2014 RECAP, 2015 OUTLOOK JANUARY 2015

2014: IS THE BOND MARKET TRYING TO TELL US SOMETHING?

Heading into 2014, one thing was almost universally agreed upon by smart economists and investors: Interest rates would increase. Naturally, they plummeted. After many winks and nods by the Federal Reserve, 2014 was to be the year when bond investors anticipated the eventual interest rate hikes by the Fed and preemptively drove yields higher through liquidation trades. For potentially numerous reasons, it didn't happen. Some of the potential forces at work include: An ongoing realization that rate hikes would be pushed further out than thought (because the global economy failed to gain traction), increased purchases of bonds from pension plans that were locking in stock gains from 2013, and increased purchases from foreign investors since U.S. bond yields are amazingly higher than those found in most developed international countries. These are all logical explanations. It would be remiss however, not to consider the bond market's knack for being a canary in the coal mine when it comes to predicting trouble in the markets. Time will tell if the increase in purchases was a flight to quality to avoid future weakness in other markets.

That being said, 2014 was a year in which the U.S. economy gained further momentum and consumers' confidence increased. This bode well for U.S. stocks, although large company stocks did meaningfully better than small ones. Other than that, international equity markets generally were disappointing, especially after factoring in the currency declines against the dollar. The big drama occurred at the end, when oil plummeted. Amusingly, the market seems to be more concerned about the negative implications regarding the energy sector instead of the positive implications for everything else. While it's true that there will be a negative ripple effect from the disruptions occurring from the energy industry, no one seems to be presenting good data on why that will outweigh the cost savings for energy consumers. Of course, supply and demand (and OPEC) will eventually find the right price . . . .

POSSIBLE ECONOMIC ISSUES FOR 2015

All else being equal, it would be reasonable to assume that economic growth will continue in the U.S. throughout the year. Employment numbers are looking decent, people are shopping more and say they're in a better mood financially, and businesses are starting to expand. Also, with foreign central bank leaders finally taking a "do whatever it takes" approach with stimulus, this could be the year that international economies start to show signs of life. The international economic headlines are still murky, but the corner usually gets turned when the news is still bad. The big drama for the year could be the buildup to the Fed's interest rate increase and the unfolding reactions in the stock, real estate, bond, currency, and commodity markets.

POSSIBLE INVESTMENT MARKET SCENARIOS FOR 2015

The markets frequently do the opposite of the consensus viewpoint. Since everyone assumes there will be a huge increase in volatility in stocks and bonds once rates increase, and since this is precisely what happened in mid-2013 when the Fed brought up the topic, it shouldn't be surprising if the initial increase is met with a yawn. (This isn't a prediction, but is rather just pointing out a potential contrarian scenario that might be helpful to keep in mind if the headlines predictably are pounding the drum of gloom before the event.) Volatility could very well increase from the low levels we've seen the past two years, but this change frequently occurs because of panics developing in corners where no one is looking.

During most every extended bull market in stocks, there comes a point where investors have to acknowledge that broad markets are no longer undervalued when comparing them to historical averages. The U.S. markets are basically at that point now. This by no means indicates that stocks are due for a bad fall in the immediate future (although they are arguably well overdue for a 10-15% slide that lasts for a few months). In the 1990's, stocks essentially started trading above average valuation multiples around 1996 . . . and kept clocking large gains for three more years. However, since not all investors have forgotten the pain of the Credit Crisis/Great Recession, it is possible that for the intermediate future stocks won't get driven to nose-bleed valuation levels. This means that we could see muted stock upside even if the economic news is good, which could cause frustration and lead people to crowd into various "hot" slivers of the various markets.

Internationally, stock valuations are below average, so if this is met with those economies turning the corner, it could result in a nice surprise.

Another longer-term stock market issue to consider, which by the looks of it probably wouldn't occur until 2016 or later, is the competing impact that interest rates of approximately 4 – 5% would have on stocks. It doesn't take a stretch of the imagination to envision many investors eagerly trading the potentially higher returns of more volatile equities for the less volatile, more fixed returns of short-term 4 – 5% bonds. That might sound attractive, but it should be remembered that short-term yields are usually always roughly in-line with inflation, meaning the net, "real" return is next to nothing. If this type of rotational trade occurred, it could likely just be setting the stage for a future stock rally and bond swoon after the movement ran its course.

Overall, investors should be prepared for more of the normal ups and downs that were largely absent the past two years. Just remember, it's completely normal, and is one of the great things about publically traded assets. While private assets like privately held businesses and real estate have certain advantages over publically traded ones, the public markets are where emotions can overwhelm logic in the short run and create opportunities where good assets trade at bargain prices.

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