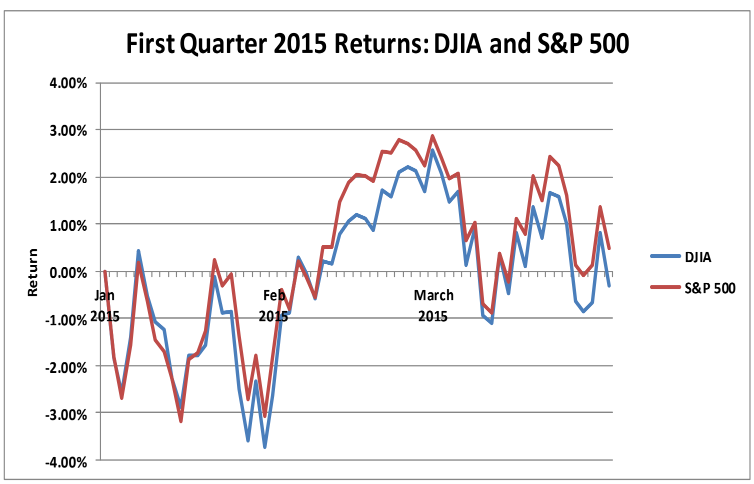
ARMORY
CAPITAL MANAGEMENT, LLC

The Buttonwood—An Informational Newsletter

First Quarter 2015

We Could've Stayed Home

If you fell asleep on New Year's Day and woke up on March 31st you might be inclined to ask what happened to the U.S. stock market over the last 90 days. The answer would have to be "not much." U.S. stocks as measured by the Dow Jones Industrial Average and the S&P 500 ended the first quarter just about where they started. The tug of war was evident if you consider that in January the DJIA and S&P 500 were down 3.70% and 3.10%, respectively. In February each gained about 5.5% and in March each was down just under 2%. Several new highs were made by each index in the first quarter, but this was accomplished with little fanfare.



We went back over the last 100 years and reviewed first quarter stock market performance as measured by the Dow Jones Industrial Average to see if there might be any common variables that could be applied to the economy and financial markets today. In particular, we were interested in whether a down or flat first quarter resulted in a year that would qualify as something more than a correction. Remember a correction is a market that declines by greater than 10% but less than 20% and we've long maintained that the markets could experience a 10% correction at any time.

History of the Buttonwood

On May 17, 1792, twenty-four merchants gathered under a Buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

It should be noted that a negative first quarter is not all that unusual; there have been 42 of them since 1915. There have been 13 occasions when the Dow was down 10% or more for the year following a down first quarter. Two of the worst years were 1920 (-32.90%) and 1932 (-23.10%). Both 1920 and 1932 were periods of economic depression accompanied by severe deflation and high unemployment. The 1920 downturn lasted about two years and the 1930 downturn was in the middle of the great depression.

In 1917 the United States was drawn into World War I. That uncertainty, combined with the sale of Liberty Bonds to fund the war effort, resulted in the Dow dropping 21.70% for the year. Declines in 1940 (-12.70%) and 1941 (-15.30%) occurred during the early stages of World War II which were periods of significant uncertainty. In 1957 the Dow dropped 12.80% and was a precursor to the recession of late 1958 and 1959. In part, this was a global downturn and would prove to be one of the most significant recessions from the post war years until 1970.

There were seven other occasions from 1962 to 2008 when stocks were down 10% or more following a negative first quarter. On four of these seven occasions, the market downturn was a result of unique and extreme international and/or domestic circumstances. In 1962 (-10.80%) the market correction was a result of the Cuban missile crisis and the Kennedy administration's confrontation with US Steel. The 1962 correction was quick and severe and was labeled the flash crash.

Wage and price controls initiated by the Nixon administration and increases in the consumer price index resulted in a 16.60% decline in the Dow in 1973. This was followed a year later by the first oil price shock which led to a 27.60% decline in 1974. You may recall that we have labeled the 1973 - 1974 stock market correction a generational correction. Most recently, in 2008, stocks corrected by 33.80% as a result of the banking - real estate crisis. We have referred to the stock market decline in 2008-2009 as a generational correction also.

The other three occasions (1966, 1969 and 1977) were a result of significant interest rate increases. 1966 saw a nearly 20% decline as a result of a liquidity crunch that drove bond rates to levels not seen in 45 years. This took place over a very short period of time and prompted investors to sell stocks because of attractive yields on bonds. Over a 12 month period the Fed Funds rate rose from 4.10% to 5.76%, a 40% increase. A Time Magazine article from March 4, 1966 said *"Long Island Lighting Co. bonds went on sale with a 5.13% interest return, one of the highest yields ever placed on a corporate issue of its type"*.

An increase in the Fed Funds rate from just under 4% in late 1967 to a peak of over 10% in August of 1969 took the Dow Jones down by almost 11%. This tightening, combined with increasing deficits from the Vietnam War, shattered investor confidence and led to further declines in the Dow's valuation. All told, the index would drop by 36% from its peak in November 1968 to the May 1970 bottom.

From January to December 1977 the Fed Funds rate would go from 4.89% to 6.53%, a 33% increase. The Dow Jones, which closed at 1,000.08 on December 28, 1976, would decline by just over 8% in the first quarter of 1977 and by 16.86% for the year. What is interesting is that rates would continue to rise with the Fed Funds rate peaking in May of 1980 at around 18%. The market would recover from 1977 losses but the Dow would not close above 1000 until November of 1980.

As mentioned above, a negative first quarter is not uncommon. Whether the market finishes down 10% or more for the year appears to be largely the result of two variables.

The first is some significant international event such as World War II, the Cuban missile crisis or the oil price shock of the 1970s. The second is a significant, and sometimes unanticipated, spike in interest rates.

International events can occur suddenly or develop over longer periods of time. This is something that we have been faced with for centuries. It makes little sense to try and anticipate what might trigger such an event. Anticipating interest rate direction, while still an inexact science, is a bit more certain.

Some Further Points of Interest

It is not an understatement to suggest that when the Federal Reserve raises interest rates for the first time since July 2006, when the last tightening cycle ended, it will be the most anticipated and talked about rate hike in history. Since 1965 the Fed has raised rates 15 times. It's interesting to note that the 9 years since that last cycle ended represents the longest stretch between tightening by a wide margin. That speaks to the depths of the recession and the slow pace of the current recovery.

The beginning of a Fed tightening cycle is bullish far more often than not. Evidence of this trend is that of the last 15 rate hikes the S&P 500 was higher over the following 12 month period 10 times. Three of the 5 times the market was down was a result of unique circumstances. On two occasions inflation was a significant issue.

The Fed began raising rates in March of 1974 and the S&P was down 15.20% over the next 12 months. The next rate hike started in February of 1977 and the S&P was down 12.50% 12 months later.

Both of these periods were marked by stubborn inflation which would linger until 1982. Another down period was after rates began to rise in February of 1987. Twelve months later the S&P was down 6.20% but much of that decline occurred on October 19, 1987 when the market was down 20% plus in one day.

A fourth tightening cycle which began in December of 1965 resulted in a market downturn of almost 20% over the following year as mentioned above. This was a period that followed what some refer to as rate normalization that occurred after World War II. The fifth time the market dipped was after the rate hikes that began in February of 1994. A somewhat minor and overblown inflation scare saw the S&P dip 2.3% 12 months after the rate hikes began.

Of the ten times the markets rallied at the beginning of a rate hike cycle, the S&P was up an average of 11.51% twelve months later. It makes sense that stocks can rally early in a rate hike cycle because "a rise in interest rates is the flip side of the coin that says the economy and profits are also doing well" says Abby Joseph Cohen of Goldman Sachs. This scenario also assumes that stocks are reasonably valued.

So when might the Fed begin to raise rates? Until very recently the consensus tilted toward a rate hike sometime this summer or early fall. However the jobs report that was released April 3rd may push any rate hike to later this year. During the first quarter of 2015 consumer spending, capital investment and manufacturing output have all slumped. It should be noted that some of this could be a result of the difficult winter weather similar to the first quarter of 2014.

The one sector that remained positive was the labor market. However the most recent report showed that job growth slowed in March to a seasonally adjusted 126,000 which is the weakest hiring pace in 15 months. Many are suggesting that job data is catching up with the other weak indicators. All of this, if it persists, will likely have an impact on when rates go up. Janet Yellen has stated that continued improvement in the labor markets is a key variable in the interest rate equation. Many now believe that Friday's (4/3/15) report reduces the odds of a rate hike at the Fed's June policy meeting.

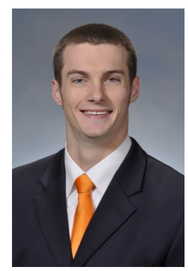
Assuming that a rate increase might be pushed into the second half of 2015, we are left to consider how much that increase might be. As we mentioned above, the recovery from the depths of the last recession has been slow and to some, disappointing. Our position has always been that the recovery would be slow and uneven because of the severity of the 2008-2009 downturn. In December, the Federal Reserve's open market committee revealed that nine of its 17 members expected the Fed Funds rate to be at 1.125% by year end 2015. Low inflation, modest economic growth and the recent job data make that an unlikely target. Kenneth Rogoff, former chief economist at the International Monetary Fund, recently said "I can't see why they would move quickly. It certainly will be a big percentage increase from nothing to something. They should be very cautious." He added that the risk of stifling the economic recovery prematurely was greater than the risk of the Fed's 2% inflation target.

From where we sit we don't see a significant stock market downturn or the risk of a recession once the Fed begins to tighten. Those risks increase later in a tightening cycle and we will track them. We also don't see the Fed raising rates aggressively given the current state of the economy in the US and abroad. We agree with Mr. Rogoff that the percentage increase will be large because rates are so low. In this regard it helps to remember that rates are at all-time lows and will slowly be returning to long term averages. As an example the current rate of the 10 year Treasury note is 1.82%, the average since 1871 is 4.62%.

In conclusion, we still believe we are in a secular bull market coming off of the generational lows we saw in March of 2009. Interest rates will slowly return to more normal levels off of all-time lows. Having said that, 2015 may well prove to be a year that requires patience. And that will prove to be rewarding for those who are willing to ***Get Rich Slow***.

CONTACT US

Henry J. Wildhack II
President, Investment Advisor
P 315.701.6415
hwildhack@armorycm.com



Matthew J. Abbott
Investment Advisor
P 315.701.6331
mabbott@armorycm.com

ARMORY
CAPITAL MANAGEMENT, LLC

Patient Investing. Steady Returns.

Successful investing is an elusive realty for many people. It should not be that way.

Investors who are willing to embrace a long-term time horizon, adhere to a conservative investment philosophy, and seek proper guidance will be rewarded. In the short run, the markets may seem volatile, in the long run, the trend is favorable for those willing to hold quality investments over time.

At ACM we believe that the underlying principles of sound investment should not alter from decade to decade. The likelihood for success is overwhelmingly in your favor if you have the required patience and proper guidance.

Please call us, we'd like to help you **Get Rich Slow**.

Armory Capital Management LLC
110 West Fayette Street, Suite 900
One Lincoln Center
Syracuse, NY 13202-1387

www.armorycm.com

ARMORY
CAPITAL MANAGEMENT, LLC