

QUARTERLY ECONOMIC UPDATE

A review of 4Q 2014

QUOTE OF THE QUARTER

“There was never a night or a problem that could defeat sunrise or hope.”

– Bern Williams

QUARTERLY TIP

Do you own a small business? Do you work for yourself, or freelance? Just a reminder: January 15 is the deadline for Q4 1040-ES forms.

THE QUARTER IN BRIEF

The last quarter of 2014 brought more volatility to the stock and commodities markets. The S&P 500 and Dow both gained more than 4%, outperforming quite a few of the major foreign indices. Oil prices took a dive, along with prices of other key energy futures. The pace of home sales slowed and year-over-year home price gains grew smaller. Tumbling energy shares and a pandemic exerted more strain on equities than the end of QE3. New economic worries arrived for the European Union, Russia and Japan. Our economy looked solid, showing less unemployment, more consumer spending and impressive growth.¹

DOMESTIC ECONOMIC HEALTH

America was clearly getting back on its feet economically. Unemployment declined only 0.1% between September and November, but at 5.8%, November’s jobless rate was down 1.2% year-over-year. (The overall jobless rate, or U-6 rate, dipped to 11.4% in that month.) Job creation really picked up in fall: there were 243,000 new hires in October, 321,000 in November. Hourly earnings rose 0.4% in November, indicating decent wage growth at last.²

Consumers were spending freely, enjoying a reduction in gas prices that gave them a little more discretionary income. On December 31, AAA’s Daily Fuel Gauge Report measured an average price of \$2.26 a gallon for unleaded fuel; falling pump prices had saved households more than \$14 billion. The Commerce Department measured a distinct rise in personal spending – up 0.3% for October, 0.6% for November and 3.2% for Q3 – and household spending certainly played a part in the terrific final GDP numbers for Q2 (4.6%) and Q3 (5.0%).^{3,4}

A consumer with more income can prove more confident and more ready to make discretionary purchases. That implication was borne out by fall figures from the Commerce Department showing retail sales up 0.3% in October and 0.7% in November, and advancing household confidence surveys. The University of Michigan consumer sentiment index rose from 84.6 to 93.6 across Q4 and the Conference Board’s consumer confidence index moved from (a revised) 89.0 to 92.6. Households certainly didn’t have much inflation pressure to worry about. By November, the annual gain in the headline Consumer Price Index was just 1.3% (it was 1.7% for the core CPI).^{5,6}

Turning from the consumer to the producer, Q4 saw the Institute for Supply Management’s much-observed PMI Producer Price Index move from 56.6 (October) to 59.0 (November) to 58.7 (December), all indicating strong sector growth. ISM’s services index went 58.6-57.1-59.3 across the last three months, flashing the same kind of signal. On the downside, core capital goods orders, minus aircraft, were off 1.9% in October and flat in November. Producer prices flattened in November, leaving the headline Producer Price Index up but 1.4% year-over-year.^{4,5}

While stocks rebounded fast from a severe October drop in reaction to the Ebola virus reaching the U.S., quarterly gains looked to be in jeopardy last month as the oil selloff gained momentum. Then Federal Reserve inserted a new passage into its December policy statement: it would be “patient in beginning to normalize the stance of monetary policy.” It also left the phrase “considerable time” in place. What did investors glean from this? A broad assumption that the central bank would likely wait until mid-2015 or later to adjust interest rates.⁷

GLOBAL ECONOMIC HEALTH

The plunge in oil prices helped to put enormous pressure on Russia’s economy: its stock market foundered in fall, and so did the ruble, which by January had lost half

of its value against the dollar (triggering memories of the banking crisis of 1998). In the European Union, a new possibility of fracture emerged as the Greek parliament failed to choose a new leader and thereby dissolved, forcing new national elections. Would the Syriza party rise to the forefront of Greek politics – the same party that wanted to undo the austerity measures set by the EU and the International Monetary Fund as a condition of Greece's bailout?^{8,9}

The quarter ended with Russia on the edge of recession and the eurozone economy at stall speed (0.8% growth projected for 2014) with the euro approaching 9-year lows against the dollar. Hopes emerged that the European Central Bank might start buying bonds, but the eurozone appeared in stagnant shape. The latest Markit manufacturing PMIs affirmed that suspicion – eurozone, 50.6; France, 47.5; Italy, 48.4; Germany, 51.2.^{8,10,11}

China's economy exhibited more hints of slowing. Its official factory PMI declined to 50.1 (the tiniest degree of expansion) in December, and its real estate market was in a downturn. (In better news, the nation's official service sector PMI stood at 54.1 by December.) GDP was expected to slow a bit from the Q3 mark of 7.3% in Q4, which would put China's 2014 growth at under 7.5%. That would represent the worst year for its economy since 1990. In Japan, data showed inflation lessening for a fourth straight month in November with factory output down 0.6% and retail sales down 0.3%. The Bank of Japan began easing on Halloween, with the yen losing 9.2% against the dollar from then to Christmas.^{12,13}

WORLD MARKETS

Benchmarks in China and Argentina came in first and last in Q4 performance. The Shanghai Composite jumped 36.84% in the quarter (its A Shares were up 36.97%), and the Merval fell 31.64%.¹

Russia's RTS dropped 29.63%, and several other European indices had quarterly losses. Q4 brought retreats of 5.04% for Spain's IBEX 35, 9.00% for Italy's FTSE MIB, 3.25% for France's CAC 40, 0.86% for the FTSE 100 and 0.16% for the DJ STOXX 600. Two exceptions to all this: Ireland's ISEQ rose 7.18% and Germany's DAX gained 3.50%. Besides the Merval, other indices in the Americas took hits: the Bovespa went -7.59%, the IPC All-Share -4.09%, the TSX Composite -2.19%.¹

In the Asia Pacific region, the Nikkei 225 rose 7.90%, the Sensex 3.26%, and the Hang Seng 2.93%; Pakistan's KSE 100 gained 8.09%, Australia's S&P/ASX 200 2.23%. Korea's KOSPI lost 5.17%. In the bigger picture, the Asia Dow retreated 1.27%, outperforming the Europe Dow (-5.63%) and Global Dow (-1.30%) but finishing behind the Dow Jones Americas (+3.13%). As for the MSCI World Index and MSCI Emerging Markets Index, the former rose 0.66% while the latter fell 4.88%.^{1,14}

COMMODITIES MARKETS

Q4 brought no relief for energy futures. Losses accelerated on the NYMEX, making 2014 awful for gasoline (-44.42%), West Texas Intermediate crude (-45.87%), natural gas (-31.68%) and heating oil (-37.62). In a true testament to the ups and downs of this sector, Q3's three worst-performing commodities were Q4's best performers: corn futures gained 23.77% in the quarter, soybeans 11.61% and wheat 23.00%. Another Q4 winner was coffee, as huge demand met less-than-ideal supply due to parched weather in Brazil. Coffee went +43.19 on the year.^{15,16}

As for the major metals, palladium far outpaced the pack, extending its 2014 advance to 11.35%. Gold wound up down -1.72% for 2014 at the end of the quarter, platinum -11.79%, copper -16.76%, silver -19.36%. The U.S. Dollar Index certainly had a nice Q4, rising another 5.04%.^{15,17}

REAL ESTATE

Existing home sales were up a (revised) 1.4% in October, but sank 6.1% in November according to the National Association of Realtors. New home sales waned as well: the Census Bureau found them down a (revised) 2.2% in October, and off another

1.6% for November. NAR's pending home sales index was up 0.8% for November after a 1.1% October slip.⁵

In news aside from sales and sales contracts, the Census Bureau said building permits and housing starts unsurprisingly dipped with the cold weather; permits increased 4.8% in October and declined 5.2% a month after while groundbreaking was up a (revised) 1.7% in October but down 1.6% in November. The lagging S&P/Case-Shiller Home Price Index showed prices rising 4.6% in the past 12 months in its broadest measurement, compared to 4.8% a month earlier.^{5,18}

All these developments happened parallel to a marked descent in mortgage interest rates. In its December 31 nationwide survey, Freddie Mac found the following average interest rates on home loan types: 30-year FRM, 3.87%; 15-year FRM, 3.15%; 5/1-year ARM, 3.01%; 1-year ARM, 2.40%. All those mean rates were higher in the September 25 survey: 30-year FRM, 4.20%; 15-year FRM, 3.36%; 5/1-year ARM, 3.08%; 1-year ARM, 2.43%.¹⁹

LOOKING BACK...LOOKING FORWARD

As the table below notes, Q4 brought big advances for the Dow, S&P and Nasdaq. It also saw the Russell 2000 rally 9.35%, putting its overall 2014 performance at +3.53%. On New Year's Eve, the Dow closed at 17,823.07, the NASDAQ at 4,736.05, the S&P at 2,058.90 and the RUT at 1,204.70. The Dow hit a peak of 18,053.71 in Q4 while the S&P peaked at 2,090.57. Among all U.S. indices, the quarter's best performer was (hardly a surprise) the CBOE VIX. It rose 17.72% to 19.20, going +39.94% for 2014. The quarter's poorest performer was the PHLX Oil Service Index, down 20.84%.¹

% CHANGE	2014	Q4 CHG	1-YR CHG	10-YR AVG
DJIA	+7.52	+4.58	+7.52	+6.53
NASDAQ	+13.40	+5.40	+13.40	+11.77
S&P 500	+11.39	+4.39	+11.39	+6.99
REAL YIELD	12/31 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	0.49%	0.80%	1.48%	1.68%

Sources: online.wsj.com, bigcharts.com, treasury.gov – 12/31/14^{1,20,21}
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

Now to this quarter. We have seen the U.S. equity market struggle out of the gate, with a selloff in energy shares dragging down the major indices. Some analysts think that what happens in January sets the tone for the year, and they wonder if the coming earnings season will provide sufficient distraction from waning oil demand, flagging overseas economies and the continuing perception of an interest rate increase in the near term. In their eyes, Q1 2015 will be full of storms and headwinds. Others see America as the best house in a bad neighborhood, with its stock market capably insulated from the brunt of these developments. January 5 saw a 331-point drop for the Dow and oil heading under \$50, but those news items didn't eradicate the core bullish sentiment that abides on Wall Street. The quarter may pleasantly surprise investors, as have many quarters in recent years.²²

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The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is not possible to invest directly in an index. NYSE Group, Inc. (NYSE:NYX) operates two securities exchanges: the New York Stock Exchange (the "NYSE") and NYSE Arca (formerly known as the Archipelago Exchange, or ArcaEx®, and the Pacific Exchange). NYSE Group is a leading provider of securities listing, trading and market data products and services. The New York Mercantile Exchange, Inc. (NYMEX) is the world's largest physical commodity futures exchange and the preeminent trading forum for energy and precious metals, with trading conducted through two divisions – the NYMEX Division, home to the energy, platinum, and palladium markets, and the COMEX Division, on which all other metals trade. The SSE Composite Index is an index of all stocks (A and B shares) that are traded at the Shanghai Stock Exchange. The MERVAL Index (MERCado de VALores, literally Stock Exchange) is the most important index of the Buenos Aires Stock Exchange. The RTS Index (abbreviated: RTSI, Russian: Индекс РТС) is a free-float capitalization-weighted index of 50 Russian stocks traded on the Moscow Exchange. The IBEX 35 is the benchmark stock market index of the Bolsa de Madrid, Spain's principal stock exchange. The FTSE MIB (Milano Italia Borsa) is the benchmark stock market index for the Borsa Italiana, the Italian national stock exchange. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. The FTSE 100 Index is a share index of the 100 most highly capitalized companies listed on the London Stock Exchange. The Dow Jones STOXX 600 Index captures more than 90% of the aggregate market cap of European-based companies. The ISEQ Overall Index is a capitalization-weighted index of all official list equities in the Irish Stock Exchange, excluding U.K.-registered companies. The DAX 30 is a Blue Chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. The Bovespa Index is a gross total return index weighted by traded volume & is comprised of the most liquid stocks traded on the Sao Paulo Stock Exchange. The Mexican IPC index (Indice de Precios y Cotizaciones) is a capitalization-weighted index of the leading stocks traded on the Mexican Stock Exchange. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. Nikkei 225 (Ticker: ^N225) is a stock market index for the Tokyo Stock Exchange (TSE). The Nikkei average is the most watched index of Asian stocks. BSE Sensex or Bombay Stock Exchange Sensitivity Index is a value-weighted index composed of 30 stocks that started January 1, 1986. The Hang Seng Index is a freefloat-adjusted market capitalization-weighted stock market index that is the main indicator of the overall market performance in Hong Kong. Karachi Stock Exchange 100 Index (KSE-100 Index) is a stock index acting as a benchmark to compare prices on the Karachi Stock Exchange (KSE) over a period. The S&P/ASX 200 is Australia's "premier" share market index. The Korea Composite Stock Price Index or KOSPI is the major stock market index of South Korea, representing all common stocks traded on the Korea Exchange. The Asia Dow measures the Asia equity markets by tracking 30 leading blue-chip companies in the region. The Europe Dow measures the European equity markets by tracking 30 leading blue-chip companies in the region. The Global Dow (GDOW) is a 150-stock index of corporations from around the world, created by Dow Jones & Company. The Dow Jones Americas Index measures the Latin American equity markets by tracking 30 leading blue-chip companies in the region. The MSCI World Index is a free-float weighted equity index that includes developed world markets, and does not include emerging markets. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The US Dollar Index measures the performance of the U.S. dollar against a basket of six currencies. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. 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