ROLLERCOASTER QUARTER

Volatility continues to be the theme for stocks. The S&P 500 was down big in January, rallied even bigger in February and went down again in March ending the quarter up 0.95%. The real action was in Europe where stocks clocked double-digit returns.

The U.S. stock market is stuck in a trading range. Valuations on U.S. stocks are high but not in bubble territory. Many have dividend yields higher than the 10-year Treasury which should support prices. Fundamentals have taken a turn for the worst though. The U.S. Economic Surprise indicator is falling while the dollar strengthens. Both of these conditions are usually associated with falling valuations for stocks but here we are near all-time highs. Earnings are now expected to fall the next two quarters and rise a paltry 2.2% for the year which is down from double-digit growth expectations just a few months ago. High valuations and anemic growth are not a good combination. However, a flood of liquidity from the world's central banks is offsetting these pressures. That is, the search for yield is forcing many risk adverse investors into dividend paying stocks.

Surprisingly Europe is starting to shine. Economic indicators are on the rise and beating expectations aided by lower oil prices, a weakening euro, and firming confidence. Valuations are markedly lower than U.S. stocks. This quarter's turnaround in performance for Eurozone stocks could last for a while.

Our strategy continues to be conservative. Simply put investors are not getting paid enough to take a lot of risk right now, and it is unlikely we will be penalized too much for this approach even if our cautiousness proves unwarranted. Too much debt remains a big problem. The legacy of the financial crisis is that we are now in uncharted territory. According to McKinsey & Co global debt has increased by $57 trillion since 2007 to almost $200 trillion and is at an all-time high as a percentage of GDP at 286%. No one really knows with any certainty(sp) what the ultimate outcome of this condition will be so it makes sense to be conservative. Right now policymakers have precious little room for maneuvering if a recession hits sometime soon. Short-term interest rates are at or below zero and the world's central banks have about $10 trillion in assets.

Even though the Fed has ended quantitative easing all the other central banks are buying assets aggressively which is **suppressing interest rates on a global basis**. The European Central Bank (ECB) launched a €1.1tn bond-buying spree to last until September 2016. This activity has resulted in negative interest rates for much of European sovereign debt five years or less and even some corporate debt. Ten year Germany Bunds pay a paltry 0.15% interest rate, Italy's 10-year only 1.22%! These rates make U.S. Treasuries look like absolute bargains and for these reasons we added a Treasury ETF to our portfolios in November 2014 including our all equity styles. Like Japan, Europe is fighting strong deflationary forces and will likely keep nominal rates near zero for years to come. **In fact, many analysts expect the ECB to have trouble finding enough bonds to buy.** Those investors who sell to the ECB should keep demand for relatively high-yielding Treasuries high.

Given this outlook for Treasuries and our high cash position we thought it made sense to add the Treasury ETF to all accounts. The 10-year Treasury was yielding about 2.3% at the time of our initial purchase, a little more than the S&P 500. So far it has been a good move as rates on the 10 year have dropped below 1.90%. The price of the ETF is up about 4.8% versus 2.2% for the S&P 500 through the end of the first quarter. In addition, bond prices tend to go up when stocks fall making the position a valuable hedge in the portfolio given our skeptical outlook. Our preference is to own attractively valued stocks, but as we've argued previously and above the conditions are not right to be fully-invested at this time.

James Tillar, CFA　　*Steve Wenstrup*

OUTSIDE COMMENTARY

GAVEKAL

Louis Vincent Gave 02/04/2015

Does It Still Make Sense To Overweight US Equities?

(Excerpted) This means that if it is to continue, the bull market in US stocks will have to rest on solid earnings.

On this front, the recent news is lackluster. First, energy companies are having to cut their estimates drastically to bring their outlook into line with the new oil price reality (according to Bloomberg, the S&P 500 energy sector is trading at 13x 2014 earnings, but 22x 2015 estimates). Meanwhile, the latest results from JP Morgan, Goldman Sachs and others show that bank earnings are getting squeezed by higher compliance costs on one side, and the challenge of making money in a world of flatter yield curves on the other. Possibly the single biggest question mark hovering over US earnings, however, is the impact that the rapid rise of the US dollar will have on bottom lines. After all, as much as a third of S&P 500 earnings is reported to come directly or indirectly from abroad, so a strong US dollar is likely to be a stiff headwind for margins and profits going forward. In recent days, releases from the likes of Caterpillar, DuPont, 3M, Procter & Gamble and Microsoft all seem to indicate that the US dollar's strength is biting hard. In short, the 'foreign' earnings component of the US earnings per share equation is very likely to disappoint over the coming years.

So, if betting on a further expansion in P/E ratios expansion makes little sense, and if betting on solid foreign earnings for US corporates is imprudent, then US equity bulls will have to pin their hopes on a massive boom in domestic US earnings. This may well materialize, thanks in part to the likely pick-up in US consumption and investment triggered by the lower oil price. But then, given the relative valuations, wouldn't it be wiser to play the US consumer by buying European or Asian exporters than to overweight US equities today? Indeed, why overweight US equities when Asia benefits more from falling oil prices than the US? Or why overweight US equities when the combination of low oil, low interest rates and a weak currency will surely boost Europe from its currently depressed state? (Or to put it another way, if euroland cannot grow with a cheaper currency, cheap oil and record low interest rates, then it will never be able grow at all, and the whole region can be written off for good.)

To put it all together, it seems that, at the margin, overall fundamentals no longer argue for US outperformance (we would argue that fundamentals are once again smiling on Asia). Nor do valuations (valuations are much more favorable in Asia and, to a lesser extent, Europe). Nor does excess liquidity creation (the Fed is now one of the few central banks not aggressively printing money). The one thing that does remain strong, however, is the US equity market's momentum. But is strong momentum alone a good enough reason to overweight US equities? We doubt it. We may soon reach the point at which underweighting US equities in a global portfolio starts to reap returns.

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

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