Year-Ahead 2015

Where the buffalo roam: The herd moves around obstacles to higher ground.

A year ago, when we introduced our year-ahead 2014 theme, we called it "Back to the Future!" and it was all about elements of this business cycle that appeared to mirror the cycle we experienced in the mid- to late 1990s—rapid technological gains (the dawn of the internet era), the rise of biotechs, and the relative outperformance of the U.S. economy, among others.

We are still seeing many trends that confirm what we suspected last year—technological advancement, a strengthening dollar, the declining twin deficits in the U.S., and volatility shifting back to the developing world. As we head into 2015, we believe that many of these trends will continue to unfold with the United States remaining the key engine of world growth.

In this year-ahead outlook, we discuss the thinking behind our expectation that equities should continue to outperform fixed income, and explore the key areas of opportunity and risk and the major themes that continue to transform the world.

> We believe this longer-than-expected business cycle (which is still only in the middle innings) should lead to a much longer-than-expected bull market in equities.
>
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WHERE THE BUFFALO ROAM

Capital, like the buffalo, migrates to areas of need and opportunity. Certain things can help it get to those areas faster and stay longer or stall its progress and move it off course. During periods of major technological advancement, like today's, we never feel the advancement is as impactful as it ultimately turns out to be until sometime after we see concrete evidence of sizable benefits. After all, it was only 20 years ago that personal computers became a widespread tool in the U.S. economy. At that time, semiconductor chips were processing at snail-like speeds, wifi didn't exist, 3-D printing was 1-D, and the cell phone looked like a huge walkie-talkie with a battery pack. Replicating the human genome took years instead of weeks or days, and the cost was into the billions; the mobile highway was believed to be a freeway in Alabama; horizontal drilling was a term heard only in a dentist's office; the cloud was a puffy white thing; personalized medicine was little more than cough medicine; and the world's middle class was a

Highlights

- We expect equities to outperform fixed income in the U.S. and globally.
- We remain overweight equities and underweight fixed income. Within equities, U.S. equities should outperform.

Areas of Portfolio Emphasis

- Global equities.
- Health care, technology, financials and energy.
- The strengthening U.S. dollar.

fraction of what it is today.

Right now in the U.S., we are on the verge of energy independence and experiencing a vibrant manufacturing renaissance. We're living in a digital, high-speed, big-data, mobile, wireless world with entrepreneurial velocity to the power of e, and incredible technological advancement across factory floors, engineering and design portals and life sciences labs.

And yet, many feel we are not making progress or believe today's slower-growth landscape means we are sliding backward. Some point to the structural deficiencies in long-term unemployment or the inefficiencies of our educational system to provide examples of what is wrong and what may never be fixed.

In periods of major adjustment and/or repair, not all areas advance at the same speed. This is usually due to the fact that capital almost always goes to the areas of highest risk-adjusted return on investment. Cheap capital buys/funds areas of underinvestment or extreme value (or, put another way, cheap capital funds/invests in/buys areas of high potential growth and reward); this exhausts itself when the cost of capital becomes higher than the return on capital. This generally occurs when supply eventually outstrips demand. The cycle ends when excessive leverage is used to increase razor-thin equity and the underlying asset price collapses.

With all of the gloom and doom about the lack of skills in engineering and computer programming, lack of a world-class infrastructure, broken educational programs, and a high-cost and deficient health care system, it would seem that we are far away from an environment that lacks opportunities or real future growth catalysts.

DEFICIENCIES ARE OPPORTUNITIES

The fact is that the deficiencies mentioned above are actually opportunities—opportunities to close major gaps and turn them into growth spigots of jobs, new or revived companies, and communities and municipalities that are reborn and turning deficits into surpluses.

What is needed to close those gaps is funding at a reasonable cost. This is what ultimately allows productive allocation of capital and an attractive net return. In some cases, after crisis periods, this capital allocation process allows for balance-sheet adjustments and distressed assets that were impaired to be repaired. Government programs or policies can help speed this process (on the flip side, unintended consequences or restrictive hurdles can thwart an effective allocation of capital).

Sound familiar? We have witnessed all of this in the last six years. Now we are out of the repair period and heading into the initial stages of the expansion phase of the cycle. The "herd" is ready to move closer to new economic catalysts such as "the internet of things," energy independence and infrastructure redevelopment, a manufacturing renaissance, and the spending power of a growing middle class outside the U.S.—all of which, thanks to low inflation, have the potential to lengthen the business cycle to twice its normal duration.

So the good news is we are in a business cycle that rivals previous technological advancement periods. Cheap funding is still available. The cost of funds is low, and purchasing power is healthy. The opportunity set is still wide and arguably growing, as is the future needs assessment. Pent-up demand is outstripping supply in most areas that drive the economy. Productivity can get better. And when did we ever think we would be back in a position of manufacturing strength, not to mention full energy independence?

Yes, we have structural unemployment issues to fix. We have to address the long-term national debt problem, income inequality, climate change, and concerns over geopolitical risk. They are the reasons for more of a grind upward in investment returns. But as long as the private sector has good reasons to invest and can do it from a healthy balance sheet, then the probability of a thriving environment is high. The extended business cycle we're expecting may see slower growth than we would prefer, but it should also be less volatile and lead to a much longer-than-expected bull market in equities.

AT A KEY RESTING SPOT FOR 2015

For 2015, we are forecasting S&P 500 earnings per share of $128 to $130 with a market multiple of a little over 17x. This implies a target for the S&P 500 of 2,222 at the high end during 2015; we think an appropriate range is 2,175 to 2,250, allowing for potential slight downside to earnings per share (EPS) due to a stronger-than-expected dollar. We are targeting U.S. gross domestic product (GDP) growth of 3.5% and global GDP growth moving toward 4% in 2015. We expect the Federal Reserve to nudge short-term rates up slowly and on a measured basis beginning in June of 2015. We expect the curve to shift up and flatten slightly as short-term rates should rise more than longer-term Treasury yields. Given this, we believe the back end of the curve should grind higher with 10-year Treasuries possibly piercing 3% by year-end 2015.

THE HERD HAS MOVED TO A NEW PATCH—TEMPORARILY

With about a 50% fall in oil prices since June, the energy sector is at a level that is significantly attractive for long-term investment. Many companies within the sector are trading at levels that are discounting oil prices some 20% below current levels. We believe the energy sector—specifically, the oil-service, infrastructure equipment, and large integrated companies—is one of the most attractive investment opportunities for the next few years, beginning in 2015.

PORTFOLIO CONSIDERATIONS AND INVESTMENT THEMES

- **We expect equities to outperform fixed income:** Our research indicates we are in the midcycle phase of the business cycle. Equities have traditionally outperformed significantly in the recovery phase and continue to outperform, albeit at a slower pace, in the midcycle. Relative valuations still favor stocks over bonds.
- **Within equities, and relative to other asset classes, we continue to expect U.S. equities to outperform:** We continue to expect the U.S. economy to lead global growth, and U.S. equities should outperform accordingly, particularly given the strengthening of the U.S. dollar.
- **We remain neutral weight emerging market equities:** Valuations are attractive, in our view. We remain selective in emerging markets with a preference for Mexico and South Korea, and we are committed to owning what the emerging market consumer needs and buys.
- **We are slightly overweight international developed equities versus our strategic allocation but on a hedged basis:** An improving global economic backdrop should provide enough tailwinds to support Europe, in addition to Japan continuing steps to end deflation. We expect a quantitative easing program from the European Central Bank early in 2015, which should support an improved equity environment. As a result, we remain market weight in Europe. Given our strong dollar view, hedging international exposure, particularly in Europe and Japan, is important at this point in the cycle.
- **Sectors:** We remain overweight financials, information technology, health care and energy. We remain neutral weight in materials and industrials, as well as in the consumer sectors. We retain our underweights in utilities and telecommunications.
- **We remain underweight fixed income overall but see potential opportunities in credit:** Within fixed income, we prefer credit over Treasuries, with an emphasis on corporate bonds, municipals, mortgage-backed securities and commercial mortgage-backed securities. We are avoiding non-North American sovereign bonds and maintaining a neutral weight to global high yield and leveraged loans. We also recommend a more active management approach to improve potential returns in a rising rate environment. A barbell strategy of owning bonds with both longer and shorter maturities should perform better than a laddered or bulleted strategy.
- **We are neutral commodities:** We expect all of the crosscurrents in the commodities space to continue in 2015 with the asset class likely to remain range-bound at best in 2015.
- **We remain slightly underweight hedge funds** even though the opportunity set is widening as monetary policy divergence unfolds globally, and we are **neutral private equity**.
- **We remain neutral real estate as an asset class:** Outperformance by real estate investment trusts (REITs) over the last few years has stretched valuations.
- **The dollar:** Faster relative growth in the U.S. is attracting bigger foreign capital inflows. We expect this positive self-reinforcing dynamic for a stronger U.S. currency to continue over the next few years.
- **"A Transforming World" investment themes (Earth, people, innovation, markets, government):** We continue to emphasize the manufacturing renaissance, cyber security, personalized medicine, obesity, the emerging market middle-class consumer, North American energy and the natural resource revolution within these categories.

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Other important information

Past performance is no guarantee of future results.

All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments.

Investing in fixed income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Single-state municipal bonds pose additional risks due to limited geographical diversification. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor.

International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments.

Global investing poses special risks, including foreign taxation, currency fluctuation, risk associated with possible differences in financial standards and other monetary and political risks.

Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility.

Stocks of small and mid cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors.

Nonfinancial assets, such as closely held businesses, real estate, oil, gas and mineral properties, and timber, farm and ranch land, are complex in nature and involve risks including total loss of value. Special risk considerations include natural events (for example, earthquakes or fires), complex tax considerations, and lack of liquidity. Nonfinancial assets are not suitable for all investors.

Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage, and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund. Hedge funds are speculative and involve a high degree of risk.

Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government.

Dividend payments are not guaranteed. The amount of a dividend payment, if any, can vary over time.

Diversification does not ensure a profit or guarantee against loss.

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