2015 INVESTMENT OUTLOOK

The year just ended marks the third consecutive year in which the broad stock market, as measured by the S&P 500, earned a total return in the vicinity of 15%, a figure notably above the historical long term trend of 10%. These gains extend the stock market's winning streak to six years in a row coming off the severe bear market of 2008 when stocks retreated 37.0%. The excellent returns in 2014 exceeded this firm's more modest expectations at the beginning of the year and encouraged a majority of investors to move out on the risk curve which pushed stock prices into all-time record territory as the year ended. Valuations as determined by price earnings ratios rose faster than S&P 500 earnings which gained some 6-7%.

A combination of factors account for the strong 2014 showing. Foremost is the reality that the United States economy is outpacing other world regions. This has produced a strong dollar and a flow of investment capital into the United States in both stock and bond markets. While U.S. growth is not robust by historical standards, the full year real progress in the area of 2.5% is relatively strong and exceeds growth in Europe which again verges on recession. The emerging economies of Brazil, Russia, India, and China made progress in the aggregate despite no growth in Brazil, a fourth quarter decline in Russia and meaningful slowdowns in both China and India. Japan, the fourth largest global economy, remains in recession mode despite a new round of monetary stimulus. A second notable factor has been the continuing easy money policy of the Federal Reserve Bank which has held short term bank lending rates close to zero for six years. The Fed reduced and then halted its third quantitative easing program of open market bond buying in the fall without impacting rates, a feat cheered by the capital markets.

A third and totally unexpected development was the sharp 50% drop in world oil prices between June and year end. This puts billions of additional dollars into consumer pockets, and favors the U.S. which, despite increased domestic production, remains a major importer of oil and finished consumer products. Lower oil prices also helped keep the lid on inflation (roughly 1.7% average for the year as measured by the Consumer Price Index) which also boosts price earnings ratios. Finally, some would argue that the mid-year elections which notably favored the Republican Party are constructive for the business outlook but, as with all things political, this remains to be seen.

Countering but not offsetting these positives were a number of troubling geo-political developments. Russia's annexation of Crimea and ongoing military intervention in Eastern Ukraine remain at the top of the list. The rise and expansion of the terrorist ISIS movement in the very troubled Syria and Iraq geography, unabated conflict between Israel and the Palestinians, and the challenges posed by fanatical terror groups seizing territory in many regions (Nigeria, Yemen, Afghanistan, and Sahara Africa) should not be discounted. Lower oil prices also pressure many oil producing sovereign governments which depend on oil revenues and hence stability becomes an issue. The slowdown in China, the world's second largest economy with a GDP approaching $9 trillion (compared with $17 plus trillion U.S.) is notable and real growth this year may be closer to 7%, a figure well off the 10% trend level of many years. An overbuilt housing industry propped up with easy money is a principal culprit and is responsible for a sharp fall in China's demand for basic commodities and other infrastructure goods.

The strength of the U.S. stock market in the year just ended becomes even more dramatic when compared with the MSCI All Country World Index, ex-USA, which ended in negative territory on a U.S. dollar basis and which conventional market wisdom and asset allocation models strongly favored in recent years.

2014 Equity Market Returns (excluding income)

	12/31/14 Price	Y/Y % Change
Dow 30 Industrials	17,823	+7.5%
S&P 500	2,059	+11.1%
NASDAQ Composite	4,735	+13.4%
MSCI All Country World Index ex-USA	263	-6.3%

Near and Intermediate Term Outlook

The broad economic framework for 2015 appears generally constructive although global growth expectations have been ratcheted down in recent months. Progress in the U.S. continues at the satisfactory but uninspiring rate of perhaps 2.5%, a relatively strong figure as compared with many other countries. Consumer spending, accounting for roughly two thirds of the economy, is being stimulated by the abrupt drop in oil prices, and consumer confidence is rising. Housing continues to recover at an uneven pace while capital spending is not as strong as it should be five plus years into a recovery cycle. The lack of a consistent and coherent federal tax policy and burdensome regulation has a lot to do with businesses tempering their expansion plans despite having cash on hand to do so. The country's net export position continues to improve and selective inventories are being rebuilt.

One area to be watched for negative fall-out from the slide in oil prices is the broadly defined energy sector. Profits will be down from 2014 levels and employment, materials purchased, and auxiliary services will also be diminished. The shale oil fracking industry will be notably impacted if prices continue for long at current levels and credit defaults and selected bankruptcies given financial leverage in the fracking industry should also be anticipated. Oil, a commodity, will always be subject to the laws of supply and demand. Demand has been less robust than anticipated and supply has grown reflecting new U.S. fracking production and the decision by OPEC to maintain full levels of production. Best estimates are that there is a global surplus of approximately two million barrels per day between production in the 93 million barrels per day area and demand in the 91 million barrels per day area. No one can predict when and for what specific reasons the gap will close but it will in due course and today's surplus and weak price structure should be viewed as a temporary phenomenon and not a permanent shift.

The issues challenging foreign economies in 2014 will continue in the New Year. Europe will have to deal with financial and political strains in weak Eurozone countries such as Greece. Russia will be in hard recession mode adding to Europe's existing problems, and China could very well report growth under last year's rate given the challenges of its overbuilt housing industry and the growing yet unreported volume of questionable credits and bank loans throughout its financial system. The aging population, falling savings rate, and export driven nature of the Japanese economy are likely to prevent meaningful growth there. Japan, however, has a positive net foreign asset position (it owns more foreign assets than foreigners own domestic assets) due to earlier years of prosperity and hence can carry on for some time with little economic growth.

The timing, extent, and impact of the Federal Reserve Bank's moving away from easy money will be a notably important driver of investor and capital market sentiment. The Fed's twin mandates of appropriate unemployment and inflation rates are essentially met although oil price weakness is keeping the inflation rate lower than it would otherwise be. This being said, and absent an unexpected setback, odds are good that short rates will rise by 50 or perhaps 75 basis points by year end. One question is whether a rise in short rates will translate into a parallel shift across the yield curve or if longer dated maturities will stay more or less anchored. Our judgment is that the yield curve will flatten but remain positively sloped.

Rising interest rates or a return to anything close to a normal yield curve would put downward pressure on stock valuations and price earnings ratios. With higher interest rates many investors will properly choose bonds over stocks where income returns and price stability exceed that of common stocks as has been the case for most of the past seventy years. The $1.3 trillion high yield or junk bond market which performed poorly in 2014 would come under additional pressure in a higher interest rate environment as many weak business models have been built on low cost money and could fail. As noted above, a number of energy companies in the oil fracking business appear to fall into this category. There also remains the unknown of what poor and leveraged bets hedge funds have made that may come asunder given a rise in interest rates or other unanticipated events. Wall Street alchemists continue to construct complex financial vehicles which are too often beyond the scope and understanding of oversight and regulatory bodies. This was the genesis of the 2008-2009 recession and financial meltdown and remains an independent risk above and beyond the interest rate issue.

One exceptional market sector in 2014 was the high tech startup company arena. According to Dow Jones Venture Source there have been some 40 start-ups valued at $1 billion or more this year. A start up is defined as a young private company with venture capital backing and which is valued at the price private investors are willing to pay on a pre-initial public offering price. Uber, a car livery service, for example was recently valued at $40 billion or some 12x what other investors had paid a year earlier. WhatsApp, another example, was acquired for $19 billion in January by Facebook and posted a $230 million loss on $15 million in revenues in the first six month of 2014. Both valuations are excessive and unlikely to be sustained in our opinion. Independent observers note that investors are pouring money into startups based on momentum rather than fundamentals, always a risky business. This is precisely what happened in the dot com bubble in late 1999 and early 2000 and history may very well be repeating itself. An abrupt change of sentiment in this highly overvalued sector could have a far reaching effect on the broad market.

That status of national politics and policymaking is also worthy of comment as the year begins. The newly Republican controlled Senate and House of Representatives is in a position to block any legislation or major appointments sought by the White House. It is also in a position, however, to work on a bipartisan basis to address the serious issues of our times. These include immigration, real tax reform, education, health care and national security. A moment of progress was achieved in the final weeks of last year when a coalition of Republicans and Democrats cobbled together an imperfect spending bill which the President signed to fund the government through its September 30th fiscal year end. In good measure President Obama's legacy will hinge on his ability to lead official Washington and find common ground and compromise for the good of the nation. A retreat into rigid ideology by either the White House or Congress, as has occurred all too often in recent years and which prevents critical issues from being addressed, could be harmful to the legacy and be an additional burden on the capital markets.

Investment Conclusions

It will come as no surprise to our readers that this firm perceives stronger headwinds and lighter tailwinds for the capital markets in the New Year and that investors in both stocks and bonds would be well served to focus on preservation of capital. Common stocks that have reached record levels and have become very fully priced in the exceptional rally of recent years are candidates for prudent profit taking and trimming, despite expectations of mid single digit earnings growth for S&P 500 companies. Simultaneously new stock purchases should be made selectively and only when there is a margin of safety in the initial purchase price. Stock market sentiment, like our New England weather, changes very quickly and the exhilarating breeze of late 2014 could turn to clouds and inclement weather on very short notice.

Caution is also warranted in the bond market given the prospect of rising interest rates as the Fed's six plus year experiment with easy money comes to an end. Quality should be uppermost in investors' minds as risking permanent capital in bonds is generally a loser's game. We are comfortable maintaining high quality short term bond portfolios and a somewhat larger than normal cash position until the yield curve presents opportunities that are likely to come along. At some point in the New Year there should be opportunities to begin the orderly process of rebuilding permanent bond ladders. Patience and selectivity are likely to be the key ingredients for sound results in 2015.

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