ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
January 9, 2015

Dear Clients:

The year 2014 ended on a high note for both stock and bond markets, with the S&P 500 Index in "all-time high" territory and the 10 year US Treasury note yield at around 2%. The US dollar rallied strongly throughout the year and remains the singular global reserve currency. The US economy seemingly is moving forward in fits and starts toward an annualized real growth rate of 3+% and an unemployment rate below 6%. Since July, 2014, oil prices have declined by roughly 50%, giving global consumers a boost to disposable income and providing significant economic sanctions to some of the world's more dangerous regimes. The GOP takeover of the US Senate in the November elections may lead to continued moderation in federal government spending and regulatory encroachment. It remains to be seen whether these positive trends are sufficient to offset systemic risks that remain from a moribund, overly-leveraged European economy, the destabilizing acts of terrorists, and the unknown path to unwinding the grand "quantitative easing" experiment undertaken by the US Federal Reserve Bank now being imitated to a larger relative degree by the Europeans, Japanese, and possibly the rest of the world as well. As one of our dear clients says so often, "we will see."

Investment Market Returns as of December 31, 2014

US equity index returns remained positive for the year, led by a 13.7% total return for the S&P 500 Index and a more modest 4.9% for the Russell 2000 Index. It should be noted that the Russell 2000 Index (US small cap stocks) generated a 9.7% return in the fourth quarter alone to bale out an otherwise down year. We had expected the US large cap market to generate single digit returns (including a 2% dividend return) at best in 2014 based on an expected index earnings level of 106 and a trailing 12 month (TTM) P/E of 16.5x. Standard & Poor's Corporation's index guru (Howard Silverblatt) now sees 2014 index earnings of around 109.5, a 9% increase over 2013 and a TTM P/E of 18.8x at year end 2014. Silverblatt's compilation of 2015 analysts' expected earnings suggests 23% growth over 2014. The resulting forward P/E of 15x seems reasonable were it not for the much lower observed trend in sales. Third quarter sales are up about 5% year over year (growth between the second and third quarters of 2014 was a measly 0.25%). Investors the world over seem to believe the prospect of a 5% annual earnings yield plus growth of 5% to be far superior to the certainty of a 2% 10 year US Treasury note.

By contrast to the equity market euphoria in the US, total returns from non-US stocks in USD terms were decidedly negative. The primary developed country index generated a -4.9% return for 2014, while the primary emerging country index realized a -2.2% loss. The same returns in local currency terms were positive at 5.9% and 5.2%, respectively, reflecting the strong dollar appreciation versus developed country currencies of nearly 11% for the year. International capital flows have favored the perceived safety and growth opportunities found in the US, despite somewhat lower P/E ratios for non-US stocks and seemingly higher potential growth rates in less developed markets.

Fixed income securities also generated higher than expected total returns despite forward annual yields less than half of historical norms. To our surprise and amazement, US bond yields continued to decline in 2014 which led to a 6% return from the Barclays US Aggregate Bond Index (taxable investment grade bonds) and 9% from the Barclays US Municipal Bond Index (tax-exempt investment grade bonds). At year end 2014, the forward annual yields on these two indices were both around 2%. Foreign bond returns were negatively impacted by the strong USD; the Barclays Global G7 ex US Bond Index generated a negative total return of -3.5% with similar yield and duration metrics to that of the US indices.

Our View Looking Forward

A year ago, we would have considered as virtually impossible a 25% total return on longer-term US Treasury bonds; but that is exactly what happened. An extraordinarily expansive US monetary policy combined with inefficient and overly-leveraged foreign economies have created strong demand for investing in US securities, real estate, and until very recently, oil and gas related-properties. At some point (timing unknown), interest rates are likely to return to historical norms if investors are to be adequately compensated for duration and inflation risk. At a 12% required equity return combined with a sustainable 5% annual earnings growth rate, an investor might feel comfortable with a forward P/E of 14 as compensation for the uncertainty and perpetual duration of future equity earnings. Applying this P/E to Silverblatt's compilation of 2015 expected index earnings yields an S&P 500 Index value of 1900+/- or slightly below today's level. However, the same P/E applied to an assumed 2015 earnings at only 5% above the 2014 earnings yields an index level of 1600+/-. So, to get comfortable with today's index level, an investor may accept a 10% or less required equity return and an assumed 5% or greater annual earnings growth to suggest another banner year for equity returns. This broad range of possible outcomes reflects the reality of equity investing and why as advisors we choose to weight our risk exposures disproportionately to the price to earnings ratio and to use conservative earnings levels to influence our clients' equity exposures.

The flip side of the "equity price risk coin" is the prospect for a broad asset deflation or "negative growth". This situation would result from a generalized loss of investor and consumer confidence, a sustained downward pressure on wages, or a combination of both. In highly leveraged societies such as we find ourselves today, declining prices for all assets creates a huge insolvency problem as asset values decline while debt obligations remain constant. We last saw this problem in the stock market crash of 1929 and the ensuing Great Depression. Preventing this potential problem is the driving force behind the Federal Reserve Bank's massive monetary expansion actions designed to keep asset values above the underlying debt burden. Whether this maneuver can be executed without negative, unintended consequences remains to be seen. The recent behavior of long term bond prices suggests deflation risk remains quite high. A generalized deflation would be positive for high quality fixed income instruments but quite negative for most equity and lower-quality fixed income securities. This specific risk remains an element in our thinking about fixed income portfolio construction and overall asset allocation.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meeting your expectations.

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