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Fourth Quarter 2014

Separation Anxiety

The fourth quarter was the year's most volatile, though US stocks rose from the ashes of a mid-October correction to end the year with healthy gains. Energy related issues of any kind (stocks, high yield bonds, MLPs) suffered as the price of a barrel of West Texas Intermediate crude oil dropped 42% and stayed there, ending the year down a remarkable 46%. The S&P GSCI Total Return index, comprised of 24 commodities across all sectors, fell 33% in 2014, a maelstrom now commonly described as the end of the commodity supercycle. This price action, along with further sharp rises in the US Dollar versus its trading partners, caused vicious sell-offs in a variety of markets as investors began to question whether such deflationary forces could be reversed. The table below shows the 2014 performance of eleven indexes and ETFs representing various global equity, commodity, currency and fixed income assets. Six of them experienced corrections of 10% to 21% during the year, most recovering reasonably well, while commodities plunged deeply into bear market territory.

	Year End 2014	Q4 2014	Worst Decline During 2014**
iShares US Treasury: 20+ Year*	27.30%	9.31%	(1.22%)
S&P 500	13.68%	4.93%	(7.29%)
NIKKEI 225 Index (Japan)	8.91%	8.00%	(11.96%)
Russell 2000 Index (Small Caps)	4.90%	9.73%	(12.94%)
Alerian MLP Index	4.80%	(12.29%)	(20.97%)
SPDR Barclays High Yield Debt*	0.77%	(2.06%)	(7.86%)
MSCI Emerging Markets	(2.08%)	(4.52%)	(16.99%)
MSCI All Countries Ex US	(3.28%)	(3.78%)	(13.34%)
Euro vs US Dollar	(11.89%)	(4.19%)	(12.90%)
S&P GSCI (Commodities) TR	(33.06%)	(27.67%)	(40.94%)
WTI Crude Oil	(45.87%)	(41.56%)	(50.63%)

Total Returns. Source: Bloomberg
* *Non-index returns are gross of fees*
** *Drawdown/decline periods vary in timing and duration, but all occurred during 2014*

Falling interest rates, currencies and commodities often presage slower economic activity. However, in recent years such declines have been associated with heightened, unconventional central bank responses to sluggish growth or disinflation and therefore supportive of risk taking. That said, plummeting oil prices in the second half of 2014 blindsided most investors and, we suspect, central bankers - not the kind of shock and awe market participants have come to expect. The end of quantitative easing (QE) programs in the US and quibbling among Eurocrats about the legality of QE in the Eurozone left a support vacuum, producing significant anxiety about future growth prospects for the global economy. The fallout among commodity exporters in emerging markets such as Russia and Brazil has been particularly damaging.

On January 14, 2015, the European Court of Justice finally opined in favor of proposed European Central Bank QE programs, including outright purchases of sovereign debt. On January 15, preferring not to catch a falling knife, the Swiss National Bank abruptly ceased its program to buy Euros, abandoning its currency peg and allowing the Franc to jump about 18% in a day. In response, the Swiss stock market fell 9% that day and 6% the next. The CEO of Swatch, one of many Swiss exporters hurt by the action, called it "a tsunami, for the export industry and for tourism, and finally for the entire country."

Suffice it to say that expectations for significant actions to be announced by the ECB as soon as January 22 were running high, and Mario Drahgi did not disappoint, outlining a plan to spend up to $1.3 trillion over the next two years to revive the Euro zone economy.

As the plates shift, and central banks react in different ways, there are at least five "separations" looming from long term trends that are making investors nervous. Some of these changes are from entrenched relationships, while others are from relatively recent post crisis policy environments.

1) *Separation from unconventional Fed policies* – We have had six years of QE, and it has been nine years since the Fed's last rate hike. How unusual has interest rate policy been since 2008? Before the credit crisis, the last time the dividend yield of the S&P 500 was higher than the ten year treasury yield was 1958.
2) *Separation of US Fed policies from those of the other central banks* – Japan, Europe and the US have all been trying to ease credit and business conditions since the crisis. China has been dealing with a credit bubble and other structural issues, but has avoided recession. Only the Fed is hoping to raise rates, and a lot of worried foreign investors are looking for a safe currency. We think US assets will remain attractive to them.
3) *Separation from a weakening USD* – The 2014 Dollar rally was impressive (see #2 above), and looks set to continue if the Fed raises rates and the Euro devalues further. Since 1974, however, the USD has been declining and is still approximately 30% lower versus its major trading partners, so it may have considerably more room to rally amid currency wars. US multinational companies which invested heavily in globalization for decades must now deal with the competitive disadvantages of a stronger dollar.
4) *Separation from the Euro* – It has been sixteen years since the Euro was launched, but the pressure on highly indebted member countries since the crisis has been enormous. Greek elections on January 25th once again raise the prospect of populist movements abandoning the currency. We believe their negotiating position in debt restructuring talks is strong and abandonment of the Euro far less likely now that QE programs have been initiated.
5) *Separation from the oligopoly of OPEC* – This one seems odd to anyone who lived through the oil embargos of the 1970s, but OPEC has been in existence since 1960, gradually evolving into the world's central bank for oil. There are pundits bemoaning the loss of stability and the free market pricing that new technologies have enabled, regardless of the benefits available to consumers.

Since the crisis of 2008, market participants and regulators have seemed happy to trade potentially higher rates of growth for less volatility amid diminishing liquidity. In our view, investors have developed an unhealthy "bad news is good news" relationship with central banks, expecting them to underwrite the smallest correction or mid-cycle pause. Higher interest rates should be welcomed by savers and the Fed, but getting there may not be pleasant. For example, our clients and other readers know we have been concerned about the junk bond market for some time, with its high energy weightings, lack of dealer support and historically low yields. Though credit risk has moved overwhelmingly from banks to the public bond markets, it would be a mistake to assume that reduced risk among banks means all borrowings are less risky.

Finally, there is much debate about the meaning of sharply lower oil prices. We believe the energy landscape has changed in a way that relieves a lot of pressure on the Fed, politicians and the middle class consumer. As 2014's epic drops in oil, natural gas, interest rates and foreign currencies work their way through the global economy in 2015, investors should eventually come to focus less on volatility and more on the massive amounts of wealth transfered and stimulus released.

Robert G. Scott
Chairman & CEO

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Chief Investment Officer

Special Note to our Clients and Friends: Delores Buchanan-Steadman, our beloved and much admired receptionist and assistant office manager for the past twenty-three years, decided to retire at year end 2014. The grateful correspondence she received from clients and the affectionate tributes from her fellow employees have been inspiring to witness. At North American, our definition of success includes qualities that Delores brought to the office every day: dedication, courtesy, warmth, and genuine concern for clients and co-workers. Her love for plants, especially delicate orchids, is both symbolic and truly special. We will remember her gifts, and miss her smiling presence in the years ahead.

Administrative Note: We are pleased to introduce our new quarterly performance reports. As one of our technology initiatives, North American Management changed portfolio accounting systems in 2014. The reports accompanying this letter were produced on the new platform. Although the format and layout are different, the content of the reports has remained largely unchanged. Please don't hesitate to contact your relationship manager if you have any questions.

Source of data not specifically cited: Bloomberg