



# KayneCast

A Podcast Series by Kayne Anderson Rudnick



## Episode 14

### A Market Review of 2014, and an Outlook for 2015

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Len: Welcome to KayneCast. My name is Len Hirsh, and I'm the Assistant Director of Marketing Communications for Kayne Anderson Rudnick Investment Management. Today our guest is Doug Foreman, the Chief Investment Officer of Kayne Anderson Rudnick. Doug is joining us to give a market review of 2014, as well as his outlook for 2015. Hey Doug, thanks for joining us.

Doug: My pleasure, Len. Thanks for having me.

Len: So, Doug, could you give us an overview of what happened in the stock market in 2014?

Doug: Sure, Len. Well the S&P 500 Index delivered double-digit returns again in 2014. It appreciated slightly over 13% for the year, and most notably this is the fifth out of the last six years that the S&P 500 has generated double-digit returns. The benchmark itself has fully recovered now from the financial crisis of 2008, and is actually up over 200% off the March 9th 2009 bottom, but unlike the unusual years of 2008 and 2009, when pretty much everything went up and down together, 2014 was more of a typical year where returns among various asset classes were actually quite different, some up a lot, some down a lot.

Len: So can you briefly touch on those different asset classes?

Doug: Sure. For starters, small-cap companies, as measured by the Russell 2000 Index, had positive returns of about 4.9% for the year. While these returns were positive, they lagged large companies, and this is basically because in 2013, small caps significantly outperformed large. So last year was sort of a give-back of 2013's outstanding performance, but international and emerging market stocks really continued to struggle in 2014. International stocks went down almost 5%, and emerging markets stocks went down slightly more than 2%, as measured by the MSCI EAFE and Emerging Markets Indexes. The strength in the U.S. dollar, which has been particularly strong over the last 12 months, really hurt foreign returns, with the dollar finishing at levels that we haven't seen since late 2005.

Len: Okay, and how about fixed income, Doug?

Doug: Well, surprisingly, fixed income appreciated about almost 6%, as measured by the Barclays U.S. Aggregate Bond Index, and Cal Munis [California municipal bonds] almost appreciated 10%. High yield lagged the overall fixed income universe, increasing only 2.5%, and commodities and precious metals continued to perform quite poorly in 2014.

Len: So, Doug, what do you think was the biggest surprise of 2014?

Doug: Well, Len, as we entered 2014, our expectation was that 10-year bond yields would rise gradually from the 3% level up to around 3.5% or so during the course of 2014. This clearly didn't happen, and this is despite an accelerating GDP report that we saw in the third quarter of over 5%, significant improvement in the job market throughout the year, which actually caused the Fed to



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cease their Quantitative Easing program in full. So despite the strength in the U.S. economy, bond yields not only didn't rise, they actually fell.

Len: Right. So, why do you think that was that they fell?

Doug: Well, we believe the key reason that the yield fell from 3% to the 2.2% level instead of rising gradually was that there was weakness internationally, particularly in Europe and Asia, with both continents showing negative GDP reports during 2014 in a few different quarters. This drove the German 10-year yields down to a whopping 0.53%, and Japanese yields fell down to the 0.32% level at year-end. So, for foreign investors a higher 10-year yield here in the U.S. over 2% combined with a strong currency (i.e., the dollar) makes the U.S. a very appealing global fixed income choice for global investors.

Len: Okay, and you mentioned weakness in Europe. Can you talk a little about what's going on in Europe and can we expect the region to be able to turn things around soon?

Doug: Well, Europe has been particularly weak throughout 2014, and it's unclear to us how much of the European slowdown has been caused by the Russian sanctions and the Ukraine situation, but it certainly didn't help growth rates there. And additionally, the price of oil has collapsed over the last six months, which has put further downward pressure on below-trend global inflation rates, particularly in Europe.

Len: Yeah, this dramatic fall in the price of crude oil was a pretty significant event last year. What should we expect going forward?

Doug: Well, it appears that there's been a little bit of a sea change where Saudi Arabia is no longer willing to stabilize global oil prices by adjusting its output. Instead they've decided to defend their low-cost position and regain some market share that they've lost over the last several years to U.S. shale oil producers. This shift in strategy of course has sent the price of oil plunging from over \$100 a barrel down to the \$55 to \$60 level at year-end. If the price of oil is sustained at these levels or lower, it's going to negatively impact the entire energy production chain. And particularly highly leveraged exploration and production companies—as well as the equipment providers—are going to be in for a very difficult 2015 if the price of oil stays where it's at. The good news is for energy consumers, which is most of America and many emerging market countries that import a lot of oil, including Japan and others, it's very good news and it's almost the equivalent of a significant tax cut. Lower gas prices in particular will help the low-end consumer in the U.S. who's really struggled throughout most of this recovery.

Len: Alright, we saw some different sectors really struggling earlier in the year. Do you think that was the extent of any kind of correction that we might experience?

Doug: It's interesting, Len. Despite the fact that we didn't have the technical definition of a correction throughout 2014, and that being, you know, the S&P 500 declining 10% or more, we had a couple periods that got very close. There were several sharp, albeit brief, pullbacks throughout 2014. And additionally, many individual sectors and industries were hit pretty hard during various times of the year. So there were a lot of corrections, a lot of rolling corrections that happened underneath the covers of the stock market and the overall S&P 500 Index which, as we mentioned before, did fairly well throughout the year. Retail stocks in particular were hit very hard in the first quarter due to weak business conditions because of the brutal winter that basically occurred in most of the U.S. Biotech and technology stocks were hit extremely hard in the spring on profit-taking and concerns about continued innovation and continued demand in the technology sector. And then of course energy stocks over the last six months of the year have been decimated as the price of oil has been cut in half. So despite the overall market making multiple new highs during the course of 2014, there were ample opportunities to invest in individual companies at reasonable prices, which of course is what we try to do day to day.



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Len: OK, Doug, well that's really helpful. Thank you. What's your outlook now for 2015?

Doug: Well, I think one of the key things to watch for is how international economies behave throughout the course of 2015. Europe, Japan, and even China to some extent did decelerate as they went through 2014. I think it's important in 2015 that these economies at least stabilize if not grow somewhat. Their central banks—whether it's the Central Bank of Japan, the ECB, or the Chinese Central Banks—have all embarked on stimulative monetary policies to some extent. The ECB has been the most reluctant to embark upon quantitative easing, but we believe that that will probably occur over the next quarter or so. These monetary policies, which are stimulative in effect, should stabilize at least these economies throughout the course of 2015. Inflation is probably going to stay below trend this year as the after-effects of the lower oil prices work themselves through the system, which provide lower input costs for both businesses and consumers. And I continue to think that global deflation, not inflation, is still the principal key risk for investors going forward.

Len: Okay, Doug. And any comments in particular about the U.S.?

Doug: Sure, Len. Domestic corporate profits we believe will continue to grow in the 5% to 10% range, and stock market returns should follow the earnings growth. We're not looking for multiple expansion or contraction in 2015, and I'm not willing to go out on a limb and forecast another consecutive year, you know, making it six out of seven of double-digit returns for the S&P 500, but if these overseas economies do the right things in terms of stimulative policies going forward, and the U.S. continues to chug along with the good head of steam that it appears to have right now, it's not out of the realm of possibility that we could even get another year of double-digit return in the S&P 500 in 2015. I think that [with] asset classes overall, we're going to continue to see a lot of dispersion very similar to what we saw in 2014. So there will be a lot of asset classes that work out in 2015, and many that don't, and I think it's important for that reason to have a well-diversified portfolio because it's really difficult to figure out in advance what those sectors are going to be every year.

Len: Okay, and I know it's pretty difficult to predict, but do you have any thoughts on when the Fed might raise rates?

Doug: Federal watchers will have a really busy 2015 attempting to guess exactly when the Fed is going to raise rates. The truth is it doesn't really matter to us whether it's mid-year—as most investors expect—or later in the year, or even 2016. The key thing to watch, I think, as this unfolds over the next year to year and a half, is not exactly when the Fed raises rates, but what happens to the long end of the bond market when the Fed does start raising rates. For instance, over the last twelve months, we've seen a pretty significant flattening of the yield curve. So short-term rates have actually already gone up in anticipation of the Fed's move next year, [and are] likely to go up more if the Fed actually follows through with an increase in short-term rates, but long-term rates actually not only didn't go up last year in 2014 as we pointed out earlier, they actually rallied, the 30-year bond being the best example of this. So I think the really important thing for investors to watch over the next year to year and a half in the bond market is how the long end reacts to the Fed's short-term interest rate increases. What we would like to see, and hope to see, is that the long end actually sells off or yields rise at the long end when the Fed actually raises rates, which would indicate that the market believes that the Fed is behind the curve still, that earnings and corporate profit growth will continue, and inflation will continue to be reasonably strong going forward, not deflation, which was the current market fear. And the adverse outcome, I believe, would be if the Fed raises short-term rates and the long end continues to rally and yields continue to fall and the yield curve actually goes inverted. An inverted yield curve is very negative for investors of all types and even equities. So that's something we're going to be watching very carefully over the next twelve to eighteen months. Given the risks that we see out there, particularly in the shape of the yield curve, at this point in the economic cycle—which has matured and we're obviously six years into this recovery now—it's very important for investors to invest in underleveraged, high-quality businesses that can do well in both good and bad times, and get through any bad times that may occur in the future.

Len: Alright, well thank you for your insight and your time, Doug. And thank you to everyone who listened in. We hope you are



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