INDEX	4th Quarter, 2014	Last 12-Months
US STOCKS		
S&P 500 Index (large-cap stocks)	4.96	13.69
Russell 2000 Index (small-cap stocks)	9.73	4.89
FOREIGN STOCKS		
MSCI EAFE Index (developed foreign markets)	(3.57)	(4.90)
MSCI Emerging Markets Index	(4.51)	(2.19)
MSCI BRIC Index (Brazil, Russia, India, China)	(4.09)	(2.85)
COMMODITIES		
US Dollar Index	5.04	12.79
Gold Spot $/oz.	(0.86)	0.12
Silver Spot $/oz.	(7.71)	(19.03)
GSCI Commodity Total Return Index	(27.67)	(33.06)
BONDS		
BarCap US Aggregate Bond (investment-grade bonds)	1.78	5.94
BarCap US 20+ Yr Treas Bd Idx (long-term US treas)	9.35	27.48
Barclays Municipal Bond Total Return Index	1.37	9.05
Barclays US Credit Bond Index (corporate bonds)	1.76	7.53
Barclays US Corp. High Yield	2.45	(1.00)
S&P/Citi Intern'l Treas Bond Ex-US (foreign bonds)	(2.69)	(2.12)

Source: iShares.com & Bloomberg

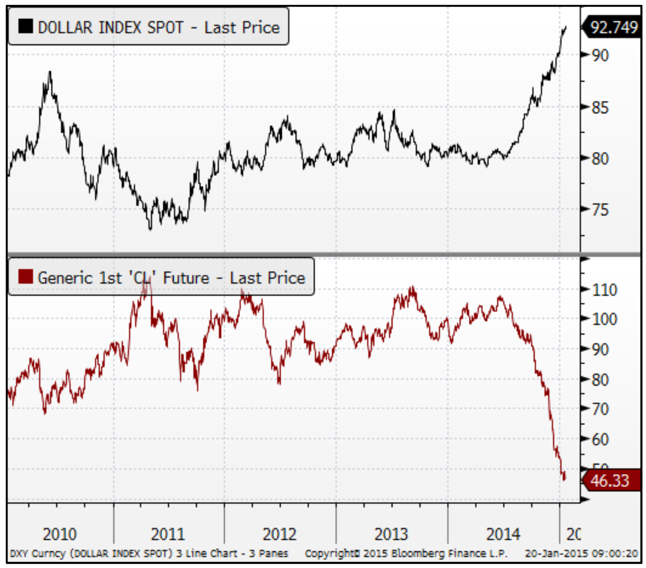
As the year drew to a close, a handful of big-picture issues dominated the investment landscape: the plunging price of oil, positive economic indicators in the US relative to most of the world, the continued strengthening of the US dollar and the ongoing influence of central banks.

Oil wins as the most notable recent mover as it hit five-and-a-half-year lows in late December (falling 40% in the fourth quarter alone – Exhibit 1). While a decline in oil prices is typically viewed as a decidedly positive development for the global economy, the result this time around has been different because of the speed and degree of the plunge. With deflation concerns already high in many parts of the world, the oil price decline is viewed as intensifying the deflationary risks.

Whether the oil shock is bullish or bearish depends upon the time horizon. Shorter-term, the decline could exacerbate emerging market economic and financial strains, further advancing US dollar strength and putting stocks at risk. The surge in US oil production will slow, as will capital spending. Energy accounted for 2% of overall non-residential fixed investment in 2002, versus 11% currently. The energy sector share is even larger for S&P 500 companies: 11% of capital expenditures and R&D in 2002, versus 24% in 2013. Moreover, industries such as steel, trucking, engineering, rails and industrial equipment manufacturers will be re-evaluating expansion plans.

Looking further out, trade and consumer spending benefits should begin to overwhelm the near-term negatives as household disposable incomes rise because of lower energy costs. Lower energy prices are also associated with lower interest rates as it signals continued global deflation and reduced domestic inflation expectations.

Exhibit 1: US Dollar and Crude Oil Price



Source: Bloomberg

Central bank policy was positive for financial assets during the quarter. Even as the Federal Reserve suggests it is on track to begin raising short-term interest rates, it once again soothed markets by reaffirming that it would continue to be patient in shifting its stance. Given the poor economic conditions that persist in Europe, investors continue to expect the European Central Bank to take a more meaningful step toward full quantitative easing (i.e., purchasing bonds and other assets with the aim of stimulating the economy). Central banks in Japan and China expanded their stimulative policy efforts during 2014. The takeaway is that even as the Fed may begin scaling back its support, there appears to be no shortage of supportive monetary policy globally. At the same time, the fact that central banks continue to undertake (or contemplate) aggressive action provides a reminder of the broader economic risks we continue to navigate.

Against this backdrop, the S&P 500 index gained almost 14% and, for the third year in a row, avoided even a modest 10% correction. On the other hand, US small-cap stocks dropped more than 13% from their summertime high through mid-October, and ended the year up 5%. Outside the United States, most major stock markets performed poorly. Developed international stocks lost 5%

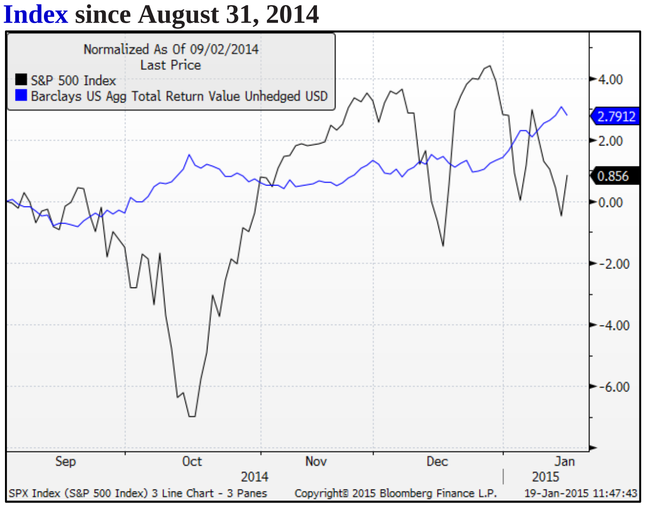
and emerging-markets stocks dropped 2% (based on MSCI EAFE and MSCI Emerging Markets indexes, respectively). These returns reflect the significant headwind presented by the strengthening US dollar, which detracted from returns for dollar-based investors.

Contrary to the consensus coming into 2014, the 10-year Treasury yield declined (from 3.03% to 2.17%) and bond prices rose. The Barclays US Aggregate Bond index was up 5.9% for the year and municipal bonds also fared well. Outside of core bonds, sectors such as high-yield and floating-rate loans lagged.

While large-cap US stocks posted strong returns, globally diversified balanced portfolio returns were less inspiring as diversification away from the US large cap stock and Treasury bond markets was a headwind to portfolio returns. By most accounts, the majority of mutual funds underperformed and hedge funds had a dismal year. Several reports have pointed to the unusually widespread underperformance of actively managed stock mutual funds last year.

The increase in stock market volatility we've been expecting for some time appears to have started in September. As illustrated below (Exhibit 2), returns from US large-cap stocks since August 31, 2014 have been volatile and flat while core fixed-income is up almost 3%.

Exhibit 2: S&P 500 and Barclays US Aggregate Bond Index since August 31, 2014

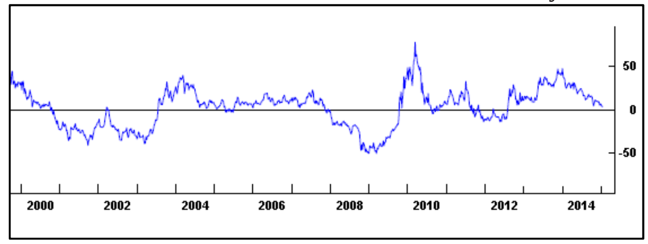


Source: Bloomberg

The main driver of the relative returns between stocks and bonds is economic growth. Currently, this ratio is sending a cautious signal with the 12-month percent change closer to zero than at any time since mid-2012 (Exhibit 3). At the same time, economic surprise indices are rolling over (Exhibit 4), stock market breadth peaked six-months ago (Exhibit 5) and growth in the rest of the world is weak.

Exhibit 3: Stock-to-Bond Ratio

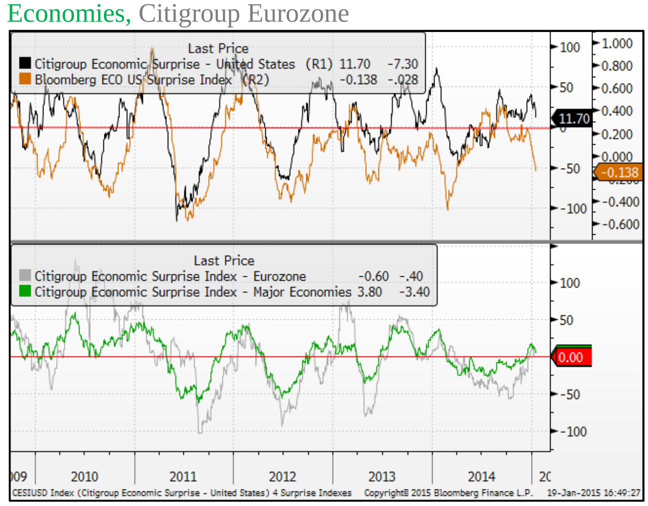
Total Return Ratio of S&P 500 to 10-Year Treasury Yield



Source: BCA Research

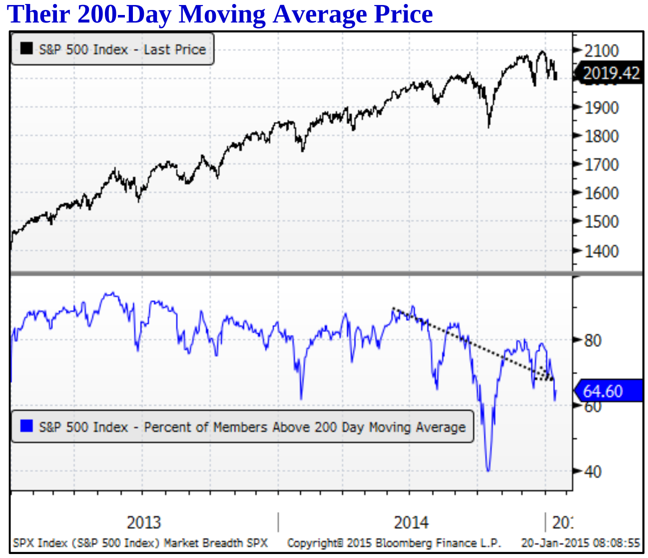
Exhibit 4: Economic Surprise Indices

Citigroup US, Bloomberg US, Citigroup Major Economies, Citigroup Eurozone



Source: Bloomberg

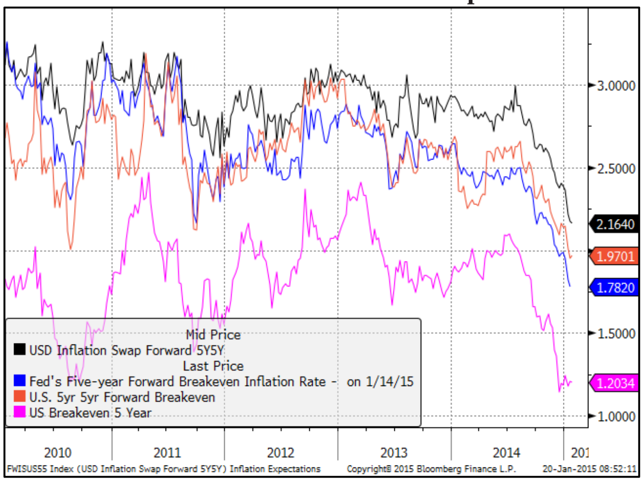
Exhibit 5: S&P 500 and Percent of Stocks Greater than Their 200-Day Moving Average Price



Source: Bloomberg

Meanwhile, the message from the Fed is that interest rates will go up starting around mid-year, as long as unemployment keeps falling and consumer spending is strong. We believe these trends will persist, but mitigating factors increase the odds that raising rates that soon could be a mistake: capital spending is likely to disappoint; inflation expectations are falling (Exhibit 6); the strong dollar has tightened monetary conditions; and emerging market financial strains are building.

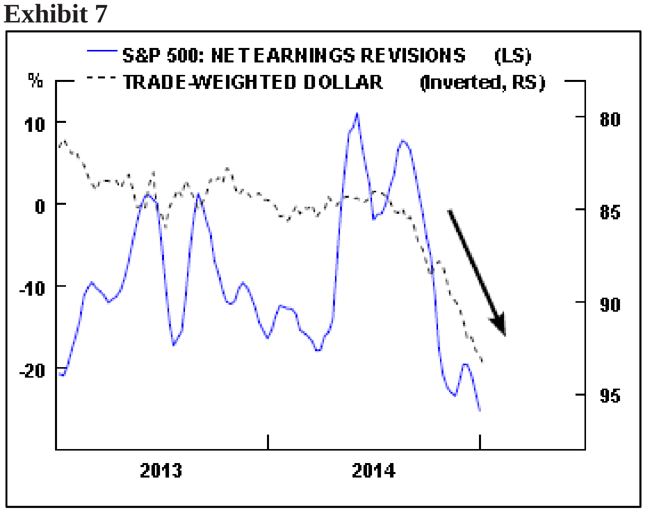
Exhibit 6: Four Measures of Inflation Expectations



Source: Bloomberg

All of this supports our expectation of a correction in risk assets during the first three- to six-months of 2015. Economic and financial vulnerability in the rest of the world means that tougher Fed talk pushes up the dollar, at a time when valuations are already demanding and earnings revisions have gone negative (Exhibit 7). The divergence between Fed normalization rhetoric and financial stress in the rest of the world puts stocks at risk.

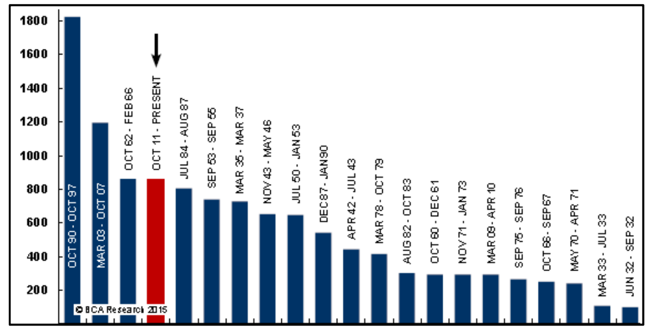
Exhibit 7



Source: BCA Research

As fourth-quarter earnings season begins, we think the odds favor more down-side volatility before the risk/reward tradeoff turns favorable. While it's impossible to know whether the anticipated correction will be "run of the mill" or something worse, we do know that the last 10% correction in the S&P 500 was 39 months ago making this one of the longest stretches without a meaningful correction (Exhibit 8).

Exhibit 8: Duration of Bull Markets without a 10% Correction



Source: BCA Research

The bottom line is that we believe the chances of a meaningful setback over the next three- to six-months is high, but beyond that the outlook improves as the effects of dollar strength and oil weakness act in opposite directions. Fed rate hikes will ultimately be gradual (even if it starts too early), and policy settings in the rest of the world will eventually become more consistent with the lack of underlying growth – albeit with a "push" from the financial markets.

In this environment, our investment strategy is focused in three areas: large-cap US stocks with an emphasis on dividend yield, intermediate-term high-quality bonds (as our main hedge against weakness in stocks) and, to a lesser extent, high-yield bonds (which we believe have reached levels of attractive valuation). The equity and high-yield components should pay off on a six- to twelve-month horizon, while the high-quality bond allocation will offset the volatility we anticipate over the shorter-term. With this allocation, we anticipate riding out volatility over the next quarter or two with the expectation that six- to twelve-month returns will be attractive as the thirst for yield returns on the back of delayed Fed interest rate normalization.

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