4.5%
Large Cap 4.8%	Cash 4.9%	Large Cap 5.5%	Large Cap -36.6%	Comdty 20.1%	Int'l Stocks 8.2%	Mid Cap -2.1%	TIPS Bonds 6.4%	Aggregate Bonds -2.0%	Cash 0.1%	Int'l Stocks 4.2%
Cash 3.1%	Aggregate Bonds 3.9%	Cash 5.0%	REITs -37.1%	TIPS Bonds 8.9%	Aggregate Bonds 6.4%	Int'l Stocks -12.3%	Aggregate Bonds 3.8%	Emerging Mkts -3.7%	Emerging Mkts -3.9%	TIPS Bonds 4.2%
TIPS Bonds 2.6%	Comdty 2.1%	Small Cap 1.8%	Int'l Stocks -41.0%	Aggregate Bonds 3.3%	TIPS Bonds 6.1%	Comdty -14.0%	Cash 0.1%	TIPS Bonds -8.5%	Int'l Stocks -6.2%	Cash 1.6%
Aggregate Bonds 2.0%	TIPS Bonds 0.2%	REITs -16.5%	Emerging Mkts -48.9%	Cash 0.2%	Cash 0.1%	Emerging Mkts -18.8%	Comdty -2.1%	Comdty -11.1%	Comdty -18.6%	Comdty -2.7%

Funds: EEM, VGSIX, MDY, SLY, SPY, EFA, TIP, AGG, DJP, T-Bills

Source: A Wealth of Common Sense