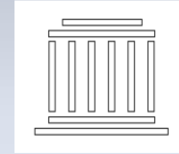
Investment Tally & Perspective

Investment Tally & Perspective – January 14, 2015

Observations, Review, and Outlook

January is named after Janus, the Roman God of beginnings and transitions, whose name comes from the Latin word for door (*ianua*), since January is the door to the year (Wikipedia). In this issue of Tally & Perspective, we look through the back door to review our expectations for 2014, and the front door to peek at what may develop in the months ahead.

- A year ago, we expected global growth to accelerate and be supportive of stock prices (higher revenues and earnings). This proved true for U.S. economic activity, companies and stocks, while much of the world experienced recession, or near-recession (Europe, Japan), or less growth than expected (China and emerging markets).
- A year ago, we noted two interrelated, significant developments spurred by continual technological changes (1) the U.S. moving towards being energy independent which supports (2) a notable increase in domestic manufacturing. Each developed as expected, though we did not envision a 50% decrease in the price of oil, and the large decline in energy/commodity related investments which negatively impacted performance in the second half of 2014.
- As energy prices dramatically declined in the last six months of 2014, the U.S. dollar rose in virtually a mirror image, reaching its highest level since 2005.
- We were correct to note the increasing odds of a significant external geopolitical event or shock (Iran, Syria, Russia, al Qaeda), with cyber-attacks being a major threat. Unfortunately, geopolitical risks are elevated as the sources of threats appear to be expanding.
- We noted that the new Fed chairperson would, most likely, feel increasing pressures to reduce monetary stimulus, with interest rates rising further and faster than generally expected. In fact, interest rates actually declined as foreign capital sought refuge and higher returns in U.S. dollar assets, as well as dollar strength augmented by energy being priced worldwide largely in dollars. *(Continued on Page 3)*



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MAJOR INDUSTRIALIZED COUNTRIES

	2014 Est. GDP	Unemployment	Consumer Prices	Budget Balance (as % of GDP)	Int. Rate 10-Yr Gov't
Britain	2.9%	6.0%	1.4%	-5.1%	1.72%
Canada	2.4%	6.6%	1.9%	-2.0%	1.66%
France	0.4%	10.3%	0.6%	**-4.4%**	**0.74%**
Germany	1.4%	6.5%	0.8%	**0.8%**	**0.47%**
Italy	-0.3%	13.4%	0.2%	**-3.0%**	**1.88%**
Japan	0.3%	3.5%	2.8%	-8.1%	0.29%
Spain	1.3%	23.9%	-0.2%	**-5.7%**	**1.61%**
Switzerland	1.7%	3.1%	0.0%	0.3%	0.20%
United States	2.3%	5.8%	1.6%	-2.8%	1.92%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, January 10, 2015

MARKET INDEX RETURNS

Fixed Income	**4th Qtr. 2014**	**1 Year**	**3 Year**	**5 Year**
Citi Treasury Bill 3 Month	0.00%	0.03%	0.05%	0.07%
Barclays US Aggregate Bond Index	1.79%	5.97%	2.66%	4.45%
Barclays Global Aggregate Bond Ex US	-2.99%	-3.08%	-0.75%	1.38%
Stock Indices				
S&P 500	4.93%	13.69%	20.41%	15.45%
Dow Jones Industrial Average	5.20%	10.04%	16.29%	14.22%
NASDAQ Composite	5.70%	14.75%	23.60%	17.19%
MSCI EAFE Index	-3.57%	-4.90%	11.06%	5.33%
MSCI Emerging Markets	-4.50%	-2.19%	4.04%	1.78%
Russell 2000	9.73%	4.89%	19.21%	15.55%
Other				
Bloomberg Commodity Index	-12.10%	-17.01%	-9.43%	-5.53%
S&P GSCI Precious Metal Index	-3.06%	-4.11%	-10.56%	0.51%

*Data obtained from Morningstar; period ending 12/31/2014

*All figures are stated as trailing total returns, and returns over 1 year are annualized

(Continued from Page 1)

- **Bottom Line** – One year ago we stated "Strategically, from our three main portfolio allocations – aggressive, neutral, and defensive – we remain neutral at the present time and continue to view stocks as the preferred asset class in 2014". At present (January 2015), we are maintaining neutral allocations, though with expectations for increased market volatility, which may result in pullbacks of 5% to 10%, perhaps more, during the course of the year. While we know that market timing is difficult to execute without knowing the future, we will continue to closely monitor portfolio allocations, as well as trim or sell securities that appear overvalued or most vulnerable to a meaningful decline. Similar to last year, the longer term prospects for global growth remain positive, as do the prospects for higher equity valuations in the years ahead. Further, bond portfolios are being managed with expectations that short term interest rates remain relatively low, from a historical perspective, while intermediate and long term interest rates gradually move higher.

January 2015 Tally Research Notes

Greg Valliere, Chief Political Strategist, Potomac Research Group, January 6, 2015

- This drop in interest rates is going to be sustained and quite dramatic for the overall economy. From Washington, there are several factors that would argue for interest rates staying low for quite some time. The Federal Reserve is faced with a dilemma. They would like to raise rates by mid-year but at the same time, if fears of deflation persist, I think the Fed is going to be very reluctant to raise rates.
- I do think the crises in Europe will persist, Greece, or perhaps another one developing with Russia.
- It's worth noting that the U.S. budget deficit will continue to fall. What a wonderful scenario – an economy that continues to grow, with unemployment falling, but with the Fed still a little gun-shy about raising rates. A great combination that should persist for the macro economy.
- The big story in my town is this new Congress and I would say that the mood in Congress definitely will change. It's a new climate, it's a new tone in Washington,
- So what could we get? There could be a modest immigration reform bill; one bill that probably won't get the President's signature would be Keystone. But there's really solid support to killing the Device Tax.
- The most exciting story would be the beginnings of something on tax reform. I think you will see the beginnings of corporate tax reform. Other areas that will get a lot of attention over the next few months, one would be curbing regulations. MdConnell is adamant about the EPA, which he feels hurts coal-producers in his home state. I think other executive orders could face a legislative pushback.

Bob Doll, Nuveen – Weekly Investment Commentary – January 1st and 12th, 2015

- Over the past six months, accelerating U.S. growth and diverging monetary policies have been pushing the value of the U.S. dollar higher while falling oil prices have kept inflation in check. The global economy remains troubled, but we expect it will slowly recover thanks to solid U.S. growth and aggressive policy support. We anticipate that oil prices will eventually experience a moderate rebound from oversold levels, which should provide some support for risk assets. Investment

markets are likely to be more volatile in 2015 than they were last year, but we expect global equity prices and bond yields to rise over the next 12 months as the recovery gains traction.

- In our view, 2015 is likely to be the year that investors transition from disbelief to belief, or from skepticism to optimism. Sir John Templeton coined the phrase, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria," and we believe we are entering the "optimism" phase. This means 2015 should result in another decent year for U.S. equities as we experience (1) solid momentum in U.S. economic growth with low inflation, (2) a pickup in consumer spending, (3) solid earnings growth, (4) a boost from low commodity prices and financing costs and (5) a relatively solid liquidity environment aided by stimulus from non-U.S. central banks.

BCA Research – Outlook 2015 – January 2015 and U.S. Investment Strategy, January 12, 2015

- The window is open for a "scare pocket" in the next few months. U.S. equities and the world economy need strong U.S. growth. Yet the Fed appears intent on hiking rates, despite inflation expectations moving in the opposite direction. However, stay positive on a 6 t 12 month horizon.
- A cautious investment strategy is appropriate, especially given that long-run asset returns will be very modest from current levels. We estimate that a balanced portfolio for a U.S.-based investor will deliver average returns of only 4.4% a year over the next decade, before inflation and taxes.
- Inflation will stay very low throughout the developed world over the coming year and central banks will maintain a highly-accommodative policy stance. The Fed is on track to raise rates in mid-2015, but slowing growth in the second half will limit the pace of subsequent hikes. The ECB will step up its QE, possibly to include purchases of sovereign bonds.

Schwab – Levitate: More Market Mood Swings in 2015? – January 5, 2015

- I believe the secular bull market is intact; but that 2015 could bring more mood swings than investors have come to expect. Primary triggers for some market unrest could be Fed policy and/or geopolitical events. It's also likely that 2015 could be a year when Main Street's optimism catches up to (and possibly exceeds) Wall Street's optimism.
- Unique in this expansion though is the large spread between the average quarterly real growth of overall gross domestic product (GDP), which has been a relatively paltry 2.4%, and that for private sector growth, which has been a healthier 3.2%. Private sector deleveraging has also largely wound down; which is why consumer spending has been recovering. It is not likely to reach prior lofty levels due to the muscle memory of the debt crisis and a general increase in "frugality." In addition, we appear to be in a more capital spending (capex)-driven phase of the economic expansion, which tend to be longer-lasting than those that are consumer spending-led.

Merrill Lynch – RIC Report – December 9, 2014

- The investment climate for 2015 is likely to be dominated by low inflation globally, and diverging paths among central banks: the Federal Reserve is likely to begin raising rates, although gingerly, while the central banks in Europe, Japan and China are likely to ease, some aggressively.
- We expect low-single-digit returns for most sectors of the bond market in 2015, and slightly better returns for stocks. In our view, investors may need to be even more selective than they were in 2014, and employ tactical portfolio rebalancing techniques in order to achieve desired returns.