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2015 – The Deflation Theme Continues
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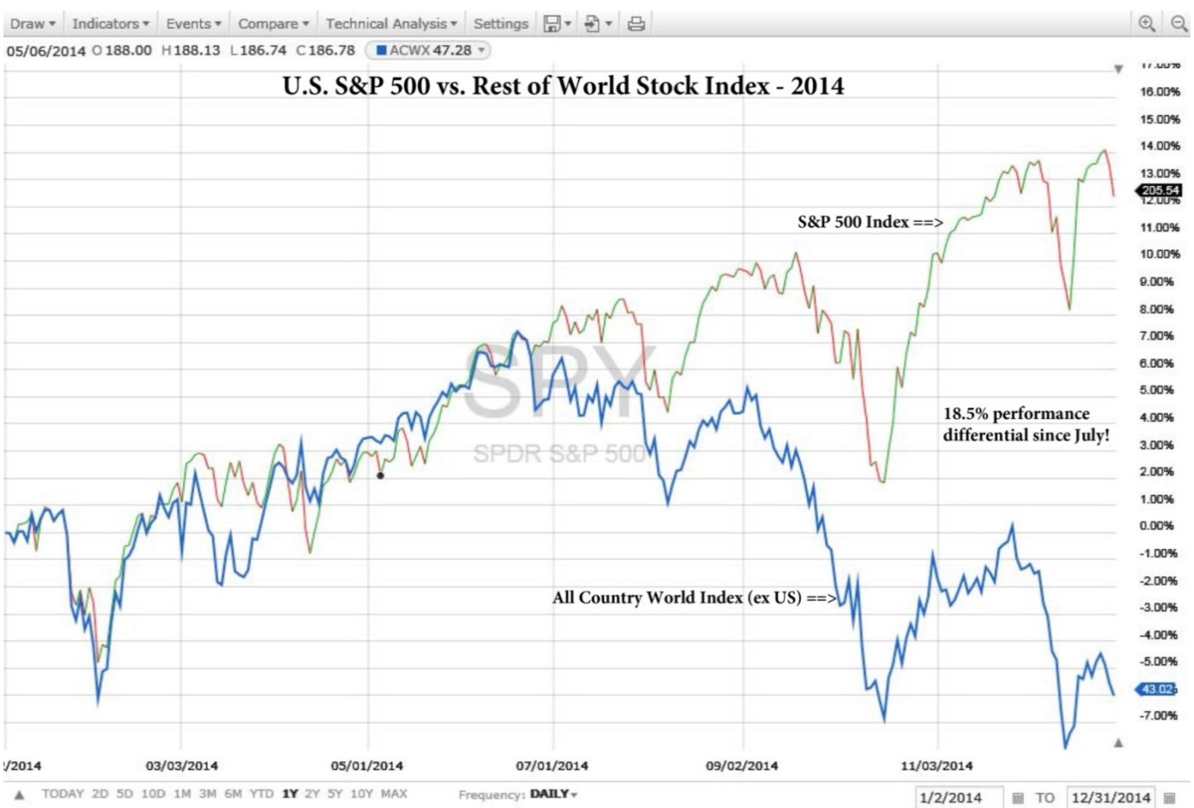
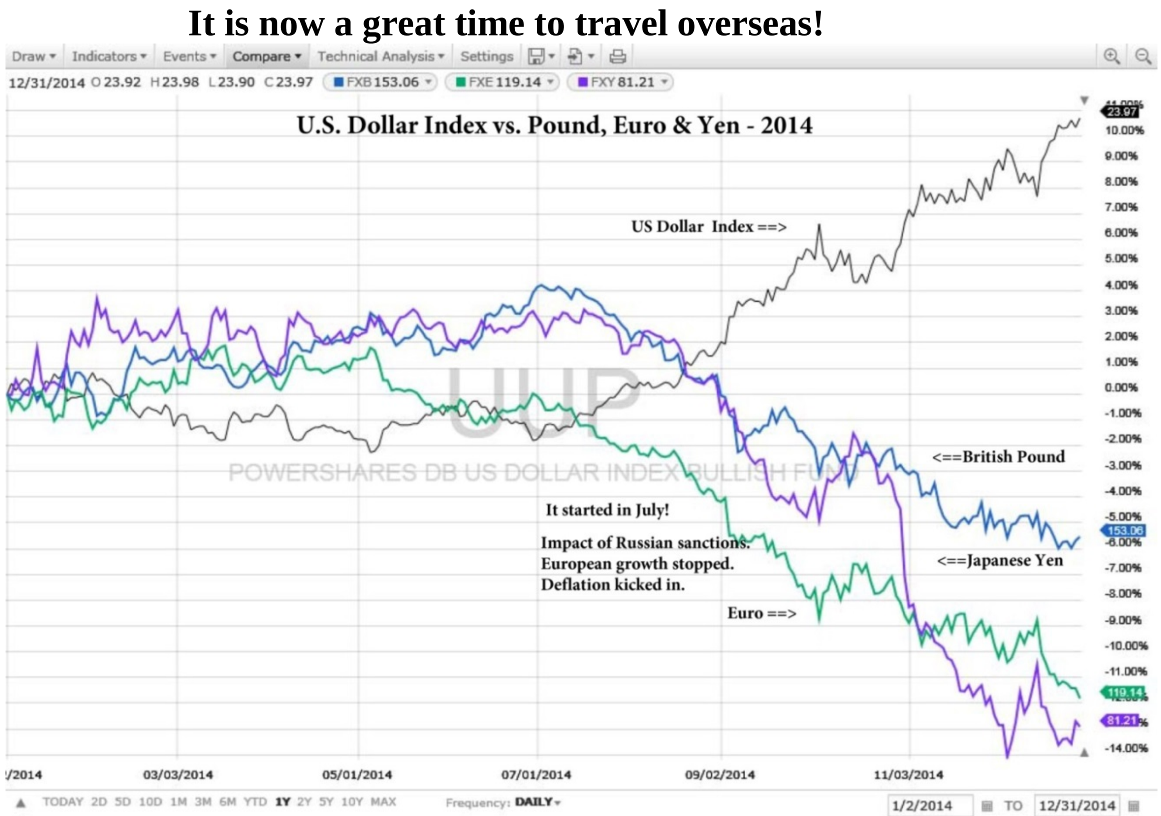
In 2014, the global stock markets were moving forward quite well until mid-year when the major investment themes changed. Expectations of increased inflation and higher interest rates shifted to concerns about deflation and lower interest rates. The general economic malaise in Europe, resulting from the cost of countervailing Russian economic sanctions, led to lower inflation outside of the United States. In an effort to avoid very low European interest rates and the substantial decline in the Euro, overseas investors moved capital to the U.S. and helped drive up U.S. stock and bond returns. The chart below shows the magnitude of this financial divergence; the S&P 500 index was up 13% on the year and the ACWI Index representing the rest of the world was down 5%, an 18% differential!

Exhibit 1. When Investment Themes Changed Mid-Year, The Markets Diverged.



As the prospects for U.S. economic growth continued to improve during 2014, capital flowed from all parts of the world into our markets. Not only did large-cap U.S. stocks and long-maturity bonds benefit from the capital flow; the U.S. Dollar rallied between 12% and 16% against most major currencies during the last half of 2014 (Exhibit 2). U.S. equity markets rose 10-13% while the European and Japan stock markets declined 4-5%. Small-cap U.S. equities did not benefit from this capital influx and returned only 4-5% for the year. Foreign capital flows into the U.S. clearly focused on long-term income-producing assets such as bonds and high-dividend stocks.

Exhibit 2. The Dollar Experienced a Significant Rally Against Major Currencies in 2014.



Deflation is Here Now

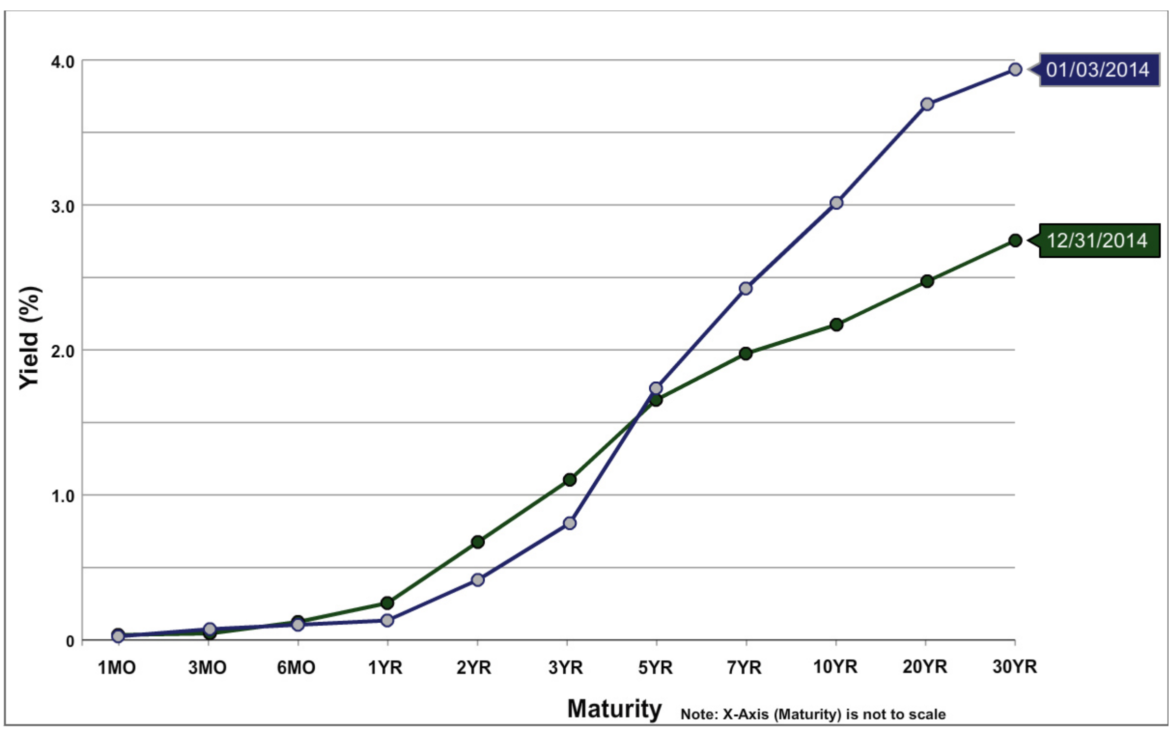
Investor expectations of reduced inflation solidified in the 4th quarter when Saudi Arabia demolished OPEC and allowed energy prices to find a real market-based floor. Brent crude has declined from approximately $100 per barrel to below $50, over a 50% decline in 2014! It could very well bottom in the $30's or $40's. The Saudis' efforts to drive out higher cost producers in the U.S., Europe and elsewhere will likely result in a bounce in energy related unemployment and deferral of capital spending on energy infrastructure in the U.S. and many countries around the world. Over time there will be a positive effect on consumer income from a decline in energy costs, but this will take time. The combined drop in oil and commodity prices should just about extinguish any expectation of global inflation in the foreseeable future. In my opinion, it is unlikely that the Federal Reserve would raise short-term interest rates in the face of global deflation.

As a result of lower inflation expectations, global long-term interest rates have dropped precipitously since mid-2014 (Table 1). European interest rates have declined dramatically, the German 10-year bund rate is now below 0.50%, clearly pricing in little or no inflation. With European rates so low and the dollar rallying, it is a compelling story for foreign investors to buy U.S. bonds and stocks. As recently as September many were still debating when the Fed would tighten and start to raise U.S. interest rates, but nobody saw the decline in long-term rates coming. While U.S. short-term interest rates are unchanged, the decline in long-term (30 year) interest rates by over 1% in 2014 resulted in a 26% positive return for those bonds for the year (Exhibit 3). Lower long-term interest rates helped several income-generating sectors of the stock market outperform: including utilities, REIT's and consumer durables. While the decline in U.S. interest rates was clearly originated overseas, the concept of deflation has now taken hold in the U.S. as well.

Table 1. 10-year Government Bond Interest Rates Have Declined Globally

	June 30, 2014	Jan 7, 2015	6 month change
US 10 yr.	2.53%	**1.98%**	(0.55%)
German 10 yr.	1.24%	**0.49%**	(0.75%)
Italian 10 yr	2.73%	1.91%	(0.82%)
Spain 10yr	2.66%	1.71%	(0.95%)
U.K. 10 yr	2.67%	1.62%	(1.05%)
Japan 10 yr	0.59%	**0.30%**	(0.29%)

Exhibit 3. The U.S. Treasury Yield Curve Flattened as Short Rates Rose and Long Rates Declined by Over 1%.



Market Performance for 2014

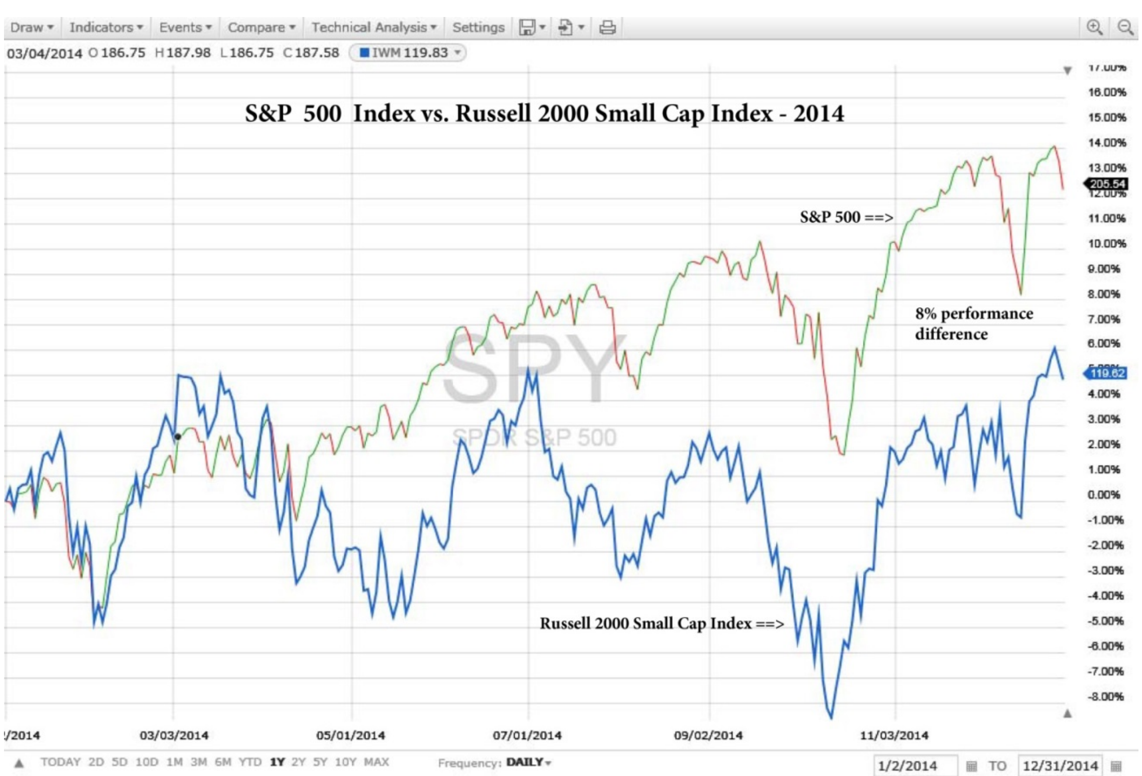
Most investment portfolios are composed of a blend of large-cap, small-cap and international equities. In most cases, U.S. large-cap stocks carried portfolio returns for investors in 2014. While small-cap stocks lagged their large-cap brethren (Exhibit 4), most commodity, energy and international investments provided negative returns (Table 2). Real estate investment trusts had a very good year after a weak 2013, gaining 14% globally. In summary, outside of U.S. large-cap stocks, all other investments reduced a typical portfolio's overall return.

In 2014, portfolio managers investing in fixed income (bonds) typically split their maturities between the short and intermediate-term as they feared higher interest rates in 2014 resulting from the improving economy and elimination of QE. However, this strategy locked in low bond market returns and missed the significant positive move which resulted from the decline in long-term rates. Overall, investors will be disappointed by their blended portfolio performance as few market sectors achieved the performance of U.S. large-cap stocks.

Table 2. Financial Market Returns for 2014

Stock Market Indexes		Bond Market Indexes	
Dow Jones Industrial Index	10.0%	Gov/Credit 1-3 yr Index	0.8%
S&P 500 Composite	13.7%	Gov/Credit 1-5 yr Index	1.5%
Russell 2000 Small Cap Idx	4.9%	Gov/Credit 5-10 yr Index	6.9%
MSCI World REIT Index	14.2%	Gov/Credit 20+ yr Index	19.3%
MSCI Europe	(6.2%)	US High Yield Index	2.5%
MSCI Japan	(4.0%)	Global Gov Bond Index	(2.9%)
MSCI Emerging Markets	(2.2%	Oil	(47.5%)

Exhibit 4. Large-Cap U.S. Stocks Outperformed Small-Caps By a Wide Margin



Europe's Malaise is Becoming Worrisome

Europe's persistent economic decline is becoming quite troubling. The forecast was that Europe would demonstrate that the "Anglo-Saxon" economic model is inferior to Europe's more statist and socially sensitive approach; this has clearly been disproven. Bureaucracy cannot create growth. Europe has not made progress in solving its longstanding economic, political and social problems. The relative prosperity of Germany and Austria diverges vastly from that of southern Europe, so much so that it calls into question the European Union's viability. Indeed, we have seen a rise of anti-EU parties and anti-immigrant parties not only in southern Europe but also in the rest of Europe as well. While none have crossed the threshold to power, many of the movements are gaining strength along with the idea that the benefits of membership in a united Europe are outweighed by the costs.

There is a growing risk that either the European Union will have to be revised dramatically to survive or it will simply fragment. And when a region as important as Europe redefines itself, the entire world will be affected. With each year that passes, we must be open to the possibility that this is no longer a crisis that will pass, but a new, permanent European reality. The European malaise is increasingly ominous because it shows no signs of improving. I hope this does not explode in 2015.

Greece….Again

While we were hoping to never mention them up again, the Greeks have an election in late January that could bring the anti-Euro party Syriza into power. They have threatened to default on bond payments and leave the Euro. Since 2012, the ECU has reduced the prospects for debt blackmail by moving Greek debts from banks to the European governments. German responses to Syriza have been swift, stating that they expect any government in Greece to honor its debts or risk a cut-off in funding. A German spokesman has stated, "Greece would be better served with the Drachma and the Euro better served without Greece." He also stated that, "Greece has to decide for itself, we won't kick them out. But the productivity gap is so enormous that Greece would have difficulty getting back up on its feet without devaluing its currency."

My personal guess is that Greece will stay in the EU; Greeks will live in debt up to their eyebrows and blame it on everybody else other than themselves.

Russia is Having an Identity Crisis

The Russians believe that Ukraine was an event triggered by the United States. Since the U.S. openly supported the demonstrators and a change in government, they believed that it must have been some type of covert cold war conspiracy. This logic reveals a public Russian mindset that assumes covert forces are operating against Russia and their problems are caused externally.

The failure of the Russian government to manage both the Ukrainian crisis and the weakening of the Russian economy may result in serious consequences in 2015. Bondholder defaults are a real possibility. Destabilization in Russian is very risky due to their massive nuclear capability. Hopefully they will choose to re-integrate within the global economic system rather than lash out at perceived enemies. Problems in Ukraine could easily heat-up with the spring thaw.

Relentless Economic Growth in the U.S. Continues

The dire predictions for the U.S. economy that were floated in the wake of the 2008 crisis have not materialized. The capitalistic economic model has prevailed. The economy did not collapse nor did inflation become a major problem. Rather, it has slowly but systematically climbed out of the hole in terms of both growth and unemployment. The job market has surged, consumer and business confidence have improved and corporations are aggressively putting cash to work.

We believe this means 2015 should result in another decent year for U.S. equities fueled by the following:

- positive momentum in U.S. economic growth with low inflation
- a pickup in consumer spending
- solid earnings growth
- a boost from low commodity prices and financing costs
- a relatively good liquidity environment aided by stimulus from non-U.S. central banks.

Prospects for 2015

- Although equities are no longer a bargain, they offer better value than other financial assets and should outperform cash, bonds, inflation and commodities. It's the T.I.N.A. principal—there is no alternative.

- Asset classes often perform differently from one year to the next. We expect that at some point in 2015, there will be a shift in relative performances from income-generating securities to growth sectors. But for now, we see most of the dominant themes of the second half of 2014 carrying over into the New Year.

- In the short term, strong seasonal equity buying patterns should continue through mid-May. Bull markets typically run until widespread euphoria or a big, unexpected negative event occurs which knocks the wind out of its sails. Currently, neither of these negative factors appears to be present.

- Many of us have been waiting for a rebound of inflation since the economic downturn ended in 2009. The collapse in oil and commodity prices has extinguished that expectation for the forseeable future.

- Against this deflationary backdrop, we doubt that the Fed will start any meaningful tightening process. The U.S. yield curve should continue to flatten as long-term rates trend lower and shorter-dated Treasuries face continued bearish headwinds.

- The U.S. Dollar is likely to trend higher over time. I believe parity between the Dollar and Euro could occur in a year or two. However, a multi-month rebound in the Euro is overdue and could occur if positive solutions can be found for the situations in Ukraine and Greece.

- Even if lacking significant economic growth, the profitability of European companies should benefit from a weaker Euro and declining energy and commodity prices. European stocks appear inexpensive when compared to their U.S. brethren.

- The rise of anti-immigration and nationalist protests in Europe, particularly against those from Muslim countries, is becoming a major political concern which could easily spread to the U.S. and elsewhere. We would not be surprised to hear about more Islamic terrorist activities globally. This would be good for the price of gold and military stocks.

- There is no doubt that the wide range of global "problems" makes us very nervous from time to time. But these problems will just keep central bank liquidity plentiful and financial assets on a strong footing. Europe, Japan and possibly China may pump more central bank funds into their economies in 2015.

We expect the bull market in equities to continue to be driven by U.S. economic growth, foreign central bank liquidity, post-midterm election gridlock, strong seasonal buying patterns and improving investor sentiment. The intermediate theme of the market should turn from deflation to growth as investor confidence improves. We are fully invested in equities and bonds up to your target asset allocation.

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