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**First Niagara**  
PRIVATE CLIENT SERVICES<sup>SM</sup>

# Market Review

The year 2014 was another positive year for equities, at least in the United States. Large capitalization stocks fared better in the United States than mid- and small capitalization stocks. The best performing asset class in 2014 was real estate investment trusts (REITs), with the Wilshire REIT Index returning 31.78% compared to the Standard & Poor's 500 Index return of 13.69%, the Standard & Poor's 400 Index (mid cap stocks) increase of 9.77%, and the Standard & Poor's 600 Index (small cap stocks) rising by 5.76%.

*“To be an investor you must be a believer in a better tomorrow.”*

~ Benjamin Graham

In contrast, 2013 saw small cap stocks as the best performing asset class with the Standard & Poor's 600 Index returning 41.3%. In addition, REITs were up just 1.86% in 2013. International markets did not perform very well in 2014.

## Index Performance

CATEGORY	REPRESENTATIVE INDEX	4th Q 2014	Y-T-D 2014	3-Year* Annualized	5-Year* Annualized
Dow Jones	<i>Dow Jones Industrial Average</i>	5.20%	10.04%	16.29%	14.22%
U.S. Large Companies	<i>S&amp;P 500</i>	4.93%	13.69%	20.41%	15.45%
U.S. Mid Cap Companies	<i>S&amp;P MidCap 400</i>	6.35%	9.77%	19.99%	16.54%
U.S. Small Companies	<i>S&amp;P SmallCap 600</i>	9.85%	5.76%	20.24%	17.27%
International	<i>MSCI EAFE Index</i>	-3.53%	-4.48%	11.56%	5.81%
European	<i>MSCI All Country Europe Index</i>	-4.94%	-6.72%	11.72%	5.40%
Pacific	<i>MSCI All Country Pacific Index</i>	-1.41%	-0.56%	9.42%	5.77%
Emerging Markets	<i>Dow Jones Emerging Markets</i>	-3.67%	-0.27%	4.91%	2.53%
U.S. Bonds	<i>Barclays Capital U.S. Aggregate Bond</i>	1.79%	5.97%	2.66%	4.45%
Municipal Bonds	<i>Barclays Capital U.S. Municipal Bond</i>	1.37%	9.05%	4.30%	5.16%
Real Estate	<i>Wilshire REIT Index</i>	15.13%	31.78%	16.43%	17.26%
Commodities	<i>Dow UBS Commodity Index</i>	-12.10%	-17.01%	-9.43%	-5.53%
Gold	<i>S&amp;P GSCI Gold</i>	-2.34%	-1.75%	-9.40%	0.97%

\* The 3-year annualized and 5-year annualized data are through 12/31/2014



The MSCI EAFE Index (developed international stocks) was down 4.48%. Emerging markets were also slightly negative for the year. Bonds did well last year, while commodities added to their 2013 losses.

Corporate earnings in the U.S. were pretty good, especially for large cap companies. In addition, despite the ending of quantitative easing (QE) in October 2014, the Federal Reserve (Fed) has remained very accommodative. The low interest rate environment and low inflation have allowed the price multiple on stocks to expand further in 2014.

As we move into 2015, we expect corporate earnings to continue their impressive growth, which should help propel domestic stocks further. There may be opportunity in Europe this year as the European Central Bank (ECB) carries out its own version of QE. The old saying coined by famous investment manager Martin Zwieg, “don’t fight Fed” can now be changed to “don’t fight central banks.” Low interest rates in Europe,

along with quantitative easing, should help advance European stocks in 2015. However, we cannot ignore the effects of potential deflation in Europe and elsewhere in the world.

We expect 2015 to be a good year for financial assets but challenges do exist, created by the Federal Reserve, conflict in the Middle East, aggression by Russia, a rising dollar, and declining oil prices.

## *Outlook*

*“More money has been lost trying to anticipate and protect from corrections than actually in them.”*

~ Peter Lynch

### **Interest rates and the Federal Reserve**

Interest rates provided one of the biggest surprises in 2014. The 10-Year U.S. Treasury note traded at a yield of 3.04% to start the



year and finished at 2.17%. One of the biggest questions for 2015 is where rates are headed. Looking at the last Federal Reserve meeting, which was held in December, the Fed dropped the words “considerable time” from its policy statement with regards to interest rate hikes. This implies that the Fed may consider raising rates in the near future. The Fed noted that economic activity is increasing at a moderate pace, labor market conditions have improved, and inflation continues to run below its target rate. Rapidly decreasing energy prices could help inflation remain lower.

The Fed has confirmed that a rate hike will happen. Janet Yellen, Chair of the Federal Reserve, has warned investors not to get too comfortable with low rates. With the economy actively rebounding, the timing is still unclear and economists continue to debate the issue. Obviously, the Fed will more likely raise rates if the economy continues to strengthen, and less likely if it starts to see data that suggest a

slowing economy. Many private economists believe that the Fed will raise rates mid-2015, but its decision will depend on the fundamental health of the economy as the year progresses. Also, as international interest rates in developed countries continue to decline, the pressure to avoid raising rates will build.

Based on our internal interest rate forecasts, we are expecting the 10-Year U.S. Treasury note to trade in the range of 2.25-2.50% in 2015. In addition, we also expect the 10-Year U.S. Treasury note yield to drop below the 1.50% level at some point in 2015, as the U.S. dollar continues to strengthen versus the Euro and other currencies. Lower rates are expected for some time, but for how long will depend on the overall continued improvement in the economy.

When the Fed finally does raise rates, there may be a positive impact on bonds and stocks. Based on historical data, the Fed usually raises rates as the economy strengthens. A strong economy is a good thing for corporate earnings,



which is one factor that can drive the stock market. On the bond side, with yields at below normal low rates, it would be difficult for interest income to offset a loss in bond prices. This is why maintaining a shorter duration bond portfolio should provide some defense against a Fed interest rate hike. It also allows for reinvestment into higher yielding bonds as shorter dated bonds mature. Alternative investments which can help protect against interest rate rises, or that are not correlated with interest rates, can continue to be natural defenses for one's portfolio to help protect against a Fed rate hike.

### ***Global currencies; a race to the bottom***

The major foreign economies, namely Europe and Japan, have allowed for the devaluation of their respective currencies (i.e. the euro and the yen). What does this mean for the economies of Europe and Japan? And how may the devaluation help or hurt their respective economies and ours?

*“Successful investing professionals are disciplined and consistent and they think a great deal about what they do and how they do it.”*

~ Benjamin Graham

Since the beginning of the financial crisis in 2008, the U.S. Federal Reserve has responded aggressively in its use of monetary policy. The two tactics it has used the most are (1) keeping interest rates low; and (2) the aggressive use of QE. Such actions have caused a reduction in the value of the dollar due to an increase in the supply of dollars (the result of QE), making them less attractive to holders due to lower interest rates. It should be noted, however, that QE has ended in the U.S., and has just begun in Europe and Japan.



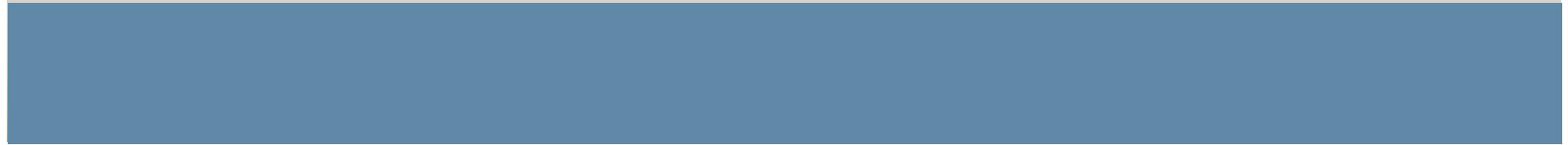
While monetary policy is an important driver of currency values, confidence is also important. Do investors have confidence in the country in question, its government, the rule of law, and its economy? Positive answers to those items, especially relative to the country's peers, help drive that currency's strength or weakness.

In 2014, the US dollar did strengthen, especially against the euro and the yen. With the ending of QE in the US in October, the supply of dollars was reduced. And while short-term rates were left unchanged, the economy did strengthen, thereby boosting confidence. In contrast, Japan is currently in the middle of its third decade of stagnant growth. In an effort to finally kick start the economy, the government of Prime Minister Abe has taken a number of aggressive policy actions (commonly known as "Abenomics"), while the Bank of Japan pursues its own version of quantitative easing. Europe is similarly suffering from weak growth. Concerns about this weakness and low confidence in the Eurozone

in general, combined with recent talk of expanding the European Central Bank's (ECB's) QE program to sovereign bonds, has helped bring on a decline of 13.6% against the dollar.

While countries usually express commitment to a strong currency out of national pride, a weak currency does have benefits. Both the Eurozone and Japan will be better positioned to export, with devalued currencies making their goods cheaper versus the dollar. This will boost revenues and earnings in those countries. Cheaper currencies can also make imported goods more expensive. Of course what helps them can hurt the U.S; our goods will be less competitive, and the higher dollar reduces the value of overseas corporate earnings, unless those earnings are hedged to protect against a rising U.S. dollar.

The U.S. has its issues – significant outstanding government debt, and growing social security and Medicare liabilities. Still, its strengths are





formidable. Europe's and Japan's monetary policy programs explain why we expect to see continued strength for the dollar in 2015.

### **Improving Economic Growth in the U.S.**

*“The aim is to make money, not to be right.”*

~ Ned Davis

The revised 3<sup>rd</sup> quarter 2014 GDP growth rate was reported at a surprisingly strong 5%, surpassing the previous high of 6.9% set over 11 years ago in the 3<sup>rd</sup> quarter of 2003. The unexpected growth rate was supported by contributions from nearly all factors of the economy. Most notably, personal consumption was revised upwards from an already acceptable 2.2% to a very positive 3.2%. This revision accounted for 2.2 percentage points of the 5% growth rate. Other areas of strength were business fixed investments (up 8.9%, representing 1.1 percentage points), a smaller

trade deficit (adding .8 percentage points), and government spending (supplying .7 percentage points to the total) (Lombardo, 2014).

The 3<sup>rd</sup> quarter growth rate appears quite strong, and in many ways it is quite strong. But as we dig into the numbers, a slightly revised outlook dampens our evaluation to a more tempered but positive outlook. Before dissecting the numbers, keep in mind that the “market” is looking for GDP performance to reflect a quality and level of growth that would convince investors that the economy has really turned the corner. Or, in other words, to convince investors that the economy has enough fundamentally strong momentum to break free from the Federal Reserve programs and grow on its own for the long term.

The long-term growth rate for GDP in the U.S. averages 4%. With the reported 3<sup>rd</sup> quarter figure at 5%, we would like to believe that if this



could be sustained, the U.S. economy could be free from monetary stimulus from the Federal Reserve. But as we break down the numbers, we may be a bit early in our expectations. For example, a large adjustment in personal spending was due to healthcare spending, which accounted for .52 percentage points (or a little over 10% of the overall growth rate). Put another way, .52 percentage points represents over 25% of the entire personal consumption growth rate. If we view this from a quality perspective, we think it represents a non-discretionary expense reflecting a need versus want. As such, personal consumption growth for the sake of need does not suggest that consumers are opening their wallets in belief of a better tomorrow (Lombardo, 2014).

In addition, the cost of having to spend more on healthcare has to divert funds from somewhere else. This, combined with the fact that disposable personal income rose only

2%, explains why the savings rate was 4.7% last year, the second lowest rate since the recovery started. One has to conclude that, with income not keeping pace with expenses and a reallocation of funds away from discretionary items, the true impact of the growth in consumer spending on GDP is questionable.

Finally, the 4.4% growth in government spending last year was the largest since the 2<sup>nd</sup> quarter of 2009, when it grew 7.5%. Much of this growth was the result of backlogged government spending for defense contracts. Spending in this category increased 16% for the quarter, again the largest increase since 2009. With the likelihood of this level of spending continuing into the new year being low, the contribution to GDP growth from defense spending will probably be less, lower than in the 3<sup>rd</sup> quarter (Lombardo, 2014).

The Bloomberg consensus thinking is that it will be difficult for the 4<sup>th</sup> quarter to improve upon





the 3<sup>rd</sup> quarter; in fact, it will likely result in less favorable numbers. Overall consensus estimates for GDP growth for 2015 in the U.S. is 3.0%, and for 2016, 2.8%. These estimates, although still reasonably good, are below historical levels.

### **Oil and the High Yield Markets**

One of the hallmarks of 2014 was the rise and fall of high yield debt. Since 2012, investors have moved aggressively into sub-investment grade bonds and floating rate bank loans, seeking higher fixed income returns and (in the case of floating rate loans) a hedge against expected rising interest rates. Robust investor appetite drove down yields from over 10% in 2011 to 5.16% in June 2014, but trouble was brewing in the largest sector of the junk market. Energy companies, the fastest-growing segment of the high-yield bond market in recent years, account for nearly 18% of all outstanding high-yield bonds, up from 9% in 2009. Oil prices plunged nearly 50% since June 2014, from

\$107.73/bbl to the low \$50 range in December 2014, and junk-grade bonds went along for the downhill ride. Since June, yields in sub-investment grade securities have soared to over 7.25%. Bank loans have fared somewhat better since energy concerns represent only 4.5% of that market and duration of these instruments is much shorter than comparable bonds (Nadig, 2014). Nevertheless, bank loans are trading at a meaningful discount to historical levels, as investors now demand a greater risk premium across all high-yield instruments.

Many of the smaller energy companies that issue this debt have hedged their exposure to oil price changes, but most of those hedges roll off by 2016. At that point, production and refinancing costs will dictate who survives and to be sure, there will be some losers. With the ever-expanding oil supply glut, there is room for the price of oil to move even lower, compounding an already tenuous situation for



energy companies operating on the fringe of profitability.

For long-term investors, high yield investments deserve a place in any well-diversified portfolio. But where there's return there is risk over shorter timeframes, and the oil price/high yield market dynamic demonstrates how quickly the ballooning risk in one industry can wreak havoc on an entire asset class.

### **Oil's Potential Impact on Equities**

The U.S. equity markets were volatile in the 2<sup>nd</sup> half of 2014 as investors struggled to parse the impact of dramatically lower oil prices on corporate earnings and the U.S. economy. Several factors are relevant, though the market effects can be contradictory:

- **The energy sector comprises a smaller proportion of the equity markets and U.S. economy.** Energy concerns represent 8%-9% of both the S&P 500 and the Russell 3000

*“I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage.”*

~ J.S. Mill

indices, down from over 14% of the S&P 500 in 2009. This suggests that the impact of energy industry earnings on index returns is more muted than in the past. Additionally, the oil and gas industry accounts for only 2.5% of GDP.

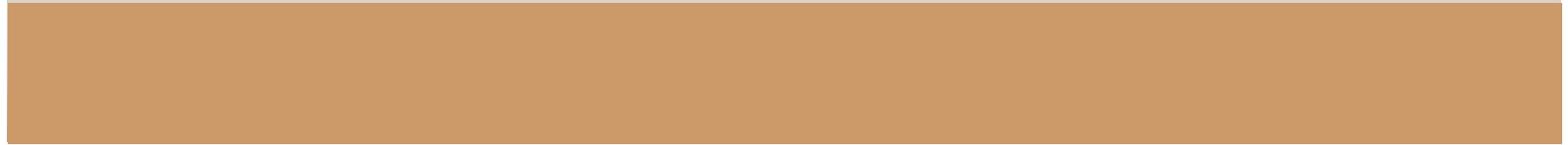
- **Consumer spending accounts for nearly 70% of GDP vs. 61% in 1980.** Less expensive oil effectively redistributes income away from oil producers, of whom there are relatively few, towards oil consumers,



of whom there are very many. The impact is especially significant for lower and middle-income Americans dealing with stagnant wage growth. The typical American household consumes 1,200 gallons of gasoline annually. The fall in gas prices from an average of \$3.78/gallon in June to \$2.39 at year end means an additional \$1,660 in annual household disposable income. In the Northeast, consumers are also benefiting from a 15% drop in the price of home heating oil since 2013. And oil prices affect the cost of many household purchases, from agricultural products to durable goods, so the effect on the consumer price index is likely to be favorable.

- **We've entered a new energy market paradigm.** Domestic shale oil production ramped up at a break-neck pace in recent years, fundamentally changing America's ability to satisfy its own energy hunger.

The U.S. now meets over 85% of domestic demand and U.S. oil stockpiles are at a 30-year high. Meanwhile, there has been a longstanding trend toward greater fuel efficiency, and global warming concerns will continue to drive technological advances. Greater energy independence will help shield the U.S. economy from the type of world price shocks that occurred in previous years.

- **Low energy prices mean less inflationary pressure on the U.S. economy.** The Fed is monitoring inflation, wage growth, and the value of the U.S. dollar for hints about when interest rates should rise. But a gauge of the dollar against the Euro has reached its highest level in nine years. Wage growth is anemic and the Purchasing Consumption Expenditure (PCE) price index (which includes food and fuel) rose just 1.2% in the 12 months ended in November, compared to a Fed target of 2%. The combination of these
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factors suggests there may be little impetus to increase interest rates.

- **Fear can be a contagion in financial markets, and there's a lot to be concerned about right now.** The freefall in oil prices reflects not just supply-side dynamics, but also anemic world economic growth. Over the short-run, volatility in the equity markets is likely to continue. But on balance, if oil prices remain low for the foreseeable future, we may see a gradual positive market impact from higher consumer spending, stronger manufacturing earnings, and low inflation.

### **Oil decline's impact on the world**

Oil prices have declined dramatically since June 2014. This decline has had a global impact on producing companies and countries. For many years oil has been used as a geopolitical tool, and this time around is no different. Many countries are trying to maximize their international clout through oil's vast economy.

The price of oil can make or break economies, currencies and political parties. The stakes are high and for some, oil's decline may have a painful outcome.

The U.S. sits in a very interesting position. The fracking boom has quickly turned the U.S. into one of the largest producers of oil and natural gas in the world. This boom is one of the causes of our current oil glut, and a contributing factor in the decline in price. While we appreciate the cost at the pumps, many firms in the industry are either scaling back on investment or laying off employees. Non-energy companies are also feeling the pinch as industry suppliers are seeing orders decline and have to make decisions in a quickly changing environment. While the net impact of cheaper oil should have a positive economic impact, pain will be felt in the industry, especially in areas with higher production and transportation costs.



In South America many oil exporting countries are teetering under already heavy debt loads, large social programs and oil's dramatic decline. For many countries this is creating a significant economic challenge, and many countries are looking for an immediate savior. Venezuela and Ecuador are increasingly partnering with China. While the specifics of the agreements are not completely public, China's sphere of influence will continue to grow. There is a potential risk to China if these countries continue to struggle, or default, but the trans-Pacific oil taps will remain open years into the future.

Russia has also been hurt badly by both oil's crash and its current economic sanctions. The Russian economy had been struggling with sanctions over its Ukraine venture, but now with oil down more than 50% from its June high, Russian debt may be downgraded to junk, the ruble has plunged in value, and there is a monetary flight out of Russia. The Russian

economy is expected to contract 4.7% in 2015, as revenue from oil exports have collapsed. There is a fear that Russia may become more aggressive in foreign policy as it tries to divert attention from its current economic issues. China has recently stepped up and entered into a 400 billion dollar energy agreement with Russia; such an agreement may help fund such future international activities. It also expands China's political reach and keeps the energy flowing for China's voracious appetite.

In the Middle East there are multiple factors at play. Iran is struggling under the weight of sanctions and the fall in oil prices. Washington is trying to use oil sanctions/price to goad Iran into making nuclear concessions. If the price of oil continues to go down, the pain being felt in Tehran will only increase, forcing policy decisions and/or inspiring civil unrest as citizens are ultimately paying the economic price. Saudi Arabia also has an interesting position, as they





are letting market forces drive price while not cutting production. By pursuing this course of action, it is able to maintain market share and is in a good position to weather the current financial storm. The intent is to let market prices decline until other suppliers cut production or drop out of the market. When that starts happening a true price floor will emerge, and prices will start to recover. There is another smaller geopolitical motive that is in play. Both Russia and Iran are supporting the current Assad regime in Syria, while Saudi Arabia is very interested in seeing a regime change. The Shia/Sunni conflict is also very much in play, and Saudi Arabia and Iran are locked in a contest for influence throughout the Middle East. Saudi Arabia can use the price of oil as a tool for other political motives.

Ever since oil has become the backbone of our modern economy it has been used as a

geopolitical and financial tool. For a time the price of oil may help the U.S. (as a consumer of oil), while hurting domestic energy companies. The U.S. has a fully diversified economy, and is not economically dependent on oil revenues. Other countries in South America, the Middle East, and Russia are realizing that the decline in the price of oil can be painful. If there is a reliance on oil for government revenues, whenever there is a price bust, it hurts. This can have serious consequences for incumbent political parties, lenders to these governments, civil strife, and economic turmoil that may take years to work through. China is trying to maximize its influence through the current oil glut, and guarantee it has access to oil in the future. If governments in these countries fail it may be an expensive lesson for China to learn.



## ***Fears of global deflation***

***“The investor’s chief problem and even his worst enemy is likely to be himself.”***

~ Benjamin Graham

Globally, we are seeing a slowdown of GDP growth, falling commodity prices and declining yields on government bonds that are signaling potential deflation. Inflation rates in Europe and Japan are almost non-existent, and any shock to the economies of the world could easily send us into a deflationary spiral. Japan has experienced periods of deflation over recent years. Some European countries, such as Italy, are already experiencing deflation, which is a major risk for their counterparts (Hilsenrath and Blackstone, 2014).

What is wrong with deflation? Are not declining prices for goods and services a good thing?

The problem with deflation is that consumers perceive that if they wait to make purchases of goods or services, those goods or services will be cheaper tomorrow than they are today. Under such circumstances, fewer and fewer transactions would take place as consumers wait for lower prices and economic growth would certainly turn negative leading to a global recession.

The intention of QE in the U.S, Europe and Japan has been to stimulate inflation to help avoid deflation. Inflation, although low, is higher in the U.S. after we have completed QE than it is in Europe and Japan, who have just begun their QE process. The premise of quantitative easing is that by central banks buying government bonds, they will cause a decrease in interest rates on longer-dated bonds, put more money into circulation and spark economic activity. Such economic activity will increase inflation rates.

Although the U.S. has completed its quantitative



easing and achieved the goals of the program, inflation remains low at 1.3% versus the 50-year average of 4.2% (as of November 2014). Europe and Japan are in the midst of their programs, and the success of their programs may dictate whether we experience global deflation or not.

### ***Corporate earnings and market valuations***

***“Investing should be like watching paint dry or watching grass grow. If you want excitement...go to Las Vegas.”***

~ Paul Samuelson

The Bloomberg consensus estimate for earnings in 2015 on the S&P 500 Index is \$129.22 per share. \$115.40 is the projected full year earnings on the S&P 500 for 2014. Thus, the projected growth rate for corporate earnings is about 11.9% for the upcoming year. We ended 2014

with a trailing price to earnings ratio (P/E) of 17.8. At the end of 2013, the trailing P/E ratio of the S&P 500 Index was 17.3, so we have continued to see an expansion of the price multiples. Although we are higher than the 20 year average of 16 times earnings, we don't believe the current market is overly expensive given the low level of interest rates and inflation. Even if the Federal Reserve does begin raising short term rates in 2015, we don't see much of an increase in longer-term rates in 2015. Interest rates should continue to remain low even with some modest increase by the Fed, and the low level of rates should allow price multiples to at least stay at current levels.

Based on our market valuation models, we expect the S&P 500 to return between 8% and 11% in 2015. The expectations for corporate earnings are an important component of our models, as are the dividends paid on those earnings. The current and anticipated low level

of interest rates and long run growth rate of the economy also play an important part in our valuation models; any changes in earnings, dividends, interest rates and growth rate would have an effect on our expected return. We monitor changes to these components throughout the year and will make changes to our expected return if warranted.

### Investment implications

*“If it’s obvious, it’s obviously wrong.”*

~ Joe Granville

Asset allocation is a key contributor to the overall performance of one’s portfolio. The weightings amongst asset classes and investment styles will determine the risk and return composition of a client’s portfolio. We strive to add value to our clients’ portfolios by monitoring various asset classes and investment styles relative to one another to determine if value can be obtained by over- or underweighting such

#### Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	15.5 / 14.0	16.2 / 16.1	18.7 / 21.0
Mid	16.4 / 14.2	18.6 / 16.5	20.0 / 21.9
Small	16.4 / 14.5	18.1 / 17.3	20.0 / 21.5

#### Current P/E as % of 20-year avg. P/E

*E.g.: Large Cap Blend stocks are fairly valued compared to historical average.*

	Value	Blend	Growth
Large	110.1%	100.6%	89.0%
Mid	118.1%	112.7%	94.5%
Small	113.1%	104.4%	93.3%

Source: Russell Investment Group, Standard & Poor’s, FactSet, J.P. Morgan Asset Management.

classes and styles. As such, we comment on our observations and suggestions with regard to the tactical weightings of our clients’ portfolios.

### Equities versus Fixed Income

Given the current low level of interest rates and the expectation that the Fed will begin raising



short-term interest rates later this year, we favor a moderate over-weight toward equities over fixed income investments. Interest rates will likely remain low relative to “normal” times even when the Fed does raise rates. Fixed income investments offer very low yields. We are only suggesting a modest shift away from fixed income.

### **Large-Cap versus Small- and Mid-Cap Equities**

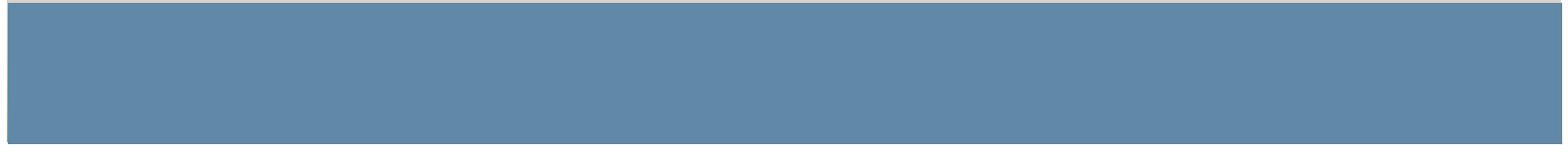
Large-cap U.S. stocks have outperformed mid-cap stocks, and significantly outperformed small-cap stocks, over the last twelve months. The relative performance advantage of large-cap versus small- and mid-cap stocks would suggest tilting heavier toward large-cap stocks. However, in reviewing the historical P/E multiples for the different market caps we see some opportunities at the margins but not enough to affect our current neutral market cap weighting, similar to the weighting of the Russell 3000.

### **Growth versus Value Stocks**

In the short-run large-, mid- and small-cap growth stocks have outperformed their value counterparts, but over the last 12 months large-cap value and growth stocks were indifferent whereas mid-cap value stocks outperformed growth stocks and small-cap growth stocks outperformed value stocks. We continue to see the same rotation trend from dividend paying stocks to non-dividend paying stocks based on Fed communications and other indicators; as previously noted, it all boils down to when the Fed will increase interest rates, and we see this trend continuing and suggest a neutral weight between growth and value but also tailored to meet the client’s need for income.

### **Developed International versus Domestic Equities**

Much of the bad news is already out in Europe. Europe will be expanding its version of quantitative easing as well as maintaining a low interest rate environment. As such, given





the improving conditions, Europe may offer opportunity for investment this year. We continue to advocate allocating a portion of assets toward international equities, including Europe.

### **Developed International versus Emerging Markets**

Developed international and emerging markets underperformed domestic equities in 2014. We suggest under weighting emerging markets relative to developed international. It is important to have exposure to both developed internationals and emerging markets within the equity asset allocation, as such allocation helps reduce risk since they are not entirely correlated with domestic equities.

### **Short- versus Intermediate-Term Bonds**

We continue to observe the relative outperformance of intermediate- and long-term bonds versus short-term bonds, and are diligently watching for future Fed actions and other key indicators. The relative strong bond market performance was driven by a stronger

dollar, cheaper oil, deflationary concerns, the flight to quality, and global central bank quantitative easing. This resulted in the 10-year U.S. Treasury note yield move from 3.04% at the end of 2013 to 2.17% on December 31, 2014. As stated earlier, we forecast that interest rates will rise modestly rather than fall further in 2015. As such, we continue to suggest that our fixed income portfolios are weighted toward 75% short and 25% intermediate term bonds.

## *Summary*

*“There is nothing riskier than the widespread perception that there is no risk.”*

~ Howard Marks

We have gone a long time without an official correction (a decline of 10% or more in equity prices), although last Fall we came very close.



We remain optimistic for the year but would not be surprised to see an official correction at some point in 2015. We are mindful of the challenges we face. The price decline in oil, though seemingly positive for consumers, may have adverse effects on the markets as its decline has far reaching implications for corporate earnings and government budgets across the globe. Strength in the U.S. dollar due to the deliberate attempt by Europe, Japan and others to devalue their currencies also has implications for corporate earnings. A stronger U.S. dollar makes foreign investment in the U.S. markets more attractive. This may lead foreigners to invest more in U.S. stocks. However, with the U.S. dollar rising, earnings from U.S. corporations overseas will be adversely affected when translated back into U.S. dollars and cause a drag on corporate earnings.

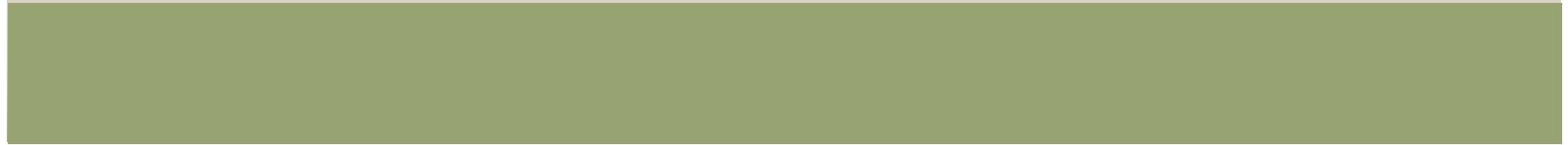
We continue to face potential trouble in the Middle East, possible terrorism in the U.S. and

continued aggression by Russia. We believe that deflation in the U.S. is unlikely but is a strong possibility in Europe and Japan. Deflation has potential negative consequences for the global economies.

The U.S. economy continues to grow, with the growth rate picking up in the 3<sup>rd</sup> quarter 2014 to 5%. The jobs market continues to improve although wage growth remains anemic. The Federal Reserve will likely raise short term rates in 2015, but still remains very accommodative for the foreseeable future. Quantitative easing in Europe and Japan should provide fuel to the global economies. We expect corporate earnings to continue to grow. There are many reasons to be optimistic.

As always, we are eager to serve our clients and lead them to achieving their goals.

***Your First Niagara  
Private Client Services  
Investment Team.***





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<b><u>Region</u></b>	<b><u>Contact</u></b>	<b><u>Phone Number</u></b>
Western New York	Jamie Raiser-Umberger, CFP®	716-819-5975
Eastern New York/ Rochester	Paul Hurley, CTFA	585-770-1624
Western Pennsylvania Pittsburgh	Brian Werner, CFA®, CFP®	412-807-2881
Eastern Pennsylvania	Bryan McGrath	856-261-0355
Northern Connecticut/ Massachusetts	Mary Ellen Nichols, CFP®	860-293-4130
Southern Connecticut/ Tri-State	Don Rotzien, CTFA	203-901-0912

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