Investment Management of Virginia

Investment Viewpoint

April, 2015

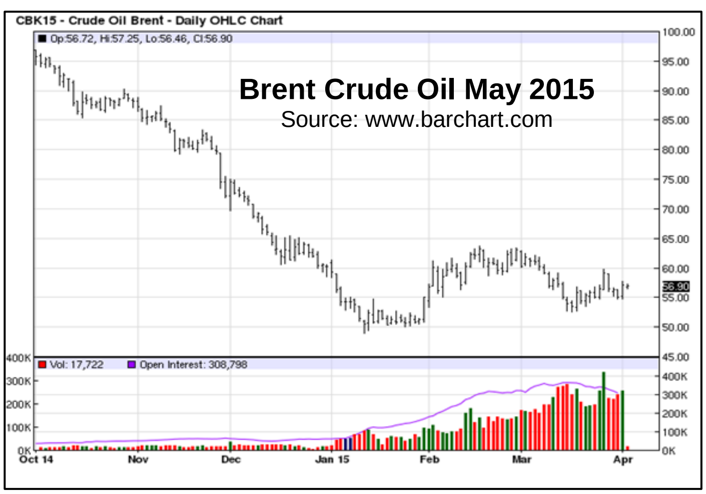
Overview

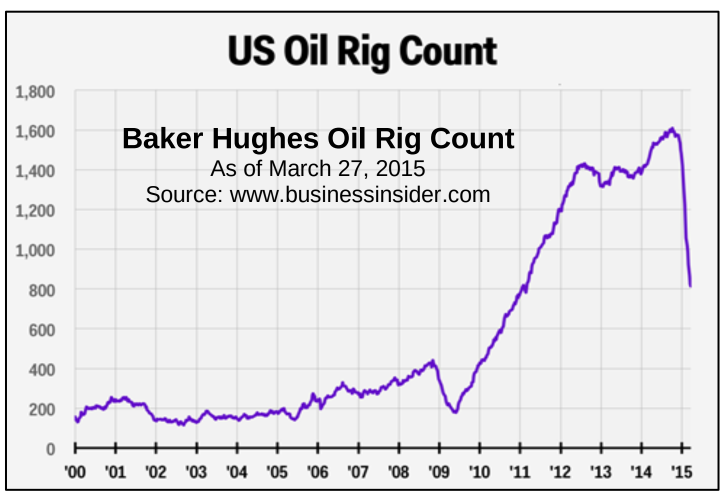
As of the end of the first three months of 2015, the major equity market indices had made little progress; the S&P 500 Index and the Dow Jones Industrial Average advanced 0.95% and 0.31%, respectively. The leading benchmarks in the first quarter were the S&P MidCap 400, the S&P SmallCap 600, and the Russell 2000, with total returns of +5.31%, +3.96%, and +4.32%, respectively. These indices had trailed the large capitalization indices in 2014. A similar passing of the torch occurred among certain industry sectors: Consumer Discretionary climbed impressively out of the doldrums; Financials and Utilities surrendered. Healthcare built upon its 2014 advance. Energy continued to lag. Overall, equity markets were choppy. In fact, the Dow Jones Industrial Average Index recorded 20 daily moves, up or down, of greater than 1%. Also, according to Barron’s, stocks experienced 28 trading days without back-to-back gains, a very unique occurrence historically.

U.S. economic growth likely cooled to a rate of 1.5%-2.0% growth during the first quarter, well below expectations and the 5.0% and 2.2% rates of the third and fourth quarters of 2014. A variety of headwinds, some transitory, others more enduring, contributed to the shortfall. First, severe winter weather froze activity across most of the country in January and February, particularly in the Northeast and Midwest. During that same time period, West Coast port shipments ceased at 29 facilities due to a souring in labor negotiations. Oil prices also continued to disappoint, bringing the U.S. oil rig count down almost 50% from last October. Huge capital spending cuts appeared within the energy industry, making that sector the poster-child for negative earnings revisions thus far in 2015. The weather appears to have let up; port activity resumed in late February; but the bottom in oil prices is hard to call. Past rig count declines of this magnitude have in the past ultimately rebalanced supply and demand, and surely the cure for low oil prices remains low oil prices.

The biggest risk to growth likely was, and continues to be, dollar appreciation. The dollar has risen ~25% against the euro since mid-year 2014. A rising U.S. dollar stimulates U.S. demand for foreign goods and services, but it makes U.S. goods and services more expensive to foreign purchasers. Accordingly, we were not surprised to see recently that European manufacturing indexes expanded and that U.S. manufacturing export orders contracted. Dollar appreciation also results in lower reported revenues and earnings among U.S.-based multinational companies as foreign sales are converted to U.S. dollars. In the past 30 years there have been two similar occasions in terms of simultaneous dollar strength and oil price contraction that were not financial crisis related, 1985 and 1997-98. Both periods proved to be periods of global rebalancing which, in time, set the stage for economic and market advances.

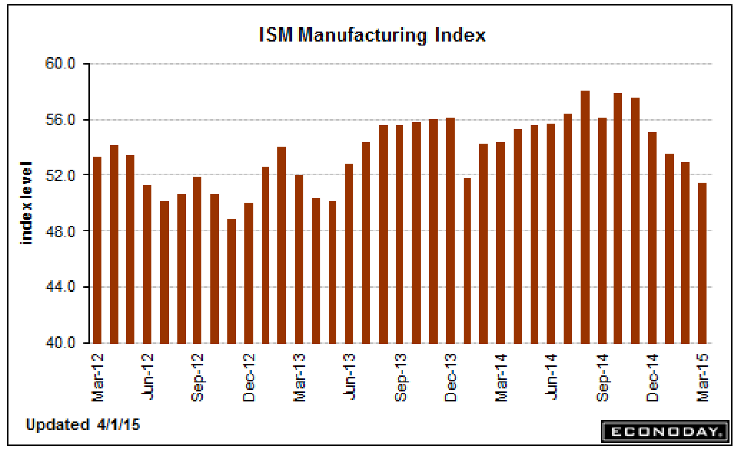
Given that market valuations remain generally full and that high uncertainty abounds with respect to forward earnings growth, interest rates, oil prices, exchange rates, etc., we anticipate further turbulence near-term. Meanwhile, easy Central Bank monetary policy, high odds for low returns among the alternatives (e.g. bonds), and healthy mergers and acquisitions activity appear to be providing a measure of support to global stock markets. Housing activity and some areas of retail are showing early signs of blossoming as well.

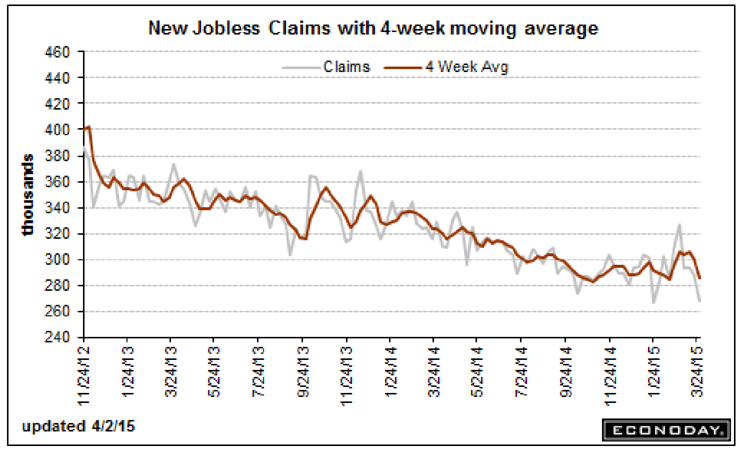




Economic Trends

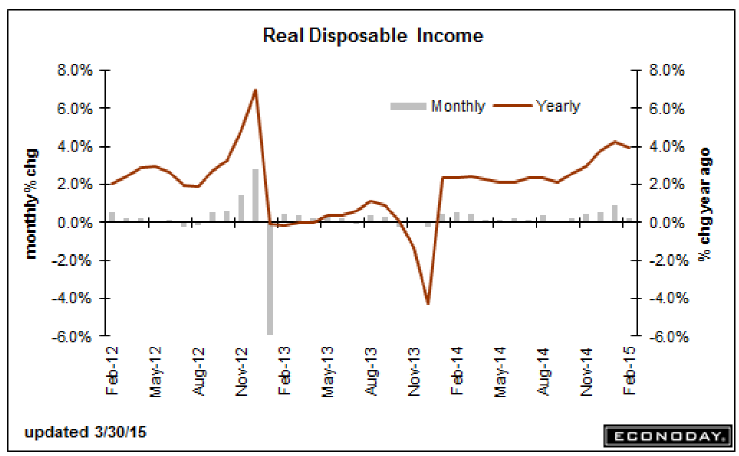
- The dynamics of global growth shifted during early 2015. Lower oil prices and improving credit benefited European domestic demand, and a string of positive data across the 19-nation bloc surprised to the upside. *"A sustained recovery is taking hold. We can rightly be optimistic about the outlook."* (Mario Draghi, ECB President)
- By contrast, U.S. data underwhelmed, pointing toward sub-2% growth, although many economists look for growth to accelerate later in 2015.
- Dollar strength and weak foreign demand pulled down the U.S. ISM Manufacturing Index from extremely high levels. Three months of contracting export orders were somewhat offset by improving domestic strength.
- Industry leadership continued to rotate back and forth among manufacturing, autos, and retail. Generally, companies and industries whose revenues depend more on U.S. trends, as opposed to global themes, appeared to occupy the sweet spot.
- According to Deutsche Bank, the economy generated 3.3 million jobs over the past 12 months, the strongest pace since March of 2000. Furthermore, unemployment dropped to 5.5%, the lowest rate during the recovery. Jobless claims also remained consistently near recovery lows.
- During the quarter, incomes rose, inflation remained low, and consumer confidence reached a 7½ year high, portending potential improvements in spending trends. These encouraging data followed household net worth's having reached record highs at year-end, enabled by rising equity and home values.
- The domestic single family home market finally began to show signs of strength, supported by jobs, income, and growth in new household formations. Millennials are growing up and moving out.
- Heading into the end of 2014, hopes for a balanced global expansion dissipated. China had slowed; Greece was a mess; and many countries worried about deflation. By the end of Q1 2015, green shoots had appeared: German unemployment reached a record low; UK GDP growth rose to 3%; and the purchasing manager index readings rose in the Eurozone, China, and India.

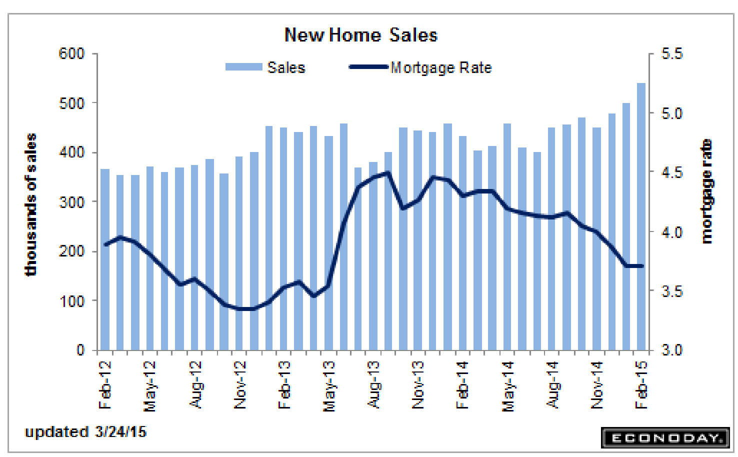


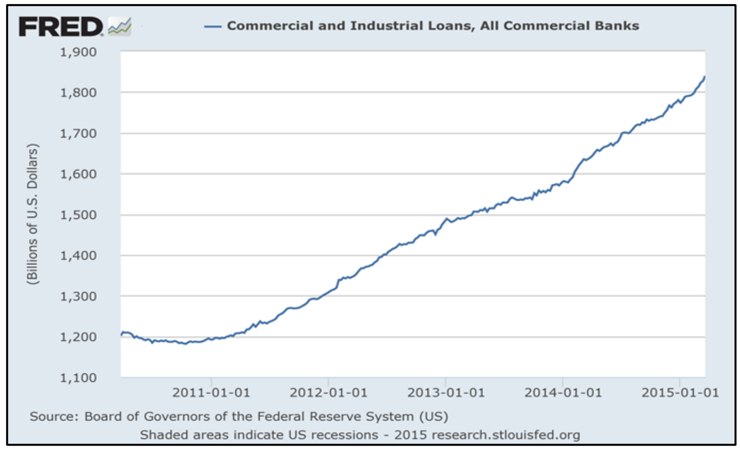


Financial Conditions/Monetary Trends

- Although Quantitative Easing ("QE") ended six months ago in the U.S., trends in money growth, as measured by MZM (Money of Zero Maturity), remained encouraging through March 31st. In fact, MZM grew in excess of 5% on an annualized basis, suggesting that capital creation/expansion is occurring in the private sector.
- As can be seen in the chart on the next page, commercial and industrial loan growth remained healthy, recently accelerating. Growing confidence among borrowers and lenders bodes well for sustaining the expansion.
- Though the U.S. Federal Reserve appears to have pushed out the timeline for rate increases, normalization of interest rates remains the goal. In the end, data will tell the tale. Per Chairwoman, Janet Yellin: sustainable GDP growth must







be visible; wage growth needs to appear; and inflation needs to move toward the Fed's 2% target. The Fed removed the word "patience" from recent pronouncements, but it likely will make incremental adjustments over a long period of time, absent unexpected stimuli.

- Jeremy Siegel, Wharton Professor of Finance, estimates that the rise in the dollar since last summer already has created an impact equivalent to a 50 basis point (0.5%) Fed tightening.

Sentiment Indicators/Market Trends

- Sentiment and Market Trend indicators generally reflected over-bought conditions at year-end. Since then, turbulent markets, ongoing rotational consolidation, and increased ambivalence among investors have pushed these measures generally back into a neutral stance, plus or minus, depending on the measure.
- On the whole, extreme bullishness readings have waned, and bearishness measures have strengthened. It is important to remember that Sentiment Indicators generally are "contrary" indicators.
- With respect to companies, sectors, and market capitalizations, many of 2014's leaders have become 2015's laggards. Year-to-date, mid-sized and small capitalization companies, whose revenues stem primarily from the U.S., have outperformed their larger brethren.

Equity Market Valuations & Earnings

- With a trailing P/E ratio of 17.4x and a forward multiple of 16.7x on the S&P 500, market valuations as of March 31st were full but not excessive versus historic measures.
- Price-to-sales metrics appeared somewhat high, but they were supported by record profit margins.
- The ~2% dividend yield on the S&P 500 Index remained compelling versus the 10-year U.S, treasury yield of 1.86% (as of April 1st, 2015), especially when considering the likelihood of future dividend growth from quality companies. An earnings yield (earnings/price) of 5.8% remained another outstanding market attribute.
- The current challenges to earnings and traditional market valuation metrics stem primarily from weak oil prices. As of April 1st, aggregate S&P 500's earnings projections reflected a mere 0.0%-2.0% in growth, but the majority of the negative drag came from the energy sector, with a projected earnings decline of -57% in 2015.
- Additionally, the strong dollar has played havoc among the earnings of U.S. companies that operate internationally. Under U.S. Generally Accepted Accounting Principles (GAAP), U.S.-based corporations must account for their foreign sales in U.S. dollar terms – as the value of the dollar strengthens versus foreign currencies, the value of foreign sales (as reported in U.S. dollars) declines, often skewing perceptions of operational performance. With ~30% of all S&P 500 sales derived from outside the U.S., currency translation adjustments have hurt multinational earnings assumptions in the first quarter. Over time, this trend should reverse.
- As mentioned earlier, 1985 and 1997-98 are periods whose fundamentals reasonably approximate the current environment. In both periods, earnings and revenue growth were penalized by a strong dollar; inflation materially declined on lower energy prices; and market turbulence prevailed uncomfortably until global balances were restored, and earnings growth caught up with valuations.

Conclusion

With modest growth in earnings and capital formation, low inflation and low interest rates, ample liquidity, fair-to-full valuations, we would not be surprised to see the market continue to move sideways near-term. If earnings continue to rise, the perception of better value will emerge, perhaps setting the stage for future advances over the long-term.

For more information about Investment Management of Virginia, visit: http://www.imva.net

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