Beacon Trust Quarterly

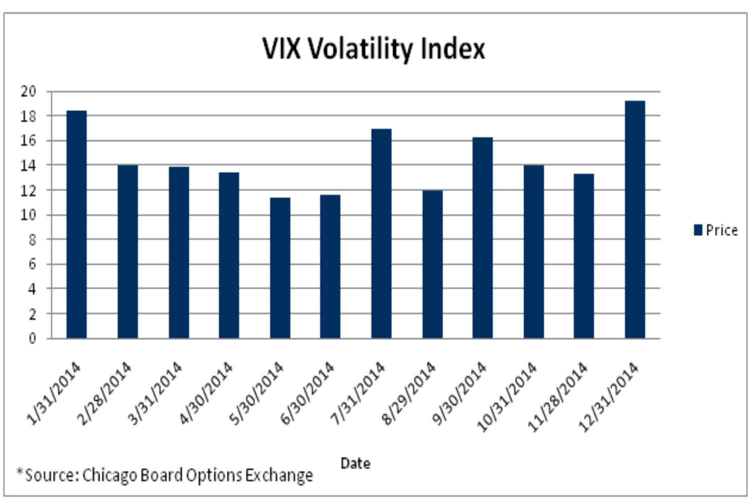
January 20, 2015

2015 Outlook

"It's like déjà vu all over again"

This famous quote by former New York Yankee catcher Yogi Berra aptly describes similarities between the start of this year and the beginning of 2014. In our 2014 Outlook, we compared the hit to equity markets to "going up against the Seattle Seahawk's defense." The comparison is legitimate in the early weeks of 2015. A spike in stock market volatility was another salient feature a year ago with the VIX (CBOE Volatility Index) rising 34% last January. Another "déjà vu" item is geopolitical risk. Again, last January, we considered geopolitical risk the main threat to stock market performance. Despite a poor start to last year, accompanied by higher volatility and proliferating geopolitical risk, the S&P 500 Index managed a total return of 13.7% and peaked very close to the level (2,075) we forecast in our 2014 Outlook piece. Will the market ending be as happy this year? We will save that prognostication for a subsequent section of this report. In the meantime, we will share our forward-looking views on market volatility and geopolitical risk, as these can engender fear in even the most seasoned investor. The spike in market volatility that occurred early last year was in essence a head fake.

For 2014 overall, volatility, as measured by the VIX, was quite muted. (See chart below.) However, the VIX began climbing last December and has remained elevated in 2015. Unlike 2014, we believe this could be a more volatile year for several reasons. First, the Federal Reserve is likely to begin normalization of interest rates during the second half by increasing the Fed funds rate.



Low market volatility during the past several years has undoubtedly been at least partially tied to a zero risk-free rate. Uncertainty as to timing and consequences of rate hikes could also feed into heightened volatility. Second, divergent central bank policies will likely be a factor. While the Fed has abandoned quantitative easing (QE), other central banks (Japan, eurozone) will embrace the exercise. Third, the abrupt decline in the price of oil creates concern regarding strength of the global economy and deflation. Fourth, credit spreads are widening. Fifth, thinner markets are the result of regulatory impact on dealer inventories and proprietary trading. Other than gut wrenching market choppiness, heightened volatility may not be a bad thing. It might very well be accompanied by greater differentiation in stock returns, thus creating stock picking opportunities.

While geopolitical risk was certainly a problem with regard to frequency in 2014, severity of these occurrences (Ukraine, Iraq, Syria, Israel, Gaza, etc.) was limited. Markets swooned temporarily and then recovered. Severity might be more of an issue this year. We are particularly concerned with Russia. The sharp decline in energy prices, the weak rouble, and Western sanctions have constrained Putin's ability to buy political support. Rebuilding the Russian empire through annexation could be seen as a viable alternative to maintain a high approval rating. In our opinion, the probability of increased military activity has increased as a result. In addition, social unrest and terrorism will likely be experienced in several other hot spots for economic, political, and religious reasons.

US Economy: Extended Economic Expansion

The PMI Non-Manufacturing Index (NMI), which tracks 90% of economic activity in the services sector, has been a reliable gauge in determining the outlook for nominal GDP. For instance, NMI gave a strong indication that nominal GDP growth would accelerate to a 6%-7% range and, indeed, GDP growth averaged 6.6% in the second and third quarters. Based on NMI's 3-month moving average, we expect growth to continue at a 6% rate during the next few quarters.

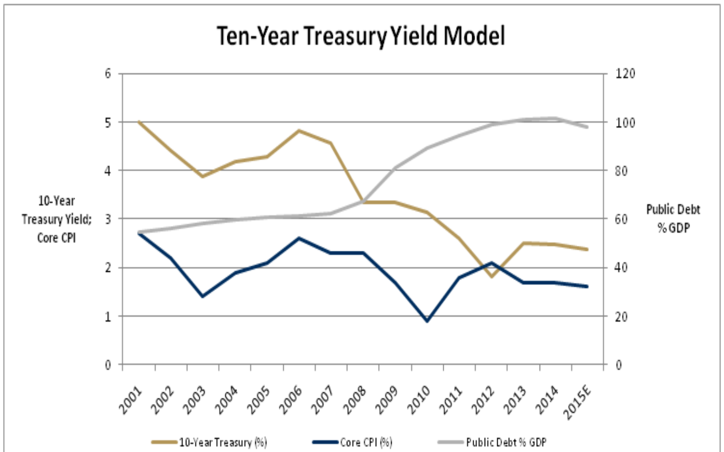
This rate of gain would help alleviate the negative impact of a strong dollar on foreign-sourced revenues. It also implies that real GDP growth can be maintained above 3%. The consumer is expected to play a major role in sustaining growth. We view total income growth as being supportive. Drilling deeper into wage rates, our view is not that pessimistic. Average weekly earnings growth has accelerated the last 3 months and was 2.5% higher year-over-year in December. With total CPI deflating in the near term, real incomes and wages are higher still. The anticipated spending tailwind from lower gasoline prices should kick in during the second half. We believe our positive Business Investment theme, which encompasses Capital Expenditures (CapEx), is still viable. While some energy Cap Ex projects will likely be abandoned, energy CapEx represents only 1% of GDP. Overall, Business Investment could climb about 10% this year. Although the labor participation rate remains low, all other major components of the jobs market, including wage rates, seem fine.

US Market Expectations

Although bond yields averaged a bit lower than expected last year, our preference for stocks versus bonds was validated by relative return results. The S&P 500 returned 13.7% versus 6.0% for the Barclays Aggregate Bond Index. Our S&P 500 price range projection for 2015 is 2,300 – 1,870. This 23% range implies more volatility than last year, which is consistent with comments made at the outset. We anticipate a total return of 12%. So, for the third consecutive year, we look forward to the company of our charming companion, T.I.N.A. – There Is No Alternative (to the US stock market). Low corporate credit spreads have supported our positive posture on the stock market. Since mid-2014, spreads have widened 35 basis points in gradual fashion. We believe another 25 basis points or so of upside risk is likely this year. As suggested earlier, widening credit spreads are a likely contributing factor to increased volatility. The dividend return, bolstered by earnings and higher payouts, will be an important contributor to stock market returns as well. From an asset allocation perspective, we remain overweight Domestic Equities.

Last year we hedged our bets on rising bond yields by indicating that “a few countervailing influences could limit or even prevent a rise in bond yields.” For the record, the 10-year Treasury note yield was flat, on average, with 2013 at 2.48%. We believe a similar situation can materialize in 2015, with disinflation, a strong dollar, and institutional and foreign demand for bonds limiting any rise in yields. On average, we expect bond yields to be down slightly.

The chart below shows our point estimate as a function of Public Debt % GDP and Core CPI. Our estimated range for the 10-year note is 3.05% - 1.70%. We have no favorite sectors in the bond market currently. Late last year, we eliminated exposure to high yield bonds and emerging market sovereign debt based on concerns for energy bonds and emerging market oil exporting countries. Overall, we are underweight fixed-income.



*Sources: Bloomberg; Federal Reserve Bank of St. Louis
Correlation Coefficient = 85.4%

Developed Markets

We continue to underweight Developed Markets. While the eurozone is expected to continue in a no growth mode (versus recession), it is absent growth drivers and suffers from a lack of demand. Quantitative Easing (QE) expectations appear to be overly optimistic, as we believe the ECB will have difficulty reaching an effective level of bond purchases. With the drop in oil prices, deflation will likely persist for a while. Any cyclical recovery in equities will likely be short-lived. Although Japan has undertaken a massive QE program encompassing government purchases of equities, stagnation is a key concern. Real wages have been flat or declining the last several years. While the labor market is tightening, labor reform is required to increase job mobility, improve worker skills and lift real wage rates. QE might result in periodic stock market rallies, but this too would likely be short-lived.

Emerging Markets

Emerging Markets (EM) are not created equally. One must analyze the economic, financial, political and governance characteristics of each country. In general, we are underweight EM.

There are several headwinds that we believe outweigh the positives. Although we do not expect a hard landing in China, growth will be a challenge for the world's second largest economy and other EM countries. Commodity exporters are facing lower oil and other commodity prices. Foreign currency debt is a risk for Russian and other EM borrowers due to size and the foreign exchange mismatch. The strong dollar outlook does not help. While not predictable, geopolitical risk and social unrest threaten countries with low standards of living.

US Dollar and Commodity Prices

The strong dollar outlook is supported by divergent central bank policies (Fed tightening, others easing), stronger US growth, higher interest rates, and safer assets. The strong dollar is one of the nails in the coffin for oil prices. In fact, oil prices began weakening last summer as the dollar gained strength. This is a consequence of oil being priced in dollars. The oversupply condition is likely to persist as Saudi Arabia is employing a long-term market share strategy to eliminate high cost producers. US production is forecast to increase this year. Shale producers are likely to increase production quickly (in months) in response to any rise in prices. The International Energy Agency has cut the demand outlook 4 times in recent months. Bottom line, there are several headwinds that could keep the price of oil depressed for a while.

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