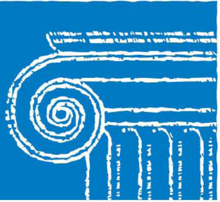

The CMC Efficient Frontier

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Q4 2014 ECONOMIC AND CAPITAL MARKET COMMENTARY • JANUARY 2015

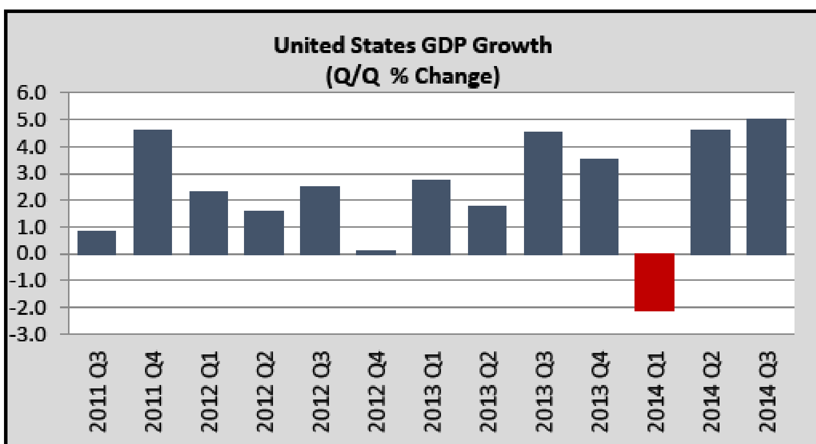
Perspective on 2014

The main story of 2014 was the divergent performance across advanced economies. The United States grew at a healthy clip (see chart 1) and labor market conditions rapidly improved. On the other hand, economic prospects flagged across Europe, Japan and big Emerging Markets, a negative turn that presented fresh challenges to the relatively robust U.S. economy that needed a dependable growth engine. In Europe, fears deepened that the continent was tipping towards deflation while in Japan, the November core consumer-price index rose at its slowest pace of 2014. In both places the fall in energy prices clouded a concerted push by central banks to boost the inflation rate and stoke consumer and business confidence.

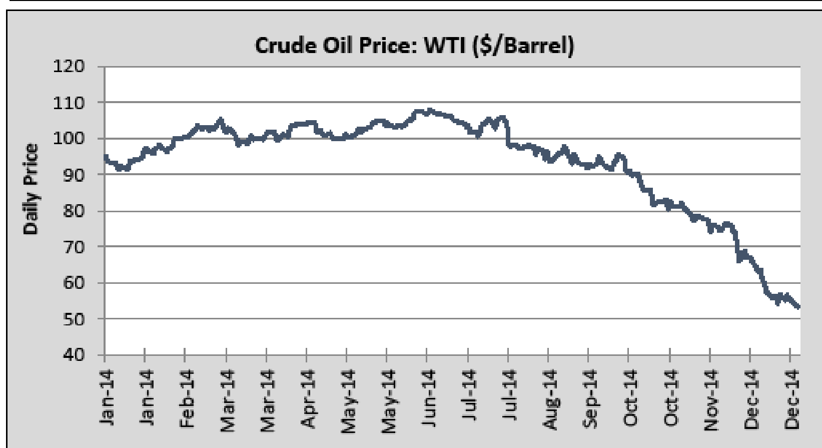
Abdur Chowdhury, Ph.D.
Chief Economist

The picture in emerging markets wasn't much brighter. Economic growth in India decelerated in the third quarter. Figures in Brazil showed Latin America's biggest economy escaped falling into recession in the third quarter; potentially prolonged stagnation remained in the cards. China's hunger for minerals and iron ore produced a long surge in the price and production of key commodities around the world. However, mineral exporting nations felt the heat as the China-fueled commodity consumption boom slowed in 2014.

This low-growth outlook raised concerns over whether weak global demand could wash onto U.S. shores in the coming months, even as American businesses and consumers benefitted from falling gasoline prices. America's economy has grown steadily in 2014 after a first-quarter weather induced contraction with employers averaging more than 200,000 new jobs created a month. Consumer spending and business investment in the U.S. was muted later in 2014, suggesting perhaps the U.S. alone might not be able to provide sufficient demand to help buoy other economies.



Cheaper energy boosted both the U.S. economy (see chart 2) and those of other oil importers, including China, by offering what amounted to a tax cut for businesses and consumers. At the same time, falling inflation expectations strengthened the existing bias by central banks to ease money supplies providing added fuel to economies.



The U.S. economy remained better insulated from a downturn in global growth because, among the world's major economies, it's reliance on overseas export demand for growth has been muted. Exports accounted for only about 14% of U.S. gross domestic product, the lowest for any developed nation and well below the 51% for Germany or 26% for China.

A grim outlook hovered over the Eurozone's $13.2 trillion economy, the world's second largest after the U.S. Unemployment ran at 11.5%. Consumer spending and retail sales fell in the major economies. The benefits for Europe's economy of cheaper oil were also diluted by the euro's recent weakness against the dollar, which meant Europeans had to pay a little more for dollar-denominated energy imports. Falling oil prices have partly been a reflection of the fact that demand for energy in Europe, one of the world's biggest energy consumers, has been weak, along with overall weak economic demand in Europe.

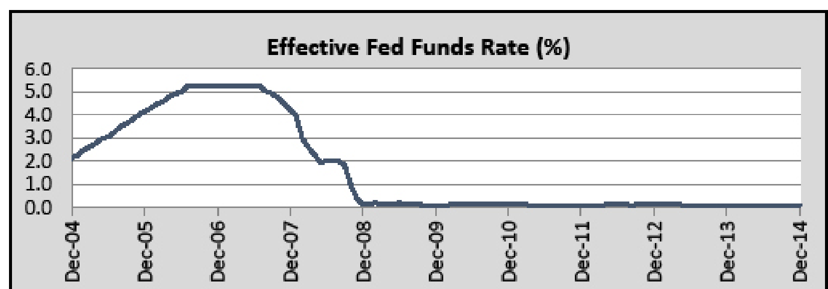
Inflation in Japan moved lower and further away from the Bank of Japan's (BoJ) 2% target, a vital element of Prime Minister Shinzo Abe's efforts to defeat deflation. This softness raised the expectation that the BoJ needed to expand its monetary easing program. Cheaper energy prices usually offer relief for an economy such as Japan's that slipped into recession in 2014 and struggled with weak consumer spending. Japan's central bank focused on stoking inflation, and changing the public's "deflationary mind-set." The Japanese economy showed signs of life in the fourth quarter, after contracting during the previous two quarters. Industrial output improved modestly while the labor market also offered some good news as the unemployment rate in October fell.

The divergent policy paths taken by the world's advanced economies provided lessons for global leaders navigating difficult post-crisis environments. The U.S. and U.K. appear to have gotten some things right, while the Eurozone and Japan fumbled. Unemployment rates after the crisis peaked at 10% in the U.S. and 8.5% in the U.K., and have declined to 5.8% and 6%, respectively. The Eurozone rate on the other hand climbed in the past few years to 11.5% while Japan's economy has fallen back into recession. The Federal Reserve Bank and the Bank of England embraced aggressive easy-money policies early on. Japan lurched toward consumption-tax increases to restrain budget deficits, while Europe moved slowly in addressing weaknesses in their banks and stuck to a course of fiscal austerity.

Looking Ahead to 2015: Key Economic Considerations and Risks

Federal Reserve: The Fed will raise rates bringing more balance to policies that have begun looking increasingly out of step with the economic realities (see chart 3). This change in policy will not be motivated by a budding inflation problem. Core inflation, the best measure of future inflation, will struggle to approach the 2.0% target over the next 12 months, and perhaps longer. The trend in headline inflation has been declining, and will remain so until mid-2015.

A key question for the Fed (and bond markets benefitting from lower inflation expectations) will be to what extent the U.S. remains immune from broader global disinflationary forces that remain in play. Policy rates will not move higher if core inflation shows a renewed disinflationary trend, a risk not expected to materialize. The pass-through effects from a strong U.S. dollar will have an impact since 80% of core prices are in non-tradable services. If economic growth firms, if wage inflation trends higher, and domestic demand remains buoyed by higher real incomes, odds will be good the recent slip in core inflation will prove only a temporary blip.



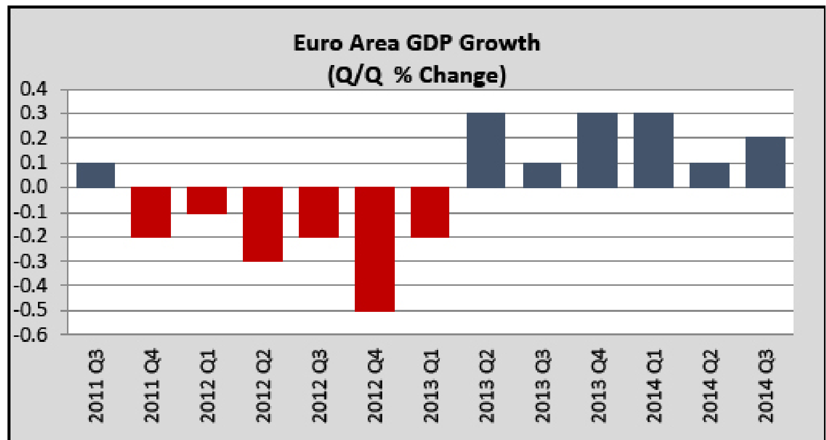
Emerging Markets: 2015 will be another challenging year for Emerging Markets (EM). As in 2014 and most of 2013, external forces will likely add negative pressure to EM interest rates and currencies, while the macro backdrop should continue to suffer from a lack of growth. The differential between U.S. growth and EM growth should remain narrow next year. With the U.S. offering the deepest and most liquid capital markets in the world, and with the prospects of higher rates later next year, the incentive for investors to move money into EM should stay low.

The trend of EM currencies weakening against the U.S. dollar is expected to continue into the next year. However, with feeble growth in the Eurozone, EM currencies should weaken less, or possibly even appreciate against the euro, as has been the case in 2014. EM yields should continue to be driven by a combination of domestic factors (such as, the local monetary policy response) and market expectations of the first Fed rate hike. In the absence of unexpected brisk changes

in the U.S. Treasury yield curve, local factors should remain in the driver's seat, which means EM rates should not see sharp yield changes.

Several risk factors will continue to make the EM environment particularly uncertain. Global political risks and low oil prices will remain major sources of risk. But other risks will stem from an uneven global recovery that sees the U.S. growing at a strong pace, against the weak recovery in the Eurozone and risks of a hard landing in China.

Europe: Eurozone deflation fears will carry through at least the first half of 2015 as countries that have not completed structural reforms (e.g., France, Italy) stagnate. Downside risks from EM mean that Germany's export-oriented economy alone will not be able to carry the region (see chart 4). Ultra-low inflation should prompt the European Central Bank to purchase large amounts of government bonds (and other asset types) in early 2015 to raise the money supply and further depress borrowing costs, following a route taken by central banks in the U.S., U.K. and Japan.

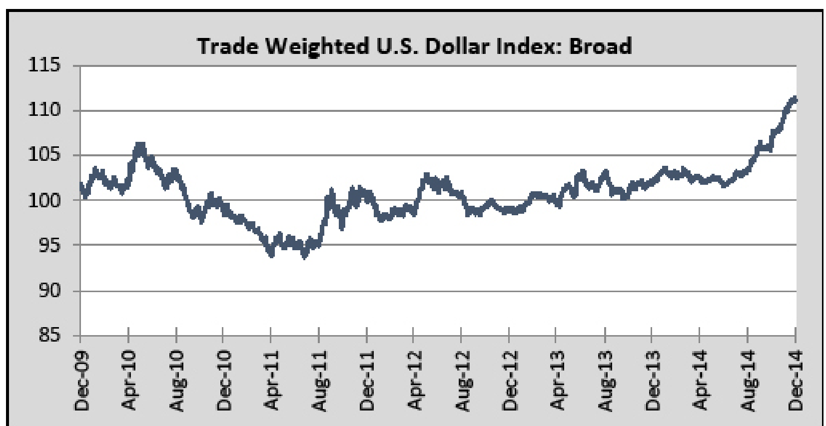


For the U.K., wage growth will be a key two-way risk, with downside from higher labor supply and more low-paying jobs, but upside from diminishing labor slack. Politics will be in focus with parliamentary elections in May and a potential EU in/out referendum in 2016.

Currencies: A surging dollar (see chart 5) and falling commodities prices delivered a windfall to American shoppers and confounded central bankers by widening the gap between the expanding U.S.'s economy and struggling countries in Europe and Asia. Currencies across the globe tumbled against the U.S. dollar. The euro dropped to a two-year low and the yen fell to a seven-year low against the dollar. The Australian dollar slid and the Malaysian ringgit fell to its lowest in almost five years. In oil rich Russia, the ruble hit new record lows, prompting the country's central bank to intervene in support of its currency raising interest rates to 17%.

The dollar's gains have been intensifying declines in commodities prices for food, metals and especially oil, which is down nearly 45% since mid-June. Sluggish growth in Europe and Asia has undermined demand for these goods, leaving markets flooded with surpluses. Most commodities are priced in dollars, so consumers and companies outside the U.S. see their buying power shrink when their currencies weaken.

These trends present new challenges for policy makers in Europe and Japan as they struggle to preserve meager recoveries and fight low inflation. Central banks have been considering—or have already introduced—drastic measures, such as negative interest rates and buying billions of dollars of bonds. But the precipitous fall in the price of oil—the most-expensive import for many countries—has reduced the effectiveness of these measures aimed at raising consumer prices.



Diverging fortunes of the U.S. and other major economies should continue to drive big swings across financial markets. The ECB is expected to

decide on plans to launch a new asset-purchase program in early Spring. Such a move would likely dent the euro even more by boosting the prospect of an increase in money supply and leading to lower yields on European debt. The yen plunged after the Bank of Japan, shocking markets, expanded its asset purchases at its October meeting. By contrast, the Federal Reserve ended its bond buying in October and is expected to raise interest rates sometime in 2015, boosting the dollar's appeal. The U.S. dollar should continue to strengthen, and commodities prices should fall, into 2015. The conditions are in place for a multi-year rally in the dollar.

Outlook: Looking ahead to 2015, prospects for the global economy have dimmed slightly. Despite unprecedented monetary stimulus from advanced economy central banks over the past year, expectations for real economic growth in world's key economies in 2015 appear weaker now than they were a year ago. Inflation has remained low in advanced economies and as a result central banks in the Eurozone and Japan have increased monetary stimulus to boost demand. Reflecting this dampened outlook for global demand, commodity prices have fallen exerting downward pressure on headline inflation.

The U.S. economy should post its strongest growth performance post-recession. The Fed will continue winding down its extraordinary monetary policy stimulus program and the U.S. government's deficits should continue to show marked improvement as the economy strengthens. This divergent performance from its advanced economy peers should contribute to further appreciation in the U.S. dollar. This is likely part of a long-term strengthening in the U.S. dollar.

The U.S. recovery should continue to outperform its developed world counterparts albeit with a relatively subdued 2.5% to 3.0% GDP growth pace. That pace should be sufficient to further bring down unemployment, support ongoing improvement in workers' wages, and effectively keep the Fed on track to raise short term interest rates in the back half of 2015.

Risks to this positive outlook will persist however in the form of an unsupportive global economic backdrop, the strong dollar, geopolitical tensions and financial instability in emerging markets. These risks seem relatively high as 2014 comes to a close. There is the risk that the U.S., rather than dragging up the rest of the world through its strong growth, is itself dragged down. 2015 should prove to be another very interesting year.

2014 Capital Markets in Review

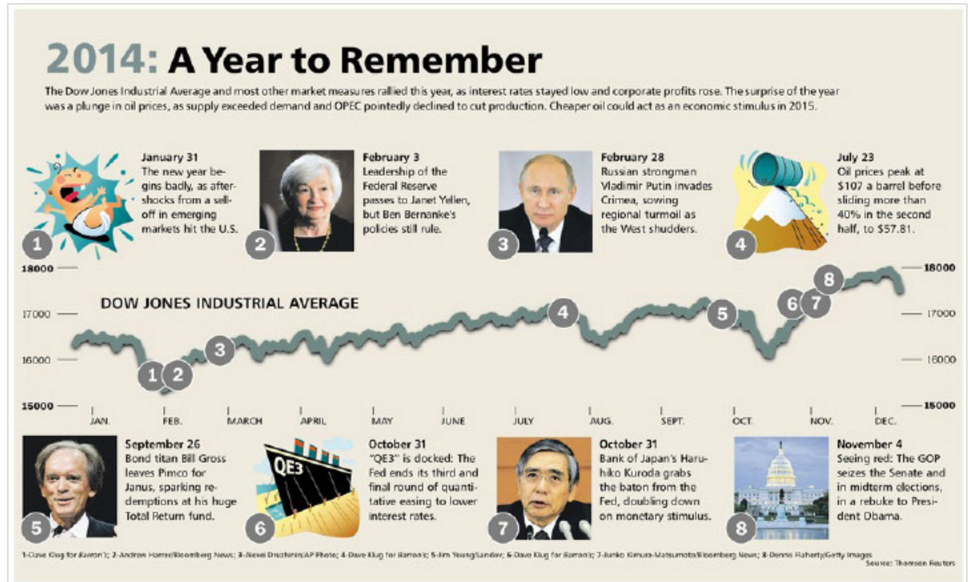
U.S. equity markets finished the year with a strong showing bolstered by corporate earnings, improving economic prospects, and lower energy prices. The S&P 500 gained almost 5% in the fourth quarter and closed the year with a total return of 13.7%. It appeared that investors were getting more comfortable with the prospects of improving economic growth and the Federal Reserve's intentions for interest rate policy change. After struggling for much of 2014, small-cap stocks rose sharply in the quarter, with the Russell 2000 Index climbing almost 10%. Nonetheless, the enormous annual dispersion of 8.35% between large and small stock performance was a notable hallmark for the year.

Robert Cummisford, CFA
Chief Investment Officer

Outside the U.S. a different picture emerged, with many local markets challenged by slowing economic growth and concerns surrounding possible contagions erupting around countries like Russia, Greece, and Venezuela. Geopolitical unrest in Russia/Ukraine, Iraq/Syria, and Israel/Palestine distressed investors for much of the year, along with economic growth concerns about Europe and Asia. The European equity market declined over 4% in the fourth quarter and closed down 5.7% for the year. China surprised many investors and posted a strong quarterly gain (7%) despite continued concerns around a slowdown in Chinese economic growth, struggling economic reforms in Japan, and the impact on the broader Asian region. Japan was down 2.4% in the quarter and down 3.7% for the year overall.

S&P 500 sector performance was mixed for the quarter. Utilities continued their strong run for the entire year with a 13% gain in the quarter to finish the year up 29%. Consumer Discretionary and Consumer Staples stocks were each up over 8% for the quarter. Financials and Health Care also did well (+7%). However, Energy stocks continued their decline (-10.7%) as oil prices for West Texas Intermediate Crude fell to $53 per barrel at the year's end. Telecom and Materials stocks also

struggled, falling 4.2% and 1.8%, respectively in the quarter. Value outperformed growth in large and mid-cap stocks for the quarter, while growth outperformed in small-cap stocks.



U.S. bonds outperformed their international counterparts for the quarter and the full year. Declining interest rates continued to challenge bond investors who expected rates to be much higher as the year came to a close on the strength of improving economic prospects in the U.S. In fact, interest rates in the U.S. gradually declined over the year, trading between 3% in January and 2.2% at year-end due in large part to the rise of the US dollar and lower rates in the Eurozone. Municipal bonds continued to see strong demand in the quarter, advancing another 1.4% to close the year up 9%. High yield bonds declined (-1%) as investors expressed concerns about corporate exposure to declining oil prices. The Energy sector has over doubled in weight in the high yield market from 5% for most of the 1990s to mid-2000s, to about 13% currently as debt capital was raised to fund the energy renaissance in the U.S. Foreign and emerging market debt declined 3% and 11%, respectively in the quarter.

In the alternative spectrum, returns were largely negative. MLPs (-12.3% in the quarter) succumbed to the decline in energy prices and the energy company earnings outlook. The REIT space experienced a sharp recovery from third quarter weakness, rising over 14% to close the year up 30%. Many hedge fund strategies were weak for the quarter and the full year, not all that surprising given the performance of the equity, fixed income, and commodities markets.

Sources: Barron's, Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Commerce, European Central Bank, Federal Reserve Board, Department of Labor, U.S. Energy Information Administration.

Index Performance as of 12/31/14

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	-0.94	0.78	5.31	5.31	12.70	12.70	20.68	15.34
3000	-0.92	0.00	5.24	5.24	12.56	12.56	20.50	15.63
3000 Growth	-0.90	-0.75	5.17	5.17	12.44	12.44	20.25	15.89
1000 Value	-1.02	0.61	4.98	4.98	13.45	13.45	20.89	15.43
1000	-0.99	-0.23	4.88	4.88	13.24	13.24	20.61	15.64
1000 Growth	-0.96	-1.04	4.78	4.78	13.05	13.05	20.26	15.82
Mid Cap Value	-0.73	0.75	6.05	6.05	14.75	14.75	21.97	17.43
Mid Cap	-0.78	0.21	5.94	5.94	13.22	13.22	21.40	17.19
Mid Cap Growth	-0.82	-0.28	5.84	5.84	11.90	11.90	20.71	16.94
2000 Value	-0.04	2.73	9.40	9.40	4.22	4.22	18.28	14.26
2000	-0.11	2.85	9.73	9.73	4.89	4.89	19.21	15.55
2000 Growth	-0.18	2.97	10.06	10.06	5.60	5.60	20.14	16.80
Standard & Poors								
S&P 500	-1.07	-0.25	4.93	4.93	13.69	13.69	20.41	15.46
Consumer Disc	0.50	0.97	8.74	8.74	9.68	9.68	24.81	21.38
Consumer Staples	-1.77	-1.04	8.15	8.15	15.98	15.98	17.45	16.08
Energy	-1.18	0.50	-10.68	-10.68	-7.78	-7.78	6.46	8.76
Financials	-0.95	1.81	7.25	7.25	15.20	15.20	26.25	13.36
Health Care	-0.33	-1.32	7.48	7.48	25.34	25.34	27.85	19.38
Industrials	-1.45	-0.14	6.76	6.76	9.83	9.83	21.24	17.56
Information Technology	-1.96	-1.70	5.24	5.24	20.12	20.12	20.99	14.86
Materials	-0.95	-0.67	-1.80	-1.80	6.91	6.91	15.57	11.23
Telecom Services	-1.48	-6.13	-4.16	-4.16	2.99	2.99	10.74	11.42
Utilities	-1.59	3.52	13.19	13.19	28.98	28.98	13.93	13.34
Other U.S. Equity								
Dow Jones Industrial Avg.	-1.15	0.12	5.20	5.20	10.04	10.04	16.29	14.23
MSCI USA	-1.06	-0.31	4.81	4.81	13.36	13.36	20.41	15.50
Wilshire 5000 (Full Cap)	-0.87	-0.13	4.88	4.88	12.07	12.07	20.36	15.64
International Equity - Broad Market								
MSCI EAFE	-0.84	-3.44	-3.53	-3.53	-4.48	-4.48	11.56	5.81
MSCI Emerging Markets	0.72	-4.56	-4.44	-4.44	-1.82	-1.82	4.41	2.11
MSCI Frontier Markets	-0.10	-4.02	-12.44	-12.44	7.21	7.21	13.94	8.45
MSCI AC World	-0.75	-1.89	0.52	0.52	4.71	4.71	14.71	9.74
MSCI AC World ex USA	-0.41	-3.57	-3.81	-3.81	-3.44	-3.44	9.48	4.89
MSCI AC Asia ex Japan	1.14	-2.05	0.17	0.17	5.11	5.11	10.05	5.80
International Equity - Country Region								
MSCI Brazil	-0.28	-11.06	-14.79	-14.79	-13.74	-13.74	-10.01	-9.40
MSCI BRIC	1.02	-5.27	-4.05	-4.05	-2.56	-2.56	2.70	-1.67
MSCI China	2.60	1.16	7.17	7.17	8.26	8.26	11.48	3.50
MSCI Europe	-1.16	-4.28	-4.30	-4.30	-5.68	-5.68	12.52	5.91
MSCI India	2.73	-5.96	-0.68	-0.68	23.87	23.87	14.48	2.66
MSCI Japan	-0.91	-1.42	-2.40	-2.40	-3.72	-3.72	9.93	5.68
MSCI EM Latin America	0.11	-9.12	-13.38	-13.38	-12.03	-12.03	-5.95	-5.02
MSCI Russia	-8.68	-23.11	-32.78	-32.78	-45.86	-45.86	-14.38	-9.57

Index Performance as of 12/31/14

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Fixed Income								
Barclays U.S. Aggregate	0.45	0.09	1.79	1.79	5.97	5.97	2.66	4.45
BofA Merrill Lynch 3-Month T-Bill	0.00	0.00	0.00	0.00	0.03	0.03	0.07	0.09
Barclays U.S. Government	0.48	0.13	1.86	1.86	4.92	4.92	1.40	3.70
Barclays U.S. Credit	0.54	0.01	1.76	1.76	7.53	7.53	4.84	6.25
Barclays High Yield Corporate Bond	0.14	-1.45	-1.00	-1.00	2.45	2.45	8.43	9.03
Barclays Municipal	0.34	0.50	1.37	1.37	9.05	9.05	4.30	5.16
Barclays TIPS	0.41	-1.13	-0.03	-0.03	3.64	3.64	0.44	4.11
Barclays Global Aggregate ex US	0.24	-1.21	-2.99	-2.99	-3.08	-3.08	-0.75	1.38
Barclays Global Aggregate	0.32	-0.69	-1.04	-1.04	0.59	0.59	0.73	2.65
BofA Merrill Lynch Emerg. Mkt. Credit	-0.28	-7.58	-11.10	-11.10	-9.07	-9.07	5.12	8.53
Alternative Investments								
Alerian MLP	-0.17	-5.62	-12.29	-12.29	4.80	4.80	11.90	16.74
Bloomberg Commodity	-1.73	-7.63	-12.10	-12.10	-17.01	-17.01	-9.43	-5.53
FTSE NAREIT Equity REIT	-0.81	1.87	14.20	14.20	30.14	30.14	16.33	16.89
S&P Global Natural Resources	-0.66	-3.00	-8.37	-8.37	-9.66	-9.66	-0.57	-1.47
S&P North American Natural Resources	-0.80	-0.85	-13.86	-13.86	-9.77	-9.77	2.42	4.28

What's New @ CMC?

We are very pleased to introduce you to **Rob Cummisford**, CFA is our new Chief Investment Officer. Rob brings a wealth of research, asset allocation and portfolio management experience to clients. You can learn more about Rob on our website where his complete bio is available...We welcome Highwater Wealth Management in Denver, CO, Cary Street Partners of Richmond, VA and Snowden Lane Partners as new clients of the firm...Manager visits this past quarter included Invesco, John Hancock, RS Global, Oppenheimer, Nuveen, Harding Loevner, Prudential, Neuberger Berman, Guggenheim, Brandes, Putnam, Baron Capital, Credit-Suisse, JP Morgan, Todd Asset Management, MacKay Shields Third Avenue, Goldman Sachs.

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