Market Monitor*	1-Year Annualized	3-Year Annualized	5-Year Annualized
Barclay's Global Aggregate Bond Index	(3.66)	(0.21)	2.31
Barclay's Municipal Bond Index	6.61	4.07	5.09
FTSE All-World Stock Index	6.11	11.44	9.54
Bloomberg Commodity Index	(27.04)	(11.53)	(5.71)
FTSE/NAREIT Global REIT Index	16.06	12.83	12.08
HFRX Global Hedge Fund Index	0.36	2.81	1.14
U.S. CPI – Unadjusted	(0.08)	1.04	1.62

*As of March 31, 2015

Each January, we join the parade of market observers reflecting on the year just passed and pontificating on the year ahead. We admit to this being a rather futile exercise; every year certain forecasts may materialize, but to attempt to predict economic and market outcomes with regular success can prove to be a fool's errand. Forecasting the exact growth profile of a nearly $75 trillion global economy with over 7 billion people engaging in trillions of transactions is a daunting exercise with a wide distribution of expected outcomes to the right and left of consensus, which is inevitably wrong on most occasions. The odds of predicting the ending value of any particular market index are equally long.

Forecasting a precise growth rate for a global economy of 7 billion people engaged in trillions of transactions is a futile exercise

Given the monumental task associated with predicting exact levels of economic growth or precise market returns for any given calendar year, we prefer to identify the forces in play that may exert the greatest influence over the direction and general level of markets and economies. We believe that understanding the underlying influential factors is a more reasonable endeavor and the exercise that contains the most value for long-term investors. Markets tend to vacillate with the natural ebb-and-flow of economic conditions, particularly relative to expectations, so properly identifying the forces that will likely exert the greatest influence should increase an investor's probability for success.

During 2015, we expect most markets to exhibit relatively higher levels of volatility than has occurred in recent years. The following is a list of 10 observations that may contribute to greater anxiety among investors. They are some of the forces that we expect may influence the direction and general level of markets and economies as we proceed through the year.

We attempt to identify the forces in play that may exert the greatest influence over the direction and general level of markets and economies

1. Extended periods of low volatility are dangerous as they lull investors into believing that market risks have dissipated. We have spent much of the last seven years in the Age of the Central Banker, a period during which extraordinary monetary policy accommodations and quantitative easing programs have suppressed volatility. The printing presses have filled financial markets, large and small, domestic and international, with excess cash that has overwhelmed the supply of market opportunities and forced the prices for all risk assets higher.
2. Central Bank policies will begin to diverge in 2015, a reflection that regional economic growth trajectories have decoupled from the synchronous globalization that markets had grown accustomed to. The ECB and BOJ will both respond to sluggish conditions in the European Union and Japanese economies, respectively, by introducing further easing measures. In the United States, the Federal Reserve will need to respond to a strengthening economy by transitioning away from the emergency programs used over the last seven years. The advent of higher interest rates is likely only months away and history has demonstrated that prolonged periods of cheap and easy money can create all sorts of mal-investment that are, often painfully, revealed when normal market forces reassert themselves.
3. Higher interest rates are a good thing. There will be much written about the effect higher interest rates will have on the U.S. economy and the financial markets as we near the Fed's first rate hike. There will be great hype and it will be covered as if it is an historic event, but it is not. Higher interest rates resulting from faster economic growth that brings with it more investment, consumption, employment and profits are always better than low interest rates and

Markets are likely to react to diverging Central Bank policies with increasing levels of anxiety and greater volatility weak growth. Will financial markets need to digest the monetary policy change? Of course, but we should welcome higher rates that result from economic strength.

Stocks will move higher in 2015 if corporate profits live up to expectations

4. Economic growth does not automatically imply higher stock prices. Corporate profits are what drive stock prices, and companies today collect profits from all corners of the globe. Some of those regions are growing quite nicely while others are not. Further, competition for profits is fierce and margin expansion becomes more difficult as a business cycle matures. We expect 2015 profits to be higher than 2014's, but the price that investors are willing to pay for a share of the profits, the P/E ratio, will not automatically expand further. The conditions for economic growth are an important determinant of the market's P/E level, but focus should be on the level of corporate profits as the primary driver of returns for shareholders in 2015.

Investors should be students of history when it comes to currency crises

5. Currency prices have moved sharply in recent months. Money tends to follow economic growth and interest rates and we expect both of these to trend higher in the United States in 2015. The Asian Crisis of 1997 that led to the collapse of Long Term Capital Management in 1998 was started by a rapid decline in the value of the Thai Baht. Investors should be students of history and resist any temptation to be complacent about currency collapses in far away places. The consequences of these events tend to reverberate through all financial markets in some fashion.

The decline in oil is a temporary transfer of wealth from producers to consumers

6. The 50% decline in the price of crude oil over just a six month period is a significant event. While a barrel of West Texas Intermediate (WTI) crude may fall below $50 in the near term, we expect these low prices to have limited duration and are more likely to settle at higher levels by year end 2015. The gap between global demand and global supply is slight, suggesting that the steep price declines are being caused by an alternative force beyond the greater productive capacity of U.S. shale. Regardless of cause, the collapse, even if short lived, will be devastating to certain countries, companies and sections of the financial markets. Investors will need to watch the fallout carefully, as the consequences often play out in unexpected places. In the meantime, the transfer of wealth from producers to consumers will be a powerful force for economic growth. Yardeni Research suggests that the 50% fall in oil prices since last summer has added $1.5 trillion of stimulus to global oil users.

7. Geopolitical events are often sideshows that distract investors. They are important to pay attention to, as they can become significant market forces, but separating noise from signal is critical. Consider the slide of asset prices that coincided with Russia, ISIL and Ebola during early October. Imaginations can run wild and media outlets are happy to elevate the frenzy. Markets eventually clear the smoke to reveal the size of the actual fire, and history suggests that geopolitical events tend to ebb-and-flow, creating significant noise that investors should mostly ignore until an inflection signal is actually apparent.

8. Confidence in Washington is exceptionally low, and most have little expectation that 2015 will bring much change. But the stakes for 2016 are extremely high, both parties needing successes to tout, and that may be incentive enough for portions of legislative agendas to be pushed through this year. Compromise on corporate tax reform may be possible, and a repatriation tax holiday for U.S. companies would be a huge boost for stocks.

The U.S. expansion is getting long-in-the-tooth but will not end in 2015

9. Now entering the sixth year of an economic expansion in the U.S., history would suggest that the current expansion and corresponding bull market for stocks is getting long-in-the-tooth. That doesn't mean it is over, but it is a word of caution that we will find ourselves in recession again at some point, and that time is probably closer in the future than it is further from the past. Investors do not need to run from this, but they should be prepared for its inevitability. Recession is likely to occur when consensus is least expecting it.

10. Finally, there is a good chance that last year's laggards will become this year's leaders. This is true among asset classes and can often be the case with sectors and individual securities. We have generated the common "Periodic Table of Investment Returns" using 10 asset class breakdowns and tracking them over the past 20 years in calendar year increments. We suspect you will find the seemingly random location of the colored boxes amusing. But the exercise also highlights the point that it is difficult to know which asset classes may perform best in the coming year based on how they finished the previous year.

Our list is certainly not complete, nor will all of these forces necessarily exert themselves over the next twelve months. However, the set of observations serve to influence our range of expected outcomes for markets and economies.

BASELINE

- A weaker 4Q14 will give way to improving global economic conditions as 2015 progresses, led by U.S. strength and aided by European stability
- Energy prices will end 2015 higher but offer significant stimulus at current levels for consumers of oil around the world
- Growing corporate profits will offer stock investors average returns with P/E multiples stagnant in the U.S. while expanding in certain international markets
- Central Bank policies will diverge, bringing higher anxiety and volatility to most markets
- Bond returns will be poor relative to historical averages

BULL CASE

- Monetary stimulus and cheap energy help Europe exceed recovery expectations
- Global stability provides a bid for commodities and Emerging Market currencies
- Stocks react to better-than-expected economic growth by moving higher, particularly outside of the U.S. where valuations are depressed and expectations are low

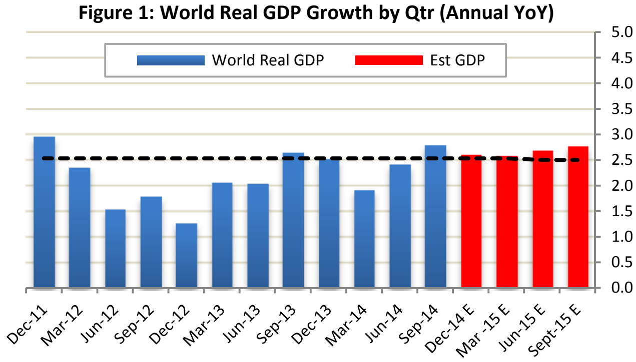
BEAR CASE

- Europe and Japan re-enter recession and drag China toward a credit crisis with broad international implications
- Deflationary pressures mount and spread globally, driving yields toward zero and boosting global bond returns
- Weaker growth pulls stocks lower on reduced profit picture

Despite a fairly steady stream of mixed headlines throughout 2014, investors in broadly-diversified portfolios fared reasonably well. When measured against a very weak inflation environment, the expansion of purchasing power within portfolios was downright solid. As the "Periodic Table of Investment Returns" illustrates, Real Estate Investment Trusts (REITs) were the clear performance leaders, but most risk assets participated with positive, albeit more modest, returns. Commodities, led by the significant decline in oil, were the primary outlier, falling for the fourth year in a row.

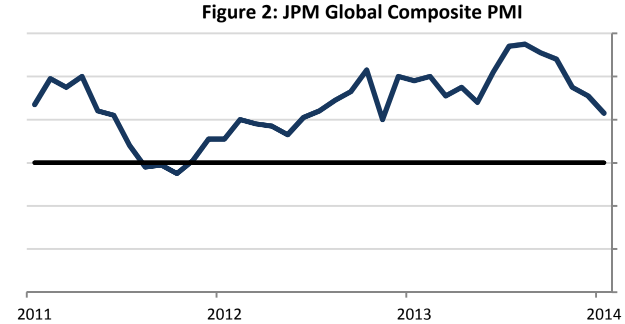
Overall, global growth improved during 2014, but was subpar relative to historical averages and not much better than previous years. By region, the United States overcame a weak 1st quarter to post strong GDP growth during the 2nd and 3rd quarters. Conversely, Europe experienced weaker-than-expected growth and Japan faltered under its Value Added Tax (VAT) hike implemented earlier in the year. Emerging markets also disappointed, as growth rates, particularly from commodity-producing regions, were below expectations. Our BASELINE Outlook for 2015 generally supports the consensus view (Figure 1), anticipating marginally better growth as the year progresses, and we again expect the U.S. to be the relative bright spot.

Figure 1: World Real GDP Growth by Qtr (Annual YoY)



Source – Bloomberg

Figure 2: JPM Global Composite PMI



Source – Markit

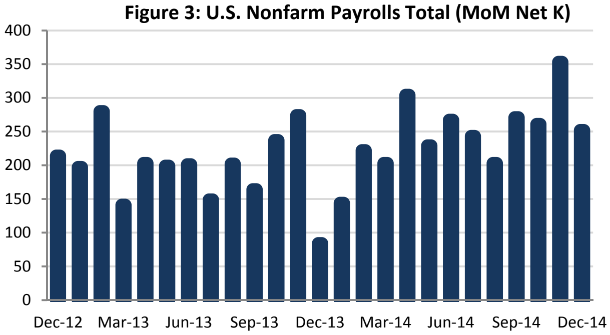
After posting reasonably strong global GDP in the 3rd quarter, business surveys have softened over the course of the year's final three months, suggesting global growth has slowed as we head into 2015, challenging the consensus view. As regular readers know, the set of monthly regional Purchasing Managers Index (PMI) surveys is our favored leading indicator as it comes with a long history of measuring economic activity in nearly real time. The JPM Global Composite PMI (Figure 2), points to a gradual loss of momentum that we ascribe to the natural back-and-forth movement of economic activity and seasonal adjustments. At a reading of 52.3, global economic growth is soft but it does not suggest an impending crisis and is certainly not sufficient demand destruction to justify the collapse in oil prices. In fact, with cheaper oil set to boost demand, we expect global growth to accelerate as we move through the New Year. The significant decline in the price of oil is particularly positive for net oil importers and high-energy users, like the U.S., continental Europe, Japan, China and India, which in aggregate account for the majority of global economic output. On the other hand, large producers that are dependent on oil exports, such as Russia, Brazil, and OPEC nations will suffer, at least temporarily.

We remain optimistic regarding the absolute level of economic output that should occur in the year ahead and assign a sizeable probability to our BASELINE Outlook. Despite softer data points of late, the U.S. economy is poised for escape velocity. Consumers are getting stronger aided by a solid labor market (Figure 3) and the retreat of energy prices (Figure 4). According to the Bureau of Labor Statistics, the U.S. economy added nearly 3 million jobs in 2014, bringing the unemployment rate down to 5.6%; for those with college degrees, the unemployment rate is a slim 3.2%. There are clear trends emerging in the labor markets in response to the Affordable Care Act and other vagaries in the data that may overstate labors strength a bit, but we are expecting upward pressure on wages to emerge in 2015. Consumer confidence is at cycle highs, home prices are higher, energy prices are lower, all of which have been catalysts for stronger consumer spending, historically. Private business investment appears likely as highlighted by three statistics: small business sentiment is at cycle highs, capacity utilization has crossed above the critical 80% level, and inventory builds are moving higher – a classic signal of business confidence. Add strong auto sales and reasonable residential and commercial construction to the mix and the aggregate level of economic activity is positive and the breadth is expanding. Even government spending, at both the federal and state levels, is shifting to be a moderate tailwind. In our view, the only detraction from U.S. Real GDP growth will come from the rise in the $US Dollar, the effect of which will be to pressure exports.

While pessimism over European growth is a prominent sentiment, we are cautiously optimistic that consensus may be overly cynical and underestimating conditions that could spark moderate economic revitalization. The European impact of sanctions imposed on Russia may be underappreciated and the timing is unfortunate for a continent already struggling for growth. But nobody has been hurt more by the collapse of oil than has Russia, and stability in that region may yet prevail should Putin succumb to international, and now domestic, pressure. Europe could benefit from four catalysts in the coming months: (1) the ECB will implement forms of quantitative easing; (2) low energy prices support household and fiscal budgets; (3) a weaker Euro currency stimulates exports; and (4) if sanctions against Russia were to be lifted, Europe will be a huge beneficiary. This isn't to suggest Europe has a clear path to cure what ails it as the structural and demographic problems are significant. But meandering growth is better than outright contraction, and the aforementioned catalysts could be enough to support improving stability.

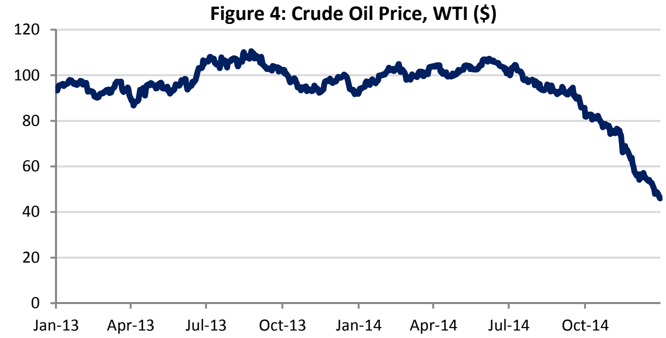
Other major economies have not been particularly rosy either, but Japan will be aided by continuing reforms, a weaker currency, quantitative easing, and cheaper energy. China's growth may slow further still, but remains one of the fastest-growing economies in the world. In fact, slower growth may help to reduce the risks of asset price bubbles and excessive credit growth within China. India has perhaps the greatest opportunity and stands to be one of the largest beneficiaries of lower oil prices. As mentioned previously, those countries that rely on the production and export of oil and other raw materials will find some tough sledding in 2015. Russia and Venezuela are atop the list, but much of Latin America falls prey to this condition, as do Canada, Australia, Norway and much of the African continent.

Figure 3: U.S. Nonfarm Payrolls Total (MoM Net K)



Source – Bloomberg

Figure 4: Crude Oil Price, WTI ($)



Source – Bloomberg

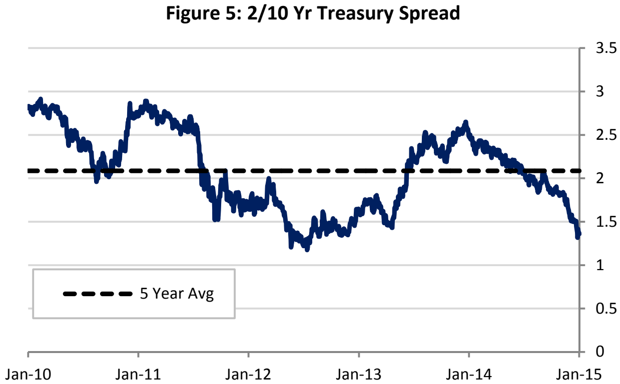
If our BASELINE Outlook is correct, that global economic conditions will improve slightly in 2015, then interest rates are set to rise in the United States where economic growth will be strongest. We believe that the rise in the value of the $US Dollar and collapse in oil prices are direct responses to this eventuality. The decoupling of growth rates and divergence of central bank policies will cause plenty of dislocations and anxiety, much of which will be misinterpreted at the surface. For example, the spread between the yields of the 10-Year and 2-Year U.S. Treasury Notes (Figure 5) has confounded many participants who have expected yields for both maturities to rise. But the declining 10-Year Treasury yield reflects capital flows that are influenced by declining yields on foreign counterparts like the German Bund (currently offering just 0.50% yield-to-maturity), while the 2-Year yield is anticipating the Fed raising short term interest rates. It is a good example of the powerful counter balances that can exist within the global financial system and the complex set of relationships among and between markets. From these levels, we expect bonds to perform poorly relative to their long-term history.

The ascent of stock markets over the past few years, in particular the U.S. market, has been driven by modest earnings growth and significant multiple expansion (Figure 4). A loose monetary policy, where Central Banks are increasing money supply within the economy, is a condition in which investors bid up stock prices in anticipation that expanding corporate profits will follow. From here, we expect U.S. stock returns to resemble earnings growth while P/E multiples peak in the face of changing Federal Reserve policy. Certain international and emerging markets, where we expect Central Banks to increase money supply more aggressively, are more apt to experience P/E multiple expansion. Weaker local currencies will be a tailwind for corporate profits and provide an opportunity for some of these international stock markets to outperform in 2015. Overall, stocks do not look overly expensive relative to the corporate earnings that are expected this year; if profits come to fruition, high single digit stock returns are likely. We emphasize, however, that the diverging monetary policies we expect from central banks are likely to increase the volatility of all markets, particularly stocks.

Finally, those who have followed us over the past dozen plus years know that we have emphasized the importance of an Investment Policy Statement process that is thorough in its drafting and revisited regularly. The exercise establishes an appropriate asset allocation structure containing a broad set of asset classes that compliment the investor's overall balance sheet. We have crafted our "Periodic Table of Investment Returns" that accompanies this note and is available on request. The point can be immediately recognized - asset class performance varies significantly from year-to-year, and supports our belief in the merits of diversification as a way to reduce the overall volatility of an investment portfolio.

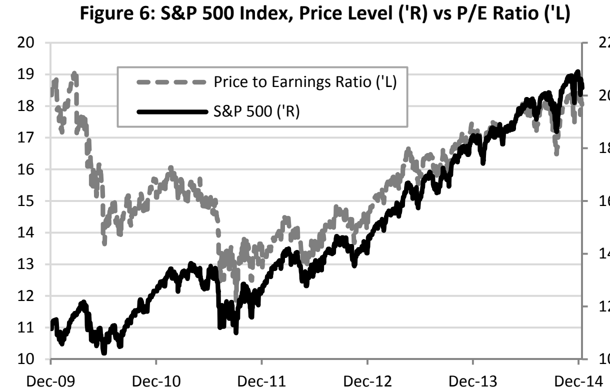
Acknowledging the unpredictable nature of markets and economies, especially in an age of rapid information availability and movement (leaving aside its reliability), leads us to two of our most important points to investors as we enter 2015. The first is liquidity management, and specifically, the importance for all investors to understand what their liquidity needs are likely to be over the next few years and the approximate timing of those needs. We expect financial markets to become more volatile in the years ahead, thereby placing a premium on proper liquidity management. The second is time horizon and patience. Higher levels of volatility are dangerous for the investor that requires regular cash flows and has not adequately established a liquidity-management strategy. But for the investor with the appropriate time horizon and the patience to ride through downward pressures, upward volatility can be taken advantage of in the pursuit of real capital appreciation.

Figure 5: 2/10 Yr Treasury Spread



Source: Bloomberg

Figure 6: S&P 500 Index, Price Level ('R) vs P/E Ratio ('L)



Source: Bloomberg

We have generally been cautious about global growth and the fundamentals of the global economy over the past five-plus years. The sub-par growth experienced during this period is evidence of the structural challenges facing many countries post the 2008 financial crisis. Many of our concerns remain over the longer-term as sovereign debt levels have not been addressed in key developed economies, and where demographics are becoming an increasing challenge to possible solutions. In the nearer term, we have identified a list of forces that are likely to determine the direction and general level of markets and economies, and specifically note that higher volatility is likely to accompany the interpretation and reaction to decoupling growth rates and diverging central bank policies. Recession is not something we fear in 2015, and we are optimistic that the U.S. economy may finally be reaching escape velocity, a condition that will have some spillover benefit to other regions as well. We have not been anticipating the stimulus of dramatically lower energy prices, and while we expect the commodity slump to be somewhat temporary, lower prices should certainly add to the world's economic growth trajectory. We are students of history and recognize that the current U.S. expansion is likely extending into its later innings, but the momentum across a broad set of categories suggests this cycle has further to go.

We are grateful for the opportunity to share our perspectives on the markets and, as always, we welcome your questions and comments.

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