TW Advisors

Fourth Quarter 2014 Newsletter

"Divergent" Markets

We expressed some concern about financial markets in last quarter's client letter and stated the theme of the letter was volatility. That characteristic carried over into the fourth quarter and caused our concern to heighten considerably. The S&P 500 finished with a flourish rising 4.9% in the quarter and 13.7% for the year. Unfortunately most other major stock indices were much weaker, and we read the divergence as a warning signal. U.S. small capitalization stocks rallied almost 10% in the quarter to get into positive territory but finished the year up 5.8%. Developed international stocks fell in the quarter more than -3% and ended the year down over -4%. Emerging market stocks declined by about -4.5% in the quarter and about -2% for the year. A healthy market is much more broad-based and usually led by cyclicals and consumer discretionary shares. In 2014, defensive sectors, healthcare and utilities, led gains in the S&P 500 while many other sectors had modest returns.

Anyone who scans the investment landscape beyond the S&P 500 should be anxious. Weak gold prices, falling commodity prices, low government-bond yields and downward revisions to growth forecasts all point to a serious risk of deflation which is the last thing that countries with high debt burdens need. The extent and suddenness of the fall in bond yields and oil prices suggests the global economic outlook is very soft. Japan has been battling deflation for decades, prices in the eurozone are falling for the first time in more than five years, and even China is experiencing low inflation. *The Economist* reports that consumer prices in the Middle Kingdom are up just 1.6% over the last 12 months, while producer prices have been falling for 32 months. Data from Bloomberg and the *Financial Times* indicate investors think low inflation is here to stay. Market inflation expectations for the five years starting in five years' time are at new lows in the eurozone and 2008 levels in the US.

Too much debt is a huge risk factor during deflationary times. While parts of the world economy, the U.S. consumer for instance, have reduced debt, the overall debt burden is at an all-time high due to central banks and sovereigns significantly increasing leverage.

It usually doesn't pay to fight the world's central banks when they are intent on propping up financial assets. The various forms of central bank largesse since the financial crisis were the main reason we've been positive on stocks. Every downturn in 2014 was halted by some news or action from one of the world's central banks, whether it was China cutting interest rates, Japan expanding their quantitative easing program, Mario Draghi hinting about buying eurozone sovereign debt, or Fed officials making dovish comments. From our perspective it appears monetary policy has done all it can. Its impact on the economy at this point is minimal. Central bank actions and musings do affect confidence in the short term, but we suspect the story for 2015 may be that investors lose faith in the ability of central banks to cure all the world's economic problems.

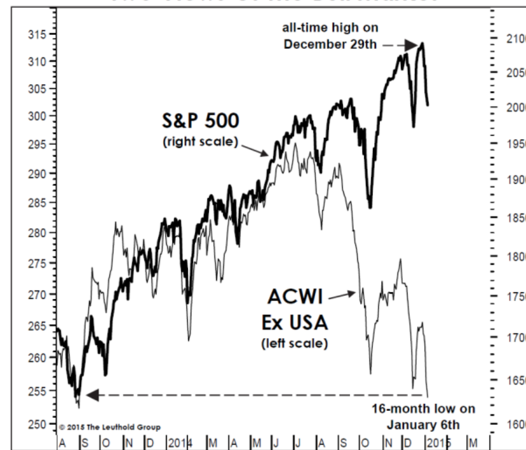
Despite all that we've said so far stocks should not be abandoned completely. U.S. stocks are not cheap but neither are they in bubble territory. Plus many companies sport attractive dividend yields and are seen as havens especially since the U.S. is by far the best developed world economy. Falling energy prices may not be the elixir many pundits hope it to be, but it will certainly be much needed relief to the beleaguered low- and middle-classes. Despite the economic challenges overseas, stocks abroad are cheap and in many cases have even higher dividend yields which are attractive in a low-yield world.

Short-term stock market movements are largely random and unpredictable. Longer term predictions are generally more accurate because they are based primarily on starting valuations, which suggests long-term returns will be modest compared to the recent past. While increased volatility may not herald a big decline we believe it is time to move from a more passive approach of generally being fully-invested to a more active approach with the goal of improving returns and reducing risk.

Please contact us if you have any questions.

James G Tillar, CFA

Steve Wenstrup



S&P 500 and the MSCI All World (ex US) Index

OUTSIDE COMMENTARY

Jonathan R. Lange

BARRON'S : Up and Down Wall Street 1/3/2015

"Jeffrey Gundlach's Surprising Forecast" Excerpt

GUNDLACH ISN'T PARTICULARLY sanguine about the prospects for U.S. stock markets. Early in the year, rebalancing of diversified institutional portfolios from stocks to bonds will create some price undertow for equities, he claims. Also, he worries that gross-domestic-product growth for next year and 2016 is unlikely to hit the 3%-plus annual targets that forecasters are assuming. That's because the deflationary tide unleashed by a slowing world economy and excess capacity will begin to lap against U.S. shores by the middle of 2015. A strengthening dollar won't help U.S. competitiveness.

Low oil prices will begin to wreak real havoc on employment, capital spending, loan collateral values, energy-company balance sheets, and the junk-bond market. "The boost to U.S. consumers from lower pump prices is the first shoe to drop, but the negative secondary effects from the crude-oil price collapse take longer to surface," he says.

There's plenty wrong globally that will eventually weigh on the stock market. He mentions the obvious. Emerging-market economies are sharply slowing. China, despite its current stock market boomlet, rests on shaky financial and economic foundations. Greece threatens to come apart again. Russia is a basket case. Sinking oil prices threaten to amp up geopolitical risks that Russia or Iran might do something dangerous out of economic desperation. Currency wars impend, led by Japan's systematic yen-devaluation campaign.

But such factors constitute the wall of worry that bull markets typically climb. Bad news or weakening fundamentals can, as often as not, have scant impact on the course of the stock market.

For Gundlach, a mathematics whiz, some of the charts and technical indicators he religiously follows are what give him pause about stocks and the global economy. He sent us over 70 charts from a recent presentation to make various points about what is going on in the belly of the beast.

One shows U.S. CRB Index Futures -- weighted commodity prices going back five years. To the untrained eye, there's not much to see beyond a vertiginous peak made between late 2009 and late 2010 with a series of smaller peaks saw-toothing down to present levels. But Gundlach draws another conclusion: "Look, commodity prices have fallen back to their lows of 2009, which of course was at the height of the financial crisis. Something is obviously very wrong these days in the global economy."

Another chart, delineating the movement in yields of two-year government securities of various key euro-zone nations over the past 14 months, looks like a tangle of spaghetti. But Gundlach points to an interesting divergence that has shown up since September, when the rate on German debt sharply diverged from two-year rates on Italian and Spanish debt. The German yield turned negative, while the two Club Med countries' yields headed the other way. This told Gundlach that trouble lies ahead for the euro zone beyond the headlines of European political unrest. "Folks in Europe are obviously losing confidence and scared if they are willing to pay Germany for the privilege of parking their funds there," he says.

TW Advisors does not necessarily agree with the opinions of the outside commentary.

The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities listed herein will remain in an account's portfolio at the time you receive this report. It should not be assumed that any of the securities holdings listed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable. In addition we do necessarily agree with or endorse any outside commentary within this newsletter. If you have received this electronic transmission in error, please notify us by telephone (937) 428-9700 or by electronic mail info@twadvisors.com. Chart in the article is from the Leuthold Group. Tillar-Wenstrup Advisors LLC does not necessarily agree with outside commentary. http://online.barrons.com/news/article_email/jeffrey-gundlachs-surprising-forecast-1420259030-lMyQjA1MTE1MzA2ODcwNTg3Wj