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Economic & Market Summary
December 2014

The macroeconomic backdrop in the U.S. remains positive. GDP expanded 5% in Q3 and is expected to increase ~3% in Q4, leading to annual growth of ~2.8%. The unemployment rate has fallen to 5.8%, from 7% last year. While wage growth remains tepid, we should see improvement as the economy approaches full employment. Consumer spending remains a strong driver of economic growth and should trend higher due to increasing confidence and growing employment. Business investment improved modestly in 2014. The ISM manufacturing and non-manufacturing surveys point to potential acceleration. After robust 2013 performance, housing starts have been flat around 1 million units, leaving plenty of room for additional growth. As a primarily consumption-based economy, we are somewhat insulated from minor vicissitudes within international economies. 2015 GDP growth in the 2.5% - 3% range is reasonable. Based upon recent data, we think it is more likely growth surprises to the upside.

On balance, economic growth outside the U.S. has slowed this year. The Eurozone economies are flat, Japan is adjusting to higher tax rates, China's growth has slowed to the 7% range, and Russia is a disaster. Meanwhile, India is growing mid-single digits and Mexico has accelerated. Foreign equity valuations reflect the dynamic of a mixed macroeconomic picture, particularly in relation to the U.S.

We acutely recall oil's spectacular rise in the 2005-2007 period and its effect on discretionary spending. We are surprised to see negative market reaction now that oil has fallen ~50% in just six months. Some emerging economies (Russia, Brazil, and Venezuela) will fall into recession as oil prices decline, but the net benefit to the rest of the global economy should be positive, particularly those that remain less efficient users of commodity inputs. Looking across portfolios, we see far more companies benefiting from than harmed by lower oil prices.

As anticipated, the Federal Reserve concluded its bond buying program in October. The next step is for the Fed to raise interest rates around mid-year 2015. Employment gains provide support for this strategy, while core inflation of ~1.6% remains below the Fed's target. Falling oil prices could lower inflation, but also stoke consumer spending. Our view is the economy no longer needs emergency type monetary policy and we should be on the path toward normalized interest rates. In terms of fixed income investments, we remain generally cautious, focusing on relative value and quality. With the 10-year U.S. Treasury offering a yield of 2.17%, our return expectations remain subdued. We are mindful of the enormous amount of cash that has flowed into fixed income markets since 2000 and the potential ramifications if these flows reversed.

The S&P 500's 2014 total return was 13.7% driven by earnings growth (+9%) and an expanding P/E multiple (18x current year earnings). 2015 earnings expectations have come down since this summer, but still reflect robust 12% year-over-year growth. The P/E on next year's earnings is 16x, several points below multiples typically found near the conclusion of a bull market. Volatility has increased in the last several months and 2015 sets up to offer more volatility given the potential for rising short-term interest rates. It will be critical to maintain focus on the distinction between permanent capital loss and volatility. The noise surrounding volatility can be deafening, but keep in mind market fluctuations create significant opportunities for investors oriented toward long-term results.

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To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address above.