Forza Investment Advisory, LLC

Strengthening Our Clients' Financial Lives

FROM THE DESK OF BOB CENTRELLA, CFA ***Jan 9, 2015***

2014 REVIEW AND 2015 MARKET OUTLOOK

As the Stock Market QB steps up to the line on January 1st he yells "Ready, 13%, 32%, 16%, 2%, 15%, 26% -- Set, GO!" The play unfolds and are we off to the 7th straight up year in the stock market (the preceding QB call is the S&P returns for the last 6) or has the bull market run its course now that the Fed is done easing and is likely to raise short term rates this year? After 32% in 2013, a 13%+ return for 2014 in stocks was a great follow-up. The Dow Jones Industrials returned close to 10% including dividends and overall Large Caps outperformed Small Caps as the Russell 2000 did correct over 10% in 2015 but rallied to end the year up 3.5%. Mid Caps fared better and climbed over 8%. The bond market somehow gave investors a 5% return in the Barclays Bond Aggregate as yields remarkably declined while the whole investment world (including yours truly) was looking for an increase. Equities did pause 4 times in the year for mini corrections, but we never reached the -10% level in the S&P 500 and they bounced back with a vengeance each time. Outside the US, things were not as good although a December rally allowed many markets to show positive returns for the year. The MSCI World (ex-US) fell 3.9% and Europe's 350 Index fell 7% as results were mixed across the Eurozone. China's Shanghai Composite rose 53% to take the crown while India climbed 30%. On the downside Brazil fell again, down 2.9% and the UK dropped 2.7%. The story as the year unfolded was the collapse in oil prices. Energy stocks tumbled as a result of WTI oil falling from over $100 a barrel to close the year at $53.27 for a 46% drop in 2014. Natural Gas fell 31% to $2.89/mmBtu and with possible deflation in the economy Gold remained flat and fell 1.5% in the year.

ECONOMY AND INTEREST RATES

Here in the US the economy came to life with real GDP growth of 5% in the 2nd and 3rd quarters after a decline in Q1 due to poor weather. Q4 net GDP is expected to have risen around 3% providing good momentum into 2015. Corporate Profit growth should finish the year at around 12% for the S&P 500 companies, supporting the gains in equities. On the employment front, unemployment fell to 5.6% as we saw about 240K average monthly employment gains. The participation rate still is a bit low at 62.8% but has stayed at that level for 8 months. There has been a clear decoupling with the rest of the world as Europe is stuck and barely growing while Japan is in recession and China growth, though still at around 7%, is clearly slowing and fear of a hard landing has not dissipated. The US dollar strengthened worldwide, especially against the Euro and Yen and gained against every G10 currency and most emerging market currencies. On the monetary policy front the US and England appear ready to tighten in 2015 while Japan and the ECB are in easing (QE) mode. The US Fed has signaled that it will remain patient in raising short term rates but it seems likely that it will happen in 2015 unless the recovery in the US stagnates.

So what do falling oil prices, a strong dollar and an increase in ST rates by the Fed signal for stock and bond prices for 2015? Surprisingly, history has shown that an increase in rates is not bad for equity prices. Several studies of the market reaction after the Fed raises rates show that although there is some negative reaction initially, prices tend to be higher 3- and 6-months later. In fact, in 14 periods since 1958 when the Fed raised rates, there were only 2 declines during the full cycle from trough to peak in rates (both in the early 70's) and the average return of the S&P 500 for the 14 periods was 9.6%, about the same as average

annual return of the market in general. Bonds on the other hand may not fare as well. On the short end, higher yields will spell lower prices although the short duration will keep total return flat to negative. On the long-end, the question is whether the yield curve remains flat or if long bond rates increase proportionally. Any increase in long bond yields will have a more pronounced negative effect on returns as a 1% increase in rates for a 10-yr UST will result in about a 8%+ loss in value. So the risk-reward is not good for holding longer-dated Treasuries.

CONCLUSION AND OUTLOOK

There are some unknowns in the marketplace as there always are that will impact financial asset prices. (1) Oil's fall and the consequences are still to be seen. Consumers and many companies will be impacted positively due to lower prices, however those companies involved in selling equipment to the energy industry and in the production of oil will be negatively impacted. Clearly the countries that rely on higher oil prices will be hurt, specifically Russia, Venezuela, Middle East. (2) Fed tightening and the end of Quantitative Easing. The Fed ended QE in October and has signaled higher short-term rates in 2015. The end of QE is a new thing as the Fed supported the markets the past 6-7 years and although as I mentioned rising rates have not meant negative equity returns, it can heighten anxiety. (3) Higher volatility - with the Fed out of the market, rates poise to move higher, charged geopolitical events, falling energy prices and a market in the 7th year of a bull run, volatility has increased recently and is likely to be higher in 2015. That means stock prices that can swing more wildly as we've already seen in the last 2 weeks. (4) The Strong Dollar can hurt multinationals due to currency headwinds as prices become higher overseas but overall signals a stronger US economy. (5) ROW (rest of world) needs to stabilize and strengthen. Weakness in Europe, emerging markets, China and elsewhere threatens US growth. (6) Geopolitical events are out of our control by and large but are likely to continue. Greece may leave the Euro, the Middle East is always a melting pot, ISIS and Al Qaeda are not going away as terrorist threats, etc...

Having said all that, I'm still bullish and prefer stocks over bonds once again and think that the S&P 500 can deliver another double-digit gain in 2015 due to Corporate Profit growth of around 8%+, continued employment growth, the stimulus effect of lower energy prices on the consumer and still reasonable valuations (although not undervaluations). It will be a bumpy ride though. From a sector standpoint I like consumer, technology and healthcare sectors as overweight areas. I'm neutral on financials, industrials and materials. Energy will bounce back but it is still too early. REITs and Utilities are rate plays so I'm neutral to positive but be wary of rate increases. International markets are intriguing and appear undervalued but that seemed the case last year and the economies did not get any better. I prefer an allocation to international markets for diversification purposes as at some point the benefit of diversification will pay-off as investors might be overallocated to the US. On the fixed income front I like High Yield to bounce back and prefer Corporate Intermediate-term bonds to short-term and long-term treasuries. Munis should also continue to do well and again I would stay in the intermediate range due to rising short rates.

HAPPY NEW YEAR! Have a wonderful 2015 and feel free to call me to discuss views at 908-447-7755!