<u>Outlook for February, 2015: "The Return of Volatility"</u>

In June of last year, we wrote a piece entitled "Calm before the Storm?" in which we suggested that global monetary policy had ***dampened volatility*** in the short run at the expense of creating significant imbalances in the long run. We saw increased volatility in equity and fixed income markets in general and currency and commodity markets in particular during the early part of this year. We suspect that the increased volatility is unfortunately ***a harbinger of things to come*** over the next few quarters.

In the U.S., ***economic data*** for January was ***mostly positive***: The U.S. economy grew by ***2.6% during 4Q2014*** (seasonally adjusted annual rate), as measured by the Commerce Department's advanced estimate of Gross Domestic Product. While this represents a deceleration from the ***robust*** third quarter growth rate of 5.0% (also saar), it is a signal that the economic engine continues to chug along.

In aggregate, the economy grew by 2.4% in 2014, in line with the subdued growth experienced over the past couple of years. This is a far cry from the 4-5% growth rate we experienced in the 90's and represents one of the most anemic recoveries ever recorded, with GDP up 13.6% since 2009. However, the ***backdrop for 2015*** looks reasonably positive as consumer spending should likely get a boost from lower energy prices and the labor market appears to be building a nice head of steam.

The U.S. labor market added ***257,000 jobs in January*** with revisions for November and December amounting to a net additional gain of 147,000 jobs. In fact, the revised November employment gains at 423,000, was the strongest monthly gain since May of 2010. Within sectors of the labor market, financial activities saw a strong jump and construction continues to add jobs at a healthy clip over the past several months. For all of 2014, the U.S. economy added 3.12 million jobs, which is the fastest pace since 1999.

The Household Survey reported a one-tenths increase in the ***unemployment rate to 5.7%*** for January. The more robust U-6 (or underemployment rate) increased slightly from 11.2% to 11.3%. Over the past year, wages are up a mere 2.2% in the private sector, marginally beating inflation, but well below historical growth rates averages. If the labor market continues to have strong momentum, we may eventually start to see some upward pressure on wages.

This could well have an impact on the Federal Reserve's trajectory for administered interest rates. While the Fed has made it known that their actions are likely to be driven by data (and as it turns out "patient" means they are not going to raise rates over the ***next two meetings!***), we suspect that if the labor market remains robust we could see the Fed move this summer (perhaps in June).

If you haven't been paying attention to the global bond market you may have missed some tremendous swings in prices (and interest rates) over the past several weeks. Monetary policy changes, currency adjustments and geopolitical risks have all caused reverberations in the bond market that were exacerbated by low yields. When yields are as low as they are right now (for example, Germany's 10 year yields 0.34%, France is at 0.64%, Japan at 0.42% and the good old US of A at 2.02%) any change has a disproportionate impact on the bond's price. It has not been uncommon this year to see government bond prices move by 2-4% in a single day!!

Frequent readers of this missive know that we have discussed quantitative easing and currency wars ad nauseam in previous editions: In the past month, the Chinese Central bank (***People's Bank of China***) eased its reserve requirement on banks by a half a percentage point (from 20% to 19.5%) to boost economic growth after coming off a year in which their annual growth rate was the lowest in a quarter century.

More recently, Sweden announced it would slash its primary interest rate to ***negative*** 0.1% and start buying government bonds (i.e. more quantitative easing). Not to be out done, the Danish Central Bank has promulgated negative deposit yields and the Danish ten year yield is now a paltry 0.14% (yup, 14bp)!

It is hard to invest where yields on a government issued piece of paper are ***negative*** – which means the investor is actually ***paying the government*** for safekeeping of the cash – rather than garnering a return for funds invested. Indeed, in much of the Euro Zone yields are negative for up to 5 or 6 years, suggesting that the entire region still suffers from the ravages of deflation.

Geopolitical risks abound with the usual suspects still garnering the media's attention: Russia, Ukraine, Syria, Iraq, Iran, ISIS, and Greece, just to name a few. European markets are warily watching the negotiations going on between Greece's far left ***Syriza party*** and the Eurozone finance ministers over how to handle ***Greece's increasing debt load***.

While the ***game of brinkmanship*** is good political theatre, it is quite damaging to longer term investors. We do think that the Greek issues gets resolved, but like anything else, the politicians will likely be successful in ***"kicking the can down the road"*** so to speak with impunity, yet again.

In Houston, the ***second order effect*** (and often negative) of lower energy prices are becoming more apparent. There have been sizeable layoffs around town, but unfortunately, this may be just the beginning. Rig counts in the US are down from a high of 2,021 in October, 2011 to 1,358 currently and we believe it might bottom out somewhere around the 800 level. ***More pain to come, we are sure.***

From an investment standpoint, it is important to understand and analyze geopolitical risks around the globe, but it is equally important to realize that unfortunately these risks are ***always present.*** History tells us that markets tend to typically overreact to these events, and volatility can often bring opportunities to the ***patient and discerning investor***.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III, CPA/PFS
MBR Financial
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

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