Investment Viewpoint

January, 2015

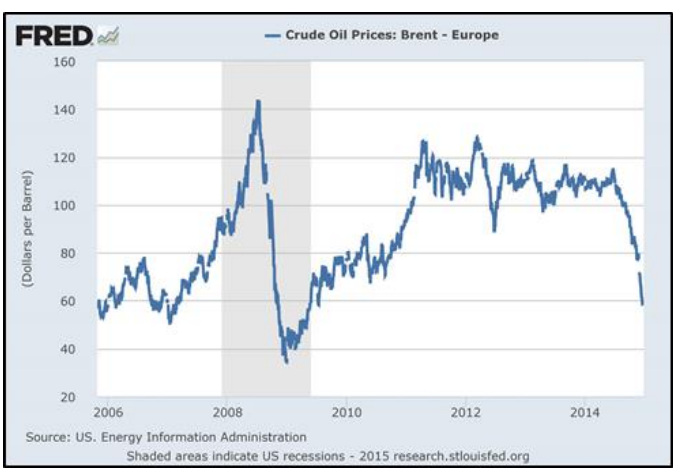
Overview

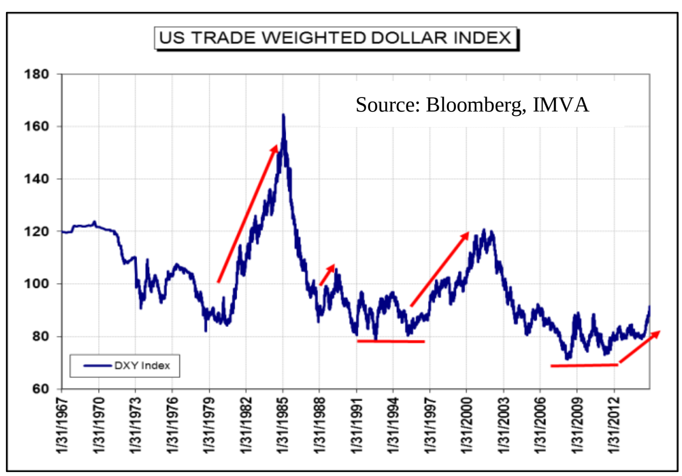
As 2014 drew to a close, U.S. economic growth accelerated, logging its sixth consecutive year of expansion from the Great Recession's bottom of early 2009. In fact, third quarter GDP rose 5.0%, up from 4.6% in the second quarter, and well up from the 1-2% growth rate in the initial years of the expansion. Major investment market indices repeatedly established new record highs throughout the year. For the full-year 2014, the S&P 500 Index and the Dow Jones Industrial Average returned 13.69% and 10.03%, respectively. Smaller capitalization indices generally lagged and depended upon strong performance in the fourth quarter to finish the year in the black; the S&P 600 and Russell 2000 advanced 5.76% and 4.89%, respectively, in 2014.

The S&P 500 also outperformed every other developed global market in 2014. Generally, across all capitalization ranges, defensive strategies – including those focused on low volatility, solid dividend yield, and domestically produced revenues – outperformed. Utilities, the second smallest S&P industry sector, led all sectors with a total return of 28.98% for the year; the healthcare sector returned 25.34%; and information technology, consumer staples, and financials, all reported double-digit returns. Energy, which had been one of the top performing S&P industry sectors through early September, collapsed into year-end on the heels of declining oil prices, finishing 2014 down 7.78%.

The two biggest surprises in 2014 comprised persistently low interest rates and the dramatic drop in oil prices. Nearly everyone had expected interest rates to rise gradually over the course of 2014, especially at the long end of the yield curve. In fact, yields on U.S. Treasuries with maturities between six months and five years did rise somewhat as the U.S. economy strengthened and the Federal Reserve ended quantitative easing. The yields of longer-dated U.S. maturities, however, declined markedly. For example, the 10-year UST yield dropped from 3.03%, on December 31, 2013, to 2.17%; the 30-year Treasury yield dropped from 3.97% to 2.75% over the same timeframe. Accelerating weakness in Europe, China, and Japan was the culprit, boosting the appetite for long-dated U.S. paper. In addition to wanting a safe haven, foreign investors identified a yield advantage in the U.S. 10-year Treasury, as other Group of Seven developed nations began the process of quantitative easing, sending their long-dated yields below those of the U.S. in many cases.

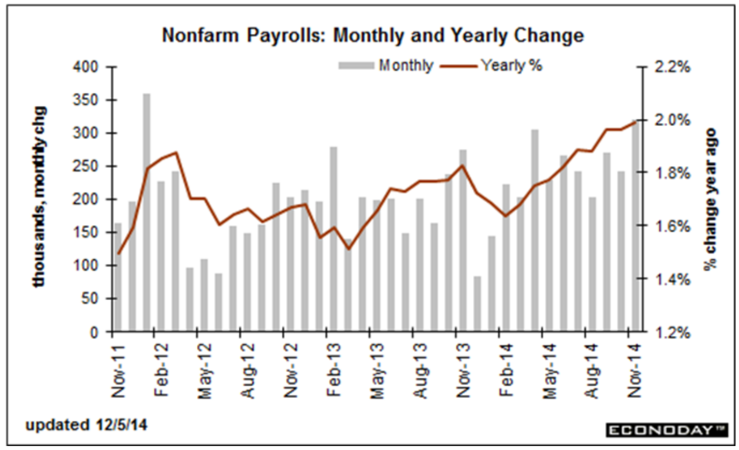
As for oil prices, late 2014 delivered a three-pronged trident to the heart in the form of increasing supply, slowing demand growth, and a rising U.S. dollar (hurting exporters of oil, which is priced in U.S. dollars). Brent crude prices stayed firmly above $100/barrel for most of the year, having averaged approximately $110 a barrel between 2011 and 2013. However, OPEC's Thanksgiving Day announcement that it would no longer cut output to boost prices stunned the markets; Brent crude oil prices dropped to $57 into year-end, the lowest price in 5 ½ years. Many experts expect crude prices to recover over time, perhaps as soon as the second half of 2015, when high-cost producers are out of the market. OPEC's decision to defend market share at the expense of prices may stifle U.S. production, which has nearly doubled over the last decade, but that math is complex and blurred by disparate political agendas – especially within OPEC itself! On the positive side, according to Sam Stovall of Standard & Poor's, every $10 drop in oil should equate to an increase of 0.25% in U.S. GDP.

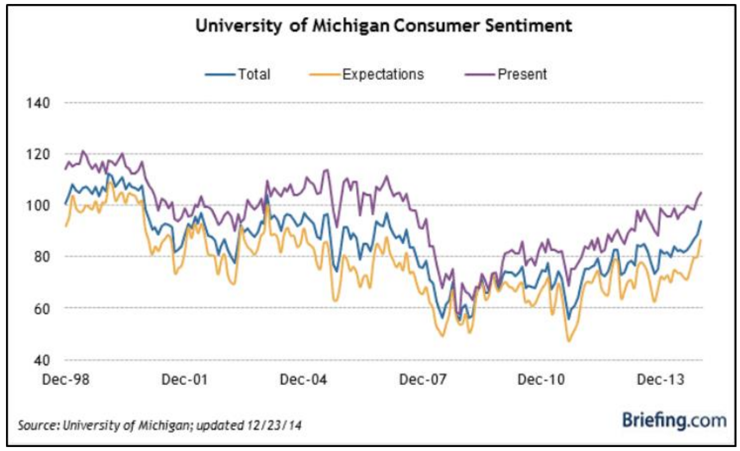


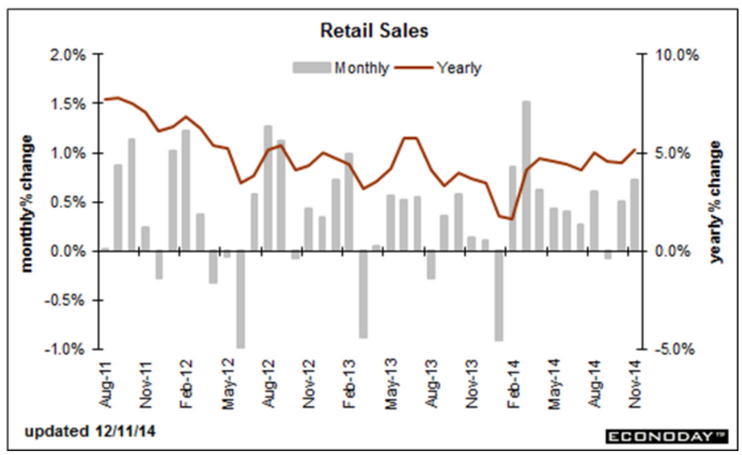


Economic Trends

- In early 2014, the major global economies expanded, each with relatively modest growth and inflation expectations. Later in the year, U.S. growth accelerated, with GDP up 4.6% in the 2nd quarter and 5.0% in the 3rd quarter; other world economies slowed markedly.
- As seen in the adjacent chart, November nonfarm payrolls were very strong; 321,000 new jobs were added – and these followed upward revisions for the September and October readings. Additionally, the unemployment rate held firm at 5.8%, the low since 2008; wages rose sharply, with a 0.4% monthly increase; and the average workweek expanded.
- Personal consumption expenditures (+3.2%), nonresidential fixed investment (+8.9%), and increased government spending (+9.9%) were the primary catalysts behind the 3rd quarter GDP surprise/surge.
- Rising consumer sentiment and rising retail sales growth (charts to the right and below, respectively) reflected increased job security and higher incomes. Pent-up demand, stemming from last winter's weather-led paralysis, surely put retail sales trends on the right road, beginning in the Spring of this year.
- Housing continued to be mixed. Sales have risen on a year-over-year basis, but they have been weaker than expected. The National Association of Realtors cites low inventory and a 5.5% year-over-year median price increase as the primary causes for slowing sales.
- Manufacturing and service purchasing indices continued to show growth; though, not so surprisingly, recent readings have eased from extremely high levels.
- Generally, U.S. economic growth appears reasonably strong, though forward GDP growth is expected to moderate into a range of 2.75% to 3.0%. A stronger U.S. dollar and plunging commodity prices have created unwelcome deflationary pressures; inflation remains missing in action.
- Given the deterioration in global economic conditions outside of the U.S., notably in Europe, Japan, and China, there were 37 easing moves around the globe in the last eleven weeks of 2014, according to Evercore ISI. Additional stimulus programs will be enacted in 2015.

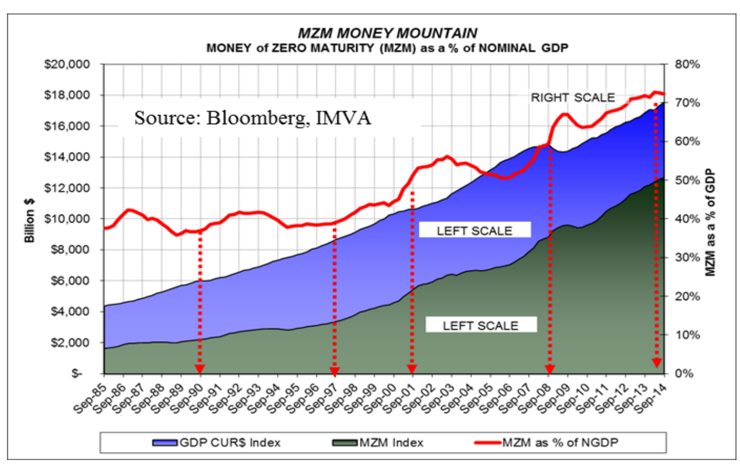






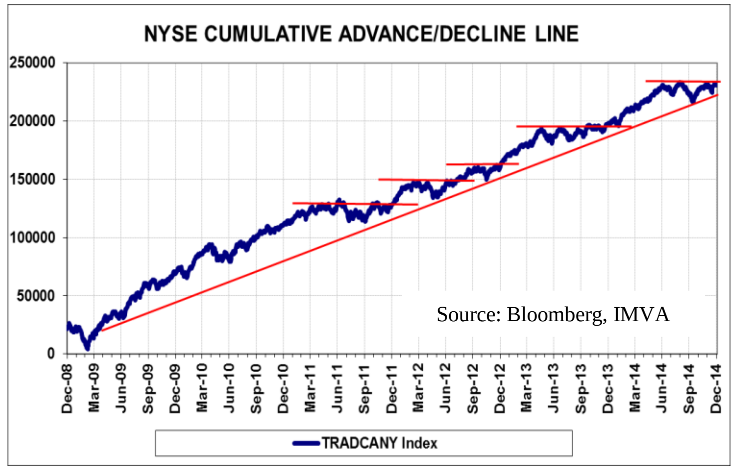
Financial Conditions/Monetary Trends

- Quantitative Easing ("QE") by the Federal Reserve came to an end in October. Even as the Fed removed itself from the market as a large buyer, U.S. interest rates failed to rise; rather, U.S. long-rates actually declined as nervous global fixed income investors sought a safe haven – and in many cases a better relative yield versus other global alternatives.
- The Fed's next step likely will be the normalization of interest rates, meaning incremental rate increases, perhaps beginning around mid-year. The actual scope and pace of normalization will depend on the Fed's opinion of the potential for U.S. growth.
- As seen in MZM (Money of Zero maturity), ample cash reserves appear to be held in the U.S. financial system. At



70% of nominal GDP, MZM held in cash and other liquid accounts represents the highest percentage of nominal GDP in the last thirty years.

- Flush with cash, U.S. corporations have begun to invest. Commercial and industrial loan growth has also continued to expand, portending the likelihood of increased capital creation and a sustainable economic expansion.
- Elsewhere, global Central Banks have been cutting interest rates and expanding balance sheets. Hopefully, these and future actions will restore growth and balance in the world economy.



Sentiment Indicators/Market Trends

- Sentiment and Market Trend indicators generally reflected over-bought conditions at year-end, at least on a short-term basis. It is normal for stocks to advance, then rest or pull back, and wait for valuations to improve as a result of rising earnings, cash flow, dividends, etc.
- Interestingly, 2014 was marked by numerous "new highs" in the market indices, yet the NYSE Cumulative Advance/Decline line indicates no upward movement since last May. The A/D chart is simply the cumulative daily sum of advancing versus declining NYSE stocks. This pattern likely is the result of the more active rotation between previous leaders and laggards, allowing for consolidation.

S&P 500 (SPX) 1/02/15 2058.2

Earnings Per Share - % change
Latest Qtr (Sep 14) ....up 10 %

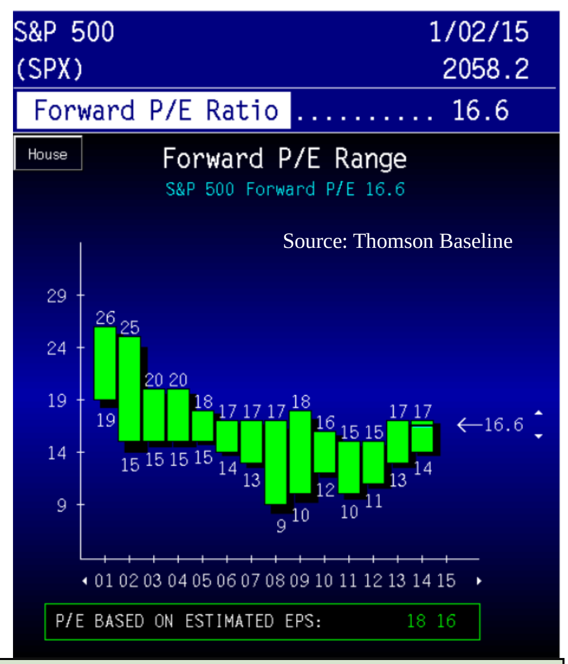
Earnings Per Share
Next Expected EPS Date: Feb 13

	2009	2010	2011	2012	2013	2014	2015
Mar	13.01	19.76	23.76	25.71	26.67	28.12	29.47
Jun	16.79	21.65	25.53	26.00	27.05	30.20	31.31
Sep	17.15	22.60	25.68	26.11	27.94	30.69	32.29
Dec	18.31	22.72	24.92	26.76	29.00	30.76	33.72
Yr.	65.27	86.74	99.88	104.58	110.67	117.32	126.80
Yr. to Yr.	33 %	15 %	5 %	6 %	6 %	8 %	

Source: Thomson Baseline

Equity Market Valuations & Earnings

- According to Standard & Poor's, since 1988, the median forward price-to-earnings multiple (P/E) of the S&P 500 is 17.4x earnings. At 16.6x earnings on the first trading day of the new year, the S&P 500 P/E ratio appeared fairly valued.
- The forward looking P/E multiple (chart to the right below) entered 2015 at the high end of its normal range; a near-term pullback or correction is possible and would be considered normal.
- Ultimately, over the longer term, earnings will tell the tale. As long as corporate earnings continue to grow, stocks are likely to continue building value.
- Against an expected backdrop of modest growth and capital formation, low interest rates and ample liquidity, and low inflation, we remain optimistic that, over the long-term, investors should be rewarded by a high quality portfolio of common stocks.



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