2015 Global Economic and Financial Market Expectations

All We Need Is Just A Little Patience

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Said, Federal Reserve, take it slow
And it'll work itself out fine
All we need is just a little patience
Said, Federal Reserve, make it slow
And we'll come together fine
All we need is just a little patience

Lyrics from the song "Patience" by Guns N' Roses

As with every new year, we approach 2015 assessing whether it will be a green year for stocks (less volatile with a -1 standard deviation or better) or a red year for stocks (more volatile with a -2 or -3 standard deviation event). For 2015, although we will likely see an increase in stock market volatility due to the potential for Fed interest rate increases and economic weakness in Europe, Japan, and China, the bull market in U.S. stocks still has room to run. The backdrop of low inflation, a gradually expanding economy, falling oil prices, and a very patient Federal Reserve should result in another green year for most risk-based assets, particularly U.S. stocks.

Global Economy

- While global economic growth will struggle to accelerate during the first half of 2015, we believe the U.S. economy should continue to grow thanks to low inflation and easy Fed monetary policy. Deflationary forces and restrictive fiscal policies in place across Europe, Japan, and China will make it difficult for the global economy to avoid a slowdown as we head into 2015. However, we are optimistic that as the year progresses, global monetary authorities outside the U.S. will eventually step up their efforts to reflate their own economies to the benefit of worldwide growth.

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- In the U.S., GDP growth should continue to improve over the coming year as the pace of job creation and private-sector credit picks up, inflation and oil prices stay low, monetary policy remains pro-growth, and consumer and corporate spending accelerate. The U.S. economy has the potential to grow at a 2.5% – 3.5% rate in 2015. However, if the central banks of Europe, China and Japan do not soon step up efforts to fight deflation and stimulate growth, a slow down in global growth could continue and ultimately spill over to the U.S and become a drag on future U. S. economic strength.

- The Euro area economy will spend much of 2015 fighting deflation. The European Central Bank (ECB) has been slow to react with aggressive monetary stimulus, thanks in part to Germany's focus on austerity measures rather than monetary reflation/bond buying. As a result, the Euro has been weakening versus the U.S. dollar. Eventually, the weaker currency should support export growth. Recently, investor and business confidence in Germany has been climbing. The ECB has hinted at ramping up its bond buying to very aggressive levels early in the year. If this is accomplished, another recession should be averted and growth may be able to reach 1%.

- Mired in deflation for the past 25 years, Japan's economy should continue to improve as we expect the Bank of Japan (BOJ) to increase its level of monetary policy accommodation in 2015 through increased asset purchases. The BOJ remains the world's easiest central bank and it should continue to make monetary policy even easier in 2015, especially if the Abe government is re-elected. The Abe government may also postpone or cancel the second part of a planned VAT (Value Added) tax that was enacted last Spring.

- The Peoples Bank of China (PBOC) has begun cutting interest rates and the government has started to increase stimulus through infrastructure-related investments. More monetary policy easing and fiscal stimulus packages should occur in the coming year to fight slowing economic growth. The Economic Work Conference of the ruling Communist Party Central Committee recently indicated that promoting economic growth will be their top priority in 2015.

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Financial Markets

- Investor focus in the coming year will center on three primary questions: Will the Fed tighten monetary policy (raise interest rates) this year? If so, when and by how much? The Fed Funds Futures market is projecting the first increase to take place mid-year (May-June). Forecasting Fed policy over the next few months is very difficult because there are many moving variables involved. If inflation continues to weaken, the U.S. dollar strengthens, and the Euro Zone economy struggles to grow, it may be difficult for the Fed to raise interest rates. However, if global growth via Europe, Japan, and China begins to surprise to the upside, then the Fed will most likely begin tightening monetary policy no sooner than late Spring. We believe the Fed will remain patient with the current level of monetary accommodation and only start to reverse policy once the U.S. economic recovery begins to accelerate at a sustainable pace while the remaining global economies show signs of stabilizing.

- We believe the bull market in U.S. stocks still has room to run. Low inflation, a strengthening U.S. dollar, and economic weakness in Europe, Japan, and China (our largest trading partners) argue against the need for any significant interest rate increases, if at all. Falling oil prices will help hold inflation down and propel corporate profits higher by keeping input costs lower. Even if the Fed begins raising interest rates, the magnitude of the move will be tempered by low inflation in the U.S. and global deflationary forces such as excess savings, aging demographics, restrictive fiscal policies, and the need for more monetary stimulus in Europe, Japan, and China.

- Volatility of global, risk-based assets will be on the rise in the coming year as the financial markets face the big uncertainties of if, when, and by how much will the Fed raise interest rates combined with economic weakness in Europe, Japan, and China, and geopolitical tensions in the Ukraine, Middle East, and Asia.

- With volatility on the rise, the U.S. stock market should continue to climb the wall of worry and once again be the performance leader in 2015. With real bond yields far below economic growth, U.S. stocks should continue to outperform bonds and cash. However, total returns of U.S. stocks should not be as large as they were in 2014.

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- As for the international markets, the BOJ should embark on a very aggressive reflation campaign. In addition, the potential for a delayed or canceled VAT tax combined with a falling yen should be bullish for Japanese stocks. The ECB may be on the verge of a very aggressive bond buying campaign to help fight deflation. European stocks look cheap by standard valuation measures and relative to U.S. stocks. Although we remain cautious on European stocks, if the ECB does deliver, European stocks could perform nicely.

- In emerging markets (EM) stocks, caution is warranted as many of these countries are tied to the performance of commodities which will continue to be in a bear market. Monetary policy in China is still too restrictive and will need to be aggressively eased in the coming year for growth to accelerate. Within this asset class, Asia should outperform Latin America. Latin America, which is a commodity producer, has been suffering greatly from the fall in commodity prices while Asia is a commodity end user and benefits when prices decline.

- Commodities will likely struggle again in 2015 as the U.S. dollar continues to strengthen, the supply of energy and industrial metals remains abundant, and Chinese demand remains moderate. However, some direct commodities exposure is warranted as this asset class provides the benefit of low correlation to stocks and bonds and acts as a hedge against financial market volatility.

- Given our modest projected level of growth for the U.S. economy and continued low inflation, fair value of the 10 year maturity U.S. Treasury Note yield should be in a range of 2.50 – 3.50%. With the 10 year U.S. Treasury currently trading at 2.22%, we expect U.S. bond yields across the curve to finish the year near the higher end of this range. A significant rise in bond yields should be prevented as the Fed takes a patient approach to re-normalizing interest rates because of the low level of inflation, the large amount of private sector deleveraging, the abundance of global savings, the safe haven appeal of U.S. Treasuries, and the relative attractiveness of U.S. government bond yields versus Europe and Japan.

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- Bond yields are low everywhere around the world, but the secular bull market in bond prices may not yet be over. Much of globe is experiencing very low inflation or even deflation. The U.S. economy is steadily improving and when viewed in isolation, the case for Fed interest rate increases can be made. However, the U.S. economy does not operate in isolation. When viewed in the context of economies in Europe, Japan, and China, it becomes less compelling for the Fed to raise interest rates. A global slowdown at some point is very likely to depress foreign demand for U.S. goods and services. This would in turn, have a negative impact upon domestic economic growth. In addition, the slowdown abroad may very well keep U.S. Treasuries and other investment-grade bonds in high demand as central banks in Europe, Japan and China increase their stimulus measures by reducing interest rates. U.S. government bond yields are already higher than government bond yields in Europe and Japan. Their relative attractiveness should only continue to grow as foreign central banks enact further monetary stimulus measures. We believe investors should maintain portfolio durations near the bond benchmark index (3.9 years) and continue to overweight investment grade corporate bonds and agency and non-agency mortgage-backed securities. Given a very low Fed Funds rate and future expectations for higher short term interest rates, the yield curve (yield spread between 2 year maturity U.S. Treasury Notes and 10 year maturity U.S. Treasury Notes) should continue to flatten as 1-5 year maturity bond yields rise faster than 10 year maturity bond yields. Bonds still remain a source of reliable income and a risk-diversifier that provides steadiness to a portfolio.

- 2014 was a solid year for municipal bonds across the maturity spectrum. While 1-5 year maturity securities experienced modest spread widening, spreads tightened on longer maturity securities which generated strong returns across the board. The Merrill Lynch 1-12 year maturity municipal index returned a solid 4% (approx.). The trend of reduced issuance and higher income taxes should continue in 2015 which will drive strong demand for municipal bonds. While our Treasury call is for potentially higher yields/interest rates, the interest rate move should not overcome the core yield advantage and tight spread conditions. Therefore, we continue to believe high quality municipal bonds will turn in a solid year in 2015 and outperform U.S. Treasury securities on an after-tax basis.

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Summary

The divergence of global financial markets and sectors that began in 2014 should continue in 2015. Global central banks are going their separate ways as the Fed is preparing to raise interest rates while the ECB, BOJ, and the PBOC are all getting ready for more monetary policy easing. While U.S. stocks should once again outperform bonds and cash, stock price appreciation should slow. Given the record highs made by U.S. stocks over the past six years combined with slowing growth outside the U.S., income may become a larger portion of total return than principal growth in the coming year as financial assets with relatively higher yields/dividends may outperform more aggressive growth-oriented assets. An acceleration of U.S. economic growth and the potential for the Fed to begin raising interest rates are clearly negative for bond prices. However, we believe the rise in yields will be a slow, gradual process given the unprecedented low levels of inflation in the developed world combined with current economic weakness in Europe, Japan, and China. In such an uncertain and complicated economic and financial environment, maintaining a balanced portfolio and taking a flexible approach to tactical asset allocation will be critical to portfolio success in the coming year. All we need is just a little patience from the Fed.

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January 5, 2015

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Notes:

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