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Fourth Quarter 2014

Fig. 1 – S&P 500

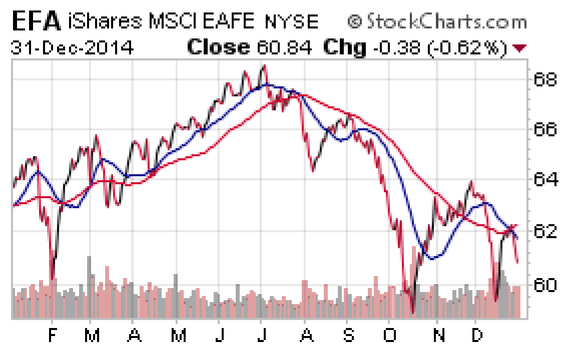

Fig. 2 – MSCI Europe, Australia, Far East

In a repeat of the third quarter, world market returns diverged significantly in the fourth quarter. The large cap U.S. S&P 500 posted a total return of 4.9%, and finished the year up 13.7% (**Figure 1**). By contrast, international indices continued to slide. The MSCI Europe, Australia and Far East Index (**Figure** 2) lost 2.8% in the quarter, ending 2014 down 4.9%. Similarly, the MSCI Emerging Markets Index fell 4.1%, dropping 4.6% in the full year. It is worth noting that, in local currency, these broad foreign indices were marginally positive for the year. However, for a U.S. investor, returns were negative due to the strengthening of the U.S. dollar.

U.S. companies generally continued to grow profitably. According to Factset, 77% of S&P 500 companies reporting during the quarter beat earnings expectations while 59% topped revenue estimates. Earnings and sales gains reflected third quarter domestic economic strength, in which U.S. gross domestic product (GDP) rose a surprising 5%, the strongest growth since 2004. Earnings grew for the seventh consecutive quarter, rising 8% after gaining 7.7% in the second quarter. Wall Street currently forecasts fourth quarter earnings growth of 3.4%, a significant drop from the September 30th estimate of 8.3%. Much of the drop in this annual growth rate can be attributed to the energy sector, which continues to see significant downward earnings revisions following sharp declines in oil and natural gas prices. Analysts will be looking for earnings improvements in sectors that should benefit from the drop in energy prices, including consumer discretionary and industrial companies.

In the fourth quarter, some of the global headlines that troubled markets earlier in the year subsided. The Ebola virus, the Russian invasion of the Ukraine, and the rise of the Islamic State of Iraq and Syria all took a back seat, helping markets to recover from an early October sell-off. However, other issues overseas held investor concerns. In Europe, continued worries over deflation and sluggish growth weighed on markets. The European Central Bank (ECB) has promised “to do whatever it takes”, implying a massive bond-buying program similar to the quantitative easing employed by the Federal Reserve in 2013, which helped keep interest rates low and promote growth. Doubts over the potential efficacy of such a program were exacerbated when ECB President Mario Draghi announced in early December that any action would wait until 2015, causing world stock markets, particularly in Europe, to fall sharply. The year ended with Greece threatening to renegotiate or default on their debt, a reminder that the structural problems that dogged the euro in 2011 persist. The euro weakened in the second half of the year (**Figure 3)**, reflecting both the monetary concerns and economic weakness in Europe.

Index returns taken from Morningstar.com

The biggest story for investors in late 2014 was undoubtedly the stunning fall in the price of oil (**Figure 4**). After years of new worldwide exploration and production, particularly by shale producers in the U.S., supply reached a tipping point causing oil inventories to grow. This growth was further engendered by slowing demand for oil overseas. As of this writing, OPEC nations, led by Saudi Arabia, have refused to cut production. Analysts have attributed many reasons to the sustained production, including putting pressure on U.S. operators, which generally have higher costs than the Middle East countries. The immediate impact is clear: much lower prices for users of petroleum products, including U.S. consumers. The fall in crude prices may act like a stimulus to the U.S. and parts of the global economy, leaving more discretionary income in the hands of spenders and helping companies that rely heavily on oil, including transports and some chemical companies, to operate more profitably. This oil "bonanza" should also help heavy importers of crude, including most of Europe, China and India.

Fig. 3 – Euro vs. U.S. Dollar Index

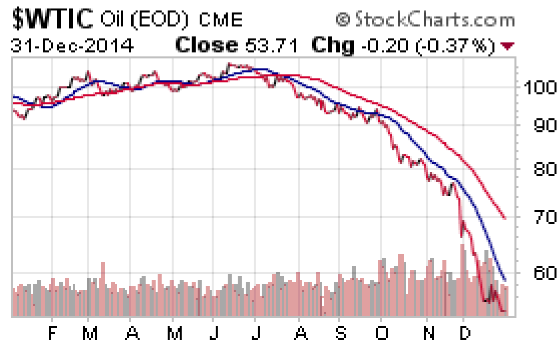

Fig. 4 – West Texas Intermediate Crude

In contrast to Europe, the U.S. generally posted solid economic numbers in the fourth quarter. Housing, manufacturing and services all showed growth, and employers continued to add jobs each month. While perceptions of our economy have been of slow growth, GDP has now expanded more than 3% in four of the last five quarters, with last quarter's 5% reading the best since 2003. This advance, along with stable government spending, has helped reduce the U.S. budget deficit to the lowest level since 2008, the sharpest reversal in more than 40 years. Reduced government borrowing should support corporate financing, which, along with improving employment and reduced fuel costs, should set the stage for another year of solid growth in the U.S.

After six years of economic and stock market recovery, investors may well express concern over rising stock indices. By some measures, the U.S. stock market is no longer a bargain, but it does not appear to have reached the very high valuations that are often associated with stock market tops, such as the NASDAQ bubble of 2000. If the growth of the last two quarters continues, U.S. stocks should produce positive returns, although weakness overseas may lead to more volatility this year. However, we recognize the difficulty of timing the market, and will generally remain invested, particularly in this low interest rate environment, where cash pays almost nothing. Moreover, we note that market pullbacks may provide new opportunities for alert investors.

We wish you a happy and healthy 2015, and look forward to working with you in the coming year.

Sincerely,

Kenneth M. Bernard, CFA