FirstPoint Financial

WEEKLY MARKET THOUGHTS

December 29, 2014

Smoke from a Distant Fire

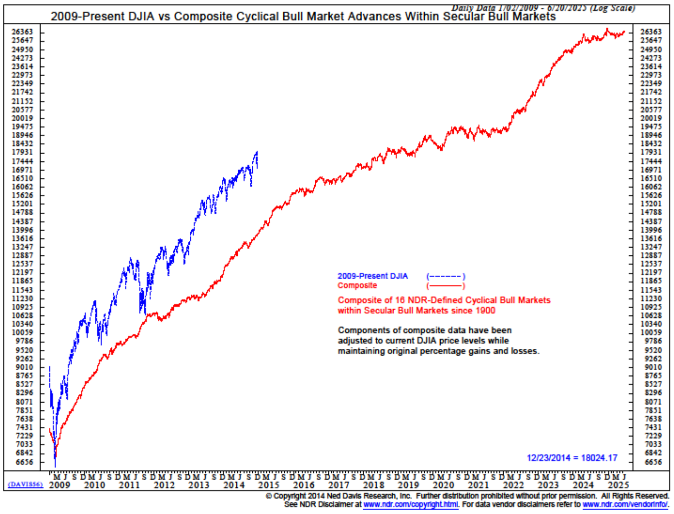
Today, we release our 2015 outlook for the global stock markets. Last week, I discussed our views on global economies. We think 2015 will be a year of growth for the world's economies. The U.S. economy should also grow nicely; although, the current socio/political and economic risks (primarily overseas) have the capability of derailing global economic growth.

With this in mind, we retain our bullish view on equity investments, in general. We believe price volatility will rise in 2015.

The reverse image is currently playing out within the foreign stock markets. These markets have dramatically underperformed the U.S. market for some time. Slow economic growth, weak currencies and serious socio/political risks specifically haunt the foreign equity markets. Will 2015 be the year foreign markets turn the tables on the U.S. market and generate superior returns? Is this the year of the long-awaited 10 – 20 percent price correction in domestic stock prices?

U.S. Stock Market Outlook

1. 2014 will go down in the books as another year of above-average returns for the U.S. stock market. We've become more convinced that, yes, the world's stock markets are experiencing their fourth "secular" bull market since 1905. The chart below highlights the Dow Jones Industrial Average movement since the lows in 2009 (blue line) as compared to the average of previous bull markets (red line). If we're correct, stock prices should continue to rise, on balance, over the next several years.



2. We believe the fundamental forces which have led to higher stock prices each year since 2008 will once again lead to positive returns for the U.S. stock market in 2015. While we maintain our bullish stance for the U.S. market, a combination of higher-than-

normal valuation levels and a change in monetary stimulus from the Fed may result in rising levels of price volatility during 2015.

3. When thinking of a market outlook, we need to start with the foundation of equity market analysis – an economic framework. We enter 2015 with an economic backdrop of accelerating domestic GDP growth. This growth acceleration, driven by higher growth rates of consumption, should lead to a good year for corporate profit growth. Rising corporate profits normally lead to rising stock prices.
4. Monetary policy (as measured by M2 growth rates as compared to nominal GDP growth rates) remains positive. Fed is expected to start raising interest rates in 2015, which will cause the positive bias to become challenged. If the rise in interest rates occurs, investors should view this as the start of a return to monetary "normalcy."
5. Equity investor sentiment remains buoyant. Participation in global equity markets is strong by household measures. The average household's stock market exposure represents 55 percent of their financial assets as compared to the long-term average of 45 percent. Shorter-term sentiment measures show a positive bias. Individual investors own fewer bonds and cash investments than the long-term averages.
6. Foreign investors have, on balance, not shown strong demand for U.S. stock market exposure. In fact, foreign investors have been net-sellers of U.S. stock market exposure since early 2013. This is a good sign. Historically, foreign investors have been late in their U.S. equity purchases.
7. U.S. stock markets are no longer "cheaply" valued in relation to global markets or long-term historical normal valuation levels. P/E ratios are near one-standard deviation above long-term averages, bringing up the question of how much more valuation "expansion" will investors support?
8. Our answer to the question above is "not much more." Since the lows in 2009, the S&P 500's P/E ratio is up 50 percent. We believe the U.S. stock market return in 2015 will be tethered to rising corporate earnings, rather than a rise in "valuation" levels.
9. With all the above, we expect price volatility to rise during 2015. This will lead to periods where firm-handed investment biases will pay off over the long-term. We view equity investments in the U.S. markets as "owned" assets, rather than "rented."
10. Our expectation for the U.S. equity market total return during 2015 is in the 5 – 9 percent range. It will be driven by rising earnings and good dividend flow.
11. Along with our balanced, positive view toward the U.S. equity market, I need to emphasize that we expect price volatility to rise during 2015. Following the lows of 2009, the stock market is entering its sixth year of rising prices. In addition, we didn't experience a "cyclical" 20 percent correction during that time. Historically, the U.S. equity market experiences a 20 percent correction every 635 trading days. It's now been 1,461 trading days since the last 20 percent correction.
12. Due to our long-term positive bias, we treat 10 – 20 percent price declines as buying opportunities.

Foreign Stock Market Outlook

1. When thinking of the foreign equity markets, we need to differentiate between the "developed" markets (Europe and Japan) and the "emerging" markets (primarily those in Asia and Latin America).

2. In the world's "developed" foreign markets, Europe is struggling to stay out of recession. Additionally, a return to the bad-old-days of banking/currency crisis may be in the cards for 2015. We believe Mario Draghi (President of the ECB) will attempt to launch a new, larger quantitative-easing action, which, if successful, could cause European equity markets to rally significantly to the upside. This would change our outlook. At this time, we are concerned the market may eventually be disappointed by Draghi's ability to successfully launch such a project. Without the successful launch, the European markets may remain mired by low growth and disinflationary pressures. Europe's long-term investment profile remains weak. The continent has demographic challenges and a lack of growth in productivity driven by government policies. We view investments in Europe as "rented" rather than "owned."
3. Like Europe, Japan is attempting to stay out of recession. Both Europe and Japan share longer-term demographic challenges. Their population bases are elderly, driving strains on the ability to provide the social safety net each country has promised through policy. Japan's economy has experienced 20 years of slow growth, highlighted by deflationary forces, a troublesome combination for stock prices. Will Shinzo Abe's (Japan's Prime Minister) three-part economic growth package succeed? Perhaps. Compared to Europe, Japan has the power to affect monetary and fiscal policy on a coordinated basis. This being said, we view equity investments in Japan as "rented" rather than "owned."
4. For investors who believe in "reversion to the mean" concepts, placing capital in the foreign markets, relative to the U.S. market, may make sense. Since the beginning of 2014, the S&P 500 is up 12 percent in price, while the EAFE (Europe, Australia and Far East) index is down 7 percent. It is truly an odd year when these major stock market indexes' returns have deviated from each other by this degree.
5. The "emerging" markets have disappointed investors over the last three years. Since May 2011, the emerging markets (as measured by the EEM ETF) have generated a negative return of 19.5 percent. Over the same period of time, the S&P 500 is up 55 percent.
6. What is happening? While very positive, overall economic growth in many emerging economies has slowed. In relation to the "developed" world, overall economic growth remains very robust in many emerging economies. We host a negative long-term view towards commodity prices, in general. Many emerging economies will be handicapped because they are major producers of commodities. However, a number of the emerging economies are strong users of commodities. These economies should continue to show well above-average economic growth.
7. China's overall growth rate is decelerating, which leads to weakness in countries that import product/commodities into the "Middle Kingdom." We believe these pressures will continue to weigh negatively on certain emerging economies in 2015.
8. That being said, the longer-term fundamentals in a number of the emerging economies remain robust and sustainable. Demographics favor a number of emerging economies where the populations are much younger than in their "developed" counterparts. Additionally, increases in per-worker productivity remains at double the developed economy pace. These factors cannot be ignored; they are drivers of long-term societal wealth generation.
9. Many emerging stock markets remain inexpensive in relation to other "developed" markets and in relation to their long-term valuation standards.

10. We encourage investors to view any major sell-off in emerging stock markets as a true buying opportunity and to treat emerging equity exposure as assets we “own” rather than “rent.”

We hope you’ve found this piece helpful. I appreciate all who have read the economic and capital market pieces this past year and hope they’ve helped you in working with your Wealth Advisor.

Here’s to a healthy, happy and prosperous New Year.

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