HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

By William N. Hudson, Jr., David D. Burrows, William Hudson III, Evan Coppola, & Jeremy Hudson

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We do not mind when it all turns out better than we predicted. We were cautious at this time last year. The market had been spectacular in 2013. We expected 2014 to be a time for pause. Instead, the bull run continued – despite some temporary hiccups – and the stock market hit record levels. Oh well…we can accept that result.

The market in 2014 continued a pattern seen since 2009. Equities have often reached levels of enthusiasm and valuations that seem excessive. But then something happens to bolster investor confidence and give the market a renewed burst of life. In 2014, those upbeat events were resurgence of the U.S. economy and the dramatic decline in oil prices.

The United States is in an intriguing place right now. Economic growth has taken firm hold. U.S. companies are in strong financial position. Consumers demonstrate confidence. This good news occurs in contrast to the international outlook: Europe in stagnation, Japan in recession, Chinese growth slowing, and other emerging economies uncertain.

So what about the market in 2015? Interestingly, we find ourselves thinking similarly to last January. The year ahead will be good – but not as good as the year just past. Again, we have some cautions. As the cliché goes: tailwinds become headwinds. The strong U.S. dollar may create a dragging effect in a weak global economy. Cheap oil creates downsides as well as upsides. The response to the end of the Federal Reserve's monetary easing is not certain. Stock valuations are relatively high. On balance, we are positive – but we are not complacent and certainly not giddy.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for 2014. Despite some periods of temporary setback, the stock market continued its nearly six-year rise. Meanwhile, the bond market demonstrated surprising resilience after its losses in 2013. There has been some discussion in the Wall Street Journal and other financial magazines comparing active management to passive management. This most recent stock market rally has certainly favored passive management and 2014 was a tough year for hedge funds, equity managers, global and domestic equity portfolios managers. A Jan 5th, 2015, Wall Street Journal article pointed out that the average diversified US Stock funds returned 7.6% in 2014 per Thomson Reuters Corp Lipper unit. The current trend has investors pulling money out of actively managed funds, global, emerging market funds and aggressively adding to large cap domestic index funds and ETFs. At Hudson Advisors, we are always a bit weary of following the crowds.

Equity Markets: Investors in 2014 showed good appetite for U.S. stocks – especially those of large cap companies. The fourth quarter was especially impressive despite periods of volatility in October and December. The S&P 500 index was up an average of 21% for last three years – its best performance since the late 1990s.

The Dow Jones Industrial Average was up 5.2% for the fourth quarter and 10.04% for year. The S&P 500 index was ahead 4.93% for the quarter and 13.69% for the year. The Nasdaq Composite gained 4.9% for the quarter and 19.4% for the year. Most interesting was the Russell 2000 – which lagged in the early quarters – but surged 9.73% in the fourth quarter to end ahead 4.89% for the year.

Fixed Income Market: The bond market was a surprise. Most analysts had expected prices to continue the decline seen in 2013. Instead, the yield on the Treasury 10-year note – which moves inversely to prices – fell to 2.17% from 3.03% at the end of 2013. This trend suggests that many investors are not on board with the equity boom and hang on to the perceived safety of government bonds.

MAJOR MARKET INDEXES

	4Q Total Return	YTD Total Return
Dow Jones Industrials	5.20	10.04
S&P 500 Index	4.93	13.69
Russell 2000 Index	9.73	4.89
NASDAQ Index	4.90	19.40
EAFE Index	-3.86	-7.35
Lipper US Diversified Fund Index	4.6	7.6
Barclays Aggregate Bond Index	1.93	5.05

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: After six years of sluggish growth, the U.S. economy seems to have firmly accelerated in 2014. The nation added 2.7 million jobs through November – the best year for employment since 1999. GDP in the third quarter increased at an annualized rate of nearly 5%. The annual growth rate for 2015 is projected at 3.1% -- back to the average rate of expansion in the last 60 years.

By some definitions, the nation has the possibility to meet full employment in 2015.

What accounts for this strength? First, slumping oil prices hurt some sectors, but the overall impact is positive. Spending less at the pump gives consumers more money for other purchases. Second, large U.S. companies are diversified, efficient, and carry healthy balance sheets. Third, the Federal Reserve will increase interest rates at a careful, measured pace. Fourth, the U.S. is less dependent on trade than most nations – which minimizes the impact of economic weakness abroad.

All that said, major concerns remains with the U.S economy. Wage growth is stagnant and the percentage of the population engaged in the workforce is at a 40-year low. These factors can offset the consumer boost from lower oil prices. Also, at some point, the now strong U.S. dollar may hurt export capability. While somewhat insulated from the anemic global economy, the U.S. is not an island and the effect of prolonged downturn abroad is uncertain.

The Market: To be clear, we expect the stock market to end 2015 with positive gains. But the performance will be less impressive than 2014. Here is why:

- The Federal Reserve will start raising interest rates at some point this year. Even if those increases are moderately paced, any changes in Fed policy make the market nervous.
- The S&P 500 traded at 17 to 18 times profits for the past 12 months. This is expensive by historic standards. Since the 1920s, the average is closer to 15 times earnings. The relatively high stock price will restrain the potential for further upward movement.
- Cheap oil prices have a mixed effect on the market. Some sectors will benefit while other sectors – especially energy companies – will suffer.
- U.S. multinational companies – particularly those with major presence in Europe – face some potential drag on profits. This uncertainty also will make investors nervous.

Overall, we expect the major stock indexes to end 2015 in the 4 to 8% growth range. This growth will not be a straight line. As in 2014, there will be periods of volatility and setback. Growth will be an upward but spikey line.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 55% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We suggest that fully invested clients trim equities to 55-65% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. Some of the sectors we are like are:

- TECHNOLOGY: Some technology companies have room for further earnings growth – especially those with innovative consumer products.
- HEALTH CARE: The implementation of Obamacare is good for this sector – especially companies strong in biotechnology.
- BASIC MATERIALS: End users of petroleum, such as diversified chemical companies, will benefit from lower energy prices.
- INTERNATIONAL: Emerging market stocks have been underperformers in recent years – and have not been our friend. But we anticipate them to rebound in the period ahead.

Fixed Income: At some point in 2015, interest rates will rise. The risk to holders of longer maturities is substantial. Our viewpoint on this issue is well-known to our clients. Instead, for the non-equity portion of client portfolios, we utilize cash, short bond instruments, and alternative investments like municipal tax lien programs.

Dow Jones U.S. Sectors
(Percent Change for YTD, Ending December 31, 2014)

Sector	Change	Sector	Change
Oil & Gas	**-9.27**	**Consumer Services**	**14.53**
Basic Materials	**3.39**	**Telecommunications**	**-1.33**
Industrials	**7.30**	**Utilities**	**28.09**
Consumer Goods	**12.11**	**Financials**	**14.59**
Health Care	**25.76**	**Technology**	**20.04**

William Hudson, Jr., Jeremy Hudson, & Evan Coppola
4445 North Hwy A-1-A, Suite 233 • Vero Beach, Florida 32963 • (772) 231-8101
237 Main Street, Suite 600 • Buffalo, New York 14203 • (877) 504-1964
William Hudson, III CFP ®
6701 Democracy Blvd, Suite 300 • Bethesda MD 20817 • (301) 840-2071
David Burrows & Elizabeth Kisken CFA ®
29 Hillside Drive • Greenwich, CT 06830 • (203) 302-3530
www.hudsonadvisors.com • (877) 504-1964