SYNOVUS®
Family Asset Management

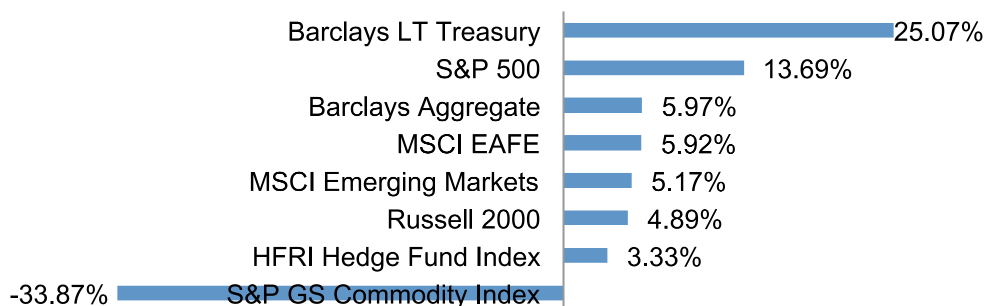
MARKET COMMENTARY

Fourth Quarter 2014 Review

2014 was a year where we saw the extreme consequences of quantitative easing, the likes of which we have not seen in a long time. Nearly everything most strategists on Wall Street have learned and have put into practice has stopped working. Going into 2014, all but one strategist in the Bloomberg Survey predicted that interest rates would go higher, and the median forecast was for 3.4%. No one predicted that oil would fall below $50, and up until the very end of 2014, many still believed oil would be above $90. Being diversified across equity markets and active management was a drag on performance, as the U.S. was the place to be. Less than 15% of active managers beat their benchmarks.

According to the Leuthold Group, the fewest number of stocks in the S&P 1500 index outperformed the index since 1999. Utilities were the best performing sector and Energy was the worst. Ned Davis reported that this was the first time that Utilities were the top performing sector when the S&P 500 was up at least 10%. Hedge funds had one of their worst years relative to the S&P, and Commodities had one of their worst years on record. A simple allocation of 60% S&P 500 and 40% Long-Term Treasuries would have earned18%. Who would have ever thought that if the S&P 500 was up over 13.5% in a year that Utilities would be up 24% and energy down 10%, or Consumer Staples up 13% and Consumer Discretionary stocks up only 8%? The effects of market distortion fueled by massive amounts of monetary injected liquidity seem to have reached extreme levels.

Asset Class Returns 2014



Source: NDR

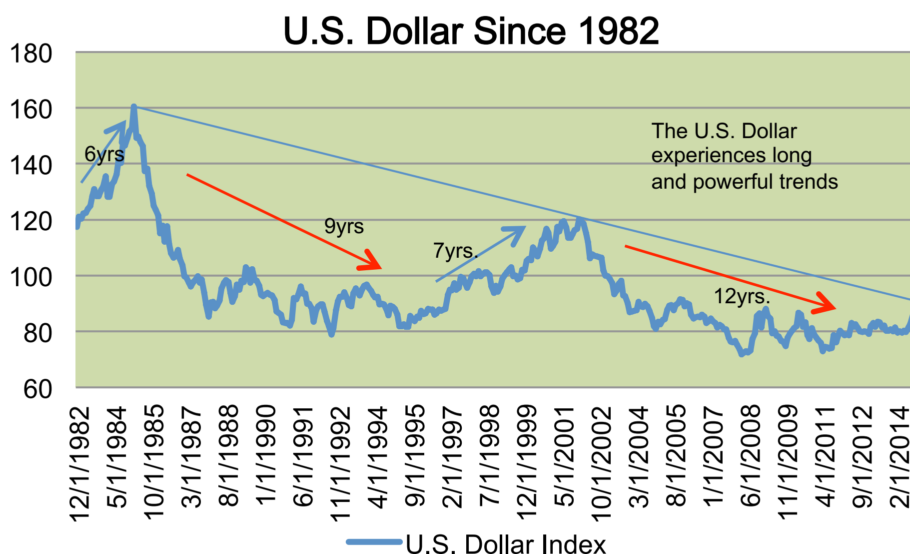
Coming into 2014 nearly every strategist expected rates in the U.S. to move higher due to the Fed's pullback in QE policy. The theory was that the U.S. was ahead of the rest of the world in regards to monetary policy and had seen the policy play out while Europe was behind and likely to be easing while the U.S. was tightening. The strategists were wrong, as the U.S. 10-Year Treasury rallied from a yield of 3% at the beginning of the year to 2.18% by year end. The Long Bond had one of its best years with a return of over 28%. As the year played out, it became likely that Japan and Europe were both experiencing disinflation (zero to very low inflation), if not outright deflation (negative price growth). The threat that this would be exported to the U.S. led to a strengthening dollar and interest rates

Please refer to important disclosures on page seven.

moving lower. The rate differential between the U.S. and Europe continued to be attractive going into year end. The fall in oil prices hinted at coming low inflation giving U.S. rates room to decline further. We managed to do relatively well during the year as we have been underweight international and small-stocks, and overweight in U.S. large-cap. On the manager front, most of our managers were slightly behind their benchmarks with one manager ahead by about 700 b.p.s. In regards to active vs. passive, we have been about 2/3 passive and 1/3 active, with passive being the place to be for the last five years. Going forward we believe that will start to change.

2015 Outlook

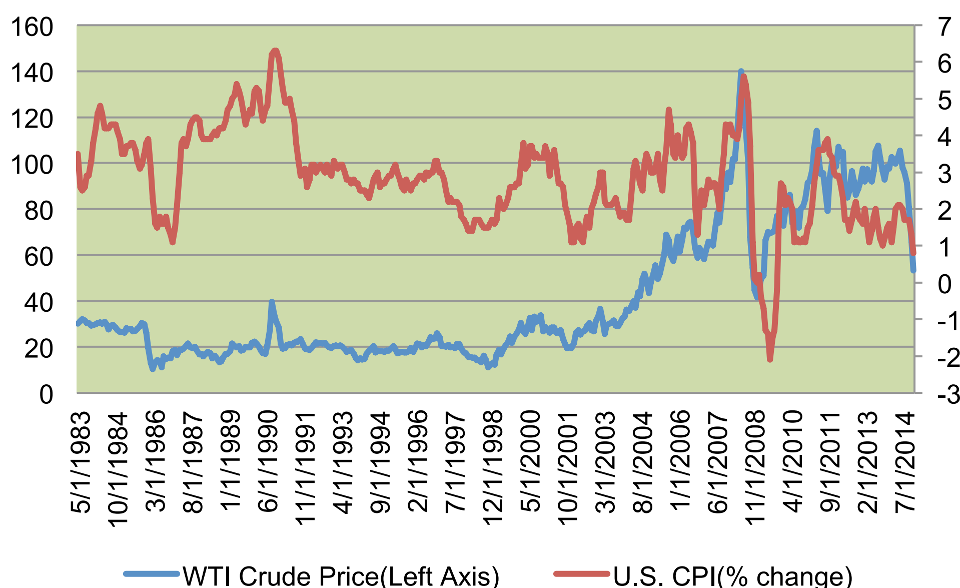
As we enter 2015, there are some themes and trends that have developed and will likely be with us for most of the year. Europe has been experiencing bouts of disinflation and possible deflation, which have resulted in weak employment and economic growth. As a result, interest rates in Europe have dropped to historical lows, in fact short term rates have turned negative in many European markets as well as Japan. Why would anyone buy bonds and actually pay, rather than receive interest? The primary reason is that there is demand due to deflationary pressures, so the real rates of return can still be positive. For example if the rate is negative .25% but the inflation rate is -1%, the real return is .75%. The other reason is if one expects the currency to appreciate. In the case of Switzerland, rates were negative but the currency appreciated 30% versus the Euro. Because of the rate differential between Europe and the U.S. that developed in the second half of 2014, we can expect that rates in the U.S. will remain low for most of the year. We are also seeing strengthening in the dollar, which is impacting commodity prices and could start to affect corporate earnings of large U.S. based multinational companies. We believe that we are starting to see the beginnings of an environment where diversification and active management start to work again.



Source: Bloomberg

Fixed Income

Unlike the beginning of 2014, this year many more people expect rates to stay lower for longer. It is likely that the Fed's own gauge of when to raise rates, the Consumer Price Index, won't average at the 2% level that they would like to see. If we look at what energy prices have done, it is very unlikely that we will see 2% in the near future. Energy makes up about 10% of the CPI index, and though it is not a high positive correlation, movements in the price of oil tend to lead the CPI index. In the chart below, we see that CPI tends to move higher and lower as the price of oil moves higher or lower.



Source: Bloomberg

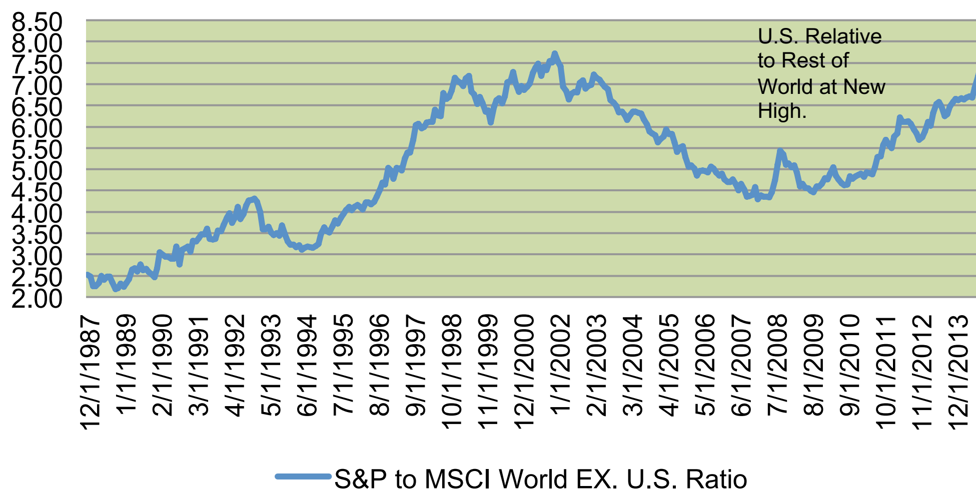
Many are forecasting that oil will rise to around $65-$70 a barrell as we get further into the year, but since oil was over $95 for most of the past year, the percentage change will be negative for the first three quarters of the year. We believe, that regardless of CPI reaching 2% this year, the Fed is likely to let short term rates move slightly higher as the employment picture continues to improve, and to not be caught off guard if energy prices move swiftly higher and wages increase at a higher rate. We also believe that yield curves will continue to get flatter, whereby the longer maturity bond yields will stay low or decline, while short term rates are likely to move higher.

In 2014, we saw nearly every major country's yield curve flatten as rates on the long end came down more than those on the short end. Because the U.S. has been the strongest major economy in the world, the expectations have been that the U.S. will raise rates soon. For most of the year, U.S. bonds lagged well behind those of Europe and Japan in rallying lower. Currently the yield gap is wide relative to history and will likely narrow as the U.S. receives strong flows into bonds from foreign buyers, due to a strong dollar and higher relative yields.

Source: Bloomberg

Equities

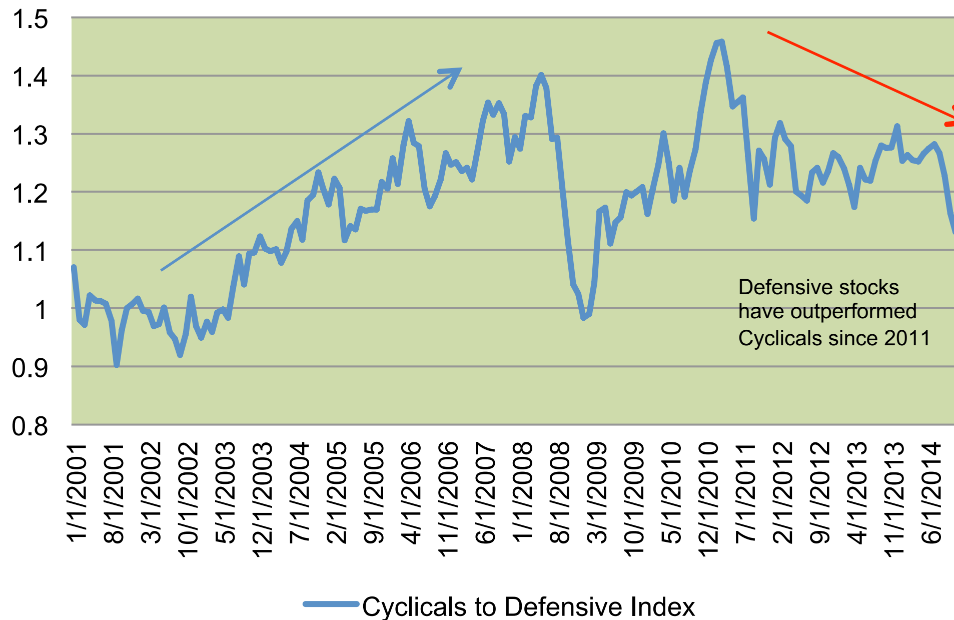
The U.S. continued to be the bright spot in 2014. Performance relative to the rest of the world was the widest since 1997. Large-cap names continued to outperform small-cap and defensive names which outperformed cyclical names. The big question is if things are really that good, why have cyclicals underperformed while a traditionally defensive sector like Utilities performed the best? We believe that the aggressive monetary stimulus being pumped into the system is pushing money in search of yield. Whether from a Japanese or European investor's standpoint, the U.S. is an attractive market to send money. For example, in Japan the yen weakened about 15% versus the dollar, so a Japanese investor investing in the U.S. market saw about a 30% return. Currently the U.S. market relative to the rest of the world is higher than its previous peak in 2002. If one believes the dollar is going to move higher relative to the yen and euro, there is likely room for U.S. stocks to run higher. The constraint is how much more U.S. firms with a large percentage of revenue can rise if their currency costs increase and costs become higher relative to European and Japanese exporters. Today over 46% of revenue of the S&P is due to Non-U.S. sales about 1/3 higher than the previous decade. It is likely that the run of relative return may be closer to the end than the beginning. The yen has continued to decline against the dollar, and has gotten to a point where it is undervalued based on interest rate and inflation spreads. If the yen were to rally, this would likely result in U.S. stocks underperforming as many investors have borrowed in yen to purchase U.S. stocks in dollars.



Source: Bloomberg

Defensive stocks, such as Utilities and Consumer Staples, have outperformed cyclicals such as Industrials and Consumer Discretionary since the end of 2010. Much of this has to do with the search for yield, as the defensive names typically have higher dividend yields. In fact, we have seen a pretty strong correlation of lower interest rates and defensives outperforming. If one believes that this is the beginning of a period of rising interest rates, one will start to see this dynamic reverse itself. The current defensive outperformance is similar to the period we had in 2011 with the growth scare. One caveat to this relationship is that though the economy has managed to grow, it has been the tech sector, health care, and energy, where jobs have been created. The old cyclicals have likely given way to the new cyclicals, such as Technology and Consumer Services. Small-cap had its worst year relative to large-cap going back to 1998. The reason is similar to all of the other distortions. International investors have gravitated to large-cap names, more investors are indexing, and large-caps tend to have higher dividend yields.

At the end of the day, many investors have placed a large bet in their portfolio that they may not realize. That bet is one of continued lower interest rates. Another bet that they have placed that they have little ideas of is a weak yen. The weakening yen has benefited interest rates and U.S. large-cap equity over the past year. In this dynamic, Japanese investors have been investing in U.S. bonds and equities taking advantage of higher yields and a stronger currency in the U.S. The primary target has been large cap dividend paying names that many investors believe are a conservative place to be. There could be a surprise this year where the yen rallies, U.S. rates rise, large-cap names underperform small-caps, and cyclicals outperform defensive names. Our strategy is to be more diversified than we have been in the past couple of years by looking to get more exposure in international and small-cap.



Source: Bloomberg

Alternatives

Hedge funds experienced one of the worst years relative to the S&P 500 ever. Our managers as a group saw weak performance due to a couple of factors. Most of our managers deal in small cap names, and the managers that take a macro view missed the rally in interest rates. The same theme that hurt long only active managers has affected most hedge fund managers. In 2014, the largest names in the indexes were the best performing. So, in the S&P 500, the largest names did better than the smallest names. We also see this in the fact that less than 30% of stocks in the S&P 1500 outperformed the index.

We expect managers to start delivering better returns as fundamentals return to favor and global macro interventions begin to slow. Our experience in Private Equity has been positive as the strong bull market has made it a great time to be selling a company. Multiples on companies have expanded while fundamentals have generally improved. In Commodities, we avoided most of the downdraft only having a small gold position early in the year. Tactically we are currently holding a small position due to the Greece election and possible disruptions. We currently believe it is the right time to start to add to investments in commodity trend followers. These are managers who can be both long and short, and are looking for persistent trends in underlying commodities. We are also looking to take advantage of the disruption in the energy credit complex. Small firms are unlikely to access the credit markets very easily, presenting an opportunity to purchase assets at depressed values and wait out what we believe to be a temporary fall in oil prices before an eventual recovery to the $70-$80 range in the coming years.

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