Investment Update
First Quarter 2015

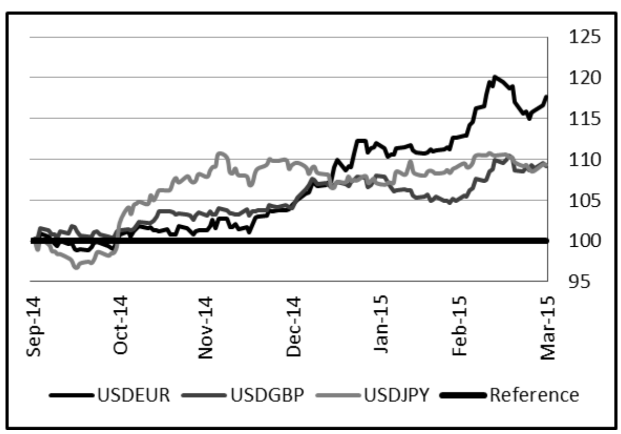
Total Returns	Q1	1-Year
Dow Jones Industrials	-0.26%	8.01%
S&P 500	0.95%	12.73%
S&P Mid Cap	5.31%	12.19%
S&P Small Cap	3.96%	8.72%
MSCI All-Country World	2.44%	5.97%
MSCI EAFE Developed Markets	5.00%	-0.48%
MSCI Emerging Markets	2.28%	0.79%

The first quarter of 2015 has seen the S&P 500 trade in a fairly narrow range, albeit with a fair amount of volatility. The 10-year Treasury continued to fall further to near-historic levels of 1.65% in late January but subsequently rebounded and spent the rest of the quarter at or slightly above 2%.

A significant contributor to the 80% rise of the S&P 500 since its last major correction in August of 2011 (when Standard & Poors downgraded the debt of the United States) has been an expansion in the price/earnings multiple investors are willing to pay for a dollar of corporate earnings. The financial media is full of reports that the market's trailing P/E multiple, whether calculated on last year's earnings or an average of the last ten, is now far too high relative to past levels. We prefer to focus on the forward P/E multiple calculated on the earnings predicted for the year to come. Of course the earnings in this case are not entirely certain, but intuitively the value of a company should have more to do with its earning potential over the next ten years than the actual earnings over the last ten.

We have been talking for some time about the potential for the market's multiple to continue expanding given that academically speaking the current low inflation and interest rate environment should directionally enable P/E multiples to be higher than they would be if inflation and interest rates were higher. The multiple has indeed expanded further in 2015, but not because of a higher price, rather because the price has stayed more or less constant and estimated earnings have fallen. While we all would rather see higher prices, it is a sign of market resilience that it has withstood both reported and estimated earnings starting to come down due to the price of oil dropping roughly 50% in the second half of 2014 and sharply cutting into energy sector earnings, and the strength of the US dollar which affects any company doing business overseas.

We discussed oil's price drop at length in our last Quarterly Update, but another pervasive trend throughout much of 2014 that many expect to continue is the strengthening of the dollar against most global currencies. In the last nine months it is up 15% against a trade-weighted basket of currencies. S&P 500 companies generate roughly 50% of their revenues abroad and the associated earnings are converted back into fewer dollars when these companies report their earnings in the US and the dollar has recently appreciated.



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Over time changes in currency values can both help and hurt reported earnings, and while the upward or downward pressure is real, it does not necessarily reflect the relative strength of a company's underlying business – in fact they might have sold more of their widgets in Europe than the previous quarter but that can be masked by a stronger dollar.

The dollar's strength can be attributed to the anticipation of tighter monetary policy and higher interest rates in the US contrasted with easy monetary policy elsewhere in the world. The Fed Funds rate has been close to zero since 2008 and over that time the Fed also undertook other unconventional monetary policies in further efforts to stimulate the economy such as several rounds of quantitative easing. The Fed stopped purchasing bonds with newly printed money in the fall of 2014 although it does continue to reinvest maturity proceeds of its holdings, maintaining its inflated balance sheet. Japan and the euro-zone in particular, have only just recently started to try some of the Fed's aggressive tactics as their economies have still not seen even the modest turnaround on display here in the US where the economy is now likely strong enough to withstand a gradual increase in rates. At least one hike is expected this year although several of the most recent economic indicators late in the quarter weakened, somewhat undermining this view. This was likely due to the harsh winter which, for instance, temporarily affected consumer spending even though consumer confidence remains at a multi-year high, suggesting that the weakness will prove to be temporary.

The "ifs, whens and whys" of the potential for the first increase in the Fed Funds rate since 2006 has fixated the stock market's participants above most other considerations for some time now. Soft economic numbers which one might think would be cause for concern amongst bullish investors are being looked at as possible evidence that we might go one more Fed meeting before interest rates are actually increased, perhaps sending the Dow up hundreds of points. A day later, public comments by influential Fed governors suggesting something to the contrary about the timing or potential pace of rate increases can then send the Dow right back to where it started the previous day.

We think that the focus on the ending of the Fed's extraordinary support is overly short-sighted, but the transition will no doubt continue to cause dislocations and near-term volatility in the stock and bond markets. Normalized monetary policy and higher interest rates are necessary and a good thing for stocks in the long run because they will signal that the economy is once again capable of standing on its own. It will also further reduce the risk of much higher future inflation that many expected the Fed's policies would have already produced.

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