Fourth Quarter 2014

Quarterly Letter to Clients

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As the Fourth Quarter of 2014 came to a close, the business media was saturated with headlines on the promising growth prospects of the domestic economy. After almost six years of below average economic growth, the numbers finally are showing an economy that is making a comeback. The labor markets saw consistent improvements during the quarter, with reported payroll growth averaging over 250,000 new jobs per month. In fact, with employers hiring over 2.7 million workers in 2014, and job openings approaching a 13-year high, the components are in place to continue to reduce the unemployment rate below the recently recorded 5.8% level. Personal income and retail sales remained in a slightly upward trend, providing ongoing support to the healthy auto and truck sales during the period. Falling oil prices sent shivers through the financial markets, as pundits and investors grappled with the changing calculus that a period of reduced energy prices might bring. While not anywhere near the vigorous pace seen in the majority of Post WWII recoveries, it appears that the U.S. Economy is once again providing global leadership in a world where real economic growth is becoming increasingly scarce.

Increased geopolitical turmoil has resulted in the spread of the “flight to quality” mentality seen earlier in the year. Not only has this put upward pressure on the foreign exchange trading value of the U.S. Dollar (USD), but many global investors that are seeking the relative safety of U.S. Treasury & Agency bonds, are also shifting their “risk” budget into U.S. Dollar denominated stocks, bonds and alternative investments. The strength in the U.S. currency has also provided a headwind to U.S. multinational company exports, as their goods and services become more expensive to those importing them. Finally, there is a negative impact for those emerging markets that borrow in U.S. Dollars, but use cash from earnings in local currencies to repay their debts. They will experience additional financial pressures due to the increasing cost to their debt payments (paying back appreciated USDs), while simultaneously having to pay higher prices for imported merchandise, resulting in declining margins and cash flow.

In Asia, China’s lofty growth numbers have come down to a more “earthly” level, as the controlled economy begins to face the necessary transition from a manufacturing economy to a more consumer oriented economy. While this transition may take years, in the near-term the central planners have a huge task in dealing with an overleveraged banking system and softening domestic / global demand that may make it increasingly difficult to engineer a soft landing or avoid a recession. The other major Asian economy, Japan, has seen continued soft economic

growth, despite massive doses of stimulus. Prospects remain dim for any sustained improvement, in spite of the efforts of the Japanese Central Bank (JCB). Growth from this area of the globe may remain muted for the foreseeable future.

On the other side of the world, Europe can best be described as a ticking time bomb. The often mentioned structural problems with the Euro have only been complicated by the "kick the can down the road" policies of both sovereign government participants to the European Union (EU) and the monetary actions of the European Central Bank (ECB), which continue only to mask the dysfunctional properties of the currency. Debt levels continue to balloon, with sovereign governments writing IOUs that are too large relative to their economies. Social unrest continues to build, as economic growth has remained stagnant. As Europe becomes economically weaker, it increases its vulnerability to additional geopolitical acts, including further incursions by Russia into Eastern Europe and additional terrorist attacks.

All of this leaves the U.S. Economy, as described by economist Nouriel Roubini, as the single working engine in the global economy. [1] The gist of his well-written article is that many challenges lie ahead for those advanced economies around the world that have relied heavily on fiscal and monetary policies to jump start their economies. The result has been "high and rising" debt levels that are nearing unsustainable levels. In addition, while the coordinated central banking actions and unconventional monetary policies resulted in the reflation of financial assets benefitting the wealthy, these policies did little to benefit those participating in the manufacturing or service sectors of the economy. Rising levels of inequality around the world may lead to additional social strife, diverting political attention towards redistribution and away from implementation of necessary structural reforms to restart the other major economic engines.

Bonds & Stocks

Chalk up another record year in the capital markets! **Outstanding** and **Unbelievable**. Those were the two words that seemed to come out of our mouth repeatedly during 2014. Given the significantly unusual times we are living in, the capital markets provided *outstanding* returns for 2014. It is almost *unbelievable* that interest rates remain so low and equally *unbelievable* that the stock market has continued its upward trajectory for such a long time period. While many strategists expected the Federal Reserve to raise rates sometime in the 2014 – 2015 timeframe, most thought that the general direction of rates in 2014 would be up. Nearly no one saw the decline in the benchmark treasury which ended the quarter at 2.17%, down 35 basis points from the 2.52% level seen at the end of the 3rd quarter, and off 82 basis points from the 2.99% rate recorded at the end of 2013.

[1] "The Single-Engine Global Economy" by Nouriel Roubini, Project Syndicate October 31, 2014.

Likewise, the good times continued for the U.S. stock market with the major indices rising for the 6th year in a row. Without dividends, the Dow Jones Industrial Average rose 7.5% during 2014, while the S&P 500 Index climbed 11.4%, with neither index suffering any price correction (which is defined as a drop of 10% from its most recent high water mark) during the entire year. The average diversified U.S. Stock Mutual Fund increased 7.6% for the year. For the quarter, the popular averages provided respectable returns. As the table below shows, the S&P 500 Index increased 4.4%, while the Dow Jones Industrial Average provided a slightly better price return of 4.6 percent. The average diversified U.S. Stock Mutual Fund increased 4.6% for the quarter.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, JANUARY 5, 2015

	Qtr	1 year	5 year	10 year
S&P 500	4.7	13.1	14.8	7.2
S&P 500 Index P	4.4	11.4	13.1	5.4
Dow Jones Ind. Averag	4.6	7.5	11.3	5.2
Equity Income	3.4	9.8	13.3	7.2
Large-Cap Core	4.3	11.3	13.9	7.1
Large-Cap Growth	4.6	10.5	14.1	7.6
Large-Cap Value	3.8	10.6	13.5	6.4
Mid-Cap Core	5.3	8.3	14.6	8.1
Mid-Cap Growth	5.2	7.0	15.1	8.4
Mid-Cap Value	5.2	9.6	15.3	8.0
General Equity	4.6	7.6	13.3	7.0

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

It seems almost cliché to say that "no one knows when the bull market will end" and yet, as most of our clients know, our focus is not on trying to guess when markets will ebb or flow, but to make sure that your portfolio is constructed to meet your needs, irrespective of what markets do going forward. Our strategy in both bonds and stocks has been to focus on high-quality companies with strong balance sheets and a history of earnings, dividends, and cash flow growth. Risk premiums have narrowed in many areas, causing us to avoid lower-quality investments that do not compensate us for taking additional risks. For short-term investors, holding high-quality fixed income investments is marginally better that earning 0% in a money market. For long-term investors, bonds are increasingly unappealing. We continue to believe that investors, who focus on owning quality companies purchased at attractive valuations, will be rewarded for their patience.