Market & Economic Commentary

Winter 2014/2015

Jim Scheinberg CIMA® AIFA®
Managing Partner

w 800 403 7065 x272
e jim.scheinberg@npier.com
www.npier.com

The information and statistical data contained within are from sources which North Pier Fiduciary Management, LLC believes to be reliable but in no way warranted by us to accuracy or completeness. North Pier does not undertake to advise you as to any change in figures of North Pier's views. This is not a solicitation of any order to buy or sell. North Pier, our affiliates, and any Officer, Director or Stockholders, or any member of their families, may have a position in and may from time to time purchase or sell any of the herein mentioned securities.

THE NORTH PIER*spective*

Market & Economic | Winter 2014/2015

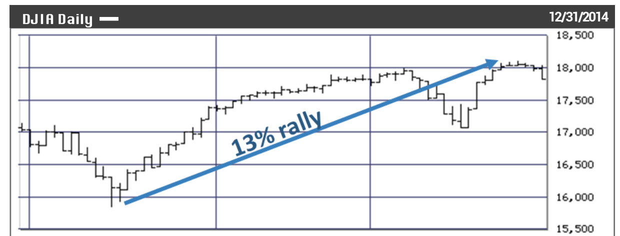
By: Jim Scheinberg - February 18, 2015

Oil's *not* well… except at the North Pole

The biggest story of the quarter, by far, was the nearly 40% drop in oil prices. Conjecture on the true reasons for – and ramifications from – the shocking price decline was at the center of a substantive spike in volatility for global markets. Equity prices, which had been relatively calm for several quarters leading into last summer, suddenly saw daily swings of 2%-3% or more. Was oil declining due to a slow-down in international economies? Would its massive drop in price scuttle the boom in the U.S. oil patch, causing a ripple in the broader domestic economy? Would the deep cut in the cost of gasoline spur increased consumer spending, right in time for Christmas? It seemed that during Q4, every piece of economic data was either labeled as a *cause* or *result* of the collapse in energy prices. And every move in the markets was linked to speculation on where prices were heading next, and what it would mean.

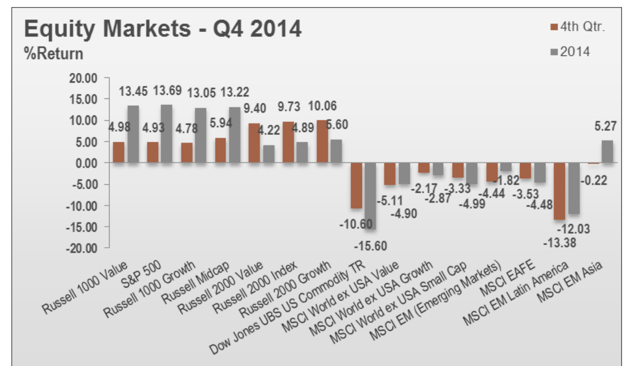
How the Markets Fared

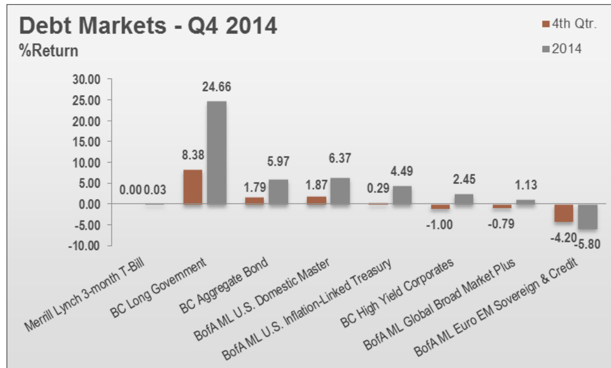
As we discussed in our Fall Commentary, markets dramatically slid to near correction levels to start the Fourth Quarter. "The S&P 500 sold off the final 7.5% of its 9.5% *correction-ette* during the last 5 days of its near month long swoon." Concerns about energy prices were joined by a threat of a European recession. However, after intraday lows were reached on October 15th, U.S. stocks surged over 13% as strong domestic economic data renewed optimism. The volatility was not over yet. As December unfolded, renewed European concerns and further oil-related speculation led to some of the largest day-to-day volatility seen in years. In the end, U.S. stocks finished near their highs of the year.



©BigCharts.com

U.S. large cap stocks netted nearly 5% returns for the quarter and over 13% for the year… capping an impressive rebound from the October lows. These results paled in comparison to the small cap asset class (which had been struggling for the first three quarters of 2014). The Russell 2000 index doubled the performance of the S&P 500 in Q4, culminating in a respectable 5% for all of 2014. Small caps likely benefited from money flow related to an increased appetite for the U.S. dollar, which surged another 5% for the quarter and 10% for the year. But the currency game always has a winner and loser. Developed market, international equities, which gain a few points in their local currencies, saw losses of 3-5% for the quarter and the year as a whole, when priced in U.S. Dollars. Emerging Markets (EM) collectively saw similar results as developed markets, but that was a *tale of two cities…* or continents. Though both areas suffered slight declines in Q4, Asian EM mounted modest gains for the year, while Latin American markets (spurred by the debt-crisis in Argentina) retreated 12% in 2014. The weakness in Latin America was likely compounded by the worst performing asset class for 2014, commodities. Weighted by the decline in oil, and exacerbated by concerns of a slowing global economy, commodities as a whole lost over 15% for the year.



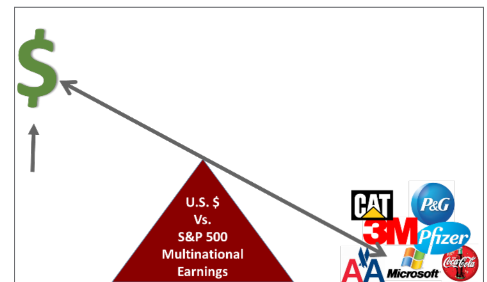


European sluggishness led global investors right into the perceivably safest market in the world, U.S. Treasuries. Even with The Fed beginning the long-awaited unwinding of its seven year long quantitative easing program, demand pushed the yield on the 10-year Treasury from 2.49% at the beginning of Q4 to 2.17% at year's end. Here too, we saw a massive increase in volatility. On October 15th, a day on which the Dow at one point was down 460 points, the 10-year Treasury yield collapsed from 2.25% to 1.89% intraday. In the world of bonds, this was a massive move. Declines in European interest rates helped counter the effect of losses against the Dollar, resulting in only a fractional drop for the quarter and slight gains for the year. Challenges in Latin America brought 5% declines in EM debt as a whole; but the Asian region fared better. On the credit front, 2014 finally saw an end to the seven year rally in high yield bonds. Credit spreads widened moderately, netting slight losses in Q4 and only a few points of positive return for the year as a whole. In a year where the two best places to be were large U.S. stocks and longer-term U.S. Treasuries, any diversification at all in a portfolio, no matter how wise, proved costly to performance.

A Changing of the Guard… Eventually

The dynamic we need to explore this quarter is asset class rotation, specifically the relationship between domestic and international stocks. All things being equal (and they seldom are), markets change leadership every few years or so. This is due to several factors. As one market (or global region) starts to do well, there can be a piling on effect. Everyone loves a winner, including portfolio managers. In 2013, the S&P 500 outperformed the MSCI EAFE 32.4% to 23.3%. The next year, investors ran the U.S. index up another 13.7% versus a loss of 4.5% for the EAFE. The S&P's 50% total return in just the last two years is virtually triple that of the EAFE's 17%. Whether it will be due to the value discrepancies between markets or because of changes in economic conditions, eventually these trends will reverse. In the present case, it may be a combination of both.

European markets currently trade at 13% discount to the U.S. Though both are trading at slightly higher multiples than their norms, large U.S. stocks are almost 17% more inflated over norms than Europe. Yes, our economy here has been stronger than those abroad for the last few years; but that dynamic may be shifting. As previously mentioned, the U.S. Dollar rallied 10% versus the Euro last year. Companies from **A**pple to Pfi**Z**er are reporting headwinds due to the appreciating U.S. currency making their products and services less affordable overseas. Well, as I mentioned earlier about currencies always having a winner and a loser, this time its European firms that are gaining an advantage. As an example, AG Bayer (based in Germany) has been raising estimates due to weakness in the Euro while P&G, which is in virtually the same business, is lowering theirs due to strength in the Dollar. Currency movements are the great equalizer over time. The question is, how much further do we have to go.



EuroPe May Improve

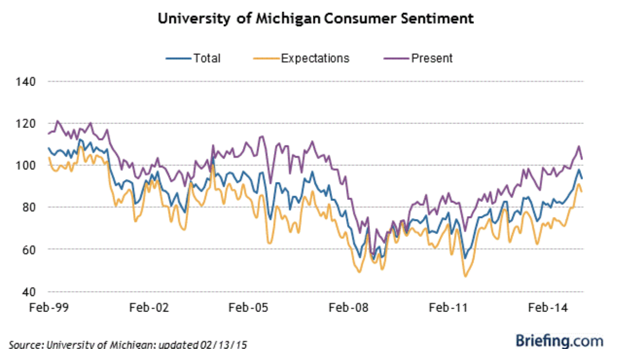
Of late, speculation on the European economy has been closely tied to short-term market moves here in the U.S. Both domestic sell offs in October and December were peppered with headlines regarding challenges in the EU. While it is true that in our increasingly global economy when one country sneezes, another can certainly catch a cold, not every

sniffle is Ebola. Thus far, the U.S. and the U.K. have proven to have a high immunity to avoid catching Europe's flu. (Maybe it can't travel over water.) That said, how close is the EU-patient to getting better? Our indicators show that some countries are well on the way to health. Ireland and Spain's recent PMI data indicates that those economies are likely to return to meaningful growth in the first half of 2015. Germany seems to have averted its economic slide and is showing initial signs of moderate growth. Italy and France are exhibiting data suggesting that the worst may be over there as well. The dampening effects of the initial rounds of austerity have been absorbed, establishing a new baseline. As I mentioned earlier, a cheaper Euro has a simulative effect on the sales and margins of European based multinationals. Thus the stage is set for better economic and equity performance abroad.

Pretty Slick Jobs Data

Though there have been concerns about layoffs in the energy industry, nothing has materially shown up in the data. If I was an oil executive, I'd likely take a wait-and-see approach for a quarter or two. Oil in the mid $50s or higher is not likely to lead to massive layoffs. Nationally, the trend in labor is strong and still improving. Unemployment has whittled down to 5.6% and we are comfortably adding over 800,000 jobs a quarter, which will likely work that rate even lower. The ripple effect from the Affordable Care Act has largely played out. As exemplified in the tiff that recently emerged between President Obama and office supply retailer, Staples, employers that needed to limit or reclassify employees to part-time status in order to maintain economic viability have largely done so. We are likely in the "new normal."

Consume All Ye Faithful



Good news on the jobs front was accompanied by better than 2% wage growth, which has the consumer feeling quite confident. In fact, recent University of Michigan Consumer Sentiment reports showed that confidence is near the highest levels since the turn of the millennium. The Conference Board's Consumer Confidence Index confirmed, jumping above 100 for the first time since 2007. And with gasoline prices suddenly so low, Americans had some extra jingle in their pockets as they strode into the Christmas season. When all was said and done, it looked like shoppers were partying like it was 1999. The National Retail Federation reported that total holiday retail sales increased 4 percent over the 2013 season. Online sales grew by another 6.8% this year.

House it going?

Well with a big drop in mortgage rates and continued strength in the labor market, one would expect home buyers to be in as exuberant of a mood as Christmas shoppers were. Not so. Just 4.9 million existing homes were sold in 2014, which was actually down 3.1% from 2013. Inventories have dropped to a lean 4.4 months' supply (6 months is normal), so pickins are getting slim, which could be partly responsible for the moderate sales rates. With such tight supply of existing homes, one would think that new home sales would be on the rise, but here too the news warranted a yawn. Sales inched up just 1.2% to 435,000 for the year, roughly half the pre-boom norms of the 1990's. This tight supply appears to have been met by generally lackluster demand, which led to modest 4.3% price appreciation last year (according to the latest November Case-Shiller 20-City Index). Median home prices rose just 6% during 2014, confirming the moderation. Prices have recovered 30% since their lows three years ago but are still about 20% away from the bubble-level highs reached in 2006. Perhaps with cheap gasoline, those newer outlying suburbs that became

so popular during the housing boom might become viable options for new construction again. But those deals will need to be compelling to lure urban-seeking hipsters away from their urban loft conversions. And thus the cycle begins again…

PIER*ing* Ahead

As we sit here in February, we are starting to see a different story emerge than we saw in 2014. European stocks are on the climb, U.S. interest rates have bottomed and seemingly turned, and most notably, oil has rallied over 20% from its lows. Though it is likely a chicken and egg relationship, we suspect that as oil prices go, so do the global markets. A year ago in our Winter 2013/2014 PIER*spective*, I wrote that, "the domestic oil and gas boom is doing more than adding jobs."(See "The Energy Payoff"). Now that cheaper prices are here, it's time for the U.S. and global economies as a whole to reap the benefits of lower energy costs. Though we remain nimble in our position, our advice is to fill up those tanks now, while gas is still cheap. You never know how long sub-$3 unleaded will be around. If we are correct about Europe's strengthening economies, it won't be here for long.

Jim Scheinberg CIMA® AIFA®
Managing Partner