COMMENTARY 2014 Q4

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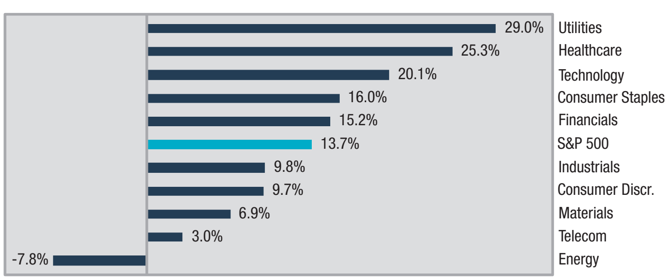
During the quarter, equity markets experienced higher volatility. After retreating almost to its January starting point in the first two weeks of the quarter, the S&P 500 abruptly changed course and rallied 10.5% to end the year at 2,058, nearly an all-time high. Volatility seems to be back up to levels we have not experienced for a few years. Commodities, including oil, experienced a significant correction, which should ease the inflationary pressures that the Federal Reserve has been watching closely. Although not robust, U.S. economic growth continues to be stronger than that of most of the world. We continue to position portfolios for modest economic growth, although we expect volatility to remain elevated as the Federal Reserve shifts its position from providing unprecedented levels of support to instead looking to raise interest rates from current low levels.

The S&P 500 Index gained 4.9% on a total return basis for the quarter and was up 13.7% for 2014. From a sector perspective, the Utilities and Consumer Staples sectors led the way this quarter. The Energy sector was down 10.7%, significantly underperforming the index. For 2014 as a whole, the Utility, Healthcare and Technology sectors were the strongest. Energy stocks were leading the market in the middle of the year but ended the year as the weakest sector.

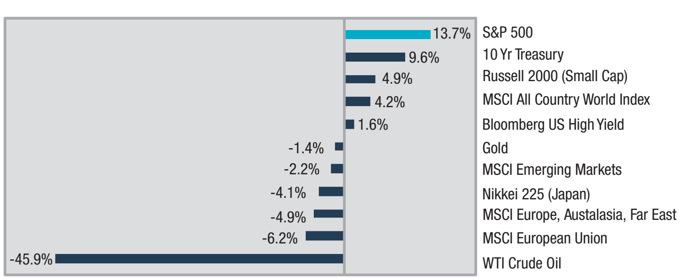
Figure 1: 2014 Performance by Sector



Source: Bloomberg. Data as of 12/31/2014.

From a broader perspective, the S&P 500 has continued to outperform most other market segments. Crude oil saw a decline of 41.6% during the quarter and is now down significantly for the year. Most European markets underperformed the S&P 500 during the quarter and for the year.

Figure 2: 2014 Performance by Category



Source: Bloomberg. Data as of 12/31/2014.

The Year in Review

We entered 2014 with a view that the economy would continue to improve and that this improvement would eventually translate into higher earnings growth for many companies. After a harsh winter that caused the economy to contract temporarily, the economy as defined by Gross Domestic Product (GDP) rebounded, and growth surprised to the upside in the second and third quarters. Real GDP growth is expected to be 2.3% in 2014 and 3.0% in 2015—not robust, but still the envy of most European and other developed economies around the world.

We focused on companies with top-line revenue growth, since we thought the incremental benefit from a low interest rate environment would be subdued going forward. For the S&P 500 as a whole, revenue is expected to grow 6.7% in 2014 and 5.7% in 2015. According to consensus estimates, about 75% of this growth is expected to come from three sectors: Healthcare, Technology, and Consumer Discretionary. We have had healthy weightings in these sectors all year, with many companies growing at a faster rate than the index.

One of the biggest surprises this year was the decline of European interest rates, to all-time lows in some cases. We noted in our third-quarter commentary that the yield on the 10-year German Bund, the equivalent of the 10-year U.S. Treasury, had dropped to the lowest level since Napoleon's defeat at Waterloo in 1815. Amazingly, yields dropped even further in the fourth quarter, and the 10-year German Bund now yields 0.54%. Deflation is once again the main fear in Europe. Although the Fed ended its quantitative easing program, the European Central Bank and the Bank of Japan announced plans to increase the size of their balance sheets, given the ongoing threat of deflation in their economies. Lower interest rates abroad and the threat of deflation have resulted in U.S. interest rates decreasing during the year, which has been a surprise for many investors.

The other big surprise this year was the significant correction in the price of many commodities—including oil, steel, copper, and iron ore—and other emerging markets. The price of oil was cut in half, from $107 a barrel this summer to a low of $53 in December. We noted in our third-quarter commentary that oil production in the U.S. had increased by 42% since 2011 and that the U.S. was on track to surpass Saudi Arabia as the world's largest oil producer by 2020. Interestingly, if Saudi Arabia had decided to cut its production quota at the OPEC meeting held on Thanksgiving Day, the U.S. could actually be producing more oil than Saudi Arabia today. OPEC did not reduce production, and prices have dropped 28% since then. For now, production remains elevated compared to demand, and most major producers continue to drill. Officials in Saudi Arabia have indicated that their economy can survive at least two years with low prices, thanks partly to the kingdom's $750 billion in foreign exchange reserves. Many OPEC countries do not have the same balance sheet strength and require much higher oil prices to balance their budgets (Figure 3). It has become a dangerous game of chicken for many oil-producing countries.

Figure 3: Estimated Oil Price Needed to Balance 2014 Government Budgets for OPEC Nations

Source: Libyan Government, Angolan Ministry of Finance, International Monetary Fund, Arab Petroleum Investments, Deutsche Bank.

Outlook for 2015

As we head into 2015, we continue to position portfolios for modest economic growth. We believe that the economy will continue to grow, given an improving employment picture, increasing wages for many workers, lower commodity prices and inflation, higher consumer confidence levels, and a healthier manufacturing sector. This positive backdrop should translate into higher revenue and earnings growth for many companies.

U.S. employers added 321,000 jobs in November—the best monthly gain in almost three years—while the unemployment rate held steady at 5.8%. Civilian wages and salaries are showing some of the biggest gains since 2008. Consumer confidence remains at levels we have not seen since before the financial crisis.

In the beginning of 2013, we identified a number of catalysts that could drive further improvement in the economy: a resurgence in U.S. manufacturing; an upturn in capital expenditures; and improved household, corporate, and bank balance sheets finally being put to work. These catalysts continued to drive improvement this year, although our fourth catalyst—continued improvement in the housing market—has been slower to materialize than expected, primarily due to weakness in the number of first-time homebuyers. As the economy continues to improve, some of the factors working against the first-time homebuyer should abate.

The consumer, who represents about 70% of the U.S. economy, is employed, getting a raise, and feeling fairly confident. At the same time, inflation indicators continue to move lower, driven primarily by lower oil prices and weakness overseas. The national average price for a gallon of gasoline fell to $2.62 in December, a five-year low. Although a lower oil price is a negative for many energy producers, it is typically viewed as a positive for the majority of companies in the S&P 500.

We, along with the Fed, continue to monitor growth, employment, and inflation closely, but given the recent weakness in inflation indicators, the Fed may be slow to raise interest rates. For now, the market is anticipating the first increase in the federal funds rate in June to 0.25%. We expect the Fed to move at a slower pace than the consensus and believe low interest rates should continue to support the consumer, the mergers and acquisitions environment, and the economy.

At the same time, we expect volatility to remain elevated in 2015. With the market facing a change in Fed policy, to be implemented by a fairly new chairwoman, we may see markets become more volatile for a period of time. Given this potential volatility, we have favored larger companies that have less financial leverage and tend to be more domestically focused.

We are also aware that this is now one of the longest bull markets in history. As this bull market matures, our investment team is focused on the indicators below (Figure 4), which have in the past provided early warning signals of markets becoming overheated. While a few of these indicators are currently shaded yellow or red, signaling a degree of caution, most other indicators continue to be benign.

Figure 4: Indicators vs. Prior Bull Market Peaks

Indicator	Reference Data	Current	2007	1999	Zone
Inflation	PCE Price Index	1.6%	2.5%	1.4%	
Economic Growth (GDP)	Expansion from Prev. Peak	12.7%	15.3%	38.8%	
Duration of Economic Expansion	Quarters of Expansion	24	21	41	
S&P 500 Total Return During Cycle	Return - Bottom to Peak	241%	121%	546%	
Valuation	S&P Forward P/E Ratio	17x	18x	27x	
Interest Rates / Trajectory	Fed Funds Rate	0.00%	4.25%	5.50%	
Wage Growth Pressure	Peak Hourly Wage Growth	2.5%	4.2%	4.4%	
Corporate Balance Sheets	Ratio Debt/Equity	1.1X	2.1X	1.9X	
Mergers & Acquisitions	Total Transaction Value	$1.4T	$1.3T	$1.2T	
Initial Public Offerings (IPOs)	Total Issuance Value	$87.7B*	$118.9B	$79.6B	

*Includes $25B Alibaba (BABA) offering

Source: Bloomberg, U.S. Bureau of Economic Analysis. Data as of 12/31/2014.

Course of Action

During 2014, we increased our exposure in the Technology and Healthcare sectors. We reduced our exposure in the Consumer Discretionary sector, which has been one of the leaders in this bull market, but we continue to have significant exposure there. We continue to find compelling opportunities in these sectors, and many companies in these groups offer attractive, above-market growth rates.

We have examined our exposure in the Energy and Industrial sectors and have adjusted where needed. We believe the Energy sector is likely to remain volatile for a while, and we have reduced or eliminated positions in companies that we believe are not well structured for this environment. Our exposure in the Industrials sector tends to be in more domestically focused companies due to concerns about slower growth abroad and currency fluctuations.

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