



Quarterly Commentary – January 2015
Is this the Year of the Dollar and the Battle for Oil Supremacy?

My Dear Client:

The fourth quarter and full-year 2014, as well as the intro into 2015, is somewhat reminiscent of a phrase from Charles Dickens' *A Tale of Two Cities*: "It was the best of times, it was the worst of times; it was the age of wisdom, it was the age of foolishness". We are seeing a divergence amongst nations in economic growth, monetary policies and political calculations. We experienced the impact of a swift, sharp decline in the price of crude oil impacted equity markets, fixed income markets and interest rates resulting in notable performance differences within and across asset classes during the fourth quarter and full-year 2014. Further, volatility increased in the fourth quarter, particularly in October and December, when equity markets sold off and bounced back each month. This divergence is noteworthy as the post crisis period until now, saw significant global coordination and collaboration amongst central banks, policy makers, and trade groups or cartels.

With the U.S. on relatively firm footing compared with the rest of the world, major U.S. equity indexes had healthy gains for the fourth quarter and full-year 2014. In the fourth quarter, the S&P 500 Index® rose 4.9%, and the Index notched its third year of double-digit gains, rising 13.7% for 2014. The broader Russell 3000® Index rose 5.2% and 12.6% in the fourth quarter and full-year 2014, respectively. The broad U.S. fixed income market, as measured by the Barclays U.S. Aggregate Bond Index, also had solid returns, rising 1.8% and 6.0% in the fourth quarter and full-year 2014, respectively. In contrast, non-U.S. developed markets, as measured by the MSCI EAFE Index (net of taxes), declined 3.6% and 4.9% for the fourth quarter and full-year 2014, respectively. Emerging markets equity, as measured by the MSCI Emerging Markets Index (net of taxes), declined 4.5% and 2.2% for the fourth quarter and full-year 2014, respectively.

Crude Oil and World Economic Growth

The divergent paths for economic growth, monetary policies and the impact of the sharp, swift decline in crude oil prices began to take shape in 2014, yet more prominently during the fourth quarter. Economic growth appears to be regaining traction in the U.S. In contrast, Japan slipped back into recession. The U.S. labor market indicators continued to show improvement in 2014, evidenced by rising payrolls and a falling number of jobless claims. In December, the unemployment rate fell to 5.6%. Inflation pressures eased domestically in 2014, with the CPI increasing at a 1.3% annual rate in November, held down by the sharp drop in energy prices. Labor costs likewise remained subdued, with average hourly earnings rising 2% in November as compared to the prior year.



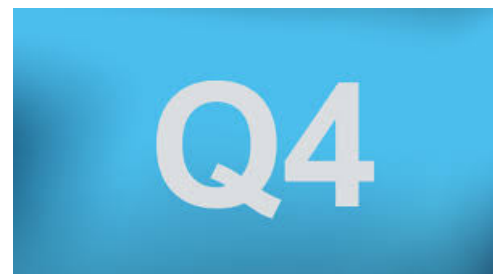


Europe's economic growth slowed, with inflation at levels worrisome to many investors. Within emerging markets, China's economy (currently the world's second-largest) slowed and Russia's economy began to contract. The U.S. Federal Reserve (Fed) wound down and ended its post-financial crisis monetary stimulus (i.e., bond-buying program) and has indicated it may begin raising interest rates in 2015. In comparison, the Bank of Japan, the European Central Bank and the Bank of China are doing the exact opposite; each have implemented additional monetary policy actions during the fourth quarter geared toward stimulating economic growth, with additional monetary actions in 2015 likely.

Just as there are two sides to every coin, there are two sides to the impact of the decline in crude oil prices. On the one side, the sharp decline in crude oil prices from \$92 a barrel in January 2014 to \$46 a barrel in January 2015 benefits consumers of oil and end-related products (i.e., individuals and industries such as airlines, the trucking industry, etc.) and countries that are net oil importers (China, India, Indonesia, Japan, etc). On the other side, lower oil prices cut into the profits of oil-related companies as well as threaten the viability of expensive drilling projects (Keystone XL?), specifically U.S. shale-oil fields and Canadian tar sands fields. Outside the U.S., falling oil prices hurt the growth prospects for countries relying heavily on net oil exports, many of which are emerging markets countries. The list of countries in economic pain could start with Russia and Iran closely followed by Venezuela, Nigeria, and Libya for starters.

Fourth Quarter Review

During the fourth quarter of 2014, the most prominent event (which also had the broadest impact across the world) was the rapid decline in the price of crude oil per barrel. The crude oil price decline began during the summer of 2014, and the velocity of the price drop snow-balled during the fourth quarter. In the fourth quarter, the price of crude oil per barrel declined more than 40%, and the price of crude oil



per barrel closed out 2014 with its second-largest annual decline on record. However, in contrast to the largely demand-driven price decline in 2008, the crude oil price decline in 2014 is largely fueled by increased global supplies arising from increased production from the U.S., as well as unanticipated output from Libya and Iraq. The Iraqis at 4 million barrels per day are producing at their highest levels ever; while, Libya is back to pre- Gaddafi coup levels a few years earlier than expected. Perhaps a third of the cause for drop in oil prices is weaker demand and outlook since many economies around the world are slowing or teetering on recession. Longer-term, low energy prices tend to support global economic growth and the demand for labor and other goods.

Yet the speed with which prices dropped can lead to challenges as nations and businesses attempt to adjust. And here is where political calculus emerges, OPEC led by Saudi Arabia this past November for Thanksgiving declared that they would not reduce supply even though prices had already fallen dramatically in the months preceding this announcement. Realizing that their share of the global oil market now stands at 40%, Saudi Arabia (who has two years' worth of reserves stockpiled at current output levels) has convinced fellow members that now is the time to make a last stand in effort to force U.S. shale and Canadian suppliers out of business.



Further, keeping prices this low acts as further punishment to Iran who due to diminished currency reserves as a result of sanctions needs oil around \$130 a barrel to balance their budget. Putin needs roughly \$100 barrel oil to keep his budget in balance too, the Nigerians and Venezuelans are similarly positioned with some analyst at CMA (a division of McGraw Hill Financial) now estimating 93% chance of a Venezuela debt default within 5 years. So we may see major upheaval internally in these and other export countries in 2015.

Equity Markets

During the fourth quarter of 2014, the U.S. equity market was bolstered by U.S. economic growth regaining traction, relatively strong corporate earnings growth, and a Fed that remained accommodative even as it ended its post-crisis stimulus (i.e., bond-buying program) in October. In addition, the decline in crude oil prices also added more money to U.S. consumers' wallets during the quarter, a positive since consumers account for roughly 70% of U.S. gross domestic product (GDP). U.S. real GDP advanced at an upwardly revised 5% annual rate in the third quarter of 2014. For the quarter, U.S. small-cap equities outpaced U.S. mid- and large-cap equities. Small-cap growth-oriented stocks generally outpaced their value-oriented counterparts, while the reverse generally was the case within mid- and large-cap stocks. Within the S&P 500 Index, which provides a proxy for the equity market, the Utilities, Consumer Discretionary and Consumer Staples sectors had the strongest gains. In contrast, the Energy, Telecommunications and Materials sectors had losses.

Overseas, relatively weak economic growth and geopolitical events, particularly in Russia and Greece, weighed on equity markets and broad non-U.S. developed equity markets posted losses for the fourth quarter -3.6% and -4.9% full-year 2014 (based on performance of MSCI EAFE Index-net of taxes). In addition to relatively weak, slowing, or recession level economic growth and geopolitical events, the decline in the price of crude oil contributed mightily to losses in broad emerging equity markets for the same periods.

U.S. Fixed Income Market

Within the U.S. fixed income market, many of the same themes from the third quarter 2014 continued in the fourth quarter: yields (intermediate- and long-term maturity) declined, longer-term duration fixed income securities outpaced shorter-term duration fixed income securities, and long-term Treasuries had relatively strong performance. The yield on the 10-year Treasury continue the path of steadily declining ended 2014 at 2.17%, down from 2.52% at the end of the third quarter 2014 and 3.04% at the end of 2013. Investment grade corporate bonds generally outperformed their US Treasury counterparts in 2014. In contrast, high yield bonds underperformed equities and US Treasuries on concerns of rising default rates primarily in the energy sector. During the fourth quarter and full-year 2014, a number of global economic, geopolitical and market scares boosted global investor demand for U.S. Treasury bonds. Many investors view U.S. Treasury bonds as a relatively "safe" haven during times of global risk. Relatively low yields in Japan and the Euro zone also boosted global demand for higher-yielding U.S. Treasuries. The implied safety of US Treasuries is likely to continue even when short-term rates rise at some point this year as much of Europe is likely to spend the year fighting deflation, while others like. More countries in Europe and elsewhere will whipsaw their currencies.



A Look Ahead

Heading into 2015, I expect the fourth quarter's four most prevalent themes—diverging global growth trends, diverging global monetary policies, divergent impacts of the crude oil price declines and increased volatility—will continue. In 2015, we should look for two themes to drive the global economy: **monetary policy divergence**, with some central banks remaining easy and a few others gradually normalizing interest rates by monetary policy and the nation by nation impact of **oil prices**. With inflation relatively tame here, I expect that U.S. monetary policy will be attempted to be very supportive of economic expansion for the next few years, even as it begins to gradually increase interest rates.



Increased volatility, the impact of the *divergence* in economic growth, monetary policies and crude oil price declines, and geopolitical events during the fourth quarter, all serve as reminders of the role active management can play in helping you navigate through the short-term uncertainties, and remain on the road of maintaining a disciplined, diversified, long-term investment approach consistent with your risk tolerance, goals and time horizon. The divergent paths may make the portfolio management balance act of identifying potential growth opportunities and potential real risks an even more important exercise to help you reach your investment goals. Tail Risks (the ones that probably do not happen yet are really bad) to consider this year include a sooner than expected rise in short term interest rates by the Federal Reserve Board, deflation spreading across Europe leading to European Union upheaval, and escalation of skirmishes amongst nations into full fledged wars.

The fourth quarter and 2015 seem to be the beginning of a more volatile period where nimbleness, risk management discipline, finding valuable investment opportunities in volatile markets, and Patience are required. Investors' preference for yield continues in the face of low interest rates, and investment grade and (a few areas) high yield corporate bonds offer attractive risk/reward characteristics relative to Treasuries for those eagerly in need of more robust yields. As some years in investing the opportunities to put new cash in play are more limited than others so: cash flow investments (Credit, Loans/collateralize debt, Private Equity Investments) yielding 6% or better with low risk to principal along with segments of Emerging markets that are getting cheaper (especially those who benefit from cheap oil) may be as good as it gets this year. And oil pain will eventually create *distressed* and *opportunistic* buying moments for savvy investors with cash and long-term horizons. This is a good year and opportune time to review your asset allocation and consider if big winners from the past few years should be brought closer in-line with your investment policy targets.

Additionally, the time is right or drawing nearer to look at the role of opportunistic and/or flexible nimble strategies within your asset allocation. Thus though equity markets have had quite a run from 2009-2014 and bonds have also had their surprisingly positive years along the way; active managers in general have mostly lagged passive strategies in publicly



traded markets. While hedge funds and other similar volatility and market trend based investment styles have lagged the S&P 500 and most of their respective benchmarks since 2009... those managers with demonstrated skill should do well in the coming three to five year market cycle.

As always, I look forward, to working with you toward your financial goals and objectives and making sure that your risk tolerance, unique circumstances and time horizon are still in alignment with your current portfolio and financial plan. If you have any concerns, questions, or general thoughts about your portfolio or any other matter, please never hesitate to contact me.

I wish you peace, health, and happiness in 2015.

Appreciatively,

Walid L. Petiri

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Sources: Barclays Capital, MSCI Barra, Russell Investments, Standard & Poors, Reuters, Federal Reserve Board, Wall Street Journal