On Our Radar – January 2015

Despite a massive two-day advance in the markets following the December Federal Open Market Committee (FOMC) meeting, the Dow Jones Industrial Average, S&P 500 index, and NASDAQ Composite recorded declines in the month of December, excluding dividends. The Dow fell a slight 0.02 percent in the month, while the S&P 500 and NASDAQ declined 0.41 percent and 1.15 percent, respectively. For calendar year 2014, the Dow gained 7.51 percent, the S&P 500 rallied 11.39 percent, and the NASDAQ increased 13.39 percent, excluding dividends. The small cap Russell 2000 index had a December gain of 2.68 percent, and was up 3.5 percent for the year. Bonds generally fared well in 2014 as the yield on the 10-year U.S. Treasury fell from 3.03 percent at year-end 2013 to 2.17 percent as of December 31, 2014.

Overall, the increase in volatility seen over the past few months and large capitalized stocks outperforming small cap stocks are consistent with a more mature phase of a bull market. Internationally, both emerging markets and developed markets declined 1.8 percent and 4.5 percent, respectively.

Gross Domestic Product (GDP) grew at an annual rate of 5 percent in the third quarter, according to the most recent estimate by the Bureau of Economic Analysis, up from 4.6 percent in the second quarter. Lower imports along with a very strong contribution from consumer and defense spending were responsible for a significant portion of the gain. Industrial Production rose 1.26 percent in November, the strongest individual month since May 2010, and Capacity Utilization registered 80.1 in November, the first time it has moved above the 80 level since March 2008.

On the employment front, November had payroll gains of 321,000, the highest month since January 2012. While the monthly figure is always subject to revisions, the 12-month moving average of gains is now 227,800, the highest 12-month reading since July 2000. On the other hand, the Institute for Supply Management (ISM) Manufacturing

index fell to 55.5 percent in December, down from 58.7 percent in November. Nevertheless, economic activity in the manufacturing sector was above the growth threshold of 50 percent for the 19th consecutive month. New Orders, however, fell 8.7 percentage points month -over - month to 57.3 percent.

The real story continues to be the collapse in oil prices as the near 50 percent decline in a barrel of West Texas Intermediate makes it cheaper to purchase oil on the market than to drill for it in the ground. While lower oil prices act like a tax cut for a majority of consumers, the second-order effects such as the decline in revenues for energy dependent countries like Russia or Venezuela, or the potentially destabilizing effects on the Middle East remain to be seen. When asked a question regarding oversupply, Saudi Arabia's oil minister Ali Al-Naimi responded "Why should we cut production?" The longer oil prices remain under pressure, the more long-lasting the ramifications will be for a number of companies and countries alike.

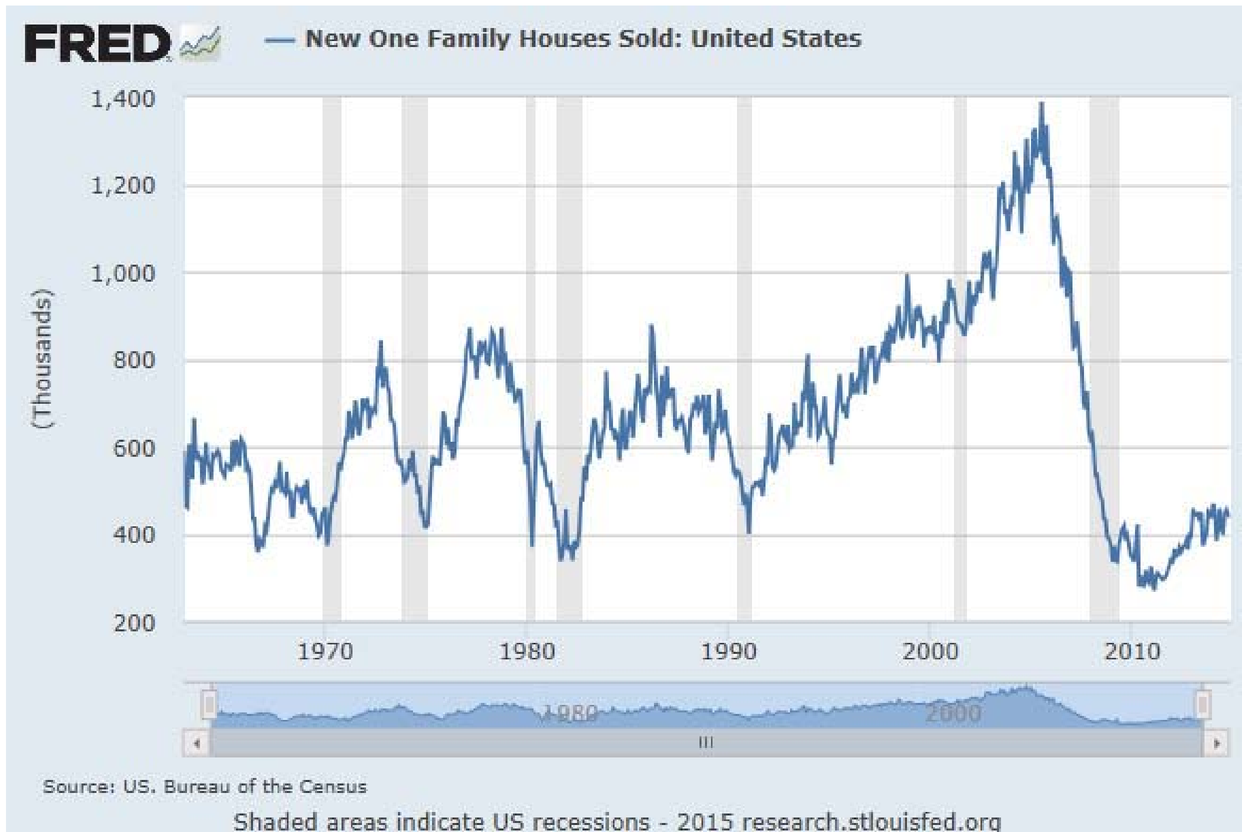
The sovereign debt crisis remains unresolved as Greek 10-year bond yields rose from 5.6 percent in September to 9.75 percent at year-end. Meanwhile, German 10-year yields fell to 0.54 percent and 2-year Bund yields were negative 0.12 percent. Investors are willing to lock-in a negative return for two years for the privilege of having the German government hold their money. Furthermore, five-year German Bunds currently yield 0.00 percent. Amazing! Upcoming elections on January 25, 2015 in Greece and the fear of left opposition party Syriza gaining control could lead to an eventual exit of Greece from the single currency euro as the economy and markets have been greatly impacted by the austerity policies that accompanied the financial bailout package. Whether that actually happens or not remains to be seen, however, the next few weeks will likely be filled with speculation and intrigue.

Federal Reserve

The Federal Open Market Committee (FOMC) added a boost to the markets in December following its announcement "that it can be patient in beginning to normalize the stance of monetary policy." While the media has focused on the "end" of quantitative easing ("QE"), the reality is that it continues to some degree. Indeed, the FOMC's statement confirmed that they "will continue its policy of reinvesting proceeds from maturing Treasury securities and principal payments from holdings of agency debt and mortgage-backed securities (MBS)."

What is interesting is that when the third round of quantitative easing ("QE 3") began in September 2012, the markets were skeptical. A day and a half after the announcement of QE 3 by the Federal Reserve, the Dow Jones Industrial Average added just over 53 points to close at 13,593.37, a gain of approximately 0.39 percent. In December 2014, however, the FOMC replaced "considerable time" with "patient" in their statement and the Dow rallied over 700 points, or roughly 4.15% in a day and a half. While some of that may have been attributable to hedge funds jockeying for position prior to year-end, the rally was, nevertheless, impressive.

Although the unemployment rate was 5.8 percent in November, the Fed stated that "there is room for further improvement" as too many who are working part time want full-time jobs and many are still unable to find jobs. Moreover, the housing recovery has still lagged as New Home Sales remain at the low end of what has been experienced over the past 50 years as seen in the following chart. In fact, the trailing 12 month moving average of sales has fallen to 587,940, its lowest level since August 1977. This prompted Fed Chair Yellen to say "I've been surprised that housing hasn't recovered more robustly." In addition, the level of inflation has continued to run below the Committee's 2-percent objective, which is yet another reason why the Fed will be "patient" before raising interest rates.

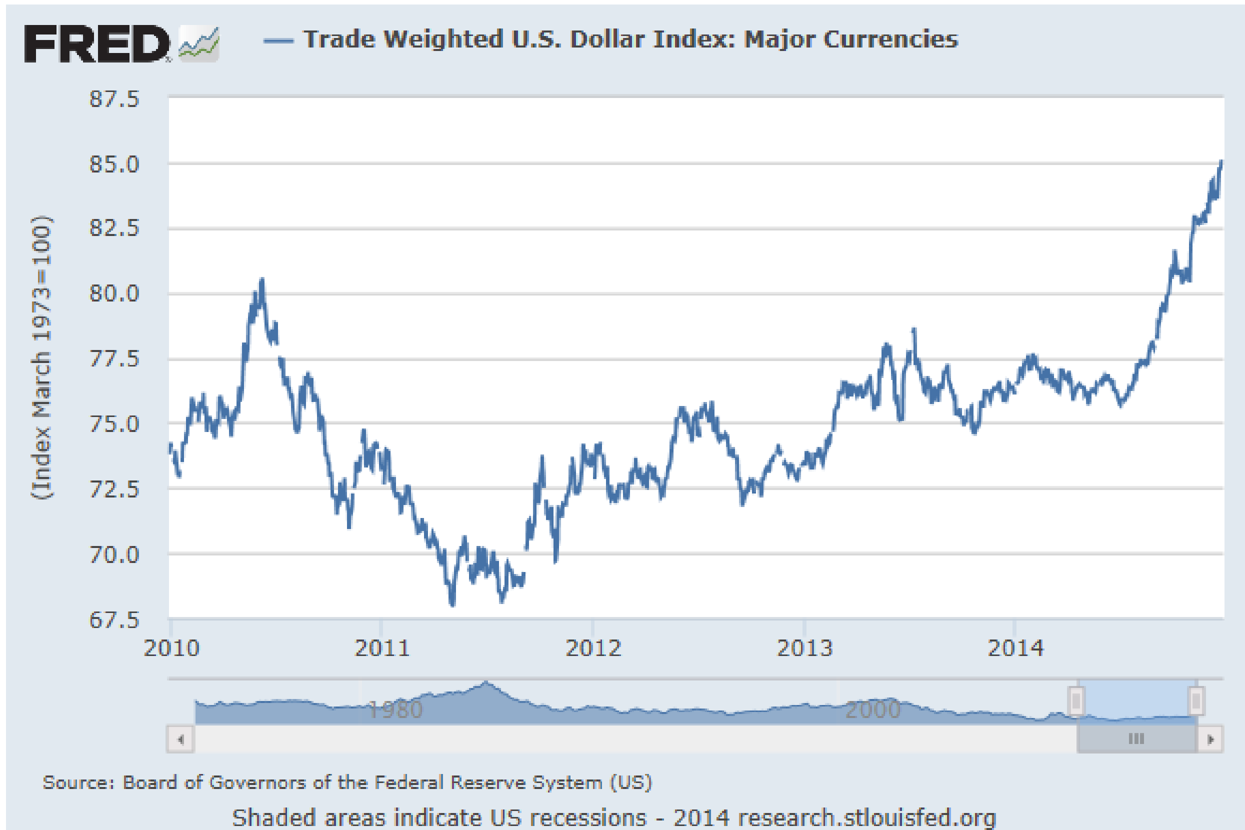


Europe / Asia

The ongoing sanctions against Russia, the collapse in oil prices, and recurring concerns about a possible Greek exit from the euro zone have sent reverberations through asset markets including currency, debt, bond and stock markets. The Russian ruble started 2014 at 33 to one U.S. dollar; it finished the year near 59, for roughly a 44 percent decline. This occurred, by the way, despite the Russian central bank raising interest rates from 10.5 percent to 17 percent overnight in December to defend the currency. The Athens stock exchange fell over 132 points, or 12.78 percent, on December 9, 2014, while China's Shanghai Stock Exchange dropped 5.4 percent.

The euro saw a high of 1.3934 in 2014 versus the U.S. dollar and finished the year near 1.20, a decline of more than 13 percent. Likewise, the Japanese yen began 2014 at roughly 105 to the U.S. dollar while closing out 2014 near 120. Clearly central banks are

using currency devaluation as a policy tool to attempt to stave off deflation as seen in the adjacent chart of the U.S. Dollar Index. While many skeptics have been predicting the demise of the U.S. dollar for some time, the opposite has in fact occurred.



European Central Bank (ECB) President Mario Draghi signaled that the central bank is likely to start a large scale government bond purchase program (AKA "Quantitative Easing"), however, German ministers continue to push back fearing they will be on the hook for a majority of any defaults. President Draghi said "We are in technical preparations to alter the size, speed and composition of our measures at the beginning of 2015, should this become necessary, to react to a too-long period of low inflation." Meanwhile, German Bundesbank President Jens Weidmann has argued that lower oil prices provide an economic stimulus and that the ECB should not bow to market pressure for a bond purchase program. In any case, the ECB Governing Council will meet on January 22, 2015 to review a QE package, although an interim meeting is scheduled for January 7, 2015.

China saw its Industrial Production increase 7.2 percent year-over-year in November, however, that figure is down from the roughly 10 percent annual growth rate seen in late 2013. While retail sales were estimated to have grown 11.7 percent in November, real estate sales continued to decline dropping 10 percent on a year - over - year basis. Nevertheless, China's Shanghai Stock Exchange rallied more than 50 percent in 2014.

Outlook

The recent volatility in global markets is a reflection of growing concerns primarily due to the collapse in oil prices and the subsequent longer-term ramifications thereof, as well as a return of the European sovereign debt crisis led by Greece. Venezuela government bonds fell to a 16-year low, trading at less than 40 cents on the dollar, as every $1 decline in the price of oil equates to roughly $770 million in lost revenue.
Since energy companies represent approximately 11 percent of the S&P 500 index, the massive decline in oil prices has caused downward revisions to 2015 earnings estimates. Although some of the earnings lost by energy companies may result in additional earnings gains for consumer companies, 2015 estimates are nonetheless being revised lower. Current 2015 earnings estimate for the companies in the S&P 500 index is $131.01. With a year-end closing level of 2058.90 on the S&P 500 index, the forward earnings ratio was 15.71. Of note is the fact that research suggests that a Price/Earnings ratio (P/E) of 16-17 is consistent with a 2-year Treasury yield of 4 percent. Today the two-year Treasury yield is approximately 0.66 percent.

While some have speculated about possible hyperinflation as a result of continued quantitative easing, the German hyperinflation from the history books began in earnest when the government lost access to the bond market. Far from losing access to the bond market and, as a result, being forced to print money, investors today are willing to lend money to the German government at negative interest rates and, therefore, lock in guaranteed losses.

To sum up, while volatility is on the rise, the U.S. economy is expected to grow and the central banks are continuing their activist ways to attempt to manage economies. While the federal funds rate has essentially been zero for the past six years, Janet Yellen stated that even as the Fed begins to normalize interest rates, "monetary policy will still be very accommodative for a

long time." Moreover, if the U.S. dollar remains strong relative to foreign currencies, additional foreign money may make its way to domestic markets. The combination of an accommodative Fed, a growing economy, higher corporate profits and low inflation has our Tactical Allocation Market Composite (TAMC) in constructive territory. Therefore, at this point we still believe selloffs will create rewarding buying opportunities. Nevertheless, investors should recognize that we are not in the first inning of this ballgame and adjust their expectations accordingly. (1.5.15)

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