Observations and Outlook

January 22, 2015

2014 ended with a marked increase in volatility across several asset classes. While ending with a healthy return for the year, the S&P 500 was *negative* year-to-date on October 15 by 1.2% (excluding dividends) and then climbed some 15% the last 10 weeks of the year. Oil collapsed by near 50%, interest rates dropped throughout the year, and the US dollar has it most significant climb vs other currencies since the summer of 2007. I believe 2015 will continue to see this kind of volatility across asset classes.

Selected Index Returns 2014

Dow Jones Industrials	+10.04%	S&P 500	+13.69%	MSCI Europe	--6.18%
Small Cap US (Russell 2000)	+4.89%	Emerging Mkts	-2.19%	High Yield Bonds	+2.13%
US Aggregate Bond Index	+5.97%	US Treasury 20+Yr	+27.48%	Dow Jones/UBS Commodity	-17%

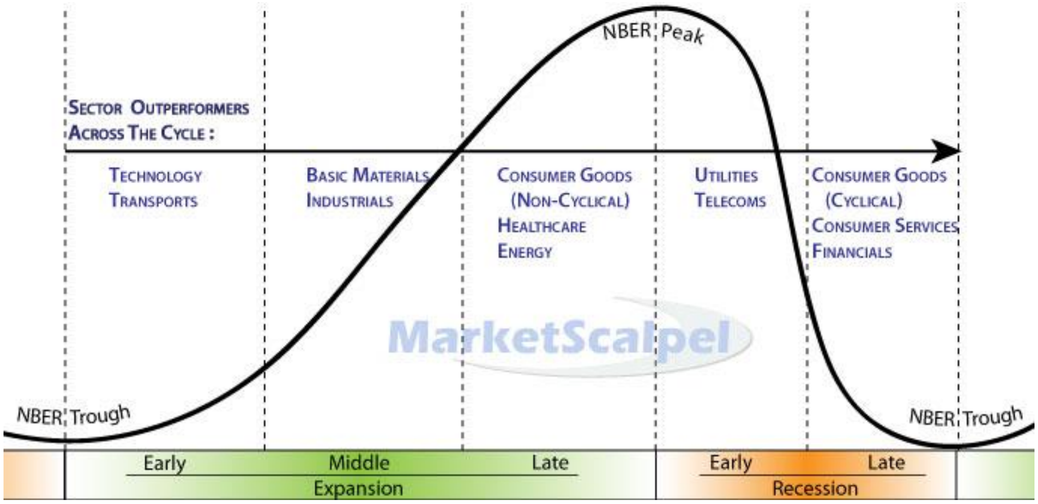
Looking at the returns from last year one can see commodities, high yield bonds, and emerging markets were weak assets while US blue chip indices were the strongest. Adding in that two of three best performing sectors of the S&P500 were, utilities (+28.09%) and healthcare (+25.76), it is clear there has been a change away from the more volatile, "high-beta", areas of the markets towards the more defensive, higher quality areas. This makes a great deal of sense given the length of the current economic expansion, now at almost 5 ½ years. This is a bit longer than past expansions in the post war era. Major areas of the globe, Europe and Japan, are in recession, and China is slowing to its lowest levels since the Crisis in 2008. Additionally the last two times oil has collapsed by 50% the US was entering recession. Given the interwoven nature of global economics and financial markets, the possibility of a recession in the United States beginning in 2015 is legitimate. Contractions follow expansions as sure as night follows day, but few if any of the investment houses would ever admit to, or advise investors to prepare for one.

Oil and Commodity Price Declines

A decline in interest rates, which should be seen as a lessening in demand for capital; a decline in commodity prices which are the raw ingredients of the production of goods; and a touch more supply combined with a decline in demand for oil have created an imbalance that has driven down oil prices by more than 50%, all point to a slowdown in global demand, despite the perpetual efforts of Central Banks to increase the demand for credit by cheapening the cost of capital. Even with historical low interest rates the Banks have failed in creating the desire to borrow and spend/invest.

Business Cycle Investing

A quick look at the chart below and one can notice that three of the five sectors whose stock prices perform best at the peak of an economic cycle, are, indeed, three of the top five performing sectors over the past 15 months: Utilities, Consumer Staples, and Healthcare. Usually, analysts use this chart to decide where to invest given their understanding of where we are in the Business Cycle. I chose to look at it to inform us as to where we are in the Business Cycle using observed sector performance

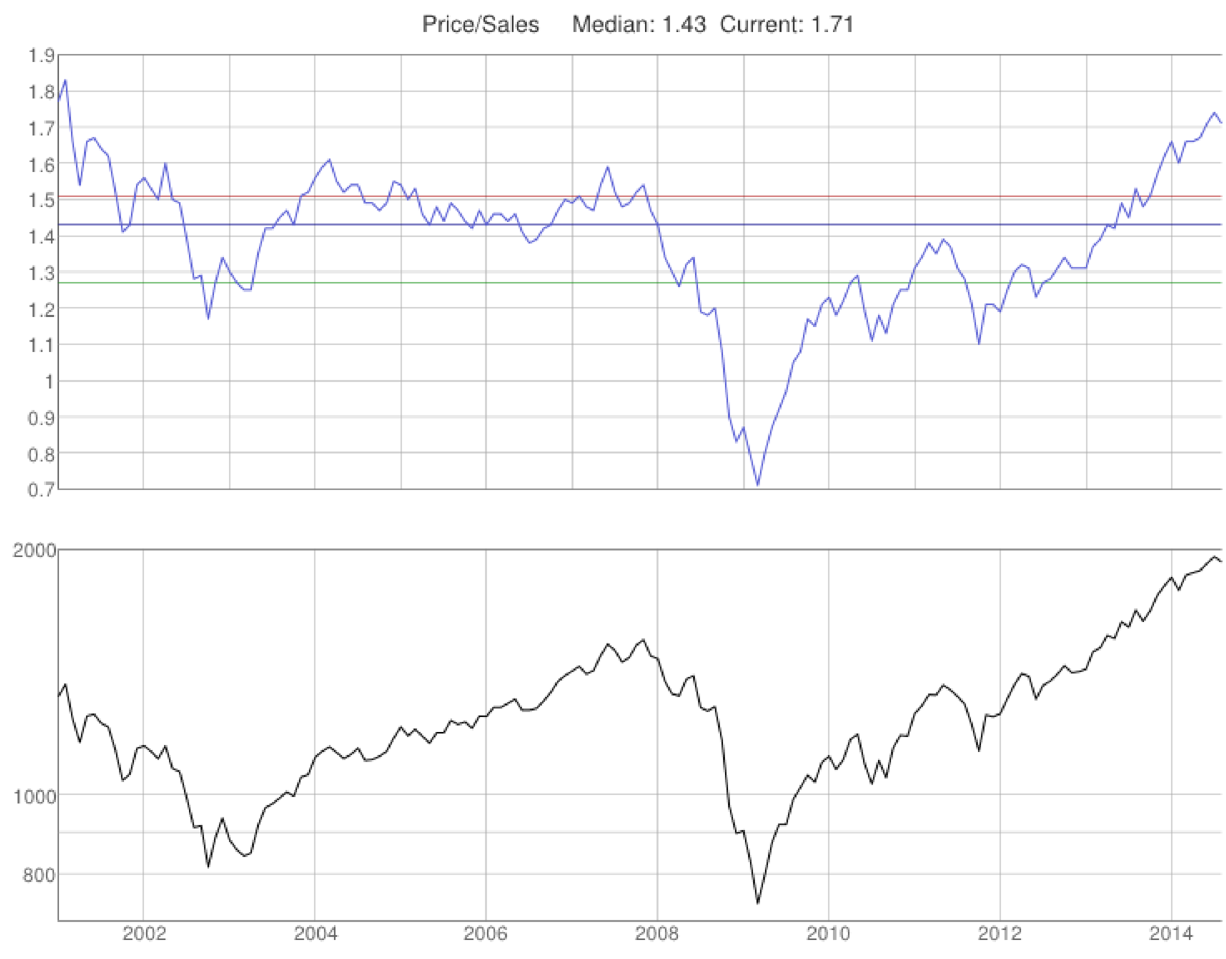


The chart below overlays a global equity index with the U.S. Dollar value of the liquidity central banks have added over the past 5 years. Recently an outsized divergence has occurred, with the supply of liquidity decreasing while equity prices remain elevated. While some may argue correlation is not causation, it is difficult to not give some respect to the impact central bank liquidity has had on equity prices.

With U.S. QE now over, and potential rise in short term interest rates), only Japan is monetizing its budget deficit. The Bank of Japan is buying all the new debt issued to cover the Japanese budget deficit, approximately $735 billion over the next 12 months. The European Central bank announced a *proposal* today for a smaller than expected bond purchase program of $58 billion per month, starting March 2015 and continuing through September 2016. It is important to understand that the *level* of monetary liquidity is not as important as the rate of change. An ever increasing amount of liquidity is required to propel buying at higher prices. As long as the ECB and Bank of Japan continue to monetize debt at ever higher rates, this should bode well for the prices of stocks and keep interest rates low.

We know that Central Bank programs have been a boon for stock prices, have kept interest rates low for corporations, and have made it nearly impossible for savers to get a safe fair rate of return on their savings. What we don't know are the knock-on effects. In very complex systems, like global finance, it is difficult to know where a problem may arise, the 'unknown unknowns' as one former Secretary of Defense described it. There is also a concept called the Law of Diminishing Returns. The more this QE medicine is applied the less effect is has. The period 2009 to 2011 created significant stock returns. These latter efforts have been positive but the percentage gain per $ of liquidity has declined. Thus, the need for *ever-increasing* size of Central Bank interventions, during this period of time described as a "recovery".

While the case for global recession is evident, what might the impact be on equities and bond prices? I believe we are already seeing the effects: stronger relative performance in defensive sectors, and lower interest rates, and lower commodity prices, and greater volatility across all asset classes. From a basic fundamental perspective, there are many metrics indicating stocks are expensive. Below we can see that the S&P500 is as richly valued based on Revenues than in 2000. While very much lower interest rates allow for lower interest expense, the greater leverage allows for positive earnings to be magnified. Leverage is a double edged sword. If sales were to drop (strong US dollar, collapse of fracking, slowing consumer spending) the leverage would amplify the drop in earnings.



Going forward 2015, I expect 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.

Adam Waszkowski, CFA
awaszkowski@naplesam.com
239.410.6555