CENTURION
ASSET MANAGEMENT

Market Insight – 2014 Review and 2015 Outlook

U.S. Equity Markets

Due to seemingly low expectations for stock and bond market performance at the onset of 2014, the year's overall return for both asset classes was admirable. After 2013's horserace in equities, with all categories advancing by double digit percentages, expectations for continued growth in 2014 was rather muted. In the end, 2014 was a bit of a surprise. So, how will 2015 turn out, and beyond?

The performance of domestic equity index's in 2014 were solid. The Standard and Poor's 500 index realized a return of 11.39% (13.69% including dividends), while the S&P 500 Growth and Value total returns were 13.01% and 9.61% respectively. Small stocks as measured by the Russell 2000 index rose 3.53% (4.89% including dividends), and Growth outperformed Value in this category as well. Some of the largest contributors to the upside in Large Caps among the S&P 500 were Apple, Microsoft, Berkshire Hathaway, Facebook, and Intel. Notable negative contributors were Amazon, IBM, CVX, XOM, and GE. It is interesting to realize that the typically well-suited contributors to an up market have not led the recent upswing. Utilities, REITs and other dividend related companies have done well, but cyclicals like machinery, metals and mining have struggled. The importance of choosing the right sectors, and companies, was evident in the volatility we witnessed during the latter part of 2014.

As we begin 2015, there is a sense that the equity markets will perform well, relative to most other asset classes. There are positive signs in the continuance of US economic improvement. The unemployment rate is lowering, US corporate earnings are growing, and there is European stabilization due to the European Central Bank's (ECB) recent actions. Even Emerging Markets issues have not been large enough to drag down the global outlook. If a negative flash occurs where US economic growth slows, or we receive a few weak jobs reports or Institute of Supply Management reports, the result could be a sharp pullback of the S&P 500. However, the likelihood of these events occurring is remote at this time, so we do not feel investors need to be overly cautious and position portfolios out of the market. That defensive position is outweighed by the upside opportunity that exists from being fully invested.

Multiple expansion – Corporate earnings

As we mentioned, a strong influence to our positive outlook is corporate earnings. We do not believe it is wise to attempt to predict the exact outcome of corporate earnings, but considering the strong connection between today's market and corporate earnings, we must understand the *factors* that influence multiple expansion – multiple as in the ratio of the earnings per share of a stock to its price – as a great base level narrative we should follow. To summarize our focus, we look at the following pieces of the puzzle: economic variables like consumer debt, consumer confidence and delinquencies, as well as corporate behaviors around capital spending, inventory, hiring, and merger and acquisitions. From the credit cycle, we look at spreads, terms, and cost of capital.

For now and the foreseeable future, on balance, these factors appear stable and will not greatly change. This would indicate a prolonged economic expansion, with modest multiple expansion occurring over that same long period. We believe in this conclusion and would consider positioning portfolio's to take advantage of this opportunity through favoring equities in asset allocation models.

Sector Overview

Surrounding the thousands of publicly traded companies are segments of the market, or industries. These major industries are defined by S&P as 10 sectors: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care,

Industrials, Information Technology, Materials, Telecommunication, and Utilities. Let us look at how the sectors performed in 2014, their outlook for 2015, and generally our favorability table (exhibit 1).

EXHIBIT 1	Performance %			Weight %	Under/Over-weight
S&P Sectors	Q4 2014	Year 2014	Since Market Low (March 2009)	Current S&P Weighting	CAM Favorability
Consumer Discretionary	8.7	9.7	399.5	12.1	Overweight
Consumer Staples	8.2	16.0	197.7	9.8	Neutral
Energy	(10.7)	(7.8)	114.1	8.4	Overweight
Financials	7.2	15.2	338.7	16.6	Neutral
Health Care	7.5	25.3	252.6	14.2	Neutral
Industrials	6.8	9.8	318.9	10.4	Underweight
Information Technology	5.2	20.1	274.2	19.7	Neutral
Materials	(1.8)	6.9	217.9	3.2	Underweight
Telecom Services	(4.2)	3.0	133.9	2.3	Neutral
Utilities	13.2	29.0	169.5	3.2	Underweight

source: JP Morgan/Standard and Poors

For many years, we have favored an approach to asset management that implements an "overweight vs underweight" process relative to a corresponding benchmark. We use this methodology for market cap based investing (Large Cap, Mid Cap, Small Cap), as well as sectors. In 2014, Utilities, Health Care, and Financials had a banner year, but since the market low in March of 2009, the Consumer Discretionary, Financial, and Industrial sectors outperformed the others. During the same periods, the sectors that struggled were Energy, Telecom, and Utilities.

2015 Overweights: Consumer Discretionary, Energy – In general, consumers across the board should benefit as the economy improves. Whether it is the lower price point retailers, or higher end dinners, both ends of the consumer spectrum will benefit from an expansion of employment, and lower energy prices. Consumer staples are typically an insulator on market pullbacks, but not necessarily an outperformer to the magnitude of Discretionary in up markets. With the recent sell-off in oil, companies within the energy sector may have an opportunity to outperform due to (1) valuations among energy services, exploration, and production companies have very favorable price-to-book and price-to-earnings ratios; (2) the cyclical nature of S&P sectors that have noticeably declined but then experienced great bounce-back outperformance over the subsequent six months; (3) these stocks typically bottom two months ahead of their earnings revision's bottom, and as they have recently experienced significant revisions, we can anticipate a rebound; and (4) the reaction to oil's dramatic decline could result in opportunistic buying in the sector, providing a floor and good risk-reward characteristics. Event risk can also be a catalyst in this sector as well.

2015 Underweights: Utilities, Industrials, Materials – These are typically among the lightest group of representatives in the S&P 500, and thus our call on these sectors is not overly impactful to investors considering them relative to others. With that said, for investors who may consider buying Utilities due to their typically high dividend and last year's performance, we convey our cautious view due to the valuation on these stocks; they have recently traded at a premium to the market, in addition to well above their historical valuations.

Economic and Fed Impact

After 2014's mid-year (July) short lived panic over the potential for the Federal Reserve Board to raise interest rates sooner than previously believed, cooler heads have prevailed and the consensus is the Fed will not act until sometime in 2016. This belief is mostly pinned to an assumption the Fed will not do anything to stress the economy until it has complete confidence that their actions will not lead to a reversal of the positive growth momentum that is building. We may hear noise in 2015, but those periods will be short-lived and may provide opportunity for new cash to be deployed as investments in the equity market.

Our longer-term thought is when the Fed does move on raising interest rates, the equity market will push higher. Once rates bottomed on June 25, 2003, the Fed went on a tightening trend (raising rates = tightening) where they raised the fed funds rate 25 basis points (0.25%) successively from June 30, 2004 to June 29, 2006, seventeen times. The Fed funds rate moved over that period from 1% to 5.25% (Source: Federal Reserve System, CRS Report to Congress, Oct 29, 2008). What happened to the market over that period? The S&P 500 rose 11.6%. In fact, since 1970 there have been six periods when the Fed has raised rates multiple times, in succession, for longer than a year, but there were five periods when the S&P 500 rose – 1971-73, 1977-80, 1988-89, 1999-2000, and 2004-2006 (1994 was a negative outcome). So, we may be experiencing one of these periods where there is a coincident increase in rates and the equity market, and not the catastrophe that many have been calling for over the past few years. Think about it, if the economy is strengthening, to the point where the Fed feels compelled to act by raising rates to cool it off, doesn't that mean that companies and individuals are doing well, and thus stocks will continue to increase in value for a period? That makes sense in our view. The key there is "for a period".

One additional action to watch out of the Fed is how long they wait to move on rates. There is greater likelihood of a positive outcome if the Fed makes a decision to raise rates sooner rather than later whereby they would run the risk of chasing inflation and the market if they wait too long. If they are able to gradually take action, with 25 basis point increments, it should result in a calm digestion of the new reality they want to impose.

The Fixed Income Playbook

We experienced surprisingly good performance for fixed income securities in 2014 due to falling rates. In general, at the beginning of 2014 most strategists warned investors to avoid bonds as it was expected that yields would rise as they did in 2013. This resulted in a negative return in the bond market in 2013, but as rates unexpectedly turned around in 2014, certain bonds performed very well.

With reference to duration, long-dated bonds have done better than short, while higher quality bonds have outperformed lower quality bonds. In 2015 we see the U.S. yield curve further flattening as short-term interest rates begin to rise due to investors selling short duration bonds in anticipation of Fed action in 2016.

We favor diversification across all fixed income asset groups, spreading our exposure across interest-rate, credit, and duration risk, but looking for opportunities as volatility becomes more noticeable. Our theme is a flattening yield curve – whereby short term, medium term, and long term rates move closer to each other – leading to our selection of medium term bonds. Our sector weightings favor an overweight to securitized ABS/CMBS and Treasury Inflation Protected securities (TIPS), but slight underweights to Investment Grade Corporates and non-collateralized Mortgage Backed Securities. We hold neutral weightings on High Yield, Emerging Market bond, and bank loans.

Conclusions

If we total the positive elements of economic influences and liquid markets factors, we can conclude that the environment for investing is fairly stable and commensurately opportunistic. There is a sense that investors are far

enough away from the gravitational pull of the 2008-09 financial crisis that their economic position has stabilized, and resulted in a better financial position than prior to the crisis. This backdrop, where individuals and institutions feel more financially confident to invest, provides a strong reason why in 2015 we foresee a continuance of the positive market performance of the past few years. The capital is there, and the willingness to invest is palpable.

Additionally, prudent corporate financial management strategies have led to healthier balance sheets, good access to additional capital, and very reasonable valuations. If an environment exists where liquidity is good and investments are financially attractive, we have the formula for a positive run in the market. Naturally, there may be factors that contradict this thesis, and cause some degree of investor trepidation, but on balance we view them as having a smaller impact than the positives that are evident.

If you have any questions regarding the enclosed comments, or how this outlook may impact your specific circumstance, please reach out to us at 610-629-0660, or via email at paul.liebezeit@cam-us.com .

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