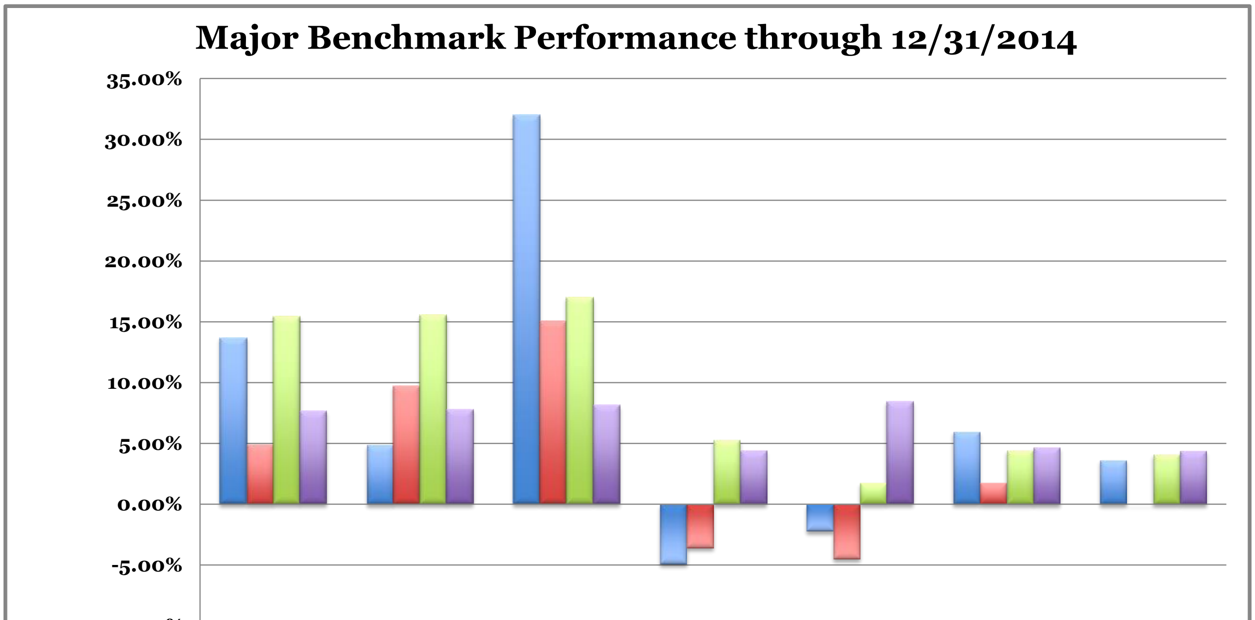
Market Summary and Outlook

Executive Summary

US markets ended up for calendar year 2014, but only after more volatility than we have seen for several years. REITs were the big winner, followed by US large cap stocks which outperformed small caps for the first time since 2011. Stocks from both developed as well as emerging markets were down modestly for the year. High quality US bonds were up 6% for the year, helped by falling interest rates. Commodities and emerging markets bonds were down, propelled by a 50% drop in oil prices in 2014.



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds	TIPS
2014	13.69%	4.89%	32.00%	-4.90%	-2.19%	5.97%	3.64%
4Q14	4.93%	9.73%	15.09%	-3.57%	-4.50%	1.79%	-0.03%
5 Year (ann.)	15.45%	15.55%	16.99%	5.33%	1.78%	4.45%	4.11%
10 Year (ann.)	7.67%	7.77%	8.13%	4.43%	8.43%	4.71%	4.38%

The 4th quarter started out with fears of the first Ebola virus case on US soil as well as a plunge in the price of oil, (which actually started in July, but the effect did not manifest itself in the US stock market until the 4th quarter).

Despite these concerns, the US economy expanded with the latest GDP estimate at 5%. Unemployment continued to drop, housing continues to rebound, although at a more sustainable level, and inflation remains low.

Market Outlook

As we start 2015, the big questions are:

- When will oil prices stabilize, and what effect will they have market performance?

- Will foreign and US equity markets produce similar returns this year?
- Will the Fed raise rates this year (when and by how much)?

Oil Prices

While a drop in prices adversely affects oil producing countries such as Russia and Venezuela greatly, the US economy is much more diverse and is impacted much less severely. Despite the increase in our energy production (including shale oil), the US has remained a net importer of oil. As a result, despite the decline in the energy sector from lower oil prices, the consumption oriented US economy is benefiting due to the extra income which is being spent on goods and services OTHER than gas. Goldman Sachs predicts that if prices remain depressed, the increased consumption could result in an additional 300,000 US jobs.

The oil price drop is due to a supply / demand mismatch. There is a slowdown in global growth, resulting in less demand for oil. OPEC is not slowing production which is resulting in a glut. Should prices have dropped by 50%? The markets have probably overreacted. The proper equilibrium price would be difficult, if not impossible, to ascertain. This is one reason (of several) why we do not invest directly in energy. Such investments are also inherently volatile and there isn't sufficient transparency in the market.

If prices continue to remain depressed in the mid-term, we expect that consumer behavior will likely change, (i.e. demand will start to increase). For example, if oil remains cheap, car buyers will opt for SUVs over less consumptive vehicles. The consensus is that prices **should** stabilize in the first half of 2015.

Of all the asset classes in our clients' portfolios, emerging markets bond funds were most adversely affected by the decrease in oil prices. This was the worst performing asset class in 2014, dropping about 6%.

Fixed Income and Interest Rates

After several years of false predictions that rates would rise, the consensus is that the Federal Reserve will start to raise interest rates in June. Given how much our economy has recovered since 2008, this seems like a reasonable next step since borrowing rates are currently close to zero. To prevent a shock to markets, Fed President Janet Yellen promises to be transparent in Fed communications.

We believe an increase is priced into the markets currently, so if the Fed remains transparent in its communications, we do not believe the markets will react as they did in mid-2013. The minutes of the December 2014 Fed meeting indicate they are carefully balancing the drop in oil prices and slowdown in world growth with the continued decrease in US unemployment and very low inflation. Even if a rate increase depresses bond prices, we do not think it will be significant or will last for a long period of time. Such a rate increase does not change our view that high quality fixed income should be a key component of a well-diversified portfolio.

Stock Markets

Despite the volatility in 2014, the S&P was up 13.7%, while developed foreign markets were down 4.5% and emerging markets were down 1.8%. The foreign markets were actually positive, but appeared negative to US investors due to a strong dollar against all major foreign currencies.

Despite the headwinds we read about (such as the upcoming election in Greece and recessions in Europe and Japan), for those with a long term investment horizon, we strongly recommend maintaining international exposure. Past studies show that countries with lower GDP and more risk provide higher long term returns. From a valuation standpoint, international markets are currently more attractively priced than US markets.

If we look at the first decade of this century, the S&P 500's return was -9.1%. Every other asset category was positive, with international markets providing a solid portion of a well-diversified portfolio's positive return for the decade.

We think there is continued upside for the US stock markets, as the fundamentals are still good. However, there is enough uncertainty with oil prices, geopolitical risks, and the fact that we are 6 years into an economic expansion that we expect to see more volatility this year, (similar to what we saw in 2014).

Conclusion

As is the case each year, there will be unforeseen surprises in 2015 that will adversely affect an asset class. With that in mind, we continue to believe a balanced and diversified portfolio is the best approach.

Please feel free to call us for any reason.

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Sources: JP Morgan, DFA, Wall Street Journal, Morningstar, PIMCO, CFA Institute, Goldman Sachs