Investment Update

Fourth Quarter, 2014

Markets

December capped a sixth positive year in a row for the S&P 500. After a stellar 2013, mid and small-cap stocks lagged their larger peers, though they finished positively and well above their lows for the year. All three of them out-paced foreign stock markets where near-stagnant economies in major developed markets, unsteady growth in emerging markets, and a strong dollar led to negative returns for the year.

Total Returns	Q4	2014
Dow Jones Industrials	5.20%	10.04%
S&P 500	4.93%	13.69%
S&P Mid Cap	6.35%	9.77%
S&P Small Cap	9.85%	5.76%
MSCI All-Country World	0.52%	4.71%
MSCI EAFE Developed Markets	-3.54%	-4.48%
MSCI Emerging Markets	-4.44%	-1.82%

Despite their overall strong performance, US large-cap stocks had several quick selloffs – roughly 6% in January, 10% in September through early October, and 5% in December – with various other market segments also participating to the downside, often to a greater degree. Pundits had differing sets of explanations for each one, but what they had in common was that they were followed by equally sharp rallies right back to previous if not even higher levels, as attention eventually turned back to a reasonably strong US economy with steady corporate earnings and a low inflation environment. As investors in equities, we always have to be prepared for significant drops over a short period of time. Larger drops usually only occur when something truly goes wrong as opposed to market participants simply worrying about the possibility, and as yet little has gone truly wrong enough to effect such an outcome for several years now.

Oil

One cannot look back at 2014, or analyze the markets in 2015, without noting the 50% drop in the price of oil over the last six months. None of the geopolitical events in the Middle East over the last forty years led to a drop of that magnitude in less than a year. Such a move previously only occurred during the 2008 financial crisis when oil demand fell for well over a year in stark contrast to its typical inexorable increase. The recent drop has been blamed somewhat on contracting growth in global demand – it is now close to flat – but mostly on production continuing to grow with no sense that supplies at the margin will change any time soon. A strengthening dollar also drives down the price of dollar-denominated commodities all things being equal.

Energy companies typically react to a drop in prices by curtailing new drilling, rather than taking existing wells out of production, and a good portion of US production – a significant contributor to increased global supplies over recent years – is hedged and thus can still be sold profitably.

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Meanwhile Saudi Arabia, historically the swing producer within OPEC, seems willing to allow both US drillers and the likes of Iran and Russia to suffer while the Saudis continue to pump their cheap-to-produce oil.

Whether this is the end of the slide in oil prices is anyone's guess. So far the damage has mostly been limited to the obvious losers – energy companies and oil producing nations – although there has been some spillover into collateral areas such as high-yield bonds and foreign exchange markets. Robust capital expenditures and hiring over the last several years by the energy industry in the US are sure to slow. However, while energy industry jobs are typically high-paying, capex in aggregate by the industry is only about 1% of GDP. What is certain is that the pain within the energy sector is felt immediately, whereas the benefits will accrue slowly to us as consumers or other oil-consuming industries as we fill our gas tanks week after week. Ultimately, we believe when all is said and done the drop in oil will prove to be a clear positive for GDP.

Interest Rates

The end of each year sees various press outlets and research providers that we follow produce a flood of outlook pieces for the following year. In most years there is one consensus prognostication shared by an unusual number of them, and quite often it ends up being wrong because no one ends up on the other side of the trade and the expected outcome becomes priced in to the asset or metric in question.

A year ago, most anyone would have predicted that the 10-year Treasury yield was going to go up from the 3% level where it traded at the time (which itself was sharply up from the all-time lows earlier in 2013). With increases in short-term rates by the Federal Reserve finally on the horizon, and their bond-buying program expected to taper off throughout 2014, this was the commonsense forecast. Nonetheless, despite continued strength in the US economy, an improved employment picture throughout the year, and the Fed's bond-buying program ending as expected last Fall, the yield in fact fell steadily throughout the year to just over 2%.

Shorter-term rates on the other hand have climbed recently as the prospects for at least one increase in the Fed Funds Rate this year have risen. However, the deflationary effects of the drop in oil and gas prices will likely keep the Fed from increasing rates quickly. While we still expect both short and longer-term interest rates to rise over the next few years, we are mindful of the fact that Japanese and German 10-year bonds can be purchased to yield roughly .25% and .50% respectively, reflecting both the dearth of growth elsewhere in the world and the relative value in US Treasuries to global investors which should put downward pressure on their yields.

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OUTLOOK

After years of holding back, businesses are starting to spend on technology and other productivity-driving initiatives to help profit margins, and they continue to repurchase their shares, both of which help earnings per share growth. Increased consumer confidence due to an improving employment landscape and lower energy costs should drive spending by the source of two-thirds of US GDP. However, the inevitable decrease in energy companies' earnings is probably not yet fully reflected in analysts' earnings estimates for the broad market, and a strengthening US dollar will weigh on the portion of earnings US multi-national companies earn abroad.

We continue to believe that US stocks represent a relative value. The current S&P 500 dividend yield is just under that of the 10-year Treasury. A strengthening dollar makes investing in the US more attractive to foreign investors providing a source of demand for our stocks, bonds and other real assets. With low energy prices keeping inflation in check, there is room for price-to-earnings multiples to continue expanding as they have over last several years, which together with steady corporate earnings growth should make 2015 another positive one for stocks.

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