CitizensTrust™ A Division of Citizens Business Bank

Investment Outlook

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We've all heard the allusion "canary in a coal mine," which refers to the practice of carrying a caged canary into a mine shaft to act as a sentinel. Although it sounds like an attractive position, the job is a bit tenuous as canaries are sensitive to carbon monoxide and methane gases, much more so than humans. Should the canary die, miners know it's time to quickly exit the mine shaft. A true warning sign indeed. In investing, we have a number of canaries in a coal mine, or warning signs that we watch to give us some visibility regarding the future path of the economy. At this point in time, a number of the birds are either dead or dying, and this has us concerned (please note: no animals were harmed in the preparation of this Outlook or our economic analysis). Read on for more, but be forewarned that there's a bit of methane in our mine shaft.

Equity Markets

We entered 2014 with positive expectations for domestic stocks, and the market didn't disappoint as it once again exceeded our expectations, rising 13.7% for the year. The year in stocks wasn't boring as it included not one, not two, not three, not four, but five pullbacks of at least 5%, with the one in October declining by nearly 10% and qualifying as a true correction (see Diagram 1). The equity markets benefitted from a true Goldilocks scenario with an economy that wasn't too hot or too cold, but just right. With modest economic growth in 2014 of roughly 3.5%, inflation remained at bay, which is good for stocks. Whereas last year at this time we were quite comfortable with equity valuations, this year we are less sanguine about the prospects for multiple expansion (i.e., higher valuations). When valuations peak, we typically experience either a correction or market appreciation closer to earnings growth, which is expected to be 10% in 2015; although we would expect equity returns to be slightly lower. If our canaries are accurate, and we experience a recession in late 2015, equity prices will decline in 2015.

The Canaries

So what are these canaries in the economy we keep discussing? **Interest rates, for one.** We have long been proponents of lower rates, and made the statement early in 2014, when the consensus was looking for a higher 3.5% 10-year treasury, that yields would see a "one-handle" (i.e., under 2%) before it saw a three-handle. Why would lower rates be a canary? Actually, lower rates themselves aren't the canary; although they are indicative of soft economic

Diagram 1

Diagram 2	S&P 500 Positive... Russell 2000 Negative... | What Happens Next?				
	S&P 500	Russell 2000		S&P 500	Russell 2000
1984	1.4%	-9.6%	1985	26.3%	28.0%
1987	2.0%	-10.8%	1988	12.4%	22.4%
1998	26.7%	-3.4	1999	19.5%	19.6%
2007	3.5%	-2.7%	2008	-38.5%	-34.8%
2011	0.0%	-5.5%	2012	13.4%	14.6%
2014	10.8%	-0.51%	2015	?	?

Strategas Research

conditions. The canary is the shape of the yield curve itself, specifically the difference between the two-year treasury (0.67% at year-end) and the 10-year treasury (2.17% at year-end). This differential becoming negative, also known as yield curve inversion, has been one of the best recession indicators of the last half century. The curve hasn't inverted; however, the Fed has been holding shorter term bond yields down through its various easing policies. As a result, we feel it is prudent to discount the short end a bit and consider that, quite possibly, the weakness in longer-dated yields could indicate problems on the horizon. Another canary includes high-yield bond spreads, which is the price above Treasuries that borrowers with lower credit quality must pay to borrow. Spreads have spiked over the past year, indicating that investors are less comfortable with the credit quality of the borrowers and may be expecting more defaults on the horizon. Historically, this type of spike has preceded economic slowdowns, although this indicator hasn't been nearly as accurate as the yield-curve inversion discussed above. Two caveats must be considered in this widening of spreads. First, spreads neared all-time lows heading into 2014, so the widening has merely moved them slightly above the long-term average. Second, the high-yield index contains a high percentage of energy companies which, as we will discuss later, have been experiencing significant weakness due to a rapid decline in oil prices. Other canaries include weakness in foreign markets, specifically emerging markets, small cap stocks underperforming large-cap stocks, lower credit creation, and sagging global demand for commodities. In the case of small-cap stocks underperforming large caps, the reliability of this indicator has been mixed, with this relationship sometimes indicating a recession and other times preceding a snap back in small cap (see Diagram 2). In summary, there isn't a single indicator that screams recession on the horizon, but the aggregation of indicators gives us pause. Canaries.

The Economy

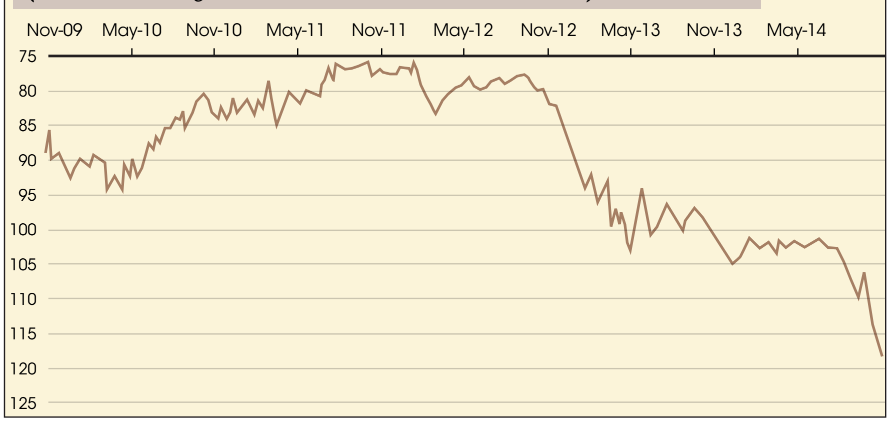
We commented early in the year that we wouldn't get a clear picture of US GDP until the third quarter of 2014. That report was a huge surprise, with GDP rising by 5.0% in the quarter. As is typical with GDP reports, there were one-time items that commentators could latch onto, but in aggregate it was a very strong quarter driven by lower gasoline prices, better hiring activity, improving consumer spending, and rising consumer sentiment. This last indicator is important because it often reflects consumers' view of their current condition. Consumer sentiment has been weak throughout the recovery; no doubt a result of the rising inflation in food and energy experienced by these consumers. Remember the Fed looks at inflation net of food and energy, as if it doesn't have an impact on consumer pocketbooks. With the rapid decline in fuel costs, consumers have benefitted from an increase in discretionary income. Another item helping GDP is the strong dollar, which not only helps keep import prices down by increasing the purchasing power of the dollar, but also helps our current account deficit. The other factor helping the economy includes the continued decline in borrowing costs. While the counter argument to lower borrowing costs is lower dividends and interest on investments and savings, the benefit of lower rates slightly outweighs the pain on investors as more consumers owe money in the US than those that rely upon investment income. We are carefully watching small businesses this year as the full costs of Obamacare will kick in this year. Businesses will face rising health care costs once again, and many will likely choose to terminate their coverage and help their employees move onto the exchanges. Politically, the timing of the cost implementation is good because the last election that the President has a vested interest in is over, but economically the timing is bad as the economy just seems to be gaining traction. Small businesses don't need to be saddled with additional costs.

The Dollar

We've discussed strength in the dollar, but let's take a look at the drivers and impact of that strength. The dollar has appreciated against the major currencies in the world; specifically the Euro and Yen (see Diagram 3). The Euro and Yen suffer from similar ailments-weak economies, skyrocketing debt, and aging populations.

Diagram 3

The Yen Has Depreciated by More Than 40% Since Abenomics Announced
(USD/JPY exchange rate, November 2009 - November 2014)

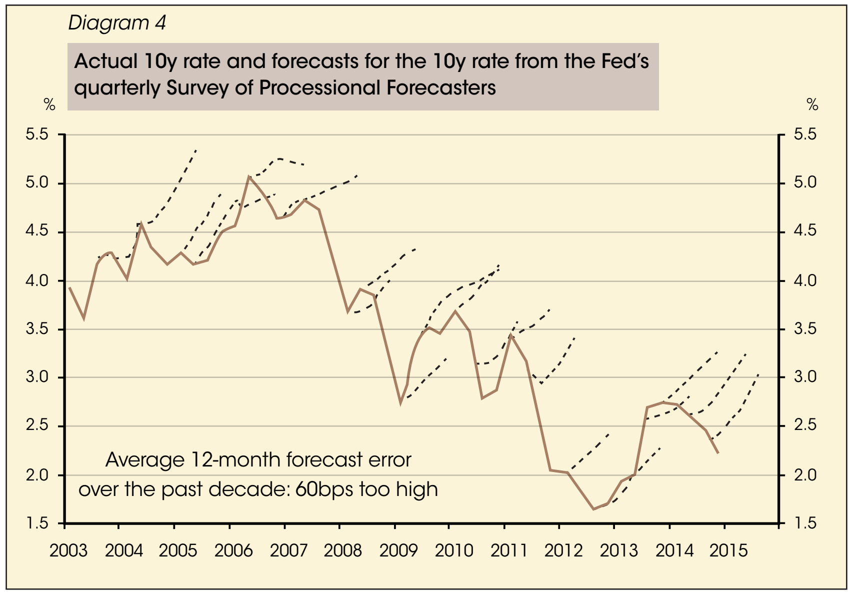


Mauldin Economics | Data from Bloomberg, as of 11/21/14

Japan has taken specific steps to weaken their currency in an effort to stimulate an export-driven recovery. Europe suffers from structural deficiencies related to the creation of the Euro that will be extremely difficult to overcome. A currency typically acts as a country's shock absorber so that, when economic activity is weak, the currency weakens and helps generate travel, trade, and foreign investments that reignite the economy. The problem in Europe is that while the European Union members share a common currency, they don't share taxing, borrowing, and other central treasury functions. This means that a weak currency could benefit one country but severely hurt another in the Union, and vice versa. This creates a situation whereby economic downturns can be deeper and longer than they would be if countries' had their own currencies.

The Fed and Fixed Income

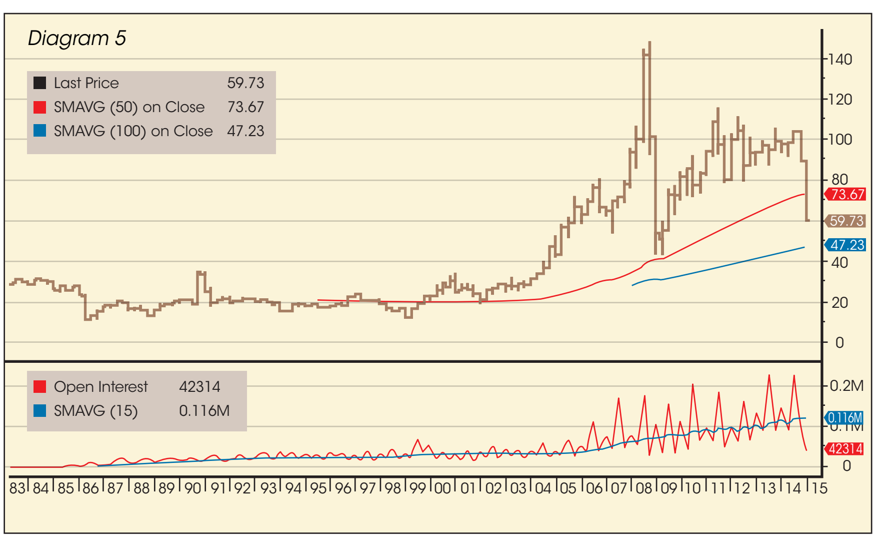
At the beginning of 2014, the 10-year treasury stood at 3% and the Fed was winding down its latest round of quantitative easing. Wall Street consensus was calling for a rise in rates to 3.5-4.5% during 2014, and the expectation was that the Fed would begin raising rates near year end. As we like to say, something happened to rates on their way to 4%; they fell below 2%. As we have repeatedly stated, the conditions required to drive a sustained rate increase don't exist today, and at this point we still don't see them emerging unless the economy maintains its torrid pace of the third quarter. Our biggest concern about rates is that the new consensus for 2015 has finally joined us in our bullishness toward rates, giving us pause and wondering whether it might be time to reverse course and position for rising rates. We aren't there yet, but our radar is up as the consensus is rarely, if ever, correct. We don't want to mock our peers too much, but the Deutsche Bank chart (see Diagram 4) shows the average error over the past decade among Wall Street forecasters when it comes to rates.



Deutsche Bank Research

Oil

The good news is that oil prices are down. The bad news is that oil prices are down. The big news is that oil prices are down. The biggest economic news of the year was the precipitous decline in oil prices during 2014. After starting the year at $98 per barrel, crude closed the year at $52 per barrel, a decline of 47%. The Bloomberg chart (see Diagram 5) shows the price of oil since 1983, and the steep decline in the back half of 2014 is matched only by the drop in 2008, just prior to the recession. A decline in oil prices is extremely good news for the US consumer and is directly attributable to the jump in consumer sentiment we discussed earlier. A $1 decline in the price of gasoline adds $60 to the average American family's pocketbook each month. This compares extremely favorably with any other stimulus program outside of a tax cut, and it doesn't cost the government money. In fact, it is quite easy to argue the government actually gains from this stimulus as consumers typically spend that $60 on other goods, thereby increasing tax receipts. The downside of the oil decline is job loss and declines in capital spending. Job growth over the past few years has been spurred by energy-related employment, which has increased to almost 0.5% of US employment (see Diagram 6). More importantly, these jobs are higher paying than the median job in the US, providing nearly $110K in annual compensation vs. $53K for the median. Job losses in this sector will have a disproportionate impact because of their high pay, and will really have an impact on energy-centric states such as the Dakotas, Pennsylvania, Texas, and Oklahoma. Consumer-focused states should benefit, including California.



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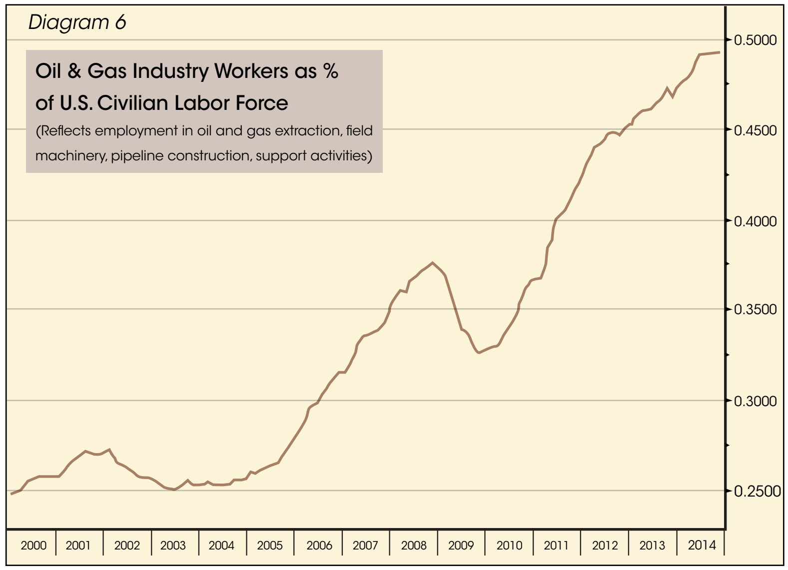
Internationally, lower oil prices benefit the economies of Japan, China, Europe, and India, but hurt the economies of Russia, Iran, Nigeria, Saudi Arabia, and Venezuela. While the magnitude of the impact varies among countries, it is estimated that oil at $40 per barrel would add 0.8% to US GDP. We are concerned and watching Russia and Venezuela closely as their economies teeter, with the possibility of default a realistic scenario.

International

Japan went "all in" this year, announcing plans to buy bonds and increase their debt-to-GDP ratio even further. Japan has been stuck in a 24-year deflationary slowdown, and their debt ratios have risen to dangerous levels. Banks and pension funds, once forbidden from owning equities, are now being pushed to own them. The yen has declined since the announcement of the plan, which the leadership hopes will stimulate exports and help the country's economy recovery.

Market Timing

We have long been proponents of asset allocation and remaining invested throughout the cycle. The chart to the right courtesy of Business Insider (see Diagram 7), shows the danger of missing even a few days each year. For the 10 years ended 2013, a $10K portfolio fully invested in the S&P 500 would have appreciated to $58K, a 9% annualized return. Attempting to market time and missing just the 10 best days over that decade decreases the ending value to $29K, a return of 5.5% per annum.



Source: Labor Department
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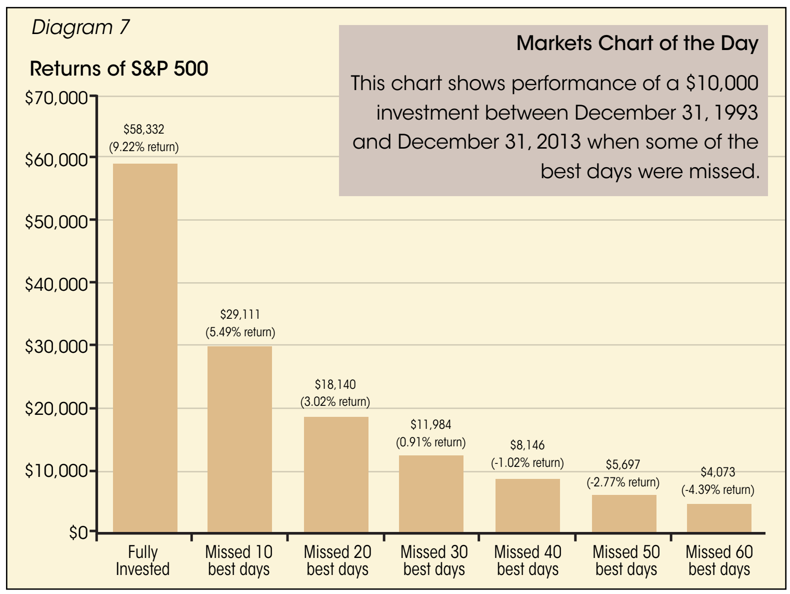

Business Insider

CitizensTrust Focus

For 2015, we expect GDP to remain modest, in the 2.5-3% range. While concerned about some of the canaries we discussed, we don't ascribe a high probability to a recession scenario during the year. We anticipate oil to rebound somewhat in the first 3-4 months of the year, but then settle back for a long time period as the globe attempts to reduce or absorb the excess capacity. We feel that US wages will improve as businesses experience better margins due to lower energy costs and a slight improvement in consumer spending. We believe there is a moderate-high probability that the Fed will raise rates a single time near the end of the year; however, we also believe they will take actions with the reinvestment of their $5 trillion portfolio before becoming aggressive with rates. We expect S&P 500 earnings to increase by 8-10% this year, which should result in comparable performance of the index. Finally, we feel that global unrest will become worse, not better, during 2015 due to instability in emerging markets caused by declining energy and commodity prices as well as a leadership vacuum and inefficient foreign policy from Washington. Once again, we wish you a Happy New Year and successful 2015. We appreciate your continued support and business, and look forward to seeing you soon.

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"Never make predictions, especially about the future."

– Casey Stengel