INVESTMENT STRATEGY
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Volatility finally returned to the market during the fourth quarter, although not where most investors expected. While the stock market made new highs in December and finished 2014 up 11.4%, the really big news was in the oil and currency markets. As most consumers now realize when refueling their car, the price of oil has tumbled to levels not seen since the financial crisis. Less apparent to U.S. consumers is the strengthening of the dollar against every major currency in 2014. Both of these large moves will have significant and different ramifications for countries, economies and investments going forward. A stronger dollar and lower oil prices will also suppress inflation for the foreseeable future. Given these developments, capital is flooding into the U.S. while many international markets are becoming increasingly hazardous.

Oil is the most basic and important commodity in the world. Its price affects all goods because it is used to extract, process, manufacture, and transport nearly everything. Only since people began the systematic use of fossil fuels some 200 years ago has economic growth become supercharged, wealth exploded, and technological innovation accelerated. More recently, oil production has also been a major engine that helped the U.S. dig out of the deep recession six years ago. The development of directional drilling coupled with high-pressure fracking has caused a domestic energy renaissance. This allowed the U.S. to sharply cut its international energy bill and successfully implement severe sanctions against Iran, reducing their oil exports by half. The surge in U.S. production was also well-timed as supplies became disrupted in several Middle Eastern and African countries. Without the growth in U.S. production, the global economy would be much weaker and oil prices might have spiked higher over the past few years, smothering any recovery.

Despite its incredible importance, oil trades like any other global commodity. When the balance between supply and demand is out of kilter, prices can move sharply. As a result of growing production in the U.S. and Iraq, the price of oil has declined by roughly 50% since this summer. The decline accelerated this last quarter as Saudi Arabia announced their intention to protect market share in a world with excess production. This dramatic move in the price of oil instantly created big winners and losers across the globe. The biggest winners are consumers and countries that import the majority of their energy. On New Year’s Day, the average price for a gallon of regular gasoline in the U.S. was $2.23, down sharply from the 2014 peak of $3.70. Importantly, this price drop provides the greatest benefit to those in the bottom half of society. It doesn’t take an economist to realize that low-income workers are still struggling six years into the economic recovery. This shift in energy prices comes at the perfect time to help Europe and Japan, two major energy importers. Both of these economies are having difficulty generating any growth, much less a level Americans would find acceptable. This huge

price cut should redirect spending toward domestic services and goods, something both economies desperately need. In the U.S., domestic oil producers will be hurt, but economists generally expect the drop in oil prices to be a net gain for the country. At the very least, money will go into consumer pocketbooks rather than oil company coffers.

The list of losers is more complicated and hazardous for investors. Clearly the oil producing nations of the world will be the most impacted by the drop in prices. Most vulnerable are Venezuela, Russia, Nigeria, and the weaker Middle Eastern countries. At this point, Venezuela's economy is in shambles and investors expect the country to default on their debt within the next two years. More consequential is the extreme stress Russia is now under. Russia is facing a financial and economic crisis that will be nearly impossible to escape if oil remains at current levels. As a result, Russia's currency fell by 42% against the U.S. dollar in 2014. This has forced Russia to take over a failing financial institution and provide funding to the state energy giant Rosneft. The situation in Russia is quickly becoming dire and the country is likely to need a lifeline. Given the faceoff with the West over Ukraine, Russia will probably look to China for help.

Aside from naming countries that we should all be thankful we do not live in, the more important question is how these global events affect our current and future investments. It turns out that many of the investments sold to investors over the past few years as providing superior yield are most at risk from recent events. High-yield bonds, international stocks and bonds, and energy-related master limited partnerships (MLPs) have all been under pressure. As oil prices sharply declined, the price of high-yield bonds backed by lower-quality oil and gas companies plummeted. The same scenario played out in energy-related MLPs. A common theme underlies both markets: When investment ideas become overly popular, it allows dubious actors to operate. We avoided both markets for this reason and focused on purchasing high-quality U.S. equities providing large and growing dividends to generate the income clients require.

The bigger story has been unfolding in the international markets. As we already mentioned, even after a partial recovery the Russian currency dropped 42% compared to the dollar in 2014. However, this is just the most extreme example. Turkey's lira fell to an all-time low and many Asian currencies are the lowest since the Asian financial crisis in 1997. Brazil's real was down 10% while Argentina's currency plummeted 23%. The developed markets were also down noticeably with the euro and Japanese yen falling 12%, and even the British pound receded 6%. With this as a backdrop, being an international stock or bond investor was very challenging in 2014.

The rapid strengthening of the dollar over the past few months is a clear sign that capital is swiftly moving out of international markets and into the U.S. Unfortunately, this will cause problems for international consumers, companies, and countries carrying too much debt as a result of overly-easy borrowing terms during the past decade. With capital moving out of these markets, it will become increasingly difficult for borrowers to roll over existing debt. On top of that, most emerging markets are based on selling commodities, all of which have declined substantially in price the past two years. If that wasn't enough, foreign corporations and countries have issued a burgeoning amount of bonds denominated in U.S. dollars during the past five years. As their own currencies weaken, repaying their U.S. dollar debt will become ever more difficult. Taken together, the outlook for international borrowers and their underlying economies is looking increasingly perilous.

Given the gloomy international outlook, we expect a number of debt defaults around the world in the next few years. The location and timing of these events will be hard to predict and difficult to escape for investors exposed to these markets. As international borrowers fall into trouble, investor funds will only move more quickly to the safety of the U.S. This will put even more pressure on international borrowers, possibly allowing small problems to snowball into a larger calamity. The three financial markets that are large enough to influence the U.S. economy are the European Union, China, and Japan. Regrettably, all three have become more fragile over the past few years for different reasons. It will be important to monitor these financial markets for stress, but we do not believe an imminent crisis is on the horizon.

As we have written for several years, we believe equity investors should be heavily weighted, if not totally weighted, to the U.S. During the next 12-18 months, the U.S. economy should have plenty of momentum to shrug off small disruptions overseas. The capital flooding to our shores as well as a drop in oil prices should only further propel U.S. growth and insulate us from the international economy. In the intermediate-to-long-term, we cannot dismiss the fact that the major financial markets outside the U.S. have become more fragile during the past few years. In particular, the stagnant European economies and China's deflating credit boom should worry all investors. We need to be cognizant that the drop in oil and strength in the dollar may very well sow the seeds for the next sizable crisis down the road. However events play out, investors are wise to keep their investments in the highest quality securities available, specifically in the shares of highly-profitable leading U.S. companies and, at some point of opportunity, in U.S. Treasury bonds.

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