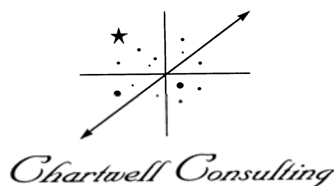

CHARTWELL REVIEW

January 2015 **FOURTH QUARTER 2014** *Volume XXI, Issue No.4*

Black Gold, Texas Tea

". . . . and up from the ground come a bubblin' crude".

That's been happening rather alot lately, to the point global oil production of about 93 million barrels/day is exceeding global oil usage of about 92mm bpd (rougher figures than we'd like to quote, but the proportions are correct).

You might think that a supply overhang of just over 1% would not become problematic. However, you'd be very wrong indeed. After holding onto triple-digit price levels through June, crude oil spot prices collapsed in the 2nd half of 2014 - especially during the 4th quarter. This weakness, and the weakness it engendered across the entire commodities complex (see Figure 1), was one of the most surprising and important developments of Q4 and FY2014.

Secondly, sovereign bond yields virtually collapsed in the world's developed markets during 2014, including another leg down during the 4th quarter (see Figure 7). This was simply not expected as we entered 2014. In fact, the opposite was expected. Structured and credit bonds, especially non-investment grade rated securities, did not do nearly as well as Treasuries. This despite an improving domestic economy, Credit spreads widened as market yields fell, which is a classic "risk-off" trade.

Third, and this all ties together, the US$ strengthened versus almost all of the world's other major currencies during the fourth quarter and full year, especially those of its primary trading partners (except the Swiss). This has accelerated into the first quarter. Another risk-off trade.

Last, inflationary pressures continued to dissipate during the fourth quarter. Consumer price changes across much of the world are rising at much lower rates than central bank policy-makers wish to see, who fear falling prices will trigger a spate of purchase deferral decisions. That, in turn, could easily trigger a demand-induced recession. In response, many central banks other than the Fed began ratcheting up their liquidity provision programs.

Global markets appear to be getting ready for a recession.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	4Q 14	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	4.9	13.7	20.4	15.5	7.7
U.S. Top-cap Stocks	4.4	13.2	20.3	15.0	7.3
U.S. Mid-cap Stocks	5.9	13.2	21.4	17.2	9.6
U.S. Small-cap Stocks	9.7	4.9	19.2	15.5	7.8
Non-US Stocks (**devel**)	(3.5)	(4.5)	11.6	5.8	4.9
Non-US Stocks (**emerg**)	(4.4)	(1.8)	4.4	2.1	8.8
3 mo. T-Bills	0.0	0.0	0.1	0.1	1.5
U.S. Aggregate Bonds	1.8	6.0	2.7	4.4	4.7
High Yield Bonds	(1.1)	2.5	8.4	8.9	7.6
Global Aggregate Bonds	(1.0)	0.6	0.7	2.6	3.6
CPI, annualized	*(5.3)*	*0.8*	*1.3*	*1.7*	*2.1*
Bloomberg Commodity	(12.1)	(17.0)	(9.4)	(5.5)	(1.9)
FTSE Nareit All REIT's	12.4	27.1	16.4	16.6	7.5
Chartwell Global 65/35	*0.9*	*5.4*	*10.9*	*8.7*	*7.0*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	4Q 14	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	4.2	10.8	19.3	14.2	7.5
U.S. Mid-cap	5.2	8.3	19.3	15.2	8.6
U.S. Small-cap	7.6	3.2	18.4	15.2	8.2
International Lg. Cap	(3.3)	(5.0)	10.8	5.7	5.0
International Sm. Cap	(3.4)	(5.6)	14.6	9.7	7.6
Emerg. Mkt. Equity	(4.8)	(2.3)	5.5	2.5	8.0
Balanced/Hybrid	1.8	5.7	10.7	8.9	6.0
General Bond	1.3	5.7	3.6	5.1	4.9
High Yield Bond	(1.3)	1.4	7.4	8.0	6.6
Equity Hedge Index	0.4	2.3	7.9	4.9	4.7

*Annualized trailing returns for periods ending 12/31/14

Economies, Economics, Prices, and Policy

	12/2014	9/2014
CPI - All, y-o-y	0.8%	1.8%
Real GDP Growth - 1yr	2.5%	2.7%
Employment / Population %	59.2%	59.0%
Not in Labor Force as % of Adult Population	37.3%	37.2%

The final estimate of 3rd quarter **real domestic GDP** was released in late December. The economy grew at an upwardly revised annual rate of 5.0%, or $195bn. The biggest swing factor in what was an unexpectedly strong quarter was personal spending, which accounted for 45% of the growth. Private investment accounted for 25% of growth. The import/export mix was quite favorable as well, primarily due to weak oil prices.

The consensus forecast for 4th quarter GDP growth is 2.5-3.0%, which is a rather wide band. The US Dollar's strength amidst slowing global demand has some concerned that Q4 could come in below 2.5%. The full-year 2014 forecast is 2.5%, as noted above.

Figure 3: Breaking Down Real U.S. GDP

% Change from Preceding Period
(seasonally adjusted at annualized rates)

Factor	3Q '14	2Q '14	1Q '14	4Q '13
Real GDP Growth	**5.0**	**4.6**	**(2.1)**	**3.5**
Nominal GDP Growth	**6.4**	**6.8**	**(0.8)**	**5.0**
Final Sales	**5.0**	**3.2**	**(1.0)**	**3.9**
Personal Spending	3.2	2.5	1.2	3.7
Private Investment	7.2	19.1	(6.9)	3.8
- Fixed, Businesses	*8.9*	*9.7*	*1.6*	*10.4*
- Fixed, Residential	*3.2*	*8.8*	*(5.3)*	*(8.5)*
*- Chg. In Inventories **($bn)***	*$82*	*$85*	*$35*	*$82*
Export growth	4.5	11.1	(9.2)	10.0
Import growth	(0.9)	11.3	2.2	1.3
Government Spending	4.4	1.7	(0.8)	(3.8)

The Fed ended its $85bn/month program of long-term Treasury and mortgage bond purchases during the quarter. The well-telegraphed move had little or no market impact. In fact, long-term Treasury bond prices once again rose strongly, despite this loss of purchasing power, implying even larger sources of marginal demand – especially foreign investors.

On the fiscal policy front, there was little definitive to comment on. Following mid-term elections in November, Republicans now comprise a majority in both chambers of Congress. Some feel this will engender an increased element of fiscal discipline during the next few years. Thus, it was disappointing to see a pork-laden appropriations bill pass both chambers of Congress in December, and get signed into law. The good news is that the 2015 federal budget deficit is currently on track to decline from that of 2014, as a stronger economy leads to greater tax receipts.

US employment again increased quite sharply during the quarter. Adjusted for seasonality, non-farm payrolls increased by a very large 866k, after rising 671k during Q3. The larger household survey reported that employment increased 835k persons, compared to only 379k in the third quarter. Despite these sharp gains, the number of part-time workers for economic reasons dropped 268k in the 4th quarter. New workers were full-time. Reported employment was up 2.78 million persons in 2014, while the number of part-time workers for economic reasons fell by almost 1.0 million.

Real hourly earnings rose 0.7% in the fourth quarter. Overall, a 1.0% rise in real hourly earnings in 2014 combined with a 0.9% increase in hours worked.

Labor productivity continued to grow at an annual rate of +2.3% in Q3, the same as Q2. Unit labor costs fell 1.0%, as productivity once again exceeded wage and benefits growth. Over the past year, labor productivity is up 1.0% and unit labor costs have increased 1.2% in nominal terms (i.e., less than inflation). U.S. labor costs remain low in real terms.

Domestically, the **"headline" CPI** index (includes the volatile food and energy sectors) declined at an annualized rate of over 5% during the fourth quarter (Figure 1). As a result, this broad price index is up only 0.8% during the past twelve months. And, the one-year trailing number is virtually guaranteed to shift to negative during the first half of 2015, which will trigger increased discussions about systemic deflation and the heightened risk of a demand-induced recession.

Looking at core CPI (ex-food & energy), we observe that it rose just 0.3% in the quarter, seasonally adjusted, and only 1.6% for the year. This was once again well short of the Fed's 2% target. **Producer prices** for final goods and services fell (0.3%) during the fourth quarter, and increased just 1.1% for the past year.

What about 2015? The current *Economist* poll reflects expectations for real US GDP growth of 2.7-3.6% in 2015. These figures are increased from earlier in Q4. By comparison, only Britain (2.3-3.0%) and Australia (2.0-3.1%) among developed markets are given any chance for such a favorable outcome. Japan and the Euro area are pegged at 1.0% and 1.1%, respectively. In emerging markets, the overall expectation is +4.9%, improved from 4.6% in 2014, as declining oil prices benefit many of the largest EM economies. But, expect considerable divergence. China's growth is expected to decline to only 7.0%, as the country restrains housing and credit markets. Conversely, Indian GDP is forecast to grow by 6.0-6.5%. Brazil should grow less than 2%, and Russia will enter a rather deep recession.

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Quantitative Ended

Long-term domestic Treasury bond yields fell sharply during the 4th quarter, despite the end of the Fed's quantitative easing program. As term interest rates sank across Europe, investors took gains and reinvested in higher yielding US bonds. The 30-year Treasury yield dropped 45bps during the quarter, and the 10-year yield declined 35bps. Medium-term bond yields were down only 5-10bps, and short-term bond rates rose 10bps. As a result, the 2yr-30yr differential declined to only 2.07%, or 55bps lower than at the end of September. One year ago this slope was 3.55%, and market strategists were falling over themselves to predict how high it would go, and how quickly, now that the Fed was going to end QE3.

The results were domestic returns heavily skewed in favor of long-term bonds, particularly those of the highest credit quality. The long Treasury index jumped another 8.6%, while the total Treasury sector returned only 1.9%. All but 1% of this wide differential was due to price appreciation. Long Treasury bonds were the best performing fixed income sector in 2014.

Similarly, A-rated bonds outperformed BBB-rated for the period, +2.2% versus 1.3%, despite 1% lower initial yields. The long duration Credit(10+yrs) index rose 4.0% in the quarter and was up a very healthy 16.3% for the year. The full Credit index, which has a much shorter duration, advanced only 1.75% in the quarter. It still gained a solid 7.5% in 2014.

Conversely, US High Yield bonds, which are generally not long-term, and certainly aren't the best credits, dropped -1.1% during the fourth quarter and returned only 2.5% in 2014. Further, returns declined notably as one dipped from BB-rated to CCC-rated.

Looking further into domestic credit, utility sector bonds performed considerably better than industrial and financial sector bonds. Utility bonds are generally much longer duration. Agency MBS bonds returned an attractive 1.8% in the quarter and 6.1% in 2014. The sector is shorter duration, but very high credit quality. Investors also expect mortgage prepayments will rise, which bolstered the quarter's returns.

In Europe, substantial deflation concerns once again led investors to aggressively bid up longer-term sovereign bond prices. German 10-year bund yields dropped 45bps, to a yield-to-maturity of 0.55%. Italian and Spanish yields declined 40bps, and remain considerably cheap to US bonds (see Figure 6). Swiss bonds out to 5-year's maturity carried negative yields at quarter's end, making them a pure currency speculation.

Global Aggregate $-hedged bonds reflected the above price appreciation, returning 2.2% in quarter and 7.6% for the year. But, the Dollar's continuing rally took 6% away from the unhedged index return for the quarter, and 12.4% for the year. You had to be $-hedged.

Figure 4: Primary Bond Sector Returns (%)

Index	4Q '14	1 Year	3 Years
US Aggregate Bond index	1.8	6.0	2.7
US Gov't: 1-3 Yrs.	0.2	0.6	0.5
US Treasury: Long	8.6	25.1	4.2
US Inflation-Linked	(0.3)	3.6	0.4
Mortgage-Backed	1.8	6.1	2.4
CMBS	1.5	4.2	4.7
Asset-Backed	0.6	1.9	1.7
Inv. Grade Credit, 1-10yr	0.8	4.3	4.3
Inv. Grade Credit, 10+yr	4.0	16.3	6.9
US High Yield Credit	(1.1)	2.5	8.4
Municipal Bonds	1.4	9.1	4.3
Global Aggregate, ($ hdgd)	2.2	7.6	4.3
Global Credit	1.1	6.6	6.2
Emerg. Mkts Bonds (US$)	(0.6)	7.4	6.1

Figure 5: Primary US$ Bond Yields in 2014

	Dec-14	Sep-14	Jun-14	Dec-13	*Y-T-D Change*
US Treasuries	(%)	(%)	(%)	(%)	*(%)*
3-month	0.04	0.02	0.05	0.07	*(0.03)*
2-year	0.68	0.59	0.46	0.39	*0.29*
5-year	1.66	1.78	1.63	1.74	*(0.08)*
10-year	2.17	2.51	2.54	3.01	*(0.84)*
30-year	2.75	3.21	3.34	3.94	*(1.19)*
BarCap Aggregate	2.25	2.36	2.22	2.49	*(0.24)*
BBB Credit	3.68	3.58	3.36	3.88	*(0.20)*
AA Credit	2.23	2.24	2.08	2.25	*(0.02)*
Agency MBS	2.60	2.90	2.79	3.26	*(0.66)*
Emerging Mkts ($)	5.64	5.40	5.35	5.88	*(0.24)*
US High Yield	6.71	6.26	5.28	5.93	*0.78*
UST30y-UST2yr	2.07	2.62	2.88	3.55	*(1.48)*

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Dec-14 %	Sep-14 %	June-14 %	Dec-13 %	*Y-T-D Change*
United States	2.17	2.51	2.54	3.01	*(0.84)*
Germany	0.55	1.01	1.26	1.94	*(1.39)*
Switzerland	0.38	0.57	0.76	1.25	*(0.87)*
Britain	1.92	2.50	2.98	3.29	*(1.37)*
Poland	2.53	2.99	3.43	4.34	*(1.81)*
Italy	1.99	2.37	2.74	4.09	*(2.10)*
Spain	1.70	2.15	2.70	4.22	*(2.52)*
Greece (new bonds)	9.64	6.25	5.88	8.57	*1.07*
China (5 year)	3.55	3.93	3.85	4.49	*(0.94)*
Australia	2.92	3.61	3.59	4.23	*(1.31)*
South Korea	2.65	2.98	3.22	3.57	*(0.92)*
Russia	13.44	9.39	8.49	7.88	*5.56*
Brazil	12.67	12.53	12.02	13.21	*(0.54)*
India	7.98	8.48	8.71	8.85	*(0.87)*

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US Small-caps Stocks Rally

Cap size continued to "matter" in our domestic equity markets. Except, this quarter the size effect was back on track with normal expectations. Smaller-cap stocks rallied to year-end and gained close to 10%. The S&P 500 returned 4.9%, and mid-caps slotted in between.

The fourth quarter's results closed some of the gap, but for the full year small-cap stocks sharply underperformed large-caps, as we observe in Figure 7. This reversed a prior two-year trend, and the trailing three-year return figures for all size/style categories are now very close to one another.

Figure 7: U.S. Equity Market - Size/Style Returns

		Trailing		
	4Q '14	**1-yr**	**3-yrs**	**5-yrs**
Growth				
Large Cap	4.3	13.6	20.1	15.5
Mid Cap	5.8	11.9	20.7	16.9
Small Cap	10.1	5.6	20.1	16.8
Value				
Large Cap	4.5	12.9	20.4	14.6
Mid Cap	6.1	14.8	22.0	17.4
Small Cap	9.4	4.2	18.3	14.3

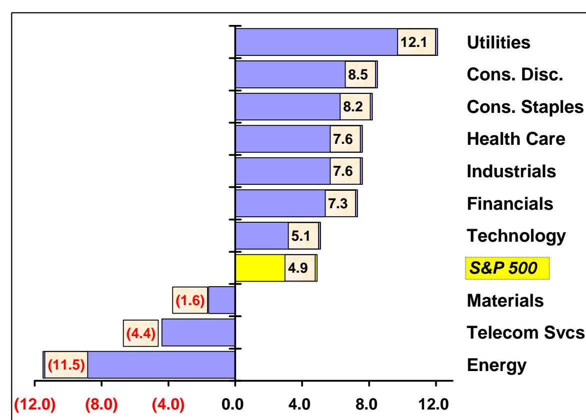
The domestic equity market's increased volatility extended itself into the 4th quarter. The VIX index measures equity market volatility. It stood at 16.31 as the quarter began. The S&P 500 index was at 1972. The VIX spiked to a near-term high of 25.27 in just two weeks, as the S&P dropped 5.6%. Then, the VIX plunged to 11.89 by 12/5, as the S&P rose to a record high of 2075 (+11.4%). December was very volatile, with the S&P again dropping 5% by 12/16, only to rally to a new record high on 12/29 of 2091 (+6%).

The quarter's top performing large/mid-cap sector was utilities, especially electric utilities, as falling interest rates and energy costs attracted investors. The group was up a huge 27% for the year. But the sector carries just a 3.2% weight in the S&P. The sector that made the greatest positive contribution to investor returns during the quarter was the most heavily weighted - financial services. It was closely followed by consumer discretionary, health care, and information technology.

Top contributing growth stocks were Apple, Visa, 3M, and Amgen. Top value stocks were Berkshire Hathaway, CVS Healthcare, UnitedHealth, and Walmart. Bottom contributors were Gilead, Google, Schlumberger and Haliburton,

Balancing the ledger was the energy sector. It was by far the largest negative contributor to performance. The drillers fell 32% and oilfield services stocks dropped 21%. The integrated majors fell only 5%.

Figure 8: US Sector Returns – 4th Quarter 2014



The U.S. economy is relatively healthy, managements remain cautious and many sectors of the economy are still operating below their longer-term trend lines. All good. Conversely, many foreign economies are weakening, the US Dollar's revaluation is going to hurt exports and boost non-oil imports. S&P earnings estimates for the 4th quarter and full year 2015 are being knocked back on a fairly regular basis. The 4th quarter's operating EPS is now forecast to be flat with the 3rd. In early September, 2015 earnings were forecast at $136/share. Now that's down to only $121, which would represent 4% growth over 2014. Not good.

Figure 9: P/E Ratios by Style and Size - Dec 2014

	Value	Blend	Growth
US Large	16.0	17.7	19.9
US Mid	20.2	22.2	24.6
US Small	19.9	22.7	26.7
EAFE		16.3	
Emerg. Mkts		13.2	

There have been ten 3+% market sell-offs since early 2013. There were only 38 during the prior 62 years. The S&P closed at a record 53 times during 2014, but then pulled back. Recent activity trends have made it easy for active managers to get caught offside, and most have. Morningstar reports just 20% of broadly diversified equity funds bested their benchmark in 2014. Specialist and sector funds also struggled, with only 33% and 25%, respectively, outperforming. It was the worst 12-month period for active managers' relative performance in over 20 years.

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International Markets – in Negative Territory

International stock market returns declined across the board in US Dollar terms during the fourth quarter. The quarter's weakness pulled year to date returns into negative territory. Falling oil prices, a financial crisis in Russia and persistent economic weakness in Europe undermined both developed and emerging markets. Local market returns were generally positive. Widespread currency devaluations versus the Dollar accounted for most of the negative equity returns.

Developed markets, as measured by the MSCI EAFE index, fell -3.7% in Q4 and -4.3% during 2014. The Pacific ex-Japan region smartly outpaced Europe for the quarter (-1.5% versus -4.4%) and the year (-0.5% versus -6.6%). Japanese stocks advanced nearly 7.0% during the quarter in Yen terms, and were up 9.5% for the year, but currency declines overwhelmed these positive returns. Canada's energy-dominated stock market did not escape the wrath of falling oil prices, dropping -4.8% for the quarter. It held onto a positive return for the year of 1.5%.

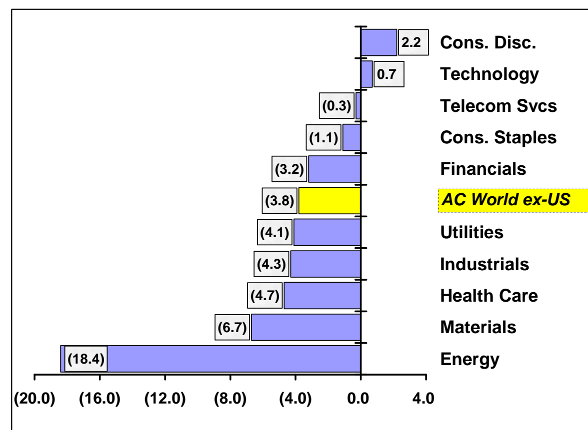
Figure 10: International Equity Markets - Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 12/31/14	4Q '14	1-Yr	4Q '14	1-Yr
World ex-USA	**(3.7)**	**(4.3)**	**1.5**	**6.3**
- MSCI Growth	*(2.2)*	*(3.3)*	*3.0*	*7.7*
- MSCI Value	*(5.2)*	*(5.4)*	*(0.1)*	*4.9*
- Europe ex-UK	(4.4)	(6.6)	0.2	6.6
- Pacific, ex-Japan	(1.5)	(0.5)	3.0	5.7
- Japan	(2.4)	(4.0)	6.7	9.5
- United Kingdom	(4.2)	(5.4)	(0.4)	0.5
Int'l Small Cap	**(3.4)**	**(5.4)**	**2.2**	**5.2**
Emerging Mkts	**(4.5)**	**(2.2)**	**0.0**	**5.2**
- EM Asia	*(0.3)*	*4.9*	*2.1*	*7.7*
- EM Europe	*(20.3)*	*(30.0)*	*(3.9)*	*(5.0)*
- EM Latin América	*(13.4)*	*(12.3)*	*(6.1)*	*(0.9)*
- EM BRIC	*(4.1)*	*(2.9)*	*1.3*	*5.5*

Fearing that stagnant GDP growth (only 0.6% in Q3), high unemployment and low price inflation (just +0.4% in 2014), would pull Europe into a recession, the ECB has just announced a massive bond-buying program (quantitative easing) of over €1 trillion in the hope of jump-starting economic activity. In anticipation, the Euro declined 4.3% in Q4 and 12.2% in 2014. The Pound was off 3.8% in Q4, and 5.6% in 2014,

In the Pacific, Japan was pulled into a recession. GDP contracted 1.9% in Q3. Inflation slowed during the quarter, interest rates declined and the yen slid 9%, touching a seven year low versus the Dollar. It dropped a total of 12.6% in 2014.

Figure 11: Ex-USA Sector Returns (in US$ terms)



Energy was the weakest sector, sliding more than -18%. Shares of all major oil and gas companies declined, as the price of crude slid from $91.30/bbl on September 30th, to $48.20 on January 6th. Materials stocks reflected weakness in metals and mining prices. Healthcare was also a weak sector. After rallying much of the year, Sanofi, Roche and Novo Nordisk all pulled back. It was still the top performing sector for all of 2014.

Consumer Discretionary stocks were the quarter's top performers, rising 2.2% as luxury goods companies rebounded. Daimler shares rose on sharply higher profit and record-breaking sales at Mercedes-Benz. Telecom and technology were relative bright spots, as the outlook for growth of wireless services improved.

In Japan, the weak yen propelled exporters (Toyota Motors, Fuji Heavy Industries, Sony, Fast Retailing). Hong Kong posted a positive return for the quarter (3.1%) and year (5.1%), buoyed by insurers and property companies.

Emerging markets declined -4.5% for the quarter, on persistent weakness in commodity prices and Russia's worst economic crisis since its 1998 bond default. Year-to-date results fell into negative territory (-2.2%), which still outpaced developed markets by over 2%. Currency effects were negative, and local market returns were flat (+0.0%) overall. Most emerging currencies fell versus the US dollar. The rouble plunged 32% in the quarter (and 40% for the year), and the energy-sensitive Mexican peso dropped 8.3%.

Emerging Asia was the strongest region, and the Chinese market was up 7.5%. Emerging Europe was by far the weakest area, with Polish, Hungarian, Czech and Ukraine stocks and currencies dragged down by Russia. Latin America was the weakest area in local currency terms, as its largest markets are heavily weighted to energy and materials shares.

India fell slightly in Q4 (-0.7%), but was amongst the top performing markets for the year, rising 23.9%.

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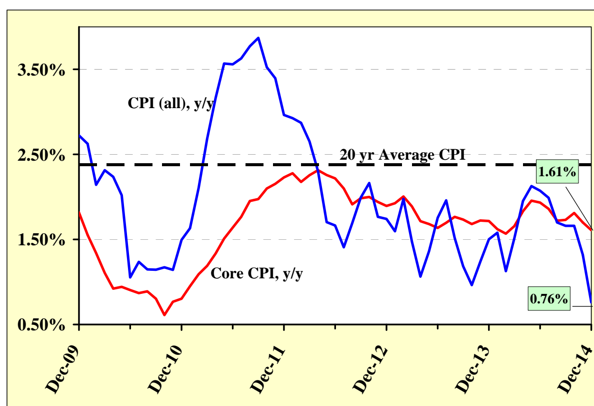
Back Page Perspectives: 2014 Surprises

As we said throughout 2014, rising inflation is presently a low risk proposition, but so is deflation. We're in sort of a sweet spot. Over the past 20 years, the central tendency for annual inflation has been 2.3%. We think long-term investors will be better served keeping that number in mind as they set strategy, rather than the current 0.76% print (see below)

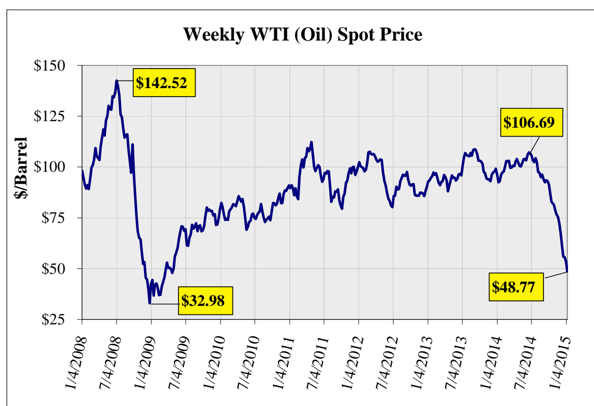
Figure 12: Inflation Experience since 2009



We recently came across the following quote, from one of the countries' better known economists -

"The collapse in oil prices is a major watershed event with enormous economic implications, and is characterized by great uncertainty. In addition, the steep decline in oil prices has been directly responsible for massive shifts in related markets: Global bond yields have declined to all-time lows; the long-term structural bear market in commodities has intensified; prices in the high-yield corporate bond market have tumbled; and the US dollar has surged to the highest level in more than a decade. The collapse in oil prices is a game-changer and a net positive for US economic growth. A partial offset will be potentially large cutbacks in spending, investment, and employment in the oil and gas industry".

Sounds like a once in a lifetime circumstance, doesn't it? So, we checked out recent spot oil prices.



Seems we've seen this movie fairly recently, except the 2008 price drop was a function of falling demand caused by the Great Recession. Current weakness has been caused by production rising faster than demand, especially in the U.S. and Libya. That's easier to fix.

So what does the oil industry have to do? Goldman Sachs believes that -

"Lower commodity prices and production overcapacity are forcing a renewed focus on capital discipline, cost efficiency and productivity across the industry. We expect significant price pressure to come through the supply chain.

Cost-cutting: *Costs across the industry need to be slashed by about 20%-30%. For the world's largest oil companies, this calls for a 30% cut to capital expenditures, just to get the free cash-flow generation back to an acceptable level.*

Consolidation: *With oil prices below $60/barrel, many unprofitable projects will have to be scrapped in a bigger mix-and-match exercise. Essentially, there are several high-quality developments that are in lack of funding. Assets need to be redistributed, so the firms with solid balance sheets get rid of the uneconomic ventures and upgrade with more promising projects".*

There's work to be done, but it doesn't sound like long-term gloom and doom. We'd be careful not to base too many strategic investment decisions on $50/bbl oil.

Our concern about current oil prices is two-fold -

1. The Russian economy needs higher oil prices to survive. The risk that Russia simply walks on its debt obligations is rising, and such a default would affect a great many global bank balance sheets and investor portfolios;
2. In the US, junk bond issuers during the past five years have increasingly been oil & gas producers. The consolidation and cost-cutting which Goldman speaks about is going to fall squarely on those companies. HY default rates haven't had an opportunity to pump up much, yet there was considerable capital flight from this sector in 2014. Defaults will only accelerate liquidations.

Bonds are even more expensive adjusted for inflation, while global stocks and real assets have gotten cheaper. Because of relative values, we recommend underweighting bonds compared to strategic targets, except corporate DB plans pursuing an LDI agenda.

Our shift in position viz. equity exposure is tempered by our concern that earnings during the next year will come in under expectations. Because of this, we also re-affirm our previous recommendation to overweight cash/liquidity, as a risk buffer.

Sell high, buy low. See you next quarter!

Natalka Bukalo
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