Quarterly Economic Update 1Q 2015

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The quarter in brief. The combination of tepid global growth and a soaring U.S. dollar pushed volatility higher and moved market leadership away from large cap U.S. equities. Interest rates moved lower, bonds higher, and international and small cap equities proved to be the champions of Q1.

Economic news. The quarter looked much like Q4, where energy prices remained under pressure, the U.S. dollar surged, business activity slowed, the labor market stayed solid, and monetary policy across the globe was varied.

Crude oil (West Texas Intermediate) hit a low of $42 per barrel in early March then rallied to end the quarter at $47. That's down from $54 at the beginning of the year, and down more than 56 percent from the peak of $107 per barrel in June of last year.

The dollar index of major currencies (the U.S. dollar vs. a basket of foreign currencies) gained 9 percent during the first quarter, with the most significant strength coming against the euro. Given the relative strength of the U.S. economy, the ECB and other regions easing monetary policy, and the U.S. set to embark on tightening monetary policy, it is of little surprise that the dollar is strong. The magnitude, however, up 22 percent in the last 12 months, might be.

U.S. real GDP increased at an annual rate of 2.2 percent in Q4 2014 according to the final estimate released in March, far less than the 5.0 percent posted in Q3. Much of the weakness was due to a decline in net exports, an unfortunate reality of a strong currency no doubt, where U.S. goods become more expensive overseas.

Q1 growth expectations also fell throughout the quarter. Retail sales declined each of the first three months, inclement weather curtailed typical spending patterns, and dollar strength and crude oil declines constrained the manufacturing sector. The ISM manufacturing index slipped to 51.5 in March, a 22 month low, and the March non-manufacturing level of 56.5 was unchanged from December. As a result, estimates are now in the range of 1.0 percent- 2.0 percent for Q1 GDP growth. However, the consensus view is that Q1 will likely be the low water mark level of the year.

At the same time, the U.S. labor market remained strong. March's non-farm payroll report came in at 126,000, breaking a 13-month streak above 200,000. The report also revised January and February down by a total of 70,000 jobs, leaving the average for Q1 at 197,000. The labor market remains on a trend of steady improvement in spite of weaker growth in March, and consumer sentiment remains high. The University of Michigan Consumer Confidence index fell back to 93.0 in March, but hit a 10-year high of 95.5 in February.

Expectations for central bank actions around the world continued to diverge. While the Federal Reserve and the Bank of England are expected to tighten monetary policy, the European Central Bank (ECB) went "all in" as they launched a much-anticipated quantitative easing (QE) program in March. This followed the already aggressive programs of China and the Bank of Japan (BOJ). The combined QE programs of the ECB and BOJ are expected to exceed that of the U.S. and U.K. (as a percentage of GDP). Three of the four largest economies are now easing, and at least 25 other central banks around the globe are doing the same.

Markets. The U.S. equity market continued to be quite volatile with the S&P 500 starting the year down (-3.0 percent) in January, bouncing back in February (5.75 percent), and again selling off in March (-1.58 percent), before ending the quarter up 0.95 percent. Though this was the ninth consecutive quarter of positive returns for the S&P 500 Index, the effects of a strong dollar and lower oil prices forced expectations for Q1 growth steadily lower. By the end of Q1, the market was anticipating a decline of 3 percent in Q1 earnings. If that ends true, it would be the first quarterly decline in over five years.

Index Performance	Q1 2015	Q4 2014	YTD
Domestic Equity			
S&P 500	0.95%	4.93%	0.95%
Russell Mid Cap	3.95%	5.94%	3.95%
Russell 2000	4.32%	9.73%	4.32%
International Equity			
MSCI EAFE	4.88%	-3.57%	4.88%
MSCI Emerging Markets	2.28%	-4.44%	2.28%
Fixed Income			
Barclays Aggregate	1.61%	1.79%	1.61%

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

The S&P 500 return was easily outdone by the Russell Mid Cap Index (3.95 percent) and Russell 2000 Index (4.32 percent). The small cap leadership during Q1 may be due, in part, to small cap's lower exposure to the energy sector as well as the fact that small companies derive less of their revenue from overseas, therefore, less sensitive to a strong dollar.

Developed international equities (MSCI EAFE) were up 4.88 percent in U.S. dollar terms, a major accomplishment given the negative effects of currency translation in the quarter. In fact the MSCI EAFE Index was actually up 10.9 percent in local currency terms with all of the developed countries in the index posting positive total returns for the quarter. Emerging market equities (2.88 percent) trailed developed international, largely due to commodity weakness and concerns of further weakness in China.

The 10-year U.S. treasury yield closed the quarter at 1.92 percent, down from 2.17 percent at the beginning of the year. The Barclays Aggregate Bond Index ended the quarter with a total return of 1.61 percent. Most bond categories were positive for the quarter, benefiting from lower rates, strong fundamentals, and increasing demand from both investors and central banks.

S&P 500 Sector Performance	Q1 2015	Q4 2014	YTD
Consumer Discretionary	4.80%	8.74%	4.80%
Consumer Staples	0.99%	8.15%	0.99%
Energy	-2.85%	-10.68%	-2.85%
Financials	-2.05%	7.25%	-2.05%
Healthcare	6.53%	7.48%	6.53%
Industrials	-0.86%	6.76%	-0.86%
Information Technology	0.57%	5.24%	0.57%
Materials	0.99%	-1.80%	0.99%
Telecommunications	1.54%	-4.16%	1.54%
Utilities	-5.17%	13.19%	-5.17%

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Sector performance was mixed in Q1. Healthcare was the top performing S&P 500 sector, assisted by biotech names and continued merger activity. Consumer discretionary stocks received help from lower fuel prices and consumer optimism, even though overall retail sales were soft in the quarter. Energy stocks continued to drag on overall index performance as the decline in oil prices continued—down 2 percent in Q1 and over 13 percent over the last six months. Utilities were off over 5 percent in the quarter, even as interest rates declined, presumably due to the increasing focus on the Fed's shift in monetary policy.

Outlook. Twenty fifteen is starting out very similar to last year, where bad weather led to mixed signals early in the year, only to rebound as weather normalized. While this winter wasn't as bad, other forces, including the West Coast dockworkers strike—which some estimate to be responsible for a reduction of 1 percent in Q1 GDP—have been new obstructions.

We are optimistic that growth will recover as many of these obstacles seem temporary. We expect that rising personal income levels and ongoing fuel cost savings will eventually translate to higher consumption. The Fed is expected to begin raising rates in Q4, but given the low—and in some cases negative—yields abroad, demand for U.S. bonds should continue, thereby keeping rates from rising too far too fast.

U.S. equity valuations are high (relative to historical averages) but remain reasonable. However, further gains will depend more on earnings growth and less on rising P/E multiples. Though Q1 earnings growth is at risk of turning negative, much of this is due to the energy sector, a group that has seen earnings decline 60 percent year-over-year. Strip out energy and Q1 corporate earnings are likely to be in the low single-digits.

The Eurozone is demonstrating clear signs of recovery, including notable improvements in the recently struggling economies of Spain and Italy. After years of decline, loan growth is on the rise and will be further supported by the ECB QE program. The decline in the euro has boosted exports and business sentiment is improving across the region. In other words, QE seems to be working.

For U.S.-based investors, the euro's weakness has detracted from international stock performance. After a 20 percent decline over the past 12 months, this, too, should subside. The market has had time to digest the onset of diverging monetary policy, and the improving economies in the Eurozone will help support the currency. With valuations at attractive levels, especially relative to U.S. large cap, capital flows outside of the U.S. could accelerate

The U.S. expansion is now in its sixth year and showing little signs of ending. While the Fed is contemplating removing stimulus, the rest of the world is adding it—a lot of it. This should help sustain global growth trends and make it easier for the Fed to normalize rates in the future.

The Russell 2000 Index measures the 2000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. The Russell Midcap Index measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The stocks of the Russell Midcap Index are also members of the Russell 1000 Growth Index. The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. The MSCI EAFE index is an unmanaged aggregate of 21 developed country indices that collectively represent many of the major markets of the world. MSCI Emerg Mkts is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. The Barclays US Aggregate Index covers the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS, ABS, and CMBS. It is not possible to invest directly in an index. The statements and opinions expressed in this article are those of the author as of the date of the article. These views should not be construed as investment advice. Content and/or statistical data may be obtained from public sources and/or third party arrangements and is believed to be reliable; however we make no representation as to its completeness or accuracy. The underlying assumptions and the views are subject to change. All economic and performance data is historical and not indicative of future results. Investors have the opportunity for losses as well as profits. The market indices discussed are unmanaged and can not be invested into directly. Investors should consult their financial advisor for guidance concerning their particular situation.