



Observations and Outlook

April 6, 2015

2015 is off to a slow start with most stock indices negative in January, positive in February and mixed in March to end slightly in the green at the end of the first quarter. The biggest change is in Europe where the Eurostoxx 350 went from being quite negative in 2014 to a top performer to start 2015. The big surprise (to some), once again, is long maturity Treasury bonds, which was among the best performing asset classes year to date as interest rates continue to move lower on the heels of dramatic decrease in rates in 2014.

Selected Index Returns First Quarter 2015

Dow Jones Industrials	+0.33%	S&P 500	+0.95%	MSCI Europe	4.32%
Small Cap US (Russell 2000)	+4.3%	Emerging Mkts	2.42%	High Yield Bonds	+2.27%
US Aggregate Bond Index	+1.61%	US Treasury 20+Yr	+4.19%	Dow Jones/UBS Commodity	-8.2%

Review of the Last 6 Months

Reviewing the last two Observations and Outlook from October 2014 and January 2015 most of the major topics that have been covered continue to develop as previously indicated. The strong US Dollar, slow growth/recession in China and Europe, the end of US Fed Quantitative Easing, and a decline in corporate earnings (due in part to US \$ strength) which is pushing valuations in stocks to excessive levels. In summary, these topics are still developing and are only beginning to impact the financial markets. Investors need to alter their expectations of future returns from equities (lower) and position themselves to best reflect their own risk (aka volatility) tolerance and investment goals.

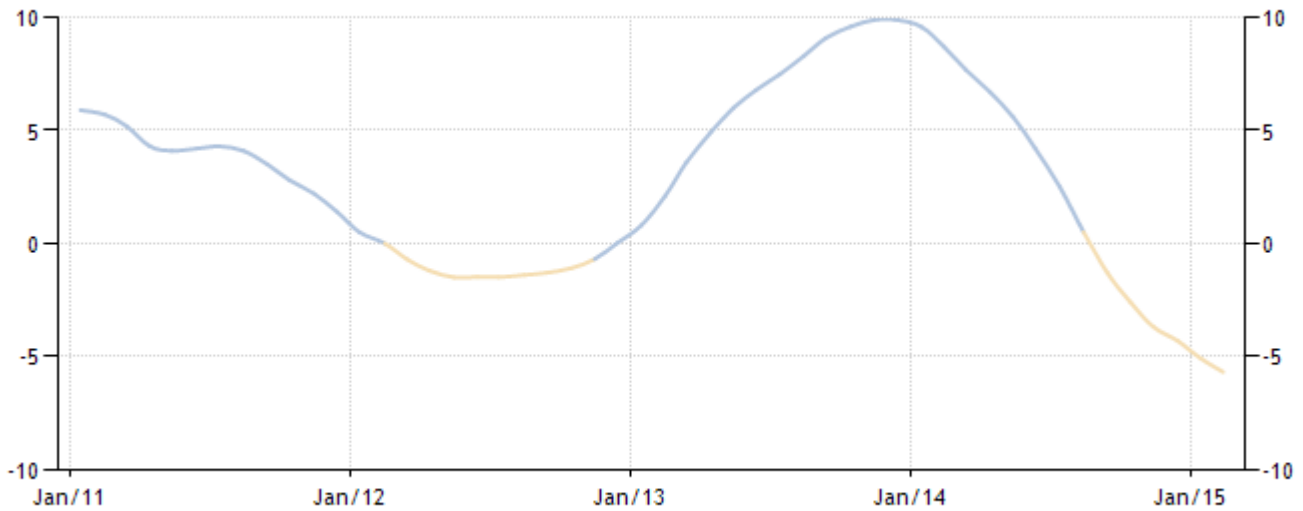
In October the main topic was the rapid strengthening of the US Dollar. At the time the USD Index had moved from 79 to 86 over a few months' time. In currencies, this is a dramatic move. Since October the greenback has continued to strengthen, hitting 100.42 on March 13th. This is a 27% move and is unmatched over the past 15 years. There was a 25% increase in the value of the US Dollar July 2008 into November of 2008. The strong dollar has crushed oil prices and other commodities and caused significant headwind to S&P500 earnings, as predicted here in October. Also forecast in October was the media's lack of attention to USD strength until discussion of earnings estimates for first quarter 2015 began in earnest. Now all one sees on the news is 'strong dollar is headwind for earnings'. The USD has pulled back more than 4% since the high and is giving some support to gold and oil prices which often move opposite to the dollar index. The US Dollar will probably remain strong but remain range bound over the next several months.

\$DXY - US Dollar Index - Daily OHLC Chart



Also in October I discussed concerns of deflation in Europe and a slowing economy in China. Both are front and center topics today. Europe's response has been yet another bond buying program to inject liquidity into financial markets which should drive up inflation according to the ECB. How exactly buying bonds leads to higher prices, the ECB doesn't say. The current state of interest rates in Euroland are that more than 1/3 of all government bonds currently have **negative** yields. This is incredibly rare and very, very odd; but receives very little discussion in the financial media. If Germany, Denmark, Sweden, Switzerland and others can go negative on 3yr bills, I don't see why the US shouldn't follow suit. China is following a similar path, recognizing that its economy will be growing well short of its politburo inspired goal of 7.5%. China's central bank has been easing credit and lowering reserve ratios in an attempt to put a floor under its faltering real estate market. Both regions equity markets have done very well in local currency, and modestly well in US dollar terms, given the US dollar strength. Lower prices mean more upside down and thus failing real estate loans.

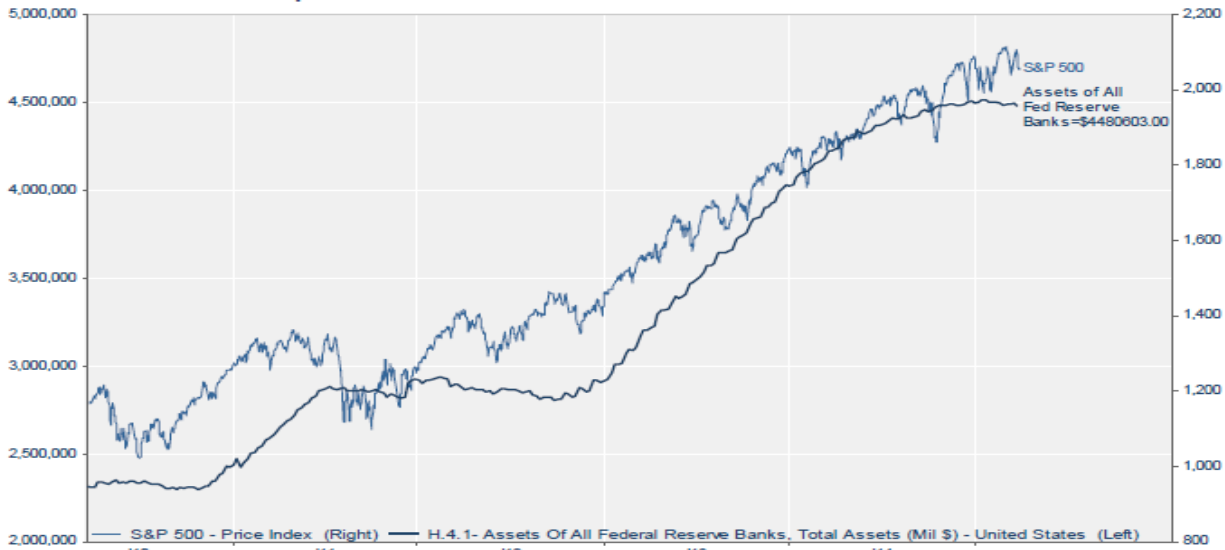
CHINA NEWLY BUILT HOUSE PRICES YOY CHANGE



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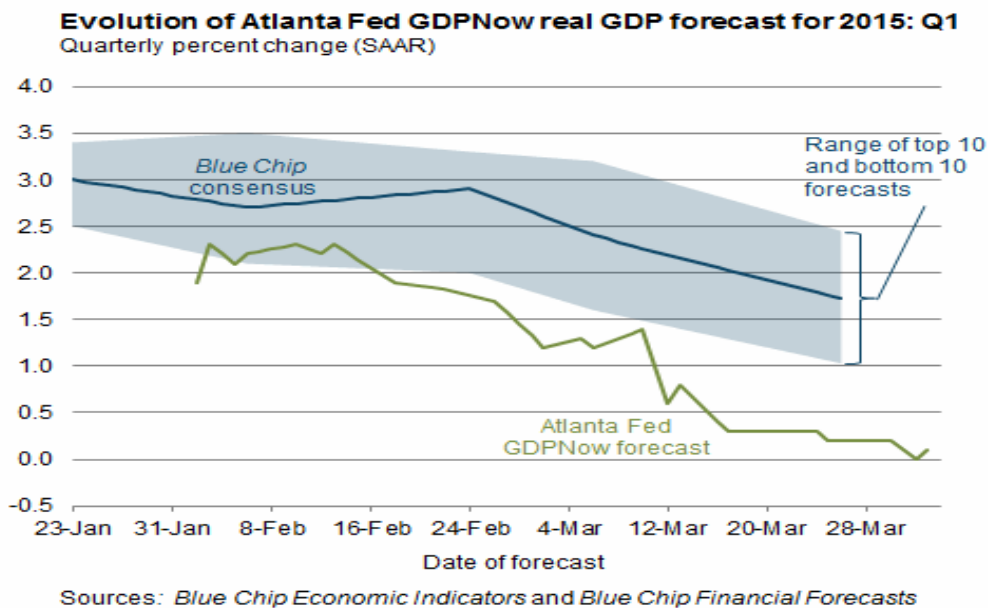
In October I posted **The Most Important Chart in the World**. Here is the update. A great deal of the stock markets rise over the past few years is directly attributable to Federal Reserve QE efforts. Those efforts have now ceased.

Expansion of the Fed's Balance Sheet vs. the S&P 500

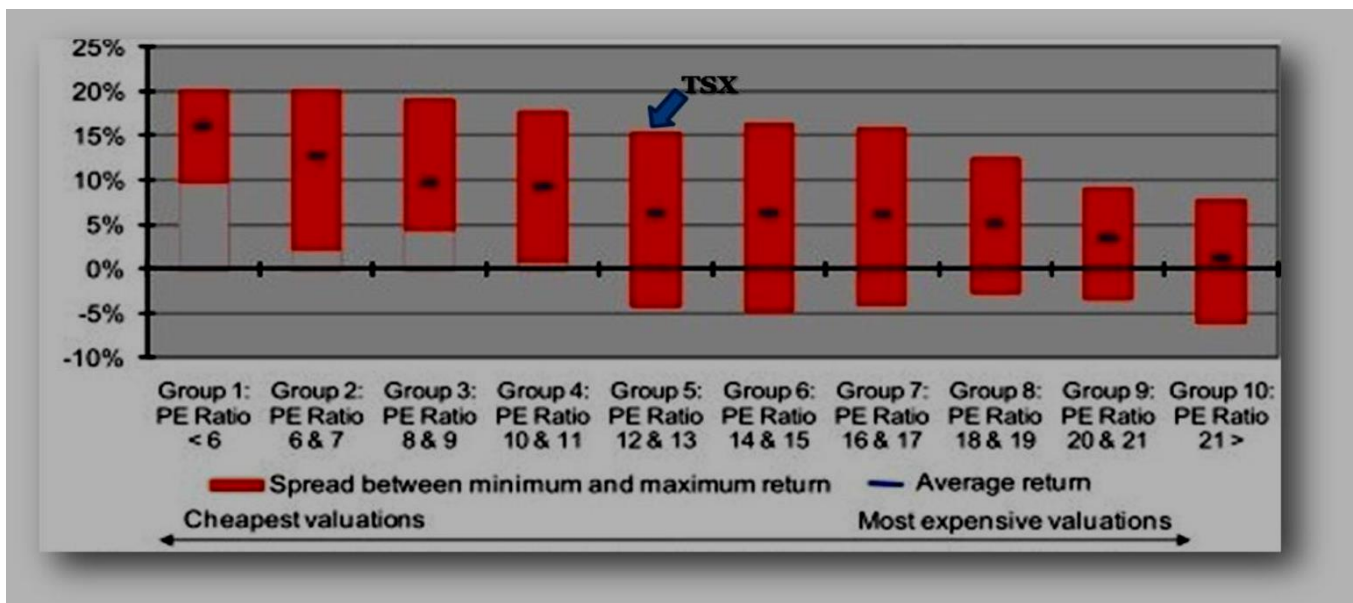


FactSet Research Systems

In January I covered the concepts that dramatic oil price changes lead to (or are at least coincident) global recession. It may simply be a factor of reduced demand for oil indicates a slowing economy and the GDP metrics (two quarters of consecutive contraction) aren't seen until well past the beginning of the price decline. The Federal Reserve Bank of Atlanta produces a series that seeks to incorporate data as it's released to predict the upcoming quarter's GDP. Given current earnings estimates are now **negative for first AND second quarters of 2015** (strong dollar drag and deflation in Europe), it is not difficult to imagine **the current 0% GDP forecast** by the Atlanta Fed, extending into the second quarter. Personally I am not concerned with a formal 'recession' being indicated by GDP contraction, as by the time that is declared the financial markets will have made it quite clear that the current economic and/or market cycles have topped. A short eight weeks ago, this indicator was pointing to +2% growth, but the economic data coming in has pushed this number all the way to 0.



Probably the most important issue out there today is market valuations and what that implies for the future. Until recently, the Forward P/E ratio (the price for a stock per \$1 of **forecast** earnings) was an acceptable 15.7x. History shows us that the price, in terms of P/E ratio, can indicate future average returns. This follows the common sense idea that if one pays a low price for \$1 in earnings, one's total returns over time will be greater than if one pays a high price for \$1 of earnings. "Low" can mean under 10x earnings, and "high" is most often seen to be in excess of 20x earnings. The chart below gives an idea of what has been the forward 10 year average annualized rate of return to stocks when valued on a P/E ratio of under 6 up to greater than 21.



As the previous graph shows, when valuations are in excess of 21x earnings, over the next 10 years one can expect those stocks to return, on average over 10 years, +/- 6% annually. Put another way, returns from stocks at this valuation are expected to be on average, near zero. Since markets never travel in a straight line, I would expect there to be large swings in stock price levels and annual returns. A recent example is the 10 years from 2005 to 2015. January 1, 2005 to January 1, 2015, the SP500 gained 70% in price, which is 5.5% annualized. In 2005, the P/E ratio was just under 20x, and the markets were 19 months from the 2003 low. Market returns into 2007 highs were well in excess of 5.5%, then 2008 occurred and the subsequent 5 years through today. In short, while the average was 5.5% there were some very large bumps along the way. This concept is what investors need to understand going forward.

Oil and Precious Metals

While stocks will probably endure major swings over the coming years, investors must not forget that there are 5 asset classes: stocks, bonds, precious metals, oil, and other commodities. While oil and precious metals can be volatile, their prices are substantially lower than in the recent past, and show some signs that these assets may be a way for investors to shift their focus away from being exclusively stocks and bonds, and to incorporate these asset classes into their portfolios. There are many ways to gain exposure to these areas and must be viewed with a great deal of respect to the potential volatility these assets have displayed.

Both gold and oil are currently priced below the cost of production. That is it costs more to get a barrel of oil out of the ground than one can sell it. Gold has the same issue. When might prices go up and by how much are the questions investors must ask themselves given their own time horizons and goals for their portfolios.

Going forward I expect 2015 to be very volatile, vacillating from fear to relief as this economic and market cycles find their peaks. Investors need to understand their tolerance for volatility, more commonly referred to as risk. Based on their risk tolerance, construct and manage investments with an understanding that the recent past doesn't extend into the future indefinitely and of the possible different outcomes for commodities, stocks, bonds, real estate, oil and precious metals. Investors can seek to protect themselves, position to take advantage of a changing landscape, or simply do nothing with the understanding that future returns from stocks may be much lower than the recent past. For investors who seek to continue to make modest positive returns, they must search out areas outside of equities.

Working with an Investment Advisor who is willing to contemplate various outcomes, seek opportunities with a strong risk/reward relationship, and has a strategy to limit downside exposure can help diversify away from the complacent and Pollyannaish outlook that virtually all of the Wall St. brokers continue to push onto the investing public.

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