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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

As we enter the new year, market commentary describes the economic and market environment as a return to normal. **GDP is modestly accelerating on a quarterly basis, unemployment is at its lowest level in years, and stock market indices are at record levels after appreciating at rates close to their long term averages.** Even volatility has returned to the stock market after an extended hiatus.

Normal, however, does not begin to describe some of the major developments of this past year, many of which will carry over into 2015. From a fundamental perspective, perhaps, the biggest shock came from the precipitous decline in the price of crude oil. **The first period of decline since 2011, last year saw oil fall 46%, mostly during the second half, to trade at levels not seen since 2009.** The impact of this price decline on the global economy is complex, precipitating a redistribution of wealth of major proportions, and testing the financial strength of countries, companies, and lenders whose futures are bound to the price of oil. Indeed, for the first time in forty years, the OPEC cartel seems to have lost control of its ability to manage the global supply (and price) of oil. Since the price collapsed so suddenly, supply has not yet fully adjusted. As expensive production is shut in, we expect to see prices reflect equilibrium with demand. But this may take time as high production levels will continue, regardless of price, in countries where oil provides the only source of hard currency. With many oil consuming countries teetering on the brink of recession, the estimated demand for oil is being revised downward with estimates of declining economic growth. **While this is a gloomy scenario for oil producers, cheap and abundant energy is a major windfall for downstream businesses and consumers.**

The U.S. economy grew at a surprising pace last year, with unemployment declining to pre-recession levels. While this was no doubt partially due to the cumulative effect of the Federal Reserve's program of quantitative easing, another major factor was increased government spending, at the state and local level, before the midterm elections in November. **The stimulus provided by this spending appears to have been more immediately effective than the monetary policy pursued by the Federal Reserve Bank these past few years**. The effect of this fiscal stimulus is likely to carry over into the first half of the 2015.

We have been aware that the aggressive monetary stimulus by the Federal Reserve Bank has only produced an anemic economic expansion during this economic recovery. With stimulus money finding its way into reserves rather than capital investment, we thought it was only a matter of time before inflation served as a catalyst to increased investment and economic activity. Our fear was that this transition might be too abrupt, with an overheating economy and high inflation. We recently read an analysis by BCA Research, Inc. which suggests that this phenomenon is occurring throughout the developed world. BCA describes this as an "Unlevered Expansion." It represents a secular reversal of decades of using debt to finance growth. BCA warns that "the lack of re-leveraging in the developed world economy would undercut strength in demand, while deleveraging would continue to create over-savings around the world. As a result, monetary reflation would be necessary to sustain growth momentum." **With the developed world pursuing divergent monetary policy cycles, BCA believes this dynamic could characterize economic cycles for a long time to come, producing less-than-optimal economic growth and the potential for deflation.**

The dollar index (DXY) rose 12% last year for its biggest gain since 2005. With tight fiscal policy and weak monetary policy on a global basis, we expect continued upward pressure on the dollar. The global divergence in fiscal and monetary policy will dictate economic and financial market prospects, but notwithstanding the success of ECB President Mario Draghi in implementing a vigorous quantitative easing program in Europe, the evolution of Fed policy in the coming year will continue to define trends for the dollar, inflation, and the global economy. **As a consequence, we see very nominal gains in the financial markets for 2015, with U.S. equities, again, producing some of the best returns.**

Fixed Income Market

During the past year, the benchmark 10 year U.S. Treasury yield declined from 3.04% to 2.17%, the largest drop since 2011. At the end of last year, the consensus was that rates would rise with the end of quantitative easing. **That clearly was not the case as 2014 ended not just with lower rates, but with a very flat yield curve, which reflects market expectations for rates to remain low for the foreseeable future.**

While we don't disagree with this assessment, we do note that low rates in the U.S. already discount ECB President Mario Draghi's success at implementing an aggressive program of quantitative easing and lower rates in Europe. Rates in the U.S. are likely to be quite volatile without Draghi's success. With the savings rate high in Europe, as it is in most of the developed world, we think that even an aggressive quantitative easing program will only be marginally effective in stimulating economic growth. **It probably also will not result in meaningful inflation and should produce higher financial asset prices.**

Overall, we expect a benign rate environment for fixed income in the coming year.

International Market

While the U.S. domestic markets performed fairly well over the past year, the same cannot be said for international markets. The MSCI EAFE Index (developed markets) dropped 7.4% for the year, and the MSCI EM Index (emerging markets) declined 4.6%. **Deflationary pressures continue to trouble European countries, especially within the euro zone, and inflation remains one of the top concerns among many emerging economies.**

Low levels of investment and consumer demand, together with the fallout from the European Union's ongoing trade sanctions with Russia, have been the main causes of the region's economic stagnation. No doubt, a prolonged period of deflation in the euro zone would be terrible for equities; however, we do not suspect that will be the case. **Not only is deflation expected to be short-lived as the European Central Bank (ECB) takes measures to fight it, but depressed valuations also serve as a safety net.**

The ECB is expected to announce a program of outright purchases of government bonds early in the 2015. While such a program will have, at best, minimal effectiveness in supporting economic activity, it could have a substantial impact on financial asset prices thereby creating opportunities in markets. **So while a full-fledged Quantitative Easing (QE) from the ECB in 2015 might have little impact on the economy, it will likely provide a substantial boost to European financial markets.**

The Bank of Japan (BOJ) has already embarked on a program of aggressive easing measures to support the local economy. In addition to the BOJ's actions, other developments such as the delay of another tax hike, lack of fiscal drag, the stimulating impact of a falling yen, and, most interestingly, and unnoticed by many investors, the potential for massive cash payouts by companies to shareholders are all reasons for maintaining an exposure in Japanese equities. Over the years, Japanese corporations have hoarded nearly $2 trillion in cash, more than the total market capitalization of its entire stock market. **Odds are increasing that there could be a move toward higher dividends or increasing share buybacks in 2015. If so, the stock market would receive a large boost.**

Falling commodity prices could put downward pressure on inflation, allowing central banks of emerging economies, many of which are troubled by high inflation, to keep monetary policy loose for the time being. However, monetary tightening by the U.S. Fed could trigger more volatility in the financial markets of emerging economies. Thus, the outlook for most emerging markets is murky.

One exception to the troubled outlook for emerging markets is China, where policymakers have plenty of leverage and the financial resources to maintain systemic stability. A main theme of a "new normal" for growth has clearly emerged from the Central Economic Work Conference, an annual gathering of senior Chinese policymakers, which sets the growth strategy and policy stance for the coming year. According to researchers at the People's Bank of China, Chinese economic growth is set at 7.1 percent in 2015, slower than the 7.5 percent targeted for 2014. Despite Chinese GDP growth continuing to slow, the ongoing reforms are proceeding well. **Additionally, given China's more attractive macro profile and valuation levels, there is growing consensus among emerging market investors that Chinese shares will outperform the EM benchmark.** This could generate self-fulfilling momentum should investors begin to position accordingly.

The recent freefall of the ruble has caused investors to worry that developments in Russia would escalate to a new global crisis, but, looking at fundamentals, we see that possibility to be minimal. The direct economic and financial linkages between Russia and much of the rest of the world are relatively small. Russia's share of world trade is around 1.7%. The country also accounted for only 2.7% of world GDP at market exchange rates in mid-December, and this figure will presumably fall much lower in 2015. The exposure of the world's banks to Russia is also small. According to Bank for International Settlements (BIS) data, U.S. bank lending to Russia accounts for only 0.1% of U.S. GDP. The equivalent figures for Japan, the U.K. and Germany are all well below 1% of GDP. Therefore, even if a significant proportion of these loans were to become non-performing, the macroeconomic impact would not be material.

In a world of slow domestic growth, there is a greater tendency for countries to resist competition from foreign goods and labor. Therefore, one potential threat that concerns us is a general retreat from open markets and open trade. A withdrawal from globalization would damage productivity, profit, and overall growth. Although there is no clear evidence of protectionism in major economies at the moment, this could change if there is subpar growth for a prolonged period. That being said, the world as a whole benefits from an extended period of lower oil prices. **Corporate earnings are expected to grow and, given depressed valuations, we continue to recommend maintaining a certain level of exposure to the international markets.**