ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT INSIGHT

4th Quarter Review

Positive Momentum in the U.S. but Global Headwinds Remain

Despite several periods of elevated volatility, equity markets posted impressive gains in the fourth-quarter. Concerns over flagging global growth, the possibility of higher interest rates in the U.S., external geopolitical uncertainties, and the dramatic fall in energy prices were trumped by strong economic data and solid corporate earnings results. The S&P 500 Index advanced by 4.4% in the quarter. The Federal Reserve concluded their Quantitative Easing program in October and despite the end of the Fed's bond buying support, fixed income markets posted positive quarterly returns with the Barclays U.S. Aggregate Bond Index advancing 1.8%. Foreign stocks continued their streak of underperformance, with the MSCI EAFE (developed international equity benchmark) posting a 3.9% decline in the final quarter of the year.

The U.S. economy continued to move in the right direction in the fourth-quarter and ended the year with positive momentum. Hiring surged in November as employers added 321,000 jobs, crowning 2014 as the strongest year for job growth since 1999. The unemployment rate dropped to 5.8%, its lowest level since mid-2008. In December, third-quarter GDP was revised to show the U.S. economy expanded at a 5% pace, its fastest rate of growth in over a decade. Consumer confidence rose to the highest level since 2007. Strong corporate earnings announcements also helped to underpin the equity rally as third-quarter earnings expanded at a respectable 7.6% year-over-year growth rate. While we are encouraged by the strength in the domestic economy, we are cognizant that current equity valuations reflect optimistic assumptions for continued economic expansion and corporate earnings growth and don't leave much room for disappointment.

While the U.S. economy appears to be heading into expansion mode, the rest of the world is struggling with deflationary headwinds. Europe's sagging economy shows the risk of entering their third recession in the past seven years. Japan has officially entered into recession territory with two consecutive quarters of GDP contraction. The Chinese economy grew at its slowest pace since the global financial crisis last quarter. Given the significant contribution of foreign-sourced profits to U.S. corporations, even a domestic focused equity portfolio is not totally insulated from persistent global economic weakness.

Oil prices continued to slide in the fourth-quarter and have declined by more than 50% since peaking at over $100 per barrel in June. The decline in energy prices can be attributed to a number of factors including increasing domestic shale production, a strong U.S. dollar, as well as OPEC's decision to avoid production cuts. While the plunge in oil prices is causing stress on energy producers and oil exporting nations, the consumer should benefit in the form of rising disposable income. Citigroup recently projected that lower energy costs bring a $900 average windfall for each U.S. household. In December economists at the International Monetary Fund raised their 2015 global growth forecasts based on lower energy prices.

Consistent with the full-year trend, interest rates declined slightly in the fourth-quarter. Weak global growth, low inflation and falling commodity prices have kept interest rates contained. Divergence in central bank policies has been a factor in keeping U.S. interest rates anchored. While the Fed has signaled its intention to start the process of normalizing interest rate policy in mid-2015, global central banks are aggressively attempting to stimulate their economies by lowering interest rates. This divergence is evident in differences between yields on 10-year U.S. Treasuries at roughly 2.15% and yields on 10-year German and Japanese bonds at a whopping 0.5%. This relative value has resulted in significant demand for U.S. Treasuries from foreign investors.

We remained at maximum equity exposure for the vast majority of the quarter and we enter 2015 with the same stance. This positioning is reflective of our positive economic outlook and our view that equities represent a more attractive value proposition than alternative options such as fixed income and cash.

While the U.S. equity market is more expensive on a valuation basis than global equities, we feel this premium is justified given decelerating growth rates in developing economies and our expectation that the domestic economy will continue to outpace the rest of the developed world. At present, valuation discounts in international equity markets are not significant enough to entice us to reduce our dramatic overweight to U.S. stocks. Avoiding dedicated foreign equity exposure was extremely beneficial to our performance results in 2014 as the S&P 500 Index advanced by 11.4% while developed international stocks declined by over 7% and emerging market equities fell by over 4.5%.

We made no significant changes to our fixed income allocation in the fourth-quarter. Given the low interest rate environment and the Fed's intention to begin to gradually raise interest rates later in 2015, we see little reason at this time to take on meaningful duration risk by notably increasing the average maturity of our fixed income holdings.