2014 Review of the Markets

Index	2014 Return
MSCI ACWI IMI	3.8%
S&P 500	13.7%
MSCI World Ex US	-4.3%
Barclay's Bond Index	6.0%
Consumer Price Index	0.7%

Investment Commentary

2014 was another strong year for U.S. equity markets. The S&P delivered its sixth consecutive positive year since the financial crisis. We think it is important to be mindful that while we did see volatility pick up in 2014, volatility is normal in financial markets and the last several years have been marked by nearly unprecedentedly low levels of volatility. Diversification naturally reduces the return of a portfolio relative to its best performing component. However, during times of volatility such as the fourth quarter of 2014, diversification can help support returns, as our clients experienced.

Outside of the U.S., there was greater uncertainty and lower returns. International markets declined 4.3% in U.S. Dollars. While 2014 was widely considered a poor year for international developed markets, these indices were slightly positive in their local currencies. Slow global growth, a strong U.S. Dollar, and geopolitical issues led to weaker market returns for U.S. Dollar based investors.

Within bond markets, yields fell throughout 2014. As was the case in 2013, this went against every major forecast. Markets widely anticipated the end of the Federal Reserve's bond buying program in 2014. Forecasters also assumed that this would lead to an increase in interest rates, since the largest buyer of government bonds would no longer be in the market. However, economic uncertainty and dramatically lower (in some cases negative) yields on foreign government bonds supported demand for U.S. Treasuries and kept a lid on interest rates. Inflation expectations have come down dramatically in light of falling oil prices and sluggish wage growth. While we do not see runaway inflation, it is important to keep a long term view of inflation expectations when planning for financial independence. We still think it is likely that 2015 will be the year in which we see wage growth start to gain traction, which will likely increase inflation.

Global markets were largely driven by three factors. First, central banks globally continued large monetary easing measures. Secondly, much of economic data from the U.S. remained strong and trending stronger including unemployment and GDP. The U.S. remains among the strongest economies in the developed world. Finally, the second half of the year saw a precipitous decline in the price of crude oil. Prices fell from their June high of $108 per barrel to $55 to end 2014, a drop of roughly 50%. The decline accelerated after the Organization of the Petroleum Exporting Countries (OPEC) decision to not cut production on their Thanksgiving Day meeting. This decision was broadly unexpected and could represent a shift in the effectiveness of OPEC.

Economic Outlook

Broadly speaking, we believe the decrease in the price of crude oil will be a net positive for much of the global economy. Most economies will have additional money to spend as a result of lower energy costs. Europe and Asia, specifically, have no material local supply of oil and will greatly benefit from additional cash in the hands of consumers and corporations who pay to transport their goods. The U.S. also falls into the camp of net benefiting from lower energy prices, although in the short-term it could be painful for those who have participated in the U.S. energy renaissance over the last decade. Obviously, nations whose economies are reliant on exporting energy will suffer. Russia in particular is being hit very hard by depressed energy prices.

In the U.S., strong economic data should keep the Fed on course to increase interest rates in 2015. We believe they are anxious to hike rates because when there is another recession (and there will be; it is part of the normal economic cycle), the Fed would not have the ability to decrease rates and accommodate markets as they did after 2008. Moving back to a more normalized interest rate environment would put that tool back in their toolbox.

The ECB will almost certainly be forced to act in 2015 – likely sooner rather than later. The questions become a) whether or not Europe's version of Quantitative Easing (the introduction of liquidity into financial markets by central banks) will be large enough and b) whether or not it will be executed effectively. In spite of ECB actions, many of the problems which have hindered the Eurozone's growth would likely still persist, including demographic, geopolitical, and labor issues. That being said, we are always cognizant of the fact that strong equity markets do not necessarily need strong economies (see U.S. circa 2009).

Investment Strategy

Despite significant economic malaise in the Eurozone, we have not seen valuations of European equities decrease meaningfully over the past year. However, the Eurozone could benefit from economic tailwinds including decreased energy costs, Quantitative Easing, and a falling Euro relative to other global currencies. For these reasons, we monitor European equities for potential entry points as we have maintained a meaningful underweight to the area relative to global markets for quite some time. This underweight has benefitted our clients; however, it has led to a concentration in U.S. equities, decreasing diversification.

Domestically, equity valuations are slightly above long term averages. Indeed, in light of low interest rates, the argument can be made that valuations should be higher than normal, since low rates lead to a higher net present value of company cash flows. We believe that valuations continue to be supported by reasonable economic growth in the U.S. as well as favorable relative valuations to foreign equity markets, certainly on a risk-adjusted basis.

From a fixed income perspective, we have observed an increase in quantity and type of "unconstrained" fixed income products that look to provide a high level of income by entering less traditional areas of bond markets. These funds generally undertake credit risk, currency risk, interest rate risk, or a combination of these and other risks in order to increase their payouts to investors. While some of these strategies have been successful, we believe it is of utmost importance to understand the risks at work within a portfolio. We believe the managers we use in client portfolios have proven track records of understanding and managing the risks they undertake. Going forward, we will continue to use fixed income to reduce portfolio volatility and not as a source of increasing return. This means limiting interest rate and credit risk as is appropriate for a client's level of risk.

We hope each of you had an enjoyable holiday season and look forward to helping provide a prosperous 2015.