Quarterly Newsletter-April 2015 Peter J LaBella, CFP & John J Klobusicky, CFA, CAIA

General Comments

During the most recent quarter, the S&P 500 Index was up .95%, while the Dow Industrials posted a negative .33% return, including dividends for both indices. For large company U.S. Stocks, the markets were basically flat—not the case for many global markets as we'll discuss below. Bond investors continued to enjoy positive price appreciation, as yields remain at historicly low levels, with the Federal Reserve recently hinting that it might keep rates low until later in the year. They are clearly worried about the deflationary effects of the strong dollar and the impact this could have on corporate earnings as companies continue to convert their overseas earnings back into a very strong currency, negatively affecting income statements and balance sheets. Some of the central bank's worries were confirmed with the most recent deceleration in hiring last month after a good stretch of strong job numbers. While the unemployment rate held steady at 5.5%, job growth slowed to just 126,000 in March, the weakest number in 15 months.

Stock Market-Are we due for a correction?

A correction is defined as a market decline of 10% or greater, with a duration that is generally fairly short, leaving investors who try to time these events behind and looking for another negative event that will bring the market back to them. We mentioned in our third quarter 2014 newsletter that there have been 58 corrections since WWII, and that based on the averages, they tend to run 221 days before being interrupted and gaining an average of 32%. With low inflation, corporate earnings growth expected at above 5% for 2015, a positive yield curve, and no event in sight that could shave over a trillion dollars off of global GDP, we think the next downturn will be a correction and a not a recession driven decline, which would be much more painful in duration and severity.

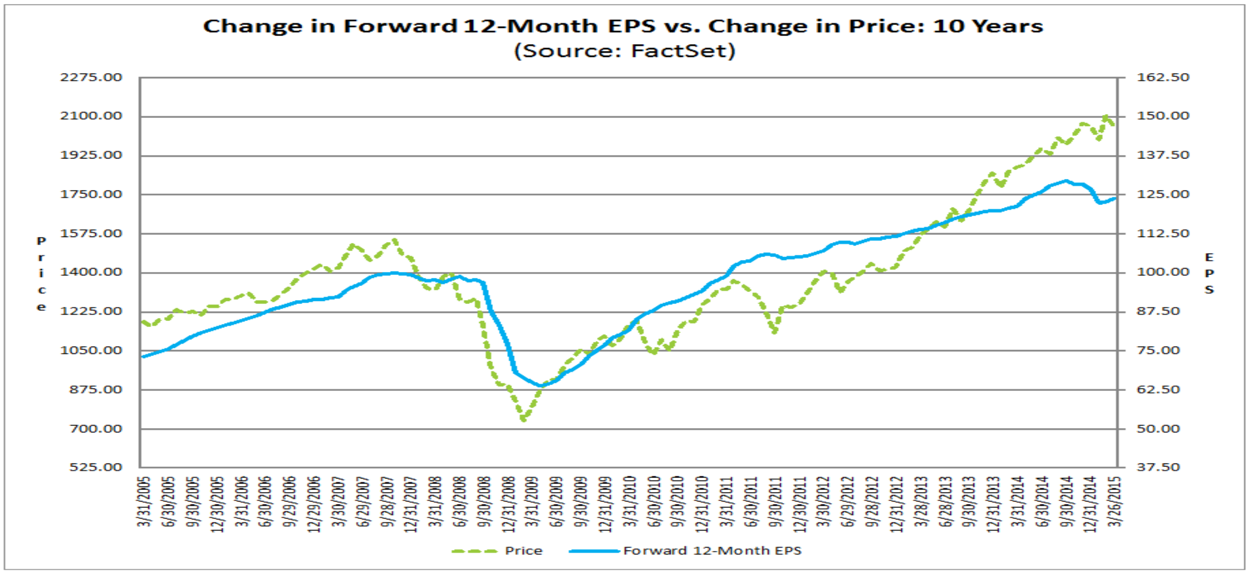
Bull markets generally go through 4 stages-three of which are depicted below- and other than a central bank response to an overheated economy, usually end with either euphoric investors, or a big unforseen event that derails the economy and earnings.

Barron's recently pointed out in a year end piece by Bloomberg that "not since the years of the credit crisis have the world's biggest investors had a lower opinion of American equities". That doesn't sound like euphoria to us. The author of the piece, Lu Wang, also points out that "the percentage of global money managers who are underweight American equities is the highest since 2008, based on a new survey by Bank of America". Euphoria? We don't think so. We believe we are still in the optimistic stage, with a healthy wall of worry still in place, checking the euphoria that leads to market tops.

And let's not forget about the global picture, where there were some bright spots for equities. We wrote in our year-end letter of the continued divergence in monetary policy and currencies among global central banks and how for the first time in years, we are beginning to see the benefits of international diversification. Markets are no longer moving in lock-step, as global central banks go their own way and diversification becomes our friend again.

We are beginning to see "green shoots" in Eurozone economic indicators, and we like the tail winds of aggressive monetary easing, cheap energy, and a weakened currency—all a good mix to attract global captal looking for better valuations.

As for the U.S. market, the focus will continue to be on earnings per share and whether over the next two quarters the benefits accruing to consumers from lower gasoline prices end up in the form of higher corporate earnings. The chart below shows earnings(darker blue line) and the S&P 500(lighter green line), and how closley they have tracked over the past ten years. We can also see that since the second quarter of 2013 the market has gotten a little bit ahead of earnings as P/E ratios have expanded above the earnings growth rate.



This may well set up for a pretty flat year for stocks, and probably a bumpy ride over the next two quarters, as investor patience is tested with the negative impact of the strong dollar on multi-national corporate earnings, as well as the loss of energy jobs. Yet, we think in the end the benefits of cheaper energy will win out against a backdrop of low inflation and a Fed that will raise rates very carefully and slowly over the next few years.

Bond Market

Yields remain low, but in the context of global bond markets, yields here in the United States are much higher than most of the Eurozone and Japan. So the dollar remains in great demand and foreign investors continue to pour money into the U.S. bond market, which has resulted in continued positive returns to bond investors. So for three years now, forecasters have predicted higher rates and lower bond returns. The opposite has occurred, with longer term bonds posting double digit returns in 2014. Will 2015 be any different? The global savings glut remains in place, and demand for higher yielding assets will continue to drive demand for fixed income assets in 2015. We expect there may be some disruption in emerging markets and domestic high yield markets as the Fed begins to raise rates, with these less liquid asset classes being sold and money continuing to move to higher quality, more liquid bonds. But with disruption, opportunities are created, and we will be on close watch to capture these event driven discounts.

With the global savings glut in place, forcing down long term yields, it is very possible that the bond market will move up in yield on the short end in anticipation of the Fed raising short term rates. Being the smarter money, bonds usually move first and with confirmation from the Fed, we could be facing an inverting yield curve-with short term rates moving above the longer end of the curve. This would be an outlier event that few are predicting, and if prolonged, would not be a good omen for the markets or the economy. We don’t think this the odds bet, but is something we will be keeping an eye on.

The bottom line is that when you look at finding value in the bond market, or what we call real returns, there is virtually none. Taking the expected inflation rate one to two years out and subtracting it from the current coupon on the five or ten year T-Note leaves you with just about zero. We are reminded that valuation gives us information about the severity of the next move in a market, but it really tells us nothing about the timing. With that in mind we will continue to remain in a conservative duration position with respect to our fixed income benchmarks, and will look for opportunities created by dislocations in the markets as the Fed begins to pull back on market stimulus.