Economic & Market Commentary

INVESTMENT OUTLOOK – Q4 2014

Investors were presented with two huge surprises during the past year. Interest rates declined rather than rose, with the 10 year Treasury starting the year yielding 3.03% and ending at 2.17%, and the price of oil cratered from a high of $107/barrel (WTI) to below $50/barrel, a decline of 56%. Most investors expected Treasury rates to increase throughout the year, yet they did the reverse. Likewise, with oil close to $100/barrel, turmoil in the Middle East and Russia in geopolitical as well as economic difficulty, most investors thought oil prices would remain flat to move higher during the year. Few got these crucial factors right. The U.S. equity market ignored these potential negatives and produced a surprisingly strong return. All major indices were positive with the S&P 500 and NASDAQ at the top of the list. Even in the final quarter, when these issues were coming to a head, all measures of equity performance were strong.

With interest rates declining, it is not surprising that long-term Treasuries continued to produce superior returns. In fact, they were the best performing asset class, easily topping stocks and all others. Also with much of the rest of the world in difficulty and a strong dollar, it is not surprising that the U.S. significantly outpaced other global markets, with many of them showing negative returns in dollars. As has been the case for most of the year, large cap stocks did better than small, growth did marginally better than value, and high quality outpaced low quality.

As we have written before, there were several factors at play that worked against stock pickers this year. First, the breadth of the market has been narrow. For the year only five of the ten S&P sectors outperformed the index. Utilities were the best performing sector (+24%), followed by healthcare, information technology, financials and consumer staples. The other five sectors lagged, with energy (-10%) being the worst. A small handful of stocks were dominant. The top ten contributors to the S&P gain, representing 14% of the index, produced almost 45% of the return. Nomura Securities points out that dispersion, the difference between the best and worst performing stocks, was the lowest since they started collecting data in 1979. Finally, there has been an unprecedented narrowness of S&P 500 sector P/E spreads to less than half the 20 year average. Although some of these factors mollified in the final quarter, they were enough to make stock picking particularly difficult during the year. Our exposure to Energy and low exposure to Utilities, given their historic and prospective lack of growth, combined to create a drag on relative performance for our equity strategies.

We have just completed the sixth year of recovery after the Great Recession. The global economy continues to suffer from the effects of deleveraging that started in 2009, while the U.S. economy seems to be the sole engine of accelerating growth. Domestically the year turned out about as expected, in spite of the large surprises. Real growth started on a down note, compliments of the Arctic Vortex, but recovered in subsequent quarters, to finish with GDP growth of around 2.5% for the year. Job growth accelerated to average monthly additions of close to 250,000, and we have now about reversed all the job losses of the downturn. This has occurred with little growth in wages, and a participation rate that is the lowest since the 1970's. Consumer balance sheets continue to be repaired, and spending from that source remains decent. Inflation is nonexistent and shows no sign of reappearing soon

The two surprises mentioned earlier have significant implications worth discussing, particularly as we turn the calendar. The decline in interest rates during the year casts a shadow of question about the vibrancy and pace of our domestic recovery. This is underscored by the fact that the trend has continued since the close of the year. The 10 year Treasury, which ended 2014 yielding 2.17%, is now yielding 1.8%, and globally, sovereign debt yields are even lower.

- Europe is in a prolonged deflationary stagnation with pending political events that could unravel the Euro
- China is growing at its slowest pace since 2009
- Japan is struggling with periodic contractions
- Many emerging market countries are dealing with a strengthened dollar and falling commodity prices

As a result, the World Bank has lowered its estimates of global growth for all countries but the U.S.

These circumstances also call into question the timing of the Federal Reserve Board move toward “normalization” of U.S. interest rates. The betting was that initial rate hikes would begin around midyear. If our economy does not pick up stream, and global monetary ease is accentuated, any move by the FED could be pushed off. (A consequence of these rates moves has been a flattening of the yield curve, which is not beneficial for financial companies, especially banks, as it puts pressure on their net interest margin.) These circumstances will provide a difficult set of unknowns for investors in the coming months.

The 50% plus decline in the price of oil presents another set of issues that must be considered. Worldwide demand for oil is about 92 million barrels per day (bpd). OPEC supplies about a third of this (down from 50% in 2000). U.S. production has reached 8.7 million bpd, about 1 million more than a year ago, thanks to fracking. Saudi Arabia has made it known that it will not cut production, and some other OPEC countries are increasing production. Demand growth, on the other hand has decelerated with lackluster global growth. The U.S. Energy Department estimates that U.S. demand is 200,000 bpd lower than last year, for example. So, supply is marginally up and demand disappointing, creating havoc for the global oil market and investors. Is this a long lasting phenomenon, or will it correct quickly? We don’t know, and won’t until it happens. What we can know is the impact on the domestic economy - which on balance is positive. BCA Research estimates that the decline in the price of gasoline adds about $150 billion to household income, with heating oil and air fares adding another $30 billion. This means a windfall (if prices stay flat) of about $1,500 per consumer for 2015, which they estimate would increase consumer spending by +1.5%.

In any transfer of wealth there are winners and losers. In this case, the winners are the consumers of the commodity (see above), while the losers are the producers. While the shale boom has been a positive for the U.S. economy, these producers and others will feel some pain. Employment in the oil and gas industry has increased, but, in relation to the whole of employment, it represents a tiny number. The larger and more important factor is energy capital expenditures, which have grown from 2% of overall non-residential fixed investment to 11% today. For S&P 500 companies, the share has gone from 11% of capex to 24% over the same period. While this is impressive growth, and has incrementally added to overall economic growth, a decrease is not large enough to dent overall GDP growth, nor offset the larger positive impact on the consumer. On the other hand, if you have invested in businesses that are involved in energy capex it definitely captures your attention.

The various economic forecasts for 2015 are fairly uniform. Most expect:

- 2-3% real GDP growth
- Continuing job growth in the 250,000/month area
- Contained inflationary prospects
- Modest corporate profit growth
- The beginning of FED normalization of interest rates leading to higher rates
- Positive returns from stocks

For planning purposes we are in this ballpark, with some subtle differences from the consensus.

From the outset of the recovery, we believed we would be in the shadow of a global balance sheet deleveraging which would suppress growth, and keep domestic progress below historic trend. We are still in that shadow, and will be for some time. Therefore, an expectation of 2-3% real GDP growth seems right for this year. The consumer should lead this growth, given the repair to the balance sheet and the windfall from reduced energy costs. We have made a bet on the return of business spending on capital goods. The logic of that bet has been spelled out in our prior Economic and Market Commentaries and we think it is compelling. While this bet has been rewarding some of the time, on balance it has been slower to gain momentum, and recently disappointing. The fact of the matter is that capital has become more efficient over the last 35 years. BCA Research points out the GDP/Capital stock ratio (how much GDP is produced by a unit of capital stock) has increased almost 40% over that period. This increase in capital efficiency mitigates the need to spend, particularly in a time of uncertainty. So, this bet demands some degree of rethinking. Likewise, the notion that interest rates would rise has been called to question. The issue is not whether rates will increase (normalize), because eventually they will, it is when they will increase. We had thought that movement would start by midyear, but now that is less certain and the start date may be much later. In the meantime, the yield curve has flattened, which makes for a difficult environment for financial companies.

The S&P 500 ended the year at 2059, or about 17x 2014's estimated earnings. Since year end, the market has given up around 3.0% to the 2000 level (close to half a P/E multiple point). We expect earnings to grow +5-6% in 2015, so the market is at about 16x forward earnings. This is what we would consider the upper end of fair value. Last year saw market volatility increase, and it has continued into 2015. Investor expectations remain high, and any sign of not meeting them, results in a decline in price and increasing volatility. However, we believe the general trend will be up. Our best guess is a mid-single digit gain in overall prices, about in line with earnings growth. So we expect the environment to be difficult, but positive for confronting these challenges. We have already dealt with one important portfolio-related question during the final quarter of 2014. The question was what to do about our exposure to energy capital expenditures. We talked about this earlier, and we concluded a significant reduction in that exposure was warranted. We did so, and that has proven to be a correct move. We believe reduced cash flow to the energy producers will have a negative effect on the equipment suppliers.

In the meantime, we continue to search for businesses that we think can grow and are mispriced. Given the level of the general market, the compression of valuations, and the narrowness of breadth, it is not surprising that finding new candidates for purchase has become increasingly difficult.

Fixed Income Review and Outlook Q42014

Much like Mark Twain who is credited with saying, “The rumors of my death have been greatly exaggerated”, the bond market confounded most predictions by not having a near death experience in 2014, but produced strong returns instead. Overall, the Barclays U.S. Aggregate Bond Index generated a 1.79% return for the three months ending in December and returned 5.97% for the year.

Treasuries outdistanced the overall market during the fourth quarter with a 1.93% return, bringing the Year-to-Date (YTD) total to 5.05%. The Treasury yield curve was beset by forces that pushed front end yields; those most affected by Fed action, higher and long end yields, those more affected by inflation concerns, much lower thereby flattening the curve. The two year yield rose from 38 basis points, 0.38%, to 66 basis points, 0.66%, during 2014. This was in response to expectations of the Federal Open Market Committee (FOMC) raising the Fed Funds target late in 2014, with an eye on even higher rates in 2015. The ten and thirty year Treasury yields fell 86 and 122 basis points respectively to finish the year with 2.17% and 2.75% yields. The collapse in long term yields drove strong performance in the 20+ year segment of the market which recorded a 27.5% return in 2014, the best of all asset classes.

The front of the Treasury curve is more subject to Federal Reserve action than is the back end. So a discussion of what the Fed is doing is warranted. Quantitative Easing ended after the October meeting. While the Fed will not be actively buying Treasuries and Mortgages in the open market to provide stimulus, it will continue to reinvest coupon payments and mortgage prepayments in these securities. The market’s attention has turned to when the Fed will start to raise the Fed Funds rate target. Some Fed governors have telegraphed their preference to begin tightening in mid-2015. Per Janet Yellen’s comments at the press conference following the December meeting, April would be the earliest we could expect the move to come. However, investors who express their belief via the futures market think late 2015 is more likely. At September 30, the futures market indicated a 40% probability of the Fed Funds target being 50 basis points or higher by June. On December 31, that figure had fallen to below 30% and, as we write this in mid-January, the figure is down to a 13% probability of a move by June.

Also playing into the calculation for how the Fed will vote is who is voting. The composition of the voting members of the FOMC changes every January. Chair Yellen leads a more dovish Fed than she did last year. Noted inflation hawks Plosser and Fisher don’t vote in 2015, nor does the dovish Kocherlakota or the more centrist Mester. Regional Fed Presidents Evans, Lockhart, Williams and Lacker rotate into a voting seat. Lacker is considered a centrist; the others are dovish. Essentially the Board has no strong hawks voting this year. As noted above, the Board would like to begin raising the Fed Funds target rate this year. However, falling oil prices, which feed directly into inflation calculations, may give the Fed reason to stay their hand until later in the year.

In the middle of last year, we tried to answer the question, “So why have rates rallied in 2014?” We concluded that it was in large part a response to the weakness in Europe and the corresponding fall in European interest rates. That conclusion still has merit. Let’s revisit Europe. In July 2012, ECB President Mario Draghi vowed to do “whatever it took” to preserve the Euro and get the economy going. Since then, year over year CPI in the Eurozone has fallen from over 2% to - 0.2% in December. Eurozone GDP continues to hover below 1% and sovereign rates have continued to fall. We reported that on June 30, the yield on the ten year German Bund was 1.25%, with the corresponding US Treasury note yielding 2.53%. Fast forward to December 31 and the German Bund yielded 0.54% versus the 2.17% offered by the US ten year Treasury. This 1.63% spread represented the sixth highest difference between the two bonds since 2000. The five higher instances came in the five trading days that proceeded December 31. From a relative value standpoint, investors would look to own the US Treasury over Bunds. We would argue that we won’t see a sizable increase in Treasury yields until European rates start to rise. With Europe in a prolonged deflationary stagnation, and expected to begin its own version of Quantitative Easing early this year, downward pressure on the already low European bond yields is likely to persist.

Under normal circumstances we would say that, at current levels, Treasury yields look too low. However these are not normal circumstances. In our clients’ portfolios, we are maintaining a defensive strategy with durations of about 90% of our target, with less exposure to the longer end of the Treasury curve. We choose to take most of our interest rate exposure using the five to ten year part of the curve. We are holding some exposure to Treasury Inflation Protected Securities or TIPS as breakeven yields, the rate at which you are indifferent to holding a nominal Treasury or a TIP, have fallen to levels usually associated with economic crisis. If breakevens move toward the historically higher levels, we would move out of the TIPS and into nominal Treasuries.

With Agencies performing less well than Treasuries, we are looking to add bullet Agencies with less than one year to maturity as a highly liquid cash equivalent in order to generate a small yield advantage over that available in short Treasuries. A bullet is a bond with a pre-determined final maturity date. Further out the curve, we are avoiding bullets at current spreads. We have opportunistically added callable Agencies as volatility increased throughout the latter half of the year. We look for those bonds with short call dates and two to four year maturities to minimize extension risk, the property where bond interest sensitivity gets higher as rates rise.

Investment grade corporate bonds underperformed the market with a 1.77% return in the quarter, yet did better (7.46%) for the year. Longer bonds outperformed shorter bonds, as the Treasury curve bull flattened. Utilities bested industrials and financials. Corporate issuance set another record in 2014. $1.145 trillion new investment grade corporate bonds were sold, according to Barclays Capital (Net issuance, new bonds less maturities and redemptions, totaled $596 billion.). That is only what was issued in US dollars and in size big enough to be included in the Barclays Aggregate Index. We will probably still see $1 trillion in issuance this year, though the net figure may be lower as bonds issued in 2005 and 2010 start to mature.

Our strategy with respect to corporates has not changed. We reduced the allocation to credit during the quarter by selling holdings that didn't offer enough yield to compensate for assuming the credit risk. We selectively added to energy credits with balance sheets strong enough to ride out the volatility of the steep drop in oil prices. We exited some bonds in the shorter end of the curve and found offerings in the same names with longer maturities that took advantage of the steepness of the Treasury curve. We continue to prefer issuers with the ability to raise prices or those engaged in ongoing balance sheet repair. And as always, we tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

Mortgages matched the performance of the Aggregate during the fourth quarter, returning 1.79% and delivered 6.06% in 2014. They benefited from lower issuance in 2014. 2014 fixed rate Mortgage-Backed (MBS) issuance was $819 billion per Barclays. In 2013, issuance stood at $1,361 billion. There has been a lot of competition for a declining supply of securities. With the Fed exiting QE3, we would expect some weakness in MBS prices and look to add on that weakness. We prefer Collateralized Mortgage Obligations (CMOs) that are carved from Fannie Mae and Ginnie Mae mortgages. Lastly, we like structured bonds priced below par ($100) that are designed to be less interest rate sensitive in the face of rising interest rates