The Oarsman Outlook

April 2015

The January-March quarter saw additional, though subdued, gains for most financial investments. In the U.S., the large-company S&P 500 Index gained just under 1%, while the small-cap Russell 2000 index rose 4%. Non-U.S. stock results were positive, on balance, despite the headwind of weaker currencies. Real-estate securities provided solid returns, while commodity-related investments were mostly lower (though gold eked out a small gain). Bond yields declined (again) – the 10-year U.S. Treasury Note finished the period at 1.93%, down from 2.17% at yearend – resulting in gains for most fixed-income investments.

The best-performing sectors within the U.S. stock market were Capital Goods/Business Services, Communications Services, Consumer Cyclicals and Health Care. Relatively weak results came from stocks in the Basic Materials, Energy, Financials, Technology and Utilities groups. Small-company stocks outperformed for a second-consecutive quarter, while growth-oriented investments clearly bested their 'value' counterparts.

Benchmark Performance – Equities

	First Quarter 2015	Last Twelve Months
S&P 500 Index	+1.0%	+12.7%
Large-Cap. Core Mutual Fund Avg. (Morningstar)	+0.8%	+9.2%
Small-Cap Stocks (Russell 2000)	+4.3%	+8.2%
Non-U.S. Stocks (Developed – MSCI EAFE)	+4.9%	-0.9%
Non-U.S. Stocks (Emerging – MSCI EM)	+2.2%	+0.4%

Benchmark Performance – Fixed Income

	First Quarter 2015	Last Twelve Months
Barclays Intermediate Gov't/Credit Index (taxable)	+1.5%	+3.6%
Intermediate Municipal Mutual Fund Avg. (Morningstar)	+0.8%	+5.0%

Review

Investor concerns regarding a sluggish economy, the impact on corporate profits of a soaring dollar and plunging oil price, and a looming shift in Federal Reserve interest-rate policy limited gains from U.S. stocks during the first quarter. Meanwhile, major monetary stimulus programs in Europe, Japan and China provided a boost for global bonds and most non-U.S. equities, though the strong dollar weighed on some emerging and frontier markets.

Recent economic news indicated the American economy was experiencing yet another slow-down following a strong finish to 2014. While the jobs market extended its solid performance through January and February, with more than 200,000 new jobs added each month, the pace of hiring weakened dramatically in March to just 126,000. Nevertheless, the unemployment rate fell to 5.5% – its lowest since before the 2008 financial crisis and ensuing recession. A range of other data confirmed that, much like early last year, the U.S. economy

had entered a soft-patch, probably attributable to a combination of harsh weather, the strong dollar and declining investment expenditures in the energy sector. Weaker statistics included measures of home-builder sentiment, purchasing-managers' surveys, and industrial production and capacity utilization rates. Consumer confidence and retail sales also sagged – something of a surprise, given the boost to disposable incomes provided by low (though no longer falling) gasoline prices.

Judging that the economic lull is likely to be transitory – and despite inflation much closer to zero than its preferred two-percent level – the Federal Reserve continued down its deliberate path toward 'normalizing' monetary conditions (i.e., bringing an end to the six-year policy of holding short-term interest rates near zero). At its March policy-setting meeting, the central bank's board signaled (by omitting the word 'patient' from a key passage of its post-meeting communication) that it was prepared to begin raising rates as early as mid-year (though market-based indicators suggested late-year was more likely).

Outside the U.S., economic activity ticked up modestly from depressed bases in both the Euro zone and Japan, while Chinese growth continued to cool (China's +7.4% GDP gain for calendar 2014 was the lowest in more than 20 years). With growth below potential and inflation continuing to fall almost everywhere, foreign central banks were especially active during the quarter. Most significant was the European Central Bank's commencement of 'quantitative easing' (i.e., using newly created money to purchase bonds issued by member nations) in an effort to stave off deflation and kick-start growth. The Bank of Japan continued its even more ambitious reflationary program, while central banks in Australia, Canada, China, Denmark, India and even Russia all either cut official interest rates or engaged in other actions to ease monetary conditions.

What's Changed?

To provide insight regarding recent stock market performance, we can deconstruct the three-month return from stocks into three components:

1) Dividend Income (for three months this is the annual yield divided by four)
2) +/- Change in Earnings per Share* (average for S&P 500 companies)
3) +/- Change in Valuation (Price/Earnings Ratio)

= Total Return

** based on forecast earnings for next 12 months (Source: S&P Outlook)*

So, *what changed* during the recent quarter to explain the +1.0% S&P 500 total return?

First Quarter (January - March) 2015		
Dividend Income	+0.5%	+1.0%
+ Change in Earnings	+4.5%	
+ Change in Valuation	-4.0%	
= Total Return	**+1.0%**	

Our read: *The year-ahead earnings gain cited above is a bit misleading (it largely reflects late-2014 accounting adjustments that depress the base). Wall Street analysts have been aggressively cutting estimates for 2015, suggesting that the indicated improvement in valuation may be illusory.*

Given the prospect of higher yields in the U.S. and aggressive monetary easing practically everywhere else, it was little surprise that the foreign-exchange value of the U.S. dollar continued the rise that began in the second half of 2014. Although the dollar's recent ascent has been quite sudden, so far its magnitude does not approach that of appreciations seen in the mid-1980s and late-1990s. Nevertheless, the changing currency regime partly explains the outperformance over the past several months by the stocks of companies that do relatively more of their business in the U.S. than abroad, including many consumer-cyclical (think: Kohl's) and small-cap names.

Dollar strength, oil weakness and some large accounting adjustments in the telecommunications sector caused Wall Street analysts to cut earnings estimates for the companies they follow more aggressively than usual during the first quarter. As a result, first-quarter aggregate profits are likely to see a year-over-year *decline* of around 5%; meanwhile, expected growth for all of 2015 fell to +5%, down from +12% when we wrote to you in January.

Outlook

In the sixth year of recovery following the 2008-2009 global financial crisis/recession, the world economy seems set to record a third-straight year of below-average growth. Among developed economies, the U.S. seems to be on the soundest footing: though the first quarter is likely to be weak, we expect pent-up consumer demand and a seasonal rebound in the housing market to drive solid expansion as the year progresses. While aggressive monetary expansion and weak currencies should provide a boost to both Europe and Japan, neither economy is likely to expand at a rate faster than 1% to 2%. And though we expect the Chinese authorities to do all they can to keep growth from falling below their 'New Normal' target of 7%, other emerging markets will be a mixed bag, with India's growth likely surpassing China's, Mexico benefiting from relative strength in the U.S., but a number of large, resource-dependent markets (e.g., Russia, Brazil, Venezuela, Nigeria, South Africa) facing decidedly tough times. A handful of emerging-market economies that have borrowed heavily in dollars could face payments crises if their currencies continue to weaken; though the most at-risk countries (e.g., Ukraine, Russia, Turkey and Venezuela) are not exactly giants, much-larger Brazil could be added to the list if its currency were to swoon further.

Having receded from the fore during the first quarter, geo-political issues could garner increased attention in coming months. Foremost will be the parrying between the newly elected Greek government and its foreign creditors. However, were this situation to deteriorate to the point of Greek default or exit from the currency union (neither of which is a forgone conclusion), we suspect the fallout would be much less severe than feared in 2011-2012. Europe's large commercial banks have greatly reduced exposure to Greek debt, most of which is now held by the continent's central banks. Moreover, developments since the Greek election suggest little likelihood that other bailed-out Euro member states (Ireland, Spain, Portugal) would be tempted to follow Greece down the path to leaving the currency union. Elsewhere, though Russia/Ukraine moved to the back-burner during the first quarter, we wouldn't expect them to stay there indefinitely. President Putin seems determined to destabilize and weaken Ukraine, and prevent it from assuming a pro-Western orientation; meanwhile, increasingly aggressive Russian military maneuvers around the Baltic and Nordic countries are less than reassuring. Finally, the progress of nuclear negotiations between the

U.S. and Iran will be worth watching closely, as they have broad regional-security and energy-market implications.

The elephant in the room remains the impending change in Federal Reserve monetary policy. Investors are concerned both with how the U.S. economy and financial markets will react to an actual change in policy, as well as to decreasing *certainty* regarding future policy. (The Fed has, for the past six years, essentially *promised* investors a prolonged period of near-zero rates; that promise is being replaced with something much more dependent on uncertain forecasts.) Many financial-market participants (and more than a few political figures) have been urging the Fed to act for some time out of worry that the zero-rate policy risked sowing the seeds of either inflation or asset-market bubbles. At the same time, many observers (mainly academic – as opposed to financial-industry – economists) have argued the Fed risks pushing the economy into a difficult-to-counter deflationary spiral by raising rates while global growth is weak and inflation is near zero. Acknowledging both sides of this debate, the Fed seems determined to be 'dovish' even while beginning to raise rates – a tricky posture to convey and maintain effectively. And while investors seemed soothed by the outcome of the Fed's most recent meeting, a rise in market volatility seems likely as the policy change unfolds.

As we look ahead to the remainder of 2015, we are modestly encouraged by two favorable statistical patterns: the tendency of U.S. stocks to perform well in the third year of presidential terms and also in years ending in the number 5 (in both cases, the average return is well above the overall, historical average). While ends-in-5 seems likely to be coincidence, the election-cycle pattern has some rational basis, as presidents and their parties have incentive to enact market-friendly policies (or at least to eschew unfriendly ones) in the run-up to their re-election campaigns. We have also noted in recent weeks some improvement in investor sentiment (less euphoria, more circumspection) and bond-market indicators (stabilizing credit spreads) that concerned us late last year. The early-year outperformance of small-company, economy-sensitive and growth- (as opposed to value-) oriented stocks, too, can be counted as encouraging; none is typical of the late-stages of a bull market.

On the negative side of the ledger, we are concerned that profits are coming under pressure at the same time that support for higher stock prices will need to shift from liquidity (i.e., easy money) to earnings growth. As noted above, profits for the current quarter will be below year-ago levels, and without a substantial pickup later in the year growth for all of 2015 could fall to near zero. Meanwhile, still-elevated valuations (for both stocks and bonds) seem likely to have a negative impact on future returns (since valuations tend eventually to revert to their long-term averages). Throw in growing uncertainty regarding Fed policy, and we believe the environment calls for a degree of caution – and is also likely to be one in which an emphasis on high-quality investments that generate reliable cash-income streams will provide substantial benefits.

We welcome comments and questions regarding our management of your investments.

Sincerely,

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