Oil Crashed, U.S. Outperformed and Government-Bond Yields Fell

In 2014, oil prices were hit by a perfect storm — increasing production in the U.S., declining demand in Europe, and a surge in the U.S. dollar. During the first half of the year, the price of Brent crude actually rose from $110/barrel, reaching $115/barrel by the middle of June. Prices began to drop in June and the decline accelerated in the fall when the Organization of Petroleum Producing Countries, OPEC, decided not to cut production to support oil prices. Brent ended the year at $57.30/barrel, down 47.6% for the year.

The U.S. economy sizzled in the second half of 2014. Gross domestic product grew at an annualized rate of 4% in the second quarter and 5% in the third. U.S. stocks rose to all-time highs with the Standard and Poor's 500-stock index rising 13.7% for the year. Overseas, it was a different story. European economic growth was flat, Japan fell into a recession, and China's economy slowed down. The MSCI EAFE index lost 4.9% and MSCI Emerging Market-stock index fell 2.2%.

As international markets slowed, investors sought safety in the U.S. dollar and government bonds in the Eurozone and Japan. Strength in the U.S. dollar and higher yields relative to the rest of the developed world also made U.S. Treasurys an attractive investment. Yield on the 10-Year Treasury bond, which began the year at 2.97%, fell to 2.2% by the end of the year.

Stocks: Solid Returns for U.S. Equities

Despite several small corrections throughout the year and almost a 10% dip in October, the Standard and Poor’s 500 stock index, including dividends, delivered a total return of 13.7%. Defensive sectors such as utilities and healthcare were the best performers, up 24.3% and 23.3% respectively, while energy stocks followed oil prices lower and fell 10%. Lower bond yields and stable business models might explain why utilities did so well in 2014. Large company stocks continued to outperform stocks of smaller companies, suggesting that the bull market is maturing. In 2014, the Russell 2000 stock index of small companies rose only 4.9%.
International stocks did not fare as well as U.S. equities in 2014. Japan fell into a recession in the second half and growth in the Eurozone was flat with a number of countries flirting with recession. The dollar rose against both the euro and the yen. With the likelihood of the anti-Eurozone Greek party, Syriza, winning the general elections set for January 25, 2015, European uncertainty also rose in the minds of investors. U.S. stocks were the beneficiaries of this uncertainty. The MSCI All-Country World Index ex U.S. fell 3.9% in 2014. The index of international developed markets’ stocks EAFE fell 4.9% and MSCI Emerging Markets was down 2.2%.

**Bonds: Slowing Growth, Low Inflation in International Markets**

Fears of deflation in Europe; another recession in Japan; slowdown in China, Brazil, and Russia; and enhanced geopolitical risks in the Middle East and Ukraine lead to a drop in bond yields around the world. Deflationary bias persisted in 2014. Eurozone inflation came in at just 0.3% in November and the Consumer Price Index in the U.S. fell to 1.2% with falling oil prices. Six years after the financial crisis, the global economy continues to be hampered by high debt loads.

The Barclays U.S. Aggregate bond index returned 6% in 2014. Foreign investors were attracted by a stronger dollar and higher yields offered by U.S. government bonds compared with sovereign debt markets in Germany, Japan, France, Canada, and the U.K. The German 10-yr closed the year at 0.542%, Japan at 0.326% and the U.K. at 1.759%. The Barclays U.S. Gov./Credit Long index was up 19.3% as falling yields helped longer duration bonds. Corporate high-yield bonds were up only 2.5% due to the fact that falling oil prices hurt the energy sector which made up almost 15% of the index.

Factors that continue to help the bond market include: subdued inflation in the U.S., falling deficits resulting in a reduced supply of Treasurys, lower rates in the Eurozone due to recessionary conditions, and purchases of U.S. Treasurys by foreign central banks and investors.

**Currencies: King Dollar**

The dollar strengthened in 2014 because of a more robust U.S. economy relative to the Eurozone and monetary policy that,
in the second half of 2014, began to diverge from the policies of the European Central Bank and the Bank of Japan. The Federal Reserve ended its quantitative easing program in October of 2014 and suggested rates could move higher in 2015. On the other hand, the central banks of other countries introduced additional easing to help growth and inflation in their economies. The Dollar Index rose 12.5% against a basket of major currencies. The euro fell 12% against the dollar while the yen fell 13.75%.

Commodities: Excess Supply, Stronger Dollar Cause Oil Prices to Tumble
Oil prices were hit by excess supply and slowing global growth. U.S. production has soared to 9 million barrels per day, close to that of Saudi Arabia, due to new technologies enabling producers to access oil trapped in shale-rock formations. U.S. output, as a percentage of global production, rose from 7.5% in 2004 to 9.8% in 2013. As a result, U.S. imports of crude have fallen from a peak of 10.8 million barrels a day in 2005 to just 7.5 million barrels a day in 2014. Even as the U.S. has become an increasingly dominant oil producer, consumption in China and the Eurozone stalled in 2014. According to the International Energy Agency, oil demand growth in 2014 was the lowest of the past three years. As a result of the supply glut, Brent crude prices fell 47.6%. Making the situation worse, the Organization of Petroleum Exporting Countries, OPEC, a group of 12 oil producing nations could not agree on cutting production at its November 2014 meeting in Vienna. Natural gas, diesel, and gasoline prices fell along with crude oil. Their prices were down 31.7%, 40%, and 48.5%, respectively. 2014 was one of the worst years for commodities. The Bloomberg UBS commodity index, which tracks 22 commodities, fell 17% in 2014. This was the fourth year of declines for commodity prices. Driven by droughts, coffee and live cattle were the best performing commodities with prices rising 50.5% and 23.2% respectively.

Outlook 2015
We expect U.S. economic growth in 2015 to accelerate from 2014 levels, boosted by low oil prices and an improving job market, both of which should support consumer spending. Consumer spending is almost 70% of the U.S. economy, and savings at the pump should enable consumers to spend more on food, eating out, clothing, and other discretionary items. Despite strong economic growth and an improving labor market, we believe that inflation will remain fairly muted. There remains significant slack in the labor market, the economy’s output gap is still quite large and oil and other commodity prices have dropped over 17% in 2014. This suggests that there is room for more growth before inflation begins to build.

With U.S. economic data improving, we expect the Federal Reserve to begin raising interest rates in the second half of 2015. The European Central Bank and the Bank of Japan, on the other hand, are expected to continue on their paths of easy monetary policies to combat modest growth and deflationary conditions in their respective economies. We expect the dollar to continue to strengthen relative to the euro, the yen, and other major currencies.

While we expect the Fed to begin raising interest rates in the second half of 2015, the Fed has also said it will “be patient” when moving to higher rates. The Fed’s favorite measure of inflation reading — the personal consumption expenditure index, recently hit 1.4%, well below its target of 2%. We do not expect a marked rise in interest rates any time soon. A stronger dollar and U.S. interest rates that are higher than those of other large economies such as Germany and Japan will continue to
attract foreign investors to the U.S. bond market. We favor fixed-income portfolio durations that are neutral, if not slightly long, relative to an investor’s benchmark.

Low rates and low inflation should persist in 2015. While the Fed will begin tightening, other central banks such as the ECB, BOJ, and China’s central bank will continue to have a large role. This is an environment that favors risk assets such as stocks and high-yield corporate bonds. We prefer U.S. equities. A broadening recovery, stronger dollar, and lack of any major issues should continue to attract foreign buyers. Within the U.S., we like the technology and consumer discretionary sectors, which should benefit from stronger economic growth and low oil prices. Many countries in the Eurozone face recessions and the ECB should take the sort of bold actions taken by the Fed. However, it is hamstrung by internal politics. Japanese stocks should also do well, but the country needs structural reforms to create a sustainable recovery. Emerging market stocks, currencies, and local bonds will be hurt by the stronger dollar as the Fed begins to raise rates.

Low oil prices may be with us for a while. U.S. oil output keeps rising, and subdued global growth weighs on demand. It may take a long time for the global glut of oil to shrink. While new capital spending will be curtailed, existing production will not slow until prices reach a level where it becomes unprofitable to pump oil from existing wells, or when existing wells begin to dry out. Current oversupply is estimated to be 2 million barrels per day.

We would also be underweight in commodities. A stronger dollar, slowdown in China’s economy, and excess supply are not good for commodities. China is dealing with its own real estate credit bubble and an economy that is slowly transforming from investment spending to consumer spending.

Key risks to our outlook:
Eurozone Uncertainty – polls indicate that the anti-Eurozone party, Syriza, is very likely to come to power in Greece. While we do not expect Greece to exit the Eurozone, we do believe that Syriza will attempt to renegotiate the terms of the country’s debt. This will raise the level of uncertainty in the Eurozone and potentially hurt risk assets.

Economic Risk – should oil prices fall to levels where pumping shale-oil from existing wells becomes unprofitable, not only will capital spending fall, but many of the high-paying jobs created in the U.S. will be lost.

Earnings Risk – low oil prices hurt S&P 500 earnings as the pickup from consumer and transportation stocks may not be sufficient to overcome the earnings decline from energy and industrial companies. A stronger dollar will also hurt earnings of large U.S. multinationals that have operations overseas.

Geopolitical Risk – emanating from potential action by Russia. The Russian economy faces a severe recession due to sanctions imposed by the West and the fall in energy prices. Putin’s popularity in Russia remains very high and there is a possibility that he will become even more aggressive with Ukraine and some of the other neighboring countries.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs, Northern Trust, Bloomberg, Factset, Morningstar