

REVIEW 2014

A casual observer might look at the Dow Jones Industrial Average return of 10% and conclude that 2014 was a fairly normal year for stocks. Indeed the monthly returns also appear uninteresting and calm and a ten percent return is equal to the long-term average annual return for US equities. But on closer examination, 2014 was anything but normal and uninteresting.

Let's rewind the clocks to January 2014. The consensus view was that the US stock market was "slightly expensive" relative to the long-term relationship between market capitalization and the US GDP. Meanwhile European countries and emerging economies looked very cheap relative to their historic price multiples. The US economy was expanding and the Federal Reserve was signaling an end to monetary support. The broadly accepted view was that interest rates would rise as the economic expansion broadened. The only dispute among analysts and economists was seemingly how far and how fast rates would rise.

Many prognosticators declared that 2014 would be a negative year for bonds. Rising interest rates were going to hurt utilities and possibly real estate. Tactical allocators sought to move bond allocations to other income sources and to move some US equity allocations overseas to buy into the deep value in other countries.

In a time when the US economy was improving while central banks in Europe and Japan were taking on enormous monetary support, it was easy to conclude that commodity prices would be stable. Some predictions even had oil going to \$150 barrel by end of 2014. Cautious investors sought the consistent returns and good yields in the energy sector.

All of these proved to be wrong. In fact, divergences from expectations were quite large. Interest rates did not rise, but instead fell sharply. Oil prices plunged in the late summer and throughout the fall. Inflation, as measured by the Consumer Price Index, was back below 2%.

By year-end, utilities (+23%) were the highest performing sector and energy (-8%) the worst. Oil prices declined 42% from \$92 to \$53 per barrel. Only 30% of the stocks in the S&P 500 outperformed the index, signaling a very narrow rally concentrated in a minority of companies.

Several of the world's largest tactical allocators finished 2014 with negative returns. The following is an excerpted list of market predictions by some of the "Smartest Market Watchers" in 2014:

- Interest rates will rise globally (rates stayed at all-time lows, Germany even saw negative rates)
- Oil will go to \$150 (oil plunged to below \$50)
- We will see inflation rise (inflation fell)
- Commodities will be strong (they dropped 24% in the last 6 months)

Investment decision-making is hard. The look back at predictions is not to poke fun at other people's outlooks but to point out just how difficult investing can be in short time frames. Looking to profit from short-term trends or to earn a good result within a calendar year is more a trading philosophy than a real investment process.

A Look Ahead into 2015 and Beyond

Despite the potential folly of trying to predict markets, the investment committee does have several key themes and data points we are watching. These may or may not be fulfilled in 2015, but in our minds they do seem important. We will seek to draw conclusions from the markets and then initiate investment decisions based on them.

2015 Major Themes:

Low commodity price inputs

Base metals, oil, and food inputs have supply and demand imbalances which will keep most commodity prices low or falling. Short-term good for consumers, longer-term risk to the economy.

Stable consumer, not rising or falling much

Mixed bag of stagnant wages and below normal workweek hours but with lower commodity (primarily gasoline) prices and all-time low interest rates.

High volume healthcare needs

ACA and aging population will increase the number of people who need medical treatment and require medications.

Strong US versus rest of world

Economic strength relatively more robust than most of the world's regions
Stronger US dollar relative to major currencies.

Corporate margin reversion

2014 had the highest profit margins in history stemming from all-time low cost of money. Mostly run its course. Possibly does not impact 2015 if rates remain low, but could be longer-term headwind for corporate profits.

Weak European / overseas sales

Fighting deflation and high unemployment in many areas. Europe has a confluence of factors causing strong deflationary forces. The European Central Bank will have its hands full in 2015.

Strong tax receipts in California

Debt obligations and pension risk decline substantially. Municipal bonds and Build America bonds may continue to offer very good risk-adjusted and after-tax returns relative to other fixed income.

Continued low interest rates, that may even decline in 2015 (first half of year)

Economic headlines and low commodity prices could push rates lower. Default risks and low inflation are likely to keep rates in check in 2015.

Will Russian leadership become aggressive?

History would suggest some unexpected and bold moves that could have an impact on assets in 2015.

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