Market Review and Outlook—January 6, 2015

So how did 2014 measure up? The chart below shows that it was a fine year for bonds, with returns in the middle single digits. US stocks did well, especially larger companies. Foreign stocks did poorly, but this was eclipsed by the losses from natural resources. Technology did well, while real estate soared.

What was going on? While the US economy recovered well in 2014, the Federal Reserve Bank (Fed) felt that continued stimulus was required. This enabled investors to hold onto expensive bonds for another year, and continue to buy these pricey assets. Long-term bonds leapt nearly 30%! The piper will be paid, bond investors will lose money, just not yet.

With the US economy's continued recovery, investors also held onto their US stocks, and added modest money to these markets. In 2014 the US dollar rose, sharply, gaining about 10%, reflecting global investors' rising confidence in the US and its economy. This brought collateral damage for US investors holding foreign stocks and foreign bonds. While foreign stocks in isolation did fine in 2014, converted back into stronger US dollars, foreign stock returns in 2014 fell to middle single-digit losses for US investors.

Oil's fall was limited to the last few months, but what it lacked in duration it overcame in magnitude. Oil prices have dropped about 50% since July. Incredibly, the supply/demand 'equation' has changed less than 1%. The oil markets are VERY volatile, and are due far more on emotions than on economics. Precious metals also fell, 10% for the year.

Volatility such as what we have experienced in 2014 leads to opportunities. Bonds, large US stocks, real estate, and technology had a better year than normal, and are likely overpriced. Foreign stocks, small US company stocks, energy had a poor year, and each could provide attractive opportunities in 2015 and beyond.

A dependable way to take advantage of high prices and attractive opportunities is to rebalance, and any time that the 3 month and 12 month columns show both red and black is a good time to rebalance. Give particular attention to your bonds, which had a surprisingly good year in 2014. While investors are naturally most comfortable with what has worked best lately, in this case bonds and large US stocks, it is likely that these are closest to an overvalued point. Better future returns will likely be earned by those who reject the natural comfort levels, and who remain well-diversified. Hang in there!

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.02%	+1.62%
Intermediate Term Bond	+1.09%	+5.16%	+3.38%	+4.77%	+4.41%
Intermediate Muni Bond	+0.75%	+6.76%	+3.30%	+4.24%	+3.79%
Large-Cap Stock	+4.18%	+10.96%	+19.01%	+13.88%	+7.02%
Mid-Cap Stock	+4.75%	+7.80%	+18.99%	+14.77%	+7.88%
Small-Cap Stock	+7.21%	+3.79%	+17.85%	+14.61%	+7.56%
Foreign Large-Cap Stock	-3.17%	-4.99%	+10.24%	+5.04%	+4.48%
Real Estate	+13.14%	+28.03%	+15.23%	+16.16%	+7.53%
Natural Resources	-13.25%	-12.48%	-0.36%	+1.48%	+5.90%
Technology	+4.52%	+12.55%	+19.69%	+13.59%	+8.51%
Moderate Allocation (60% stocks)	+1.82%	+6.21%	+11.68%	+9.41%	+5.93%

The data in this table comes from Morningstar and is as of December 31, 2014.

So, How Did I Do? Not too well. Regardless of how painful, each January, I review the accuracy of my predictions for the past year, and then share my predictions for the upcoming year. On January 6, 2014 the MARKET REVIEW AND OUTLOOK forecasted that 2014 would be solid, but certainly not as good as 2013. This was the case, but there were more mediocre results than I expected.

My 2014 predictions were disappointing—I only got two out of seven correct, large US stocks gained over 9% and real estate gains (much) more than 5%. Three of the misses weren't off by much. Smaller US stocks gained just under my 7% prediction. Value outperformed growth, but by a very small margin. Bonds gained 5.2% while I expected them to gain less than 4%.

My other misses were more significant. High yield bonds gained only 1.1%; I had expected gains of 5% or more. My big miss was in foreign stocks, where I expected strong gains, of 8% or more (in my defense, the stocks did fairly well, but the large US dollar jump more than wiped those out). In 2014 foreign stocks fell 5%. 2014 began with extremes—bonds being overpriced, and foreign stocks being cheaper than US stocks—and these extremes surprisingly widened in 2014.

Sector	2014 Prediction	2014 Actual	2015 Prediction
Large-cap US Stocks	More than +9%	+11.0%	More than +5%
Smaller US Stocks	More than +7%	+6.5%	More than +5%
Non-US Stocks	More than +8%	-5.0%	More than +8%
Growth vs Value	Growth outperforms	Growth +10.0%, Value +10.2%	Growth outperforms
Real Estate	More than +5%	+28.0%	Less than +8%
General Bonds	Less than +4%	+5.2%	Less than +5%
High-yield bonds	More than +5%	+1.1%	More than +5%

2015 Predictions—Global economic growth should continue to improve in 2015. As such, I expect that most stocks will do better than most bonds. US stocks are no longer underpriced, and so I expect them to underperform foreign stocks in 2015. That said, investors both in the US and abroad are more comfortable with US stocks than foreign ones, so while foreign stocks should outperform economically, emotions could well prove me wrong.

I expect that the US dollar will not jump so much in 2015, and thus not pull the rug out from under foreign stocks in 2015 as it did in 2014. Real estate has provided very strong results over the past months and years. It is overdue for a correction, or at least a time-out, and I therefore expect uninspiring results in 2015 for real estate. Economically sensitive bonds, such as high-yield bonds, should fare well in 2015, due both to improving financial strength of the underlying companies, and from investors shifting from general bonds whose prices drop with rising rates.

Oil—This was one of the biggest surprises of 2014, with a 50% decline in the final months. This has broad implications, with the overall message that there will be winners and losers. Europe benefits from lower oil prices, as does Japan, India, and China. The US as a whole is not significantly affected—our oil sector companies are challenged, but lower oil prices helps many US companies, US consumers, and can specifically help car manufacturers, who should see increased demand for their higher-margin (less fuel-efficient) vehicles. Lower oil prices lead to lower home heating costs and lower costs at the gas pumps, which can lead to boosted consumer and investor confidence. Internationally there are several losers from lower oil, with Russia at the head of the list.

Oil is expected to gradually recover; it may take two or more years to reach its summer 2014 levels again. Such expectations are just that, guesses. We remain committed to a piece of natural resources in our clients' portfolios, as a solid long-term strategy. Furthermore, it seems as though current prices are an over-reaction, and that early 2015 presents a poor time to cut back on energy.

We have always adopted a contrarian approach, rarely joining in with investor crowds. We much prefer to be early—early in **and** early out. We have established positions in European stocks several quarters ago, and this has not yet paid off. We continue to believe that a specific focus on Europe stocks is warranted, and the case seems even stronger in 2015. We have just boosted our commitment to opportunity bonds, those which are more sensitive to the economy than typical, quality bonds. This is based primarily on the growing unattractiveness of quality bonds than on any growing attractiveness of opportunity bonds. At some point, investors will depart quality bonds in large crowds, and we want to be holding quality bonds in low levels well in advance.

We also favor very long-term, global balance in portfolios. This means that we hold onto strategic positions even when they aren't "working" in the short-run. Emerging market stocks have been weak for two years. Nevertheless, we feel strongly that the economic strength of emerging market economies is an unstoppable long-term force, and we will not let short-term weakness shake our determination. The best returns after the 2008-2009 meltdown have likely been earned already, but 2015 can still be fine for investors.