AMB

Economic and Portfolio Outlook 1st Quarter 2015

(Released January 2015)

The Dow Jones Industrial Average (DJIA) and the S&P 500 Index are still well within reach of the new all-time highs they recorded in 2014, and the U.S. Labor Department reported that 252,000 jobs were added to the U.S. economy in December; however, there are other signals that give us reason for pause. The 10 year treasury yield dropped below 2% again during the first week of the year, some 300,000 people dropped out of the U.S. work force in December, inflation is well below the Fed's 2% target, along with an increase in volatility and a significant drop in the price of oil.

In fact, we believe the decline of oil prices in 2014 will be the story of the stock market in 2015. We are seeing more and more commentary that sub-$50 per barrel oil is positive for the economy. Although a benefit for consumers, there are broader consequences to oil companies and the overall general economy. If the negative impact on oil companies is not contained, it could lead to further erosion in financial markets.

Shale projects that need $100 oil to be profitable are not viable when oil is below $50. The high yield energy bond market since the last half of 2014 has been in decline, indicating the risk associated with the many highly levered domestic oil producers. The projects undertaken by these producers cannot pay off their debt and they need to borrow more money. But at $50 oil, they are unable to borrow more money and consequently the high yield energy bond market has collapsed.

So what? Isn't the default risk only associated and contained to the oil companies? Well, here is where we go back to 2007 and remember the term "counterparty risk." During the subprime loan crisis, many analysts believed the crisis was contained to a few institutions, later to find out the vulnerability of other institutions being poisoned by doing business with the infected few: counterparty risk.

Total global debt at oil producing companies is about $1.6 trillion. At the subprime mortgage peak, there was about $1.3 trillion of subprime housing debt outstanding. U.S. banks eventually had to write off just under $1.0 trillion of that debt. In other words, the total oil industry debt at risk is somewhat larger than subprime debt in the great housing bubble. And that's just the private sector, ignoring the sovereign budgets that need $80 to $100 oil in order to maintain fiscal stability.

So what impact will lower oil have on interest rates? Lower oil will cause highly levered companies to lay off higher paid employees, reduce their capital expenditures, and leads to default in some instances. We have already begun to see market reaction as investors move away from high yield corporate credits into U.S. treasuries due to the fact that 17% of the junk bond market is energy related. Layoffs and reduced capital expenditures will lead to a slowdown in the economy making it hard to believe an interest rate increase on the part of the Federal Reserve (Fed) would be a good move.

Historically, interest rates are increased in order to strengthen the currency and to slow inflation. Currently, the dollar is continuing to strengthen and inflation continues to fall. Fed officials have indicated they may raise rates sooner rather than expected and the market has responded with a rising dollar and declining yields, indicating that if the Fed hikes rates too soon the economy may enter into a recession. The Fed has kept short-term interest rates at 0% for 6 years. This is the longest period of time they have kept rates stable, let alone at a rate of 0%. An unintended consequence of such an unprecedented lengthy period of 0% short-term rates is the psychology of investors has become distorted which leads to, as former Fed Chairman Alan Greenspan would say, "irrational exuberance." For this reason, the Fed may opt to raise rates just to see how the market and the economy will react. In addition, raising rates gives the Fed another monetary policy tool, allowing them to ease by lowering rates if necessary.

Taking a global view, we see that interest rates around the world are suppressed. Ten year government bonds are yielding less than 2.0% in Italy, 1.7% in Spain, 0.9% in France and 0.6% in Germany. Japan is no longer the outlier for rates. The U.S. has become the outlier with the 10 year treasury at around 2.0% even as the dollar is strengthening, which explains why U.S. bond prices are finding it difficult to move to higher levels. The reality is they shouldn't. As we move forward into 2015, there are three defining cross-currents that the world's central banks will have to navigate: A Federal Reserve that is more confident about the prospects for the for the U.S. economy; doubts about growth in the world's other large economies; and a decrease in oil prices that will make it difficult to read inflation trends.

The bottom line is we expect greater volatility in the stock market in 2015 and higher volatility means elevated risk. We saw evidence to support our expectation as the large advance in the S&P 500 in 2014 occurred in a year when declines in small caps and technology companies left fewer equities beating the index than any time since 1999, according to data compiled by Leuthold Group, LLC. As of early November 2014, the average stock measured by the Value Line Arithmetic index was up only 4.4%, half as much as the S&P 500. About half the stocks in the Nasdaq Composite Index had fallen by 20% from their 52-week highs and more than 40% of the Russell 2000 stocks were stuck in bear markets. More than 87% of mid-cap funds lagged behind their benchmark measures according to Morningstar data, and only about 30% of the companies in the S&P 1500 Composite Index beat the S&P 500 in the 12 months through September, the fewest since 1999, according to Leuthhold Group data.

This data clearly shows that the S&P 500 has been masking what has been going on underneath the surface in the broader markets and it has been hard for active money managers to outperform. However, rising volatility could be a positive for active money managers, setting the stage for them to earn their stripes. We believe there will be a significant reversal in the success of passive investing versus active money management as sector rotation and stock picking becomes the superior strategy over buying the index in a bull market that is past its prime and posting new all-time highs becomes more difficult. Utilities, considered to be the most hated group in July according to Goldman Sachs Group, Inc., were, surprisingly, the best performing group in 2014 while the energy sector lagged as the price of oil collapsed. Consumer Discretionary, the industry that led the S&P 500 with a 322% gain from the bear market's bottom through 2013, lagged the index for the first year since 2007.

There is a cloud of uncertainty hanging over the potential "oil crisis" and the associated financial fallout. As always, we will continue to monitor heightened levels of risk in the stock market and adjust our strategies to be more cautious in times of elevated risk as well as being prepared to take advantage of opportunities when given by the market for our long-term investors. We have already made changes in our fixed income portfolios by reducing our exposure to corporate bonds and moving into a heavier weighting in U.S. treasuries and municipal bonds, which we believe provide the best risk profile. We believe the economy will be sluggish, inflation will be low and real wages will be stagnant in 2015, which also leads us to believe interest rates will remain low.

Foreign Markets

While the Fed works to figure out if and when to begin raising short-term interest rates, the European Central Bank (ECB) and the Bank of Japan (BOJ) are searching for new ways to cheapen the cost of credit to stimulate investment and spending. The ECB began purchasing covered bonds and asset-backed securities in 2014. In December, ECB President Mario Draghi stated that these purchase programs would last for at least two years and announced that they were about to conduct the second targeted longer-term refinancing operation, to be followed by six further operations until June 2016. He also reported they would further ease monetary policy in the coming months to support the ECB's forward guidance.

The BOJ's asset purchase program continues to soar as Governor Haruhiko Kuroda tries to reflate the world's third largest economy. However, the drop in oil prices since June has intensified heads for the BOJ and could pressure Kuroda to do more monetary easing as inflation is expected to slow in May to 0.4%--less than one quarter the central bank's target.

In December, Russia's central bank raised interest rates from 10.5% to 17% at an emergency in an attempt to rescue the ruble which had fallen 50% against the dollar. The desperate move to save the Russian currency comes at the cost of sacrificing the Russian economy. Russia is in the oil exporting business. Cheaper oil means Russian companies have fewer dollars to run into rubles, creating less demand for the currency. With oil prices still falling, Russians do not want to hold their money in rubles even if they get paid 17%. Unfortunately, the central bank's rescue attempt was short lived. Following a brief rally, the ruble fell another 14% to a low of 80 rubles per dollar. It was over 60 rubles per dollar the day before. Russia now faces a collapsing currency and exorbitant interest rates.

The Bank of England (BOE) was expected to be the first of the world's major central bank to finally begin raising rates from record lows in early 2015; however, the BOE's Monetary Policy Committee voted at its last meeting to maintain their current rate of 0.5%, a rate that was set in March 2009. The Committee also voted to maintain the stock o purchased assets financed by the issuance of central bank reserves at £375 billion. The oil price slump, a supermarket price and a freeze on household utility bills threatens to cut inflation to as low as 0.7%. Mark Carney my find himself the first governor since Bank of England independence in 1997 to write an open letter to the chancellor explaining why inflation is so low. The Bank's remit requires the governor to write a letter to the chancellor explaining why inflation is off target if it strays more than one percentage point in either direction from the 2.0% target along with the central bank's intended course of action.

China's economic growth is expected to slow from an expected 7.4% in 2014 to 7.1% in 2015 due to a sagging property sector. While exports are expected to grow 6.9% in 2015, it is not expected to be enough to offset the impact of weakening property investment according to a report published on the central bank's website, www.pbc.gov.cn. The report warned that a rate increase on the part of the Fed in 2015 could hit emerging market economies. China's economic growth slowed to 7.3% in the third quarter of 2014 and economists who advise the government have recommended that China lower its growth target to around 7% in 2015.

CAPITAL MARKETS SNAPSHOT

EQUITY	As of 12/31/2014	4Q2014	12-Month Return
DJIA	17,823.07	5.20%	10.04%
S&P 500	2,058.90	4.93%	13.69%
NASDAQ	4,736.05	5.75%	14.81%
MSCI EAFE	1,778.04	-3.46%	-4.22%

RATES	As of 12/31/2014	As of 9/30/2014	As of 12/31/2013
Fed Funds Target Rate	0.25	0.25	0.25
3-Month Libor	0.25	0.25	0.25
6-Month CD	0.43	0.35	0.27
2-Year Treasury	0.66	0.56	0.38
10-Year Treasury	2.17	2.48	3.03
30-Year Mortgage	3.83	4.20	4.48
Prime Rate	3.25	3.25	3.25
COMMODITIES	As of 12/31/2014	4Q2014	12-Month Return
Gold	$1,206.00	-0.86%	0.12%
Crude Oil	$53.27	-41.56%	-45.87%