ECONOMY: US Strength amid Global Weakness

**Asset Allocation – A Year of Divergent Returns**
Asset class returns varied dramatically in 2014: China & India soared, while most other emerging markets fell; Europe sank; the U.S. outperformed; commodities plunged; REITs soared; Gold was flat; and long term bonds rallied as yields fell.

**Interesting Notes on the S&P 500**
According to Standard & Poor’s, the S&P 500 has only posted three consecutive years of double-digit percentage gains three times in the past 100 years. This year marks the fourth time, with the last ending in 1999, and a subsequent 40% drop in equities. An analyst at Societe Generale recently highlighted that since 1875, the S&P has never risen for seven calendar years in a row. 2015 would represent year 7.

**Correction?**
Since 1945 there have only been three other periods (out of 51 total) where the market has had a longer streak of positive performance without at least a 10% correction, according to Ned Davis Research. The length of the average market rally without a 10% correction is 346 calendar days, whereas the current rally stands at 1,172 days and counting; the historical average gain during these rallies is 38%, compared to the current 88% gain.

**Historic Fall for Oil**
The price of West Texas Intermediate (WTI) crude oil plummeted 44% during the year, the largest calendar year crash during an economic expansion on record with history back to March 1983.

**Consumer Confidence Recovers**
The Conference Board Consumer Confidence Index, which had declined in November, improved in December. “Consumer confidence rebounded modestly in December, propelled by a considerably more favorable assessment of current economic and labor market conditions. As a result, the Present Situation Index is now at its highest level since February 2008. Consumers were moderately less optimistic about the short-term outlook in December, but even so, they are more confident at year-end than they were at the beginning of the year.”

**More Job Strength**
U.S. employers added to payrolls at a solid pace in December, a sign of steady momentum for the labor market after the strongest year of job growth in 15 years. Nonfarm payrolls rose a seasonally adjusted 252,000 in December. The unemployment rate was at 5.6% in December, now at its lowest level since June 2008.

**Greece Again in Focus**
Fears resurged of a Greek exit from the currency union. Many investors worry that the radical left Syriza party may gain a majority in parliament and force Greece out of the Eurozone.

**Europe Data Decidedly Mixed**
The Markit business survey for the Eurozone edged higher to 50.6 from 50.1. The German PMI rose nicely to 51.2 from 49.5. But, others fell: France, from 48.4 to 47.5; Italy, from 49 to 48.4; Spain, from 54.7 to 53.8. There was deflation in Spain as the CPI contracted 1.1% in December from the prior year, the largest drop since 2009, and much larger than expected.

**ECB ‘QE’**
ECB President Mario Draghi made it very clear that the ECB was ready for further action, likely widespread purchases of sovereign bonds. According to the central bank leader, “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.”

**China Growth Slows**
China will likely miss its growth target (7.5%) for the first time since 1998. The latest business survey suggest growth will not pick up as the HSBC PMI fell below 50 (49.6) for the first time since May. However, the economy could benefit from falling oil prices and other stimulative measures enacted by the Peoples Bank of China.
A WALL OF WORRY
We learned again in 2014 that unexpected events should be expected and that a diversified portfolio will help weather these storms. In 2014, we had the “polar vortex,” Russian invasions, quantitative easing ending, Ebola, a midterm election, oil falling off a cliff, and numerous other domestic and international events. While none of these derailed the U.S. stock market, the same was not true around the globe.

THE U.S. MARKET
As noted previously, the S&P 500 is reaching lofty levels in terms of annual returns. Valuations, while not overly expensive given the interest rate environment and historical averages, are certainly not cheap. More stretched valuations place increased importance on earnings growth. So while we remain positive on equity market prospects heading into 2015, we anticipate a greater level of volatility than has been seen over the past few years. We continue to anticipate a modest correction at some point, which should allow for an opportunity to reallocate capital at more attractive levels.

EVERYBODY ELSE
According to data from MSCI, only Israel, with a 22.8% return in 2014, bested the U.S. among developed markets. Overall, 14 of the 23 MSCI developed market country indices fell, led by Portugal down 38%, Austria down 30% and Norway down 22%. Europe had a difficult year as well, as the MSCI Europe Index fell 6.2% in 2014. While the MSCI Emerging Markets Index fell only 2.2% in 2014, individual country performance varied significantly. While Egypt was up 29.3% and India returned 23.9%, Hungary fell 27.4% and Russia was literally a “bear,” falling 46.3%.

GLOBAL EQUITIES: US Outperforms

GLOBAL EQUITY PERFORMANCE

MSCI COUNTRY PERFORMANCE
RATES WERE SUPPOSED TO RISE...
One year ago, the median forecast projected 10-year U.S. Treasury yields rising by year-end 2014 to around 3.5%. The thinking was that yields had already soared from 1.66% in May 2013 to 3.03% on December 31st and the economy was strengthening by the day. Higher rates were a foregone conclusion...maybe? The economic forecasts were on target despite a weather induced contraction in the first quarter, but the positive impact on Treasury yields did not happen.

WHAT HAPPENED?
The bond market was beset with worries: turmoil in the Middle East and Ukraine; slowing growth and potential financial stress in China; deflation and recession in the Eurozone; a tax induced contraction in Japan; collapsing oil prices that brought fears of a global recession; and economic slowdowns within the emerging markets. Even though none of these factors hindered U.S. economic growth, bond investors flocked to safe havens, specifically U.S. Treasuries. With sovereign yields in Japan and Germany well below 1%, the 2% yield on the 10-year U.S. Treasury proved to be very attractive.

SECTOR WATCH
Investment grade bonds outperformed high yield in 2014 as the Barclays U.S. Aggregate Bond Index returned almost 6%, while the Barclays U.S. High Yield index returned only 2.5%. Municipal performance was better than expected. Overall, municipals benefitted from continued low supply, increased demand, and favorable news regarding fundamental credit developments.
HEDGE FUNDS DISAPPOINT
In 2014, nearly all hedge fund strategies trailed both the U.S. stock and bond markets, measured by the S&P 500 and Barclays U.S. Aggregate Bond indices. Hedge funds posted a slight loss in December as the HFRX Global Composite fell 0.8%. The biggest winners in the hedge fund space for 2014 were Global Macro and Commodity Trading Advisors (CTAs). These strategies were able to profit from trends in energy, currencies and interest rates.

CONFLICTING VIEWS ON LOWER OIL
Oil prices were down 40% for the quarter hitting five-and-a-half-year lows in late December. An oil price decline is typically viewed as a positive development for the global economy as it benefits consumers and most businesses, while helping to alleviate any inflationary pressures. The negative impact of lower oil prices on the increasingly important U.S. shale energy industry complicates this a bit for the U.S. economy. Most analysts continue to believe that falling oil prices will have a positive net economic impact, for both the U.S. and global economy. Market prices are a function of supply and demand. New sources of oil supply from U.S. shale, Libya, and elsewhere have been increasing. But, the sharp price drop also reflected fears of a deeper weakness in global demand. For example, in early December both OPEC and the International Energy Agency reduced their 2015 estimates of oil demand growth, which could impact global economic growth as well.