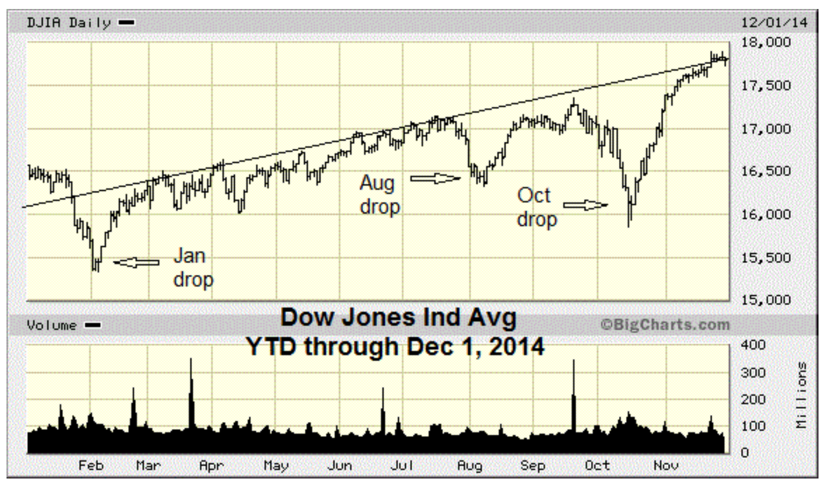
American Heritage Financial

December Update **December 2, 2014**

Ascent and Assent

*The stock market of 2014 can be characterized as a year of **ascent** and **assent** in that stock prices ascended ever higher over the year and investors finally assented to the long bull market.*

First, a look at the ascent in stock prices. With the exception of three blips, stocks were uneventfully strong all year. Short, sharp declines in January, August and October got investors' attention, but each of those declines quickly reversed into powerful rebounds which conditioned investors to focus more on the opportunity of the rebound rather than the risk of the decline. October was the most severe of the declines and it also provided the most dramatic rebound, convincing most everyone that the market should continue to enjoy favorable returns at least through yearend. Our accompanying chart of the Dow Jones Industrial Average clearly shows the three declines as well as the consistent, over-riding up-trend.



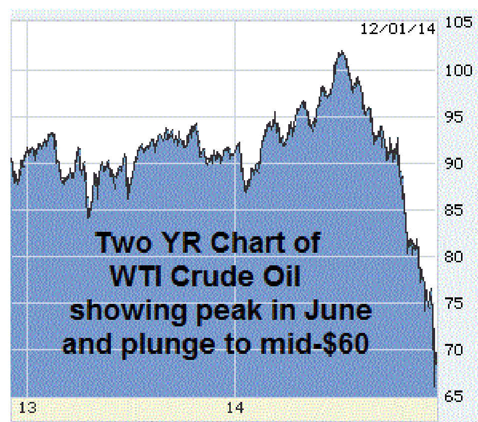
As of early December, the Dow has a year-to-date gain of 7.5% while the broad-based S&P 500 Index is ahead by nearly 12%. As indicated by the difference in the Dow and S&P (which normally produce surprisingly similar results), there has been unusual variation among different types of stocks this year. Size mattered in 2014; small company stocks generally lagged as shown by the benchmark for smaller stocks, the Russell 2000, which is barely positive with a 0.8% year-to-date return thorough November. Returns also varied drastically among industries. Health industry stocks have been leading the pack all year long. Assisted by huge gains in biotech, the S&P Healthcare Sector is up 25.1% YTD. At the other end of the spectrum, the S&P Energy Sector is sitting with a YTD decline of 10.3%; and nearly all of that came in the past month. Energy is the only U.S. market sector with negative returns this year. (More on the debacle in energy later.) Non-U.S. stocks were a different story; most major European and Asian markets sport YTD returns in the low single digits while emerging country stocks have their typical wide variation of positive and negative returns.

As to the assent, or acceptance of the stock market by the general investing public—well it has been a long time coming but **public investors finally turned bullish in 2014.** The two painful bear markets of 2000 and 2008, along with the crushing financial crisis of 2008, turned all but the most die-hard investors against the stock market. Stinging losses, bitter feelings and the constant fear that prices could collapse again prevented many people from participating in the strong market that began in March 2009. Measures of investor sentiment such as mutual fund flows, margin purchases and attitude polls are just recently producing readings that indicate investors are again warming to the market. Even more, we can provide anecdotal evidence that our clients are showing greater acceptance to suggestions to invest in stocks. Clearly, this "assent" has a lot to do with the fact that there are few other alternatives since interest rates remain near zero, but rates have been low for many years. What is different now is that the **strong market gains of this long bull market have finally conditioned investors that stocks aren't so bad after all.**

Other than steady gains which helped investors rediscover the market, there were a few very s**ignificant financial issues in 2014** which need to be understood in relation to prospects for 2015. First, and by far the most significant issue, is the **influence of central banks.** Most investors are vaguely familiar with how the Federal Reserve works to manage the economy by keeping interest rates low and the Fed has been providing extra stimulus by buying bonds (i.e. the mysterious "QE" programs). The goal of these efforts was to boost the economy—and it has helped—but a **significant side effect is the impact on stock prices.** The combination of economic stimulus, low interest rates and slow economic growth has produced perfect conditions for stock investors. While sensible investors realize that extraordinary stimulus creates unhealthy imbalances and might lead to eventual problems, it appears the Fed will continue its accommodative ways even as it starts to reduce some stimulus programs. Meanwhile, however, it is all but certain other major central banks in Europe, Japan and even China are about to take up stimulus programs which will be at least as aggressive as those the Fed engineered. This likely means **global markets—now extremely depressed relative to our exuberant markets—could start producing strong results as early as next year**.

In addition to the significant boost central banks could give to global stock markets, the U.S. dollar is likely to enhance the attractiveness of non-U.S. stocks. The d**ollar has appreciated against foreign currencies since mid-2014.** By most measures, our currency is about 10% stronger than it was six to eight months ago—a gigantic move for major currencies. The dollar's strength reflects our relatively stronger economy and more stable conditions versus just about any other country in the world and that strength is expected to continue for at least a few more quarters. The downside of a strong dollar is that it makes U.S. produced good less competitive (foreign goods become less expensive), it reduces the value of international profits earned by the big global U.S. corporations and the currency difference makes foreign stock markets "cheaper" (all else being equal). These central bank policies, depressed foreign stock markets and the strong dollar are all factors that are likely to combine to produce **stronger returns for foreign stocks in 2015 relative to U.S. stock market returns.**

The strong U.S. dollar is also one of the components of the final great financial event of 2014—the **collapse of commodity prices, especially the world's most important commodity, oil.** Oil peaked in June but the big plunge occurred in November as crude fell 35% from its recent high to a five-year low (see accompanying two-year chart of WTI Crude). The dramatic decline in oil is a fascinating and still unfolding story. It is a reminder that oil, like all commodities, is dependent of the basic laws of supply and demand; yet the intrigue of global politics and economic warfare are a large part of the turmoil in oil markets. At this point, it is impossible to say if the plunge to mid-60 dollar-a-barrel oil is simply an aberration or the "new normal" for a world that is suddenly able to produce more oil than it uses. We believe it is more a case of the former and a pick-up in demand in 2015 will bring the market back to more "normal" levels of $80 to $95 oil. Still, the market faces tremendous uncertainty and a volatile future. Of course the low price of oil will provide great stimulus to the economy in the form of lower gas prices and lower costs for industry but cheap oil is a double-edged sword. Our economy has become a major oil producer and the oil industry's impact on job growth has been significant. From an investment standpoint, every stock related to producing energy has suffered and the rush to invest in oil exploration will likely taper-off significantly.



Oil is not the only commodity to suffer price declines in 2014. The impact the strong dollar, weak global demand and excess capacity from over investment have combined to reduce prices of copper, iron ore, silver, coal and other industrial commodities. The impact these lower prices have on global financial markets, economies, and politics will be a major story of early 2015—and possibly beyond.

Central banks, the strong U.S. dollar, collapsing commodity prices and more confident investors all promise to be important components of what looks to be another exciting year in the financial market in 2015. We look forward to helping you navigate your way through another prosperous year. Best Wishes for a Happy Holiday Season!

Best regards,

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Questions or comments?
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