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Market Commentary

Winter 2015

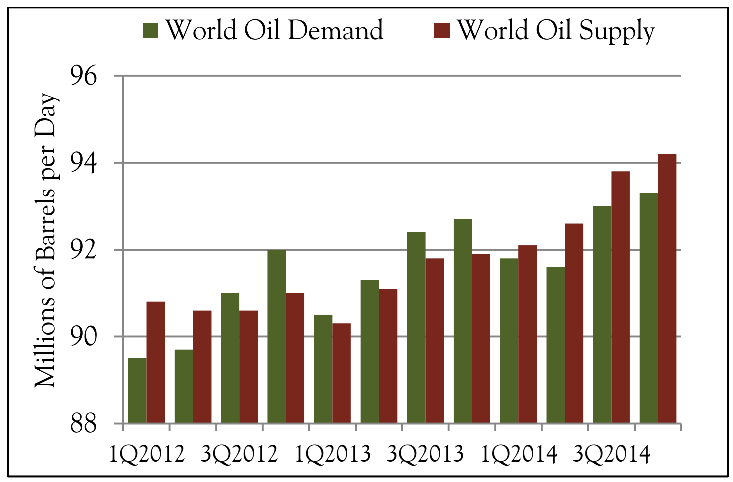
Q4 Key Takeaways

- **As the year drew to a close, a handful of big-picture issues dominated the investment landscape:** the plunging price of oil, positive economic indicators in the United States relative to most of the globe, and the ongoing influence of central banks (a key effect of which has been to bolster stocks and other risk assets).
- **Large-cap U.S. stocks continued their unusually strong and unbroken stretch of gains.** The S&P 500 rose 14% and avoided even a modest 10% "correction" for the third year in a row.
- **Most other major stock markets fared poorly in 2014. Developed international stocks lost 5% and emerging-markets stocks dropped 2%.** These returns reflect the significant headwind presented by the strengthening U.S. dollar. Again, relative to history, we have seen an unusually strong stretch of U.S. outperformance relative to foreign markets.
- **Contrary to the consensus, the 10-year U.S. Treasury yield declined further and bond prices rose.** The core investment-grade bond index was up nearly 6% for the year and municipal bonds also fared well. Credit-sensitive sectors such as high-yield and floating-rate loans lagged.
- **In terms of the investment environment, the U.S. economy looks to be in good shape over the near term.** Fed monetary policy remains accommodative and we would be surprised if it shocks the economy or markets with an unexpectedly strong interest-rate hike.
- **Our view is that Europe offers attractive return potential, reflecting the fact that we believe earnings are temporarily depressed, while valuations are reasonably attractive.** However, we are not increasing our allocation to European or developed international stocks because we believe the deflation or stagnation risk in Europe is not yet adequately priced in. One exception to this is dividend stocks hedged in U.S. dollars.
- **Similarly, we remain optimistic about emerging markets' long-term fundamentals and believe they are likely to perform well over our five-year investment horizon,** but have held off on increasing our exposure based on potential shorter-term downside risks and volatility.
- **On the fixed-income side, we think higher rates are likely over our multiyear investment horizon, although the timing and magnitude are uncertain.**

Q4 Investment Commentary

As the year drew to a close, a handful of big-picture issues dominated the investment landscape: the plunging price of oil, positive economic indicators in the U.S. relative to most of the globe, and the ongoing influence of central banks (a key effect of which has been to bolster stocks and other risk assets). In the financial markets, the year saw strong gains for U.S. large-cap stocks and core bonds with lagging performance elsewhere.

Looking at the investment environment, oil prices hit five-and-a-half-year lows in late December (falling 40% in the fourth quarter alone) as new sources of supply met with potentially slowing global demand. While a decline in oil prices is typically viewed as an unambiguously positive development for the global economy, the result this time around is different because of the rapidity of the plunge and the current fragile global economic environment. With deflation concerns already high in Europe in particular, the oil price decline was seen as intensifying the deflationary risks.



It is interesting to note above, oil production began to exceed demand in early 2014 and the differential should not be enough to cause this magnitude of a price decline. Fears of European deflation may be overdone and selected energy companies are attractive.

One offsetting factor that helped the markets regain their footing in the fourth quarter (as it has many times in the post-financial-crisis period) was the ongoing influence of central banks. Even as the Federal Reserve suggests it is on track to begin raising rates in the face of U.S. economic improvement, it once again soothed markets by reaffirming that it would continue to be patient in shifting its stance. Given the poor economic conditions that persist in Europe, investors continue to expect the European Central Bank to take a more meaningful step toward full quantitative easing (i.e., purchasing bonds and other assets with the aim of stimulating the economy).

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Central banks in Japan and China expanded their simulative policy efforts over 2014. The takeaway is that even as the Fed may begin scaling back its support, there appears to be no shortage of supportive monetary policy globally. At the same time, the fact that central banks continue to undertake (or contemplate) aggressive action provides a reminder of the broader economic risks we continue to navigate.

Our Asset Class Views Looking Ahead

U.S. Stocks

In terms of the investment environment, the U.S. economy looks to be in pretty good shape for the near term. There are several positives: the labor market continues to strengthen, inflation remains subdued, manufacturing indexes and other leading economic indicators are consistent with solid GDP growth, falling oil prices should boost consumer spending, and government fiscal policy is likely to become more of a growth tailwind than a headwind as the impact of past budget cuts rolls off.

Fed monetary policy remains something of a wild card, but based on the Fed's words and actions, we would be surprised if it shocks the economy or markets with an unexpectedly strong interest-rate hike.

Looking at the dichotomy between the strong U.S. equity markets and weakness in most other major stock indices, clients are asking why this is happening and what does this mean for Northern Oak's Investment Policy. The main difference explaining the different market returns has been the strength of the U.S. economy relative to the global markets. The U.S. economy continues to gain traction despite the end of the Federal Reserve's quantitative easing program in October of last year. Fourth quarter GDP (preliminary) was up an estimated 5.0% which should bring overall 2014 GDP growth to 2.8%. The Federal Reserve continues to be accommodative and employment improvement continues.

We expect large-cap U.S. stocks to continue to do well, both absolutely and relatively. The S&P 500 composite earnings have shown solid growth in recent years and were up 9.0% in 2014. Estimated growth in 2015 and 2016 are in the 7.0% range. At current prices, the S&P Index is trading at 16.2 times this year's estimated earnings compared with a median multiple of 15.6 times estimated earnings over the last 25 years, a slight premium.

As always, the wise view of the market is to look at the long-term. The following table shows that time is on one's side when it comes to investing in the market.

The Stock Market's Positive Returns: 1871-2014

	5-year	10-year	15-year	20-year	30-year
Stocks	15.8%	8.5%	5.2%	10.2%	11.3%
Updated Equity Data	5-year	10-year	15-year	20-year	30-year
Best	27.0%	19.0%	17.8%	16.9%	13.8%
25th Percentile	14.9	13.2	12.0	11.6	10.8
Median	9.5	8.6	8.4	8.2	9.6
75th Percentile	3.3	5.4	6.1	6.7	6.9
Worst	-15.6	-2.1	0.2	2.8	4.1
	5-year	10-year	15-year	20-year	30-year
Number of times negative	16	4	0	0	0
Number of times total	139	134	129	124	114

Note: Data as of 12/31/14. The 25th, Median, and 75th numbers are break points for the returns and not specific years. Source: Wisdom Tree Asset Management

Since 1871 thru 2014, the market has never experienced a loss in rolling 15-year periods and only infrequent, minor losses in 10-year rolling periods. Given that we have just come out of a decade of negative returns (2000-2009), we believe the odds of solid market returns going forward are in our favor.

European Stocks

In contrast to the United States, the Eurozone (ex-U.K.) continues to fight deflationary headwinds. The December year-over-year headline inflation number fell to negative 0.2%, real GDP growth is below 1%, and two-year government bond yields in Germany and France are actually negative, meaning investors are paying the government for the privilege of owning these bonds. Our view is that in Europe we are getting below-trend or below-normal earnings at average to below-average prices. But we are not increasing our weighting to European or developed international stocks relative to our strategic weighting because we believe the deflation or stagnation risk in Europe is not yet adequately priced in.

Emerging-Markets Stocks

There is a lot of negative news surrounding emerging-markets stocks—such as slowing growth in China and other BRICs and the decline in emerging-markets currencies. Nevertheless, we remain optimistic about emerging markets' long-term fundamentals and believe they are likely to perform well over our five-year investment horizon. However, we are conscious of the shorter-term downside risk and volatility they pose.

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Investment-Grade Bonds

From an asset class perspective, we believe investment-grade bonds are likely to generate very low single-digit annualized returns over our five-year investment horizon, which incorporates a range of economic scenarios. Our very low return estimates are explained by the low current yields and our expectations that interest rates will move higher over our time frame, although the timing and magnitude are of course uncertain. Still, bonds serve to protect our client's portfolio in down markets.

In Conclusion

The U.S. economy is improving against a global headwind of slower growth and deflationary concerns. While 2015 may not be as calm as 2014 was, we do believe that increased volatility will give U.S. opportunities in the market. And finally, while we do expect gains in 2015 due to strong expected EPS growth, we feel these gains will not be as strong as 2014 due to the risks that are pervasive outside the United States.