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The Buttonwood—An Informational Newsletter

Fourth Quarter 2014

Throughout 2014, the bull market continued to roll along, proving it could take a few punches. The first quarter of 2014 was sluggish due to weather related issues and as a result, most major stock market indices were flat to slightly up during that time frame. US markets shrugged off the first quarter jitters and showed respectable gains through September, aided by an improving US economy, which finally gained some meaningful traction.

4th Quarter Brought Healthy Gains

The 4th quarter saw the US markets come under some considerable pressure early resulting in downward volatility in October. The NASDAQ dropped nearly 10% which would have put the index officially in the "correction" category. Once again prices would rebound quickly only to head south again in early December on oil price concerns. For the third time in 2014, the market rallied and posted healthy gains for all of 2014.

International News

Outside the US the situation was quite different. The Japanese economy slipped into a recession which forced Prime Minister Shinzo Abe to approve an emergency stimulus package on December 27th. Across Europe the major concern, among many, was not inflation, but rather deflation. European indices mostly posted losses led by the MSCI Europe Index which was down 6.2%. US stocks were the beneficiary of Europe's uncertainties as investors viewed US stocks as a safer place in which to invest.

China also stumbled in 2014 and the outlook for 2015 is not as favorable as in the recent past. Consensus forecasts suggest that China will not be able to maintain the 10% economic growth it enjoyed as recently as 2010. In December the Chinese central bank suggested that the 7.5% growth predicted for 2014 would not be reached.

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.

Estimates for 2015 came in at 7.1%. While China does not appear headed for a recession, a slowdown could have a negative impact on Asia and developing economies elsewhere.

Russia was the other big news maker in 2014. From an economic perspective Russia is greatly dependent on energy, in particular, oil. Because Russia is an oil exporter, falling prices have had a significant negative impact. The possibility of a large Russian corporation defaulting or Russia itself defaulting has been discussed among some international economists.

Lori Heinel, chief portfolio strategist at State Street Global Advisors, stated that a default "isn't our core call, but you cannot ignore the possibility." As recently as January 2, 2015, the Wall Street Journal reported that Russia's third largest lender, Gazprombank, received aid from the Kremlins National Welfare Fund to shore up its finances. Finally, given Russia's staggering economy, no one can accurately predict how aggressive Putin might become on the international front.

When Will This Bull Market End?

As we mentioned in the last Buttonwood, this is currently the 4th longest bull market since 1929. The obvious question going forward is can and will it continue? Our guess is that it can continue, but will need to do so without help from the Federal Reserve. There is no question that Fed policy has been a positive catalyst for the US stock market. We all know that's about to end.

If US stocks push higher they will do so as a result of several variables in the investment equation. These include earnings growth, gross domestic product growth, employment, inflation, and interest rate levels among others.

With respect to earnings projections, US stocks remain fairly valued to slightly expensive. According to Yardeni Research, industry analysts have penciled a consensus of $128.80 for S&P 500 earnings for 2015. This equates to a price to earnings multiple of 16.0 based on the S&P 500 close of 2058.90 on 12/31/14. While that is not cheap, it is nowhere near the extremes we see at major market tops.

In a low interest rate environment these are reasonable levels. When measured against international or emerging market equities, US shares look favorable. Finally when measured against bonds, US stocks look very reasonable.

Jan Hatzius of Goldman Sachs, who is looking for GDP growth of 3% in 2015, suggests that the "acceleration that we've seen in the course of 2014" should continue. He maintains that we have "arrived at a strong recovery across all the major areas of private domestic demand".

Forecasts for Q4 2014 are below the robust growth we saw in Q3 2014. Analysts suggest that it is not uncommon for several strong quarters of growth to be followed by a weaker one, with continued growth then bouncing back going forward.

Positive Job Growth

Generally speaking the consensus is that the good news on the jobs front should continue. In November 2014 job gains came in at 321,000, the largest one month increase in three years. Kiplinger calls for unemployment to end 2014 at 5.8% and decline to 5.3% in 2015. A key component to the employment picture is wage growth, which has remained stagnant at best. While reasonable wage growth would be welcome too much could arguably fan inflation. The latest figures show wage growth at 2.2% in November; consensus calls for a slight increase to 2.4% in 2015.

Inflation

The core inflation rate, which excludes food and energy prices, is forecast to rise by 1.8% year-over-year. Food and energy prices are excluded from the core inflation rate because of price volatility over the short term. These forecasts support our contention that inflation is likely to remain benign. Eventually a stronger economy will likely raise the inflation rate, but this seems to be at least a year away.

Interest Rates

There's no debate that interest rates are going up. Our sense is that the Federal Reserve will raise rates slowly and with great clarity. The Fed doesn't want any surprises. Longer term rates, which the Fed doesn't control, will likely rise before the Fed moves, pushing bond prices lower. This end of the market should stabilize if it becomes clear that short term rates won't rise quickly or sharply. Evidence suggesting that rates will rise slowly includes an uneven economic recovery world-wide, slow economic growth in the US, and lack of meaningful inflation.

Conclusion

In conclusion, we believe that 2015 will be a positive year for US stock prices. There is no evidence of a speculative bubble that would derail the recovery which began in 2009. A healthy degree of skepticism still exists with respect to the stock market. Evidence of this is the fact that bonds remain far more expensive than stocks. It is our contention that as long as investors are willing to purchase bonds with a 2% return, we are not at market top, especially when taking into consideration the positive economic/investment data we mentioned above.

Finally, there was very little fanfare associated with the S&P 500 making a new high 53 times last year. We would argue that if this were a market top, the number of new highs for the S&P 500 would have been major headlines.

While this year's returns might not match those of the last 3 years we believe that 2015 could provide investors with an opportunity to ***Get Rich Slow.*** However, you're going to have to be patient.

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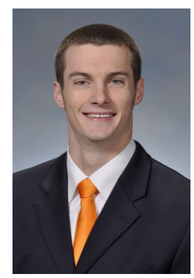

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