ISSUE 7 | VOLUME 3 | JANUARY 2015

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

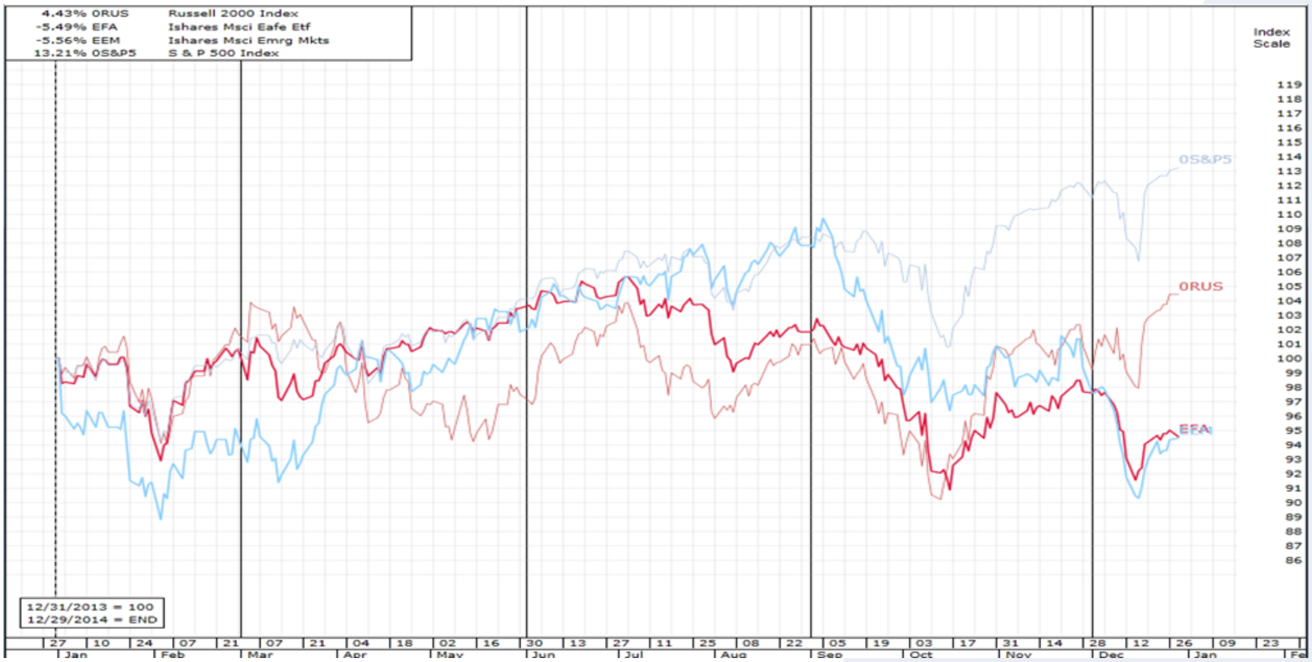
2014 – The Year Stocks Struggled?

With the S&P 500 logging 53 all-time highs this year, and the Dow 39 of its own, one couldn't be blamed for thinking stocks shot through the roof. While not the best year, the 13% return for the S&P 500 ranks this year 27 out of the last 63. Not too shabby at all, especially on the back of the 30% return for 2013, which ranked 6.

However, the success of large U.S. stocks wasn't shared across all equity asset classes. Small company stocks in the U.S. as measured by the Russell 2000 index returned a paltry 4.5%, while foreign stocks outright struggled. The European MSCI EAFE index and the popular MSCI Emerging Markets index were both off about 5.5% (-5.5%) for the year. If your "aggressive" portfolio was invested in U.S. stocks then you were happy. A portfolio of stocks in anything but most likely left you disappointed.

In fact, for such a respectable year for the S&P 500, a broadly diversified portfolio of stocks would have left you with a much lower return of somewhere around 5.5% including dividends. For the less aggressive, a portfolio spread out across both stock and bond categories would have yielded a return in the neighborhood of… wait for it… 5.5%. So whether you leaned more in the conservative or aggressive direction this year, your outcome would have been similar if you were properly diversified. Even with unprecedented efforts from central banks around the globe to encourage risk-taking and prop up risk assets, there was still plenty of demand for traditionally safer bond investments in 2014 as economic, political, and structural issues abound.

As you can see from the chart below, it wasn't a smooth ride from January through December. Volatility, which had been conspicuously missing from markets over the last few years began to reappear. In August, October, and December, stocks wavered and although the 10% correction we're long overdue for by historical standards didn't materialize, there were small signs of panic, which when it comes to stocks, is perfectly normal and what we would consider a good thing. For the last three calendar years, the S&P 500 is up 66% compared to an average three year return of 27.6% over the last 63 years. No matter how encouraging the next round of economic data is, that's not sustainable. The only other two periods of time in the last 60 years where we've seen similar market returns over a 3 year period (in the U.S.) were the mid 50's and late 90's where the economic landscape was quite a bit better than at present. In contrast to the markets recent disregard for risk due to Central Bank accommodation, what we started to see in 2014 was volatility creeping back into the picture – potentially a questioning as to the efficacy of Central Bank intervention. This made for some ups and downs, and that's encouraging. The longer the market goes straight up, the more unsuspecting investors will be hurt when it snaps back to a more normal, sustainable state.



Quick Take: It was a solid year for U.S. stocks of big companies, an okay year for some bonds, and a poor year for most foreign stocks.

2015 – The Year Ahead

Every time we hear or read a prediction from an "expert" on what the market holds for 2015, it's nearly always the same – high single digit returns for the S&P 500 and higher interest rates for bonds. Most professional prognosticators are required to pick their number then back it up with rationale. In most cases, the rationale is very similar which is why more than one "guesser" arrived at a similar number. Or is it that they arrived at the same rationale after randomly selecting a number that seemed a safe bet? Whatever the case may be, the number always seems to be a very average, safe bet that's influenced quite a bit by the mood of the day.

Not that we're exempt from such criticism, but the odds are that the market delivers something very different than what's being projected. After all, if the stock market averages 9% per year, it's a series of numbers that are both bigger and smaller that help us arrive at that average – some much bigger and smaller. Given the randomness of markets over shorter periods of time – one year definitely qualifying – predicting the events that drive markets higher or lower than the average is nearly impossible. Thus the safe bet and the only real way to preserve one's reputation from year to year is not to stray too far from the middle. This tendency was demonstrated recently where, according to Business Insider, the average of 14 professional estimates for the S&P 500 in 2014 was just under 6% and in 2013, a smidge under 8%. The actual performance of the index thus far for 2014 is 13% and 29.6% for 2013. One could let 2014 slide, but 2013 is the perfect example of a year that just can't be predicted.

Quick Take: It's really hard to predict what the market will do over a one-year time frame. Getting it right usually means you just guessed well.

All the variables are in place to make 2015 an unbelievable year—unbelievably great if the current liquidity-fueled rally keeps its steam; unbelievably bad if the ill effects of excess liquidity rear their ugly heads and markets revert back to their historical norms. Another possible outcome is that it could it could end up being a pretty average year after all the ups and downs - although we doubt it. Our sense is that we'll experience something outside of the norm given how markets are currently valued and how many "abnormal" variables are at play that can drive volatility back into the markets over the coming months. We're not going to pick a number for the S&P 500 or interest rates - that would be pointless. What we will say is that stocks continue to look very expensive to us and are by no means a sure bet, even if the Fed does seem to have our backs. Sooner or later stocks will get cheaper, and most likely much more so than they are now. The environment we're in is artificial, the necessary fiscal re-tooling that created the tech bubble fourteen plus years ago still hasn't been allowed to take place, and systemic risks are building. The party will continue until it stops abruptly because there were too many people gathering on the back deck. The deck will break, people will get hurt, and we'll all be talking about the clear warning signs in retrospect. This isn't a new script.

As for interest rates, just because they're low doesn't mean they can't go lower. As we observed in our October 2014 letter, Japan's rates have been below 3% for roughly 20 years as a result of incessant deflation. If what we're witnessing now are in fact global deflationary pressures as a side effect of the record-setting 30 year build-up in global debt levels, our rates could move well below the current 2.2% on the 10-year Government Bond. After all, Germany's comparable bonds are yielding .55%, Japan's .33%, and even Spain and Italy's bonds are yielding 1.67% and 1.95% respectively. The factors at work here are two-fold: 1) Central banks are buying lots of government bonds while large domestic banks are being incented to do the same resulting in lower rates; 2) Deflation is currently taking place across Europe and to a lesser extent, the rest of the world making lower rates much more tolerable. If prices aren't rising or are going down, you don't need to earn much on your money to get ahead. If central banks don't succeed in creating inflation, low rates could be here to stay so long as nations don't default on their debt. While that's a real possibility, rates would probably stay low for the less fiscally distressed creating a bifurcated yield environment. The low yields on most developed countries bonds compared to the recent spike in Greek bond yields is a good example of how quickly the pendulum can swing.

If growth in the U.S. manages to buck the global trend and continue accelerating in a lasting way, then we could see rates trend higher. However, unless the rest of the world follows suit, low global bond yields would most likely keep U.S. interest rates from rising too high. From an investment perspective, the world is much flatter than it used to be. Investors have a choice between Japanese, German, and U.S. bonds when building their portfolios. Given the options, when considering both yield and safety of principal, most would continue to find U.S. Government bonds a very compelling option in a stable dollar environment. That demand puts a ceiling on longer-term interest rates.

Markets Look Forward

One of the arguments for a continuation of the stock market party into next year is the economic data. With GDP growth picking up to a robust 5% in the third quarter from negative growth in the first quarter, the trend looks good. Recent PMI Index data from the Institute of Supply Management also looks very strong. The PMI index looks at five parts of the economy in an effort to gauge overall health; new orders, inventory levels, production, supplier deliveries, and employment. The November reading of 58.7 was well above the 50 level which indicates expansion. In fact it was even well above the long term average reading of 53, which would indicate an economy that's thriving. Although there are plenty of

Americans who would argue the accuracy of this index, relying too heavily on the data for your investment decisions going forward can be perilous. Markets tend to rise in anticipation of the good data, so once it starts showing up, it may be time for investors to move on. There's a great quote that pertains to this situation: "When you have the price you don't have the proof, and when you have the proof, you don't have the price". Well, the proof is starting to roll in, but unfortunately the price just isn't that good.

When we look at PMI data as far back as 1955 relative to the direction of the stock market, we see an interesting relationship. When the PMI index is really strong (as indicated by a reading 1 standard deviation from the average), the average return over the next 12 months for the S&P 500 is just 2.7%. On the other hand, when the number is relatively weak (one deviation below the average), the average return for the following 12 months is a much more robust 15.4%. This may be one of the better examples of how markets tend to look ahead when evaluating economic conditions. Even more important is how it may be suggesting we interpret these solid economic numbers everyone's getting excited about. We should always root for economic prosperity, but basing investment decisions solely on it is another matter.

If Not The Economy, Then What?

Price. It's that simple. The best answer would be to invest according to what the economy is most likely to do 12-24 months from now, but since we don't have that crystal ball, the only prudent way to play it is by looking at price. Besides, not having the crystal ball may not be such a bad thing since market activity actually affects the economy directly anyhow. In other words, when the stock and bond markets are rising, wealth is being created and this new wealth gets dispersed throughout the economy. That after all, is the Fed's principal strategy and what it's banking on. On the other hand, if markets are falling, the destruction of wealth and the aversion to risk-taking has a direct negative impact on the economy. So weighing investment decisions more heavily on price rather than future economic activity may not be a concession at all.

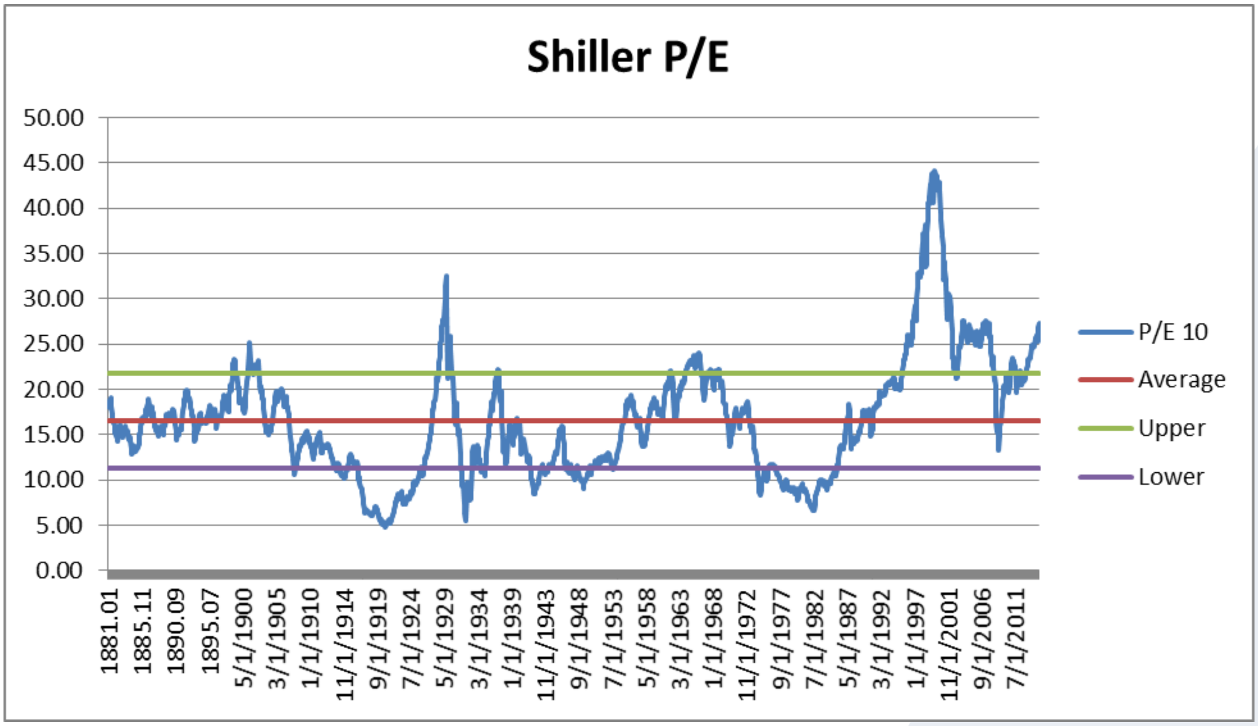
Price

There are a number of ways to assess the price of the stock market as a whole. The most ubiquitous is the Price to Earnings ratio, which as we've written about previously, has its flaws. Because it requires us to either look backward at earnings or guess what we think they'll be going forward, the results can be misleading. We prefer gauges that eliminate any bias imparted by the economic cycle, because as we know, that cycle can change rather quickly. The two we've found to be most reliable over long time periods are the Schiller CAPE and the Stock Market Capitalization to GDP methods.

Robert Shiller of Yale University founded a method of valuing the stock market against an earnings stream that hasn't been influenced by the most recent business cycle. He did this by taking the average of the last ten years of earnings for the S&P 500 and adjusting them for inflation. He then divided the price of the S&P 500 by these earnings leading to a P/E ratio free of any cycle bias. To believe in this approach requires one to believe in the natural and healthy cyclicality of business, economic, and market cycles. There are good times and bad times. If things expand, then they must also contract – nothing can expand forever. Not an inch worm, not an elastic, not ones mood. Nothing. Believe in these natural laws, and you'll likely find the Schiller method valuable.

What we notice when looking at the Shiller P/E chart below is that we're right back to where we were at the height of things in 2007. If you remove the mega tech bubble that was 1999-2000, we're in rarified air relative to what we've seen the last 130 years. The average Shiller P/E over that timeframe is about 16.5 compared to where we are today at over 27! Historically, these are not good times to invest in stocks.

Quick Take: We're paying way more for stocks today than we normally do. It's like paying $165 dollars for a pair of shoes rather than $100.

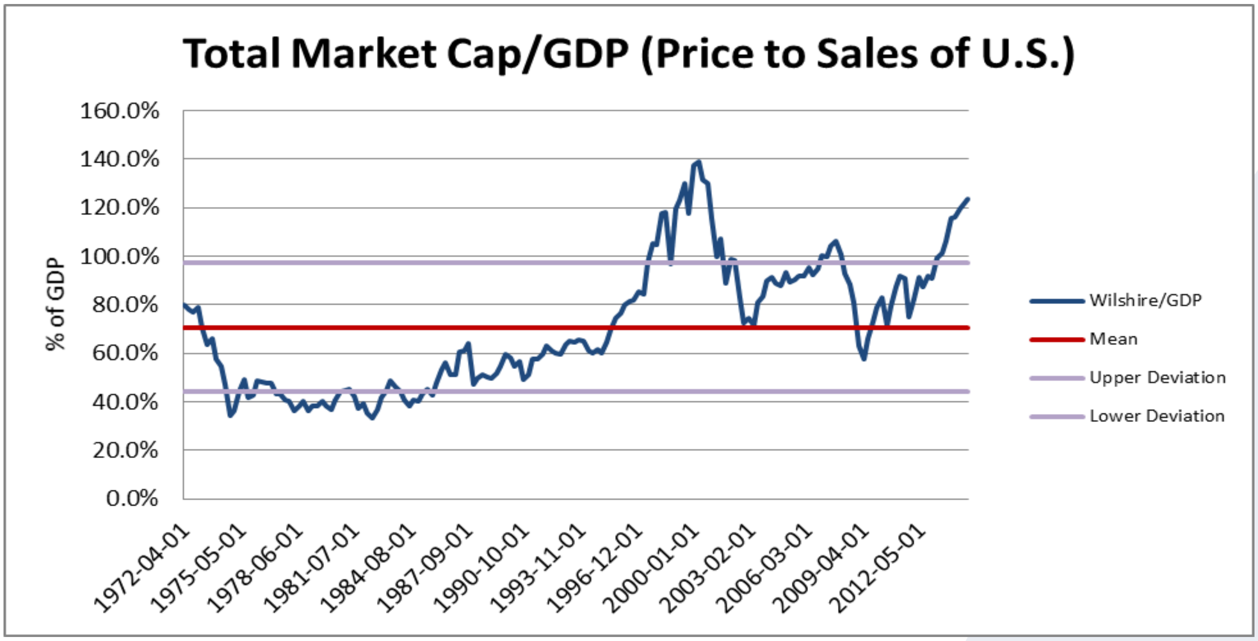


When we look at the other market gauge, coincidentally the one favored by the great Warren Buffett, we can draw a very similar conclusion. Here we take the overall value of the stock market and divide it by total economic output. The result is very simple. It tells us how big the stock market is relative to the economy. If the economy's booming and companies are doing equally well, then the line will be flat from left to right. If stocks are growing faster than the economy for too long a period, then the line slopes up and to the right, and we have a problem. To believe in this metric, one must believe that companies (that comprise the market) can't grow faster than the underlying economy indefinitely. For short periods of time, sure, but indefinitely, no. I liken this to an endurance athlete. All of us have a given physiology that allows us to compete up to a certain level of potential. Most of us will never reach this full potential, but endurance athletes train their bodies relentlessly in an effort to meet it. They build their cardio fitness, strength, and mental toughness. In response to the targeted training they're placing on their bodies, adaptations are made over time to help the body achieve its potential. At the end of all this conditioning, an athlete is capable of maintaining a certain speed or pace over a long period of time.

If a runner can maintain a 6 minute per mile pace, then any time spent running faster will be time borrowed from later in the run that will have to get paid back. Going out too hard will mean running out of steam later on down the road. It's really that simple. Push too hard to get faster by losing too much weight or overtraining and you'll get slower. Every athlete has encountered this. It feels so logical that it would yield better results that you stick with it even though the measurable evidence suggests otherwise. It usually takes a complete and total body breakdown to regain your sensibility. Markets are not different in this regard. They can push and push. Employers can cut costs and lay off employees in an effort to get leaner and "faster". This will work for a while, until the larger economy (body) is left weak and dragging as a result of the relentless stress it's taken on in pursuit of quick gains. Taking on too much debt in an effort to juice earnings or returns is similar to borrowing speed from later in the run. The economy can only deliver so much potential return to the market over longer periods of time.

What we can see from the graph below is that our stock market still appears to be borrowing from future performance. There may be a lot to pay back.

Quick Take: The stock market has grown way faster than the economy over the last six years. At some point, either the economy has to accelerate significantly to catch up or the market has to come back down.



A Word on Oil

Speaking of deflationary pressure and markets looking ahead, the price decline in oil is something that bears watching. The magnitude of the drop has been stunning. Light Crude Oil for February delivery dropped from over $100 per barrel in late June to under $54 at present. There's no question that a good portion of the decline could be attributable to oversupply due to the increased production of oil here in the United States. This is a great thing for the average Joe in the short term, no question. However, what may also be at work here is some concern about the demand for oil due to a global slowdown. Regardless of why, the fact remains that markets have taken a significant amount of value out of oil over a very short period of time, which is deflationary. This bears watching as it could be the proverbial canary in the coal mine relative to other capital markets and the global economy.

In addition, any time a large commodity or asset class moves this dramatically, it has the potential to expose systemic vulnerabilities and/or create knock on effects. As an example, if a large bank or hedge fund had too large a position (or leveraged with borrowed money) in oil, that could mean game over for that particular institution creating a very uneasy and uncertain environment in which to operate. There's certainly precedent for this, whether it be the Russian debt crisis and Long Term Capital Management in 1998 or the subprime CDO mess and the banks in 2007 and 2008. Again, this bears watching.

Quick Take: Low oil prices are good for us as consumers – they mean cheaper gas and potentially cheaper products if the cost savings get passed down to us from the companies making stuff. The downside is that the low prices may be a reflection of a slowing economy just around the corner. Time will tell.

Here's How We Plan for 2015…

The market's had a great run and although it could run higher, we continue to be very guarded heading into 2015. Thinking globally, when considering the huge amounts and continued accumulation of leverage in the financial system, demographic trends around employment and consumption being week, and monetary policies being accommodative for a good duration of time, we see abnormally high potential for market instability. This has the potential to generate persistent deflationary pressures which along with any type of flight to quality in the event of a systemic or market shock, can serve to keep rates low for much longer than people think. This could help to support longer term, high quality bond prices even though they continue to look very expensive.

Further, this natural deflationary cycle the economy and markets are trying to work themselves through (much to the disapproval of global central banks) is long overdue to take place. The visual that comes to mind is trying to hold back a wall of water. Well we've been holding up the wall for the last 15+ years and the water continues to build. At some point, the natural law of cycles will likely win out. The fact that stock and bond markets are at historically high valuations will likely serve to turn what would otherwise be a natural tidal shift of water into more of a surge. In our June letter, we discuss the magnitude of the eventual pullback in stocks. Suffice it to say that given the market's higher level now, that pullback would be even larger. Timing is always the hard part, but given the potential magnitude of loss when things turn, when it happens isn't as important as taking precautionary steps now. Making portfolio adjustments in the middle of a cycle change is very difficult to do. We often can't identify the turn until we're able to look back at it objectively.

Our guidance at this point is to avoid chasing returns and resist that natural urge to feel as though you've missed out. There's always an investment category you can point to that's done better than you, it just so happens that the most visible of all categories has had the spotlight the last couple years. High quality bonds, cash, and low volatility alternative investments are investments we like. High yielding bonds, stocks, real estate, and most commodities are categories we are very distrusting of. It doesn't mean you shouldn't own them. What it does mean is that you need to have a strategy in place that limits your exposure to them either right out of the gate or as we progress through 2015. There's nothing wrong with low yielding investments if their objective is to preserve principal on a temporary basis. Active management is also something that is much more important at this stage of the bull market. Part of your game plan should probably be to employ managers who also have a game plan. As we discussed in our November letter, a good portion of your investment success assuming you don't fall asleep at the wheel for 20 years at a time, is having a well thought out plan of action before things get exciting.

So we enter 2015 with even more squints and winces than we had in 2014. The markets may well make it through with positive returns if the powers that be (global central banks) continue to hold the water back. However, if the weight of that water finally overpowers the arms holding up the wall, this may well be one of those years that the "experts" weren't even close to getting right.

Quick Take: Now may be a good time to be even more conservative than you ordinarily would be. Things are expensive, the world is crazy, and there's a very good chance that most investments will be cheaper down the road. This doesn't mean you shouldn't invest, it just means you may have to invest differently. Markets that go up and down create opportunity. We look forward to more of this in 2015.

Key Takeaways:

- Expect volatility to creep back into the picture in 2015. As the central bank experiments get longer in the tooth and global economies continue to struggle, markets could start to lose faith. This could translate both into bigger market declines as well as sharper subsequent rallies as central bankers start throwing every tool they have and then some at the world's problems in an effort not to be wrong in the end.

- Markets have not gotten any cheaper over the course of 2014, but rather more expensive. Historically, these are very dangerous times to invest in stocks and a more conservative stance would likely be wise.

- Active management should play a larger role in this type of environment. Whether it's with traditional mutual funds or alternative investments or strategies, part of your game plan should be protect principal against large losses on the downside while pursuing the returns necessary for long term goals. Avoiding large losses when they're most likely to occur can give you a significant long term advantage.

Important Disclosures

This newsletter is provided for informational purposes and is not to be considered investment advice. Cadence Wealth Management, LLC, a registered investment advisor, may only provide advice after entering into an advisory agreement and obtaining all relevant information from a client. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

CADENCE
WEALTH MANAGEMENT