

Investment Commentary

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Aviance Capital Partners
Focused Asset Management

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Caution in the marketplace seems to be in abundance. After all, stock prices have been bouncing along record highs – while interest rates, having been in decline for over three decades, sit near historic lows. On the other hand, there are many reasons to believe market values are reasonable and interest rates will be stuck at low levels for some time. With this report, we present our cautiously optimistic view for the markets over the near-term and discuss areas where opportunities exist.

Stocks

From our perspective, the stock market is positioned for modest appreciation over the next year. Market returns are driven by three primary factors: 1) dividends, 2) growth in business (i.e. sales and earnings growth among other measures), and 3) adjustments in valuation (i.e. changes in price-to-earnings ratios among other factors). All three of these factors appear to be neutral-to-mildly-positive.

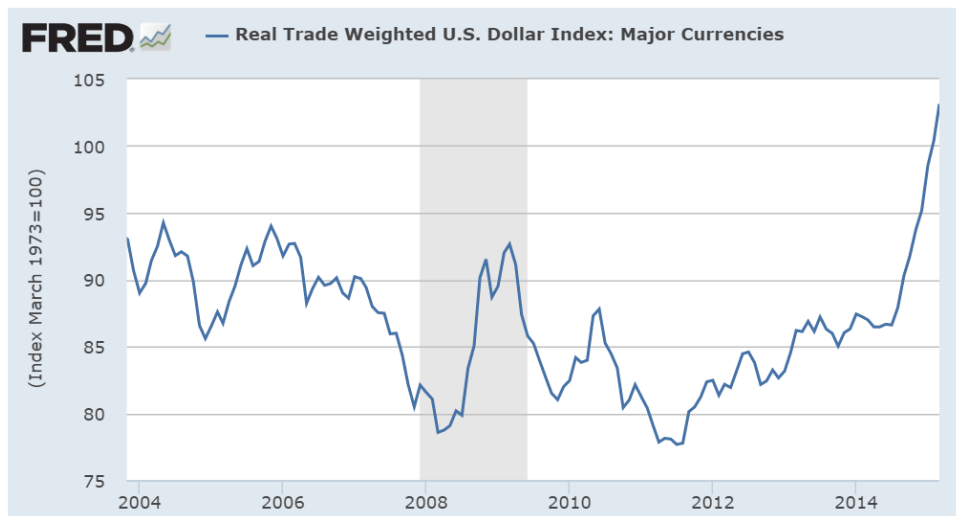
Dividends

Companies in the stock market (as represented by the S&P 500) are currently paying out approximately 40% of earnings in the form of dividends; providing yields above 2% overall. As a result, dividends remain a positive contributor to future market returns.

Growth in Business

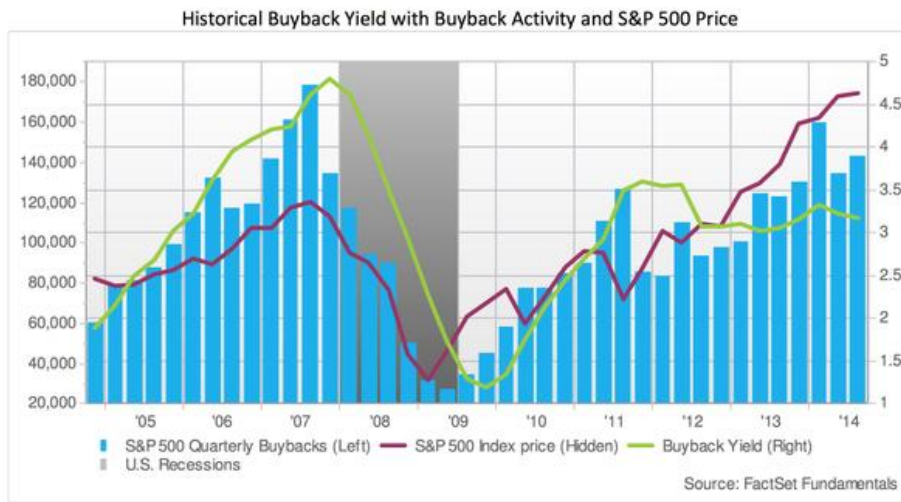
Given a positive view on the economy over the next year, more on that later, we believe companies will continue to grow over this period – albeit at a much slower pace than the past few years. This likely slowdown is attributed to some headwinds that have presented themselves over the past few months including:

1. A stronger Dollar. U.S. companies earning money overseas will suffer when it's time to translate those earnings back to Dollars, and some companies will hesitate to increase prices here in the U.S. given lower priced goods and services from non-U.S. competitors.



2. Wage increases may pressure margins. Many major companies such as McDonalds, The Gap, and Wal-Mart have recently announced increases in wages. This is a double-edged sword since it is good for the economy as consumers have more money to spend, but in the short-run will likely reduce profit margins for these companies.

3. The share buyback cycle could be winding down. When companies buy their own shares, the number of shares outstanding decreases. In turn, this increases the level of earnings on a per share basis. Recent buybacks have been an enhancement to earnings growth over the past few years – with 2014 setting a record. While many believe this trend will continue, it could wind down given pressure on margins and be less impactful with higher stock prices.



4. Weaker oil prices which will impact the earnings for many of the largest energy companies.

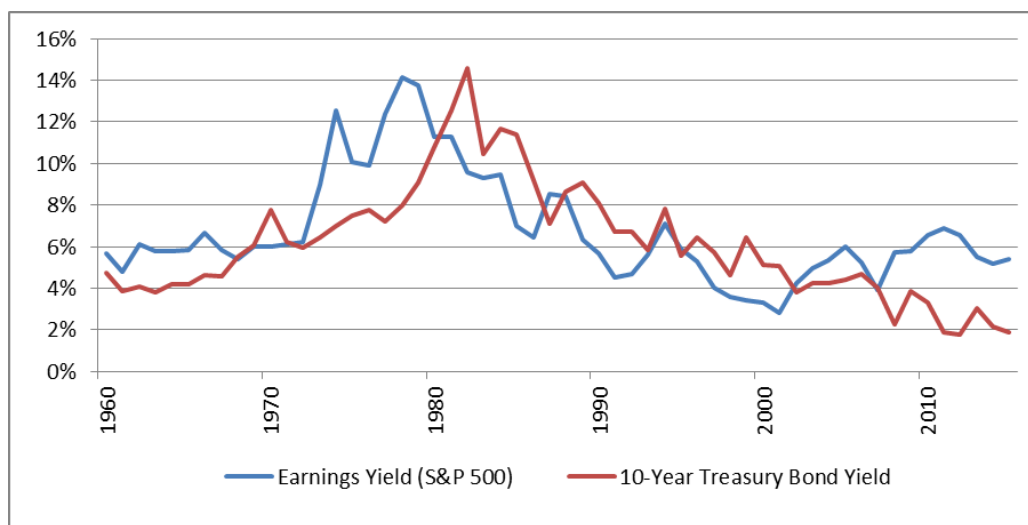


Adjustments in Valuation

Markets can sell-off or inflate for a variety of reasons. Our view is that the market, while fully-valued, will not enter into a longer-term corrective phase over the next year. This view is predicated on the idea that:

1. The market, in our opinion, is not over-valued;
2. Alternatives to stocks, namely most securities tied to interest rates such as bonds, are not particularly appealing given low yields.

Money invested in stocks provides a higher fraction of earnings compared to interest income from bonds



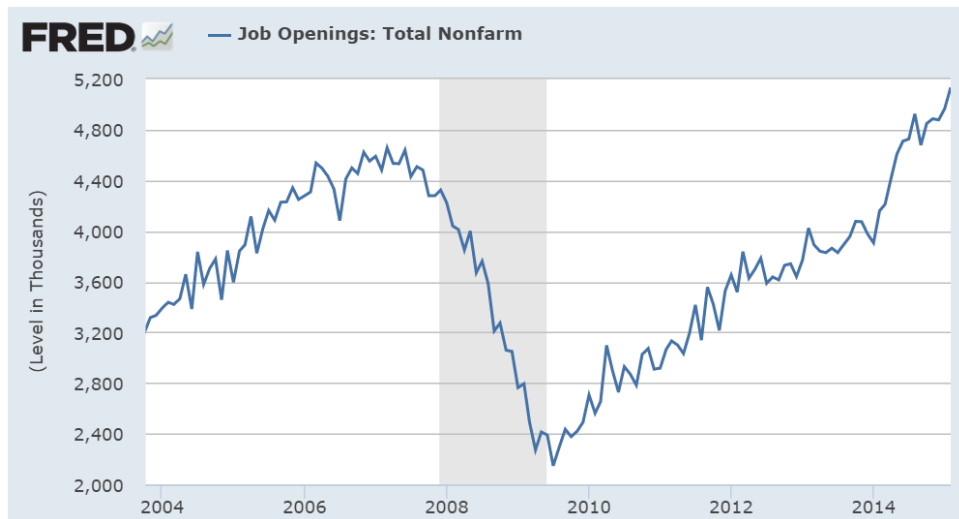
Our view also assumes that 1) the economy does not enter into a recession; 2) the Federal Reserve will increase its target rates at a controlled pace; 3) earnings do not fall by wider margins than expected.

Finally, there seems to be an uptick in the use of the “B” word. However, the likelihood that the market actually is in a *bubble* is low. In fact, a heightened level of investor apprehension argues against the existence of a bubble. Robert Shiller of Yale University (who famously predicted bubbles in stocks and real-estate) claims that current markets – while not cheap – do not appear to be in bubble territory¹.

The Economy and Interest Rates

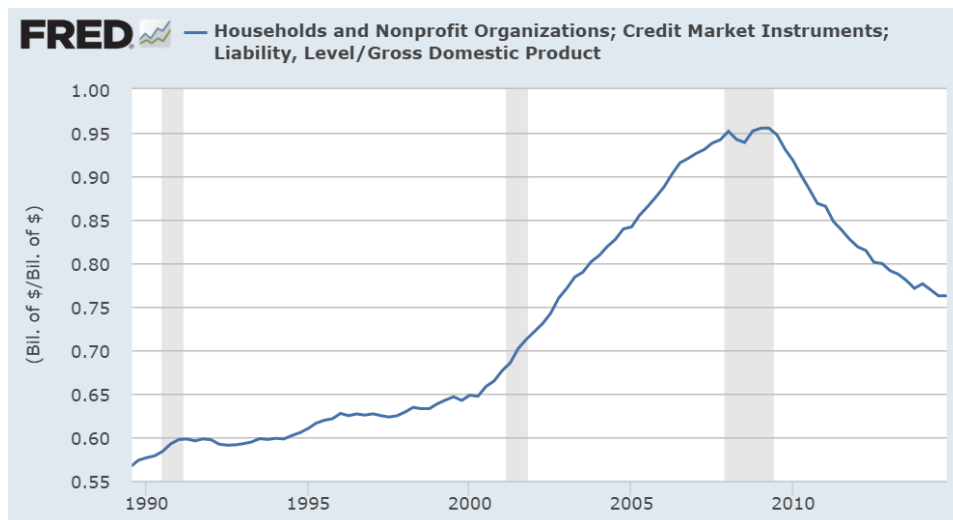
The consumer is currently positioned well to ensure continued economic growth. Consumer spending accounts for approximately 70% of economic activity as measured by Gross Domestic Product (GDP). Consumers are benefiting from more available jobs, raises, and strengthening personal balance sheets. Jobs and wages – while not growing rapidly – are growing steadily. These trends provide tremendous support for continued economic growth.

¹ “Robert Shiller Doesn’t Fear A Global Reckoning in Bond Market” WSJ, 3/18/15 and “Why Robert Shiller is calling this U.S. stock market ‘a great enigma’” MarketWatch, 4/2/15.



Consumers are also reducing personal debt levels. Most economists quickly point out that when consumers save more income (and reduce debt), economic growth suffers. However, a moderate levels of savings (what we see now) is healthy; bringing down excess personal Debt-to-GDP levels that have contributed to instability in financial markets. This positive trend has been playing out since 2009 and could continue for several years.

Household Debt to GDP



More savings and modest borrowing is also a reason why interest rates could stay lower longer. Less demand for borrowing means rates would need to be lower in order to attract new borrowers. An increase in Fed Fund rates would be more likely to stimulate banks to increase lending. Higher Fed Fund rates mean higher deposit rates which would weigh more on profits. An increase in the supply of loans argues against an accelerated pick-up in longer-term borrowing rates as banks compete.

Further, given the lack of inflation and tepid economic growth across the globe, investors of longer-term bonds are not demanding higher yields. At some point, however, when the economy begins to impress on the upside, it's easier to envision an accelerated demand for loans and a significantly higher equilibrium for interest rates.

What we are monitoring

Given the view for the next few quarters that earnings growth will be mild and yields on most securities will remain lower than historically average, we will be keep an eye on certain opportunities and risk factors.

Opportunities

- ✦ Companies that can distinguish themselves with strong earnings growth will attract buyers – such as individual opportunities within the technology and healthcare sectors;
- ✦ Companies insulated from currency translation effects and international competition will likely outperform – service sector and mid-to-small capitalization stocks;
- ✦ Companies offering compelling valuations will benefit;
- ✦ Non-traditional income generating securities – multi-asset funds and individual opportunities.

Risks

- ✦ Credit spread widening – given the run-up in prices, any significant selloff in the corporate bond market could indicate risk for stocks as well. As the search for yield continues, we feel this is a low probability event for the time being;
- ✦ Worse than expected earnings declines – analysts are projecting relatively flat earnings growth. However, if companies report excessively weak earnings, investors could flock to Treasury bonds. Because this is a reasonably well-publicized risk, we feel the impact to stock prices would be limited;
- ✦ Yield Curve flattening – if investors flock to U.S. Treasuries (or if the Fed becomes overly hawkish), a flat yield curve would ensue. This presents a variety of challenges. Examples include: 1) funds employing leverage (when there is no premium earned for holding long-term securities over the cost of borrowing) may be forced to sell investments; 2) companies that earn a net interest margin (i.e. banks) will be squeezed. A flat yield curve historically tends to be a precursor to recessions. However, we believe Janet Yellen and crew will do everything in their control to avoid this.

Overall, we believe stock price are likely to climb for the remainder of 2015. Interest rates may increase somewhat with an increase in Fed Fund rates but in a limited fashion based on modest economic growth and reasonable consumer borrowing trends.

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