Q4|2014 and Year-end Commentary: Markets Finish More Mixed than Headlines Suggest

Overview

The final quarter turned out to be the most interesting of 2014. It was packed with news headlines and market volatility. At one point during mid-October, almost all the global equity averages were either down or flat for the year, as interest rates continued their path lower from the highs seen at the end of 2013. Investors appeared to be spooked by the Federal Reserve's (Fed) "tapering", Ebola scares within the U.S., rapidly dropping energy prices and a host of other news worthy events. Overall, the financial markets finished much more mixed than the headlines suggested.

U.S. Economy

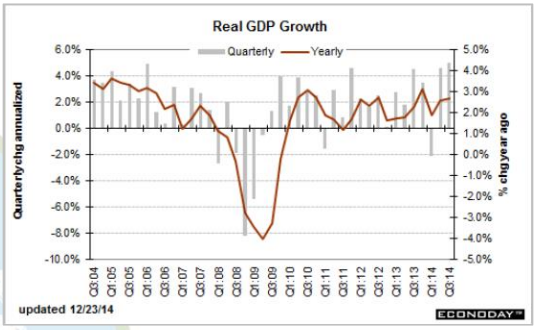
U.S. economic data continued to impress during 2014, and the fourth quarter was no exception. Revised Q3 GDP came in at **5.0%,** confirming that the U.S. growth story remains intact.[1] Chart 1 illustrates just how far the U.S. economy has come over the last five years.

Employment data has been another positive within the domestic economic landscape. Chart 2 shows that the U.S. unemployment rate has dropped to **5.8%**, down from nearly **10%** just 5 years ago.[2] Additionally, the underemployment rate has continued to slide and now stands at **11.4%.**[3] All of this has led to an ever increasingly more confident U.S. consumer as noted by chart 3 below.

Finally, housing has continued to trend in a positive direction as both new and existing sales remain elevated. Consistent demand and limited supply have helped to keep prices moving modestly higher, although at a slower rate than seen during 2013. Stronger employment data coupled with a more optimistic consumer should help to keep this trend intact.

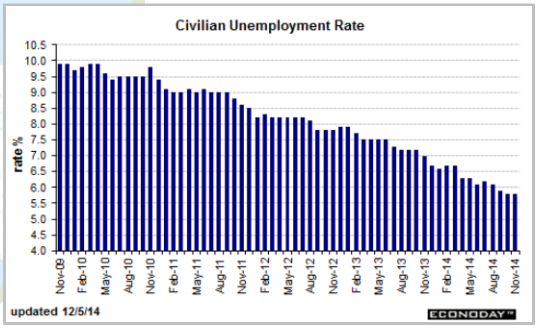
Overall, we remain optimistic that the U.S. economy is on track for continued growth during 2015. The Fed has continued to remain accommodative by keeping rates low, inflation remains muted, the U.S. dollar remains strong and most data points show steady signs of improvement. Additionally, recent weakness in energy prices should act as a stimulus for the U.S. consumer and encourage increased discretionary spending. Barring any major hiccups, the U.S. will likely remain the strongest economy in the developed world over the next twelve months.

Chart 1



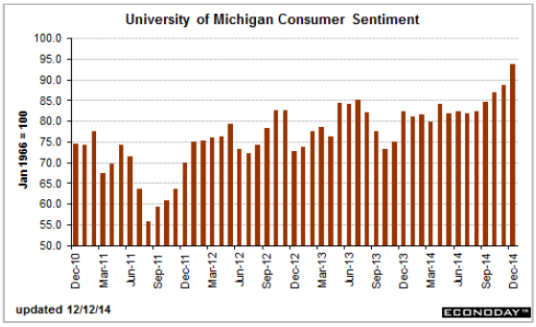
Source: Bloomberg.com, Econoday

Chart 2



Source: Bloomberg.com, Econoday

Chart 3

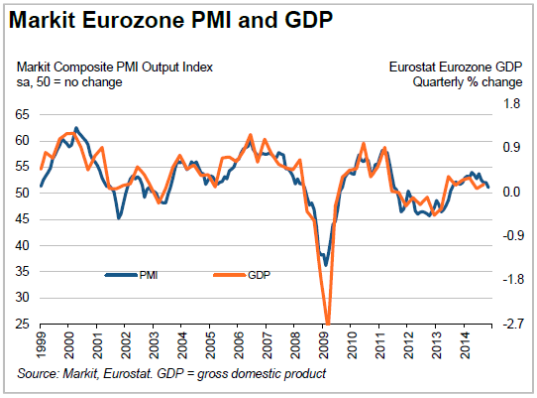


Source: Bloomberg.com, Econoday

Global Economy

The data outside the U.S. hasn't been as healthy but remains constructive. Europe started showing signs of weakness earlier this year and has continued to struggle with threats of deflation, slow growth and high unemployment. Charts 4 and 5 illustrate the recent weakness seen in both manufacturing and GDP growth within the Eurozone. With that being said, the European Central Bank (ECB) has pledged to remain accomodative. They have implemented a quantitative easing program similar to that of the U.S. Federal Reserve, and recent weakness in the euro will likely attract foreign capital and stimulate growth.

Chart 4



Source: Markit

Further east, Japan has seen a steady increase in manufacturing and production over the last few moths. This comes after a drastic decrease during the spring when they initiated a country wide Valued Added Tax (VAT). Like the ECB, the Bank of Japan (BOJ) has also vowed to remain highly accomodative in an attempt to spur economic growth.

Finally, the emerging markets (EM) and frontier markets (FM) have remained a bifurcated group. Many countries have shown positive growth, while others have struggled. The recent drop in oil prices has both helped and hurt EM countries. Nations such as China have benefited due to their being a net importer, but other such as Russia and Brazil have struggled due to their dependence on revenues from energy exports. Lastly, weakness in Europe has not helped, as large amounts of goods are imported into the Eurozone from the emerging markets. We still believe the emerging markets will prevail but remain skeptical that they will return to the growth seen during the mid-2000s.

Chart 5

Global Purchasing Managers' Index for Manufacturing

	Oct'12	Nov'12	Dec'12	Jan'13	Feb'13	Mar'13	Apr'13	May'13	Jun'13	Jul'13	Aug'13	Sep'13	Oct'13	Nov'13	Dec'13	Jan'14	Feb'14	Mar'14	Apr'14	May'14	Jun'14	Jul'14	Aug'14	Sep'14
Global	48.9	49.7	50.1	51.4	50.8	51.0	50.2	50.4	50.4	50.6	51.5	51.6	51.9	52.9	52.9	53.0	53.2	52.4	51.9	52.2	52.6	52.4	52.5	52.2
U.S.	51.0	52.8	54.0	55.8	54.3	54.6	52.1	52.3	51.9	53.7	53.1	52.8	51.8	54.7	55.0	53.7	57.1	55.5	55.4	56.4	57.3	55.8	57.9	57.5
Canada	51.4	50.4	50.4	50.5	51.7	49.3	50.1	53.2	52.4	52.0	52.1	54.2	55.6	55.3	53.5	51.7	52.9	53.3	52.9	52.2	53.5	54.3	54.8	53.5
U.K.	47.7	48.0	50.6	51.0	48.1	50.2	50.6	52.2	52.8	55.0	57.4	56.4	56.1	57.9	57.0	56.5	56.4	55.6	57.2	56.8	57.2	54.7	52.2	51.6
Euro Area	45.4	46.2	46.1	47.9	47.9	46.8	46.7	48.3	48.8	50.3	51.4	51.1	51.3	51.6	52.7	54.0	53.2	53.0	53.4	52.2	51.8	51.8	50.7	50.3
Germany	46.0	46.8	46.0	49.8	50.3	49.0	48.1	49.4	48.6	50.7	51.8	51.1	51.7	52.7	54.3	56.5	54.8	53.7	54.1	52.3	52.0	52.4	51.4	49.9
France	43.7	44.5	44.6	42.9	43.9	44.0	44.4	46.4	48.4	49.7	49.7	49.8	49.1	48.4	47.0	49.3	49.7	52.1	51.2	49.6	48.2	47.8	46.9	48.8
Italy	45.5	45.1	46.7	47.8	45.8	44.5	45.5	47.3	49.1	50.4	51.3	50.8	50.7	51.4	53.3	53.1	52.3	52.4	54.0	53.2	52.6	51.9	49.8	50.7
Spain	43.5	45.3	44.6	46.1	46.8	44.2	44.7	48.1	50.0	49.8	51.1	50.7	50.9	48.6	50.8	52.2	52.5	52.8	52.7	52.9	54.6	53.9	52.8	52.6
Greece	41.0	41.8	41.4	41.7	43.0	42.1	45.0	45.3	45.4	47.0	48.7	47.5	47.3	49.2	49.6	51.2	51.3	49.7	51.1	51.0	49.4	48.7	50.1	48.4
Ireland	52.1	52.4	51.4	50.3	51.5	48.6	48.0	49.7	50.3	51.0	52.0	52.7	54.9	52.4	53.5	52.8	52.9	55.5	56.1	55.0	55.3	55.4	57.3	55.7
Australia	42.8	44.3	44.3	40.2	45.6	44.4	36.7	43.8	49.6	42.0	46.4	51.7	53.2	47.7	47.6	46.7	48.6	47.9	44.8	49.2	48.9	50.7	47.3	46.5
Japan	46.9	46.5	45.0	47.7	48.5	50.4	51.1	51.5	52.3	50.7	52.2	52.5	54.2	55.1	55.2	56.6	55.5	53.9	49.4	49.9	51.5	50.5	52.2	51.7
China	49.5	50.5	51.5	52.3	50.4	51.6	50.4	49.2	48.2	47.7	50.1	50.2	50.9	50.8	50.5	49.5	48.5	48.0	48.1	49.4	50.7	51.7	50.2	50.2
Indonesia	51.9	51.5	50.7	49.7	50.5	51.3	51.7	51.6	51.0	50.7	48.5	50.2	50.9	50.3	50.9	51.0	50.5	50.1	51.1	52.4	52.7	52.7	49.5	50.7
Korea	47.4	48.2	50.1	49.9	50.9	52.0	52.6	51.1	49.4	47.2	47.5	49.7	50.2	50.4	50.8	50.9	49.8	50.4	50.2	49.5	48.4	49.3	50.3	48.8
Taiwan	47.8	47.4	50.6	51.5	50.2	51.2	50.7	47.1	49.5	48.6	50.0	52.0	53.0	53.4	55.2	55.5	54.7	52.7	52.3	52.4	54.0	55.8	56.1	53.3
India	52.9	53.7	54.7	53.2	54.2	52.0	51.0	50.1	50.3	50.1	48.5	49.6	49.6	51.3	50.7	51.4	52.5	51.3	51.3	51.4	51.5	53.0	52.4	51.0
Brazil	50.2	52.2	51.1	53.2	52.5	51.8	50.8	50.4	50.4	48.5	49.4	49.9	50.2	49.7	50.5	50.8	50.4	50.6	49.3	48.8	48.7	49.1	50.2	49.3
Mexico	55.5	55.6	57.1	55.0	53.4	52.2	51.7	51.8	51.3	49.7	50.8	50.0	50.2	51.9	52.6	54.0	52.0	51.7	51.8	51.9	51.8	51.5	52.1	52.6
Russia	52.9	52.2	50.0	52.0	52.0	50.8	50.6	50.4	51.7	49.2	49.4	49.4	51.8	49.4	48.8	48.0	48.5	48.3	48.5	48.9	49.1	51.0	51.0	50.4

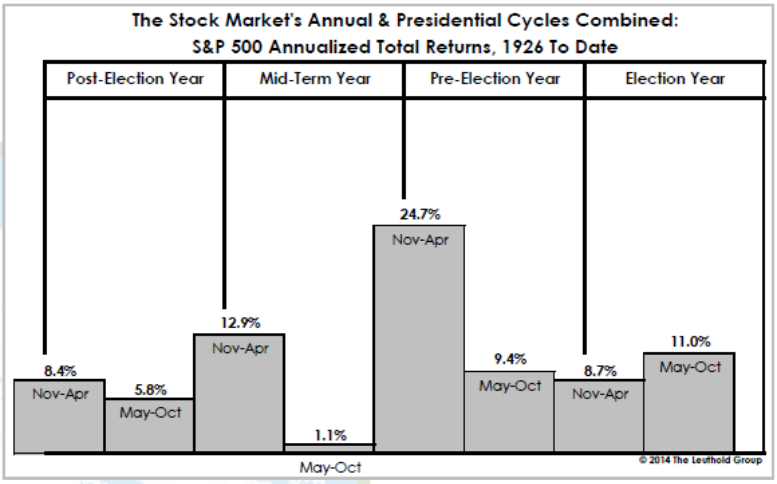
Source: JP Morgan Markit

U.S. Equities

U.S. equities, specifically large caps, as represented by the S&P 500 index, were once again one of the best performing asset classes during Q4 and 2014 but saw significantly more volatility than in the previous year. During the 4th quarter, the S&P 500 finally sustained a notable pullback, dropping almost 10% at one point, but managed to rally back and finished the quarter and year up **4.93%** and **13.69%**, respectively.[4] Returns in other areas of the equity market were less impressive, as the Russell 2000 Small Cap index finished the quarter with a positive gain of **9.73%** but was only up **4.89%** on the year.[5]

The current bull market is approaching its 6th year but remains strong. With that being said, 2014 brought significant dispersion within the underlying market sector returns. For instance, the utilities sector led the market and finished the year up **28.98%**, while the energy complex lagged considerably and ended 2014 down -**7.78%**.[6] This large spread between the winners and losers shows the difficulty of investing in the current market environment.

Chart 6



Source: Leuthold Group

On a positive note, cycle analysis shows that we are entering a period that has historically been very favorable for the equity markets. More specifically, going back to 1926, the presidential cycle analysis shown on chart 6 suggests that November through April in-between the mid-term and pre-election years has been the best time to invest in the S&P 500.

International Equities

The entire international equity complex underperformed the U.S. markets during 2014 and again during the 4th quarter. Within Europe, the STOXX Europe 50 index finished the year and quarter down **-8.66%** and **-6.23%** respectively.[7] Japan's performance was also weak, as the Japanese Nikkei 225 equity index finished the quarter and year down **-1.28%** and **-6.10%**, respectively.[8] Much of the weakness came at the hand of a stronger U.S. dollar which vastly outperformed the euro and yen throughout 2014.

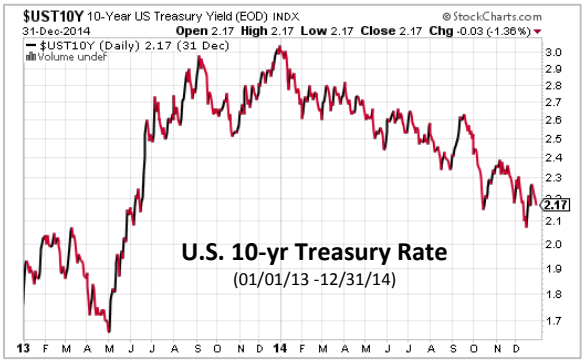
Emerging Market (EM) equities, as represented by the MSCI EM index, finished both the quarter and year in the red. The EM index was down **-4.50%** during Q4 and **-2.19%** for the year.[9] As previously noted, factors such as weakening commodity prices, lack of growth in Europe and a strong U.S. dollar all played a role in emerging markets' underperformance.

Frontier Markets were not immune to the weakness, as the MSCI Frontier Markets Index was down **-11.94%** during the 4th quarter, but ended the year up **4.99%**.[10] This asset class was negatively impacted by falling energy prices, as uninformed investors fled due to fears of lower oil revenue. In reality, most frontier market countries are net importers of oil and will benefit from the lower oil prices.

Fixed Income

Looking back to the end of 2013, it appeared that U.S. interest rates could only go higher. The benchmark 10-year U.S. Treasury rate stood around 3.0%, and most pundits predicted it would finish between 3.5-4.0% by the end of 2014.[11] Much to the chagrin of these analysts, U.S. rates plummeted throughout 2014 and the 10-yr finished at 2.17% as seen on chart 7.[12] Even more surprising was the fact that the 30-yr U.S. Treasury Bond returned over **25%** during 2014.[13] The Barclays US Aggregate Bond Index was a direct benefactor of this decrease in rates, and returned **1.79%** for the quarter and **5.97%** for year.[14] On the opposite end of the risk spectrum, the Barclays US Corporate High Yield Bond index and Barclays Global Aggregate ex-USD Bond index both lagged their less risky counterpart. The indices finished the year up **2.45%** and down **-3.08%**, respectively.[15]

Chart 7



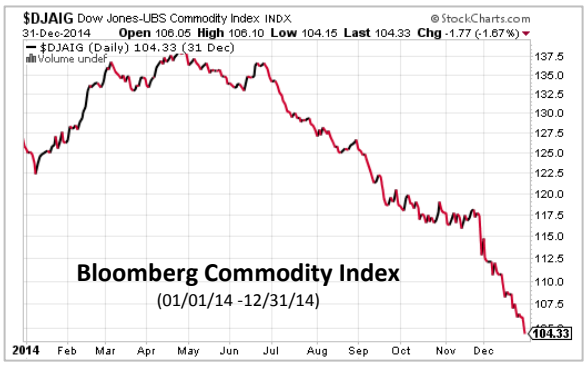
Source: Stockcharts.com

Many explanations have surfaced as to why U.S. rates dropped during a period when the Federal Reserve essentially tightened their policy by "tapering" new bond purchases. The most common rationale pertains to the relative value seen in U.S. bonds, as interest rates on many European bonds are yielding less than comparable ones in the U.S., thus keeping domestic rates effectively capped. For instance, as of 12/30/14, French Government 10-yr bonds were yielding 0.837%, compared to 2.17% for the U.S. 10-yr.[16] Many believe that this has led to increased foreign demand of U.S. bonds. Other analysts have suggested that benign levels of inflation have caused rates to drop, as investors are less fearful of a rapid rise in rates in the near term.

Commodities

During Q4, commodities remained the year's biggest loser, as the Bloomberg Commodity Index finished the quarter and year down **-10.59%** and **-15.59%** respectively.[17] As we mentioned last quarter and as illustrated on charts 8 and 9 below, "majority of the weakness can be attributed to the impressive strength of the US dollar. Commodities and the dollar tend to have an inverse relationship, and the recent weakness seen abroad led to significant amounts of capital flows into the US dollar during the quarter." In addition, plummeting energy prices and non-existent inflationary data caused investors to pull significant capital from the space.

Chart 8



Source: Stockcharts.com

Chart 9

Source: Stockcharts.com

Outlook

This year turned out to be very different than most expected. U.S. large stocks were the only game in town, benefiting from rising earnings multiples and a desire for big liquid stocks. International equity markets performed poorly and lagged their domestic counterparts. Within the bond market, while nearly everyone expected rates to rise, yields actually fell creating unexpected difficulties for many active bond managers. Lastly, commodities started out strong but finished down double digits as fears of inflation slowly turned to fears of deflation.

Looking forward, we still believe equities have room to climb higher – albeit modestly. U.S. equities remain our highest conviction idea due to their relative safety, while the developed international and emerging markets offer strong relative value as they continue to sort out their economic woes. We expect that Euro based monetary programs, a strong U.S. dollar, and the stimulus of oil price declines, will help Europe's economy and exports, providing a catalyst for a possible rally.

We think continued strong U.S. economic data, accommodative monetary policy abroad, lower energy prices and favorable seasonality conditions should all lead to positive market equity returns. However, U.S. stocks may not get the additional lift of higher multiples as they did over the last couple of years (they'll have to earn it in 2015).

The bond market remains challenging, as we believe rates should start to normalize higher during 2015. Based on this, we are positioned into credit focused investments due to the continued strength of the U.S. economy. Credit focused bonds tend to perform well during periods of economic growth, as corporate balance sheets become healthier and profits rise. Additionally, credit investments are much less interest rate sensitive and are less likely to be negatively affected by rising rates.
Finally, we believe commodities will likely continue to exhibit high levels of volatility. We will continue to monitor the underlying commodity markets and inflationary data, but currently have no plans to invest.

In closing, we want to reiterate the importance of proper diversification within any investment portfolio. The old adage of "not putting all your eggs in one basket" still makes sense. We remain confident in our process to help our clients achieve positive outcomes for their specific situation.

As always, please feel free to contact us with any questions you may have.

William Kring, CFP®, AIF®
Chief Investment Officer

Matt B. Bailey, CFA®
Portfolio Manager

Source:

1. bloomberg.com/markets/economic-calendar
2. Ibid
3. bloomberg.com/quote/USUDMAER:IND
4. Morningstar
5. Ibid
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8. Ibid
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12. Stockcharts.com
13. Morningstar
14. Ibid
15. Orion
16. Investing.com
17. Orion

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