Investment Update

BNY MELLON
WEALTH MANAGEMENT

January 2015

Shifting Gears into 2015

My first car was a 1969 Volkswagen Bug. Along with many other bells and whistles, this 4-speed standard transmission, 53-horsepower car included, as standard equipment, an analog odometer with five digits. So, in 1979, it was cause for great celebration when the odometer turned from 99,999 back to 0 (I grew up in Maine, where we celebrated even the smallest accomplishments.) The turn of the numbers represented a milestone, but also a new start. There must be something about resetting that is very satisfying, at least to me, as that memory still sticks.

Lucky for me, I'm in the money management and investment strategy business, and every January brings cause for celebration as we reset our own market odometers and look ahead to what the new year may bring. While others seem to dread this time of year, I've always liked both the reflective nature and the new beginning aspects of the season. With that in mind, let's outline some major themes that we expect to see moving forward.

Favor Stocks Over Bonds

Forgive me for sounding like a broken record, but our recommended overweight equity position relative to bonds continues to add value in client portfolios. We believe that 2015 will be yet another year that favors this same positioning. While naysayers will claim that this bull market is petering out, we would disagree. Historically, late-cycle bull markets (generally defined as the last 1/3 of the bull market run) have lasted as long as four years and generated an average total return of 50% before ending—typically as the economy enters a recession. By our calculations the current late-cycle bull just passed its one-year anniversary mark and thus, we expect this bull market has room to run. This is also supported by our forecast for three years of 3% real gross domestic product in the U.S., a fairly valued market and the prospect for continued earnings growth.

Do Not Abandon Bonds, Even as Rates Rise

Although interest rates moved lower last year, reversing their upward trend established in 2013, we think 2015 will be a year of rising rates as economic growth continues to gain momentum, especially in the U.S. Therefore, we expect the Federal Reserve to begin raising short-term rates sometime in the summer of 2015.

The lift in rates will occur in short maturity bonds related to a rise in the Federal funds rate, but also in longer maturity bonds, though to a lesser degree. Because we believe rates will rise only modestly, investors should not abandon bonds. Instead, manage duration (interest rate risk) by incorporating both short-term and long-term bonds in portfolios. Diversification within fixed income will also be paramount. Investors should consider strategies that are less correlated to traditional bond benchmarks, with examples being global credit and floating-rate debt. In addition, investors may also want to look beyond traditional fixed income to include alternatives in their portfolios, such as absolute return vehicles and managed futures strategies. Both of these alternative investment strategies have low correlations with equity markets and therefore, should provide investors with diversification as well as the potential for positive returns in a rising rate environment.

Favor Large Cap Over Small Cap & Growth Over Value

Late-cycle bull markets also have historical traits relating to market capitalization and style. In researching investment style data going back to the late 1970s, history shows that U.S. large capitalization stocks have a tendency to dominate small capitalization stocks. Also, growth stocks tend to beat their value stock counterparts. This late-cycle bull market has been no exception. Large cap U.S. stocks, as defined by the S&P 500 Index, have been among the strongest asset class in the world since this late-cycle bull market began, beating both the MSCI World Index and the Russell 2000 Index by 9% (26% return for the S&P 500 vs 17% return for both the MSCI World and the Russell 2000). While a relative pullback is always possible, we believe large cap stocks will once again prove difficult to beat in 2015 and thus, we will continue our long-standing recommendation to overweight large cap stocks in client portfolios.

Growth stocks, defined broadly as those companies that are growing revenues at an above-average rate and having generally more volatile stock prices than the overall market, also have the historical tailwind in late-cycle bull markets. This time around has been no exception, with growth beating value in both large cap and small cap areas of the market. As this bull market marches forward, growth stocks' expected outperformance should continue to benefit our clients.

Volatility is Here to Stay

Late-cycle bull markets have a nasty side: they are volatile. In our view, markets are currently fairly valued, which brings greater price fluctuations as individual stocks must justify their valuations. Investors who are able to withstand these swings are usually rewarded with higher overall prices as the market grinds slowly, almost inevitably, upward. In addition, buying on short-term pullbacks to take advantage of price weakness should continue to prove to be a winning strategy in 2015.

Multi-Year Dollar Strength: Favor Domestic Over International

In our view, the dollar has embarked on a multi-year, strengthening trend relative to a basket of other currencies. Currencies trade relative to one another based upon two things: interest-rate differentials and relative economic strength. In both of these criteria, the dollar has considerable advantages over other major currencies of the world. U.S. interest rates remain relatively higher than those in Germany or Japan, while U.S. economic growth prospects remain among the strongest in the developed world.

Dollar strength has many implications including higher real interest rates in the U.S. and weaker global commodity prices. Inflation should remain constrained as a stronger dollar helps to contain the price of imports. Domestic companies will benefit as a result, while those firms exposed to international markets may be negatively impacted on a relative basis.

We revisited international exposure in client portfolios throughout 2014 and currently hold an underweight position in both international developed and emerging market equities, limiting our clients' direct dollar exposure. We also maintained an underweight to commodities throughout 2014 and continue that positioning as we begin 2015. Each of these recommendations will enable our clients to take advantage of a strong dollar trend going forward.

Conclusion

As we embark on a new year, each of these themes supports our overarching viewpoint that we are in a late-stage bull market with some room to run. We expect an accelerated pace of economic growth in 2015, with the U.S. outpacing other developed countries, bringing with it slightly higher domestic interest rates and solid corporate profits. Historically, bull markets have been killed by inflation, sharply rising interest rates and severe market overvaluation. So far, none of these variables are present.

My current car is more powerful than my 1969 Bug and while more comfortable and modern, I sometimes miss the simpler times. The current odometer is digital and, in my opinion, a lot less interesting. It's a good thing that markets are there to fill the void, as understanding them year in and year out has proven to be a worthy, lifelong challenge.

Jeff Mortimer, CFA
Director of Investment Strategy