

Having spent the previous 3 weeks pouring through research in order to provide readers with our outlook for the coming year, we identified an economic trifecta that increases our confidence level in what the future holds. We had already determined there was a very strong likelihood that the economy would remain on track in 2015. The combination of continued Fed accommodation and a dearth of attractive alternatives to the U.S. equity markets causes us to tilt bullish for the coming 12 months. It was the trifecta of solid economic reports, however, that raises our expectations as we enter the New Year.

For the first time since the Great Recession, Consumer Confidence (Conference Board), Consumer Sentiment (University of Michigan/Reuters), and Small Business Optimism (NFIB) are all back above 2007 highs. While we recognize that sentiment can change quickly, the consumer appears poised to step up spending next year. PCE (personal consumption expenditures) were revised from +2.2% to +3.2% in the 3<sup>rd</sup> quarter and savings at the gas pump should only encourage greater spending.

On the business side, technology spending to increase productivity should finally ramp up as wage pressure has been slowly building. There is a strong correlation between rising wages and investment in productivity leading us to believe technology spending will rise dramatically in 2015. We are currently forecasting productivity to rise 2% next year (1.5% average gains the last 7 years) that should lead to overall GDP growth between 3.5% and 4.0%.

The Fed remains ultra-accommodative over the next four quarters from our perspective. While QE3 was successfully wound down in late 2014, the impact of their more than \$4 trillion balance sheet remains intact. With an average duration around 6 years, the Fed is still providing liquidity on the order of \$60 billion per month to stimulate economic and employment growth. The latest CPI reading of -0.3%

and current year-over-year of 1.3% keeps all pressure off the Fed to hike rates. The continued strength of the U.S. dollar plus low energy prices means the Fed is extremely unlikely to consider a rate hike before August of next year.

One of the most compelling reasons for our tilting bullish outlook is the absolute lack of attractive alternatives to U.S. equities. The risk/reward ratio suggests domestic stocks should be favored over emerging market equities and debt, developed markets equity and debt, and domestic debt. Commodities have a significant headwind in low inflation and strong greenback so cash might be the 2<sup>nd</sup> best alternative to stocks and it pays essentially 0%. Strong dollar flows into U.S. stocks in 2015 should be the most important data point when analyzing the investment environment.

***Strong dollar flows into U.S. stocks in 2015 should be the most important data point when analyzing the investment environment.***

We expect earnings per share growth next year to be +9% exclusive of the energy sector that we believe will continue to be weak. Energy is only

approximately 8% of market cap of the S&P 500 but has delivered nearly 12% of recent earnings. With a 30% reduction in energy sector earnings, we are forecasting EPS of \$126 for the S&P 500 in 2015 and a year end multiple of 17 times earnings. This results in an end-of-year value of 2140 or about 7% above where the year began.

There are risks to this forecast that are worth mentioning at this time. The greatest risk is Russia as the plunge in oil prices is wreaking havoc with their economy and currency and creating suffering at levels not seen since the Cold War. Putin has demonstrated a willingness to defy logic and probably feels like a caged tiger. The Russian people will demand change and the only way Putin can influence oil prices higher would be to create global instability. An attack on Kiev, doing something to disrupt Saudi flow of oil, or even putting troops in Syria are actions that would not surprise us and could lead to a dramatic correction in global equity prices.

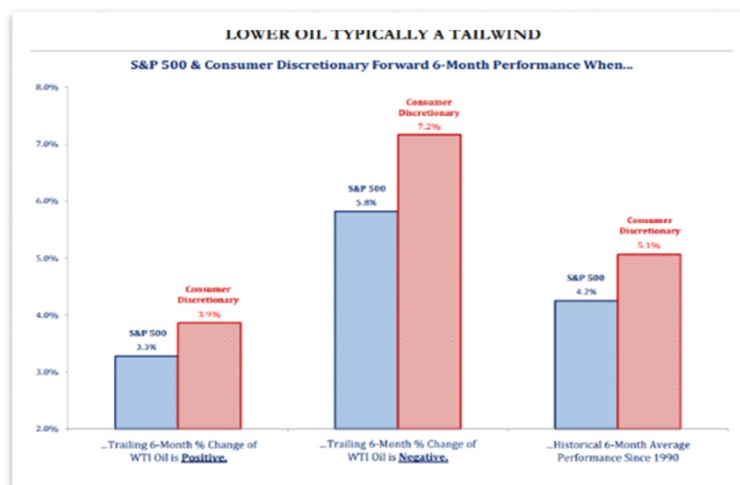
## Living in the material world

It is safe to say that the Material Girl of the 1980s was not drawing on macroeconomic forces given volatility in the price of oil but, rather, she was citing the insatiable appetite for consumption by the American consumer. Nothing has changed from Madonna's mid-1980s rally cry for excess to today, 2015. Rather than growth through Reaganomics and a reprieve from the 1970s economy, today's consumer is enjoying a sort of progressive tax cut as a result of plummeting oil and gas prices. It is time well spent in quantifying and qualifying the impact saving at the pump have on consumption, the market, and the economy as a whole.

History gives us a solid framework from which to analyze the impact savings at the pump can have on households. For example, in 2012, households earning less than \$50,000 annually spent around 21% of their after-tax income on energy versus 12% in 2001, according to analysts at Bank of America Merrill Lynch. For households earning over \$50,000, 9% of their after-tax income was spent on energy in 2012 versus 5% in 2001. At just at under \$3/gallon, the average American household could save \$380 in 2015 according to research firm Clear View Energy Partners. A separate estimate from IHS Global Insight shows average yearly savings of approximately \$750 per household. The concept can also be expressed as a whole. In 2013, consumers spent \$370 billion on gasoline, according to analysis by Kris Dawsey at Goldman Sachs. Gas prices have been nearly cut in half, breaking \$2/gallon in many parts of the country. This helps GDP in a very meaningful way. It certainly begs the question as to how much of the savings will actually be spent. Goldman's forecast makes the assumption that around half of the savings will be spent by consumers in 2015. Other economists have estimated a savings of approximately \$100 billion up to this point in time.

The chart below delivers a clear depiction of the benefits falling oil prices have on the consumer discretionary sector. Six-month performance in the sector following a six-month negative percent change in oil was 7.2%, whereas when the percent change in oil was positive over the trailing six-month period, consumer discretionary was up 3.9%.

Falling oil prices benefit to GDP and the consumer is not exclusive to the U.S. Cornerstone Macro quantified the benefit to each nation or region. The net benefit to lower commodity prices is \$16.8 trillion for the U.S., \$17.6 trillion for the EU. There may be clear tailwind to keep the global economy afloat, as the nations and regions with the greatest benefit make up 62% of the global economy. Nations or regions with the least

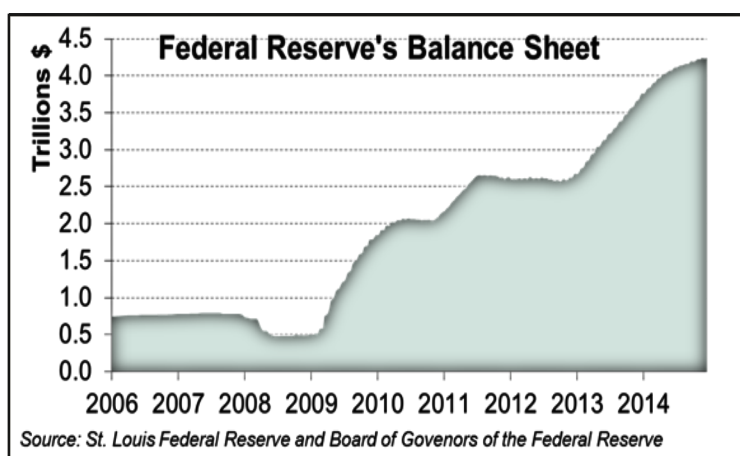


benefit or where falling oil prices are a hindrance to growth only make up about 19% of the world economy.

It will be interesting to watch as the impact of commodity prices plays out in 2015. Let's hope, though, that the price of oil does not inspire Madonna to resurrect the Material Girl.

## The Fed's stealth QE

Much has been said about the Fed ending its quantitative easing (QE) this past October and the inevitable Fed Funds rate increase widely expected sometime in 2015. But has QE really ended? The Fed's balance sheet (see chart) has grown to over \$4.2 trillion since 2007 and the Fed has stopped its outright purchases of MBS and U.S. Treasuries.



This does not mean the Fed has stopped buying these securities altogether. In fact, the purchases continue as the Fed maintains its balance sheet at or near current levels. As existing bonds held on the Fed's balance sheet mature, the Fed rolls the proceeds into new bonds, effectively replacing the bonds that matured with new purchases. This basically means that QE continues, though in a much less noticeable format.

If the Fed were to stop reinvesting the funds from maturing bonds, there would likely be a slight tightening in monetary policy in the form of higher long-term rates, something the Fed is not ready to do just yet. As a result, the Fed's balance sheet has to remain relatively stable in order for the Fed to maintain its accommodative stance. This will help keep downward pressure on interest rates, namely long-term rates, until the Fed decides to make a change. Since the Fed is not likely to raise its benchmark short-term rate until the second half of 2015, we would expect this downward pressure on long-term rates to remain in place over at least the first half of 2015 if not longer.

Inflation remains tame and is not likely to see a large surge in 2015. We think short-term rates will continue to decouple from the Fed Funds rate as 2015 unfolds and the inevitable rate increase approaches, likely resulting in a bear flattening of the yield curve.

So, in our view, the Fed's QE is not quite over yet if you truly think about it. And it won't be for some time, probably not until the Fed's balance sheet reaches normal levels relative to GDP. This could take years to unfold as we expect the Fed to be very slow in unwinding its balance sheet so not to create undue upward pressure on interest rates and sap what continues to be a relatively fragile U.S. economy. The Fed has done a fairly good job so far. It helped avoid another great depression by flooding the market with liquidity. And though this liquidity can be very inflationary, deflationary forces such as large amounts of debt, austerity and falling commodity prices continue to dominate much of the world's landscape. It will take more time for things to normalize in our view.

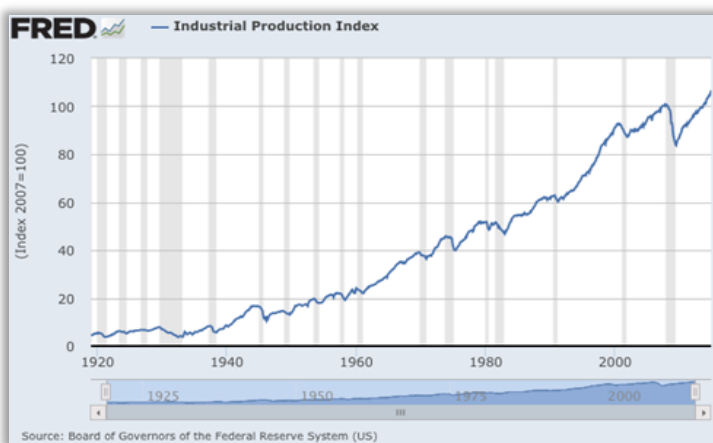
We continue to be mindful of the potential for inflation to accelerate amid an economy that may finally be ratcheting up growth. But we do not think this will happen any time soon. We think the Fed has the flexibility to be "patient." The question remains if investors will show the same kind of restraint.

## A Manufacturing Renaissance

The state of the global economy is perilous: Russia just raised short-term rates by 6.5% to 17% to stop the bleeding of the ruble as falling oil has already guaranteed a recession next year. Japan recently slipped back into recession despite the massive stimulus spending known as Abenomics. Europe is mired in the early stages of a deflationary spiral that the ECB currently does not have the tools to effectively combat. Lastly, China's "new normal" growth rate appears to be closer to 6% instead of 8% and as debt-fueled speculation is coming to an end.

So, is there positive news anywhere? Yes, surprisingly in U.S. manufacturing.

While the rest of the world struggles to avoid the economic abyss, manufacturing in the U.S. recently achieved an all-time high as measured by Industrial Production. November's reading showed an increase 1.3% and October was revised higher. Manufacturing output has risen by 5.2% over the past 12 months led by strong vehicle and auto parts sales.



The current drivers of the resurgence in manufacturing are low cost energy resulting from technological advances leading to increased production and a strong U.S. dollar that is expected to continue to appreciate.

The heart of the manufacturing renaissance is low-cost and reliable energy and the U.S. is in the early stages of an energy revolution. Manufacturing of the future will depend on automation and robotics that will resemble a clean room more than an Asian sweatshop.

A strong dollar will attract global investment dollars to the U.S. but will create a headwind for exports, as products are less competitively priced than products made overseas. This creates less of a problem than many think, especially in light of strong domestic demand. This is, however, a primary concern if you were a Chinese exporter.

Manufacturing jobs have been steadily rising in the U.S. and should continue to do so. Because mining and energy exploration are also included in capacity utilization calculations, the dramatic fall in oil prices will likely result in a significant short-term fall in exploration jobs.

With the Fed committed to keeping interest rates at extreme lows and capacity utilization for manufacturing hovering just above 80%, we expect to see strong manufacturing spending emphasizing technology over the next several years.

## Fundamental

The fundamental picture of the markets continues to demonstrate improvement as the U.S. economy decouples from the rest of the world. The ISM (Institute for Supply Management) readings going into the end of 2014 were particularly strong with both the Purchasing Managers and New Order's Indices reaching 10 year high's. This bodes well for 2015 corporate spending estimates and suggests there is virtually no risk of the economy being in a recession in the next 6 to 9 months.



The dramatic drop in crude oil prices should provide for a 1% to 2% boost to GDP in 2015 causing us to increase Earnings Per Share growth estimates on the S&P 500 next year. Economic

growth coming in between 3.5% and 4% should result in approximately 9% EPS growth on the S&P bringing 2015 estimates to \$130. However, because the energy sector represents 12% of earnings, we are reducing estimated earnings to \$126 to account for lower than expected energy profits.

The hardest variable for us to project for 2015 is how the markets will choose to value \$1 of earnings. Volatility is almost certain to be higher next year considering we are coming off a year of historically low volatility. There was just a single day in 2014 where the Dow Jones fell 2% compared to 134 such days in 2008. The advantage that equities have is the lack of legitimate alternatives. We expect the P/E ratio of the S&P to end 2015 at a multiple of 17, slightly higher than the year started and leading to modest gains.

There are nearly 5 million current job openings and the labor turnover rate has been steadily rising, a bullish sign for 2015. Personal Consumption Expenditures (PCE), revised higher in the 3<sup>rd</sup> quarter, should continue to lead to strong economic results in 2015.

## Technical

Santa Claus did not disappoint in 2014 even after the month of December began with a short but steep correction. Headlines ranged from the deflationary problems caused by plummeting oil prices one day to the euphoria over the idea that the Fed may wait until 2016 to hike rates. Through all the volatility, the S&P 500 is still very much in a bullish trading pattern with some market technicians suggesting this bull market still has a long way to go.

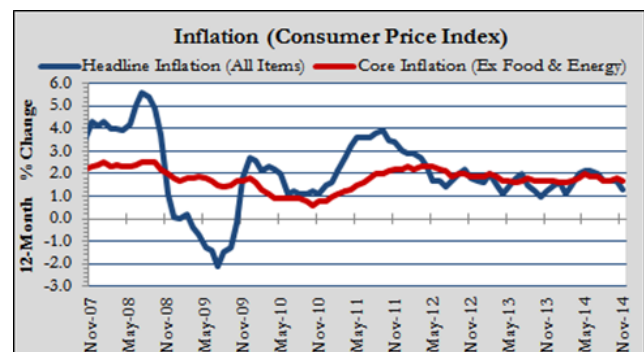
At nearly 6 years in length, this bull market, which has seen stocks increase nearly threefold, is already long in the tooth. Only a couple of bull markets in history have gone as far as the current run without a 10% correction. The market did finally breach its 50-day moving average, something that never occurred in 2013, but it quickly rose back above both the 50 and all-important 200-day moving averages.

Those who sit on the bearish side of the fence were once again frustrated when the December pullback didn't materialize into at least a mini-bear. Bears have made every possible argument as to why investors should not trust this market to go higher but continue to be wrong. Arguments about excessive valuations no longer seem plausible given the market is trading just below 16 times earnings. The Fed's policies are clearly impacting investment decisions but, at least at this point, appear to have been validated given current momentum with job growth and corporate earnings.

The most compelling reason to remain cautiously bullish continues to be the relative unattractiveness of all other investment options. Ultra low interest rates clearly favor equities as the risk of owning bonds is elevated and make stock valuation models look reasonable if not outright cheap. The collapse of oil prices combined with already low inflation means the Fed will more than likely push back rate hikes to the third quarter if not the fourth quarter. A growing number of analysts now believe the Fed will not raise rates until 2016, taking a cue from voting members of the Fed like Kocherlakota. Most importantly, demand for U.S. equities appears almost certainly to remain high both domestically and abroad.

## Fixed Income

Our 2015 Outlook for fixed income is predominately driven by what drives interest rates: inflation. Because we expect inflation to remain benign throughout 2015, we do not expect the bear market in bonds caused by rising interest rates to start for at least another year. Low energy prices, strong U.S. dollar, and deflationary pressure in Europe and Japan make it very unlikely the Fed will feel any inflationary pressure next year.



We continue to believe the Fed will initiate rate hikes next year at a "measured pace." We have done extensive



analysis of the previous periods when the Fed was tightening, looking for clues as to how best to position portfolios and which segments of the bond market will be most vulnerable when rates begin rising.

Given global macroeconomic indicators, we expect the rise in short-term rates to have little impact on economic growth in the U.S. or abroad. There are massive excess reserves on deposit with the Fed meaning higher borrowing costs for banks will be insignificant and should result in only modestly higher consumer lending costs coming off historic lows. We forecast long-term rates to remain little changed and that the yield curve continues to flatten in 2015.

The barbell strategy of very short-term durations combined with long durations should continue to outperform a fixed income portfolio holding predominately intermediate term bonds. We do not expect a rise in defaults across the board, but believe high yield default rates are going significantly higher. Nearly 20% of the high yield bond index is comprised of energy companies and many of these companies do not have the staying power to remain viable if oil remains below \$60 for an extended period.

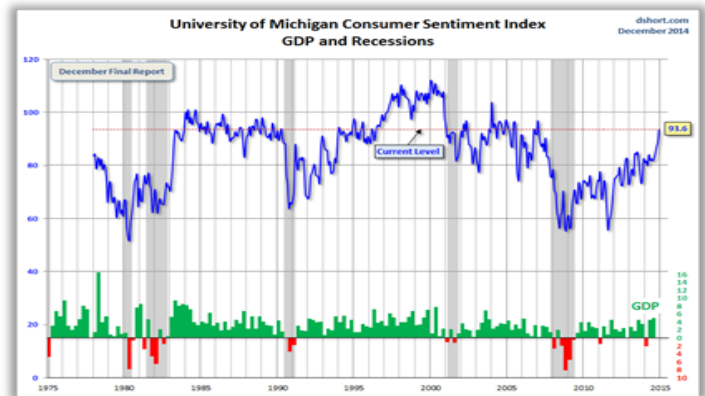
## Currency & Commodity

The U.S. dollar was up over 11% as 2014 came to an end and we anticipate continued strength in the dollar in the coming year given a strengthening U.S. economy and weaker economies abroad. The dollar is and will continue to be a flight to safety in times of global stress, not to mention its status as the world's reserve currency. The ripple effect of a strengthening dollar is quite meaningful. For one, U.S. exporters will be less competitive, which could weigh on U.S. economic growth. A second effect of the rising dollar, one that may be flying under many investors' radars, is the potential for significant debt problems to arise, particularly in emerging markets that borrow in dollars but earn revenue in their respective currencies. This will be a key item to watch as the risks of a debt crisis could be very real.

Our view on gold and silver is for a continuation of what we've seen in 2014. Supply/demand forces, a strengthening dollar and low inflation lessen the attractiveness of precious metals at this point in the cycle. The opportunity for any breakout in precious metal prices is largely on geopolitical risk such as terrorism, unrest and/or a debt crisis of some sort. As the Russian economy moves into a depression, Putin becomes highly incentivized to see the price of oil increase quickly. Such motivation may facilitate further disruption throughout the Ukraine and the Middle East. Lower oil prices and thus lower revenues may serve as a catalyst for unrest across the Middle East or oil-exporting Latin American nations like Venezuela. These scenarios could bode well for the price of gold and silver.

## Macro

With third quarter revised GDP coming in at a 5% annualized rate and largely driven by the consumer, we believe U.S. GDP will grow at or above trend in 2015. The chart below shows that the 5% revision, up from the 3.9% initial estimate, is the fastest quarterly pace since the third quarter of 2003. Our view that U.S. GDP will grow above trend in 2015 implies that the other areas of the economy will overcome the likely lower activity in the energy sector due to depressed oil prices.



In particular, we believe the consumer will drive growth based on stable and improving employment coupled with meaningful savings at the gas pump. This is depicted in the chart below, showing a robust picture of consumer sentiment based on the University of Michigan Consumer Sentiment Index. The index currently sits around 93.6, a level last seen in 2007 before the recession. Given an increase in consumer spending, we expect other winners from falling gas prices to include consumer discretionary companies, airlines, autos and auto parts, and retail.

The National Association for Business Economics (NABE), a panel of 48 economists, expects the overall economy to expand by 3.1%, the strongest growth since 2005 when the economy grew by 3.3 percent. NABE President, John Silvia, expects inflation to remain restrained in 2015. The panel predicted consumer prices to remain at 1.7 percent, the same as expected for 2014. We concur that inflation will remain tempered, giving the Fed time and space in raising rates. We are not expecting strong inflationary pressures. Instead we see continued concern over deflationary pressures, which may be masked by a strengthening economy.

Other macro factors at play include a continued decline in the labor force amid an aging population. We could see an uptick in unemployment as energy companies ratchet down their growth. Nevertheless, we see employment gains elsewhere in the economy. Housing starts are anticipated to slow, particularly as much of the growth in recent years has been surrounding energy. We do not anticipate housing starts or home prices to fall off a cliff given economic growth outside of energy.

## Q : What is the biggest risk to your outlook for 2015?



I think Russia probably poses the greatest risk for equities right now. Stock markets around the world are somewhat priced for perfection (or at least massive levels of central bank stimulus) and rising geopolitical tensions can quickly interrupt already fragile economies. Russia is bankrupt and Putin knows people's suffering has a limit. If oil prices do not quickly rebound, I would not be surprised if Putin tried to shore up support by creating an us vs. them situation. This would most likely involve Kiev but could also extend beyond the border of Ukraine, especially if his goal is to create instability in oil markets.

I emphasized Russia being the greatest risk to stocks because Russian aggression would have the opposite effect on U.S. Treasuries and gold. We would see a massive flight to safety that would drive bond yields to lows that would not be justified given economic conditions. The likelihood of Putin misbehaving is greater than most analysts seem to expect in my opinion and something that requires close attention.



I think geopolitical disruptions remain a big concern. If the U.S. oil revolution means we have essentially reached energy independence then we could see a prolonged period of less demand for Middle-Eastern and Russian oil. This could prompt civil unrest across many heavily oil-export dependent nations, including those in Latin America. My biggest concern is that Putin takes more drastic action. Russia was already headed for a deep recession amid the sanctions. Now it is likely to experience a depression with oil prices falling. Putin remains a big wildcard in my view. He has defied the West and may be backed further into a corner with few options but to respond aggressively.

Growth outside of the U.S. remains a concern for me as well. Europe still needs structural reforms and China has to become less dependent on export growth. A strong dollar may provide these governments with less incentive to enact the necessary policy changes, assuming they see a pickup in exports to the U.S. I think the U.S. is primed for continued growth even if the Fed raises rate earlier than expected. The growth will likely be from non-energy-related sectors.

## Q : Is cyber-terrorism a threat to the markets?



Cyber-terrorism certainly became a threat to Sony Entertainment's market cap in the last month!

In all seriousness, yes, I do believe cyber-terrorism is a threat and has created many opportunities in the technology space. FireEye (FEYE), for example, is a leader among companies designing technology designed to protect against corporate or government cyber attacks. Having just gone public a little over a year ago, this relatively new company that went public one year ago has a market cap over \$5 billion.

(FEYE)



The IT security space is becoming very crowded and the Sony hack will only increase the number of firms trying to establish themselves as experts in cyber protection. It will be very difficult to pick the winners from the losers, similar to what was happening with networking or fiber companies in the late 1990's.

It is safe to assume that there will always be people and countries that oppose freedom and the capitalistic economies that accompany liberty. Greater resources than ever before are being allocated to disrupting economies and wealth creation. A tremendous amount is spent annually to protect private data against unwelcome intruders. Exchanges are particularly vulnerable to data attacks as cyber-terrorists realize that confidence is required for markets to work efficiently.



As the world becomes more and more connected, cyberterrorism will become a bigger nuisance than a real threat in my view. I think most financial institutions are already well protected. You rarely hear of a successful attack on them. It's not for a lack of trying. But hackers have been drawn to the weakest link, the retailers. Home Depot and Staples, among others, have been compromised and are working to improve their security. Many other retailers are taking notice as well. I think the recent headlines around hacking and the greater attention on system vulnerabilities will lead to greater security.

Cyberterrorism is not new. Companies and governments have had to deal with it for over two decades, if not longer. The recent attack on Sony, be it North Korea or some other group, will likely prompt most corporations to review their vulnerabilities and up their security. Country-based "cyberterrorism" is as old as World War II really. Ally code breakers worked tirelessly to interpret Japanese and German communications during the war and vice versa. In fact, a new movie called "The Imitation Game" is all about how the Allies worked to crack the Germans' Enigma code. They were mathematicians instead of computer geeks, but probably cut from the same cloth. I don't want to dismiss the potential for a system-wide disruption in the financial system or the global economy. A successful attack could prove much larger than a nuisance in that event. Nevertheless, I think the recent headlines will prompt even tighter security not less. And that is a good thing.



### **As seen in Barron's Investment News:**

'Muni experts stress the need to peer beyond credit ratings when assessing issuers. "You can look at some cities and see that five or 10 years from now they're potentially going to be in crisis mode if they don't make significant changes," says Brian Lockhart, chief investment officer at Peak Capital Management. He says some defaults are easy to see coming, like Detroit's, but others, like that of Orange County, Calif., in 1994, surprise the market. Unfunded future pension liabilities, he adds, can be vastly different even among cities with similar investment-grade ratings.' — [Brian Lockhart, CIO, Peak Capital Management](#)

Aneiro 2014, 'Bondholders and Pension Risk', *Barron's Investment News*, vol. XCIV, no. 45

### **S&P Dow Jones National Municipal Bond Forum Videos:**

[Munis' Record Breaking Run](#)

[Credit and Duration as Risk Factors in the Municipal Bond Market](#)

**15455 Gleneagle Dr., Suite 100  
Colorado Springs, CO 80921**

**Phone: 719.203.6926**

**Fax: 719.465.1386**

**Email: [info@pcmstrategies.com](mailto:info@pcmstrategies.com)**

**Website: [www.pcmstrategies.com](http://www.pcmstrategies.com)**

The information contained in this report represents the opinions of Peak Capital Management, LLC, as of the report date and does not constitute investment advice or an offer to provide investment management services. Before purchasing any investment, a prospective investor should consult with its own investment, accounting, legal and tax advisers to evaluate independently the risks, consequences and suitability of any investment.

Past performance is not indicative of future results, loss of principal is possible.  
Please consider charges, risks, expenses and investment objectives carefully before investing.

The data and information presented and used in generating this report are believed to be reliable.  
Peak Capital Management, LLC. does not warrant or guarantee the accuracy or completeness of such data.

Peak Capital Management, LLC is a Registered Investment Adviser. Advisory services are only offered to clients or prospective clients where our firm and its representatives are properly licensed or exempt from licensure. No advice may be rendered by Peak Capital Management, LLC unless a client service agreement is in place. Nothing herein should be construed as a solicitation to purchase or sell securities or an attempt to render personalized investment advice.