STERLING CAPITAL
MANAGEMENT, INC.
Registered Investment Advisor

2014 Year in Review

A tough year to predict. Tell us if you saw it coming in 2014—yields on the 10-year Treasury below 2%, oil just north of $50 per barrel, the Royals in the World Series. Don't feel bad if you, like us, failed to foresee these developments—we have plenty of company in perhaps every one of Wall Street's highly paid strategists, most of whom pegged oil to trade around $100 per barrel at year's end and the 10-year Treasury to yield over 3.4%. And if any recognized baseball expert foresaw the Royals' post-season run before the season started, he or she didn't put it in writing.

One thing we did get right, if anyone is keeping score, was the performance of the equity market. Our call that "the odds favor another positive year in the stock market but also increased volatility" was correct as was our caveat that "another 30% year is unlikely." The S&P 500 rose 13.7% on a total return basis, and the VIX, a measure of market volatility, spiked above 2013's highest reading three different times.

Our clients' portfolios. It was not a good year for most money managers. According to Bank of America Merrill Lynch, just 14% of all active managers beat the capitalization-weighted S&P 500, whose return is substantially determined by the performance of its larger stocks. Several of these stocks did very well, including Apple, the largest stock in the Index, up 40%, and Microsoft, the third largest component, up 24%. Also making it tough on money managers was the weak relative performance of small-cap stocks, which are prominently featured in active managers' portfolios. The proxy for small-caps, the Russell 2000, gained just 4.9%.

The equity component of the portfolios managed by Sterling Capital fared pretty well, exceeding the total return of the Russell 2000 but, for the most part, failing to match the appreciation of the S&P 500. Portfolio performance was bolstered by positions in Cisco and Microsoft, both of which were among the top five gainers in the Dow Jones Industrials. As you have probably guessed, however, our holdings in the battered energy sector hurt results.

Throughout the year, we kept portfolio equity weightings at the high end of the parameters established in clients' Investment Policy Statements. This action helped overall portfolio performance. Because positions in longer-duration bonds would have been clobbered had interest rates risen, we kept maturities short. As you may know, rates fell and longer-term bonds did well. Avoiding these bonds cost our portfolios interest income and some unrealized gain, but we were unwilling to expose clients to the substantial risk of loss of principal.

Still waiting for that whistle. Longer-term equity performance is largely driven by corporate earnings, which in most cases are substantially influenced by the strength of the economy. And the U.S. economy does appear to be picking up some steam as it rolls down the tracks. The last two GDP reports, for Q2 and Q3, were encouraging, and Q3 real GDP (adjusted for inflation) was especially strong, expanding at an annualized rate of 5%. The employment picture also seems to be brightening. Last year was the best year for jobs growth since the recession in 2009, and the unemployment rate has continued to drop. Moreover, most of the statistical indicators that forecast economic growth in upcoming quarters are headed in the right direction.

But the engineer has not yet sounded the all-clear signal (two long whistles, in case you're interested). December's retail sales number (ex gas and autos) from the Commerce Department was much worse than expected, dropping instead of rising as predicted; housing was disappointing--existing home sales were down for the year and construction starts slowed to roughly half their rate of growth for 2013; and manufacturing grew less in December than in October and November. Indeed, manufacturing growth actually peaked in August.

The global funk. The twists and turns of our economy always affect the stock market, but their impact will be magnified this year because of the weakness in overseas economies. If the U. S. economic engine throws a rod, other countries' economies may not be strong enough to power global growth. As you probably know, Europe is in a deep economic funk. For the first time since records were kept on the statistic (1997), consumer prices actually fell across the Eurozone in December, further heightening fears of a continent-wide deflation. The Chinese economy, which has keyed global economic growth for years, is still expanding, but at a much slower rate than just a few years ago, as it transitions from a manufacturing, export-led economy to one driven by domestic consumption. Making the transition more difficult is China's overbuilt housing market, which creates a serious drag on growth. The global economy will get little help from Japan. Solutions to its deeply ingrained, long-term economic problems remain elusive.

There are a few bright spots around the globe, such as India, which may soon surpass China's as the world's fastest-growing economy. But for now, these bright spots remain the exception, and it's safe to say that a lot is riding on the performance of the U.S. economy. We really need to hear those two long whistles.

Falling oil prices to the rescue—or not. Some of the dollars we're saving at the pump will no doubt find their way into the economy. These cheaper gas prices will save each American family several hundred dollars in 2015, ultimately boosting sales of all kinds of consumer goods. Many economists think the impact on the economy will be unquestionably positive, but others are not so sure. These dissenters assert that the impact of the profit-hit absorbed by energy companies will outweigh the positive effect of increased consumer spending. Among other things, they contend that the reduction in drilling and exploration activities by oil and gas companies will have a substantial impact on economic growth since energy companies account for around 33% of all S&P 500 capital expenditures. This decline in cap ex will ripple through the economy, lowering revenues of the industrial companies that manufacture drilling equipment, for example, and dampening capital spending in this sector as well. These ripples, they argue, will eventually spread across many other sectors of the economy, trimming GDP.

There is likely some merit to these pessimistic projections. Falling oil and gas prices will help some sectors of the economy, but the impact will not be positive for others. As a result, lower energy prices may not have the economy-stimulating effect expected by many. We note, however, that oil prices have dropped 50% or more 5 other times since 1980. Six months later, the stock market was higher 4 of those times.

Valuation. As the economy's headwinds and tailwinds swirl about the market, heightening investor anxiety, assessing market risk becomes critical. A good starting point for this assessment is the current valuation of the S&P 500. Based on consensus estimates, the S&P now trades at around 16 times next year's earnings, a multiple that is not unreasonable considering the absence of inflationary pressures in the economy. As long as inflation remains subdued in its current range of 1-2%, the multiple on the S&P can expand significantly without reaching historically extended levels. A reasonable multiple does not mean that the market can't correct, but it does diminish the chances of a substantial sell-off.

The valuation of stocks versus bonds is also favorable for the stock market. Early this month, the current yield on the S&P 500 rose above the yield on 10-Year treasuries. This has happened just three other times since 1962, and the S&P was higher one year later each time, with a median gain of over 30%.

Going cycling. Also boding well for the market's prospects is the election cycle. We have just entered the cycle's 3rd, and historically most favorable, year. Since 1928, the S&P has risen in 86% of all 3rd years, adding 13% on average (not counting dividends) each of these years. Moreover, the stock market is usually happy when a Democratic President is paired with a Republican Congress. When this favorable coupling has been in place since 1900, the Dow Jones Industrial Average has gained 10% per year (without dividends). A potential added kicker is the tendency of the market to rise during years ending in 5. Since 1905, the market has produced double-digit gains in these years every time but one. The average return has exceeded 35%. (We're not getting carried away with this occurrence. It appears to be a phenomenon in the purest sense—there is no solid explanation for it.)

Buck up. The dollar rose nearly 13% this year as measured by the U.S. Dollar Index, which values the dollar versus a basket of foreign currencies. A rising dollar has often been viewed as a source of concern since it makes U.S. exports more expensive and thereby reduces revenues. (The same is true for any currency, and governments around the world often take steps to prevent their currencies from appreciating too quickly.) But there are certainly positive ramifications to a strong dollar. Not only does it reflect confidence in our economy by foreign investors, it holds interest rates and gas prices down. It also provides a flow of capital that can power investment in the U.S. economy.

For better or worse, most experts contend that the dollar's upward trend will continue because of steps taken abroad to stimulate foreign economies. The European Central Bank, for example, is poised to embark upon its own version of quantitative easing by pumping billions of euros per month into Eurozone bond markets, which should lower interest rates and, the ECB hopes, chase away the specter of deflation. China, too, will also likely take aggressive steps to re-invigorate its economy. China's Producer Price Index, a measure of price stability, has fallen 34 months in a row on a year-over-year basis, a strong signal that the Bank of China will expand its own version of quantitative easing that it announced in November.

In contrast, the Fed has recently signaled that its next move will likely be to increase, not decrease, short-term rates. Some question whether the U. S. economy is strong enough to withstand any increase, but it is nevertheless clear that Fed's monetary policy will almost certainly be less accommodative than that of the ECB and the Bank of China. In this environment, the dollar is positioned to move even higher versus the euro and China's yuan. The euro is already at a 9-year low. The yuan gained versus the dollar throughout most of 2014 but reversed course when the Bank of China acknowledged it had injected money into its economy.

As noted above, the rising dollar may not be a bad thing for the U.S. stock market. In fact, since the inception of the Dollar Index in the late ‘60s, the dollar has registered 10%+ gains in 7 other years. In the year following those gains, the U.S. stock market has risen every time. The median rally has been 14%.

Taking a hike. Because rising short-term rates are viewed as removing liquidity from the financial markets, investors in stocks generally fear hikes in the federal funds rate (the overnight lending rate for funds held at the Federal Reserve). So what will likely happen to stocks if the Fed does gently nudge the fed funds rate higher sometime during the year? History says we can relax a little. Hikes in the fed funds rate often eventually pressure stocks, but as a general rule, stocks do not stumble immediately after a hike or even in anticipation of a hike. Since 1962, the S&P on average rose 3% in the first 6 months after the Fed first raised its short-term rate.

And in the 6 months before the hike, when investors were anticipating the rate increase, the market gained nearly 4%. Technology and energy were the two strongest sectors during these periods.

An increase in short-term rates, however, could spell trouble for the fixed income market. Although action by the Fed does not have a direct effect on intermediate or long-term bond prices, an increase in the fed funds rate could trigger selling of bonds all across the yield curve, driving prices down. As a result, we once again will be extremely cautious in the fixed income market.

Getting sentimental. The stock market does not like happy people, at least not too many of them. When stocks are doing extremely well and investors get too bubbly, you can be pretty sure that the market is about to turn most of those smiles into frowns. As a result, various sentiment indicators are closely monitored by many investors. Some of these gauges of sentiment recently revealed high levels of optimism. The survey conducted by the American Association of Individual Investors, for example, showed that bullish sentiment reached high levels last November right about the time the stock market encountered headwinds. Moreover, bearish opinions on the stock market’s short-term direction were below average in 80% of the AAII’s weekly surveys. By the end of 2014, investors’ equity allocations were the highest since 2007, and cash allocations were the lowest since the 2000 tech bubble. Pretty scary stuff, indeed.

Longer-term sentiment studies, however, depict a more cautious investing public. Surveys conducted by Robert Shiller of Yale University show that investors’ confidence in the one-year performance of the stock market has been declining since 2000 and that confidence in the market is even lower now than it was during the financial crisis in 2008-09. Although short-term optimism suggests an elevated risk of a sell-off late in 2014 and early 2015, considered together the surveys do not reveal the level of euphoria usually associated with a long-term market top.

Putting it all together. Despite the many obstacles in the market’s path to higher territory, our best guess is that stocks will produce positive returns during what appears to be a volatile 2015. The outlook for bonds remains a tough call, but the risks of owning longer-term bonds still far outweigh the potential reward in our opinion. Of course, as we saw this year with bonds, the financial markets are extremely hard to predict no matter who is doing the forecasting. As *Post-Dispatch* financial columnist David Nicklaus asked in a recent column about interest rates, “How could so many smart people be so wrong?”

As a result, we do not tailor our investment philosophy to reflect our opinions on the direction of the markets. Our focus remains on seeking undervalued equities that will outperform over the long term and balancing the portfolio with fixed-income securities we deem unlikely to lose principal. Although there are other more exciting, aggressive approaches, our value-oriented philosophy has a solid track record and, we believe, a bright future.

Please do not hesitate to contact us if you have any questions about the matters discussed in this somewhat lengthy letter. As always, Sterling Capital Management appreciates your trust and confidence.

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