Insights: February 2015

Market Overview and Performance

During the month of January, a lot of things happened, but not a lot changed. The market witnessed a massive quantitative easing announcement from the European Central Bank, 15 central banks cut interest rates globally, experienced enormous unexpected shifts in currencies, 8% intra-day moves in oil and the highest recorded profit in history on the part of Apple. That is a lot for investors to digest in one 30 day period; however, at the end of the day, the narrative from last year remained in place. The U.S. economic engine continued to gain strength, the U.S. dollar furthered its rise against all other currencies, oil could not halt its downward trend, and volatility remained elevated. It seems that the clearest take away from the month however, is that it is important to distinguish between market noise and real pivot points that can alter investment strategy. Another notable take away from the period was the fact that perceived uncertainty levels in the market generated a decidedly "risk-off" posture. That was the tone reflected in many of the asset class returns in January with a few exceptions, but as we have alluded to, much of what we saw this month was largely just an extension of the themes in place at the end of 2014.

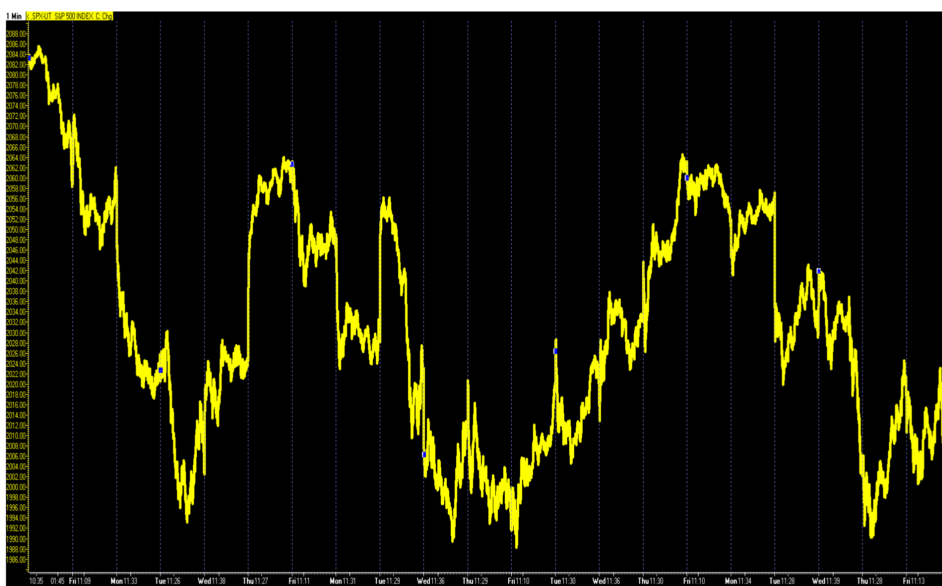
As always, we hope you find our ideas to be thought provoking and insightful and we look forward to speaking with you soon.

	Month to Date	***Year to Date***
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	***-3.00***	-3.00
Russell 2000 Index	-3.22	-3.22
MSCI EAFE Index	***0.49***	0.49
MSCI Emerging Markets Index	***0.60***	0.60
Fixed Income		
Barclay's U.S. Aggregate Bond Index	***2.10***	2.10
Barclay's U.S. Credit Index	2.83	2.83
Barclay's Corporate High Yield Index	0.66	0.66
Barclay's Municipal Bond Index	1.77	1.77
Macro Measures		
Gold	8.03	8.03
Crude Oil	***-9.45***	-9.45
CBOE Volatility Index	9.22	9.22
USD Dollar Index	5.06	5.06

January Themes – We saw this Movie Last Year…Except Oil is a lot Cheaper Now

The uncertainty driven by the swings in varyingly positive and negative macro developments is clearly reflected in the choppy monthly path for the S&P 500 Index illustrated below.

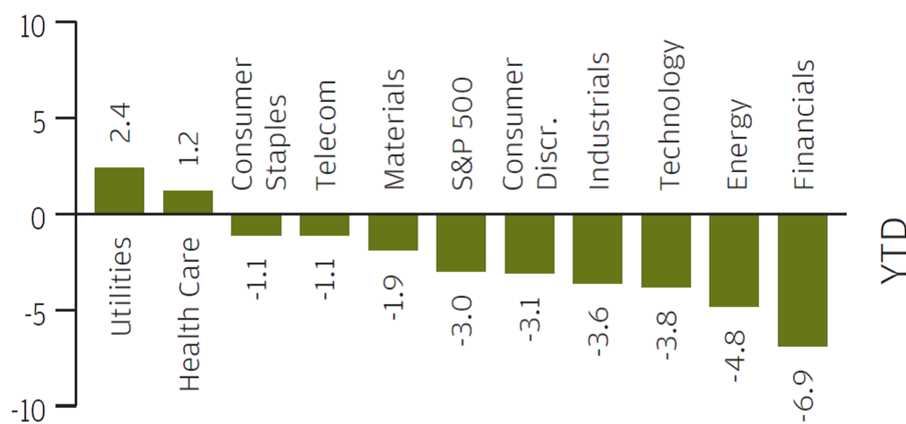
S&P 500 Index 12/31/2014 through 1/30/2015



Source: S&P Dow Jones; JP Morgan Asset Management

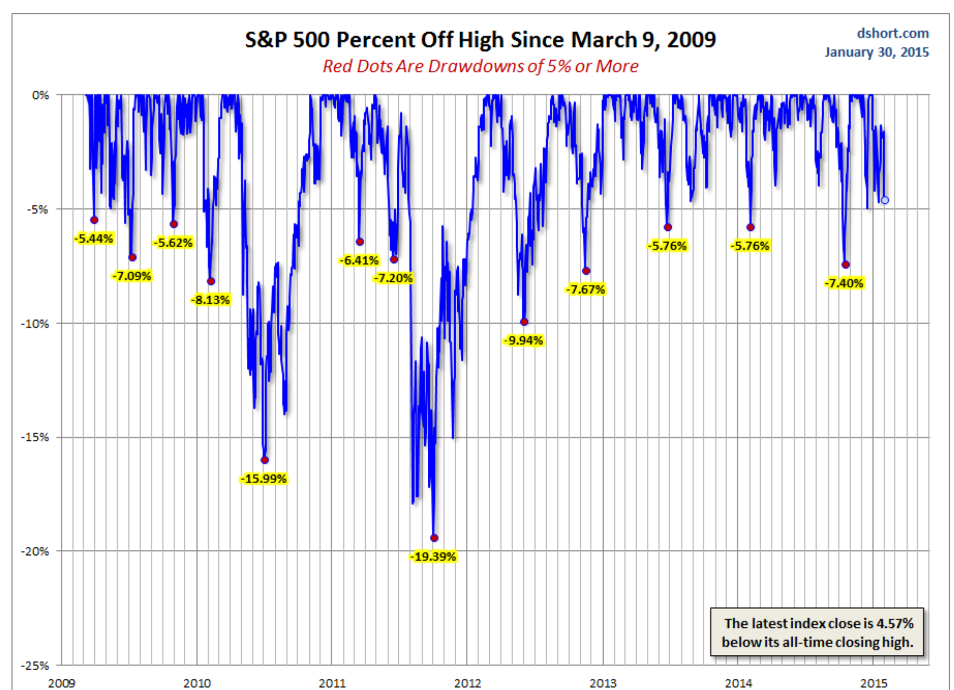
Not surprisingly, investors reacted by fleeing to the perceived safe haven segments of the markets such as utilities despite the lofty valuations present in that sector after an eye-popping return of over 28% in 2014.

S&P 500 Index 12/31/2014 through 1/30/2015



In the end, the Index declined 3%, failing to notch a new all-time high at any point during the period and therefore, snapping a 17 month streak of new all time highs dating back to July of 2013. But as we mentioned in our opening comments, the narrative from last year has not fundamentally changed. In fact, the Index performed in exactly the same manner last January, declining 3.5%, (and a further 3% in the first week of February) before climbing the perpetual "Wall of Worry" to finish up roughly 13% for the year. And as shown in the chart below from Doug Short, the market spends a good deal of time living in the 5-10% "Off High" levels, so modest pullbacks are to be expected.

The Market is Often Just Below All Time Highs



Source: www.dshort.com

U.S. Divergence Intensifies

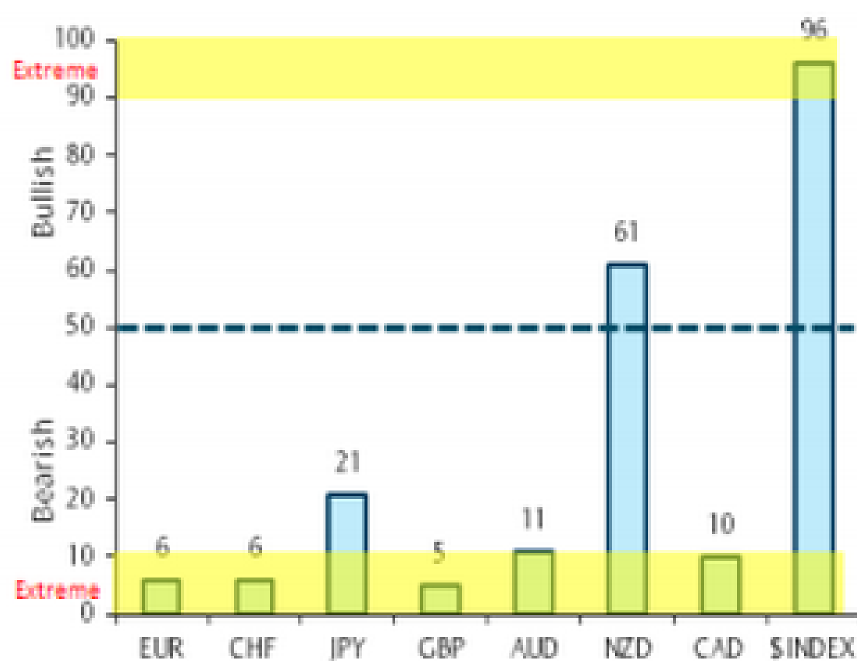
It goes without saying however that there were some truly remarkable global events that occurred during the month. As we mentioned earlier, over 15 central banks cut their interest rates in January, (with Australia and India joining in during the first week of February), in an effort to stimulate growth. This "competitive devaluation" dynamic is shaping up to be a prevalent theme for 2015 . Countries appear to be lowering rates to discourage investors from buying their currency which in turn, lowers the price. A cheaper currency improves the competitiveness of exports which can help keep an

economy afloat, however when 17 or so countries are trying to accomplish this at the same time, finding a buyer for your exports becomes much more difficult. This is all occurring at a time when the U.S. is heading in the opposite direction, likely raising rates sometime in the mid-part of this year. The obvious implication is that what was already a very strong U.S. dollar has become an even more desired currency, and as you can see from the currency futures below, currency expectations both negative and positive, are at extreme levels.

Further Strength Widely Anticipated for the US Dollar

FIGURE 1

Daily Sentiment Index

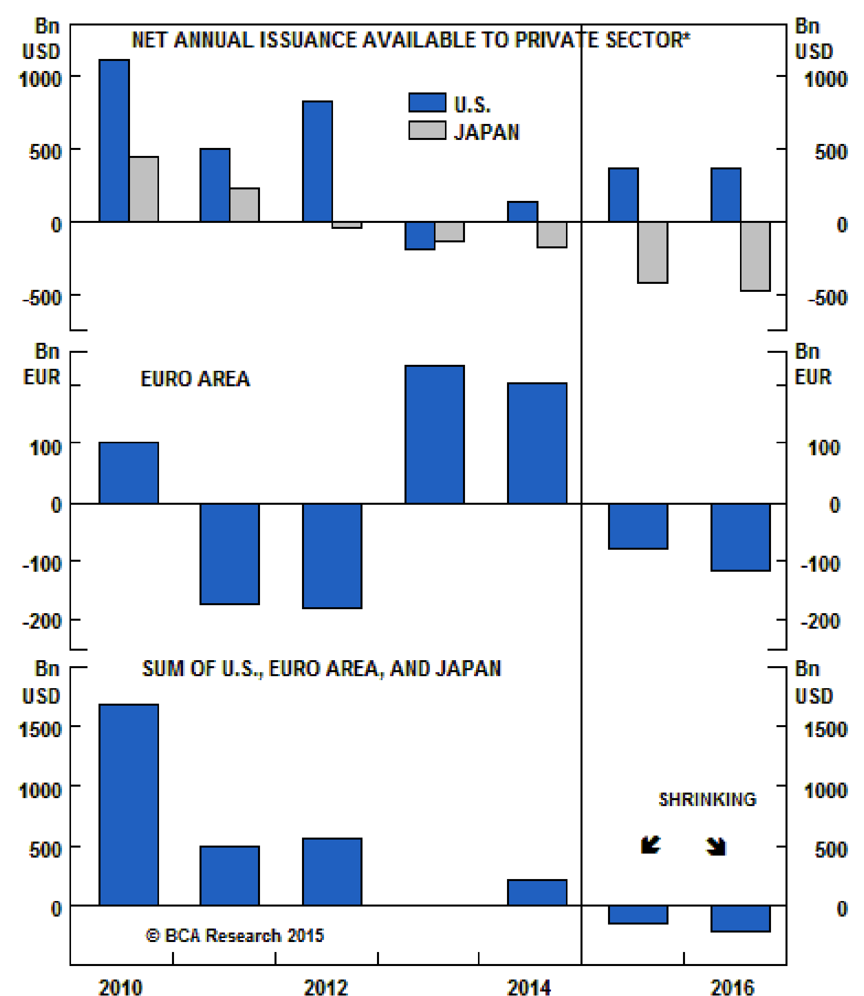


Source: http://trade-futures.com

Even with the remarkably concentrated occurrences of central bank rate cuts, by far the event of the month was the announcement of the European Central Bank's long awaited quantitative easing program totaling roughly $1.2 *trillion* U.S. dollars. The magnitude of the asset purchase program was larger than the market had anticipated, so investor reaction was positive, despite the fact the Swiss National Bank had removed its currency peg, roiling European markets just days before the ECB announcement.

That may seem like a lot of activity going on outside of the U.S., and it is, but what does it all mean for investors? Well, as we said, these trends toward a strong U.S. economy combined with difficulties elsewhere have been in place since last year, but now, there are additional catalysts present which will likely result in the themes becoming even more pronounced. Specifically, with the European Central Bank initiating a fairly massive bond buying program akin to the one already underway in Japan, the amount of global bond supplies will be greatly diminished. Conversely, the U.S. has just begun the process of eliminating its purchase program resulting in increased supply as demonstrated in the chart below from BCA Analytics. With global bond yields already competing in a race toward zero yields (or even negative in some cases), U.S. bonds have become increasingly attractive given their relatively healthy yields.

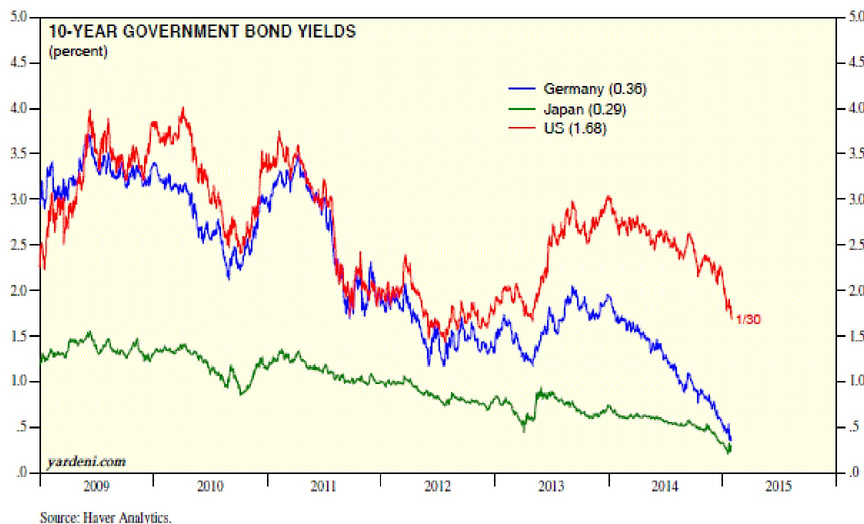
Global Bond Supply Falling While US Increasing



* TOTAL SECURITIES OUTSTANDING LESS CENTRAL BANK PURCHASES AND FOREIGN OFFICIAL HOLDINGS; SOURCE: IMF AND BCA ESTIMATES.
NOTE: VERTICAL LINE DENOTES FORECASTS.

Source: BCA Analytics

Global Bond Yields Approaching Zero – US Higher

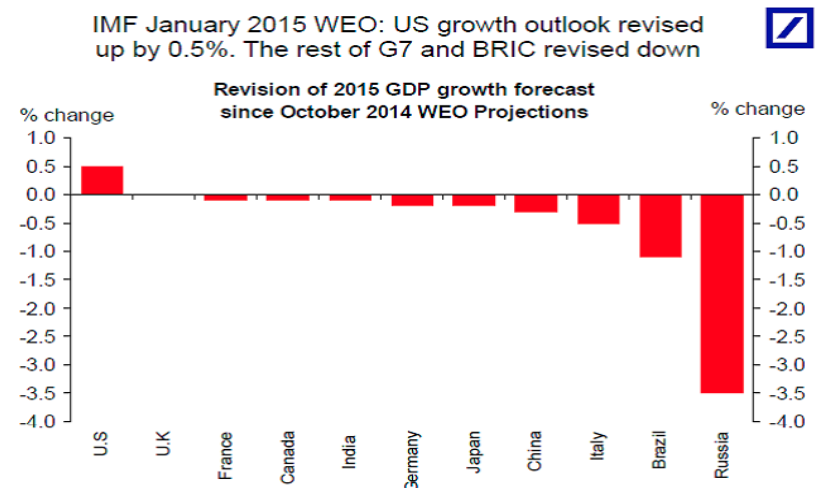


Source: Yardeni.com

But if everyone wants to buy U.S. bonds and the equity market leadership has been defensive as of late, wouldn't that generally imply that the U.S. economy is poised for weakness? Historically, the answer would be yes, but again, as we have pointed out, the U.S. economy was gaining momentum at this point last year, and now, it appears that there is unequivocal evidence that the US economy can in fact thrive in an environment where others languish. This is significant because it has been one of the larger stumbling blocks preventing investors from truly committing to the U.S. recovery in earnest.

This divergence is being confirmed across a number of different areas. For example, in an unprecedented report out this month, the International Monetary Fund issued its revised expectations for global growth in 2015 which listed the United States as the only region to have its outlook projected *higher* for the year while all other major economies were revised lower, meaningfully in some cases.

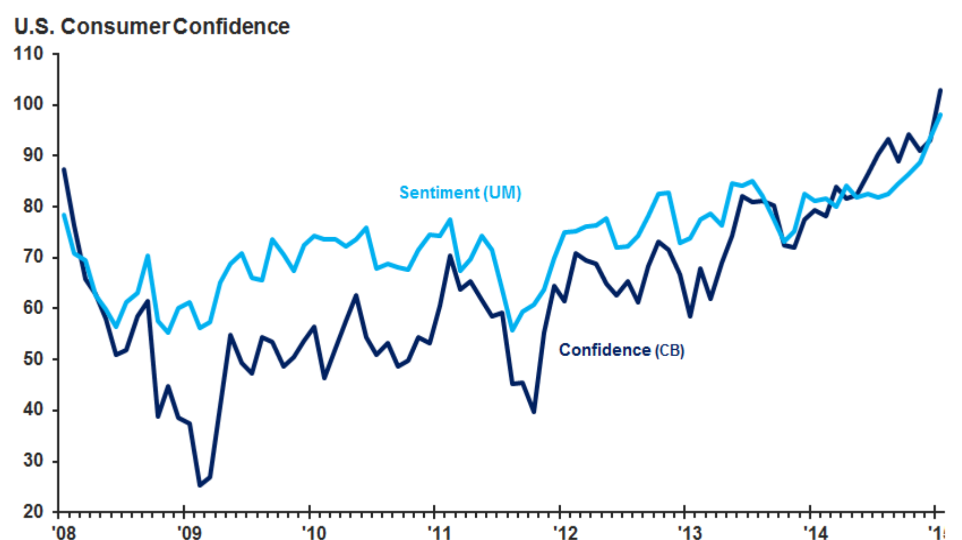
US Growth Only Region Revised Higher by IMF



Source: Deutsche Bank

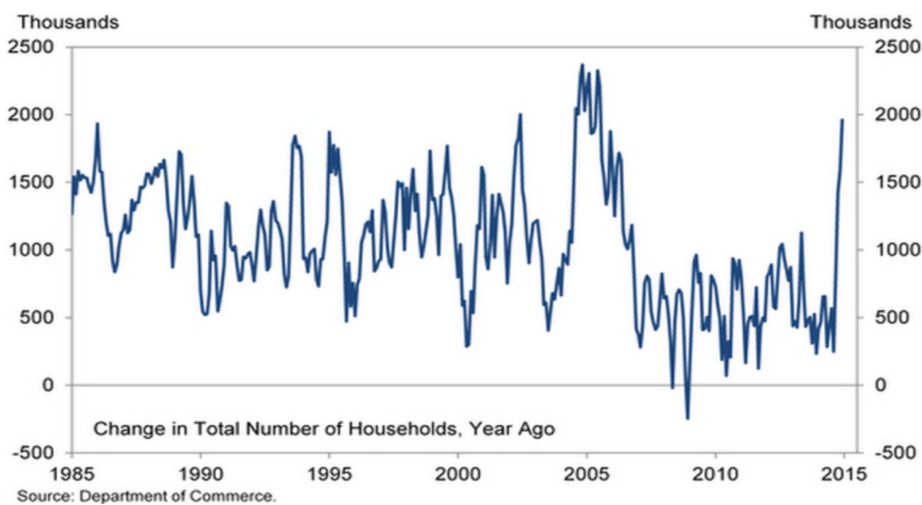
Beyond forecasts, actual economic data continued to exceed expecatations in large part. Taken as a whole, these measures point to a very robust economy. Throughout the month, a patchwork of strong indicators began to unfold, with auto sales, expected small business hiring, wage growth, consumer spending and "quit rates" all showing solid and continued improvement. Two important items, that really provide a view into economic health are consumer sentiment and housing, and both did not fail to deliver in January. Consumer confidence spiked higher, finally returning to 2007 levels, and household formations, essentially a measure of young people moving out on their own, moved wildly higher, back to pre-crisis levels. These measures suggest that people feel the near term future is improving and they will therfore act according. This is preciely how an ecomonic expansion gains traction.

Consumer Confidence Back to Pre-2007 Level



Source:; University of Michigan; Conference Board

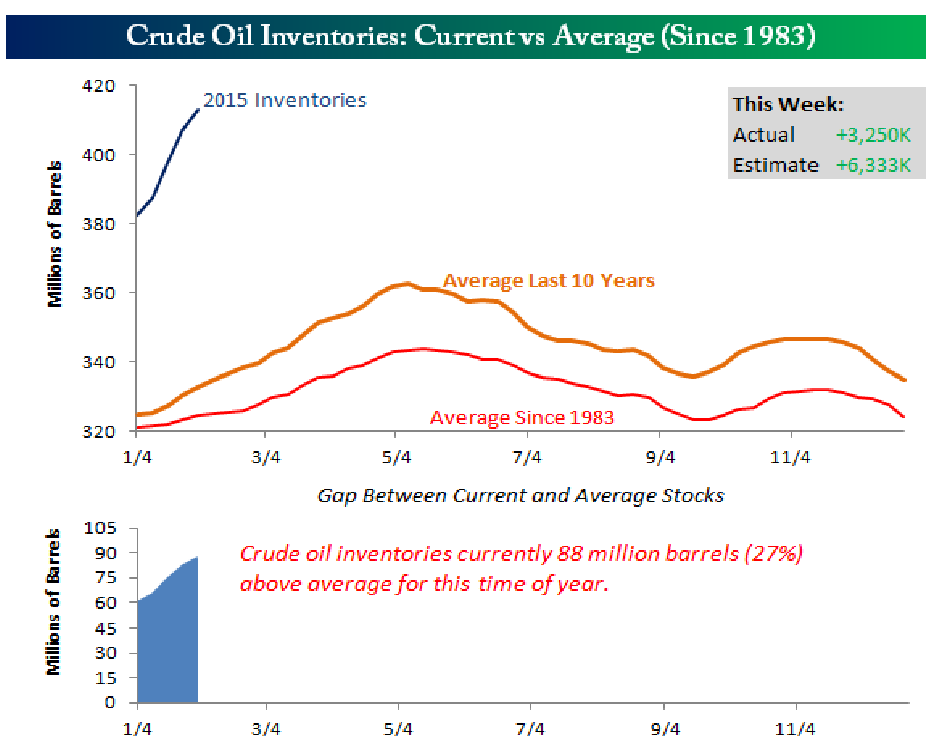
New Housing Formation Rises Dramatically



Oil

Finally, we and others have discussed the enormous stimulative impact that lower oil prices provide to U.S. consumers, boosting real disposable income in an immediate way. However, some question remains as to how long oil prices would stay depressed and the data out in January suggests that the supply side of the equation is in the drivers seat for keeping prices low for the foreseeable future. As you can see from the following chart, crude oil inventory levels are beyond the levels seen historically.

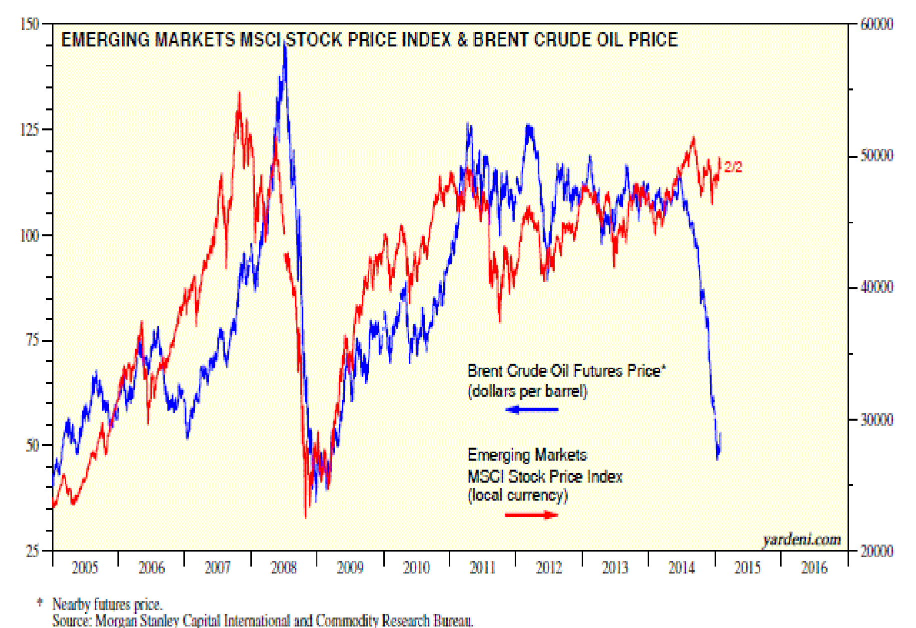
Crude Oil Inventories Sharply Above Historical



Source: BespokeInvestments.com

Interestingly, as Ed Yardeni points out, Emerging markets stocks, which have had a strong correlation to oil prices for quite sometime, have de-coupled, suggesting that demand has not actually fallen. If that is indeed the case, you want to buy the countries that are the commodity consumers in the emerging markets, who are helped by lower costs, not the commodity producers, who will be hurt the most. With valuations the cheapest they have been relative to the developed markets in many years, the potential for extended low energy costs could prove to be the catalyst some of these countries need to start making up the six year long performance gap against the developed markets.

Emerging Markets Stocks No Longer Tied to Oil



Source: www.yardeni.com

And if lower oil is good for consumers and potentially good for selected emerging markets, what about U.S. equities? There are certainly some obvious beneficiaries like airlines, but what about the broader market? Well, interestingly, if history is any guide, the periods following dramatic sell-offs in oil have been very supportive of strong U.S. equity gains in subsequent periods as highlighted in the table below.

Historical Impacts of 50% Declines in Oil

What Happens When Oil Prices Fall?
Four Past Oil Price Declines Greater than 50%

Date	Months	Drop in Oil	Change in S&P 500	Oil: 1 Year After Bottom	S&P 500: 1 Year After Bottom
Nov '85-Mar '86	8	-65%	+17%	+91%	+29%
Sep '90-Dec '93	40	-64%	+52%	+25%	-2%
Dec '96-Nov '98	23	-56%	+57%	+117%	+19%
Jun '08-Jan '09	8	-70%	-35%	+102%	+30%
Average	**20**	**-64%**	**+23%**	**+84%**	**+19%**
Jun '14-?	7+	More than 50%	+5% (end of 2014)	?	?

Source: S&P Dow Jones; Edward Jones Associates

Going Forward

If we believe that the narrative from last year is largely in tact as we have stated, then our positioning preferences necessarily have not changed a great deal. Within equities, we favor the large cap segment of the U.S. market. We would prefer to continue to gain our exposure through cyclical areas of the market such as technology, health care and the consumer discretionary sectors which stand to benefit the most from a strong U.S. economy and a strong dollar.

In terms of areas of focus, as we discussed, we are gaining increased confidence in adding to our exposure in the energy space and emerging markets and have begun shifting allocations mildly to reflect those opportunities.

We still remain underweight traditional fixed income. It appears as though the Fed will be poised to raise rates near the half way point 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. However, in times of uncertainty, they do have a place as a volatility dampener in some of our client's portfolios.

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. We would be happy to discuss any items in greater detail with you in the future.

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