SPRING ? April 2015

As Mainers know, spring's eventual conquest of winter is very rarely evidenced by the first of April. This struggle sometimes persists until Memorial Day when we give up on spring entirely and hope for a decent summer. The first quarter of 2015 has been no exception as the brutal winter weather throughout much of the country has impacted our collective psyches, the economy and the stock market. As economists lowered their growth expectations for the first quarter the volatile stock market finished the quarter virtually unchanged.

While the corporate earnings reports of the first quarter of 2015 are a few weeks away, many companies have already given fair warning that the impact of weather in the US combined with the strong dollar for companies with large overseas businesses will negatively impact results. To what extent these issues will influence earnings for the rest of 2015 is debatable as the weather at least, even in Maine, should improve. The strong dollar could be a longer term negative factor for multinational companies. One positive however, as Ned Davis Research points out, import prices have declined significantly due to the strong dollar which will help consumers and help moderate any inflationary pressures in certain goods.

While we usually focus on the earnings of the individual companies in client portfolios it is worthwhile looking at earnings projections for the S&P 500 as a whole to get a feel for the basic valuation of the stock market. At the beginning of the year the consensus estimate for the 2015 earnings of the S&P 500 was roughly $125. At current levels that would give the S&P 500 a Price/Earnings Ratio (P/E) of 16.7 times expected earnings. That seems reasonable in the current interest rate and inflation environment but the $125 estimate may be vulnerable to downward revision as the impacts of first quarter weather and the strong dollar are felt. Also affecting the earnings of the S&P 500 negatively will be the weakness in earnings this year of many energy companies due to the collapse in oil prices.

There may well be positive counters to the negative factors impacting earnings this quarter as the renewed growth of the economy, buoyed perhaps by lower energy costs, results in earnings increases for certain sectors. As the snow slowly melts, growth in GDP should resume at an annual rate of 2-3% for the rest of the year after dipping to 1% or so in the first quarter. Job growth continues to be encouraging and a stronger consumer will benefit a wide range of industries.

One more potential positive factor for earnings growth is one that is also causing a lot of consternation among investors and the financial media; the expected increase in interest rates this year by the Federal Reserve. While the speculation as to when the first increase will come provides limitless fodder for discussion, we think the Fed will act at least by the fall. The impact

Advisory services offered through Knox & Downing Advisors • A Member of Advisory Services Network, LLC • 1040 Crown Pointe Pkwy, Ste 840, Atlanta, GA 30338 • 770-352-0449

of this very modest "tightening" on the markets will be interesting to observe but it seems a Fed rate hike can be tolerated without too much disruption. Rising interest rates could have a positive impact on the earnings of banks and other financial services companies, an important component of the S&P 500.

Observing the clamor over the potential moves by the Fed, we are reminded of an old cartoon depicting former Fed Chairman Alan Greenspan as a matador, standing sword in hand over a dead bull and saying something to the effect of…"Gee, I only stuck him with a quarter point." Given the current volatility of the stock market, when the increase does come we may have a violent reaction. Yet in spite of the market's potential vulnerability, we would prefer the Fed begin the process as that would confirm solid economic growth. A recent Credit Suisse report projected 3 quarter point rate hikes in 2015 to a range of 0.75-1.0% and 4 in 2016 bringing the target rate to 1.75-2.0% by the end of next year. The last tightening cycle by the Fed was from 2004-2006 when rates went from 1.25-5.25%. As we outlined in an earlier newsletter, the stock market may sell off initially when rate hikes begin but generally stocks advance during these cycles.

The bond market, conversely, usually declines during the rate hike cycle as rising interest rates drive down bond prices. Just how much bond prices decline as yields rise is very difficult to predict. Fed rate hikes usually impact short term rates more than longer term interest rates. Examining the historic spread between the yield on the 10 year Treasury Notes and the Fed Funds rate is not much help as the spread has varied widely over the years. Now, with Fed Funds at 0% and the 10 year Notes at 1.90% or so, the spread is 190 basis points. Maintaining the same spread on the Credit Suisse Fed Funds estimates of 0.75-1.0% for 2015 brings the 10 year to 2.65-2.90% and 3.65-3.90% at the end of 2016. However, any predictions on yields based on current spreads is shaky as the spread between the Fed Funds rate and the 10 year Notes has ranged from an average of 62 basis points in the 80's to 190 now according to Econoday. During the last rate hikes in 2004-2006 as the Fed funds rates went from 1.25-5.25% the 10 year Treasury yield moved modestly from 4.15% to 4.76%. Current low interest rates abroad and low inflation may allow for Fed rate hikes without significant damage to the bond market.

As we patiently await spring and first quarter earnings results, we conclude that stocks seem fairly valued on a P/E basis using the admittedly vulnerable 2015 S&P earnings estimate of $125. We believe stocks remain a better value than bonds but we don't expect a debacle for the bond market. We think the economic difficulties of the first quarter will be offset by renewed growth for the balance of the year and we believe the stock market can successfully weather the long anticipated rate hike cycle.

We appreciate your confidence in Knox & Downing Advisors and we welcome your thoughts or questions on any investment matter.

The views expressed here are those of Knox & Downing Advisors and not necessarily those of the Advisory Services Network, LLC. All information contained herein is derived from sources deemed to be reliable but cannot be guaranteed. All economic and performance data is historical and not indicative of future results. The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is not possible to invest directly in an index.

477 CONGRESS STREET, 5TH FLOOR • PORTLAND, MAINE 04101 • OFFICE: 207.523.3494 • WWW.KDA-ASN.COM