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Keep Calm, Wary and Carry On

Once again, at the start of 2015, leading economists and market pundits assembled their points of view on the upcoming year. A review of these pundits' track records shows just how absurd it can be to distill any form of clarity from the proverbial crystal ball. 2014 was no exception; the "Great Humiliator" struck again (a tip of the hat here to investor and long-time Forbes columnist Ken Fisher's characterization of the financial markets). While the large cap U.S. equity market turned in an admirable result (+13.7%, S&P 500), particularly in the light of 2013's astonishing gains, their large cap brethren in the European Union and Emerging Markets were not so lucky for U.S. Dollar investors, down -7.4% (MSCI EAFE) and down -4.6% (MSCI EM) respectively.

At this point one year ago, expectations were near uniform that interest rates would rise (such uniformity of opinion often should serve as a warning sign). As could be expected, market strategist opinions tend to reflect their current investment positioning. As the year progresses and reality unfolds, their attempt to keep up with a benchmark or return bogey has them chasing the winning areas of the market. This herd-chasing mentality can provide ample lift to segments of the market that were previously unloved. In 2014's case, interest rate-sensitive assets like Utilities (+29.0%, S&P 500 Utilities), Real Estate Investment Trusts (+22.8%, S&P Global REITs) and long-dated U.S. Treasuries (+28.3%, S&P/BGCantor 20+ U.S. Treasury index) were the belles of the ball. Few were prepared to ask them for a dance at the beginning of the year.

Global liquidity is searching for higher returns

One still has to ask: *What is causing interest rates to decline so precipitously?* Will the U.S. catch Euroland's deflation (as declining oil prices might suggest)? Are we the liquid-market beneficiaries of a flight to quality? Our view is that the U.S.'s real interest rates, while low in absolute terms, were *relatively* high, particularly when considering our stability, growth prospects and reserve currency status (and a good-old-fashioned momentum tail wind). But we caution those considering a jump onto the long-duration bandwagon, as *absolute* returns are what we ultimately earn. The only way we see rates going much lower from here would be as the result of a global

recession. We don't see that as yet, but we do think the cyclical bull market in U.S. equities and secular bull market in U.S. Treasuries are probably closer to their end than their beginning. Note, though, that any healthy correction in either of these asset classes should be reviewed for buying or rebalancing opportunities.

As we mentioned in our 3rd Quarter "Pigs Get Slaughtered," and echoed in our 4th Quarter "Tale of Two Signals" *Insight* commentaries, we have not been advocating a strong tilt towards risk assets. Indeed, with the U.S. equity market completing its sixth positive year, with valuations appearing "full," *and* with last year's high performance concentrated in defensive sectors and a select handful of mega-cap stocks,* it's hard to argue that the U.S. market appears all that healthy—except, perhaps, in comparison to everything else. There is a great deal of global liquidity searching for higher returns.

High-yield fixed income has been under pressure, with particular concerns about the future claims-paying abilities of energy firms. There may be some bottom-fishing opportunities in those marketplaces as long as oil prices do not stay at or below $50 for the next several years. Very active management and deep credit analysis should be rewarded.

Impacts of the price of oil

To that end, one cannot review 2014 without mentioning the extreme downside movement seen in oil prices. Our review will not get into the nuances of the discussion, as many financial periodicals and market commentaries have amply reviewed the pros and cons over the past four months. On balance, we suggest it's a strong economic tail wind for U.S. consumer demand (the vast majority of our GDP), but a headwind for cap-ex, employment and general inflationary trends. The geopolitical front is another matter; we'll speak further to that below. To us, though, it's a prime example of the un-forcastability of markets and a reminder to be diversified—no matter the "renaissance" upon us.

As one of our esteemed colleagues, Duncan Smith, suggests: "We need not get bogged down with input streams and dynamic assumptions to conclude that there is no single, global value of a barrel that is 'right'… oil is 1/3rd

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politics and 2/3rds supply and demand. I'll leave it to the reader to determine which of these can change the price so dramatically in 90 days." Indeed, what is the "right" price for any asset class?

Values can be estimated, but as the idiom suggests, beauty is in the eye of the beholder.

*Interestingly, looking at the components of the U.S. equity market, just five stocks drove 20% of the returns in 2014: Apple, Berkshire Hathaway, Johnson & Johnson, Microsoft and Intel. Given typical capitalization-based market-weighting schemes of ETFs and Index Funds, a typical "passive" investor will continue to buy these companies at greater and greater weights (aka: higher and higher prices). This is a positive feedback loop, until it becomes a negative one. We are beginning to diversify away from this risk with rules-based, non-capitalization-weighted strategies.

Central Bank divergences

We think much of the challenge for investors in 2014 was exacerbated by the divergence among the actions of central banks. The Fed is taking its foot off the pedal while the ECB and the BOJ are stepping on theirs. Looking forward, we see the Fed's "transparency" movement turning towards opacity. Recall that beginning in January 2012, FOMC decision commentaries laid forth explicit targets that would ring the bell for the end of QE (i.e., a "2% target inflation rate" and "6.5% unemployment rate"). How can the Fed jawbone if they also draw lines in the sand? To that end, when was the last time you heard the Fed speak of an unemployment rate target? Today, Fed watchers parse phrases and words like "a considerable time" or "patience" to divine when the Fed may see fit to raise rates. Now the Fed is "data dependent" – a less insightful or revealing commentary would be difficult to make. We believe this obfuscation is intentional; the Fed can wrest power back from the market by moving back into the shadows of Jekyll Island.

Overall, we are concerned about the general narrative of Central Bank omnipotence and believe we are entering a

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"show-me" phase of QE policy. The ECB and BOJ's effectiveness should be measured by positive GDP prints- and the avoidance of staggering inflation. Fortunately for those of us stateside, U.S. GDP statistics through Q2 and Q3 2014 were very strong (+4.6% and 5.0% respectively) with inflation showing little sign of life. BOJ Governor Kuroda's latest announcements produced a ~20% equity return since early October (in Yen) while ECB President Draghi's efforts helped stage a reasonable ~5% return on the year (in Euro terms).

Market gains notwithstanding, Euroland's economy is hanging on by a thread. But remember, a low bar is easier to hurdle, so developed international markets could be a positive surprise in 2015. Japan is looking desperate with inflation above target and GDP still waning. Ultimately, we're less sanguine about Japan's prospects, but if Euroland improves and China doesn't fall off a cliff, the world could absorb Japan's liquidity.

Remaining vigilant ...

What happens when a five-trillion-dollar gravy train comes to its final destination? What happens when the momentum shifts and hedge funds executing massive carry trades get squeezed by unexpected outcomes? We're not suggesting we've reached a tipping point, but investors should be vigilant. As mentioned in our 3rd Quarter outlook, our moving average signals still have us sitting with ~25% of our standard allocation to developed international markets in cash. That said, our firm believes that no equity market is "best" over the long run, so a representation of markets outside our borders should be a standard part of our long-term allocation.

Relative to surveys of most U.S. investors, it could be said that we have a strategic (long-term) overweight to non-U.S. markets, albeit with a current (short-term) tactical underweight.

It is possible that geo-political conflict will reemerge as more of a driver of global investing than it has been in the past two years. With the unprecedented bull run of the U.S. equity markets, U.S. investors have been mostly ambivalent about the goings-on of the rest of the world. When Russia invaded Ukraine last February 26th, for example, the U.S. market barely flinched: The S&P 500 was up 0.02%. Two near-term drivers of conflict in 2015

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may be the aforementioned chasm of global monetary policy and the potential social turmoil created within (or by) oil-dependent political economies feeling the pinch of declining revenues.

These are significant-enough drivers of money and politics and could fuel large-scale political shifts such as secessionist and/or nationalistic movements. Tensions between China and Japan, for example, are not likely assuaged by the BOJ's efforts. And more than half of Russia's government budget and a quarter of its GDP come from energy exports. The latter has further challenges given recent sanctions and ostracizing by the West.

… and carrying on

All told, we expect 2015 to be a year of heightened volatility, but a year in which we should "keep calm, wary and carry on." 2014 reminds us that even given a barrage of seemingly negative events (Ukraine/Putin, Argentina default, ISIS (ISIL), Ebola, etc.), global markets are resilient and can still churn out positive results.

It behooves us also to remember that by the time the general discourse has caught on to an issue, its impact is likely at or reaching its peak. Greater volatility may further enhance rebalancing-return opportunities for well-diversified investors. Other opportunities may also present themselves in terms of assets that have little-to-no correlation to financial markets (i.e., reinsurance). Or opportunities that can take advantage of trends, whether they be positive or negative (i.e., moving averages, managed futures and variance risk harvesting).

The last two years have rewarded simplicity, particularly for the "typical" U.S. investor who allocates only between stocks and bonds—with a predominant bias towards U.S. stocks and U.S. bonds. Looking into 2015, we suggest that alternative *sources* of returns may end up having their day in the sun in spite of what otherwise may be a "normal" year in terms of year-end results overall.

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