December 31, 2014

2015 – THE YEAR AHEAD

With 2014 now in the books, U.S. stocks have risen for six consecutive years. Despite the debate about its strength and sustainability, the U.S. economy has continued to expand at a moderate pace. Corporate profits are growing, unemployment is trending lower, inflation remains subdued, and the Fed continues to delay the timing of tightening monetary policy.

It may seem counterintuitive, but the below-trend economic growth since 2009 is actually quite conducive to the sustainability of the uptrend. Typically, economic advances have come to an end when strong growth results in some combination of upward wage pressures, increasing capacity constraints, and rising inflation expectations. Inevitably, the Fed's reaction to such environments has been to fight inflation by taking away the punchbowl – in other words, raising interest rates, thereby tightening credit and restraining future growth or even sending the economy into recession. We do not believe such is the case currently.

Despite many potential sources of risk, we think the coming year holds the promise of positive returns for stocks but mediocre returns for bonds. In *2015 – THE YEAR AHEAD* we lay out this case. We remind you, however, that while we are attempting to forecast the future, our continued investment success will largely depend on our ability to interpret and adjust to trends and events as they occur and as new information becomes available.

The Economy

During 2014, U.S. real (inflation-adjusted) Gross Domestic Product is expected to have grown at a rate of more than 2.5%, which is sub-par for most economic recoveries. We expect growth to increase in 2015 as the U.S. economy finally reaches "escape velocity," becoming strong enough to grow without the benefit of extreme monetary intervention from the Federal Reserve. This would be the best economic performance in a decade and should far exceed that of most major industrialized nations.

In the U.S., the consumer appears ready to assume the lead role. The growth in employment to date has been very sluggish compared to past expansions, but has been picking up in recent months, and initial claims for unemployment insurance have now dropped to levels more typically seen in "normal" expansions. Also, the massive consumer deleveraging that occurred in response to the severity of the last downturn finally seems to be over. Credit card debt and auto loans have again begun to grow, mortgage defaults have diminished, and there has even been some increase in home equity lines of credit. Recent surveys of consumer confidence have shown increasing levels of optimism. Housing starts have also begun to pick up in most parts of the country, and recently hit an annual pace of more than one million for the first time since the last economic peak.

On the corporate side of the equation, industrial production has been rising and factory utilization has returned to more normal levels. Many companies which have deferred capital spending beyond that required by the normal depreciation of plant and equipment, are now gradually beginning to increase spending on infrastructure. The pent-up demand for capital goods and technology equipment should add to overall economic output.

Also, for the first time in several years the government sector is no longer acting as a drag on the economy. Federal sequestration and spending cuts have been a major factor in the slow pace of growth during this cycle. The Federal government remains in cutting mode, but state and local governments have recently begun to increase spending as their coffers fill with rising receipts from income, property, and sales taxes.

While the U.S. economy appears to be in good shape, it does not exist in a vacuum. Economic developments in other countries can affect us to a degree that did not exist in earlier times. Many parts of the world, but particularly Europe, are enduring near-zero economic growth, and previously fast-growing China is seeing what we consider to be a natural slowing of its growth rate. If this situation persists or deteriorates, and the dollar continues to rise, our own growth could be constrained through reduced trade with our partners. For their part, the European Central Bank has promised to embark on its own Quantitative Easing program, and the Chinese government has begun to undertake stimulus measures of its own, so at this stage we do not think that the economic situation overseas will worsen enough to knock our economy off track.

One positive wild card for the economy is much lower oil prices. To nearly everyone's surprise, benchmark crude oil prices plunged from over $100 per barrel in the summer to below $60 by year-end as OPEC decided not to reduce production in the face of waning global demand and rising supply from the U.S. As oil is a cost to many sectors of our economy, lower prices should stimulate further economic growth. It is estimated that the typical family in our country will save more than $1,000 in annual gasoline costs as a result of this drop, which would in aggregate put an extra $125 billion per year into consumers' pockets. While the energy sector will most certainly suffer from the drop in oil prices, the overall effect on the economy should be a significant net positive.

Inflation, Interest Rates, and the Bond Market

In our outlook piece a year ago, we described the battle between the forces of deflation resulting from slowing global growth and the intense reflationary efforts of the world's central bankers. This tug-of-war continues but, in the U.S. at least, the balance may gradually be starting to tip toward inflation. After many months of resting in the 1%-2% range, we think that the core Consumer Price Index (excluding volatile food and energy prices) will move up before year-end 2015.

One of the chief drivers of rising prices would be an uptick in wage inflation, which has been near zero in this economic recovery. Employment is finally growing enough to reduce the official unemployment rate to near 5%, a level at which wage pressures have historically begun to rise. Even with a large number of under-employed workers and the uncounted potential workers who have temporarily withdrawn from the workforce, the current rate of economic growth should be high enough to lead to some wage inflation. Industrial capacity utilization has also been increasing, to its current rate of about 80%, a level at which inflation typically begins to pick up. We expect capacity utilization to rise further as the economy continues to grow.

One big surprise of 2014 was that interest rates on intermediate- and long-maturity bonds actually declined over the course of the year, after a sharp rise in the second half of 2013. This, despite continued economic growth and the steady march towards the day when employment, and inflation, would begin to increase. Economic growth in other parts of the world, especially Europe, was so slow that interest rates and inflation declined abroad, in turn keeping a lid on U.S. inflation and interest rates. The recent oil price drop has resulted in further deflationary pressure for U.S. dollar-based investments.

In 2015, bond market investors will be closely watching inflation rates and the speed and size of Fed funds rate increases. Federal Reserve policy has been extremely accommodative throughout the current recovery. Although the Fed has now ended its program of printing money to buy government bonds directly in the marketplace, monetary policy remains stimulative, as the short-term interest rates controlled by the Fed remain essentially at zero. We believe that with employment growing and core inflation showing signs of rising, the Fed will have the opportunity in the second half of 2015 to raise interest rates to some degree. However, any increases will be gradual and small, intended not to restrict economic growth, but to send a message of policy "normalization" from artificially low levels in an improving economy.

However, if investors think that inflation is moving up faster than the Fed's response to it, then they will start to demand higher rates of return as compensation, especially for longer-maturity bonds. We believe the Fed would rather deal with inflation than with the renewed risk of recession. Thus, if inflation does pick up meaningfully, we would expect to see a bigger reaction in longer-term bonds, whose rates are not controlled directly by the Fed. It is possible the 10-year Treasury note could see yields exceed 3% from the current low-2% range.

In an environment where bond rates start to rise, we believe it is important to limit investments to bonds of short and intermediate maturities. These will be less at risk of their prices falling meaningfully in a rising rate environment. Furthermore, using a "laddered" approach whereby maturities occur regularly over the next several years means that money will become available to reinvest at times when higher rates are likely available, whatever the speed of the Fed's rate increases. We also continually research special situations as appropriate to safely pick up additional yield.

The Stock Market

The current bull market in stocks will be six years old this coming March, but we think it still has the potential to endure. Its primary driver will be continued economic and earnings growth which, as we have noted, should not falter during 2015. However, with valuations no longer a bargain, we are expecting that stock-market returns may be less than in the past several years, and accompanied by greater volatility.

If the U.S. economy does grow at 3%, adjusted for inflation, this should allow U.S. corporate earnings to continue to rise. Much of the earnings growth that companies generated over the last several years came from cost control and thus rising profit margins, but 2015 may finally start to see commensurate revenue growth, which is a more sustainable source of earning increases. As noted, consumer spending should improve and we expect that a capital spending cycle will finally start to kick in. Because the U.S. clearly remains the "best house on the block" economically, the U.S. stock market should also appear relatively more attractive to many investors around the world, particularly as the dollar is likely to remain strong against the currencies of weaker economies.

One concern of many investors is the ongoing increase in the ratio of stock prices to underlying earnings, i.e. the P/E ratio. In the long run, stock prices grow at the same rate as underlying earnings. But during this recovery, stock prices have grown faster than earnings, and the P/E ratio of the overall market has crept up to around 16 times forward earnings. While the highest level so far in this recovery, this is still well within the range of valuations over typical market cycles, particularly during times of low interest rates (which make future earnings more valuable today). That said, we do not expect valuations to increase substantially from today's levels, meaning that future stock-price growth will increasingly have to be linked to earnings growth.

Higher valuations could also make the stock market more vulnerable to increased volatility and possible corrections along the way, as there is less room for error in investor estimations of the worth of the companies in which they invest. Since there has not been a correction in the major market indices of even 10% since mid-2012, we think one is overdue, although we also said this a year ago. Periodic, moderate corrections are healthy for a longer-term sustained bull market in that they restore value, keep investor expectations realistic, encourage more critical thinking about the prospects for companies, and remind all participants that volatility is a normal aspect of investing in stocks.

Stock market investors will be watching the actions of the Federal Reserve Board, just as their bond market counterparts do. The primary concern will be whether or not the Fed moves too fast on rate increases, in the process slowing economic and earnings growth. The reality of a rate increase may cause a negative knee-jerk reaction in stocks. However, as long as interest rate increases are gradual and small, and do not seem to be occurring ahead of underlying growth, the first few increases should not derail the bull market.

An additional source of return for stock investors, beyond the stock-price appreciation that comes with growth in earnings, is the dividend yield on stocks. In the subpar-growth environment of the current recovery, companies have been cautious with all forms of spending, including dividends. Thus, dividends have not grown as fast as earnings. Our expectation is that dividend growth will better keep pace with earnings growth going forward, at least for companies with strong balance sheets, so dividend yield could become a greater part of the total return from stocks in 2015.

Those who follow cycles, particularly presidential election cycles, should note that the third year of a U.S. president's term is historically the best one for the stock market. On the heels of an already-long bull market, that feat may be difficult to pull off this time, but third year returns have been positive 75% of the time since 1900. Perhaps there will finally be some bipartisan support for measures that help the economy, which is cited as one of the reasons the third year typically does so well. The political landscape of a Democratic White House and a Republican Congress, which will exist for the next two years, has also historically been very good for stock prices. Finally, for what it's worth, years that end in "5" seem to be good for stocks to an extent that is out of proportion to random chance.

Within the stock market, there is likely to be a disparity of returns among industry sectors. Although the consumer will likely increase spending, the stocks of many consumer products companies have already appreciated a great deal. As such, we find it difficult to uncover much value in that sector. Conversely, the stocks of many technology companies do not yet appear to reflect fully the increase in capital spending that has to begin to take place, and we like exposure to this sector. Industrial companies should also be helped by increased capital spending, but the exposure of many to relatively weak international end markets may hold back their growth somewhat, particularly if the dollar gets even stronger.

Healthcare has been a great area of the stock market in which to invest as our aging demographic profile has coincided with the increased utilization of health care resulting from the Affordable Care Act. We are still finding opportunities here, although more selectively than previously. Financial stocks are gradually beginning to benefit from the rebuilding of the U.S. financial system and increased consumer spending and borrowing. This sector should also do well.

Energy stocks are an interesting contrarian play. If low oil prices persist, the earnings of most of these companies will suffer; however, the steep drop in stock prices in 2014 appears to discount much of this effect. We are unsure of the timing, but the cure for low oil prices is actually low oil prices, since the result is a reduction in supply along with an increase in demand. Staying with the highest-quality companies will be important as many of the weaker energy players may be seriously damaged. Finally, interest-sensitive areas such as utilities and REITs could be at risk of underperformance if interest rates begin a more sustained rise.

Conclusion

Putting everything in our view together, the U.S. economy should continue to grow. Employment is finally picking up, supporting consumer spending, and rising business confidence should foster increased capital investment.

Federal Reserve policy will remain supportive of growth, although it will likely begin to become slightly less expansionary as the economy moves closer to full employment. 2015 should be the year when the Fed funds rate finally moves above zero. Longer-term interest rates should also begin to move upward, keeping us cautious regarding the average maturity of the bonds in our clients' portfolios.

Economic growth and Fed policy should provide sufficient support for a continued bull market in stocks. While the speed of economic growth going forward is subject to debate and Federal Reserve policy bears watching, corporate earnings growth should drive continued stock-price increases. The rising valuations that have added to returns in recent years will likely play a reduced role in returns in 2015. Dividend growth, however, should increasingly add to overall returns, at least among the stronger companies.

We recognize that all is not well in the world. Global economic growth remains below trend, geopolitical concerns are a constant menace, the recent plunge in oil prices is disruptive, and income inequality is increasingly becoming a more serious problem. But in the coming year, none of those factors are likely to rise to a level that will meaningfully impact U.S. growth, or serve to derail the ongoing uptrend in U.S. stock prices.

It is also worth reminding ourselves that in today's world, with the Internet and smartphones enabling unfettered access to real-time information about every investment imaginable, it is easy to be bombarded with inputs that focus on short-term factors and the volatility present in financial markets. We continue to believe that successful investing rests on a longer-term perspective, one which looks beyond the day-to-day noise that often impairs, rather than improves, investment decision making.

As we enter our 26th year, we would like to express our gratitude for all of our clients and friends of the firm. It is a pleasure to work with you, and we wish you all peace, joy, health, and prosperity in this New Year and for many years to come.