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INSIGHTS

A Quarterly Newsletter Bringing you Financial Insights

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2014 Q4 INSIGHTS: *"Mixed"*

RECAP: The last quarter of the year had its share of historic events including a global virus epidemic, a sharp drop in crude oil prices, deflationary fears across both oceans along with the corresponding drop in European/Japanese interest rates, an increase in Quantitative Easing (QE) in Japan, an end to QE in the U.S, the politics of a mid-term election and the politics surrounding the "hack" of a major media conglomerate. Coincidence or not, the mixed bag of news mirrored global capital markets, as many assets did not perform in line with traditions and norms. In short, global assets of all stripes had *mixed results* this quarter with U.S. assets generally outperforming international assets.

The positive performance of U.S. stocks, as opined here last quarter, followed the historical pattern of Q4 being an especially strong quarter for stocks (including years in which the sitting President is a "lame duck"). Large Cap stocks (S&P 500) posted all-time highs in November and again towards the end of the year, reaching a high of 2090 (up 118 points on the quarter) before ultimately giving up some ground on the last trading day of the year (the worst 'last-trading day' since 2001) to finish at 2058—up 4.93% for the quarter and 13.69% for the year. Solely analyzing quarter-end numbers, however, conceals some intra-quarter drama and renewed volatility.

Early in the quarter, U.S. stocks sold off 190 points (nearly 10%) and reached an intraday low of 1820 as Ebola virus fears reached a crescendo. While tragic for the nearly 8,000 souls that lost their lives, the virus was eventually contained and stocks quickly rebounded 260 points in a sharp "V-shaped" recovery. After posting another new high in early December, stocks again sold off, shedding another 100 points. The culprit this time was the rapid drop in the price of Crude Oil and its effects on energy stocks, energy bonds (especially the High Yield sector), and energy currencies (i.e., currencies of oil producing countries around the globe – particularly Russia). But with the holiday shopping season quickly approaching, U.S. equity markets determined that lower gas prices would ultimately benefit an economy that derives 70% of GDP from consumption. Another V-shaped recovery ensued, and the Santa Claus rally pushed stocks to another new high on December 29th.

Overseas, the situation was quite different. Fears of deflation, economic malaise, an increase in Japanese Quantitative Easing and a looming European QE all conspired to push interest rates in most developed markets to historic lows. German Bunds ended the quarter at 0.53% (down 37 basis points), and Japan posted a new low at 0.31%. Understandably, capital fled in search of higher yields elsewhere, with the bulk landing in U.S. capital markets. Contrary to logic, the United States which is traditionally one of the more "safer" bonds is also currently one of the highest yielding. The result? Overseas investors clamored for U.S. bonds which pushed our rates lower (supply vs. demand) and correspondingly drove our currency higher by 5.05% this quarter. The currency "teeter-totter" of a higher U.S. Dollar resulted in lower Yen and Euro values—ultimately hurting assets

	Notable Sectors	Q4	2014
Stocks	**Global Equity**	**0.41**	**4.16**
	U.S. Large Cap (S&P 500)	4.93	13.69
	U.S. Small Cap (Russell 2000)	9.73	4.89
	International Developed Markets	-3.57	-4.90
	International Emerging Markets	-4.50	-2.19
Bonds	**Global Bonds**	**-1.04**	**0.59**
	U.S. Aggregate (High Quality)	1.79	5.97
	U.S. High Yield (Low Quality)	-1.00	2.45
	International Aggregate	-2.99	-3.08
	Emerging Market Debt	-1.72	4.76
Alts	Gold	-2.27	-1.51
	Commodities	-12.10	-17.01
	Master Limited Partnership	-12.29	4.80
	Real Estate	14.34	30.38
Cash	Inflation	0.15	2.29
	Cash (3-month T-bills)	0.01	0.03

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priced in these currencies. Thus for U.S. investors, international stocks and bonds did not fare as well, due to adverse currency movements.

EQUITY: Global stocks were *mixed*. Global Equity was essentially flat for the 4th quarter but saw large divergences within the asset class, with U.S. stocks gaining 5-10% while International stocks lost 3-5%. In the U.S., Small Caps outperformed Large Caps for the first time in six quarters, despite Large Caps gaining ground for the 8th consecutive quarter. Growth and Value performed in line with the overall market, but underneath the hood there were large discrepancies within individual sectors. The *"mixed"* theme continued as the Consumer Discretionary (8.74%) *offensive* sector and the Utilities (13.19%) *defensive* sector both led the market. Meanwhile, Telecom and Materials lost ground in the quarter, and the Energy sector emerged as Q4's big laggard (-10.68%). Currency movements hurt overseas equities. Developed Markets led all groups losing "only" -3.57%. Emerging Markets lost -4.50% (due in part to Russia's near -32% loss), while International Small Caps lagged all major groups losing -4.74%.

FIXED INCOME: Global bonds were *mixed* as well. In the U.S., the benchmark 10-Year Treasury yield started the quarter at 2.51%, but subsequently followed overseas yields lower, losing 34 basis points and finished the year at 2.17%. The drop in yields drove up high-quality bond prices, with Treasuries (1.93%) and Mortgages (1.60%) posting solid results. But lower-quality bonds (High Yield) did not fare as well (-1.00%) as many high yield issuers are in the energy sector. In lockstep with equities, overseas bonds lagged all bond groups, as Emerging Market Debt (-1.72%) and International Aggregate (-2.99%) were both hurt with the rising dollar headwind.

ALTERNATIVE ASSETS: And in keeping with the quarter's theme, Alternative Assets were also *mixed*. Real Estate (14.34%) posted another strong quarter and led most groups with a gain of 30.38% for the year. Master Limited Partnerships (-12.29%) sold off in sympathy with energy stocks, but did manage to post a 4.80% gain for the year. Commodities suffered large losses both for the quarter (-12.10%) and the year (-17.01%) as both Gold (-2.27%) and Crude Oil (-41.56%) lost ground.

OUTLOOK: Once again the calendar and historical precedence look to be an investor's friend, as the third-year of a Presidential cycle is historically kind to U.S. stocks and is, in fact, the best year of the cycle for equities. The fundamentals are lining up here as well. The U.S. economy is seemingly gaining strength as we get further removed from the crisis. So much so that the Federal Reserve decided this quarter to end its QE, as emergency measures are deemed to be no longer necessary. Employment numbers are gradually but steadily increasing (although it remains to be seen how potential layoffs in domestic oil producing regions will hurt the national jobs number). And consumers are in better shape, as major expenses are lower in the forms of energy prices (lower heating bills, lower prices at the pump) as well as borrowing costs (lower mortgage rates are helping new home construction as well as allowing some to refinance). But when good news is everywhere, prudent investors should start to be cautious. While early 2015 may be too soon, at some point over the next 18 months investors may want to ask whether *"the good news is already priced into the stock market."* Unfortunately, the answer may be yes. Unlike the valuation tailwind of yesteryear (2010-2012), U.S. stock valuations (Price/Earnings and other valuation multiples) are now higher than all previous periods over the last 40 years, with the lone exception being the dot-com/tech bubble of 1999-2000—a period which arguably will likely not be repeated in our lifetimes. Valuations can always move higher, but probably should not be relied upon at this moment in time. Rather, in the New Year investors will need other tailwinds such as another year of earnings growth in conjunction with another year of a dovish Fed. Even at elevated P/E ratios, these twin drivers can fuel further stock profits though probably at more modest levels than recent years. For potentially larger returns (albeit with more risk), investors may be wise to set their sights overseas in search of assets that have lower valuations, higher growth rates and larger dividend yields, all with an increasingly accommodative central bank. But it's important to stay ever mindful of any adverse currency movements. And if the Euro and Yen continue to weaken, it may be wise to dust off the passport and travel overseas as well—Felice Anno Nuovo!

Sincerely,
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Chief Investment Officer

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