Investment Review and Outlook – Winter 2015

Summary

The U.S. stock market continued on an upward path during 2014. As we look into 2015, in the current protracted low interest rate environment, the benefit of the doubt is likely to remain with the stock market bulls. Furthermore, despite a new comprehensive report from the International Monetary Fund on slower global prospects for much of the world in 2015, and a seemingly endless string of news stories relating to changing financial and geopolitical matters, the U.S. continues to be a shining light within the global arena for economic development and investment. This was underscored by the IMF report, estimating increased growth for the U.S. in the current year. However, after a long period of economic expansion that commenced in June 2009, and a stock market advance that began in March 2009, caution and prudence are warranted, along with tempered expectations for future gains in the U.S. equity market.

Domestic Economic Landscape

The U.S. gross domestic product contracted in early 2014 but during the third quarter, the economy put on its best performance in eleven years. Our expectation is that the U.S. business expansion, now in its 6th year, will be more modest, but stable and not as volatile as in 2014. Most key economic indicators support this thesis. For 2015, the U.S. economic growth has been revised up by the IMF to 3.6%, largely due to more robust consumer demand, low interest rates, a significant decline in oil and gasoline prices, a boost in real incomes and improved consumer sentiment.

Some recent economic developments should be noted, however, as we assess the health of the overall U.S. economy. There has been regional unevenness in the housing industry, although falling mortgage rates should help sustain a modest advance during 2015. Growth has also slowed somewhat in the manufacturing and service sectors but remains at healthy levels. Retail sales were disappointing in December, following an increase for the previous month. While the December jobless rate improved to 5.6%, a solid showing, there was a retracement in average wages. This ebb and flow, which is normal for this long, understated business expansion, has likely sustained the up cycle without producing inflation. Furthermore, the softness in some key sectors of the economy has given rise to speculation that an interest rate hike by the Federal Reserve could be further down the road than previously thought. Such an irregular pattern of economic growth in recent months has also enabled the Fed to remain on an accommodative monetary course. The Fed's pending challenge will be to extricate itself from years of unrelenting and often unconventional monetary accommodation. Such an unwinding process will not be easy.

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Global Growth Forecast

A key concern among investors is centered on a slowdown in the global economy, ex the US. On January 20th, the IMF in its "World Economic Outlook" report lowered its forecast for global economic expansion for both 2015 and 2016 by 0.3% to 3.5% and 3.7%, respectively. The IMF also called for central banks to put in place accommodative monetary policies and structural reforms to accelerate economic growth. The U.S. was the only standout in an otherwise gloomy global report with projected 2015 growth raised to 3.6% from 3.1 %, largely offsetting new estimates of more economic weakness in euro countries. Projections for emerging economies were broadly reduced, especially for oil exporters Russia, Nigeria and Saudi Arabia. According to the IMF, a forecast for slowing growth in China during 2015 is the result of Beijing reining in credit expansion and investment as the economy is tilted more toward personal consumption rather than the expansion of real estate and banking sectors in the past.

Other risks, underscored in the IMF report, involved the possible shifts in sentiment and volatility in global financial markets, especially in emerging markets. The exposure to these risks, however, has shifted among emerging market economies with the rapid decline in oil prices. The IMF estimated that lower global oil prices would provide a boost to oil importers but more difficulties for oil exporters who will experience greater balance sheet vulnerabilities.

The upcoming year will have its share of global challenges. The overriding concern of investors is the situation overseas, both economic and geopolitical. Even where there is an expected increase in economic growth, it may be tempered. Most economies in Europe are either in recession or heading in that direction: Japan is still battling a better than decade-long case of deflation, China's rapid expansion is slowing notably, Russia is facing further economic strain due to plummeting oil prices and economic sanctions, and political and military instability is continuing to wreak havoc across key regions of the globe.

Oil and Global Currencies

The drop in world oil prices, which have fallen more than 50% since June 2014, is largely the result of OPEC not cutting supplies, along with increased output from oil-producing countries, especially with new "fracking" technologies in place in the US. The decrease in price is likely to be with us for some time, although some rebound should be expected as market forces become more balanced. Lower oil prices are also likely to keep downward pressure on global interest rates, offsetting inflationary pressures as economic policies re-energize expansion around the world, especially in developing markets. Falling energy prices will also give countries a chance to reform energy subsidies and taxes.

The prospects for commodity importers and exporters are likely to further diverge in the future. Oil exporters can draw on funds amassed when prices were high and can further allow for substantial depreciation in their currencies to offset the economic shock of plunging prices. The IMF suggested that even with falling oil prices and strong U.S. growth, there was little likelihood to be upbeat about many "global players." The euro zone and Japan could suffer a long period of weak growth and dangerously low inflation. Within this outlook, however, is the possibility of increasing divergence between the United States, on one hand, and the euro area and Japan, on the other. These countries will need to adjust to lower valuations of their respective currencies and lower global energy prices, while putting in place programs to stimulate economic expansion.

At the country level, the cross currents make for a complicated picture. It means good news for oil importers and bad news for oil exporters. It is also means good news for commodity importers and bad news for exporters. And there will be continuing struggles for countries which show scars of the past conflicts in the mid-east and elsewhere. There is also good news for countries linked to the euro and the yen but bad news for those linked to the strong dollar, which is likely to limit export growth.

The US Stock Market

As we move into 2015, we are generally positive on the U.S. stock market. However, we also think a measure of caution is warranted when viewing the success of the market over the past few years. Presently, there is increasing pressure on corporations to continue delivering stellar results, as stock prices advance. We are currently seeing this as fourth quarter 2014 earnings are being reported, rewarding companies that exceed expectations and punishing those who disappoint. While overall expectations should be for a continuing stock market advance during 2015, a more modest pace than we have seen over the past few years appears likely.

Investment Strategy

Our investment strategy is very focused on the duration of the current economic cycle at the present time as we are in the process of repositioning portfolio exposure on three levels: toward beneficiaries of lower energy pricing, which we expect to be with us for some time, avoiding the consequences of an eventual increase in interest rates, and tilting security selection toward high quality, defensive securities that boast of higher than average dividend yields. Of course, our on-going search for diversified growth never ceases. As noted in the past, capital preservation with growth is at the core of our portfolio management philosophy in building wealth for our clients over the long run.

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