2015 SPRING INVESTMENT OUTLOOK

Many of the trends in place toward the end of last year have persisted in the opening months of 2015. The U.S. economy continues to expand at a subdued pace which has led to ongoing, modest improvement in the job market. Growth in corporate profits is expected again in 2015 although still at only a mid-single digit rate and likely below the rate of increase experienced in 2014. Nevertheless, the underlying fundamental picture in the United States continues to outshine that of many other parts of the world which has resulted in the U.S. dollar extending its gains versus many other currencies, most notably the Euro, the Yen and those of several emerging market economies. As displayed in the chart below, the ongoing U.S. expansion has also allowed most major stock market indices to enjoy modest improvement year to date, with both the Dow Jones Industrial Average and the broader market S&P 500 each achieving record high levels earlier this month.

Interest rates remain low throughout much of the world which has also contributed to the continued rise in stock prices. Central banks in most developed countries continue to oversee easy money policies as a way to help reduce burdens on borrowers and stimulate demand to reenergize economic growth. One notable change to this picture is that the U.S. central bank, the Federal Reserve, is expected to begin to raise interest rates later this year as it views a slightly tighter stance appropriate given the economic improvement that has occurred in this country since the current policy was adopted in December 2008. This stands in stark contrast to the central banks in Europe, Japan and China which all recently eased policy given the challenges still facing those economies. In these countries it is clear that additional remedies, including structural and regulatory reforms, will need to augment monetary policy in order to ease debt problems and restore economic growth. Given the extreme measures Federal Reserve officials have taken in recent years, the job of returning interest rates to more normalized levels in this country may prove challenging with unintended consequences both here and abroad.

The global geopolitical situation remains fraught with risk and, if anything, is in modestly worse shape than it was even late last year. Among the notable recent headlines, Greece will soon face another round of debt payments that it cannot make without help from the rest of Europe, the U.S./Israeli relationship is as strained as it has been in many years and Yemen became yet another example of a nation devolving into sectarian conflict with larger security implications for the region and the world at large. It is with all of the above in mind that we consider the outlook for the remainder of 2015 and what the implications this may have as we monitor and manage client portfolios for their current and long term benefit.

Year to Date Market Returns (excluding income)

	3/25/15 Price	Change From Year End
Dow 30 Industrials	17,719	-0.6%
S&P 500	2,061	+0.1%
NASDAQ Composite	4,877	+3.0%
MSCI ACWI-exUS*	277	+5.1%

**MSCI All Country World Index excluding U.S*

Current Developments and Outlook

Domestic growth provides the primary underpinning for all economic activity and on this front the news has been generally satisfactory. Fourth quarter GDP growth of 2.2%, while less than half the rate of the preceding two quarters, was still in line with the average rate of growth of the current expansion which began nearly six years ago. As one would expect, one positive manifestation of the expanding economy has been an improving job market and jobs have now been created for 53 consecutive months. The February unemployment figure of 5.5% was down from 5.7% in January and compares favorably to the average of 6.2% for all of 2014 and the peak of 10.0% back in October 2009. While this trend has been constructive, the news hasn't been all positive. Aside from weakness in recent months, to find a labor force participation rate as low as the current level of 62.8% would require one to look back to 1978. This metric measures the percentage of the population working or actively looking for work and while some of this decline may have to do with the demographics of an aging population, some no doubt, also reflects discouraged former workers who have simply given up looking for a job. Wage growth also remains sluggish with average hourly earnings increasing at only a 2.1% rate since the recovery began in July 2009 as compared with 3.3% over the prior 20 year period. This lends credence to the theory that the job market isn't as healthy as the low unemployment figure suggests but rather implies that slack remains in the labor force and employees generally do not have the ability to demand higher pay. Indeed, there has been a historical correlation between the economy's growth rate and wage growth so it may take a period of sustained economic performance in order to provide a larger boost to wages and household incomes.

Fortunately for workers, overall inflation remains subdued and, in fact, has been negative in recent months driven mainly by the fall in oil prices which recently hit a six year low. This has allowed real (i.e. inflation adjusted) earnings to grow at closer to a 3% pace and has acted like a tax cut for consumers who have spent some of that windfall but also, importantly, have increased their savings rate as they repair their personal balance sheets. Low interest rates continue to benefit consumers as well. The latest quarterly household debt service ratio of 9.93% is the second lowest on record with data going back to 1980. Total debt levels remain elevated, however, so a rise in interest rates could change this scenario.

Given the ongoing improvement in the U.S. economic picture, it is highly likely that the Federal Reserve will begin to raise its key short term lending rate later this year though it remains to be seen what impact this may have on longer term interest rates. U.S. government bonds continued to be viewed as a safe haven asset globally and given the persistent economic troubles in Europe, slower growth in several emerging market economies and ongoing geopolitical turmoil in many parts of the world, this source of demand should remain strong. Additionally, monetary easing in Europe, Japan and elsewhere is expected to keep rates low in those geographies which, all else equal, could result in less upward pressure on U.S. interest rates in this Fed tightening cycle. In fact, European Central Bank action has pushed interest rates *below zero* in more than a few countries including Germany when investors have to go out to seven years before they can earn a positive return. Low rates will be a critical element to the recovery outside the U.S. though some structural, regulatory and legal reforms will also need to become part of the solution as well. Economic recovery is essential as much of the world still is saddled with overly high debt levels, both government and private.

One manifestation of the divergent paths of interest rate policies between the U.S. and much of the rest of the world has been the steady appreciation of the dollar against most major foreign currencies. This is an important development to follow for many reasons, one of which was pointed out in a recent article in the U.K. based newspaper The Telegraph, which noted that "the world is more dollarized than ever" as a result of the years of easy Fed policy which flooded the world with dollar liquidity. According to the Bank of International Settlements, there is now approximately $9.2 trillion in dollar denominated corporate debt outside the U.S., up 50% from the level of 2009. Approximately $4.5 trillion of that debt is in emerging markets, double the rate of six years ago, while the $1.1 trillion loaned to Chinese companies represents a five-fold increase. This will add a degree of difficulty to the job the Federal Reserve faces in normalizing interest rates in this country as small changes in U.S. policy may trigger outsized impacts across the globe. Adding uncertainty to this process, Federal Reserve Vice Chair Stanley Fischer recently suggested that the Fed needs to “wean” investors off the idea that it will forewarn them months in advance of any possible policy change so as to not “unnecessarily constrain” potential Fed actions. We agree this would be wise while also cautioning that one cornerstone of the market stability of the past several years has been the predictability of Fed policy.

The stronger dollar will also adversely affect corporate earnings in the coming quarters which will add a degree of volatility to stock prices as has already been experienced early in 2015. All else equal, a stronger dollar makes U.S. exports less competitive in the global marketplace and therefore could negatively impact top line growth for Corporate America. At the same time, currency impacts will provide a headwind to earnings as sales in depreciating currencies result in diminished reported earnings once translated back into the stronger dollar. In our view, the market is not prepared for a potential disappointment in the earnings outlook. Stock valuations remain above the long term average as a result of the historic bull run of the past six years. Regarding the current expansion phase for stocks, the current bull market now ranks as the fourth longest of the past 85 years. If it lasts until early May, it will become the third longest trailing only the great 1990’s bull and the post WWII rally from 1949-1956. The current advance has resulted in over a 200% gain excluding dividends nearly double the historic average during this period of 106% and well ahead of the median gain of 77%. By any measure, this has been a powerful market advance fueled in part by the risk taking encouraged by the easy money policies of the Fed. As a recent Financial Times article noted, however, “The share of GDP accounted for by profits cannot go much higher. So, if productivity growth remains low, it is hard to see how equity investments can yield large returns. Monetary policy can boost markets in the short-run, but this cannot be sustained indefinitely.” Investors would be well served to pay attention to this wisdom.

Finally, as noted at the outset, geopolitical tensions around the globe are as tenuous as they have been in many years. It remains to be seen whether Greece will ultimately remain in the Eurozone as there is no obvious solution to the present standoff between that country and its creditors. The historically important relationship between the U.S. and Israel has reached a low point recently. Violence appears to be spreading in the Middle East as well as in some African nations. Russia faces ongoing sanctions while China continues to flex its muscles in its corner of the world. These factors and others caused former Secretary of State Henry Kissinger to comment recently that “We haven’t faced such diverse crises since the end of the Second World War.” Aside from the obvious threats to global security and the immediate capital market reactions that may result, such crises could also cause a slowdown in global trade, investment and capital flows, a resumption of tariffs or other protectionist responses, and other measures that may impede the path to a resumption to more normal economic growth.

Investment Conclusion

In the present environment, we believe that exercising investment patience and discipline is more important than ever. The current expansion phase of the stock market ranks among the longest bull markets of the past century and has caused equity valuations to increase to levels meaningfully above historic averages. With this in mind and given the many challenges outlined above, we are comfortable maintaining a slight cautionary bias in our outlook. That being said, we are not in the business of predicting market peaks and troughs as it is simply not possible to enjoy long term investment success with such a strategy. Although it is impossible to predict when the next bear market may begin, one conclusion we would draw today is that forthcoming near to intermediate term stock market returns will likely fall short of long term averages and disappoint investors’ expectations. As such, we will continue to selectively invest in equities but only on a case by case basis when the individual stocks we favor sell at prices that make them attractive long term investments.

Many fixed income securities today are selling at extreme valuation levels and investors who purchase them are likely to be disappointed at some point. We continue to caution against these types of investments and instead suggest clients focus on preservation of capital with short term, high quality securities. Money market returns remain disappointingly low. However, cash reserves provide overall portfolio stability as well as serving as stock buying reserves in times of market stress so remain an important component of a successful long term investment program.

Finally, we note that the famous investor Irving Kahn recently passed away at the age of 109. He began his investment career a few months before the stock market crash of 1929 and until very recently would regularly go to work at the eponymous investment management firm he founded in 1978. He was known for being a serious long term investor who studied the underlying fundamental factors that influenced businesses over time and placed great value in the management teams running those businesses. He regularly ignored the advice of both Wall Street and the popular press instead focusing on the “real facts” uncovered by his own analysis. When asked about the most important ingredient for long term investment success he answered “patience.” We certainly agree with this assessment and believe that patient investors today will be rewarded with ample profitable investment opportunities in due course.

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