Making Sense of Finance

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Fourth Quarter Review

STOCK MARKET

Investors in the U.S. stock market able to withstand the usual ups and downs were rewarded for the most part with gains in all the major stock indexes last quarter. The Nasdaq composite lead the way for the fourth quarter and the year with increases of 5.4% and 13.4% respectively. The S & P 500 and Dow Jones Industrial Average lagged slightly (fourth quarter increases of 4.4% and 4.6% respectively), primarily due to declines in energy related stocks. Last quarter was the eighth quarter of advances in the S & P 500, the longest rally since the 14 quarters of increases that ended in 1998. Oil prices continued their dramatic decline in the last few months and by December many investors looked upon this drop as detrimental for all stocks, not just the energy related. Dividend yields persisted at the 2% level for the S & P 500 index, as companies continued with their dividend increases in the fourth quarter. And why not give back to the shareholders? Net income margins are at a record high for many companies (S & P 500 index net margin hit a high of 10.1% in the last reported quarter).

The energy sector was the worst performing stock group in the fourth quarter (-11 %) and in 2014 (-10%). These stocks reacted to the shocking plunge in oil prices (decrease of over 40% last quarter). Oil and gas drillers and equipment and services providers were particularly hard hit. Within the energy sector, oil and gas refiner stocks held up the best with barely any change in the last quarter. In relationship to the stock market as a whole, it appears that price movement in oil and stocks are sometimes positively correlated (move in same direction) and sometimes negatively correlated (move in opposite directions). It is hard to decipher a pattern, so the recent market reaction can be considered expected or not. Healthcare, consumer staples and REITs (real estate investment trusts) were among the better performing sectors in the fourth quarter.

Foreign equity markets continued to fare worse than our domestic market last quarter as most developed European and Asian markets posted declines in U.S. dollar terms. The MSCI EAFE (measured in U.S. dollars)

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Everybody and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice focuses more on making sensible and prudent choices based on logic and experience, not emotion.

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index had a loss of 3.9% in the fourth quarter and 7.4% for the year. European countries shared renewed recession concerns and the region pinned their hopes on stimulus measures by the European Central Bank. Japan's stock market had a strong quarter in local currency terms, but not so good when translated into U.S. dollars as our dollar continued to strengthen the last three months of 2014. Emerging markets did just as poorly last quarter and for the whole year. In particular, the Russian and Greek stock market had horrendous double digit percentage declines during the fourth quarter. Russia's was due to the swift drop in energy prices. Greece's market issues are due to the same old problems that have plagued Greece for the last few years: uncertainties regarding remaining with the Euro, paying off sovereign debt, maintaining an austerity program; all this within a backdrop of major political divisions on the direction of the country. The rest of the European Union, however, views this as not as serious a problem as it was a few years ago.

BOND MARKET

Overall bonds continued to make gains in the fourth quarter with the exception of high yield (below investment grade) bonds which lost 1% last quarter and only had a small gain for the year of 2.5% according to the Barclays High Yield Index. The Barclays Aggregate Bond index, which is a measure of investment grade quality U. S. government and corporate bonds, gained close to 2% in the quarter and 6% for the year. The end of bond buying by the Federal Reserve did not seem to affect the bond market as there was still no lack of demand. Coming into 2014, many would not have predicted U. S. Treasury yields to fall, let alone a decline of 87 basis points in the 10 Year Treasury, which closed the year at a yield of 2.17%. This proved to be a pleasant surprise for those wishing to refinance their mortgage.

Municipal bonds had the best performance among bonds last year with a total return of over 9%, reversing the loss of the previous year. This sector also had a positive return last quarter with the yields on these non-taxable bonds almost equivalent to taxable bonds. A lack of supply of new issues and large inflows into municipal bond funds contributed to their increase in price.

OUTLOOK

We still think there is potential upside in the equity markets. Several factors could help spur continued growth in the economy and stock market, including low interest rates, a recovery in the rest of the global economy, rich balance sheets and reasonable valuations for stocks. As cited earlier, operating profit margins are near record highs, which suggest that S&P 500 companies are fairly lean in operation. This has been achieved without great revenue growth, implying that further margin expansion could occur if growth picks up. As optimistic as we are, a decline in the economy or stock market for any number of reasons is still possible. Investing is of course a process over years, not months.

The drop in oil prices can partially be attributed to the strong dollar (Oil traded in $ USD). The reverse effect occurred throughout most of the decade as the dollar declined in value relative to other currencies. This is simply a reflection of the strength of the U.S. economy versus the rest of the world; a good thing. We attribute the rest of the decline in oil prices to slight differences in supply and demand, but mostly from mindless financial speculation, in our opinion. The short-term benefit of lower prices are more funds in consumer pockets and the weaning of weak players in the oil and gas industry. Our view is that the pros and cons of low oil prices will mostly offset each other. Furthermore, the price move is mostly artificial due to OPEC (Organization of the Petroleum Exporting Countries) which is purposely producing oil above their quotas which may not be sustainable over the long run.

The long-term outlook remains unchanged for fixed-income securities. Near record low interest rates persist and may do so for many years, but an eventual increase in rates is inevitable making long-term bonds less attractive and short-term bonds only good as a substitute for cash.

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