



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Fourth Quarter of 2014

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Executive Summary

- After a sharp sell-off in October, U.S. equities ended the quarter on a decent note, with the overall market increasing by 5.2%. For the first time this year, investors received a boost from smaller companies stocks, which increased by 9.7% on average during the quarter. The story was different for European and emerging market equity markets, both of which were pummeled in U.S. dollar terms by the sharp appreciation of the dollar during the quarter.
- The key headlines for the quarter were the sharp decline in oil prices and further appreciation of the U.S. dollar. Lower gas prices, combined with slowing growth in China, continued to put downward pressure on all commodities prices, which in the aggregate fell by -12% during the quarter.
- On the whole, 2014 was a year of several big surprises in the markets. Contrary to just about everyone's expectations, interest rates declined in the U.S., which boosted fixed income returns. Other surprises included the rapid decline in oil prices, the sharp appreciation of the U.S. dollar, and the large degree of underperformance of U.S. small companies. Only the continued outperformance of the broad U.S. equity market and poor commodities returns matched expectations at the beginning of the year. The U.S. market returned +12.5%, but global equity market returns were only +3.8%.
- The outlook for 2015 is decidedly mixed. We are likely to see continued growth in the U.S., some modest growth in Europe, and a very mixed bag in terms of emerging markets. The outlook for interest rates is also cloudy, given divergent monetary cycles globally. We do expect that stocks will outperform bonds in the U.S. and that U.S. equity returns will continue to outpace international returns, due to forces that are favorable to continued dollar appreciation.
- In such an uncertain environment, we believe the best course of action is to adhere to our core investment principles of diversification and timely rebalancing, especially for our clients who are close to retirement. We are underweighting emerging market assets and overweighting the U.S. We will continue to hold a diversified array of fixed income assets, with a tilt toward municipal income.



Markets in Review

In Q4, we saw a return to some volatility in the equity markets. Fortunately, however, after a sharp sell-off in October, U.S. equities ended on a decent note, with the overall market increasing by 5.2%. This was a nice reprieve from the mostly negative results of Q3. For the first time this year, investors received a boost from smaller companies' stocks, which increased by 9.7% on average during the quarter. REITS also performed very well, increasing by 4.0% (See figure 1.)¹

Figure 1: Asset Class Performance in 2014 (percentage points)



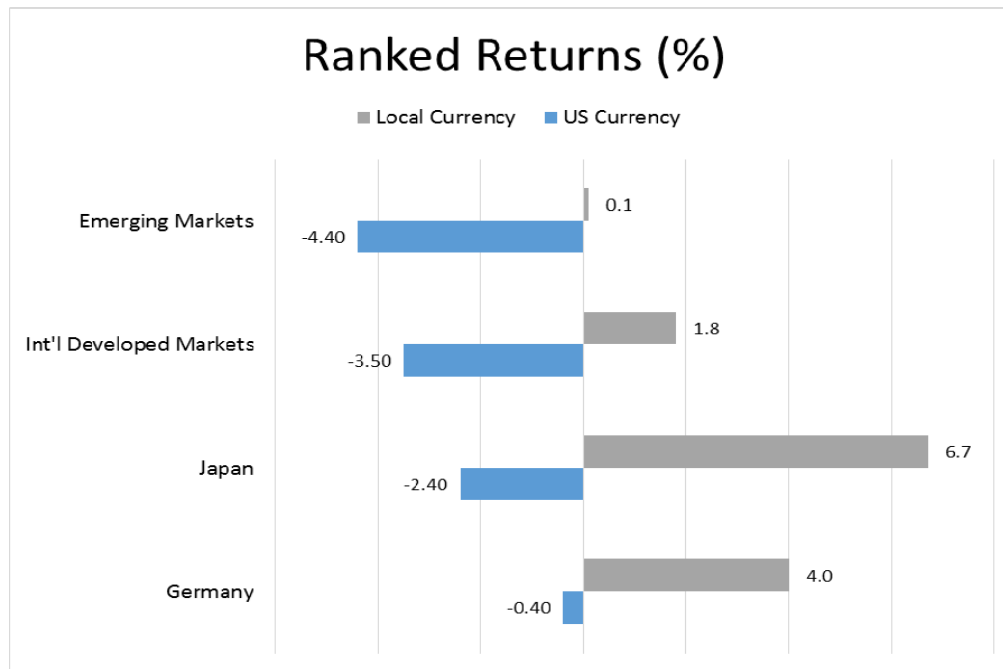
The key headline for the quarter was the sharp decline in oil prices and further appreciation of the U.S. dollar. The former helped to drive down inflation in the U.S., which dipped sharply to 1.3% in November. Lower gasoline prices, combined with slowing growth in

¹ Our REIT index is a blended index of equity and debt due to how we invest in the sector, hence returns are typically lower than the more commonly used REIT equity index.

China, continued to put downward pressure on all commodities prices, which in the aggregate fell by -12% during the quarter.

The story was different for European and emerging market equity markets, both of which were pummeled in U.S. dollar terms by the sharp appreciation of the dollar during the quarter. (See Figure 2.) Europe’s problems were more of the same – disappointing growth data, a further decline in inflation, and policy inaction at all levels. Even worse, the tail end of the period saw the re-emergence of Eurozone break-up risk, with Greece calling parliamentary elections for January 25 after the ruling party’s presidential candidate failed to garner sufficient support.

Figure 2: Select International Stock Returns in Q4 2014



Source: Dimensional Advisors, J.P. Morgan

As for emerging markets, the sell-off that began in September gathered steam in the fourth quarter. It was driven by the steep decline in oil prices, deteriorating economic conditions in Russia, and geopolitical uncertainties. The rapid pace of the oil price drop, coupled with renewed fears regarding global growth, led to indiscriminate selling of many emerging market assets.



In terms of fixed income, U.S. corporate bond prices broadly progressed, with the exception of high yield and floating rate bonds. Returns in these segments were harmed by their heavy exposure to the energy industry, where defaults are likely to rise.

The surprising winner was U.S. Treasuries, whose yields continued to decline (which boosted prices and returns). Indeed, the 10-year U.S. Treasury returned 3.6% in Q4, and the 30-year Treasury was up an amazing 10%. In U.S. dollar terms, almost all international fixed income returns were negative, with emerging market bonds especially hard hit.

2014 in Retrospective

In many ways, 2014 was a year of big economic surprises. Contrary to just about everyone's expectations at the start of the year, interest rates declined in the U.S., despite the Fed tapering its bond purchases incrementally throughout the year. Whereas the 10-year Treasury yield started the year at 3.0%, it ended at 2.2%. The Barclay's Bond Aggregate, a broad measure of all U.S. bond returns, returned a very respectable 6.0% for the year, due in large part to Treasuries. International yields also continued their descent -- falling into negative territory by the end of the year.

Last quarter I wrote in some detail why interest rates have been declining. In brief, the lack of sufficient global demand for goods and services (a.k.a., sluggish international growth) has led to a global savings glut. The savings has to go somewhere, and, as in the past, is finding its way to assets such as long-term Treasuries, which increases their price and reduces their yield. (Remember, an increase in demand for bonds lowers the yield and increases the price.)

Another surprise during the year was the rapid decline in oil prices. While I and others have long argued that the so-called commodities super-cycle of the last decade was over, few predicted gasoline would be near \$2.00 a gallon by the end of the year! This represents a total decline of over 50% since mid-2014. Some of the sharp decline came about after Saudi Arabia announced that it would not restrict supply to boost prices as it has often done in the past.

Much is currently being written about who gains and who loses with lower gas prices. The emerging consensus is that the decline in price inflation due to lower oil prices, with wage inflation not falling commensurately, will result in a major boost to real income and consumer spending in the developed economies. There will, admittedly, be negative effects on investment in the energy sector, but a recently published World Bank report estimates that real global GDP in the medium term will gain about 0.5%, assuming that oil prices hold

at 30% below prior levels. (If the actual, much larger drop that we see today holds in place, the boost to global output could be closer to 1.0%.) Note that this is a permanent gain to the level of output, for as long as oil prices remain at present levels.

A third surprise in 2014 was the sharp appreciation of the U.S. dollar against the euro, the yen and many emerging market currencies. The surprise here was that the dollar took so long to start appreciating, given the large and growing divergence in economic performance and policy between the U.S. and the U.K., and the rest of the world. From a policy perspective, the U.S. and the U.K. are likely to begin increasing short-term interest rates modestly in 2015, consistent with the recovery of their economies. Europe and Japan, however, are marching in the other direction, taking measures to decrease interest rates to stimulate growth. The key issue is that money chases prospective higher economic growth and higher interest rates, both of which define the U.S. environment. Hence, the strong appreciation of the U.S. dollar in the second half of the year.

Finally, one other surprise was the degree of underperformance of public U.S. small companies relative to large companies. (See Figure 3.) Indeed, U.S. small company stock returns trailed large company returns in 2014 by the biggest margin since 1999. While it is true that small companies outperformed large companies in 2013, I believed that small companies would continue to perform well in 2014 as U.S. growth accelerated because they are less exposed to international markets and more geared to economic growth.

Figure 3. U.S. Equity Returns in 2014 by Size and Style

2014			
	Value	Blend	Growth
Large	13.5%	13.7%	13.0%
Mid	14.7%	13.2%	11.9%
Small	4.2%	4.9%	5.6%

Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan. Figures as of 12/31/2014



What didn't surprise most market strategists in 2014? There was a large consensus at the beginning of 2014 that U.S. growth would accelerate and that the U.S. market would outperform. The U.S. market did lead the pack of developed market economies by growing just under 3% for the year, while Europe, in particular, flirted with yet another recession. Japan also had a tough year. Most analysts also predicted continued softness in commodities prices and emerging market assets.

For all of the reasons mentioned above, 2014 was a reasonable, but not a stellar, year for global balanced portfolios (i.e., portfolios that contain a mixture of stocks, bonds, real estate, commodities, and cash). While the overall U.S. equity market returned +12.5%, the global equity market, as measured by the MSCI All Country World Index (in which the U.S. weight is only 50%), returned only +3.8%. Most proxies/benchmarks for globally balanced portfolios returns came in between +4-5% for the year.

2015 Outlook

The outlook for 2015 is decidedly mixed; frankly, it's fraught with uncertainty. Global investors are struggling to understand the implications of diverging regional growth stories, uncoordinated monetary policy, and increasing geopolitical complexity. Equity markets don't like uncertainty, hence the increase in volatility we have already seen since the start of the year. I'm afraid we are likely to see more volatility as the year progresses.

In the U.S., we are likely to see continued economic growth in the 3% range, decent job growth, and low (but not negative) inflation. Indeed, there are many indications suggesting even better growth ahead, including a rising ISM, a clear quickening in job creation and growing private sector credit. As a result, the Fed is widely expected to raise short-term interest rates this year for the first time in nearly a decade, although below-target inflation in particular could delay the first move.

While stocks could take a brief hit from a rate rise, the Fed's move would be a sign that the economy is strengthening, which should be good for stocks. Studies from banks and others show that stocks can continue to climb during periods of rising interest rates, especially at the early stages of a tightening cycle. I expect that the U.S. equity market will eke out another positive return in 2015, but likely lower than we saw in 2014. Stellar corporate earnings from U.S. companies have kept P/E ratios from expanding into overvalued territory, but stocks are fully priced.



It is tough to be as optimistic about Europe. For Europe, the beneficial impact of sustained low oil prices, a markedly weaker euro, and increasingly accommodative monetary policy will likely help growth improve. However, Europe is also beset with what economists call “bad deflation,” stemming from a persistent shortage of demand for goods and services. The great concern for Europe is that good deflation (reduced oil prices) will now unhinge price expectations, making bad deflation even worse as businesses and consumers delay purchases on the assumption that such goods will be cheaper in the future. This is the vicious cycle of deflation.

Europe is now widely expected to implement an expanded quantitative easing (i.e., bond purchase) program late in January with the hope of breaking the deflationary spiral. But without a strong fiscal boost, many believe the positive impacts of such a program will be modest at best. And gains to U.S. investors, unless they hedge currency risks, will likely be very modest due to dollar appreciation.

The political backdrop in Europe is also not encouraging. General elections in the U.K. and Spain may well witness populist parties gain significant ground. The political situation in Greece again seems to be coming to a head, where the growing popularity of left-wing party Syriza may well pose a threat to the negotiated arrangements in place with Greece’s creditors. A Syriza election victory may force the Eurozone to choose between a fiscal union debt write-off for Greece or the first euro exit.

China and More: What about China? Much of emerging market outperformance of the last decade was due to rapid growth in China and the Chinese government’s willingness to stimulate demand to keep growth rates high. However, in the last few years, Chinese economic policy has changed course. Worried about over-investment, the government has been tightening both monetary and fiscal policy. Not surprisingly, growth has slowed. Very recently, the government has signaled it may ease during 2015, but it’s a difficult balancing act, so I don’t expect any sharp turnaround.

As for the other emerging markets, commodity exporters have lost more than commodity importers have gained. Emerging markets is still fundamentally a commodities exporting asset class, and portfolio flows are discouraged as risk appetite falls. Moreover, rising interest rates may draw capital out of some emerging markets in a repeat of the taper tantrum of 2013. In addition, emerging markets have typically underperformed developed markets during periods of dollar strength.

I do not, however, anticipate the balance-of-payment crisis we saw amongst emerging markets in the late 1990s. The key difference is that today many of them have made their

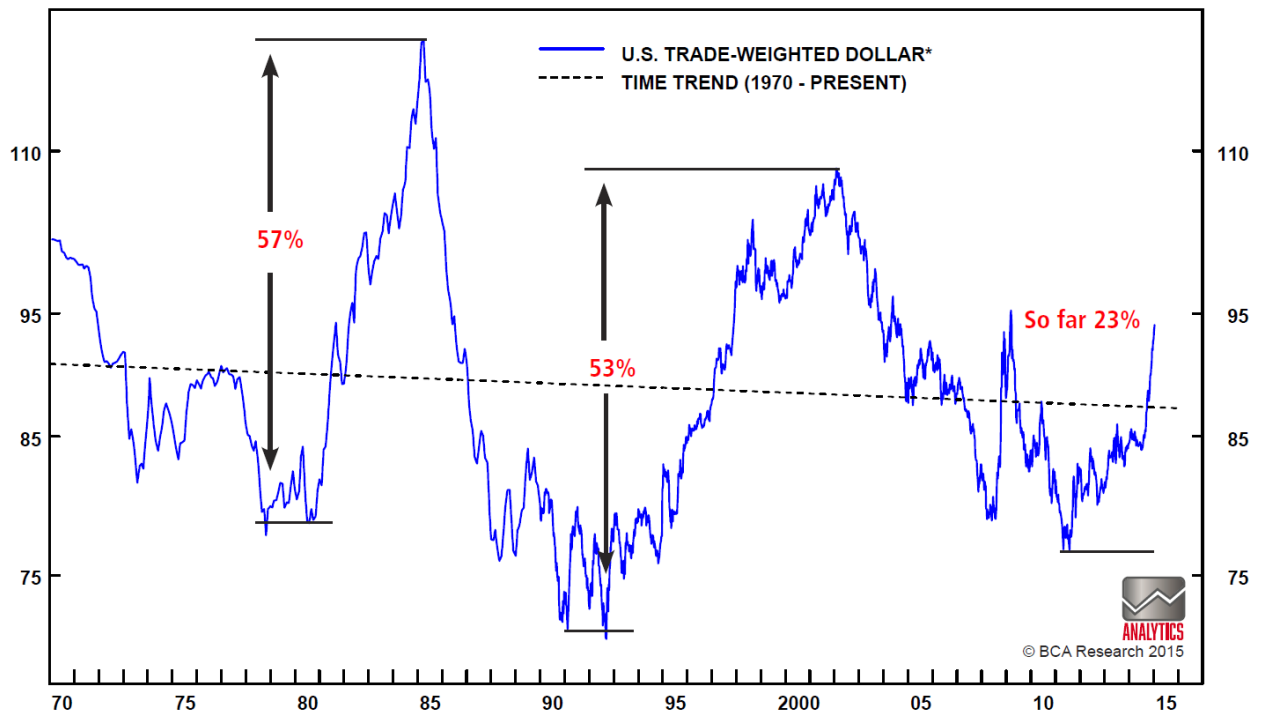


exchange rates more flexible to deal with imbalances. Emerging market countries have also built up a higher level of foreign exchange resources relative to their current account position and external debt exposure than they had in the late 1990s.

Fixed Income: Finally, a word about fixed income. Last year reminded all of us how difficult it is to predict interest rates, and 2015 is likely not going to be much different. Low inflation and a strengthening U.S. dollar are both supportive of bond prices. And, as usual, any signs of faltering growth or lower-than-expected corporate earnings will also be supportive for bond prices. These are some of the reasons why we are seeing a shaky start to the year in the U.S. equity market and continued Treasury yield declines. On the other hand, many believe that rates will move up as the U.S. economy “normalizes.” We’ll see.

The last issue to contend with is the exchange rate. As one strategist recently pointed out, the dollar usually moves in big cycles, with a bull market lasting about 5-6 years. The trade-weighted dollar index reached a bottom in July of 2011 and, given divergent monetary cycles, very likely has more room to run. (See Figure 4.)

Figure 4. U.S. Trade-weighted Dollar Index





Artemis Portfolio Strategy

2014 Retrospective

First, a bit of retrospective on 2014. During 2014, Artemis portfolios continued to benefit from the absence of holding any commodities, a general overweight position to U.S. equity, and sizable real estate exposure. A few clients were harmed by holding legacy individual energy and oil services stocks but as a rule, Artemis exited the commodities asset class back in 2012. We did not succumb to ever-more-popular liquid alternatives, which, frankly, have not added any value as best as I can see. Finally, Artemis portfolios also benefited by our decision not to do much rebalancing until the end of the year.

Not everything went well, however. The big miss was that we increased our allocation to Europe and other developed markets in the spring and early summer on a relative valuation basis, only to turn around and reduce to an underweight position in phases, following Putin's invasion of the Ukraine and fears over accelerated dollar appreciation. We also got ahead of ourselves in our more aggressive portfolios by rebalancing into slightly more emerging market equity as the asset class rallied early in the year.

Our emerging market equity return was also harmed by the poor showing of the principal fund we use, which has a small company and value tilt. Whereas the overall emerging market index returned – 1.8% in dollar terms, our core holding (DFEVX) earned -4.1%. We started to diversify this holding late in the 4th quarter as part of a tax-loss harvesting exercise. Finally, like just about every investment manager, I wish I had bought some Treasuries in 2014!

In summary, most of our client's individual portfolio returns were in line with their benchmarks for the year, but only by a hair, due to the large number of surprises and rapidly changing investment environment during the year. Once again, the big portfolio dampener was low international equity returns, in part due to dollar appreciation.

2015 Positioning

Due to some late 2014 trimming of international equity and selective easing of emerging market equity in client portfolios, we are now neutral on Europe and firmly underweight emerging market equity. (We have been underweight emerging market debt since the summer of 2013.) As much as it is tempting, I do not believe it is prudent further reduce our global exposure. Let's remember that while the U.S. equity market appears to be well positioned in the short run, we don't know exactly how the world can and will unfold, and



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we do know that investor sentiment can change rapidly (especially when the market is fully priced). As such, it is always unwise to abandon the principles of diversification. I am, however, exploring (inexpensive) ways to hedge some of the currency risk of our international exposure.

As for fixed income, we started adding to municipal exposure in the fall and will be adding a bit more this year, taking from our high-yield allocations, which appear vulnerable due to their high energy weight. The fundamentals of the municipal market are strong going into 2015 due to projected flat bond issuance (because revenue is up in cities and states) and strong demand. The sharp rise in top federal tax rates at the start of 2013 has increased the attractiveness of municipal bonds, and they are likely to become even more attractive if Obama's tax proposals have any legs. We will, however, continue to remain well diversified in our fixed income holdings due to the highly uncertain climate surrounding rates.

Finally, we continue to like real estate, particularly internationally. Real estate offers a stream of income, which should continue to be attractive in Europe and Japan, where very easy money will continue to depress fixed income yields.