Dear Client,

The biggest surprise of 2014 in the financial markets was likely the plunge in the price of oil, and it will shape market performance through 2015 and beyond. After Brent crude prices peaked at $115 per barrel in mid-June, a combination of high supply and some slowing in demand has led to a decline of more than 45% to under $60 a barrel. There are clear benefits to oil-importing countries, as energy costs to consumers and businesses fall.

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However, we believe some offsetting factors will lessen the benefit: the positive effects on the U.S. economy from shale-related capital expenditures and hiring will clearly fall, and the financial market pressures on highly leveraged energy companies will dent some investors’ risk appetite. In addition, the significant fall in revenue for some of the world’s biggest oil-exporting countries could serve to increase an already tense geopolitical landscape.

So far, U.S. consumers seem to be enjoying the windfall at the gas pump, as November retail sales were particularly strong and job gains were robust. While Europe and Japan will also benefit from lower energy prices, the relative weakness in their currencies offsets some of the benefit. Some of the largest emerging-market economies, such as China and India, should benefit because of their energy intensity and reliance on imports, but Middle Eastern countries and Russia in particular will feel revenue pressure. At a global level, it’s a transfer of wealth from oil producers to oil consumers—which should benefit the real economy.

Financial markets love predictability, and the uncertainty around the causes of the oil price drop and its implications have increased volatility. One result that appears clear is the disinflationary effect that falling energy prices will have on the global economy. Concerns over this effect, expressed by many central bankers, will likely impact the duration and score of the current accommodative monetary policy cycle. In the current environment, we believe the United States stands out among developed nations for its relatively strong economic growth outlook, its slowly normalizing monetary policy and the prospect of continued currency appreciation.

U.S. Equity

The price of a barrel of crude oil has declined more than 45% since its peak in June, reducing earnings expectations from a range of a 20% reduction for integrated majors to a 70% reduction for some exploration and production companies. This assumes oil prices stabilize at $60 to $65 per barrel, and this would represent an approximate 5% reduction to S&P 500 earnings. However, close to half of all oil consumed in the United States is used to produce gasoline, so consumers will benefit from lower oil prices. The consumer sectors comprise close to 20% of S&P 500 earnings, while energy is approximately 10%. Declining energy earnings are a headwind which should dissipate during the next year as the benefits of lower oil prices cycle through the economy to the consumer.
Emerging-Market Equity

Chinese equities are a global standout this year, with the Shanghai Stock Exchange Composite Index up 43% since late July. However, the broad emerging-market equity index is actually down 11% during this same period, indicating that the Chinese rally is technical in nature and does not reflect an improving outlook for emerging-market growth. With limited investment alternatives and falling housing prices, Chinese investors have jumped on easing monetary policy signals with abandon. This has recently led regulators to tighten collateral requirements in an effort to deflate the bubble. We continue to have some concern over the outlook for emerging market growth during the next year, and see an increased risk of stress from a surge in dollar-denominated corporate debt issued in recent years. This leaves us tactically underweight in emerging-market equities until we see signs of improved economic momentum.
European Equity

European profit margins remain stubbornly lower than prior cycle highs and are still below levels experienced during the economic recovery in 2011. Encouragingly, European net profit margins have improved from approximately 60% of the S&P 500’s at the beginning of last year to 67% at the end of the third quarter. The stronger U.S. dollar, combined with lower input costs and exposure to faster growing regions, likely helped overcome the less competitive economies at home. The key to further operating leverage is stronger revenue growth, which should continue to be elusive given limited political progress and slowing economic growth. Given this backdrop, we expect the trend of disappointing European earnings growth to persist and equities to underperform their developed-market peers.

U.S. Fixed Income

In the largest corporate bond deal of the year, Medtronic issued $17 billion of new debt at the beginning of December. Like many other nonfinancial firms, Medtronic used record-low borrowing costs to assist with its merger and acquisition plans. Year-to-date sales of investment-grade corporate bonds of $1.1 trillion are on pace to surpass the previous record set in 2013. Corporations have been issuing new debt for a variety of reasons, including funding capital projects, increasing dividends and stock buybacks, and refinancing existing debt. The heavy corporate issuance has overwhelmed investors in the second half of the year and pushed credit spreads wider, which we believe has created a buying opportunity.
Real Assets

The price of oil continues its downward spiral, a result of the strong dollar, the U.S. energy renaissance, and slowing demand out of Europe and China. This has resulted in a 12% fall in the commodities index (in dollar terms). For now, the path of least resistance for commodity prices is down. The dollar should continue to strengthen in 2015 given central bank divergence. Oil supply continues to grow as OPEC maintains its production quotas, and U.S. drillers continue to grow production to appease investors most interested in production growth. Lower commodity prices should help the European growth outlook and eventually stabilize energy demand. However, as seen in the accompanying graph, the benefit to Europe (and Japan) is dramatically less than that to the United States, given euro and yen currency weakness.

Conclusion

We have three key themes guiding our tactical asset allocation views as we begin 2015. First, we want to hold U.S. assets in the current environment. U.S. growth is a relative standout, the Federal Reserve is actually moving toward some normalization of policy and the United States is a safe haven geopolitically. Second, we see asynchronous growth because of uncoordinated global policy. This may lead to increased volatility, but may also push monetary policy toward accommodation and keep interest rates low. Finally, the low interest rate environment means there’s a high bar for taking out portfolio insurance by investing in low-risk bonds or cash.

What kind of market environment are we expecting in 2015? Our equity market return forecasts are driven by earnings growth, and U.S. earnings growth of 7% drives our total return forecast of 9%. We think the recent increase in yields in U.S. high yield bonds improves their prospective returns, and forecast a return of 7% to 8%. We believe this return outlook justifies an overweight recommendation, especially as the return potential is above what we expect from EAFE and emerging-market equities (which we forecast at 2% to 3% and 5%, respectively). An unexpected downturn from U.S. or Chinese growth remains our primary risk case, along with concerns about Russian/Western relations and market volatility stemming from monetary policy developments.
Meet a Member of the Enterprise Investment Advisors Team

Jeffrey L. McDonald, MBA®
Senior Vice President, Chief Investment Officer

Jeffrey McDonald is a Senior Vice President and Chief Investment Officer at Enterprise Investment Advisors. Jeff joined Enterprise Investment Advisors in August 2009 as a Portfolio Manager working closely with our Relationship Managers to deliver world class investment advice and strategies to our clients. He is responsible for in-depth analyses of investment portfolios, research coverage of individual stocks, bonds, mutual funds and alternative investments. Jeffrey has over 23 years of investment management experience.

Prior to joining Enterprise Investment Advisors, Jeffrey was a portfolio manager at Sovereign Bank’s Wealth Management Group in Boston where he managed over $1 billion in client assets. In addition, he served as a fixed income manager for a $3 billion pension fund in New York, worked on the institutional fixed income trading desk at Fidelity, and developed a wealth management practice at Merrill Lynch. He is currently a candidate for Level II of the CFA designation. Jeffrey is actively involved in various fundraising events such as the Swim Across America and the Connecticut Challenge cycling event. He is also involved in community building associations such as Habitat for Humanity and has served as a member of the fundraising committee and orchestra for South Church in Andover. In addition, Jeffrey currently volunteers his time as a coach in North Andover’s soccer and baseball leagues.

At Enterprise Investment Advisors, our mission is to help clients achieve their financial goals by providing professional money management, extensive resources, and independent, objective advice that you can trust. Enterprise Investment Advisors was established in 1992 and manages $650 million in client assets. Our clients are successful executives, professionals, entrepreneurs, non-profit organizations, private foundations, and retirees who desire a financial partnership that can provide access to investment opportunities and alternative strategies.