BRIDGES | INVESTMENT MANAGEMENT

Think Forward

Market Comments
January 26, 2015

S&P 500	2057
10 year Treasury	1.53%

The market comments are in two parts: 1) an executive summary for those who want a brief summary of our outlook, and 2) a more detailed second part that gives more granularity regarding our expectations for the capital markets for 2015-16.

Executive Summary:

1. 2014 was a very good year for large capitalization U.S. equities
2. Other equity sectors – midcap, small cap, and international – materially lagged large cap U.S. stocks
3. Positive stock returns in 2014 were the result of solid corporate earnings growth, and a modest uptick in equity valuations
4. Interest rate declines during 2014 drove positive returns for bonds
5. An extension of the strong bull market in stock prices since 2009 will be dependent on continued corporate earnings growth in 2015-16
6. We see increasing risks to U.S. stocks in 2015 due to a persistently strong dollar, commodity price weakness and volatility, and ongoing soft global economic conditions
7. We expect 2015 to be marked by increasing stock price volatility
8. We believe stocks remain attractive and currently trade about 7-10% below our estimate of fair value for 2015 (~2200-2300 on the S&P 500)
9. We expect stocks to outperform bonds over the intermediate to long-term, given reasonable valuations for stocks and high valuations for bonds at present
10. We continue to believe exceptionally low interest rates make bonds unattractive, and we continue to take a defensive posture toward bonds in terms of 1) bond portfolio allocations (lower than normal), and 2) bond portfolio durations (shorter than normal)

U.S. equities posted strong returns in the fourth quarter to finish 2014 with solid total returns, as summarized in the following table, which also provides total return data back to year end 2008, which marked the approximate bottom of the 2008-09 financial crisis:

	Q4	2014	Since 2008	Annualized 2008
S&P 500	4.92	13.66	159.18	17.19
S&P 400 Midcap Index	6.34	9.72	194.75	19.73
S&P 600 Small Cap Index	9.83	5.73	178.15	18.58
MSCI EAFE Index	-3.46	-4.20	55.16	8.11
MSCI Emerging Markets Index	-4.55	-2.10	123.79	15.37
Barclays U.S. Aggregate Bond Index	1.79	5.97	29.70	4.72

In 2014, large capitalization U.S. equities were the best-performing asset class. Returns were driven by continued strong corporate earnings growth, particularly in the second and third quarters, and by a slight expansion in equity valuations, as price-earnings multiples overall moved from 15-16x earnings to 16-17x earnings over the course of the year.

Midcap and small cap stocks lagged larger stocks significantly most of the year, but played some catch-up in the fourth quarter, posting mid-to-high single digit total returns for the year.

Overall, 2014 was a solid year for U.S. equities, especially on the heels of the extremely large returns that stocks experienced in 2013, and given the large run in stock prices since the bear market low of March 2009.

International and emerging stocks ended 2014 with negative returns, as economic conditions outside the U.S. remained weak. Notably, since the financial crisis of 2008-09, U.S. economic growth and corporate earnings have been far stronger than economic growth outside the U.S., which is reflected in the total returns shown in the table above.

The U.S. dollar has strengthened materially against other major currencies, which creates some earnings risk for U.S. multinationals in 2015: not only is demand for goods and services weaker in international markets, but relative prices for U.S. goods and services in the global marketplace are higher due to the strength of the dollar. This is a risk factor that we will monitor closely as 2015 unfolds.

Interest rates continued their multi-year downward trend in 2014. The ten-year Treasury yield declined from 3.03% to 2.17% over the course of 2014, as solid U.S. GDP growth was offset by very low inflation and a continuation of accommodative Fed policy. The interest rate decline drove positive bond returns, with the Barclays U.S. Aggregate Bond Index generating a 5.97% total return.

We believe the outlook for bond returns going forward is problematic because nominal and real interest rates remain near historic lows, and credit spreads remain tight. We believe many investors are either underestimating the downside risk to bond prices if/when interest rates begin to rise and move back toward long-term historic norms, or those investors believe that they will be able to quickly reduce or exit bond exposures if/when rates eventually have a sustained upward move.

We continue to take a defensive approach to bonds because as long as nominal and real interest rate levels are at or near historically low levels, we believe bonds offer an unattractive risk-reward trade-off. Consequently, we remain under-weighted in terms of allocations to bonds relative to long-term portfolio asset allocation targets, and we continue to maintain bond portfolio durations that are shorter than long-term portfolio targets in order to minimize interest risk.

We remain constructive on the intermediate to long-term outlook for equities.

While overall equity valuations have risen materially over the past three years, valuations currently are at the upper end of “average” long-term valuations for U.S. equities, and they are arguably well below valuation levels that might be expected, and could be supported, given the current low interest rate environment and given the solid corporate earnings growth that most U.S. companies are currently generating. Absent a sharp deterioration in corporate earnings, and/or a sharp rise in interest rates, we expect stock valuations to remain near current levels, with a slight bias to higher valuations should interest rates remain persistently at or below current levels.

The key risks to our constructive outlook for stocks include: 1) faltering corporate earnings growth that could stem from a combination of persistently weak international economic conditions and a strong dollar; 2) economic disruptions emanating from sharply lower oil prices; and 3) an escalation of global political instability and/or terrorism.

We have established a 2015 year-end fair value target range of 2200-2300 for the S&P 500 (about 17x estimated 2015 earnings of ~$130), which implies upside of roughly 7-9% from the S&P’s 2014 year-end level of 2058. Our preliminary year-end 2016 fair value target range is 2300-2400 (~17x estimated 2016 earnings of ~$133-140).

We believe there is somewhat less visibility to corporate earnings in 2015 than over the past several years (and hence more risk) because of two factors: 1) the strong U.S. dollar, and 2) sharply lower oil prices, both of which could cause material earnings estimate changes as 2015 unfolds. Concomitant with these uncertainties, we expect that stock price volatility could continue to rise in 2015 (as it did during the last four months of 2014, after an extended period of well below-average volatility dating to the second half of 2012); a range for the S&P 500 of 1800-2400 during calendar 2015 would not be surprising.

We continue to focus on those companies which we believe offer investors the best combination of 1) exceptional business franchise and balance sheet strength, 2) long-term business growth prospects, and 3) attractive valuation characteristics

In sum, we expect 2015 to be a very challenging year, marked by increased bond and stock price volatility. We continue to expect that stocks will outperform bonds, given the current valuations and implied intermediate and long-term total returns implied by those valuations.

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