The Unforeseen

January, 2015

As year-end reflections and 2015 projections are offered in this new year by investment professionals we find it instructive to review those events and outcomes envisioned by very few (including us) at this time last year. Having been investment advisors for over thirty years we understand the folly of picking specific target prices at a particular date for the major indices, asset classes or individual stocks. It is very humbling as a seasoned investment professional to admit that the best answer to the question of where exactly stocks or bonds may be in 12 months is…"I don't know." We certainly have an opinion about valuations and it is generally positive for stocks and somewhat negative for bonds but we would not hazard a guess as to specific targets. Long experience has taught us that the unexpected occurs far more frequently than we would like and upsets even the most carefully crafted projections.

The dispersion of returns among various stock indices last year was somewhat unexpected as the S & P 500 had a good year in 2014, up 13.7% including dividends. The 30 stock Dow Jones Industrial Average (DJIA) had a total return of 10.0% while small cap stocks as measured by the Russell 2000 were up 3.5%. Foreign developed and emerging markets had difficult years, down 7.5% and down 4.6% as measured by the respective MSCI Indices. Hence common stock portfolios diversified across all of these strategies, which we certainly advocate for long term investors, underperformed the S & P 500 by a significant margin in 2014.

The positive returns for the U.S. indices did not boost all stocks as within the Dow Jones Industrial Average technology leaders Intel, up 39.8% and IBM, down 14.5%, marked the extremes for individual stock performance in 2015. Indeed, according to Barron's, IBM has been the worst performing stock in the DJIA for the last 2 years, a feat last achieved by Bethlehem Steel. We don't believe the fortunes of IBM are anything like those of Bethlehem Steel going forward but it does point to the dispersion of returns even within a 30 stock index such as the DJIA.

The two biggest surprises in 2014, in our view, were the collapse in oil prices and the decline in interest rates. In January of 2014 we were looking for interest rates to rise over the year, negatively impacting bond prices and the opposite occurred. As to oil, while we did not have any specific idea about price levels we certainly did not anticipate the dramatic fall in crude oil and the resulting poor performance in the energy and energy services stocks.

The magnitude and speed of the collapse in oil prices sparked fears of both a global supply glut and a demand slowdown due to weakening foreign economies. In 6 months, according to the Wall Street Journal, U.S. crude oil prices went from $107.26 to $53.27 per barrel. While most analysts expect oil prices to advance in 2015 the ramifications of the rapid decline are still being debated. One immediate impact was on the prices of energy stocks such as Chevron, down 17% from yearly highs, and oil service companies like Halliburton, down over 40% since in July. Many energy stocks fared far worse and while the short term price outlook for oil and natural gas remains uncertain we believe there are many good long term values in the energy sector.

In spite of the damage to energy stocks and the negative ramifications to US energy producers, the positive effects of lower oil and gas prices should be a great help to the ongoing economic recovery. The beleaguered overseas economies relying on imported oil and gas should also benefit.

The other big surprise of 2014, to us at least, was the decline in interest rates. The yield on the 10 year Treasury Notes dropped from 3.0% to 2.2% in 2014, defying once again consensus calls for higher rates during the year. This year may finally bring higher interest rates as the Federal Reserve seems poised to raise rates by the 2nd or 3rd quarter but the increase may be modest. U. S. interest rates may be held down by the competition from overseas rates which are at levels very few predicted a few years ago. If an investor can get higher yields on U.S. Treasury Notes than on comparable German, French, Italian and Spanish bonds, demand may keep our rates artificially low.

The decline in interest rates in 2014 propelled the interest sensitive utility sector to a gain of 24.3%, the best performing sector in the S & P 500. This positive performance did not extend to all the traditionally interest sensitive stocks as AT&T and Verizon had relatively poor years, down 4.5% and 4.8% respectively. We believe that unlike most electric utilities at current prices both of these telecommunications stocks are attractive. Generally, we believe that interest sensitive assets such as utility stocks and bonds in general are vulnerable in 2015. The pace of any increase in interest rates may be modest but we believe the increase will come as the economy continues to improve.

With the realization that there will be major unanticipated factors influencing the markets in 2015 we rely, as always, on valuations. The S & P 500 is trading at roughly 16-17 times estimated earnings for 2015. In the current interest rate environment that seems reasonable. The current dividend yield on the S & P 500 is 1.9% which is just below the 2.1% yield on the 10 year Treasury Notes. Unlike bonds, the stocks in the S & P 500 offer the prospect for both principal appreciation and dividend growth. As 2014 proved, this comparative valuation does not guarantee that stocks will outperform bonds, but we believe stocks offer the better value. We expect volatility in 2015 as the markets adjust to any Federal Reserve rate hikes, oil prices changes and the aforementioned unanticipated factors. We are positive on many domestic stocks and we believe opportunities exist in both foreign developed and emerging markets. Hence, we continue to favor international diversification in common stock portfolios.

We wish you all the very best in the New Year and we deeply appreciate your confidence in Knox & Downing Advisors.

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