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Market Commentary

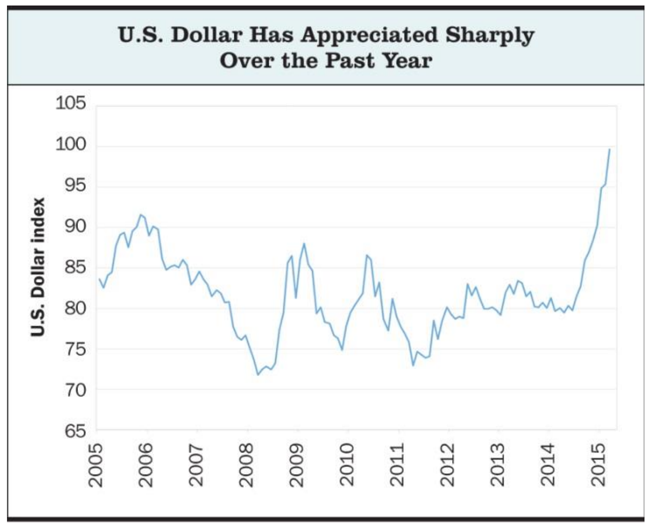
Spring 2015

Q1 Key Takeaways

- International stocks led in the first quarter with Europe, Japan, and China posting especially strong gains. U.S. stocks were also positive, with smaller caps outpacing larger caps, and growth beating value. Some of the quarter's big-picture themes included global central bank policy, the strength (or lack thereof) in economic growth, U.S. dollar dominance, and the ongoing decline in oil prices. In emerging markets, China's growth continued to slow even as the government undertook monetary stimulus measures including changing reserve requirements and cutting rates.
- The U.S. economy appears to be in pretty good shape and on a positive uptrend. However, various forces have clouded the economic picture at least over the near-term. Some of these forces are temporary (e.g., harsh weather in the Northeast), but others, such as the rising U.S. dollar and the decline in oil prices, could have spillover effects on the broader economy.
- The stronger dollar is dampening export growth and has already prompted a spate of downward earnings and revenue estimates. And, while the decline in oil prices is a positive for U.S. consumers, it will weigh heavily on energy companies, their earnings, and their willingness to spend on new projects and hire additional workers.
- All of these issues complicate the outlook for U.S. economic growth and are among the factors that the U.S. Federal Reserve has to weigh as it contemplates raising interest rates. The Fed's March statement took the much-watched step of removing the word "patient" from the official text, yet Chair Janet Yellen continues to suggest the Fed will exercise exactly that quality as it moves toward its first rate increase and considers the pace of subsequent hikes. Markets appeared to take the Fed's update to mean rates would remain low, potentially into the fall.
- Meanwhile, other major central banks are expanding their support, with Japan in stimulus mode and the European Central Bank the latest entrant to the mix. The ECB announced a quantitative easing program in January and launched its bond buying in early March.
- On the fixed-income front, with a pronounced lack of competition from other developed-market bonds, U.S. Treasurys continued to hold their value with the 10-year yield below 2%. This factor, along with investors' sense that the Fed might be slower to scale back its accommodation, helped government bonds to their fifth consecutive quarterly gain. Investors' search for yield has helped support returns for both investment-grade and high-yield corporate bonds as well.

Q1 Investment Commentary

The strength of the dollar is a significant force affecting the economic landscape. The dollar has appreciated 23% over the past 12 months. Moreover, based on the concept of purchasing power parity (PPP), the dollar now looks to have overshot its longer-term fundamental value relative to the basket of other major currencies in the dollar index. The converse is true as well—other currencies have undershot their fair value versus the dollar. However, despite the calls for a peak in the dollar, we feel that as long as the Fed considers increasing interest rates (a move that would strengthen the dollar) and the rest of the world continues with its quantitative easing programs (a move that weakens its currency), it is hard to see a weakening dollar.



There are several cross currents from the rise in the dollar in terms of its impact on both the real economy and financial markets. On the positive side, a strengthening dollar reduces the cost of imported goods and is also associated with falling oil and commodity prices that are priced in dollars on the global market. This will tend to depress domestic inflation—a positive result unless an economy is at risk of a deflationary spiral, which the United States is not. All in all, these things benefit U.S. consumers, increasing their purchasing power and leaving them more money available for spending (or saving). A stronger dollar also tends to attract more foreign investment. To the extent this foreign capital flows into U.S. Treasury bonds or corporate debt, it helps keep interest rates lower, and it may also support higher U.S. stock prices. All of these factors are reasons why investors cite the stronger dollar as another reason for optimism about U.S. stocks. However, a dollar that is too strong is not necessarily good for U.S. stocks, as investors start to weigh the negative impacts more heavily. So far this year, the daily correlation between the dollar and U.S. stocks has been negative.

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On the negative side, a stronger dollar has a negative impact on U.S. exports, U.S. manufacturers, and U.S. multinational company profits. And by also making imported goods more attractive it typically leads to a worsening of our trade deficit. This has a negative effect on overall economic growth, because GDP is defined as the sum of consumer spending, investment spending, government spending, and net exports. Also, from a dollar-based investor's perspective, a rising U.S. dollar hurts foreign asset class returns as they are translated back into dollars from weaker currencies. All of these impacts are reversed for the investors, consumers, and economies whose currencies are depreciating versus the dollar.

Market Outlook

U.S. Stocks— We continue to expect markets to move higher in 2015, albeit at a slower pace than 2014, as earnings continue to climb on a calendar year basis. Earnings for the S&P 500 took a step back in the first quarter, down 3%, but the drop was primarily due to the energy stocks where falling oil prices over the past nine months have reduced profits in that sector by over 60%. Still, for the full year, S&P earnings are expected to rise between 5%-9% with 8% gains forecasted for 2016. If declines in other sectors were material, we would be more concerned, but this does not appear to be the case. Increasing headwinds, such as the aforementioned stronger U.S. dollar and reduced earnings estimates, require us to be ever vigilant and pay particular attention to market valuations. To put current equity valuation in perspective, the S&P 500 stock index is currently trading at 15.9 times its estimated 2016 consensus earnings per share. By comparison, the median multiple for the index over the past 20 years has been 15.6 times its estimated consensus earnings.

Fixed Income Markets— The bond markets' momentum continued into 2015 as interest rates continued to decline. The 10-year U.S. Treasury started the year at 2.17% and is around 1.90% near the end of April. Credit market fundamentals are strong, however and yields on bonds imply low returns over the next year. There is no refuge to be found looking to core bond markets outside the United States either. In Europe, the comparable index has a yield of only 0.5% and almost a third of European government bonds actually have a negative yield-to-maturity, meaning investors who hold these bonds to maturity are locking in a certain loss.

Summary

The trends of higher stock prices and lower yields continued into 2015 and while we expect the market to rise further by year end, we do expect interest rates to pick up alongside a growing economy. It should be noted, however, that any initial interest rate increases by the Federal Reserve are expected to be minimal and very gradual. The consensus belief is that the initial interest rate increase will be to move the federal funds rate from a target of 0.00% - 0.25% to a new range of 0.25% to 0.50%, not likely to have a meaningful impact on the economy. 2015 appears to have many more variables at play compared to 2014, such as increasing volatility, that introduces a little more uncertainty in our forecasts. However, the U.S. is still a growing economy and combined with a turnaround in the international markets, could lead to another solid year for equity markets. As always, we will continue to make every effort to monitor the economy and markets, and manage out portfolios in our opportunistic yet prudent approach.

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