ND&S
Newman Dignan & Sheerar
INVESTMENT ADVISORS

ECONOMIC & CAPITAL
MARKETS REVIEW
NEWMAN DIGNAN & SHEERAR, INC.

Much Ado About Nothing

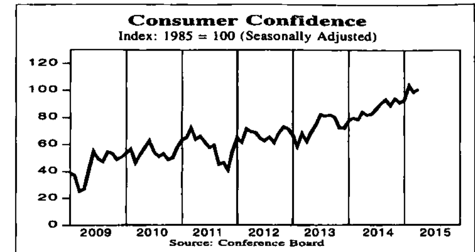
1st Quarter 2015

ECONOMY & MARKETS

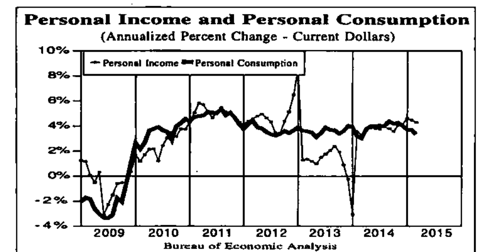
Shakespeare's 1599 comedy – *Much Ado About Nothing* – sort of reminds us of the most recent quarter … filled with deception, false promises and recommitments. Markets had the potential to sell-off, yet they finished the quarter essentially flat.

The first quarter of 2015 was chock full of potentially market-moving and deceptive events … it seems like there is always something to worry about. Increased volatility in the quarter resulted from a number of things: severe winter weather in much of the country, a major west coast port strike, ongoing U.S. – Iran negotiations, terrorist murders in Paris at Charlie Hebdo, fear of a Greek exit (Grexit) from the Eurozone, Swiss National Bank removing their euro-exchange cap, continuing tensions throughout the Middle East, a major drop in the price of oil, a significant increase in the value of the U.S. dollar, a massive bond buying program by the ECB, the Fed's removal of the word 'patient' from its stance on eventually raising interest rates, and the assassination/murder of long-time Putin critic Boris Nemtsov … we could go on, but you get the message. It was *Much Ado About Nothing* … despite Benedick's vow to never get married, he relented and married Beatrice nonetheless. Likewise, investors are ignoring the deceptions of headline news and staying in the markets.

In the first quarter of 2015, the **DJIA** inched lower by 0.3% while the **S&P** inched higher by 0.4%. The **NASDAQ** advanced 3.5% for the quarter due to lesser exposure to currency headwinds. International markets made up for lost ground as the **EAFE** Index climbed 4.2% for the quarter. Bond returns were decent as the Barclay's Aggregate **Bond Index** gained 1.6% for the quarter. Interestingly, the Barclay's Global Aggregate Bond Index (a broad-based measure of the global investment-grade fixed rate debt market) declined 1.9% for the quarter.



Domestic economic news continues to gradually improve. Low oil and gasoline prices, tame inflation, lower jobless claims and rising home prices are all contributing to encouraging **Consumer Confidence** *(see chart above)*. Increased consumer confidence, however, has not been able to jump start consumer spending despite slightly higher **Personal Income** *(see chart below)*.

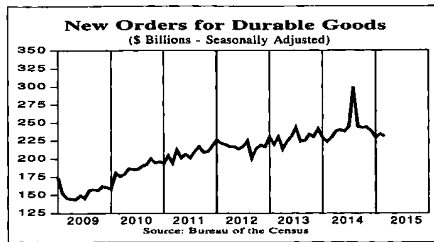


Personal Consumption has been somewhat stagnant lately, as shown above. One would think that consumer spending would have improved by now given the economic backdrop, but consumers have been paying down debt instead (always a good thing). Sluggish wage growth has, no doubt, been hindering consumption, but we suspect that is about to change. Auto sales, housing permits, commercial and industrial loans, vacation planning and new home sales are all pointing to better consumption ahead.

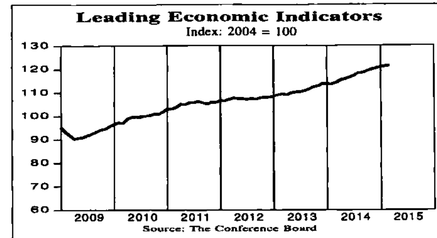
Durable Goods Orders *(see next page)* are a bit troublesome. February's 1.4% month-over-month drop was unimpressive, but was likely caused by a strong dollar (12 year high) and a weak energy sector. On the other hand,

Leading Economic Indicators *(see below)* indicate an expanding economy.

Temporary?



Good Sign



OUTLOOK

Bottom Line – John Kenneth Galbraith once said of those making predictions - "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." We are in the first camp – we certainly don't know what will happen to the markets; however, we suspect that volatility will continue and that markets will push along a bit higher for the next quarter. Weak first quarter GDP *(roughly flat)* will likely be followed by decent second quarter GDP as the effects of the severe winter weather and the west coast port stoppage fade away.

Market valuations have certainly increased over the past year, but current valuations are not a hindrance to further market advances. With 2015 consensus earnings estimates for the S&P 500 around $118 or so (down from $127 earlier in the year), the market is selling at 17.5x forward earnings. These estimate declines are due mostly to a 50% drop in oil prices and a 20% gain in the dollar since last June. Corporate America is doing fine, and we doubt that likely temporary issues will derail our economy. Of course, higher valuations provide less room for disappointments, and we expect higher volatility as a result. Remember, a correction in the markets is long overdue … we have gone 1,275 calendar days without a 10% or greater drop in the S&P 500.

Remember

European valuations have moved higher as well with European stocks trading at 16.6 times forward earnings. Profit margins in the euro area are roughly one half of what they are in the U.S. … leaving more room for earnings growth. Interestingly, S&P 500 earnings are 23% above their pre-crisis peak while the Stoxx Europe 600 earnings are 26% below (according to FactSet data). Of course, the ECB is still in easing mode while the U.S. Fed will likely raise rates later this year *(tell me something I don't know ...)*.

Bond prices should fluctuate widely over the next quarter as chatter about a potential Fed rate hike intensifies. We anticipate keeping average durations in the short-to-intermediate range … we are not willing to take on much interest rate risk given the likelihood of higher rates. We are, however, willing to take on more credit risk as corporate balance sheets are reasonably strong. The world is starved for yield, and we see flows coming into U.S. treasuries as bonds in Europe are at stupefyingly low levels … Switzerland just issued a 10-year bond with a negative yield! Yield purgatory will be around for a while.

Small and mid-cap equities still add value to an overall asset allocation strategy as a strong U.S. dollar benefits this slightly-overvalued group. We are sanguine on *international equities* – both *developed* and *developing,* given relatively attractive valuations and yields (and dollar strength). Again, we believe that *large-cap companies with higher quality attributes* should continue to provide better-than-market returns (valuations are a bit stretched, but they provide predictable growth and dividends). We like companies with excellent dividend growth potential *(not necessarily just high dividend yields)*. *Commodities* offer investors some protection from potential inflation and dollar weakness, but those scenarios do not seem likely for the next quarter or so. *Alternative assets* will continue to provide good risk-management for portfolios ... particularly in an environment of increased volatility.

We suggest that investors maintain a fully diversified portfolio consistent with one's longer-term objectives and risk tolerance. ***Happy Spring!***

Crude Oil: Sweet and Sour

The dramatic decline of oil prices, over 50% since last June, has caught investors, lenders, oil companies and our economy by surprise. There is now a global excess supply of oil, mostly due to increased production. Saudi Arabia is determined to maintain its market share. Furthermore, Obama's "framework" with Iran will enable them to dramatically increase production. Overall demand has weakened since China's growth has been slowing and Europe's economy remains sluggish. So far, US production continues to increase despite a dramatic reduction in the North American rig count. It turns out that hydraulic fracturing [fracking] is more efficient than previously believed. US oil inventories have climbed to nearly 11 million barrels in the week ending April 3rd, the highest level since 1930.

As a result of the oil glut, energy stocks have taken a hit. Moreover, tens of thousands of oil-related jobs have been lost and consumer confidence in the oil states is back down to recession lows. There is also concern in the financial sector that lenders to some oil companies, especially over-leveraged drillers, will experience loan defaults. Most of the better-managed drillers have protected themselves by purchasing hedges against oil price declines, but those who sold those price hedges will have to make good. Major banks, like JP Morgan, Bank of America and Citigroup could be on the hook for as much as $26 million in hedged investments.

Good news for consumers ↪

The good news is that the US consumer will see gas and heating oil prices stay low and should begin spending their windfall. US manufacturing will also benefit especially those relying on energy and oil related products. The US is now importing less oil, which reduces OPEC's influence on the world stage. Where do we go from here?

This industry has always been subject to booms and busts, so the question is not if the price of oil will bottom, but where and when. Near term, employment reductions will continue, and domestic production will plateau. The sector is also looking at mergers and acquisitions, such as Royal Dutch Shell's recently announced offer for BG Group PLC. This 50% premium and $70B size offer assumes oil at $90 by 2018, setting a high bar for follow-on acquirers. Additional transactions will occur, but the currently high "bid-ask" spread will delay follow-on announcements. Long-term investors will be well-rewarded by increasing positions in well-managed operators during this period of turbulence.

Everyone Pile in the Greenback!

The US set the example for monetary easing starting in 2009, engaging in ~three versions of "quantitative easing", which concluded last year. Now most of the rest of the world is following suit. As a result, since last summer the dollar has risen 25% versus the Euro, 20% against the Yen, and 15% on a broad trade-weighted basis. To put things in perspective, we have not seen a move like this since the financial crisis in 2008/2009. This upward dollar trend will likely continue, as currency trends usually last over multiple years.

And the winners are…

The stronger dollar will have a negative effect on US GDP growth (a 1/2%-3/4% headwind), and is particularly impacting US exporters. A stronger dollar means consumers in other countries will have to be willing to pay more for US made goods & services or the producer will have to reduce prices to remain competitive. On the other hand, foreign-based corporations will be more competitive. As a result, the winners of a stronger dollar will be the Euro-zone manufacturers, Japan, select Emerging Market countries, domestic-oriented US companies as well as US consumers.

1st QUARTER 2015 SCOREBOARD

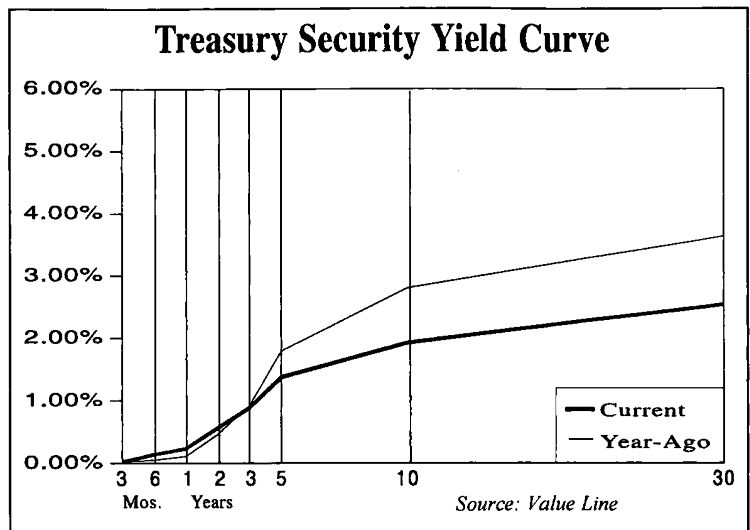
Index	Close	1st Quarter % Change	Year-to-Date % Change
DJIA	17776.1	-0.3	-0.3
S&P 500	2067.9	0.4	0.4
NASDAQ	4900.1	3.5	3.5
Nikkei	19206.9	10.1	10.1
MSCI EAFE	1849.3	4.2	4.2

3 Month T-Bill	0.03%	Fed Funds Rate	0 - 0.25%
5 Year T-Note	1.38%	Prime Rate	3.25%
10 Year T-Note	1.93%	Gold	$1183.10
30 Year T-Note	2.55%	Oil	$47.60

Index returns are price only

Gold prices were flat while oil prices declined 11% during the quarter.

Yields moved lower during the quarter... expect a gradual move higher.



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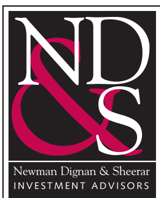

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