MARKET PERSPECTIVE

JANUARY, 2015

> *"To achieve a genuine world order, its components, while maintaining their own values, need to acquire a second culture that is global, structural, and juridical – a concept of order that transcends the perspective and ideals of any one region or nation."*
>
> Henry Kissinger*

IN VIEW

Despite various attempts by the European Central Banks to revive lending since the financial crisis, their economies continue to languish. However, across the Atlantic a very different story has emerged. The U.S. markets ended 2014 on a very positive note as investors received a surprising holiday present in the form of a 4.1% real GDP growth rate for the third quarter as determined by the Bureau of Economic Analysis. This compares to an annual rate of 2.5% in the second quarter and 1.1% in the first quarter. The acceleration of economic growth against the background of higher taxation and the government sequester was a surprising development. The expansion of monetary policy in the form of an approximate 7% annual growth in M-2 money supply and a 0-25% federal funds rate offered a reasonable explanation for the faster economic growth.

The announcement in December by the Federal Reserve of a reduction of $10 billion in its $85 billion of monthly purchases of mortgage and Treasury bonds due to start in January was a welcome development - the beginning of the end of quantitative easing. With this action the Federal Reserve signaled that it is more comfortable with the improvement of the economy. The above positive developments were reinforced by the falling annual inflation rate as measured by the CPI of 1.2% through November and by the PPI of 0.7%. Although it seems like so long ago, the equity markets responded positively to the above developments and reached new record highs, and, in conjunction with improving housing prices, added to overall wealth.

However, as January unfolded, the global headwinds resurfaced putting pressure on equity markets at the starting gate. We outline some of these headwinds briefly below and conclude that the challenge for the new year is to see if the U.S. can break out of its "new normal" of 2.2% growth, the average of the post Great Recession period since 2008. We are optimistic that we can break from the recent disappointing growth trends, but recognize that there are many uncertainties, most of them global. Our four top challenges:

- The U.S. dollar at a nine -year high against the backdrop of foreign economic weakness,
- The more than 50% fall in oil prices from a year ago - its positive effect on consumer spending, the potential near term negatives on employment and capital spending and energy profits as it relates to the end of the commodity super-cycle,
- The slowing Chinese growth, near-recessionary conditions in Europe and the impact these will have on the deflationary process,
- Potential slowdown of Fed policy accommodation.

Of course higher inflation and resultant interest rates could slow the economy. Any decline in manufacturing is no reason to panic, particularly since a large number of companies in the leading indicators are expected to be hardest hit by the dollar's surge. In contrast, the slump in energy prices and the subsequent surge in households' purchasing power will benefit smaller domestically focused firms in the service sector, especially retail and construction. All things considered, any decline in the manufacturing index doesn't change our view that the overall GDP growth for the U.S. will be close to a 3.0% rate annualized over the first half of the year and accelerating beyond. We again emphasize that fortunately most U.S. economic statistics remain strong and interest rates are at historic lows.

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*Henry Kissinger, *World Order*, Penguin Press, New York, 2014, pg. 373

The Global Backdrop

At present, the world is facing an unusually high level of uncertainty, particularly in Europe. Economic growth is only 0.8% with unemployment at 11.3%. Additionally in Greece, the radical left-wing Syriza party just won power over the existing New Democracy party by 36% to 27%. The vote was two short of a Parliamentary majority, and so a coalition government was formed with the center-right Independent Greeks party that won 4.75% of the vote. The Syriza party intends to rewrite the rules governing its debt to the Euro-zone countries. A failure to reach an agreement with its creditors could lead to a debt default and its departure from the Euro-zone.

Even more serious is the recent acceleration of the war between Ukraine and its separatists backed by Russia, who currently control about 20% of Ukraine's industrial production. The war is expanding along the southern coastline in an attempt to construct a land corridor to the Crimea. Failure to reach an accommodation with Russia over this issue could possibly lead to a wider war in which President Putin could realize his ambition of controlling all of Ukraine, thereby putting at risk the Baltic States and other countries which are members of NATO.

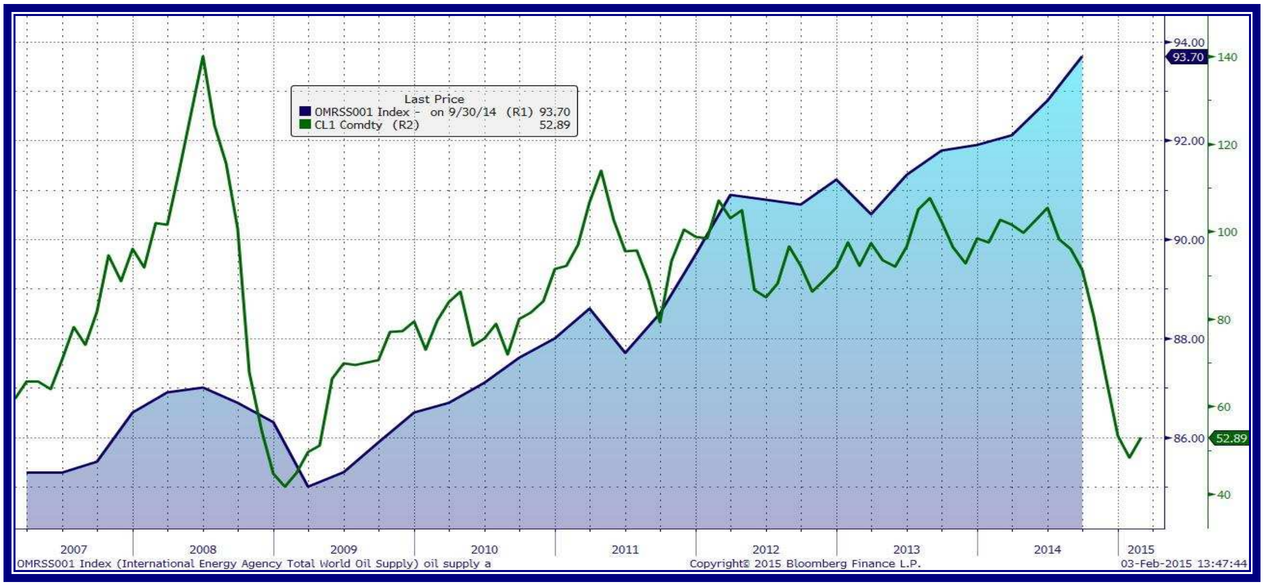
On January 22, Mario Draghi, head of the European Central Bank, announced a well-advertised program of quantitative easing to start in March and last until September, 2016. The size of the program will be $68 billion per month of bond purchases or approximately $1.2 trillion over the 18 month period although it can be extended. This program of monetary expansion follows similar action by the Federal Reserve, the Bank of England and the Bank of Japan, and is occurring over the objections of Germany's monetary authorities. The immediate result was a further weakening of the Euro to $1.12. A year ago the Euro/Dollar conversion rate was $1.40. The Germans, like other conservative countries, believe that monetary devaluations do not solve basic economic problems and can in some circumstances have devastating consequences. It is important to recognize that most economists, even those supporting the devaluation, believe that many of Europe's economic and financial problems are structural in nature and require major labor and political reforms.

CLOSE-UP: The Economic Landscape

In spite of the global backdrop, the U.S. economy is in a relatively good position having just registered quarterly growth rates of 4.6% and 5.0% in its last two quarters. On January 30th, the fourth quarter real GDP was announced at an annual adjusted rate of 2.6% which was a bit below economists' expectation of 3.0% or better. The high-valued U.S. dollar will make it difficult to continue the strong export record of recent years against the backdrop of foreign economic weakness. Exports are 13.5% of the U.S. economy. However, the over 50% fall in oil prices from a year ago will aid consumer purchasing power and consumption is 70% of the economy. The lower oil prices, though, will lead to some layoffs and reduce capital expenditures if they remain below $70 per barrel. At present they are about $50 per barrel. The end of the commodity super-cycle because of slowing Chinese growth and near-recessionary conditions in Europe will directly aid the U.S. economy by continuing the disinflationary process. Higher inflation and resultant interest rates again could dampen our U.S. growth forecast.

But fortunately most U.S. economic statistics remain strong and interest rates are at historic lows. Supporting the economy are strong employment gains (3 million in 2014), personal income (+3.9% in 2014), retail sales (+5.1% in November), industrial production (+4.9% in December), the leading indicators (+6.1% in November), high consumer confidence (92.6 in Conference Board survey, a new high), an improving balance of trade, gradual improvement in housing, and recent evidence of better wages. Also the manufacturing and non-manufacturing (services) ISM numbers last reported at 53.5 (above 50 defines expansion) suggesting healthy growth ahead despite the recent surge in the dollar and the weakness of global demand.

EXHIBIT I
Supply Balance vs. Oil Prices (WTI Crude)

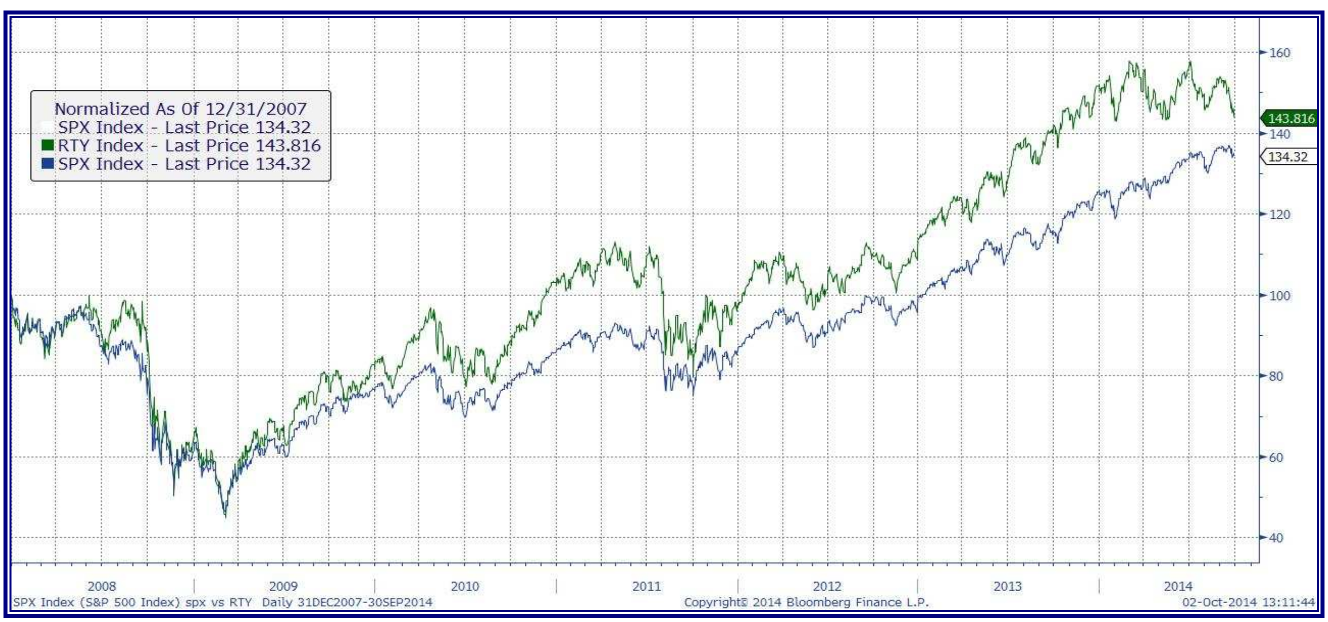


Source: Bloomberg, International Energy Agency and Altman Research

The Outlook for the Financial Markets

It is not uncommon for large cap stocks to out-perform small caps in the latter stages of a bull market. In 5 of the past 7 years, small cap stocks have out-performed as they often do following a recession. Once the strong dollar headwinds dissipate alleviating near term profit expectations, investors will begin to migrate their support to companies with a global reach and once again favor large cap stocks. We would expect this shift to begin in the latter half of 2015, and continue to maintain an equal weighting in the industrial sector versus the S&P 500 index in investor portfolios.

EXHIBIT II
Standard and Poor's 500 Index versus the Russell 2000 Index

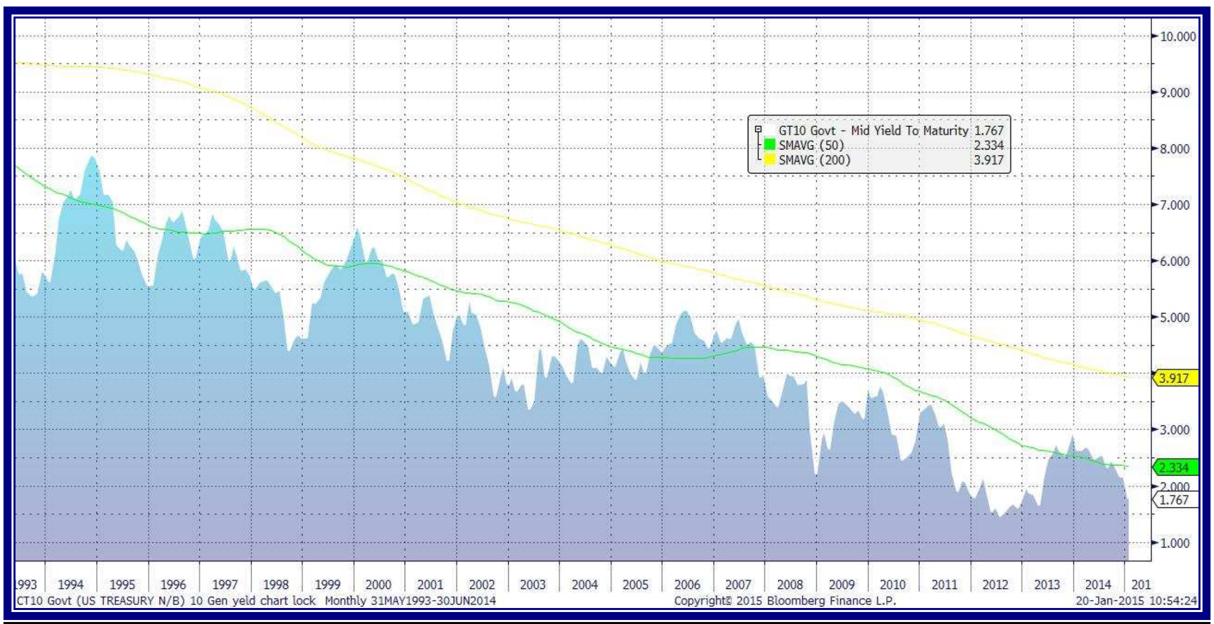


Source: Bloomberg and Altman Research

Our forecast for 2015 is that real U.S. GDP will grow at 3.0%, CPI inflation will be 2.2% (down from 2.5%), and that corporate profits will advance by 5.0%. Because of global slowing accompanied by currency devaluations, it is possible that the Federal Reserve will hesitate to raise interest rates by 25 basis points in the third quarter (as we have forecasted) because the strong dollar is restraining inflationary forces.

The financial data for bonds, commodities and currencies show a continuation of the trends that were evident in the latter half of 2014. Stocks, while relatively unchanged became much more volatile in January. Bond yields have continued to fall close to historically low levels. Three month Treasury bills are at 0.01% versus 0.02% a month earlier, with 10-Year Treasury bonds at 1.75% compared to 2.16% and long-term high quality corporate bonds at 3.52% versus 3.79% a month ago. 30-year mortgage bonds currently yield 3.85% compared to 4.00% at yearend. The reason for the continuation of lower interest rates rests with continued disinflation in the U.S. and even lower interest rates in Europe as it grapples with deflation. The strong U.S. dollar aids in keeping inflation in check.

EXHIBIT III
10 Year Government Bond Yields



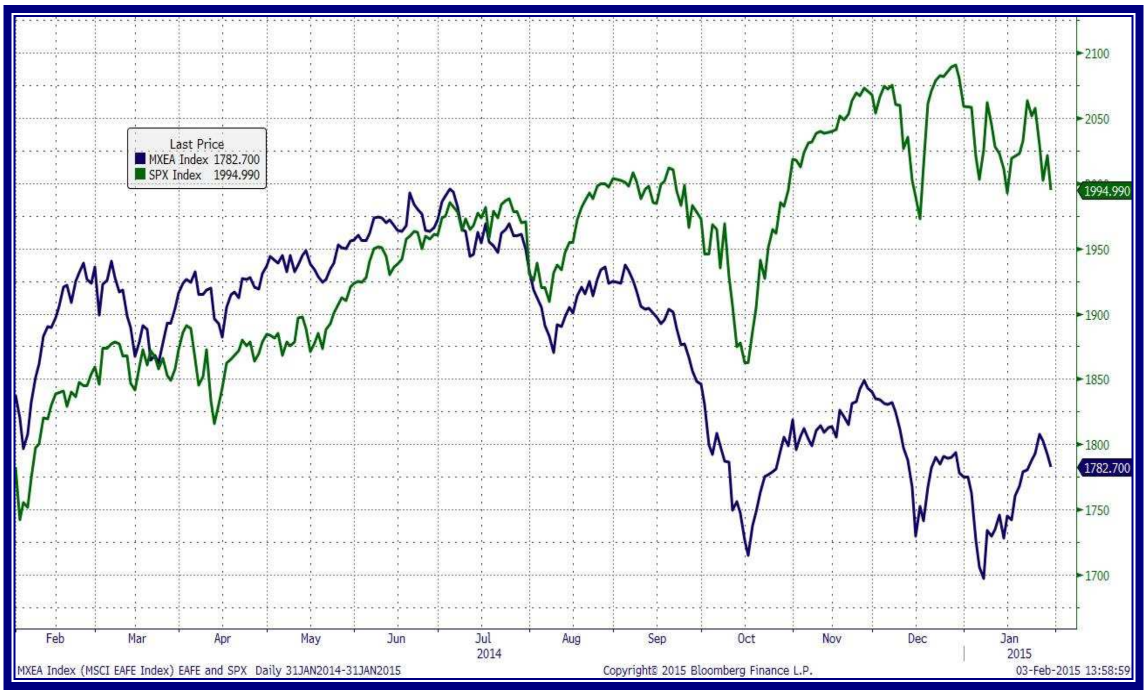
Source: Bloomberg and Altman Research

In the past month, at $44, crude oil prices have fallen rapidly to levels not seen in more than two years, sounding alarm bells among investors(2). With regards to the other lower commodity prices, natural gas followed a similar pattern and copper has fallen to $2.50 per lb. down from 2.80 per lb. in the prior month. The CRB index of all commodities (422) is down from 438 a month earlier and 459 a year ago. This reflected the end of the super-upside cycle which was largely caused by the rapid growth of China and the resulting boom in many emerging markets over the last thirty years. Oil has fallen close to 70% from its June, 2008 high of $145 per barrel, and by 61% from its April, 2011 high of $115 per barrel. The fears of peak oil fed by the belief that the growing population was running out of fixed resources has changed to fears of over-supply caused by hydraulic fracking and horizon drilling.

(2) See our recent commentary "Energy Insights" published in December 2014. In this paper, we address our view on how the oil market arrived at this position, the dynamics under current and future consideration, and how as longer-term value investors we view this capital market dislocation.

Demand has weakened in some of the developed countries, because of greater efficiencies combined with slower growing economies. If the assumption is made that global economies will not fall into renewed recession, commodities could be close to their lows. Inflation as measured by the CPI was 0.8% in 2014, with PPI inflation actually falling by 1.2%. Gold and silver, now at 5 month highs, have been an exception to falling commodity prices. This is because of greater geopolitical uncertainty and a healthier supply/demand balance as mining development has slowed. We expect this trend to continue.

EXHBIT IV
Standard and Poor's 500 Index versus Morgan Stanley Global Index (EAFE)



Source: Bloomberg and Altman Research

The S&P 500 index (2058) declined 3.2% from yearend levels and is up 15.5% from a year ago. In contrast, the Morgan Stanley EAFE index, a measure of foreign stock performance, is up 0.5% over the past month but flat from a year ago. The yearly equity performance difference represents the disparity in economic growth rate performance. At present, the S&P sells at 17.7 times our earnings estimate of $117 per share for 2014 and at 16.8 times our $123 per share estimate for 2015. The latter is a gain of 5% for 2015 and has become the consensus estimate as many analysts and strategists have recently lowered earnings estimates because of some of the above uncertainties.

We remain positive on overweighting portfolios' equity representation, despite a more conservative outlook on near term earnings progress slowing from the 2014 rate of growth. Our view of modestly higher valuations on stocks reflects the backdrop of growing uncertainties, mainly of a geopolitical nature (Russia being the primary one). With the 2016 election appearing on the horizon from a political perspective, we are additionally suspect of an overly optimistic view that the two political parties will become more cooperative. However, there is always the chance that an external threat, such as Russia, could unite the two parties.

Investment Strategy

As we enter the current fourth quarter earnings season, we are paying close attention to managements' observations - not only on what is currently impacting their businesses but also what they believe will materialize in the markets they serve in the coming year. The following list will help our investors have a better perspective on our strategic overview as the year unfolds:

- Global growth should slowly accelerate, with an expansion bolstered by the continuation of accommodative policies from central banks and historically low oil prices. Keep in mind that monetary devaluations do not solve the basic economic problems in the Eurozone, and that the financial challenges are structural in nature and require major labor and political reform.

- The U.S. economy should continue to lead the developed world as consumer confidence improves, slack in the labor market diminishes, and credit conditions moderate as corporate and household balance sheets improve.

- Growth in corporate profits - although at a potentially slower aggregate rate than what we experienced in 2014 - is still expected to expand by at least 5% in the coming year. The potential for higher inflation and interest rates puts a ceiling on valuation expansion and places a premium on stock selection and fundamentals.

- We forecast that the U.S. GDP growth accelerates to an estimated 3.5% growth rate in the second half of the year, supported by increasing demand for capital goods and consumer spending.

- Continued moderate CPI inflation below the Federal Reserve stated target of 2.0%, accompanied by currency devaluations and a strong dollar, should keep Federal monetary constraint on the side lines longer than most investors expect. We are targeting a 25 basis point rise in the Fed funds rate by September of this year.

LOOKING AHEAD:

Our investment perspective, as always, is focused on the longer term, looking out at least three to five years. However, we remain cautious about the prospects for broad equity valuation expansion at this juncture, but optimistic about the shares of what we view as higher-quality companies that are trading below their long-term intrinsic value. While we think total returns for U.S. equities during 2015 will be subjected to valuation headwinds - such as earnings and sales growth, cash flow and book value multiple expansion and slowing dividend growth - it's our belief that these returns (likely in the mid-single-digit range) should continue to be competitive versus other asset classes.

Everyone's been down on the global economic outlook. Both the IMF and World Bank have lowered their global growth forecasts for 2015 and 2016. There has been quite a bit of skepticism about the likelihood that ultra-easy monetary policies in Japan and now the Eurozone will do much to lift their economies. We have been skeptical as well. However, we are open to the possibility that surprises may be to the upside rather than the downside. On balance, the plunge in oil prices should be stimulative for the global economy and the same can be said for the plunge in bond yields.

The question is whether the devaluations of the yen and the euro will boost exports in Japan and the Eurozone. However keep in mind that their gain could be some other economy's loss. In particular, U.S. exporters could suffer if the U.S. dollar continues to strengthen. However, that could be offset by stronger U.S. consumer spending and home building demand.

In conclusion, interest rates remain very low across the board, and prospective returns on stocks are still attractive compared to those on bonds. With these key issues in mind, we continue to favor a positive bias towards stocks. Despite political turmoil and the uncertainties associated with the Euro-zone challenges in the near term, we are emphasizing U.S. domestic cyclicals and returning to the large multinational theme that stands to benefit longer term from the resumption of global economic growth in emerging markets and China.

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