Economic & Investment Outlook 2015

FMG has just celebrated its 25 year anniversary! We have been blessed with a wonderful group of clients who continue to make FMG an enjoyable and healthy environment for all of us. As we embark on 2015, we are excited about the multiple opportunities ahead and look forward to discussing each individual client's financial and legacy goals, to achieve financial security and peace of mind.

The Year in Review – Mixed Results Short-term, Strong Results Long-term

First, as a review of 2014, please see the chart below summarizing investment returns for several of the diversified indices. Note that depending on the particular asset class, investment returns were mixed, which is not particularly unexpected given that four out of the past five years (2009-2013) have provided double digit returns for diversified portfolios.

Index	2014	3 year	5 year	10 year	20 year	Description
S&P 500 Index	13.69%	20.41%	15.45%	7.67%	9.85%	Large-Cap Stocks
Russell 2000 Index	4.89%	19.21%	15.55%	7.77%	9.64%	Small-Cap Stocks
MSCI – EAFE	-4.90%	11.06%	5.33%	4.43%	5.02%	International Stocks
MSCI – Emerging Market	-1.82%	4.41%	2.11%	8.78%	6.01%	Emerging Market Stocks
Barclay's Aggregate Bond Index	5.97%	2.66%	4.45%	4.71%	6.20%	Domestic Bonds

In 2014, stocks of large US companies provided double digit rates of return and significantly outperformed most other asset classes. The S&P 500 Index, for example, increased +13.69% during the year. The performance of mid- and small-capitalization stocks at the same time only increased +4.89% as measured by the Russell 2000 Index. Importantly, over longer timeframes such as the past 10 to 20 years, the performance of both of these indices has been 8-10%, consistent with expected long term averages. Obviously the period of the Great Recession in 2008 is included in this time period as well, highlighting the importance of maintaining a long term focus.

In stark contrast, international indices declined -4.90% in 2014 as measured by the MSCI – EAFE Index. The underlying companies actually experienced moderate growth in their local economies, but due to a significant rise in the value of the US dollar, the net result was a small loss in this asset class for the year. Currency fluctuations will sometimes amplify the volatility associated with international investments but as part of a structured portfolio, investors derive significant diversification benefits from the asset class. As with domestic equities, international investments have provided good returns for long-term investors.

Yields on US bonds remain near historical lows, with 10-year US Treasury yields having dropped from 3% to 2% throughout the year. This decrease in the interest rate for new issues increases the values of existing bonds and was the primary driver of positive bond returns during the year.

2015 Outlook – Is the Bull Market Over?

A natural question for investors after several years of strong market performance is "Is the Bull Market Over?" Media reports of equity markets now achieving all-time highs often create confusion, leading many to wonder whether market advances can be sustained. Some investors may even fear that the only way to experience growth in the future is by having to trudge through another market correction. FMG's Investment Committee has considered this outcome, but our expectation is that continued growth is more likely in 2015. Our belief is grounded in an analysis of three particular events that typically precede a sustained market correction: recession, restrictive Federal Reserve polices, and stock market over valuation. We will summarize our views on each of these below, but our overall expectation is that the probability is low for each to occur in 2015.

<u>Recession</u>

An increased likelihood of a recession can often be a catalyst for a bear market. When consumer spending and corporate profits decline for an extended period of time, this can lead to economic contraction and recession. Elements of today's economy seem to indicate we are at a low risk of recession in the near term for the following reasons:

- We expect profit margins to be sustainable with room for growth of revenue in many sectors including the largest: auto and housing sectors. Moreover, we expect continued consumer spending and investment as indicated by record low household debt obligations. This tells us that consumers have paid down outstanding debts and may have surplus cash flow for spending or investing. The recent sharp decline in the price of oil also puts more money in consumers' pockets to spend.

- Further evidence supporting higher profit margins lies in the historically low detractors of profit: corporate taxes and interest expense. Yields remain relatively low and global competition has pressure on Congress to match our corporate tax code with that of other countries seeking to attract business.

- Prior to a recession, interest rates for short-term bonds often rise above the levels of long-term bonds, creating an "inverted" yield curve. While our expectation is for rates to slowly rise, we anticipate they will increase across all maturities, which is typically associated with strong economic growth.

- While certain international markets are likely to experience a recession in 2015, our expectation is this will not result in a global economic slowdown. Media attention to certain regions, including Russia and other European countries, will likely create intermittent market volatility but as a long-term investor the most prudent practice is to stay the course and to look for additional investment opportunities as they arise.

Restrictive Fed Policy

Often referred to as a "hawkish" Federal Reserve, this is where economic stimulus is removed and higher interest rates prevail. During this period, which is typically associated with the later stages of an economic cycle, the intent is to stave off the potential for inflation by proactively raising short term interest rates for a sustained period of time. In the current environment, the Fed has been clear in its intentions and methodical in its actions.

- Although the Fed is reducing economic stimulus, any policy of raising interest rates at all is unlikely until at least mid-2015, and even then is likely to be very modest in nature.

- Media headlines often infer that higher interest rates will increase borrowing costs and choke off market growth, but historical data suggests this is not the case. Rather a steep yield curve, where interest rates are high for long term bonds and low for short term bonds, has historically been an indicator of strong economic growth.

- Wages and employment costs are most company's single largest input cost and, as a result, are the single largest indicator of expected inflation for the economy. Currently, employment cost growth rates remain very low and are not a risk factor that is expected to fuel consumer price inflation in the near future.

Stock Market Overvaluation

Valuations of stocks are measured in a number of ways, most commonly a ratio of stock price relative to assets, earnings, or sales. When we see valuations at very high historical levels, we are then at greater risk for potential decline.

- The US market is currently near 17.5 times earnings which historically has not been a level of overvaluation. Rather it is approximately "average" based upon historical ranges, and could even be argued as being below average given the current low inflationary environment. World markets are also fairly valued compared to historical levels.

- Forecasted earnings for 2015 are trending higher providing further justification for increase in stock prices.

Other unexpected factors can certainly trigger short-term market volatility and even an economic slowdown. However, a complete analysis of the economic climate which includes each of the points above provides support for us to continue with a policy of slightly overweighting equity asset classes within the investment portfolios.

Prudent Portfolio Management Integrated with Comprehensive Financial Planning Provides the Best Long Term Results

As described in previous FMG communications, we advocate a proven Nobel Prize-Winning Approach for managing our client's investment portfolios. By maintaining consistent exposure to a diversified array of 15-20 individual asset classes, client investment portfolios will have every opportunity for growth and by making tactical shifts, over and above periodic rebalancing and profit taking opportunities, we seek to add value, especially during periods of elevated volatility. At FMG, our team of financial planning and investment management professionals work closely together to ensure opportunities are not overlooked for adding value to your financial situation. In our opinion, wealth building and preservation must include not only investment management, but also financial planning activities such as cash management, debt management, tax planning, risk management, college funding, retirement planning, and estate preservation.

We appreciate the trust and confidence clients have placed in us for the past 25 years and we look forward to seeing you in 2015!

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