INVESTMENT COMMENTARY: Q1 2015

April | 2015

VOLATILITY IS ON THE RISE

The 1st Quarter of 2015 saw a market that chopped around, yet showed little overall net price improvement. Large-cap stocks barely budged, up less than 1% for the first 3 months. Small and midsized stocks outperformed their larger brethren, based in part on the adverse impact of the strengthening U.S. dollar, which rose by 9%. While the overall market is moving sideways, daily market price volatility is rising. Here is an astonishing figure: The Dow Jones Industrial Average had triple-digit changes in more than 60% of the trading days in the first quarter.

Economic sector price performance was quite varied in the first quarter. The energy, utility, financial, and industrial sectors saw broad declines, while biotech and consumer discretionary were strong. Other asset classes were also mixed and volatile in the first quarter. Commodities dipped by 5%, European bond and stock funds thrived, as did the Asian markets.

Interest rates fluctuated wildly during the quarter. The 10-year US Treasury started the year yielding 2.04%, fell hard for the first six weeks of the year before bottoming out at 1.64% in February. Yields then rose sharply as the Federal Reserve started hinting that it could start raising interest rates as soon as June of this year if economic data remained robust. Rates hit a high of 2.24% in March, then tailed off to finish the month at 1.94%.

So volatility is increasing, and if there is a consistent theme to be divined from the market's volatility in the first quarter, it is that uncertainty is on the rise. Investors are having a difficult time forecasting economic growth for the balance of 2015. Adding to the economic uncertainty is the fact that the Federal Reserve recently changed the language of its policy decision to state that they are now "data dependent" in making their next change in interest rate policy. In other words, the upcoming economic data will not only have an impact on investors' expectations for economic growth and corporate profits, but the economic data will also have an impact on near-term interest rate policies adopted by the Federal Reserve. Therefore the stakes have increased.

Assessing the US economy, Gross Domestic Product (GDP) grew by 2.8% in the 4th quarter of 2014, and the current economists' consensus estimate is that the GDP grew by 2.7% in the 1st quarter of 2015. There are many reasons to believe that this estimate is too rosy, and that the economy grew at a slower pace in the 1st quarter. Poor weather throughout most of the country kept a lid on sales, and the March employment report showed that new job creation has slowed. So it is likely that the upcoming economic data will disappoint, and not spur the Federal Reserve to take action immediately.

Looking forward, the key issue is whether economic growth will re-accelerate in the second-quarter, because if it does, the Federal Reserve will likely raise rates; if growth remains subdued, rates will remain low. We will soon discover to what degree bad weather impacted the 1st quarter (and whether this rebounds with better weather in the 2nd quarter), and how the stronger dollar and lower oil price adversely impact corporate profits and continuing economic growth.

In addition, the 2nd quarter will differ materially from 2014 in that:

- The Federal Reserve is infusing less liquidity today than a year ago (no more QE).
- The dollar has strengthened.
- The price of oil has peaked.
- Market leadership is narrowing (fewer stocks making new highs)

We are seeing several indications of slowing growth relative to expectations. The poor March employment report captured headlines, but other recent economic surveys for housing, consumer, and industrial production have signaled that the economy is cooling. That said, support for U.S. equities should come from continued central bank liquidity and still-low, by historic standards, interest rates.

In addition, aggressive corporate repurchase programs and a still relatively strong U.S. dollar will attract buyers of U.S. assets.

Stepping back from the near-term U.S. economic outlook, other factors will weigh on the stock market throughout the rest of the year. Some of the near-term headwinds include:

1. The growing chasm between financial assets and real economies continues to widen (stocks rising while economies stagnate);
2. The rate of corporate profit growth is decelerating markedly. A year ago, consensus 2015 S&P EPS was more than $135 a share and it is now under $120 a share;
3. Valuations have repeatedly risen, despite disappointing (relative to consensus expectations) economic and corporate profit growth. Earnings now must do the heavy lifting;
4. Leadership has narrowed (fewer stocks making new highs).

For three years, the stock market has accepted 2.5% US GDP, allowing valuations to expand to above historic Price Earnings Multiples. The growing chasm between stock prices and the real economy is a source of market discomfort. There comes a point when stock valuations rise to levels, particularly with gross profit margins near records, that profits have to do the heavy lifting. It does not appear likely that corporate profits are up to the task at this moment.

Given this backdrop, it is reasonable to expect that stock prices are ahead of the fundamentals, and are due to take a pause here. That's not to say we will see a major stock market correction or Bear Market on the horizon; these occur due to recessions, and the economy is still on solid ground. Rather, we expect that the low returns we saw in the 1st quarter are likely to persist for a while, and investors shouldn't be unrealistic in their expectations.

While the broad market could struggle to advance significantly from current levels, we continue to see many attractive investment opportunities. Several sectors within the market are undervalued and have strong fundamentals. In addition, we like innovative companies that are able to grow their revenues and earnings at an above-average rate, provided that their valuations are reasonable. We also like safe income-generating investments, which should serve as core holdings in long-term investment portfolios. Maintaining a balanced, well diversified portfolio is the best course of action in today's environment.

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