<u>Outlook for January, 2015: "A Scary New World…"</u>

With the European Central Bank now launching Quantitative Easing (QE), markets appear to be entering a ***Scary New World*** (with our apologies to Aldous Huxley, the author of "Brave New World"). With this move by the ECB, all three of the major central banks, including the US Federal Reserve and the Bank of Japan have now resorted to ***unconventional monetary policy*** to combat deflationary forces. Indeed, QE has the proverbial effect of increasing asset prices, thus promoting a ***"wealth effect",*** which leads to a scary new world of higher asset prices and bloated central bank balance sheets.

Recent economic data points to an overall ***positive picture for the U.S.***: The U.S. labor market added 252,000 jobs in December, taking the average monthly gain to 246k in 2014, a marked improvement from 194k in 2013. Upwards revisions for October and November were also positive as the net adjustment was for an additional +50,000 jobs. Within sectors, construction added 48k jobs, professional and business services were up 52k, and healthcare gained 34k.

In a separate survey, the ***unemployment rate*** dropped in December to ***5.6%,*** down sizably from 6.7% a year ago. The broadest measure of unemployment, which considers involuntary part-time workers, the so called U-6 measure, dropped slightly to a still high 11.2% from 11.4%. In aggregate, the U.S. employment backdrop is improving slowly but surely and expectations for continued improvement appear to be reasonable.

Despite the improvement, there remains a large pool of long-term unemployed and those forced to work part-time even though they are seeking full-time work. Since 2008, there has been an increase of 2.17 million involuntary part-time workers and 1.46 million long-term unemployed. These groups are essentially keeping a lid on ***wage growth*** and hindering upward mobility that is a mainstay of America's economic history and cultural DNA. For confirmation of this trend, we pay attention to average hourly earnings growth, which increased a mere 1.7% in 2014, barely surpassing inflation.

According to the latest GDP report from the Commerce Department, economic activity in the 3rd quarter increased by ***5.0%*** on a seasonally adjusted annual rate. Overall, economists project an annual growth rate of 2.5% for 2014, which is good news considering the 1st quarter saw a ***contraction of 2.9%***, given the polar vortex related weather disruptions (how quickly we forget!). While skeptics will point to larger military spending and recent changes to the GDP formula as major factors for 2014's rise, we still believe that the economy is growing and should continue to grow in 2015 and beyond.

While 2014 will go down in annals of financial history as the year of ***"di-worsification"*** (where holding any asset other than the S&P500 caused portfolios to under-perform) it is illustrative to look at these returns in some detail. ***Apple, Inc.*** – a single stock (and the largest company in terms of market capitalization) - was alone responsible for 10% of the total return of the S&P500 (SPX: 13.7%; AAPL: 1.36%). In addition, the top 100 companies by market capitalization were responsible for ***76% of the total return*** of the S&P500. Further, fully 4 in 5 active money managers under-performed the S&P500 for the year as a whole – with the SPX clearly outshining the Small Cap, Mid Cap, as well as International indices.

The ***total return differential*** between the SPX and the EuroStoxx 600 (an index of 600 large European Companies) was an **unprecedented 19%** for the full year – a trend we certainly feel is likely to reverse in 2015. European markets have been "left for dead" with the consensus feeling that the spectacular run by US markets is likely to continue. While economic growth in the Eurozone has been "damp" (to coin a phrase) equity markets usually move in anticipation of sunnier times and we feel that the unleashing of QE by the ECB is precisely the catalyst that is needed. If anything, the ECB has succeeded in ***exceeding market expectations*** and we expect this to provide a fillip to European equity markets.

By now the details of the ECB QE are well known: The ECB will buy ***€60 Billion*** worth of sovereign and corporate debt per month beginning in March until September 2016 (which translates to ***about €1.08 Trillion in total***). National central banks (like the Bundesbank and the Banca de Espana – which all still exist) will be the primary purchasers of government and corporate debt of their individual countries' domiciled issuers, thus avoiding any cross-subsidization of weaker issuers (Portugal, Ireland or Spain).

Mario ("whatever it takes") Draghi appears to have delivered the goods for now and European equity markets are off to the races in the past couple of days. Clearly, while QE has been left as fairly open ended, comments by other ECB Governing Council members as well as by Draghi suggest that the ECB is essentially ***"all in" on its battle against deflationary forces***. Interestingly, Greece has been left out of this exercise for now, with worries that parliamentary elections there this weekend could roil the well laid plans of the ECB if the left leaning Syriza Party wins the elections.

The ***Swiss National Bank*** stopped defending its upside limit of ***€1.20*** for the Swiss Franc in a palpable surprise last week – ahead of the promulgation of QE by the ECB. Many market participants were caught flat-footed and some retail foreign exchange brokers were forced to shut their doors given the leveraged positions carried by their clients – as they could ill-afford to cover the margin calls that were generated. Such is the virulence with which currencies move when there is an ***exogenous event!***

News from Saudi Arabia about the ***death of King Abdullah*** (who has been ill for a while) provided a small bid to crude oil, but the ascension of Crown prince Salman as the new King in an orderly transition of power is positive. We do believe that King Salman (the deceased King's half-brother) is likely to maintain the slow and steady pace of reform within the Kingdom amidst increasing threats from both within and outside the Kingdom. King Salman and the ruling council have been quick to appoint ***Prince Muqrin*** (the new King's half-brother) as the new Crown prince as well.

The recent rise in the US Dollar has some investors worried that we may see a repeat of the 80's and 90's currency crises. The fundamental problem with a ***rising USD*** is that many companies in emerging economies finance their operations in USD, but receive their revenues in local currency. Since currencies are a relative price, a rising dollar means borrowing costs go up but revenues go down, all else being equal.

Many analysts continue to believe that with the Federal Reserve likely to raise rates this year, the USD will likely be on an ***upward trajectory***. Our experience with rising rates is that this is not necessarily a panacea for all that ails an economy and, often times, rising rates imply that a central bank might indeed be falling behind the curve. If such is the case with the Federal Reserve, we are not at all convinced that a rising USD is the outcome that everyone appears to be ***expecting and hoping for.***

While it is our job to pay attention to markets and understand the outcomes of monetary and fiscal policy, we do not lose sight of the fact that you've engaged us not to be day traders or return chasers, but to ***invest your assets and capital*** in areas we feel are positioned well from a risk/return standpoint over the long-term. The ultimate goal is to meet your financial goals and objectives, by efficiently allocating capital, holding down costs and maintaining a well-diversified portfolio – ***lonesome (and contrarian) though these positions might be.***

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