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INSIGHTS

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2015 Q1 INSIGHTS:

"The U.S. Trifecta: Historic Milestones for Stocks, Bonds, and Cash (Dollars)"

RECAP: Several U.S. asset classes achieved milestones this quarter. With a gain of 0.95%, ***U.S. Large Cap Stocks*** (S&P 500) posted a positive return for the *9th consecutive quarter*. It's a feat seldom achieved, with only one other occurrence since 1970 (a streak of fourteen consecutive profitable quarters from Q1 1995 to Q2 1998). The gains pushed stocks to another all-time high (2117) set in early March nearly six years into this current bull market. If stocks once again push into new highs later in the spring, this bull market will become the 3rd longest since 1928.

Another U.S. index, the NASDAQ Composite, broke the 5000 mark for the first time this century (and millennium!) as it closed at 5026 in late March—just 22 points shy of its all-time closing high of 5048 set *15 years* ago on March 10th, 2000. While newsworthy in and of itself, the march back to 5000 also serves as a reminder that the "buy and hold" ideology doesn't always prove fruitful. Nine of the ten largest NASDAQ's companies ranked by market capitalization (Cisco, Microsoft, Intel, Qualcomm, JDSU, Nextel, Veritas, Dell, and WorldCom) have not returned to their former peak. Rather, a large portion of the retracement has been driven by newer entrants into the top 10 (e.g., Apple, Google, Amazon, Facebook, and Gilead) which reinforces the idea that it's always wise to rebalance and refresh your portfolio with new concepts, new products and new ideas. And there have been many new ideas over the last decade and half. Forget the smart phone, fifteen years ago the subcomponents like the iPod and consumer GPS didn't even exist (Global Positioning System was a military capability). The word "google" was merely a large number rather than an action verb and the human genome project had yet to be completed. Financial markets change as well—stocks traded in fractions, the yield on a 1-year Certificates of Deposit was close to 5.50% and the 30-year Conventional Mortgage was north of 8%. Politics, of course, always change as "hanging chads" had yet to enter the electoral lexicon with Bill Clinton still serving as president—although Vladimir Putin was just getting started. Indeed, the world was quite a bit different 15 years ago, at least in some parts of the world.

Speaking of parts of the world, the real economic news this quarter came from overseas. In January, the European Central Bank (ECB) finally launched their version of Quantitative Easing (QE). Thus far, the monetary policy is not only driving yields down towards zero (similar to our Zero Interest Rate Policy or ZIRP) but in some instances is also driving some yields *below* zero (the Negative Interest Rate Policy or NIRP was first outlined here in 2014 Q2). As a result, the Swiss 10-year bond yield moved into negative territory and the already low benchmark 10-year German Bund, which started the year at 0.54%, fell further to 0.16% by quarter end.

	Notable Sectors	Q1	TTM
Stocks	**Global Equity**	**2.31**	**5.42**
	U.S. Large Cap (S&P 500)	0.95	12.73
	U.S. Small Cap (Russell 2000)	4.32	8.21
	International Developed Markets	4.88	-0.92
	International Emerging Markets	2.24	0.44
Bonds	**Global Bonds**	**-1.92**	**-3.66**
	U.S. Aggregate (High Quality)	1.61	5.72
	U.S. High Yield (Low Quality)	2.52	2.00
	International Aggregate	-4.63	-10.08
	Emerging Market Debt	2.30	4.23
Alts	Gold	-0.08	-7.84
	Commodities	-5.94	-27.04
	Master Limited Partnership	-5.23	-2.50
	Real Estate	4.75	24.17
Cash	Inflation	-0.24	-0.87
	Cash (3-month T-bills)	0.00	0.02

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European QE had a direct effect on U.S. assets as well as record low yields across the pond helped drag U.S. rates lower. The 10-year Treasury yield fell from 2.17% to 1.93% by quarter end, allowing an investment in ***U.S. Bonds*** (Barclays Aggregate Bond Index) to reach another all-time high. Finally, the ***U.S. Dollar*** had its strongest quarter on record against the Euro (reaching a _12-year_ high) as we saw the foreign currency fall from $1.21 to $1.07.

EQUITY: Although new highs were reached, gains were marginal by quarter end. Why? With U.S. stocks trading at elevated valuations, earnings growth needs to be the dominant driver of gains. And headwinds are everywhere: the high dollar may crimp margins for exporters, and low crude oil prices are hurting the energy sector. Other headwinds, although severe, will likely prove to be temporary. The west coast port shutdown earlier in the quarter sent negative reverberations throughout the supply chain, but should return to normal in the quarters to come. Likewise, the central U.S. deep freeze and the east coast snow put a pause on consumer/economic activity, an effect that should prove transitory as temperatures rise—much as the 2014 Polar Vortex experience demonstrated.

In a period of low earnings growth, companies that **do** show solid growth tend to be rewarded, and this quarter was no different. Growth stocks (+4.05%) handily beat Value (-0.51%) as typical growth sectors (Healthcare and Consumer Discretionary) outpaced more value stalwarts (Financials and Utilities). Gains were more pronounced in smaller companies as Small Caps (+4.32%) outpaced their Large Cap (+0.95%) brethren for the second consecutive quarter. The biggest gains, however, were found overseas as Developed Markets (+4.88%) outperformed the S&P 500 for only the second time since 2011 Q3. Easing monetary policies helped stoke gains in both Europe and Japan, although foreign currency weakness hindered US-based investors.

FIXED INCOME: For the time being, a strong dollar coupled with economic weakness is allowing the Fed and Chairperson Yellen to remain dovish. Although short-term interest rates might rise later in the year, for the foreseeable future intermediate-term rates seem range-bound. As a result, longer-term yields fell this quarter allowing high-quality, longer duration assets to do well, with U.S. Treasuries (+1.64%), U.S. TIPS (+1.42%), and Ginnie Mae's (0.75%) all gaining ground. But Credit outpaced Government as both High Yield (+2.52%) and Preferred Stocks (+2.96%) outperformed.

ALTERNATIVE ASSETS: The strong dollar (+8.34%) acted as a headwind to commodities with both Gold (-0.08%) and Oil (-10.64%) posting losses both for the quarter and the trailing twelve months (TTM). The weakness in oil spilled over to Master Limited Partnerships (-5.23%), but Real Estate (+4.75%) offset most of the losses with a decent quarterly gain.

OUTLOOK: The theme from last quarter's 2015 Investment Landscape remains intact. The calendar is an investor's friend, as the third-year of a Presidential cycle is historically kind to U.S. stocks and has on average been the best year of the cycle for equities. If recent weakness does indeed prove temporary, economic fundamentals are friendly. Consumers are in better shape as jobs are becoming more plentiful, while at the same time major expenses (energy prices, borrowing costs) are lower. But when good news is everywhere, prudent investors are well-served to exercise caution. The gains in U.S. equities over the last 6 years have moved valuations 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 not be repeated in our lifetimes. Valuations may ultimately move higher, but history suggests otherwise since any future stock gains must be fueled by earnings growth which faces multiple headwinds in the near term. Thus, for potentially larger returns (albeit with more risk), investors would be wise to reallocate a portion of their portfolio overseas in search of stocks that have higher growth rates, larger dividend yields, lower valuations, an accommodative central bank, and a currency tailwind to boot. And if the Euro and Yen remain weak, it may be wise to reallocate your summer vacation overseas as well. Bon Voyage!

Sincerely,
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Chief Investment Officer

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