TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets December 2014

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U.S. equity markets recovered 5 times from declines of more than 4% from their highs in 2014. In comparable declines beginning in January, April, July and September the index took about a month each time to erase losses (*Bloomberg*). Market corrections coincided with the drop in WTI crude oil prices of 62% this year with a drop of 15% between 12/5 and 12/16 alone. Up to 12/17/14, the S&P 500 Index was nevertheless up 11.1% YTD, reflecting a more robust economic trend. The Dollar appreciated vs. all major currencies, in particular 10.6% vs. the Euro. Treasury 30-year bond returns topped 30 percent versus 6% for the broader market in 2014, surging on the outlook for slow inflation and a flight to quality. The yield reached a low of 2.69% on 12/16. Benchmark 10-year notes yielded 2.06 percent down from a high of 2.6% (Bloomberg). Much of the global growth in 2015 will come from the U.S. and China. In China, having entered an interest rate cutting cycle, and with lower oil imports ahead, there will be less pressure in achieving employment targets as the workforce shrinks in 2015. This should avoid downside risks of over-stimulus. In Europe, lower oil prices and a weaker Euro will help to make a QE success more likely, however, the risk remains that the real QE impact on the economies will continue to be a challenge for the ECB because of the banks' unwillingness to increase lending to the private sector which has been the case until now despite very low interest rates. Further risks in 2015 include failure to build an ECB coalition in a timely fashion, a faster than expected increase in key interest rates in the U.S., a sharper economic slowdown in China, competitive devaluations, and market risks if oil prices remain depressed for a long period of time. Also, geopolitical and idiosyncratic risks - Russia, ISIS, Greece, Ebola - remain material.

The U.S. Economy is Gaining Traction

The economy expanded at a seasonally adjusted annual rate of 3.9% in Q3. The combined growth rate in the second and third quarters was 4.25%, the best since 2003. The divergence between the U.S. economy and the rest of the world is striking. Japan's economy slipped into a recession in Q3, the Eurozone 's growth barely stayed positive and the rate of growth in emerging markets from China to Brazil is also slowing. Consumer expenditures, 2/3rd of GDP, gained 2.2%, business spending on new buildings, machinery, research and development increased at a 7.1% and spending on residential building and improvements advanced at a 2.7%. Trade added 0.78 %, supported by a 4.9% increase in U.S. exports. Government spending contributed the second straight quarter due to a 16% increase in military spending. We expect the economy to grow 3%-3.5% in 2015.

Federal Reserve Will be Patient

The Fed has met their dual mandate half way and will, therefore, remain in a wait-and-see mode. The unemployment rate declined to 5.8%, beating their target of 6.4%, whereas the inflation rate of 1.5% is below their target of 2%. As inflationary pressures are likely to diminish further in 2015 due to falling oil prices, the Fed revised their inflation outlook in 2015 down to 1% - 1.6% and is expecting the core inflation (ex food and energy) to remain largely unchanged. We expect the Fed to start tightening in June if they want to reach their goal of a 1.25% key fed funds rate in a timely and for the markets orderly fashion.

Energy

The dynamics behind the re-pricing of oil are not only a question of supply (the rapid growth of U.S. energy production) and demand (a slowing global economy), but also about OPEC's share of global energy production, the leadership within OPEC, and the geopolitical impact on Russia. The impact could be evident by mid-2015 and even stretch into 2017. While new production investment may slow, cost-effective incremental investments to extract more from existing fields are likely to rise globally. A growing movement to follow the example of Mexico to privatize national oil companies to increase their capital efficiency, which, despite lower oil prices, could generate incremental growth opportunities. As the largest user of oil, the U.S. economy is likely to be the main beneficiary from lower oil prices; Europe and Japan, as the largest energy importers, are likely to benefit, and so will China, as it intends to build up their strategic reserves and buys energy at market rates. OPEC producers, Russia and some emerging market producers are likely to be adversely affected as local subsidies, which in the past reduced local energy costs, will become more challenging. Long term, the demand for fossil energy is likely to continue to expand. The eventual shift to offshore deep water sources for new oil and gas are likely to put a rising premium on the ability to reduce the cost of recovering a barrel of oil by commercializing seabed processing. We are, therefore, not alarmed about the likely near-term adverse impact and, instead, believe that the stronger U.S. GDP growth which has been the driver of outperformance in the past could be a net positive for the energy sector.

Outlook

In the sixth year of a historic bull market, U.S. equity markets are likely to continue to perform well in 2015 based on solid earnings growth, reasonable and attractive valuations in absolute terms and relative to cash and bonds. Equity market valuation measures, price to earnings, dividend yield, price to book and price to cash flow are in line with the 25 year averages (*J.P.Morgan*). In a stronger growth/higher interest rate environment in 2015, we expect cyclical stocks to respond better than defensive stocks in general. Furthermore, performance has been driven by liquidity in recent years. As three of the four largest Central Banks globally are on hold or reducing interest rates, it is likely that the liquidity in the markets will double in 2015. Despite increasing risks of a profit recession led by dollar strength and commodity weakness, we expect earnings to continue to grow in the mid-digits in this mid-cycle economy in 2015. We recommend to take a balanced approach in cyclical- and defensive stocks, as we expect heightened market volatility during the interest-rate normalization process. We see particular value in the consumer discretionary, healthcare, energy and financial sectors. In fixed income, we recommend to stay in intermediate-term bonds or bond closed-end funds to avoid opportunity cost by trying to time the market. As credit risk in high-yield bonds is expected to increase in a higher interest rate environment, we recommend to rebalance a portion of the high-yield bonds into investment-grade bonds. Should credit spreads substantially widen, like in 2008, there will come a time to shift back into high-yield bonds.

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