INDEPENDENT WEALTH MANAGEMENT

Market & Economic Review

IWM

A Quarterly Publication | Historical Perspectives | 1st Quarter 2015

1Q15 Benchmark Returns

	1Q	YTD
Equities		
S&P 500 Total Return Index	1.0%	1.0%
Russell Index 1000 w/Dividend	1.6%	1.6%
Russell Index 2000 w/Dividend	4.3%	4.3%
Russell Index 3000 w/Dividend	1.8%	1.8%
MSCI Developed EAFE (USD)	4.2%	4.2%
MSCI Emerging Markets (USD)	1.7%	1.7%
Alternatives		
Credit Suisse Hedge Fund Index	1.9%	1.9%
DJ Wilshire Global REIT Index	3.2%	3.2%
Credit Suisse Hedge Mgd Fut Index	4.8%	4.8%
S&P GSSI Natural Resources Index	-1.5%	-1.5%
Barclays High Yield Bond Index	2.5%	2.5%
Fixed Income		
90 Day Treasury Bill	0.0%	0.0%
Barclays Muni Bond Index	1.0%	1.0%
Barclays Aggregate Bond Index	1.6%	1.6%
Barclays Global Bond Index	-3.7%	-3.7%

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First Quarter / Key Takeaways

International stocks led in the first quarter with Europe, Japan, and China posting especially strong gains. U.S. stocks were also positive, with smaller caps outpacing larger caps, and growth beating value. Some of the quarter's big-picture themes included global central bank policy, the strength (or lack thereof) in economic growth, U.S. dollar dominance, and the ongoing decline in oil prices.

The stronger dollar is dampening export growth and has already prompted a spate of downward earnings and revenue estimates. And, while the decline in oil prices is a positive for U.S. consumers, it may weigh heavily on energy companies, their earnings, and their willingness to spend on new projects and hire additional workers.

All of these issues complicate the outlook for U.S. economic growth and are among the factors that the U.S. Federal Reserve has to weigh as it contemplates raising interest rates. The Fed's March statement took the much-watched step of removing the word "patient" from the official text, yet Chair Janet Yellen continues to suggest the Fed will exercise exactly that quality as it moves toward its first rate increase and considers the pace of subsequent hikes. Markets appeared to take the Fed's update to mean rates would remain low, potentially into the fall.

Meanwhile, other major central banks are expanding their support, with Japan in stimulus mode and the European Central Bank the latest entrant to the mix. The ECB announced a quantitative easing program in January and launched its bond buying in early March. European stocks rallied during the quarter on the hope that this stimulus would have a similar effect in Europe as it has had in the United States. For U.S.-based investors, strong local-equity returns in international stocks were largely offset by currency movements due to an appreciating U.S. dollar.

In emerging markets, China's growth continued to slow even as the government undertook monetary stimulus measures including changing reserve requirements and cutting rates. Nonetheless, emerging markets in aggregate were positive.

On the fixed-income front, with a pronounced lack of competition from other developed-market bonds, U.S. Treasurys continue to look relatively appealing even with a 10-year yield below 2%. This factor, along with investors' sense that the Fed might be slower to scale back its accommodation, helped government bonds to their fifth consecutive quarterly gain.

Investors' search for yield has helped support returns for both investment-grade and high-yield corporate bonds as well. Floating-rate loans, which tend to do well when rates rise, had a very strong quarter as investors girded for future rate hikes.

First Quarter 2015 Investment Commentary:

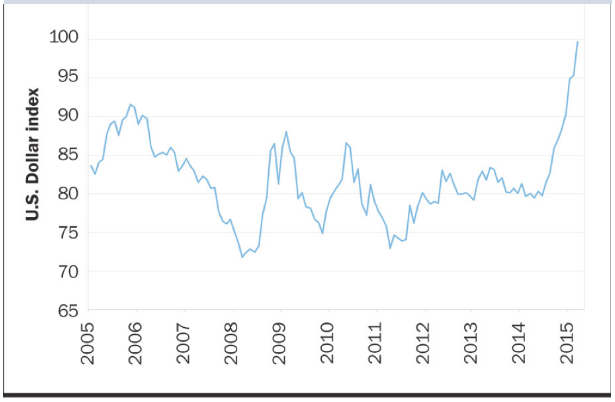
The Strengthening Dollar—Positives & Negatives

The strength of the dollar is a significant force affecting the economic landscape. The dollar has appreciated 23% over the past 12 months. Moreover, based on the concept of purchasing power parity (PPP), the dollar now looks to have significantly overshot its longer-term fundamental value relative to the basket of other major currencies in the dollar index. The converse is true as well—other currencies have undershot their fair value versus the dollar.

There are several cross currents from the rise in the dollar in terms of its impact on both the real economy and financial markets. On the positive side, a strengthening dollar reduces the cost of imported goods and is also associated with falling oil and commodity prices that are priced in dollars on the global market. This will tend to depress domestic inflation—a positive result unless an economy is at risk of a deflationary spiral, which the United States is not. All in all, these things benefit U.S. consumers, increasing their purchasing power and leaving them more money available for spending (or saving). A stronger dollar also tends to attract more foreign investment. To the extent this foreign capital flows into U.S. Treasury bonds or corporate debt, it helps keep interest rates lower, and it may also support higher U.S. stock prices. All of these factors are reasons why investors cite the stronger dollar as another reason for optimism about U.S. stocks. However, a dollar that is too strong is not necessarily good for U.S. stocks, as investors start to weigh the negative impacts more heavily. So far this year, the daily correlation between the dollar and U.S. stocks has been negative.

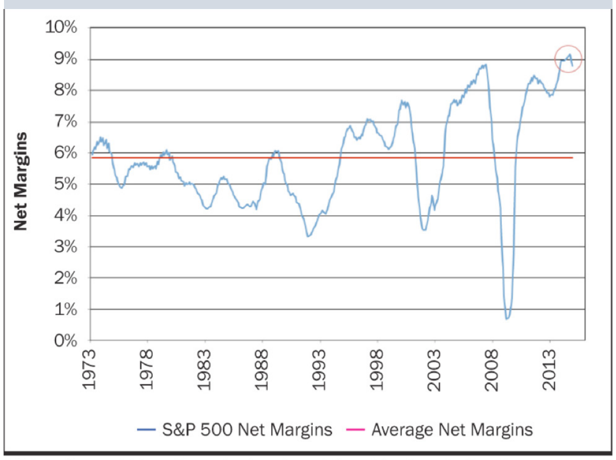
On the negative side, a stronger dollar has a negative impact on U.S. exports, U.S. manufacturers, and U.S. multinational company profits. And by also making imported goods more attractive it typically leads to a worsening of our trade deficit. This has a negative effect on overall economic growth, because GDP is defined as the sum of consumer spending, investment spending, government spending, and net exports. Also, from a dollar-based investor's perspective, a rising U.S. dollar hurts foreign asset class returns as they are translated back into dollars from weaker currencies. All of these impacts are reversed for the investors, consumers, and economies whose currencies are depreciating versus the dollar.

U.S. Dollar Has Appreciated Sharply Over the Past Year



The DXY Index constituents include Euro (57.6%), Yen (13.6%), Pound (11.9%), Canadian Dollar (9.1%), Swedish Krona (4.2%), and Swiss Franc (3.6%). Data as of 3/17/2015. Source: Bloomberg, L.P.

Profit Margins Are Far Above Long-Term Averages



Historically, very high profit margins have been followed by sharp declines in company profitability. Data as of 12/31/2014. Source: Robert J. Shiller and Standard & Poor's.

Asset Class Views

U.S. Stocks—Profit margins are a key driver of earnings and earnings growth. The adjacent chart shows profit margins for the S&P 500 are at all-time highs. The chart is also very clear in showing that profit margins are cyclical. That is, neither the trend nor the level of margins is sustained for very long. Moreover, history has shown that high profit margins are negatively correlated with subsequent five-year earnings growth (i.e., foretell lower future earnings growth).

In addition to the natural forces of competition, a big reason profit margins are likely to decline is from increased labor and wage costs, which have yet to really kick in. Another factor is the sharply rising dollar, which is hurting the profits of U.S. multinational companies.

We seem to be seeing this impact already, as earnings-per-share estimates for the first quarter have dropped sharply to a 5% year-over-year decline, compared to the positive 4% growth that was expected for the first quarter at the beginning of the year. The plunge in oil prices, which hurts earnings for energy companies specifically, is also a significant driver of these negative results.

The second key piece to our negative view on U.S. equities is elevated valuations. While valuations are not a good short-term market indicator—overvalued markets can get even more overvalued for a while—history shows that high valuations are a deterrent to future long-term returns, which is our focus.

If our view on earnings is correct, we'd expect a meaningful market correction at some point. All else equal, we would view such a decline as an opportunity to shift some capital back into U.S. stocks (which at that point should be offering attractive return potential commensurate with their risk) and out of our more defensive fixed-income holdings.

European Stocks—Unlike in the United States, where we see unsustainably high profit margins, earnings growth, and valuation multiples, in Europe we see earnings that are below trend and relatively attractive valuations.

Investment-Grade Bonds—With the U.S. core bond index yielding only 2%, any reasonable interest-rate or macro scenario might imply very low returns over the next five years. There is no refuge to be found looking to core bond markets outside the United States either. In Europe, the comparable index has a yield of only 0.5% and almost a third of European government bonds actually have a negative yield-to-maturity, meaning investors who hold these bonds to maturity are locking in a certain loss.

Concluding Comments

As market prices, valuations, and fundamentals change, our views and positioning may change. We expect (rationally so, we believe) that markets will be volatile in the future. And when market prices and underlying asset values diverge due to the inevitable and enduring cycles of investor herd behavior driven by greed and fear (or excessive optimism and pessimism), our disciplined, patient, long-term investment approach will be in prime position to take advantage of those cycles.

As always, we thank you for your continued trust and confidence as we work together to achieve your financial goals.

Independent Wealth Management IWM

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