

Market Review

International stocks led in the first quarter with Europe, Japan, and China posting especially strong gains. U.S. stocks were also positive, with smaller caps outpacing larger caps, and growth beating value. Some of the quarter's big-picture themes included global central bank policy, the strength (or lack thereof) in economic growth, U.S. dollar dominance, and the ongoing decline in oil prices.

Starting first with the United States, overall the U.S. economy appears to be in pretty good shape and on a positive uptrend. However, various forces have clouded the economic picture at least over the near-term. Some of these forces are temporary (e.g., harsh weather in the Northeast), but others, such as the rising U.S. dollar and the decline in oil prices, could have spillover effects on the broader economy.

Index Returns

Through 3/31/2015

Index	QTD	YTD	Annualized Returns		
			1-Year	3-Year	5-Year
S&P 500	0.95%	0.95%	12.73%	16.11%	14.47%
Russell 2000	4.32%	4.32%	8.21%	16.27%	14.57%
MSCI EAFE	4.88%	4.88%	-0.92%	9.02%	6.16%
MSCI All Country World Index	2.57%	2.57%	5.02%	10.93%	9.25%
MSCI Emerging Markets Index	2.24%	2.24%	0.44%	0.31%	1.75%
Barclay Capital US Aggregate Bond	1.61%	1.61%	5.72%	3.10%	4.41%
Barclay Capital Municipals	1.01%	1.01%	6.62%	4.05%	5.11%
Dow Jones UBS Commodity	-5.94%	-5.94%	-27.04%	-11.52%	-5.71%
HFRI Fund of Funds Composite Index	2.53%	2.53%	5.39%	5.39%	3.52%

The stronger dollar is dampening export growth and has already prompted a spate of downward earnings and revenue estimates. And, while the decline in oil prices is a positive for U.S. consumers, it will weigh heavily on energy companies, their earnings, and their willingness to spend on new projects and hire additional workers.

All of these issues complicate the outlook for U.S. economic growth and are among the factors that the U.S. Federal Reserve has to weigh as it contemplates raising interest rates. The Fed's March statement took the much-watched step of removing the word "patient" from the official text, yet Chair Janet Yellen continues to suggest the Fed will exercise exactly that quality as it moves toward its first rate increase and considers the pace of subsequent hikes. Markets appeared to take the Fed's update to mean rates would remain low, potentially into the fall.

Meanwhile, other major central banks are expanding their support, with Japan in stimulus mode and the European Central Bank the latest entrant to the mix. The ECB announced a quantitative easing program in January and launched its bond buying in early March. European stocks rallied during the quarter on the hope that this stimulus would have a similar effect in Europe as it has had in the United States. For U.S.-based investors, strong local-equity returns in international stocks were largely offset by currency movements due to an appreciating U.S. dollar.

In emerging markets, China's growth continued to slow even as the government undertook monetary stimulus measures including changing reserve requirements and cutting rates. Nonetheless, emerging markets in aggregate were positive.

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On the fixed-income front, with a pronounced lack of competition from other developed-market bonds, U.S. Treasuries continue to look relatively appealing even with a 10-year yield below 2%. This factor, along with investors' sense that the Fed might be slower to scale back its accommodation, helped government bonds to their fifth consecutive quarterly gain.

Investors' search for yield has helped support returns for both investment-grade and high-yield corporate bonds as well. Floating-rate loans, which tend to do well when rates rise, had a very strong quarter as investors girded for future rate hikes.

The strength of the dollar is a significant force affecting the economic landscape. The dollar has appreciated 23% over the past 12 months. Moreover, based on the concept of purchasing power parity (PPP), the dollar may have overshoot its longer-term fundamental value relative to the basket of other major currencies in the dollar index. The converse is true as well—other currencies may have undershot their fair value versus the dollar.

There are several cross currents from the rise in the dollar in terms of its impact on both the real economy and financial markets. On the positive side, a strengthening dollar reduces the cost of imported goods and is also

associated with falling oil and commodity prices that are priced in dollars on the global market. This will tend to depress domestic inflation—a positive result unless an economy is at risk of a deflationary spiral, which the United States is not. All in all, these things benefit U.S. consumers, increasing their purchasing power and leaving them more money available for spending (or saving). A stronger dollar also tends to attract more foreign investment. To the extent this foreign capital flows into U.S. Treasury bonds or corporate debt, it helps keep interest rates lower, and it may also support higher U.S. stock prices. All of these factors are reasons why investors cite the stronger dollar as another reason for optimism about U.S. stocks. However, a dollar that is too strong is not necessarily good for U.S. stocks, as investors start to weigh the negative impacts more heavily. So far this year, the daily correlation between the dollar and U.S. stocks has been negative.

On the negative side, a stronger dollar has a negative impact on U.S. exports, U.S. manufacturers, and U.S. multinational company profits. And by also making imported goods more attractive it typically leads to a worsening of our trade deficit. This has a negative effect on overall economic growth, because GDP is defined as the sum of consumer spending, investment spending, government spending, and net exports. Also, from a dollar-based investor's perspective, a rising U.S. dollar hurts foreign asset class returns as they are translated back into dollars from weaker currencies.

All of these impacts are reversed for the investors, consumers, and economies whose currencies are depreciating versus the dollar. The negative currency translation effect creates an immediate negative impact on dollar-based returns. Most active international stock managers typically do not try to hedge against this translation risk as they don't believe they have an edge in predicting currency movements, so they are doubtful they would add value to client returns over time from doing so. While they rarely hedge currencies, our international managers do



The DXY Index constituents include Euro (57.8%), Yen (33.8%), Pound (11.9%), Canadian Dollar (8.1%), Swedish Krona (4.2%), and Swiss Franc (3.6%). Data as of 3/17/2015. Source: Bloomberg L.P.

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consider potential currency impacts as part of their fundamental, company-specific analysis and valuation. For example, they say that over the medium term a weaker currency should begin to positively impact the profit margins and earnings of foreign companies that do business globally. We have recently been adding indexed currency hedged positions to our international allocations to dampen this negative currency translation.

Asset Class Views and Portfolio Positioning

U.S. Stocks— It is important to acknowledge that the current bull market is quite advanced, now entering the 7th year of its advance when measured by the S&P 500 from its March 2009 low. It currently represents the 3rd longest bull market in the past 85 years. Our five-year outlook for U.S. stock returns is subdued when compared to international stocks. This reflects our view that (1) corporate earnings are above their long-term “normalized” trend; and, (2) stock market valuations are also above normal. We question whether either trend is sustainable but that’s not to say that the U.S. markets won’t continue to be more enduring given the accommodative Fed policy, low inflation, and potential for an improved housing market. Thus, the U.S. market still has the potential to advance but its long term opportunities seem less attractive on the whole.

Profit margins are a key driver of earnings and earnings growth. History has shown that high profit margins are negatively correlated with subsequent five-year earnings growth (i.e., foretell lower future earnings growth). We don’t think this time will be different. We believe margins and earnings growth will come down from their current levels and revert toward their longer-term norms.

In addition to the natural forces of competition, a big reason profit margins are likely to decline is from increased labor and wage costs, which have yet to really kick in. Another factor is the sharply rising dollar, which, as we highlighted earlier, is hurting the profits of U.S. multinational companies.

We seem to be seeing this impact already, as earnings-per-share estimates for the first quarter have dropped sharply to a 5% year-over-year decline, compared to the positive 4% growth that was expected for the first quarter at the beginning of the year. The plunge in oil prices, which hurts earnings for energy companies specifically, is also a significant driver of these negative results.

Our second concern regarding U.S. equities is valuation. We measure valuations in a number of ways and across many different metrics, and they all tell pretty much the same story: U.S. stock valuations are elevated. While valuations are not a good short-term market indicator—overvalued markets can get even more overvalued for a while—history shows that high valuations are a deterrent to future long-term returns, which is our focus.

If our view on earnings is correct, we’d expect a meaningful market correction at some point but of course cannot pinpoint exactly when. All else equal, we would view such a decline as an opportunity to shift some capital back into U.S. stocks (which at that point should be offering attractive return potential commensurate with their risk).

European Stocks—Moving to developed international stocks, and Europe in particular, our top-down asset class view is almost a mirror image of the United States. Unlike in the United States, where we see high profit margins, earnings growth, and valuation multiples, in Europe we see

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earnings that are below trend and relatively attractive valuations.

Over the next five years, we think European stock market earnings growth will be higher than the market is currently expecting, and more in line with its long-term trend, as the economy recovers and companies benefit from operating leverage, cost cutting, and the weaker euro currency. We also believe European stock market valuation multiples will at least be in line with their longer-term norm, consistent with an economic and earnings recovery. This makes for an attractive asset class to invest in relative to U.S. stocks. As such, we are at or near a full weighting to international/European stocks in our portfolios.

Emerging-Markets Stocks - Our top-down analysis for emerging-markets stocks is similar to Europe, in that their valuations look attractive and earnings appear to be depressed relative to our longer-term expectations. Of course, emerging markets face some unique risks, which we have discussed frequently in past commentaries. These include most prominently:

- 1) The potential for a sharper-than-expected economic slowdown in China, as the authorities try to gently deflate their infrastructure/credit bubble and engineer a transition to a consumer-led economy.
- 2) The potential negative contagion effects from the impact of continued strong dollar appreciation on the high levels of dollar-denominated debt on emerging-markets companies' (and some governments') balance sheets.

Today, as we weigh what we believe are the most likely scenarios, the upside in the more neutral or positive scenarios is significant and therefore, we maintain a full allocation to emerging-markets stocks in our portfolios.

Investment-Grade Bonds—With the U.S. core bond index yielding only 2%, any reasonable interest-rate or macro scenario implies very low returns over the next five years. There is no refuge to be found looking to core bond markets outside the United States either. In Europe, the comparable index has a yield of only 0.5% and almost a third of European government bonds actually have negative yield-to-maturity, meaning investors who hold these bonds to maturity are locking in a certain loss.

We think there are relatively more attractive—and more durable—options within pockets of the bond market, and we've tilted the portfolios to take advantage of these. Specifically, we have increased the allocation to active funds that have significant flexibility to manage their interest-rate risk as well as other risk exposures. The funds' much lower duration means they face less of a negative price impact from rising interest rates. Our investments in floating-rate loan funds will actually benefit from rising rates, and their higher yields provide a head start in terms of their multiyear total return potential.

Concluding Comments—As market prices, valuations, and fundamentals change, our views and positioning may change. We expect (rationally so, we believe) that markets will be volatile in the future. And when market prices and underlying asset values diverge due to the inevitable and enduring cycles of investor herd behavior driven by greed and fear (or excessive optimism and pessimism), our disciplined, patient, tactical, long-term investment approach will be in prime position to take advantage of those cycles.

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