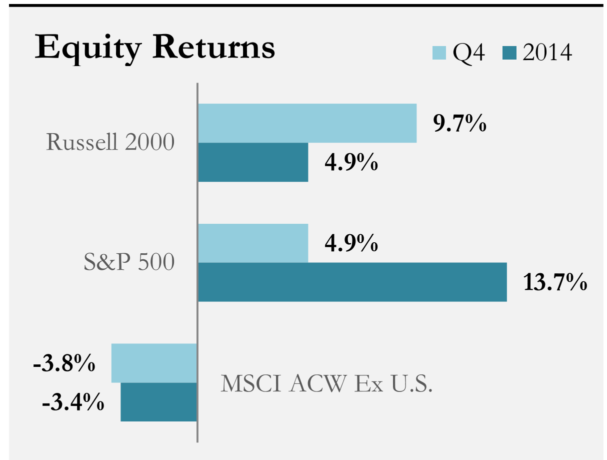
# Global Commentary

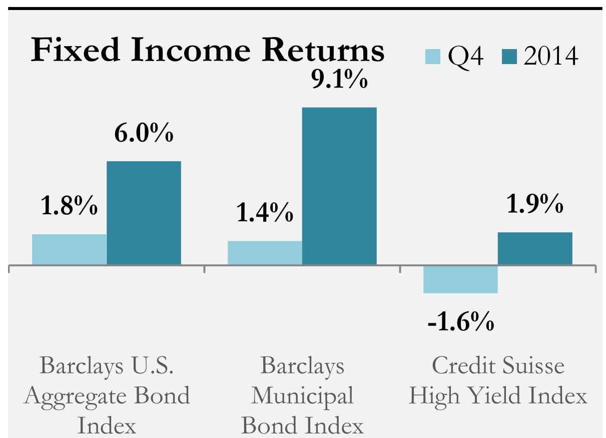
December 31, 2014

Avalon Advisors
GLOBAL INVESTMENT MANAGEMENT

## Fourth Quarter and 2014 Overview




U.S. equity markets continued to rise in the fourth quarter on increasing evidence of a strengthening economy, with the S&P 500 Index returning 4.9%. The best performing sectors in the quarter were Utilities and Consumer Discretionary, up 13.2% and 8.7%, respectively, while Energy, down 10.7% was by far the worst performing sector. Small stocks outperformed large caps in the quarter, with the Russell 2000 returning 9.7%, but this index's annual return of 4.9% significantly lagged the S&P's annual return of 13.7%.




Outside of the U.S., most markets performed poorly and returns to U.S. investors were diminished further by the rise in the dollar. The MSCI All Country World Ex U.S. Index lost 3.8% in the quarter and 3.4% for the year. China and India were the standouts among the larger emerging markets last year, with the China's restricted A-share market up 58% and India's Sensex Index up 32% in local currencies. Although economic growth in China continued to slow in 2014, GDP growth was still over 7% and China's central bank cut interest rates in November for the first time since 2012. China's equity market also benefited from steps taken late last year to increase access for global investors. In India, hopes were raised by the election of new leadership in the spring, although it remains to be seen whether the needed reforms can be implemented.

U.S. interest rates fell further in the fourth quarter and the Treasury yield curve continued to flatten. The 10-year Treasury ended the year at 2.17%, down from 3.04% at the end of 2013. The Barclays Aggregate Index returned 1.8% in the quarter and 6.0% for the year. Municipals did particularly well, returning 1.4% in the quarter and 9.1% for the year. Municipals have been benefiting from strong demand, improving financial strength of issuers and constrained supply. High yield bonds, with an estimated 20% tied to the energy sector, performed poorly in the quarter. The Credit Suisse High Yield Bond Index lost 1.6% in the quarter and ended the year up only 1.9%.

## Changing Expectations

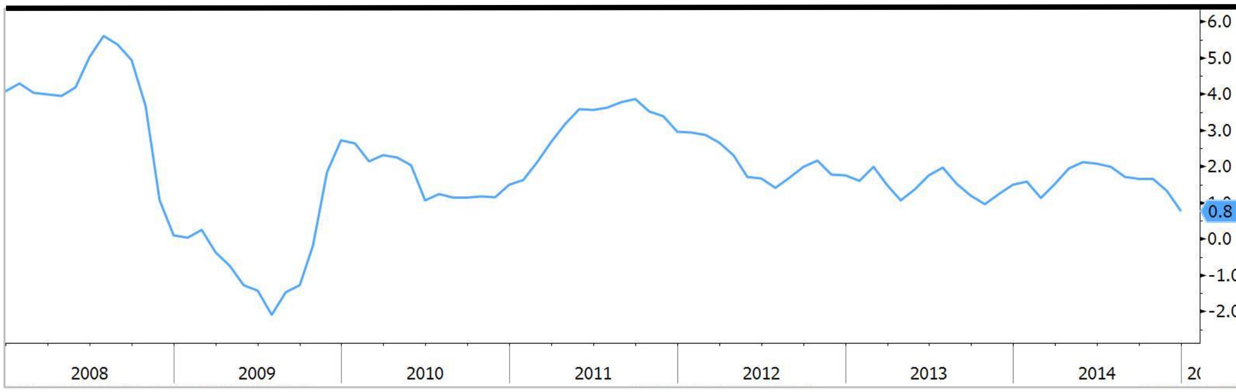
As we think about what financial markets might do in 2015 and beyond, it is useful to look at some of the predictions made over the last few years that have not come to pass. For example, many predicted that the Fed's large expansion of the money supply through its successive Quantitative Easing (QE) programs would devalue the dollar and significantly increase inflation. There was also general agreement among forecasters throughout much of the last decade that high growth in emerging markets would continue and therefore oil and commodity prices would continue to rise. Finally, there was the widely held view at the end of 2013 that interest rates would rise in 2014, with the Fed tapering and eventually ending its last QE. The charts below show what has happened to some key statistics from January 2008 to January 23, 2015.



AVALON ADVISORS, LLC
2929 ALLEN PARKWAY SUITE 3000
HOUSTON, TX 77019 | 713.238.2050
WWW.AVALONADVISORS.COM

PUBLICATION DATE: 1/27/2015

## U.S. Consumer Price Index (CPI) - 1/1/2008 to 1/23/2015




**Last Price** 0.80

**High** 7/31/08 5.60

**Low** 7/31/09 -2.10

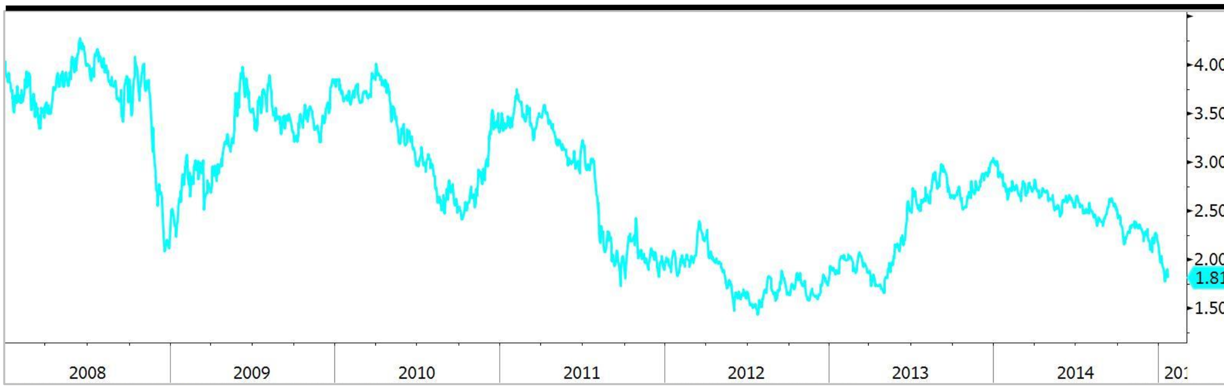
## U.S. Dollar Trade Weighted Index - 1/1/2008 to 1/23/2015


**Last Price** 94.76

**High** 1/23/15 94.76

**Low** 4/22/08 71.32

## U.S. Treasury 10-Year Yield - 1/1/2008 to 1/23/2015

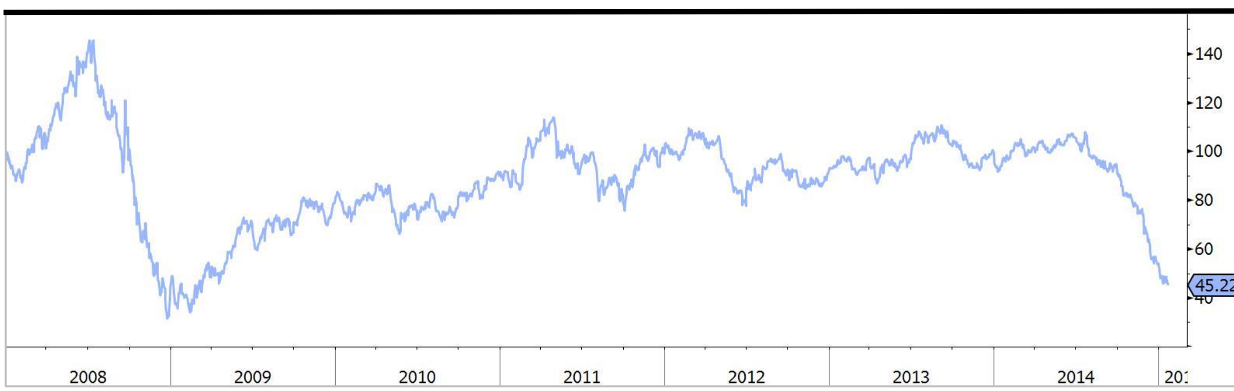



**Last Price** 1.81

**High** 6/13/08 4.27

**Low** 7/25/12 1.43

## West Texas Intermediate Crude Oil Spot Price - 1/1/2008 to 1/23/2015




**Last Price** 45.22

**High** 7/03/08 145.29

**Low** 12/22/08 31.41

*Source: Bloomberg*



AVALON ADVISORS, LLC
2929 ALLEN PARKWAY SUITE 3000
HOUSTON, TX 77019 | 713.238.2050
WWW.AVALONADVISORS.COM

PUBLICATION DATE: 1/27/2015

As these charts show, inflation was at its highest point in 2008 and has been falling since then. The dollar was at its lowest for the period in 2008 and, at the end of 2014, surpassed its peak for the period. The 10-year Treasury rate has fallen from a high of 4.72% and is currently not far from its low for the period of 1.43%. Oil prices have fallen from a high of $145.29 in 2008 and, now at $45, are closer to their 7-year low of $31.41 – also in 2008. Oil prices plunged almost 50% in 2014 and have fallen further since the end of the year.

Investors often focus more on geopolitical events and potential Federal Reserve moves rather than economic growth rates around the world, but the recent changes in global growth expectations explain a lot about why the above-mentioned predictions did not materialize. Over the last several years, U.S. growth has steadily improved. GDP is significantly higher than in 2008 and has grown every year since 2009 (contrary to a few predictions of a "double dip" or fall back into recession.) The effectiveness of quantitative easing in stimulating economic growth is still up for debate. But growth in the Eurozone, which has had no QE, has been very poor and, after starting to improve early last year, actually worsened in the summer. (The Eurozone's policy makers finally responded to the weak growth, initiating their own QE mid-January.) Japan, which announced its quantitative easing policy late in 2012, has yet to see its economy pick up. In the largest emerging markets, growth has slowed significantly over the last few years.

The trend of improving growth in the U.S. and slowing growth internationally continued in 2014. The table compares the International Monetary Fund's 2015 GDP growth projections made in January of last year with those made January 15th of this year.

**World Output Expectations for 2015**
**Selected Regions and Countries**
**Year over Year Percent Changes in GDP**

| | Projections as of Jan 2014 | Projections as of Jan 2015 | Difference |
|---|---|---|---|
| **World Output** | 3.9 | 3.5 | -0.4 |
| **Advanced Economies** | 2.3 | 2.4 | 0.1 |
| United States | 3.0 | 3.6 | 0.6 |
| Euro Area | 1.4 | 1.2 | -0.2 |
| Germany | 1.4 | 1.3 | -0.1 |
| France | 1.5 | 0.9 | -0.6 |
| Italy | 1.1 | 0.4 | -0.7 |
| Spain | 0.8 | 2.0 | 1.2 |
| Japan | 1.0 | 0.6 | -0.4 |
| **Emerging Markets and Developing Economies** | 5.4 | 4.3 | -1.1 |
| Russia | 2.5 | -3.0 | -5.5 |
| China | 7.3 | 6.8 | -0.5 |
| India | 6.4 | 6.3 | -0.1 |
| Brazil | 2.8 | 0.3 | -2.5 |

*Source: International Monetary Fund*

While the IMF raised its 2015 growth forecasts for the U.S., it lowered its forecasts for a number of other countries. Overall, the world growth forecast for 2015 fell 0.4%. Slowing global growth and falling growth expectations have resulted in downward pressure on world inflation and interest rates and weaker demand for oil and other commodities. Obviously, falling commodity prices directly reduce inflation.

However, the widening differential between growth in the U.S. and that of other countries has had additional effects: in particular, a stronger dollar and falling rates in the weaker economies.

A stronger dollar puts downward pressure on inflation in the U.S., lowering prices of imported goods and global commodities (such as oil), which are priced in dollars. A stronger currency also makes our financial markets a more attractive place to invest. In addition, interest rates in Japan, Germany and other European countries have fallen to record lows, widening the spreads between foreign interest rates and those in the U.S. Considering our strengthening currency, widening interest rate spreads, the end of QE, and our improved fiscal situation (despite predictions just two years ago that we would go over the fiscal cliff), our Treasuries look relatively inviting.

The plunge in oil prices we have seen over the last several months is not due solely to weaker demand and a rising dollar; excess supply has been a significant factor. It is true that technological advancements have led to faster production growth. But much of the production expansion, particularly in the shale regions, was predicated on expectations of continued strong growth in emerging markets (another prediction that did not materialize). Add in the Saudi decision last November not to cut production, and you have the perfect storm: too much supply, too little demand and a rising dollar.

## Time Lags, Valuations and the Invisible Hand

So what should we expect for financial markets in 2015? We believe that lower global growth will continue to exert downward pressure on our interest rates, inflation and oil prices. Equity valuations in the U.S. are still not excessive on a historical basis, especially considering the low inflationary environment we are in. The 12-month forward P/E on the S&P 500 Index was 16.6 as of January 23, slightly above its 15-year average of 16.1, and the S&P is expected to have record earnings this year. The problem is that earnings expectations have been declining significantly since the end of the third quarter and estimate reductions have continued in January. In fact, the P/E on the S&P has increased over the last few months as the index climbed (the P part of the ratio) but also as earnings estimates (the E) have been cut. Falling earnings estimates are not positive for equities. Since oil prices began declining mid-year, we have seen numerous predictions that lower prices would benefit the consumer, leading to more spending and ultimately increasing corporate earnings, but so far this has not happened.

Looking further into the estimate cuts, we see that the majority occurred in the energy industry, not a surprise given what has happened to oil prices. However, we are also seeing estimate cuts for U.S. multinationals, which are hurt by slower international growth and a rising dollar. About 30% of the S&P 500's revenues come from outside the U.S. It is important to recognize that while lower oil price assumptions can quickly translate into lower estimates for energy companies, it may take some time for consumers to increase spending. Thus we might eventually see global earnings start to increase as a result of lower energy prices. The U.S. should also benefit, although it is not nearly as big of an oil importer as it was a few years ago.

Globally, valuations in Europe and Japan are lower than in the U.S., but at present the differences seem warranted. These markets may start to become more attractive if the monetary stimulus starts to have an effect and the benefits of lower oil prices kick in.

Finally, we need to remember the invisible hand of the market place is always working. Lower oil prices will ultimately stimulate demand and diminish supply as producers cut back. We are not predicting when!

For our equity portfolios, we continue to focus on companies with sound fundamentals selling at attractive valuations. We remain on the lookout for changes in expectations and the effects of the invisible hand.