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The HeadInvest Quarterly

MarketComment.

The year 2014 turned out surprisingly well for most investors. In the US, major stock market indices rose 8% to 12% in the year. Because the dollar appreciated nearly 15% on a trade-weighted basis, European and Japanese investors in the US made out even better, with returns of 25% or higher in their local currencies. (Unfortunately, the converse was true for those investing US dollars abroad, as returns from foreign investments were hurt by the dollar's appreciation.) Though interest rates fell, bond investors benefited from the capital appreciation of bonds; the longer the bond, the more its price rose. In 2014, the US was definitely a good place to be.

STRENGTH IN THE US ECONOMY DROVE CORPORATE EARNINGS HIGHER, ALONG WITH EMPLOYMENT, PERSONAL INCOME AND HOME PRICES.

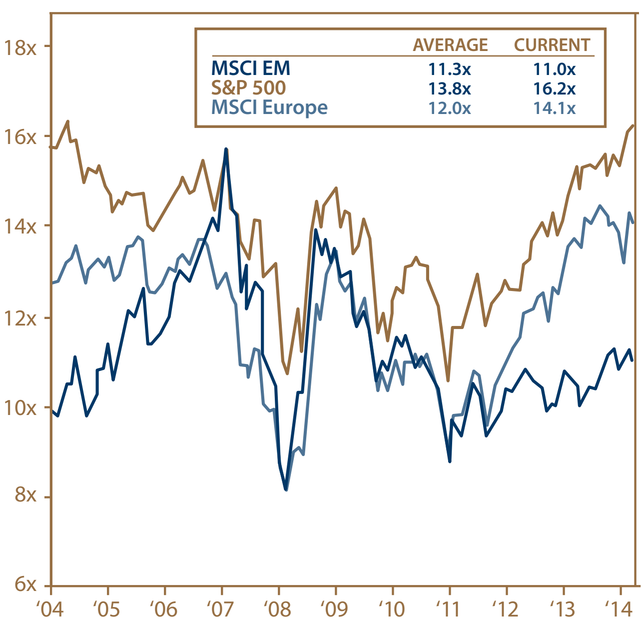
While it was a good year for Wall Street, it was also a good a year for Main Street. Strength in the US economy drove corporate earnings higher, along with employment, personal income and home prices. Unemployment fell below 6% and consumer confidence reached its highest level in seven years. Household balance sheets continued to improve and banks started lending again.

In the coming year, we expect Main Street to continue to benefit from trends already in place, including the dramatic decline in oil prices in recent months. The party on Wall Street, however, may moderate, as much of the improvement seems already to have been incorporated into stock prices. The stock market seems likely to continue its recent volatility. In the longer-term, however, even from today's levels, it is reasonable to expect equity prices to rise faster than bond prices, which may finally this year see the deleterious impact of rising rates.

EARNINGS AND VALUATION Stock valuations have reached their highest level in ten years, a good reason to temper expectations for further gains this year. The forward price to earnings ratio for the S&P 500 is 16.2x, as shown in the graph below. This equals the highest multiple of the past ten years and is above its long-term average of 13.6x. The lower multiples shown for both the MSCI Europe and Emerging Market ("EM") indices reflect the relative growth challenges in both developed and developing international markets, but also potential opportunities.

FORWARD PRICE TO EARNINGS

P/E rations for next 12-month consensus EPS



Source: JP Morgan

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Most US stocks are more expensive than the index figures suggest. The median price to earnings ratio for US stocks is at a post-war high of over 20x. This valuation extreme extends to valuation measures based on cash flow and book value as well. At times, the popularity of certain stock sectors distorts the overall multiple. In 2000, high multiples and large market capitalizations for tech stocks drove the average PE for the S&P 500 to 30x, though many non-tech stocks were rationally valued. Today's market, however, is characterized by high valuations across all sectors.

This valuation signal in itself is a bit of a red flag, even before considering that interest rates are widely expected to rise, that corporate profit margins are at an all-time high, and that political and currency risks are elevated. Though high valuation itself does not necessarily trigger corrections, the market is vulnerable to events that could cause earnings or confidence to fall.

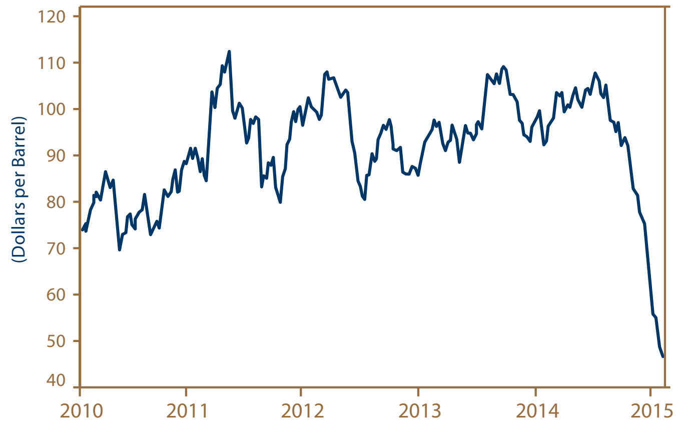
SHOWDOWN IN THE OIL PATCH On the plus side, lower oil prices will add strength to the economy. The decline in oil prices was perhaps the largest economic shock of the past year. Oil prices fell over 50% in 2014, nearly 35% from the beginning of December, and the declines have continued so far this year. The oil market is oversupplied relative to demand, an imbalance which had been building over the past twelve months. When OPEC announced on November 29 that it would not cut production in the face of this imbalance, a selloff was triggered that brought oil prices to levels not seen since 2009.

> THOUGH HIGH VALUATION ITSELF DOES NOT NECESSARILY TRIGGER CORRECTIONS, THE MARKET IS VULNERABLE TO EVENTS THAT COULD CAUSE EARNINGS OR CONFIDENCE TO FALL.

Normally, oil price declines boost aggregate demand by shifting income to consumers, who have a higher propensity to spend than oil producers. This is the most likely impact this time as well. However, many of the world's marginal producers of crude oil are now located in the US. As a result, the boost to growth from a decline in the "oil tax" may turn out to be less favorable to US consumers than usual, especially those in Texas and North Dakota. At the same time, the oil price decline increases the risks of spreading deflation in Japan and the Eurozone and potential political crisis, especially in Russia. Russian President Putin claims the West is out to get Russia, take its nuclear weapons and its natural resources, and one can only hope this posture does not lead to desperate action.

CRUDE OIL PRICES

West Texas Intermediate (WTI) - Cushing Oklahoma



Source: U.S. Energy Information Administration

In the longer-term, however, the price of a commodity should approach the marginal cost of production. In recent years, much of the growth in production has come from expensive sources, including offshore deepwater, oil shales and tar sands. This high-cost production was drawn into the market by high and relatively stable oil prices, which have traded in a range of $90 to $110 per barrel. Once global economic growth resumes, one can expect prices to move toward this level again.

A NEW ERA FOR MONETARY POLICY? Last year saw the end of the Federal Reserve Board's policy of quantitative easing. First launched in the immediate aftermath of the financial crisis of 2009, the Fed's stimulus program had been paused before, only to be restarted when the Fed concluded the economy needed more help. In October, the Fed

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decided the economy no longer needed the help and, as predicted by outgoing Fed Chair Ben Bernanke last summer, the program was brought to a halt.

As Bernanke famously remarked, "The problem with [quantitative easing] is it works in practice, but it doesn't work in theory." It is therefore not surprising that no one was sure what to expect when it ended. Since one of its intended effects was to lower interest rates, for example, many expected rates to rise when the policy ended. Instead, the opposite happened. The yield of the 10-year US Treasury has declined steadily this year, from 3% at the end of 2013 to 1.7% as of this writing.

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Another of the policy's intended effects was to boost stock prices. Some central banks in the world, notably Japan's, actually purchase stocks to boost prices, but the US Fed has not. Nonetheless, they targeted stock prices as a policy outcome, and it seems to have worked. Would it be logical to conclude that stock prices would weaken when the policy ended? So far, the opposite has occurred.

Inability to predict consequences notwithstanding, central banks in Europe and Japan have picked up where the Fed left off. Last October, Japan increased its QE program to a "different dimension" and announced plans to buy $712 billion of bonds each year to increase asset prices, lower the exchange rate for the Yen and, thereby, boost its economy. This month, the European Central Bank announced its intention to purchase 1 trillion Euros of bonds over the next 18 months. Interest rates in Europe are already so low—the rate on German 10-year bonds was already microscopic before the announcement—that the ECB had to make clear it would purchase bonds even if yields were negative.

What has been the effect of all of this bond buying? First, interest rates globally are at or near historic lows. In the US, the 10 year Treasury yields a measly 1.7%. In Germany, the 10 year yield is 0.35%. In Spain, the yield is 1.4%. Second, lenders are being punished. Their income is now being redistributed to borrowers for the sake of the greater economic good.

These two impacts are clear; after that, it is open to speculation. Is it possible for investors to drive the prices of higher-yielding assets above rational levels? Clearly, yes, though policymakers hope to contain this risk through "macroprudential" policies — rules designed to limit leverage, or speculation or other potential market distortions. But the drive for yield may well explain the high stock valuations discussed earlier.

For investors, the new era of monetary policy has positives and negatives. On the positive side, conventional central bank thinking seems to be that higher asset prices is a valid policy target that leads to improving economic performance, a policy that has not historically been explicit. On the negative side, as central banks assume new and greater responsibilities, the risks of policy mistakes rise. All central bank heads point to fiscal policy or economic re-structuring as the true path to higher growth, but accomplishments so far remain lackluster. Like it or not, intervention in markets by central banks, whether targeting interest rates or stock prices, seems to be here to stay.

IF POLICYMAKER GOALS ARE MET, THE EXCHANGE RATE CHANGES WILL SERVE TO DISTRIBUTE THE RELATIVE ECONOMIC STRENGTH OF THE US MORE EVENLY AROUND THE GLOBE.

THE ALMIGHTY DOLLAR? Since last year, the US dollar has appreciated markedly against both the Japanese Yen and the Euro. The dollar buys nearly 20% more Yen than it did last year at this time and nearly 50% more than in 2012, just prior to the election of its current prime minister, Shizo Abe. The Euro has lost about 20% of its value versus the dollar since last year.

To a degree, both of these moves are welcomed by their countries' respective policymakers. Lower

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exchange rates could stimulate exports and make imports more expensive. If policymaker goals are met, the exchange rate changes will serve to distribute the relative economic strength of the US more evenly around the globe, or at least to Europe and Japan.

What is the outlook for further dollar appreciation? Unfortunately, it is very difficult to predict. In 2007, model Giselle Bundchen famously insisted that she be paid in an almost any currency but the US dollar. At the same time, even Bill Gross, of PIMCO fame, said, "If you only had one idea, one investment, it would be to buy an investment in a non-dollar currency." Unfortunately, the dollar soon reversed its slide and gained 25% against the Euro in the following year.

CURRENCY MOVES CAN BE BREATHTAKINGLY FAST, AS SHOWN BY THE RECENT 25% APPRECIATION OF THE SWISS FRANC IN ONE DAY, OR, AS IS USUALLY THE CASE, ALMOST INVISIBLY SLOW.

Currency moves can be breathtakingly fast, as shown by the recent 25% appreciation of the Swiss Franc in one day, or, as is usually the case, almost invisibly slow. Since the early 70's, the Japanese Yen has more than tripled against the dollar, even including its recent 50% decline. But other than on a few occasions, such as the Plaza Accord in 1985, currency moves are rarely predictable.

COMMUNICATION BASED ON A PERSONAL RELATIONSHIP CAN HELP YOU INTERPRET THE INVESTMENT ENVIRONMENT AND MAKE SUITABLE ADJUSTMENTS TO YOUR PORTFOLIO, YOUR SAVINGS RATE AND YOUR SPENDING.

In the meantime, however, as noted above, US dollars invested abroad did not fare well last year. And we have already begun to hear disappointing earnings reports from US companies for the fourth quarter of 2014 as a result of the strength of the dollar. The consensus is for dollar strength to continue.

CONCLUSION A solid investment plan is designed to help meet your goals. Working with an advisor to develop one does not mean that returns are always positive, far from it. It does mean that communication based on a personal relationship can help you interpret the investment environment and make suitable adjustments to your portfolio, your savings rate and your spending.

We value your Comments

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