2015 First Quarter ReView of the Markets

Index	1st Qtr Return
S&P 500	0.95%
MSCI World Ex US	3.8%
Barclay's Bond Index	1.6%
Consumer Price Index	-0.2%

Investment Commentary

U.S. stocks and bonds ended the first quarter of 2015 little changed, leveling off after a steep rise over recent years and raising questions about the road ahead. A dramatically strengthening U.S. Dollar and falling oil prices (more on both of these topics later) contributed to the second straight quarter of earnings declines for U.S. companies. Similar to the first quarter of last year, volatility in U.S. equities increased relative to the previous calendar year with the S&P 500 index returning 1% for the quarter. We have continued to caution our clients that an increase in volatility is possible, not because we expect volatility to be atypically high, but rather because for years volatility has been atypically low.

Internationally, the European Central Bank (ECB) garnered the headlines. As we anticipated in last quarter's ReView, the ECB launched their quantitative easing (QE) program in February in an attempt to foster economic expansion. The program met the market's broad expectations in terms of size and international equity markets reacted favorably, with the MSCI World ex USA returning 3.8%. International stocks were up significantly more in their local currencies, with a 10.1% return in the first quarter. The difference between these two is attributable to a strengthening U.S. Dollar.

Domestically, the Federal Reserve ("the Fed") opened the door to an increase in interest rates in 2015. The Fed continues to signal that they will be "data dependent", meaning that they will only tighten monetary policy if the economic data points to an economy that appears to be strong enough to handle the increase in rates. Despite significant policy changes by global central banks, U.S. interest rates did not see significant moves. Yields on short term bonds increased more than yields on long term bonds (an event known as a "yield curve flattener"). The yield on the 10 year U.S. Treasury fell back below 2%, closing the quarter at 1.9%. U.S. bonds slightly outperformed U.S. stocks for the quarter with the Barclays Aggregate Bond Index returning 1.6% for the quarter.

Economic Outlook

As has been the case for years, investors are focusing their attention on whether or not the Fed will begin raising interest rates this year. After their March meeting, the Fed removed the word "patient" from their statement describing when they could raise rates. Shortly thereafter, Fed Chair Yellen clarified that the absence of the word patient does not mean that they will be impatient. If you are thinking "that doesn't tell me much," then you're following right along!

Given the current state of the U.S. economy, our expectation is that the Fed will begin normalizing rates within the next 12 months. The Fed wants to raise rates from historically low levels so that when there is an economic slowdown in the future, they would have the ability to lower rates in order to fight recessionary pressures. Said differently, the Fed is still positioned as if it were fighting a recession; should there be another recession before they normalize, they wouldn't have the tools to effectively fight the recession and promote economic growth. We must be mindful that while Central Banks' QE programs have served to help bring about the end of the Financial Crisis, QE on such a massive global scale is unprecedented and the long-term effects of these drastic programs are still unknown. We believe that the U.S. economy and equity markets are healthy enough to support a modest rise in rates based on our previously outlined economic outlook, and relative valuations. We also believe that the slow and deliberate normalizing of interest rates is the prudent course of action for the Fed.

Returning to currency movements, it is worth noting that the 20%+ appreciation of the US Dollar relative to a basket of foreign currencies since July 2014 will provide a significant drag against U.S. economic growth over the next few years. The sharp decline in the price of crude oil over that same time period will partially, but not completely, mitigate the negative effects of a strengthening dollar on GDP growth given the U.S. economy's status as a net importer of crude oil.

Investment Strategy

We wrote last quarter that our meaningful underweight to non-U.S. equities was a function of high international asset prices relative to the level of economic uncertainty. We also mentioned that the ECB would be forced to act. As a result of the ECB meeting our expectations, we increased our allocation to non-U.S. equities fairly meaningfully during the first quarter. This is not because we believe quantitative easing will send asset prices soaring for years to come. We increased our foreign allocation primarily to diversify equity exposure outside of the U.S. For years, economic conditions abroad were such that we could not see a case in which foreign equities would appreciate significantly and the U.S. would not participate. However, we did see the potential for the U.S. doing reasonably well while foreign equities fell. Based on this perceived profile of risk versus reward, our clients' exposure to non-U.S. equity had been minimal. In hindsight, our clients have been rewarded for our heavy U.S. equity bias as over the last 5 years as U.S. equity markets have meaningfully outperformed foreign equities.

Now that QE has "leveled the playing field" relative to domestic assets, we believe our clients will be well served by a more diversified approach. Further tailwinds for foreign companies are an appreciating U.S. Dollar (which should boost exports), lower energy prices (as most foreign economies are net importers of energy), and the prospect of earnings growth (U.S. companies have far surpassed pre-2008 earnings levels, European companies still have yet to reach pre-2008 levels). This of course begs the question "why have we not loaded both barrels with respect to international equities?" International equities, although they have significantly lagged their U.S. counterparts since 2009, are not priced as if they are "coming off of the bottom"; stated differently, we consider valuations to be reasonable rather than cheap. If and as economic conditions abroad improve, we can increase our clients' international exposure selectively.

On the fixed income side, many would assume that, if the Fed raises rates, all bond prices will fall and investors should simply remain in cash while they wait for higher rates at which to invest. An argument for this could have been made for the past several years and investors would have missed out on relatively meaningful gains along the way. As in the past, we are continuing to avoid being overly aggressive with what is traditionally the safe part of a client's portfolio (fixed income). We believe that the actual downside in a Fed rate hike event is fairly minimal in our fixed income allocation due to the short duration (a measure of sensitivity to interest rates) of our clients' bond portfolios and our use of skilled fixed income fund managers who in most cases have positioned their portfolios for rising interest rates. In the interim, this part of the portfolio is providing a nice ballast against rocky equity markets (as seen in Q1).

We believe our clients' portfolios are well-positioned for the remainder of the year. However, it is important to remember that our goal is to construct diversified portfolios with reasonable risk versus reward profiles. Our clients' portfolios are designed to be resilient across a range of potential scenarios, rather than heavily reliant on one particular theme playing out. We remain watchful and prepared to make allocation changes as is warranted and always welcome conversations with our clients regarding these changes as well as other matters that may impact your financial independence.