Insights: December 2014

Market Overview and Performance

If October proved to be remarkable for its dramatic and unexpected spike in volatility, November was equally noteworthy for its extreme lack of volatility. This is somewhat hard to believe given the fact that investors woke up on Monday November 3rd to the announcement that the Bank of Japan would be accelerating its bond purchasing program and significantly increasing its allocation to equities. That market friendly news was book-ended on the final trading day by the announcement that the members of OPEC would not be reducing their production levels, which subsequently sent oil prices spiraling downward by over 8 percent.

In between those market moving events however, investors appeared to maintain a business as usual attitude, focused more on the solid U.S. fundamental backdrop than the shifting macro environment. When all was said and done, U.S. large cap equities led the way higher once again, climbing almost 3 percent, while developed international markets were modestly higher and emerging markets stocks declined. Bonds were largely unchanged and volatility remained low, however, as the month progressed, all conversations had turned to the weakness in oil.

As always, we hope you enjoy our thoughts and comments on the current market environment as we begin looking forward to 2015.

	Month to Date	***Year to Date***
Equity	***Percentage Change***	***Percentage Change***
S&P 500 Index	***2.86***	***13.98***
Russell 2000 Index	0.09	1.99
MSCI EAFE Index	1.36	-1.49
MSCI Emerging Markets Index	-1.06	2.54
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.70	5.86
Barclay's U.S. Credit Index	0.64	7.48
Barclay's Corporate High Yield Index	-0.73	3.96
Barclay's Municipal Bond Index	0.17	8.50
Macro Measures		
Gold	-0.54	-2.64
Crude Oil	***-17.87***	***-32.79***
CBOE Volatility Index	-4.99	-2.84
USD Dollar Index	2.57	***10.45***

Equities

The S&P 500 Index marched roughly 3 percent higher for the month in a fairly orderly fashion as illustrated in the chart below. In fact, the S&P 500 marked its 47th record closing high for the year on the day before Thanksgiving. And as we mentioned earlier, in sharp contrast to the previous month, volatility was astoundingly low. So much so, that during the middle of the month, the S&P 500 Index had logged five straight days without a daily price change of more than 0.1%. That tied the record for most consecutive days of without a sizable change which dates back all the way to 1928.

S&P 500 Index 10/31/2014 – 11/28/2014

Source: Thomson Reuters

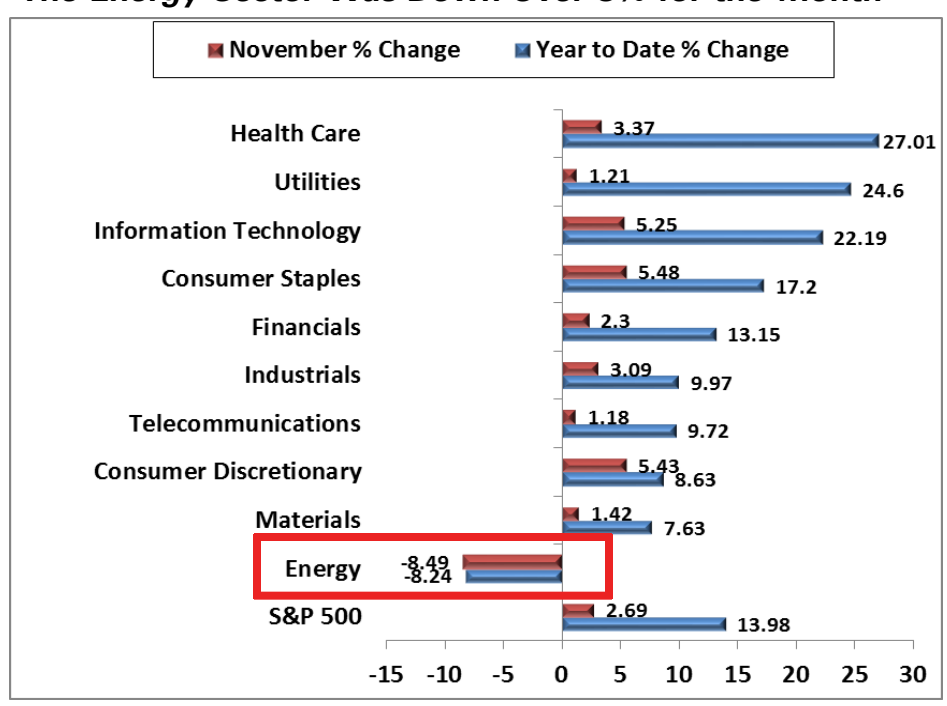
It may sound rather boring to the outside observer, but investors welcome an environment with reduced uncertainty and are even happier when they are presented with a strong trending market. And that's just what they got for the bulk of the trading days in November. As the chart below highlights, another record dating back to the 1920's was also broken during the month according to John Krinsky at MKM (Chart via ZeroHedge). Starting with the rally that began in mid-October, the S&P 500 recorded 27 straight days of trading above its 5 day moving average. That is an investor friendly environment.

S&P 500 Broke a Trading Record Dating to the 1920's

Source: MKM Partners; Zero Hedge

However, despite the combination of low volatility and strong momentum in the market, the real story for the month came from the energy sector. What's clear from the chart below is that the energy sector was completely decoupled from the rest of the broader equity market during the month as the OPEC discussion to refrain from reducing oil production fueled selling in the last week of the month. As we will discuss, the severe decline in the price of oil has implications across much of the economic environment.

The Energy Sector Was Down Over 8% for the Month



Source: S&P Dow Jones

Fixed Income

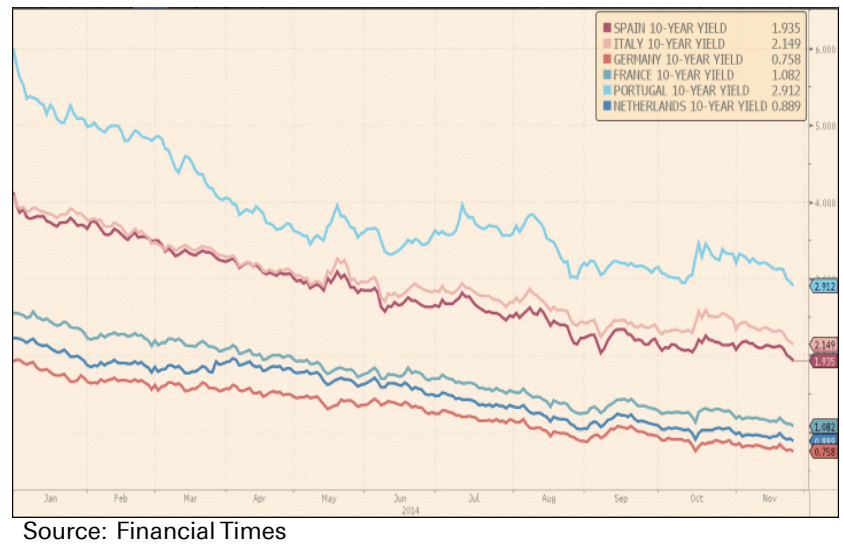
U.S. fixed income markets in November, like their equity counterparts, were distinguished more by a lack of drama than anything else when compared to the wild swings in performance experienced during the October period. In fact, while the yield on the U.S. 10 Year Government Bond floated mildly lower during the month, it was the sovereign debt changes in Europe that garnered most of the attention.

Eurozone bond yields sank to record low levels during the month as investor anticipation that the European Central Bank will expand its asset purchasing program increased. Major economies including Spain, Italy, France and even Germany reached previously unexplored low yield levels for the 10 Year benchmark security ranging from 1.93 percent in Spain to just 0.75 percent in Germany.

To put that in context, the U.S. 10 year government bond, the gold standard for asset safety globally, yields 2.18 percent. In other words, in economic terms, an investor would require a higher return to take the risk of investing in a security backed by the U.S. government than they would for investing in still challenged economies like Spain or Italy. This is clearly not the case in practicality.

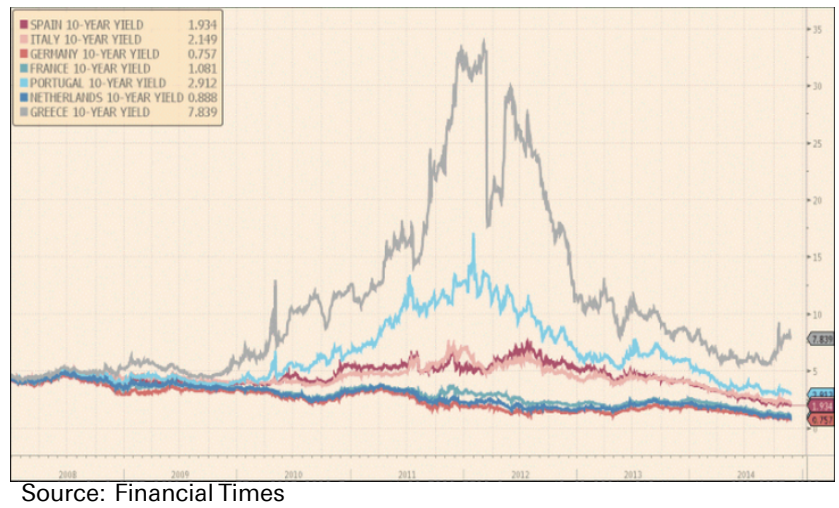
What is really going on is market participants believe that ECB Chairman Mario Draghi will be true to his word, and "do whatever it takes" by launching a buying program of corporate and government bonds early next year. This is creating strong demand for sovereign bonds, which in turn drives yields lower, as investors seek to purchase assets before the ECB begins their quantitative easing program. As the following charts from the Financial Times point out, this trend downward in yields has been in place for much the of the year, punctuating a dramatic push lower from the incredibly high levels experienced during the crisis on 2011.

Eurozone Yields Reached Record Low Levels



Source: Financial Times

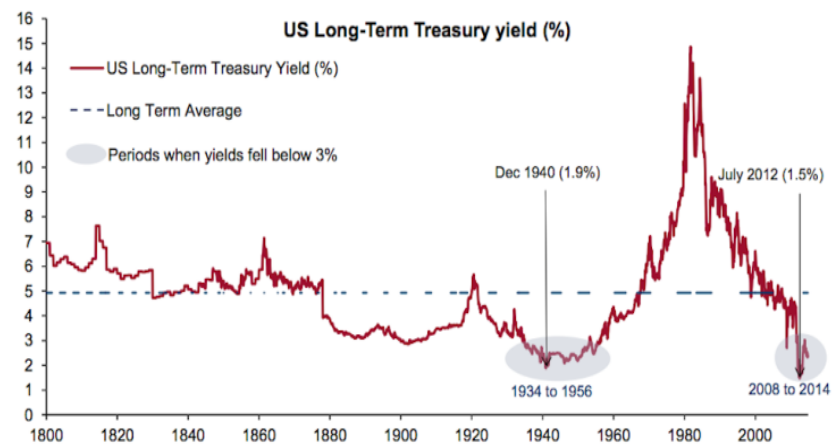
Yields Have Contracted Immensely from Crisis Levels



Source: Financial Times

Low yields also persist because supply is low. In fact, JP Morgan Chase estimates that demand has outstripped supply globally for five of the last seven years. The U.S. is not immune to this dynamic either. As Credit Suisse points out in the chart below, the long-term Treasury composite rate, an aggregate of bonds that aren't due or callable within 10 years, is not just low, but historically low.

U.S. Long Term Yields Historically Low



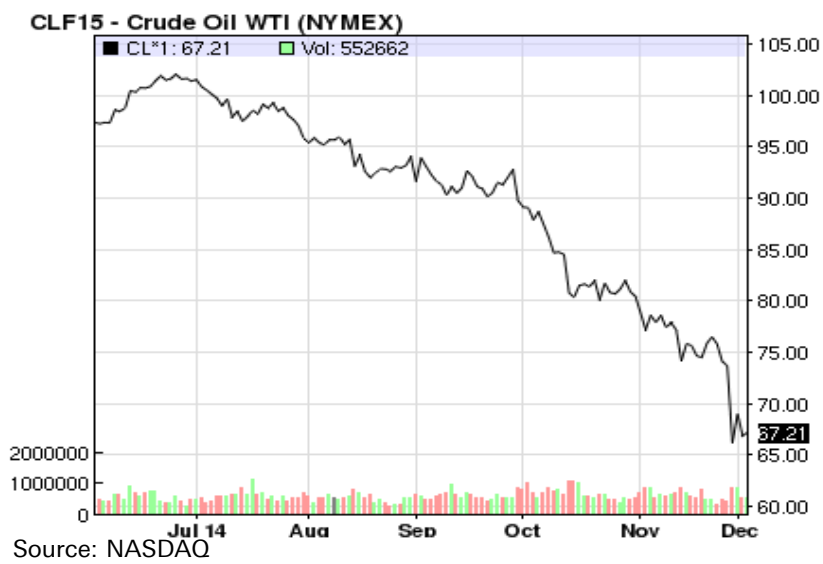
Source: Credit Suisse

What's so bad about low rates you might ask? Inherently, nothing, unless you are a long-term saver, however, there is the uneasy acknowledgement in the market that if long-term rates remain low but short-term rates rise as the Fed begins raising interest rates sometime in 2015, the yield curve could become inverted. This has historically been the precursor of recession within the U.S.

Oil

Without question, oil dominated the global investment landscape in November. The commodity fell roughly 18 percent in November and is now down by over a third since earlier this summer as shown in this chart from Nasdaq.

Crude Oil is down 34% Since its June High

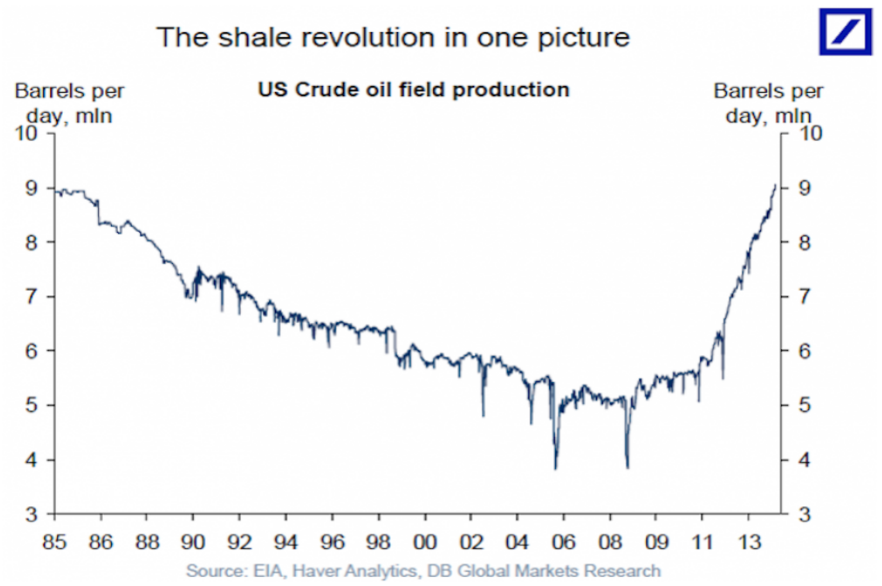


Source: NASDAQ

The impetus behind the November downdraft was the decision by the OPEC to not reduce their production levels. Although this outcome was well anticiapted, the precipitous slide over the past few months provided a glimmer of possibilty that the members of OPEC would have to act to halt the declines.

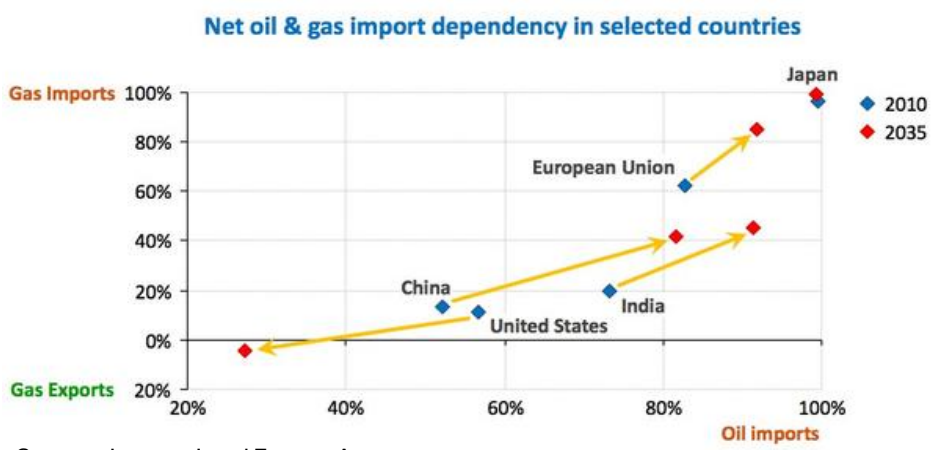
Looking out longer term though, what is driving these dramatic shifts? First, and most widely cited, is the supply side. The oil production renaissance in the U.S. is well documeted, however the scale of the adavance is put into persepctive effectively in this chart from Deutcshe Bank showing that U.S. crude oil production has effectively doubled in the last five years and is on track to hit all time production levels of 10 million barrel per day reached in the 1970's.

U.S. Crude Oil Production has Risen Dramatically



On the demand side, while the U.S. economy continues to improve, other large oil consuming regions such as China, Europe and Japan have slowed consumption as their econonic growth rates have remained low, keeping near term pressures on the price of oil muted. However, looking over a longer time horizon , as the International Energy Agency did this month, you can see that the U.S. is projected to benefit from a severly decreased dependecy on imported oil while other countries are moving in the oppsite direction.

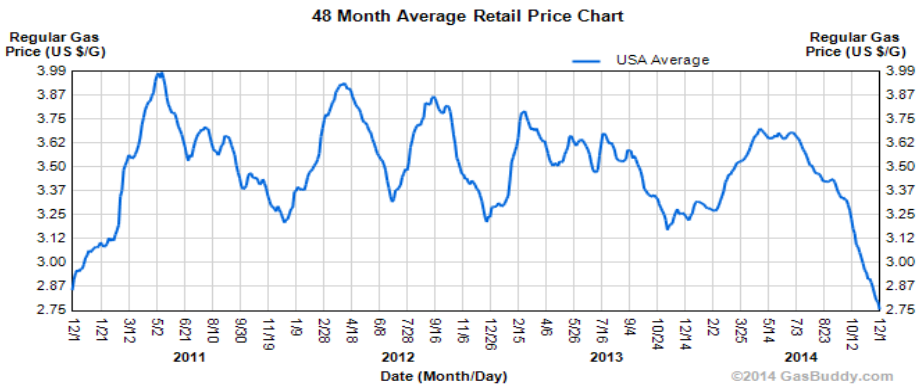
U.S. Oil Imports Projected to Fall to Less Than 30 Percent



Source: International Energy Agency

And make no mistake, low priced oil is a huge boost to the U.S. ecomony. In addition to the cheaper input costs for manufacturing and industries like airlines, the sharp reduction in the price of gasoline is a tremendous boon to U.S. consumers.

Average U.S. Gasoline Price is at a 4 Year Low

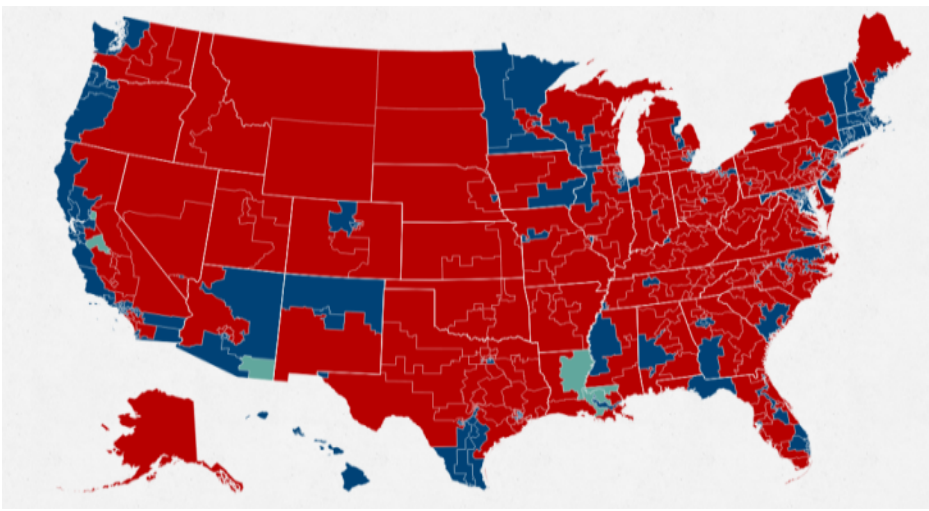


Goldman Sachs estimates that U.S. consumers spent $370 billion on gasiline last year, and now with the price down over 20 percent in November from its summer highs, consumer dsicretionary income has been handed the equivalent of a $75 billion boost. This savings is even more meaningful to households earning under $50,000 who spend roughly 21 percent of their after tax income on enrgy according to Bank of America Merrill Lynch.

Macro Environment

From a macro persepctive, the month of November began with a fairly clear signal that Americans were ready for a change.

Congressional Election Map via Politico
Red=Republican

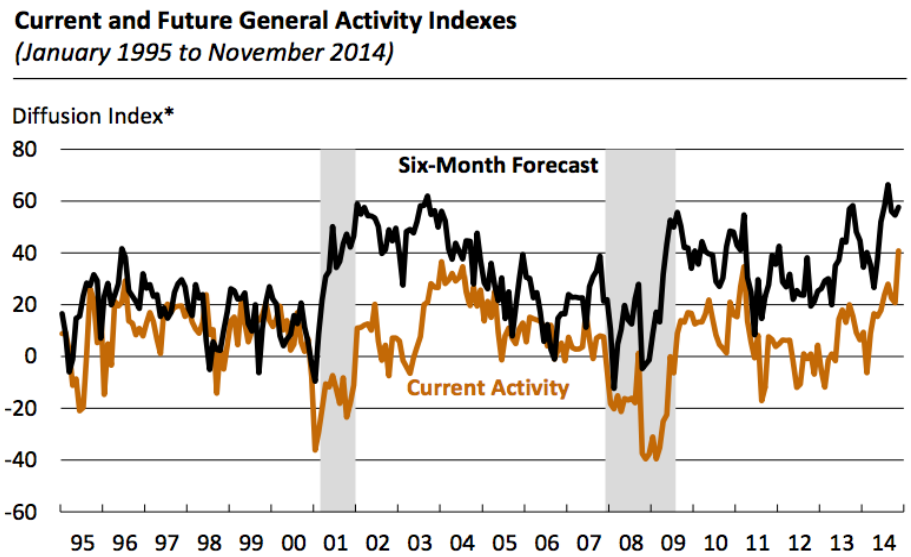


Source: Politico

As we mentioned earlier, investors are happy when uncertainty is reduced, and after the completion of the election early in the month, more question marks surrounding the strength of the U.S. were also removed.

Most notably, the Philadelphia Fed Manufacturing Survey exploded to over 40 when it was anticipated to be only 18. What that means is that 40 percent of the various manufacturers who comprise the survey said that current activity is improving, more than double the expected rate. More importantly, looking out over the next six months, almost 60 percent of respondents said they believed activity would increase, close to an all-time high level reading.

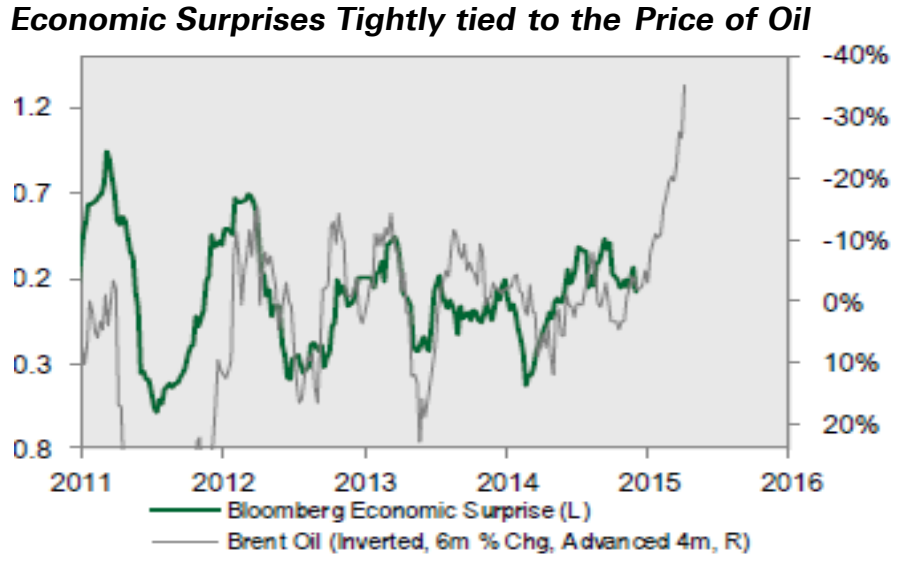
Philly Fed Manufacturing Survey Doubled Expectations



Source: Federal Reserve Bank of Philadelphia

Further, as the team at Cornerstone Macro states, the Philadelphia survey frequently leads other regional reports. As lower oil prices start to trickle through the economy, they would antipicate further positive economic surprises going forward. They highlight the chart below showing that economic surprises are inversely correlated with oil prices, meaning that when oil prices fall, economic surrpises tend to increase.

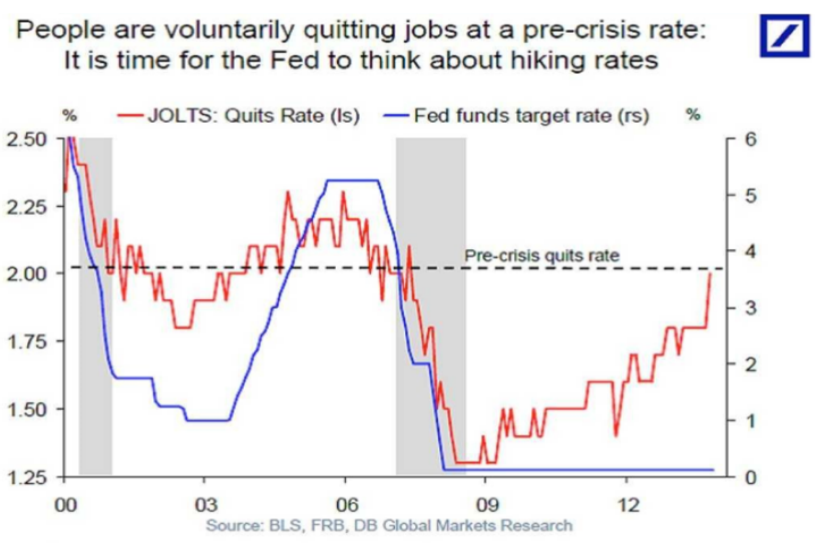
Economic Surprises Tightly tied to the Price of Oil



Source: Cornerstone Macro

Further evidence of the improving economy came in the form of an upward revision in third quarter GDP number to 3.9 percent. Perhaps the most intriguing figure out of the report was the fact that personal consumption accounted for 1.5, or roughly 40 percent, of the 3.9 rate of growth. This suggests that consumers are feeling confident at present, a notion that was reinforced by another unique data point this month, the quit rate. As indicated in the chart below from Deutsche Bank, the rate at which people are willing to leave their jobs is now essentially back to pre-crisis levels. We would expect this confidence to translate into a strong tailwind for the consumer sector broadly.

National "Quit Rate" is Back to Pre-Crisis Levels



Going Forward

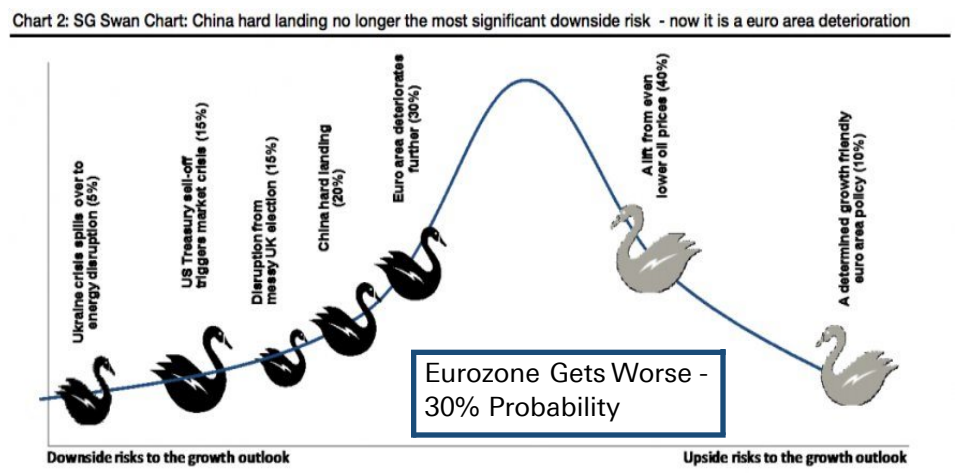
The economic trend within the U.S. is certainly constructive in our estimation. And with equity valuations still fair in our opinion, history would suggest that December could continue to bring cheer to investors. As Jeffrey Saut at Raymond James pointed out, since 1950, the S&P 500 Index in December has delivered positive returns in 49 months and negative returns in only 15 – that's 75 percent of the time with average return coming in at 1.62 percent.
However, as always, there are number of potential risks that we are monitoring. As we mentioned last month, Russia has been backed into a corner economically, and with the further decrease in oil, the foundation of their economy, the situation has only deteriorated.

Russia is now faced with a severely devalued currency, high and rising inflation, lower demand for their main export, and punitive economic sanctions from the rest of the globe. Russia themselves, have already admitted that they are in a recession. When this context is combined with an authoritative head of state of state who is reluctant to compromise, the results historically have not been good.

Russian Ruble Has De-Valued Dramatically

While some dismiss the situation as not being "important enough", others like Societe Generale believe that this confluence of events could be enough to de-ride what is already a very precarious recovery within Europe. In fact, in their widely cited "Black Swan Chart", they moved European Deterioration up to the number ranking risk, above a China hard landing, with a probability of 30 percent.

European Deterioration now the #1 Risk to Some



Source: Societe Generale

And finally, there are downsides to lower oil prices. From a macro economic sense, if the price of oil falls too low, energy companies will stop making investments in new projects which would quickly halt growth. As a refrence, the prouction cost in aggreate for U.S. producers is roughly $60 per barrel. Although, producers will generally run at loss to avoid the expense of a shut down, at the $67 level currently, this warrants montoring.

Another nuance raised by some like Alliance Bernstein, is the fact that a large portion of the high yield bond market is comprised of the energy sector, and of the shale companies in particular. If these companies are forced into a position where they can no longer afford to meet their debt obligations, this could potentially have a mjor impact on the high yield bond market.

Energy Companies Dominate the High Yield Bond Market

As of October 31, 2014
Columns represent the weight of the energy sector in the index. All columns represent year-end values, except 2014.
Source: Barclays

In Closing

At the end of last month, we wrote that the low volatility regime in place for much of the year may have come to an end. Although the markets themselves remained tepid, November came to a close by throwing perhaps the most global of assets, oil, into a tailspin. Against that backdrop however, we continue to believe that the economic environment within the U.S. will continue to strengthen, providing a backdrop for asset prices to move higher over the coming months.

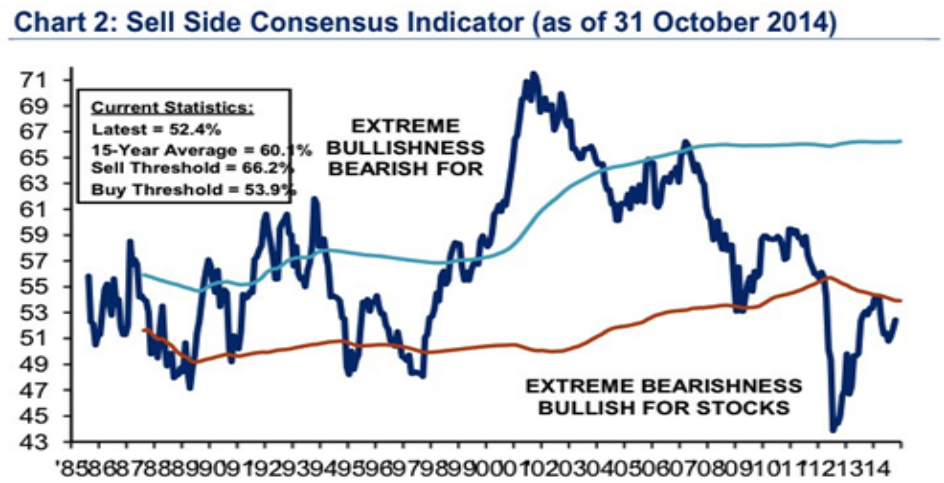
Our preference is to remain overweight equities, favoring large cap U.S. stocks over smaller market cap names or other non-US areas. However, looking ahead, we are assessing the opportunities in Europe and Japan, where the combination of attractive valuation levels and accommodative fiscal policies could provide an attractive risk/reward profile for 2015.

We still remain underweight traditional fixed income. Although an increase in interest rates is perhaps not quite as imminent as it appeared a few months ago, within fixed income allocations, we continue to emphasis the less interest rate sensitive options available, leading us to shorter duration exposures and unconstrained strategies.

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. Given the striking moves in the energy space however, we are now more inclined to consider adding exposure in this area as we head into 2015.

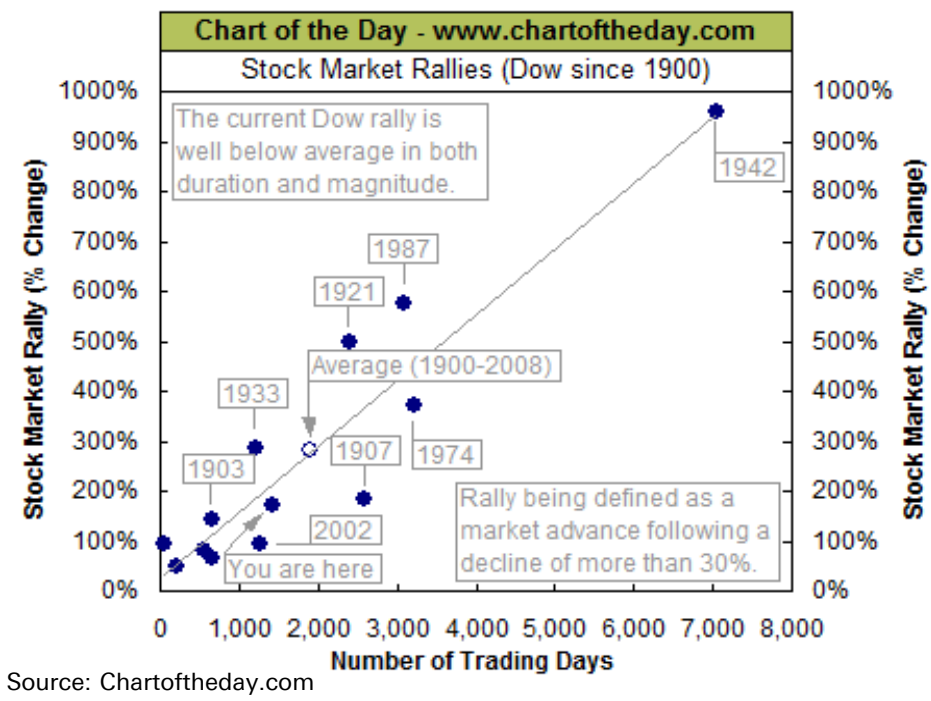
In parting, two great charts if you are bullish. The first from Bank of America Merrill Lynch's quantitative group is the measure of Sell-Side Bullishness which they claim is their most effective contrarian predictor of future returns. The second is a graphic from Chartof the Day.com suggesting that the current rally in equities, as measured by the Dow, is still below average in terms of both duration and percentage change.

Sell Side Continues to Not Believe in Stocks



Source: BofA Merrill Lynch US Equity & Quant Strategy
Note: Buy and Sell signals are based on rolling 15-year +/- 1 standard deviations from the rolling 15-year mean. A reading above the blue line indicates a Sell signal and a reading below the red line indicates a Buy signal.

Equity Rally Perhaps Not So "Long in the Tooth"



Source: Chartoftheday.com

Happy Holidays!

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