Quarterly Newsletter

MV FINANCIAL

Fourth Quarter Review: Return of the Pullback

There is a certain quality of *déjà vu* to the opening days of 2015. Just three months ago, as we were preparing our commentary for the quarter ended September 30, global equity markets were trading sharply in a context of falling energy prices and rising concerns about Europe's economic challenges. Fast forward to January and we have…well, stock prices well off their recent highs, still-falling energy prices and nervous eyes focused on the upcoming election in Greece that some fear will lead to a Greek exit from the Eurozone. Volatility is back, and with it the frequent pullbacks that have been missing for most of the last three years. In the course of Q4 the S&P 500 experienced three significant pullbacks: the big one in October that nearly crossed into 10% correction territory before rebounding strongly, and then two back-to-back retreats of more than 4% each in mid to late December.

The pullbacks weren't enough to shake the markets off their winning ways, though. The S&P 500 earned a total return of 4.6% for the quarter, seeing out the old year with double digit gains for the third year in a row (13.7% was the final count). Consumer stocks got something of a tailwind as households appeared inclined to take their savings from lower gas prices and boost their holiday spending. Utilities and healthcare extended their 2014 outperformance into the year's final weeks. Investors made several runs at bargain-basement rallies in energy and other resource plays, but the continued freefall in prices made for stiff headwinds. The energy sector was the only one to end the year lower than where it began.

The bond market continued to serve up conundrums, keeping the pundits wondering about where rates are headed. Short term rates did rise considerably for a long stretch – the yield on the 2 year Treasury note more than doubled from its low in mid-October to its high mark for the year in the last week of December. But longer term bond prices kept rallying, and when all was said and done as the year approached its close, the 10-year yield was just a tad over 2%, or nearly a third lower than where it stood in January one year ago. Foreign demand proved to be more than adequate to offset the lower domestic appetite brought about by the Fed's winding down of its quantitative easing program.

First Quarter Outlook: Focus on Growth and Earnings

Despite the recent volatility, our base case for the coming year remains little changed. We see earnings as a key variable for stocks in 2015. During the rally of the past three years stock prices grew much faster than earnings. The ratio of prices to forecasted earnings for the next twelve months (the NTM P/E) for the S&P 500 is currently 16.3x, substantially above the 11.7x level it sported at the beginning of 2012. With the U.S. economy expected to grow between 2.5 – 3% and continuing growth problems elsewhere in the world, we do not see a compelling case for another "expansion rally" year, i.e. price gains outstripping earnings growth. If earnings grow in the mid to higher single digits, as the current forecast suggests, that could be a durable tether for stock price gains. Of course, any number of other variables will also be at play, not to mention the unknowns that will no doubt find their way into the mix at some point.

Consensus opinion still expects the Fed to begin raising rates sometime in the middle or second half of the year. If that does happen, chances are it will be a modest increase of 0.25%. But even this small increase is not necessarily a done deal. In addition to paying attention to headline unemployment and inflation numbers, the Fed also keeps a close eye on wage growth. This metric has disappointed of late. Coupled with inflation still well below the 2% target threshold, the Fed will likely have considerable leeway as it orchestrates rate policy. Rate movements may be somewhat muted in wait-and-see mode until then.

Energy prices will continue to make headlines. Crude oil prices are already down more than 13% in the very brief year to date as of this writing, on top of the 50% loss achieved last year. At some point we expect this to present bargain-hunting opportunities, but any significant rebound in energy and other commodity prices may face growth headwinds in large import markets like Europe, Japan and even China, where many expect growth to be below trend this year. We will be looking for continued evidence that growth travails elsewhere in the world will not pull the promising U.S. economy down with it.

MVCM 2015 0004
DOFU: January 2015