Investment Commentary

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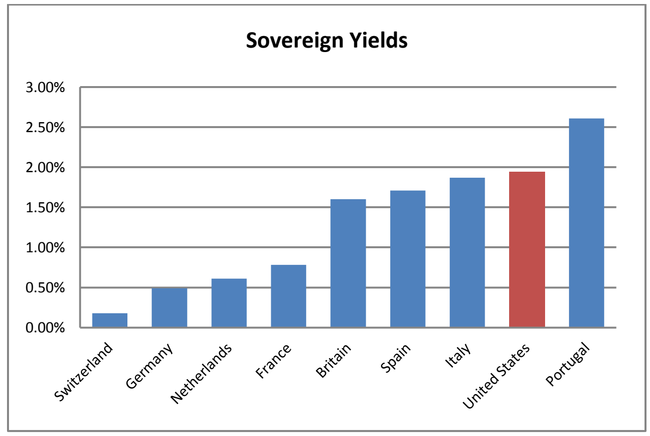
Pockets of Strength in 2014

With a strengthening economy and rising confidence, 2014 proved to be a solid year for large cap stocks and traditional bonds.

Specifically, the yields on most bonds fell, meaning bond prices rose. In the case of the 10-year Treasury bond, a decent proxy for the fixed-income market, yields dropped by nearly 1% over the year leading to a +11% return for these securities.

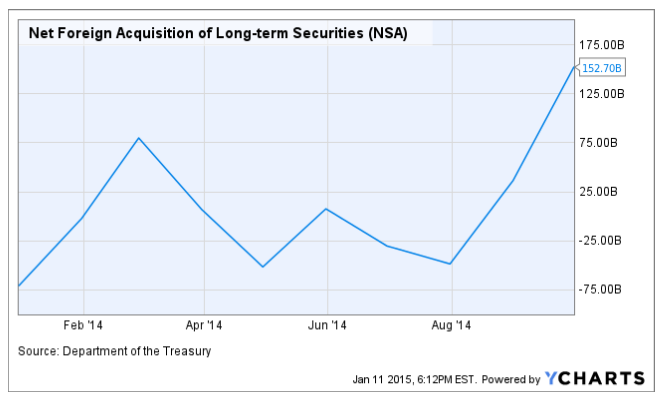
For the majority of 2014, large flows of funds came from the Federal Reserve in order to purchase Treasury and mortgage bonds. This buying pressure contributed to positive returns. However, despite the termination of this bond-buying program (known as Quantitative Easing "QE") in November, yields continued to fall into 2015 (10-Year Treasury Yields below 2% as of January 9, 2015).

Much of this can be attributed to foreign investors flocking to U.S. assets. Specifically, the powerful dual incentives of 1) relatively higher U.S. treasury yields (especially vs. Europe), and 2) a strengthening Dollar, led foreign investors to the conclusion that safe and strengthening assets are worth pursuing.



As of January 1, 2015

The chart below shows net foreign acquisitions of Treasury bonds with the latest data through September 2014. Despite being a relatively volatile data point, the latest $152 billion surge represents the largest foreign net acquisition of long-term treasuries on record (since 1980).



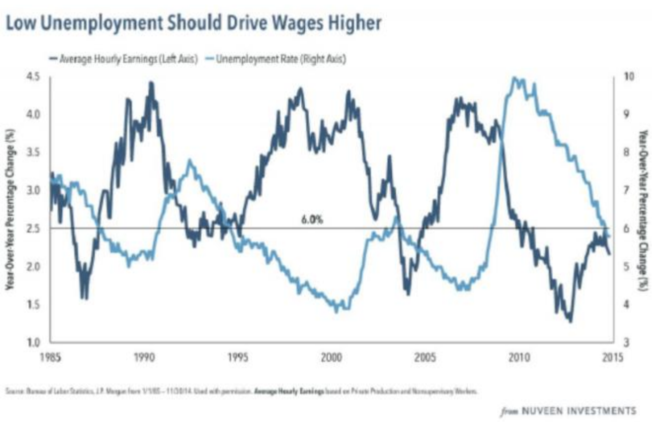
Consequently, an aggressive Federal Reserve program, Quantitative Easing, has for now been replaced by anxious international investors responding to logical incentives.

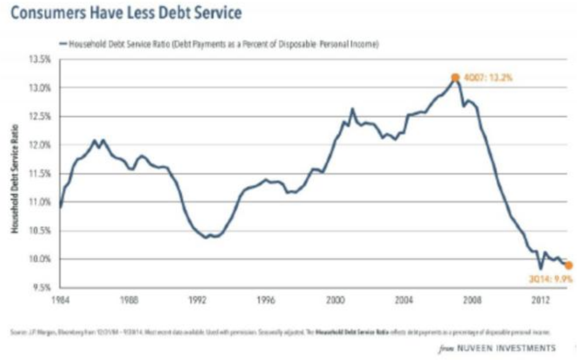
This means that the tide still rises and lifts all boats – including stocks.

However, much of the enthusiasm of equities in 2014 has been in the large company universe. On the next chart we can see that while the S&P 500 rallied by more than 11%, smaller companies (as represented by the Russell 2000 Index) rose by a more humble +3.5%.

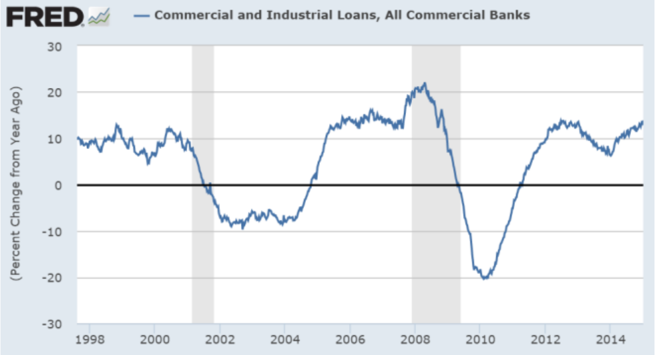
Continued Economic Strength

For the next several months, we expect the U.S. economy to continue to growth at healthy levels. As the unemployment rate has continued to fall, hiring managers will be enticed to increase wages to attract quality employees. With less debt and higher wages, we expect consumers to support solid growth.

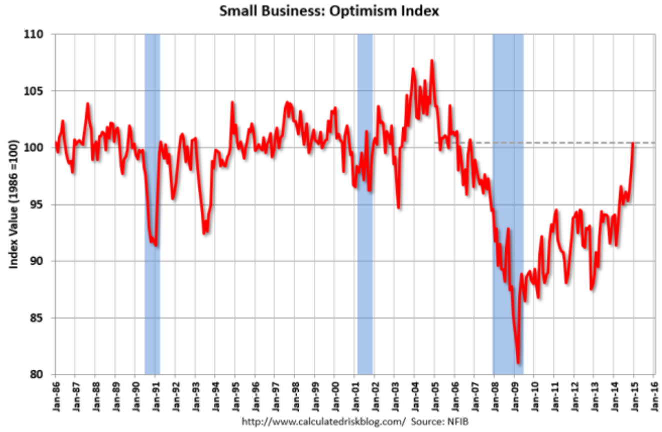




Unlike the consumer, businesses have had solid balance sheets for a while but are now expanding borrowing activities. This supports commercial investment activities as well as economic growth.

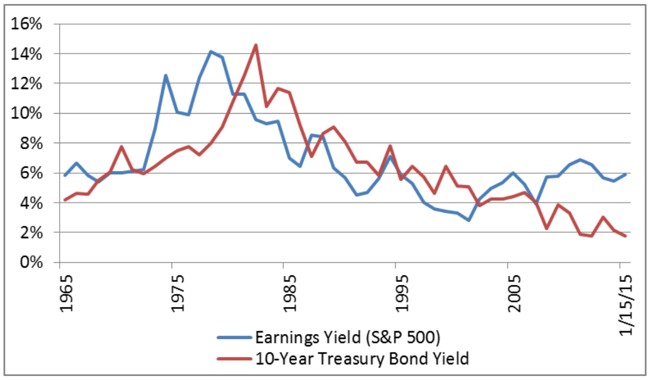


Finally, confidence is broadly on the rise. While consumer confidence had been making impressive strides over the past several years, the NFIB Small Business Optimism Survey reflected a somewhat more cautious business climate. However, 2014 turned into a breakout year with confidence rising to 100.4, its highest level in nine years.



Stock Market

Healthy U.S. economic growth is supportive of earnings growth. We expect the majority of stock market performance to come from continued earnings growth. While we are optimistic on growth, we are less ebullient on the stock market's valuation given, among other factors, the current price-to-earnings ratio – which is in-line with historically average levels. On the other hand, interest rates are near historically low levels. This means investors have relatively less incentive to buy bonds given the low income levels.



Note: Earnings yield represents the S&P 500 earnings divided by price.

As such, we remain comfortable with business growth potential and market valuations.

Nevertheless, we are beginning to see signs of increasing market volatility - stemming from anxiety related to massive price declines in oil and slower economic growth in Europe and emerging economies.

Conclusion

In 2015, we are faced with a slowing global but strengthening domestic economy. As the U.S. has taken the lead in this regard, international investors looking for a safe and growing climate have found their way to our shores. This has buoyed the bond market and arguably larger U.S. stocks. We expect this theme to continue for several months. While this has seemingly been a wind at our backs, it could also serve as a headwind once the price of oil settles, the Dollar finds a new equilibrium, or economic strength picks up in Europe.

There is also the near-certainty that the Federal Reserve will begin to raise target Fed Fund rates off the zero boundary; proving to be a neutral-to-positive event as it will be a sign of the Fed's confidence of solid economic strength.

In the end, we believe investors should maintain their long-term strategic asset allocations with an eye on reviewing risk exposures.

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