# BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

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## FINANCIAL MARKET OVERVIEW

The U.S. stock market finished the year on a strong note while international and emerging market countries finished the year with negative performance. Fourth quarter performance varied within the U.S. stock market as small-company stocks ended the fourth quarter with 10% gains but were only up about 5% for the entire calendar year. Conversely, large-company U.S. stocks increased by about 4.5% during the fourth quarter, but were up about 12% for the entire calendar year. In summary, 2014 was a one-horse race led by large U.S. company stocks.

Fourth quarter financial market performance was positive for all basic investment categories except for international stocks, emerging market stocks and gold. The quarterly return for U.S. stocks varied between 4% and 5%. International and emerging market stocks were down over 4% during the fourth quarter and down 4% to 6% for the 2014 calendar year.

Once again, interest rates *declined* during the fourth quarter and over the entire calendar year. The interest rate paid on 10-year U.S. Treasury Notes began the year at about 3% and ended at 2.17% by the end of the year. Therefore, bond funds had moderate gains (when interest rates fall bond values increase) with long-term bonds gaining about 9% during 2014 and short-term bonds gained about 1%.

The value of the U.S. dollar compared to six other major currencies rose to an 11-year high by the end of the fourth quarter. Crude oil prices dropped from over $100 per barrel at the beginning of 2014 to about $90 by the end of third quarter and then a drastic drop to $50 per barrel by year-end. Gold prices declined 2.25% during the fourth quarter and ended the year with a 2% decline.

Real estate (REITs) values (investment real estate – not homes) ended the fourth quarter with a spectacular gain of over 14%! REITs posted the best performance in 2014 with a whopping 30% gain compared to all of the other indices shown below. The following chart displays sample returns of various asset categories during the fourth quarter and the entire 2014 calendar year:

| **Calendar Yr. 2014** | **4th Qtr. 2014** | **Index Return** (***includes dividends reinvested***) |
|---|---|---|
| + 7.52% | + 4.58% | **Dow Jones Industrial Average (^DJI)** |
| + 13.46% | + 4.90% | **Standard & Poor's 500 Index (^GSPC)** |
| + 12.55 % | + 5.25% | **DJ U.S. Total Stock Market (VTI)** |
| + 12.79% | + 4.74% | **Large-company stock-Growth (IWF)** |
| + 13.17% | + 4.91% | **Large-company stock-Value (IWD)** |
| + 11.69% | + 5.88% | **Mid-Size Stocks – Growth (IWP)** |
| + 14.39% | + 6.04% | **Mid-Size Stocks – Value (IWS)** |
| + 5.86% | +10.06% | **Small-company stock- Growth (IWO)** |
| + 4.14% | + 9.38% | **Small-company stock- Value (IWN)** |
| - 6.02% | - 4.19% | **International (EFA)** |
| - 3.89% | - 4.10% | **Emerging Markets (EEM)** |
| + 30.39% | + 14.28% | **Real Estate Invest. Trusts (VNQ)** |
| | | *Fixed Income* |
| + 0.45% | + 0.07% | **Short-term U.S. Treasury (SHY)** *(includes appreciation)* |
| + 9.07% | + 2.97% | **Intermediate U.S. Treasury (IEF)** *(includes appreciation)* |
| | | *Alternative Investment Category* |
| - 2.19% | - 2.26% | **Gold (GLD)** |

## ECONOMIC AND FINANCIAL MARKET OUTLOOK

Once again, the U.S. stock market continued advancing during the fourth quarter. Stock returns were up just over 2% in October and November. December stock market performance was flat. Repeatedly, investors' willingness to buy more of whatever asset class is rising (U.S. stocks)

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continues to be the preferred choice as investor confidence generally rises as stock prices rise. And a slowly improving U.S economy compares favorably to weakness in just about everywhere else in the world. Compared to a 12% plus return on U.S. stocks in 2014, foreign stocks were down nearly 7% and emerging markets were down about 3% during 2014.

From the rear-view mirror perspective, U.S. stocks appear to offer the best potential return. Plain vanilla large–company U.S. stocks performed best in 2014. However, looking ahead, international and emerging market stocks offer better value in the future if slow to moderate economic growth begins to spread worldwide.

Last year's market performance (and market performance since 2009) should convince you that the financial markets are unpredictable and not simply controlled by any one variable such as politics, interest rates, GDP growth, or any other single variable.

The crowd is definitely following the lone asset class (large U.S. stocks) that is performing well (along with REITs). Simply stated, large U.S. stocks have been leading the pack over the past 6 years and now everyone is aboard this train. Knowing when the 'crowd' has had enough is an often frustrating task, and it behooves an individual investor to stand clear of making significant new investments into large-company U.S. stocks at this time. It is much more comfortable to ride the stellar performance by continuing to hold your stock positions rather than making significant increases in the immediate future.

The big picture or theme: The consensus forecast of economists and investment managers is **low interest rates, low to moderate U.S. economic growth, and low inflation**. Does this summary bring a smile? This "theme" is exactly what the picture has been in the rear-view mirror. In retrospect, it is much easier to explain how we arrived where we are today than it is to accurately predict *where* we are headed, *when* the expected scenario will occur and *how* will people (financial markets) react to it.

Excluding politics, media stories, global conflict/terrorism and day traders who can move the market significantly over a short period of time, below is a summary of relevant indicators and variables that may have an impact on future market performance.

*Strong U.S. Dollar*: (Mostly) foreign buyers are purchasing dollars and dollar-related assets. By the end of 2014, the U.S. Dollar had reached an 11-year high against other major currencies betting that the U.S. economy will continue to pull ahead of the rest of the world. Therefore, the consensus expectation is 1) the U.S. economy will continue growing; 2) U.S. interest rates will begin to rise. Yes, many investors and investment managers (including us), predicted that artificially low interest rates would have risen by now. With an improving economy, it's just a matter of time in 2015 when the Fed will begin raising short-term interest rates. Rising interest rates make the U.S. Dollar even stronger (higher interest income); 3) The negative consequence of a strong dollar is that it lowers foreign demand (exports) for our goods and services – a strong dollar makes our exports more expensive. Following this line, economic growth would be negatively impacted – by how much is debatable.

*Rising GDP – Economic Growth:* The U.S. economy is "out of the woods" regarding an eminent recession. The economy is growing slowly. The question is will it continue to grow and more importantly, how fast or slow? Current stock prices are at a level that suggests more growth is expected – it's already priced in the market with the Dow recently hitting an all-time high of 18,000. More growth would support the forecast that unemployment will continue improving slowly. Together growth and lower unemployment would support a continued advance for the rising U.S. stock market. If U.S. economic growth does not continue to improve and spread worldwide, then current stock prices are at risk of losing value. Currently, Europe is flirting with recession and China's growth rate is slowing considerably.

*Low Inflation Rate Expectations:* Normally, rising economic growth increases consumer demand and

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consequently prices and our inflation rate begins to rise. Thus far, it hasn't happened. Is it different this time? Or, will inflation begin to rise above the current 2% rate? Certainly, the sudden decline in oil prices will dampen the energy component of our inflation rate. The price of oil at the beginning of 2014 was over $100 per barrel. By late summer, the price of oil dropped to $80 per barrel and then suddenly swooned to $50 per barrel by year-end. This sudden and precipitous drop in the price of oil is a perfect example of how the market (stocks, bonds, oil, etc.) can move suddenly without anyone accurately identifying the asset or commodity that is about to change, when it will occur and how investors will react to it. With an enormous amount of expertise and data available to everyone, how could the price of nearly anything fall 50% in one year without warning? Lastly, lower oil prices are a two-edged sword. It helps improve consumer spending, but it also lowers the earnings of oil companies and their contribution to overall corporate earnings growth rate.

*Low Interest Rates:* The 10-year U.S Treasury Note paid 3% interest at the beginning of 2014, but fell to 2.17% by year-end. A nearly 1% move from this already low level was significant. If the economy was on a solid start to better growth, interest rates would not be at a 65-year low and trending down. If growth is going to occur, interest rates will rise – the question is how fast? As long as interest rates do not rise faster than what the general consensus expects, then our stock market returns may slow, but not reverse course significantly. Real estate prices (and bond values) are at risk of decline under a rising interest rate environment. Some offer their arguments supporting how real estate prices don't necessarily have to decline under a rising interest rate environment (rental real estate of all kinds), but all one has to do is look at investment real estate prices during 2014 when interest rates dropped nearly 1 percent. REIT's (real estate investment trusts) rose, on average, 30% during 2014! The reverse also holds true – rising interest rates do negatively impact investment real estate prices (higher mortgage rates, higher expenses).

*Price-Earnings or P/E Ratio:* A simple and useful valuation measure is price per share (stock) divided by earnings per share. A "normal range" is 12 to 18. Based on the past four quarters of historical corporate earnings, the P/E ratio stands at 19.7 – the high end of the spectrum. This means stock prices are already more-than-fully-valued at this time. If we use analysts' consensus forecast of corporate earnings for the next four quarters, the P/E ratio is 16.5. Yes, our economy must continue to grow, otherwise the P/E ratio will fall (and consequently stock prices will fall as well). We will have to wait and see how strong economic growth will be in 2015 (consensus forecast is 2.5% - 3%). For 2014, the U.S. GDP growth rate was 2.5%.

The bottom line is the variables that recently impacted the future direction of the stock market - such as will we avoid a recession, will politics continue to adversely affect our country's deficit spending, global conflict, whether the Fed will continue to keep short-term interest rates artificially low, mid-term elections, will shift more towards traditional "hard data" such as growth in corporate earnings, GDP, interest rates, inflation, and consumer spending.

Our biggest challenge is not to try and accurately predict all of the variables discussed above, but rather, what strategies and changes to client portfolios we will make under differing future outcomes. We think we see the path ahead of us, but we could be mistaken (just as the overall market valuation may be too optimistic or pessimistic) and what will we do and how fast should we react to changes in expectations and the direction of the financial markets. How much volatility in prices should we accept before making meaningful changes? If sudden asset price changes are significantly overblown and occur too rapidly (energy prices), should we react with the crowd, or is the sudden change likely to adjust itself over a relatively short period of time? There have been numerous reasons or opportunities to sell assets over the past three years, yet none of the negative expectations materialized. Reducing stock exposure at any time over the past three years would have been a mistake.

Over the near-term, we do not expect to increase our clients' exposure to the equity markets. It is more likely that we will wait for short periods of weakness to add stocks. Energy, technology, and emerging markets appear particularly attractive. Economic growth,

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interest and inflation rates over the first two quarters of 2015 should provide a better glimpse of where we are heading. Inevitable interest rate increases in 2015 will be the likely test of the market's strength.

## Check Your Credit Report for Errors & Identity Theft

Each year, you have the right to get one free credit report from each of the three credit bureaus. Unfortunately, it is very easy and common for errors to creep into this compilation of personal data, credit history and public information. Regular checkups are critically important.

Monitoring your credit report is your best line of defense against credit card fraud and identity theft. To get started, go to www.annualcreditreport.com or call 877 322-8228. You will be given a choice of which credit bureau to start with. Be prepared to verify your identity by answering several questions such as the name of your mortgage lender, amount of your monthly payment, who holds your auto loan and previous personal addresses. If you answer incorrectly, you may be locked out of the online system and must order by mail. Remember to print out a copy or save it on your computer. Lastly, be advised additional detail about your credit score may be purchased for a nominal fee. If you find an error in your report, contact the credit bureau for details on how to correct the error. Don't wait until you need to apply for credit or refinance your home.

## Copies of 2014 Income Tax Returns Review Strategies

Please send paper or electronic (email) copies of your 2014 income tax returns to our office at your earliest convenience. Our investment decisions, income tax management and retirement planning strategies are greatly improved when we have your most recent income tax returns in our files.

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Best regards

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