

## A 2014 Recap

The domestic economy turned convincingly toward expansion in the back half of 2014, led by a 5.0% gain in GDP for the third quarter. The year's fourth quarter GDP results are not yet in, but estimates call for further growth, in the 3.0 – 3.5% range. Encouragingly, the labor market has continued to firm, and both workweeks and wages are growing over the year-ago period, albeit at a still-modest clip. Two more tailwinds are apparent for the economy, lower energy prices and continued low interest rates; more on those in a moment.

Buoyed by solid earnings growth in 2014, the US stock market turned in another good year, led by large companies. Overseas markets did not fare so well, hurt by sluggish growth and weak currencies versus the dollar.

Index	2014 Price Return	Description
S&P 500	11.39%	Large Cap US equities
Russell 2000	3.53%	Small Cap US equities
MSCI EAFE	-7.35%	Europe, Australasia, Far East
MSCI Emerging Markets	-4.63%	e.g. China, S. Korea, Brazil
Barclays Aggregate	5.97%	Intermediate Bonds

Sources: Morgan Stanley, Standard & Poor's, Barclays

**The global market is telling us, through interest rates, that growth is expected to be slow, and consumer prices are expected to fall.**

## Divergent Economies – A Quick Trip around the World

**In contrast to an improving US economy, much of the rest of the world is struggling with slow growth.** Policymakers are scrambling to address the condition. In Europe, the Eurozone (EZ) is beset with multiple issues – sluggish growth overall, with France and Italy in recession, and Germany nearing stall speed; falling price levels across the region, with outright deflation a worrisome possibility; and political and financial uncertainty issuing once again from Greece, which is at risk of defaulting on its debt commitments. A central problem to the EZ is its disconnect of currency union (i.e., the Euro) to political union (nineteen independently governed nations, and national agendas). In this mix, the European Central Bank tries to be the monetary glue for a fractious and creaky system. The ECB is widely expected to announce a Quantitative Easing package for the region later this month.

Japan has undertaken radical policies intended to reverse two decades of relative stagnation. “Abenomics” describes a three-pronged package of deficit spending, monetary stimulus and

corporate reforms intended to boost growth and price levels. Similar to Europe, Japan is contending with deflation. The Bank of Japan is buying both government debt *and* public equities; printing electronic money to buy assets, and cycling the new money to the financial system. The Japanese stock market set new highs in 2014, accompanied (rather predictably) by weakness in the Yen. Japan is playing a high-stakes policy game with a compromised economy. With a public debt level 2.5x the size of its economy, no other industrialized nation comes close to Japan's current indebtedness. Japan's population is rapidly aging, and the country has lost jobs to lower-cost Asian competitors. **Abenomics remains an experiment in progress, with unpredictable outcomes.**

A sampling of emerging market (EM) economies shows their uneven prospects. China's official growth rate slowed to 7.3% in the third quarter, the most recent period available. Its infrastructure boom has clearly come off the boil, as evidenced by broad weakening in commodity prices. Low commodity prices have, in turn, pressured economies in South America, and also Russia. Elsewhere in the EM, the 2014 election in India of pro-business Prime Minister Modi has helped to stoke economic confidence in that country. Mexico's substantial linkages to the US economy, plus reforms in the Mexican energy sector, should help with growth in that nation. South Korea is sluggish, hurt by slowdowns in its export car industry, and at electronics giant Samsung. Overall, we rate the EM sector as a mixed bag.

## The Energy Dividend

The ongoing collapse in oil prices that began in 2014's second half has been historic. Prices remain in a downtrend, falling for Brent crude

from \$112 per barrel at mid-year to a current \$45. Excess supplies from overproduction have clearly taken their toll, and concerns over weakening global demand have further weighed on price. Saudi Arabia is often a "swing" producer that throttles its crude production to balance the market, but has announced no cuts, and is willing to endure a price war in the short term to curtail US shale production.

In the present, output levels are high across OPEC, Russia and the US, with cash-hungry producers trying to sell every barrel they can, despite the falling price. **As time and low prices grind on, however, higher-cost producers will gradually be forced to leave the market, and new projects will be deferred or cancelled.** And thus will supply correct; nothing cures low prices like low prices, as the saying goes. Our expectation is for low prices throughout 2015, and their eventual resettlement at much lower levels than the triple digits of recent years, perhaps in the \$60-\$70 range.

Given the collapse in prices, the domestic oil boom of the last several years is threatening to come to an abrupt halt. Oil production from shale formations is costly, and it needs high prices to thrive. In a "lower for longer" oil price scenario, expect to see something of a bust in the new oil patches of North Dakota, and the Eagle Ford, Texas, with job losses, bank loans, and local real estate prices among the casualties.

**The pain in the oil patch is offset by the gain to the consumer.** Falling gasoline prices have been a welcome windfall to the average household, saving individuals and families \$500 - \$1,000 annually or more, depending on their driving patterns. (As a reminder, the median household income in the US is a bit more than about \$52,000 annually. To millions of people, these

gas savings represent significant money.) Unlike the heady gains in financial assets the last few years, which have tended to accrue to wealthier households, the advent of lower gas prices is truly a democratizing event; anyone who drives gains a benefit, with lower income consumers benefiting disproportionately. Along with an improving jobs picture, the break in gas prices should be a significant boost for the consumer economy in the US.

## Rock Bottom Rates

Despite the encouraging growth in the US, interest rates remain low – very low. The 10-year US Treasury bond yields about 2%. That's it – an investor lending her money to the government will get 2% annually, barely above the rate of inflation, and about the same dividend rate as she'd get from owning the stocks in the S&P 500, without the added upside potential from stock market gains. As we all know, short term rates are close to nil, although the Fed is widely expected to begin hiking rates sometime in 2015.

**A pickup in inflation, any pickup in inflation, would serve to boost interest rates, but none is apparent.** Shrinking energy prices are having the opposite effect, serving up lower inflation, or at least an offset to price rises elsewhere in the consumer's market basket. Labor markets are often a source of inflation pressures, but ours is only now returning to a sense of normalcy after the 08-09 financial crisis. High-skilled jobs are seeing wage gains, but the broadest swath of middle-skill and lower-skill jobs have much more limited bargaining power. At the risk of over-generalizing, there is too much supply of most things, and not enough demand for too many things, all around the world. Add to that equation the incredible disruption to pricing and margins from internet-based commerce - thank

you, Amazon.com – and we are hard-pressed to suggest when and where broad-based inflation rears its head once again (although it surely shall).

In our globalized investing world, yield conditions overseas also serve as something of a governor to our rates in the US. Rates overseas are *exceptionally* low, reflecting slow economies and deflation worries. Japanese 10-year government bonds yield about 0.30%. That is not a misprint. German 10-year bonds yield 0.45%. Global investors in those countries have great incentive to own 2% US Treasuries in preference to their home market bonds. The investors will pick up significant yield owning the US bond, and if the dollar appreciates relative to the Yen and Euro as is widely expected, the Japanese and German investors will gain further from changes in currency values. **Simply put, overseas demand may well serve to cap our interest rates here at home, unless and until our economy begins to overheat through supply bottlenecks or excessive credit growth.** Only then might interest rates move materially higher.

## A Brief Update on Our Strategy

**The improving jobs market, energy savings, and a degree of pent-up demand for housing should all help to drive consumer-led growth domestically.** In the US, we do not see precursors to a slowdown, and we expect the economy to continue its expansion in 2015. Our recent moves have included trimming our exposure to the energy patch, and deploying capital to various health care, technology, and consumer-levered exposures. We are neutral on the financial sector – there we believe negatives and positives on the sector are roughly in balance. We are incrementally less positive, as well, on industrial names, as many are facing the

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twin headwinds of slowing overseas growth and the strong dollar.

**What benefits “Main Street” may not flow directly to Wall Street.** Forward earnings estimates are in elevated flux due to the fall in oil and the surging US dollar. While consumer-levered names are poised for stronger profits, energy companies’ earnings are due for a severe haircut in 2015, and the impact of the strong dollar on multi-national companies’ profits is a wildcard at present.

**Based solely on valuation, the stock market is less attractive than at this time a year ago.** We think the S&P 500 is trading at about 16x forward earnings; hardly a bargain, but fair, if growth remains firm. Quarterly earnings season should prove to be a confessional for a good swath of the S&P 500. Companies and investors alike will likely need a few quarters of the present low oil / strong dollar regime to understand the flow-through impacts to overall corporate earnings, and in turn, to assess just how expensive stocks are (or are not). Full valuations are apparent across much of the market, including utilities, food, household product, and personal care companies. At present, we believe the “average” stock to be fully priced. We are looking hard to find compelling values.

**Despite positive trends in the US, we are watching developments overseas carefully.** Currently, for the “price is truth” crowd, the global market is telling us, through interest rates, that growth is expected to be slow, and consumer prices are expected to fall. We know that the non-US portion of the world economy is presently under stress. Both politicians and central bankers alike are adjusting policies to address growth and deflation challenges. What

investors need to keep in mind is that the risks of policy error (e.g., central banks getting it wrong), and the consequences, are also heightened. A key question will be the degree to which the US can decouple from overseas weakness, should the latter prove protracted.

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