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Investment Review and Outlook

Should any investor ever trust the economic forecasts of the market pros? As 2014 began, economists and market pundits were betting heavily that interest rates in the United States would rise as the Federal Reserve completed its quantitative easing program (QE3). While the Fed indeed ended the program on schedule, interest rates on most fixed income securities moved steadily lower through the year. In our screed one year ago, we laid out the following thesis: "Contrary to conventional wisdom, we believe that bonds could actually rally this year should economic growth and inflation remain tepid." That was a major call we got right in 2014. While US economic growth steadily picked up steam, global growth faltered as Europe and a number of emerging markets faced significant economic and political headwinds.

The fourth quarter of 2014 saw equity markets trade in a volatile range. But indices advanced during the quarter and ended the year near record highs. Some could say we are in a "Goldilocks economy," where economic growth is not too hot and not too cold – just right. If the US economy continues to grow modestly, we believe the Federal Reserve will gingerly raise interest rates. But even as they raise interest rates, we are not concerned about a panicky response from the equity markets. First, in most prior interest rate cycles, the initial phase of a Federal Reserve tightening is normally associated with higher stock prices. Moreover, if the Federal Funds rate moves up to 1% by the end of the year, we cannot imagine a diminution of corporate capital spending and hiring. Nor do we see such a benign rise in interest rates to have any impact on consumer sentiment and spending behavior.

While we may be approaching the latter innings of this bull market in equities, we do not see any major storm clouds on the horizon and we believe that equities will likely generate positive, albeit modest returns in 2015.

Oil, Oil, Everywhere

While our interest rate call for last year was on the money, the albatross around the neck of this mariner was the unanticipated and sharp decline in the price of oil during the last few months of the year. That decline led to a significant drag on our clients' portfolio returns in the second half of the year after a strong start. We factored into our analysis of energy stocks a potential decline in energy prices of 10-20%. On that basis, oil and oil service stocks appeared to be not only undervalued, but they also seemed like an effective defensive hedge against the increasing geopolitical risks surfacing across the globe.

After OPEC met in November and decided not to cut production, oil prices collapsed by as much as 50% from the high. We have seen sharp declines in the price of oil in the past. In 2008, oil prices fell nearly 80% from peak to trough. But prices rebounded sharply as the fears of a financial collapse faded. To be sure, we do not anticipate a rapid recovery in the oil price this time around. That said, we do not believe that oil prices will remain in the $50 per barrel range. The fact of the matter is that the supply/demand imbalance is less than 2% of global daily production. And we believe that production will undoubtedly begin to decline as exploration and production companies scale back their capital spending programs.

We believe that maintaining an overweight position in energy stocks still makes sense. At the same time, a shakeout in the industry is inevitable. We are sharpening our focus on companies with strong financial positions like **Exxon Mobil (XOM $92.10)** and **Chevron (CVX $108.21),** which will not only survive, but possibly thrive, by acquiring assets from distressed competitors on the cheap.

While we lick the wounds of a less than stellar performance of our energy stock holdings in 2014, we remain confident that we will see a recovery in energy stock prices at some point in 2015 and beyond.