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First Quarter 2015

Aftershocks

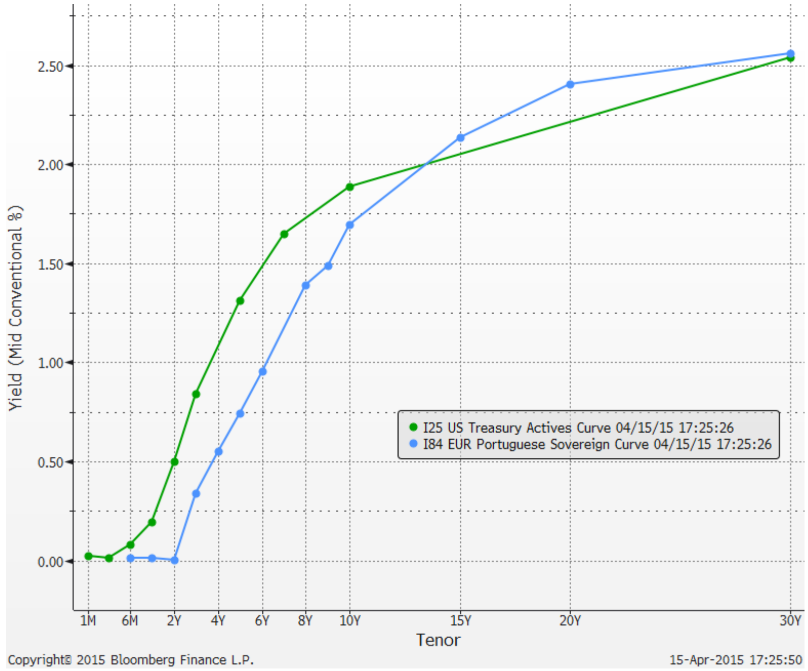
After a punishing 2014, commodities and the currencies of many of America's key trading partners declined further in the new year, while global stocks and bonds rallied. Large cap US stocks significantly lagged small cap and foreign stocks as investors rebalanced portfolios away from US multinationals facing currency headwinds that could negatively affect earnings. To date, dropping input costs of various raw materials and fuels have not been enough to offset the currency translation effects worrying investors. In addition, the US economy experienced another in what has become a series of first quarter "soft patches." Apart from the harsh northeast winter, the largest and second largest ports in the nation (Los Angeles and Long Beach) suffered debilitating slowdowns during protracted negotiations with their dock workers. The weather and the inventory backlogs are clearing, and many analysts expect a pickup from latent business activity.

Index or ETF	**First Quarter 2015**	**Full Year 2014**
NIKKEI 225 Index (Japan)	10.24%	(4.16%)
Euro Stoxx 50	4.55%	(7.93%)
Russell 2000 Index (Small Caps)	4.32%	4.90%
iShares US Treasury: 20+ Year	4.21%	27.30%
MSCI All Countries Ex US	3.62%	(3.24%)
SPDR Barclays High Yield Debt	2.55%	0.78%
MSCI Emerging Markets	2.22%	(1.97%)
S&P 500	0.95%	13.68%
S&P GSCI (Commodities)	(5.14%)	(33.87%)
JP Morgan-Alerian MLP	(5.62%)	3.85%
Euro vs US Dollar	(11.30%)	(12.19%)
WTI Crude Oil	(13.39%)	(45.87%)

Total Returns in US Dollars. Source: Bloomberg.

Competitive devaluations abound. According to *The Economist*, there have been 29 instances of monetary easing around the world in the past five months. The European Central Bank (ECB) stands out, for it intends to buy more than three times the net new issuance of government bonds in the Euro area in 2015.* This new ECB program dwarfs all other quantitative easing efforts past and present relative to the size of its sovereign bond market. As a result, short term to medium term yields across much of the region are negative and German yields, where the shortage of paper is acute, reached -0.08% for seven year bonds and a paltry 0.11% for ten year bonds on April 15. Fifty year Swiss government bonds, while not directly part of the ECB's purview, yield 0.34%. A lot would have to go wrong in Europe over the next fifty years to make an eighty year old retiree content having earned 0.34% per year since the age of thirty, though it must be noted the Swiss are excellent stewards of their currency. As shown on the graph on page two, it is somewhat shocking to see that Portuguese borrowing costs are generally lower than ours, and offer the same yields for thirty years. Our view is that most borrowers are on the better side of the trade, including Europeans who enjoy floating rate mortgage payments reset to negative rates - they are now being paid to live in their houses! We are all familiar with the concept of financial repression of savers through low interest rates, but issuers and investors have entered new territory with negative yields.

In the aftermath of such extreme and rapid adjustments, market participants are waiting for various shoes to drop, including energy company dividend cuts and bankruptcies, massive currency related profit declines among U.S. companies, or maybe a policy mistake by the Fed. However, the Fed has some room to maneuver: 1) oil price declines help consumers and ease inflationary pressure; 2) foreign demand for U.S. dollar assets will likely remain strong as Euro area yields go negative (the S&P was up 13.86% in Euros during the first quarter, and the iShares 20+ Year Treasury ETF was up 17.53%); 3) foreign demand for long dated US Treasuries may be so strong that a modest Fed Funds rate hike won't necessarily punish the U.S. housing market. Sharp currency and commodity moves have also begun to shift the plates under less liquid markets like M&A. The Federal Express bid for Dutch transporter TNT Express caught investors by surprise, as did Royal Dutch Shell's $70 billion offer for gas giant BG Group Plc (formerly British Gas). General Electric's recent decision to sell most of GE Capital has been well received. GE will become a pure industrial concern, freed from the depressed multiples and dividend limits that plague the highly regulated financial sector, perhaps allowing lower commodity costs to make a more meaningful contribution to profit margins.



Worries about a Greek exit from the Euro aside, is Europe the new epicenter of global growth? In our opinion, probably not. Bullish prognosticators have been identifying green shoots but their Euro area growth estimates for 2015 remain modest at 1.5% to 1.8%, slightly above consensus of 1.3%. The current euphoria seems to be more about the ECB proactively avoiding the black hole of deflation, which could have become a global problem if left unaddressed. Clients will see in their Q1 2015 Strategies Overview that European equity investments were raised in two of our strategies during the quarter, though we remain slightly underweight the benchmark. While the strong dollar effect on first quarter earnings will likely be significant, and there is some added risk to market share for U.S. companies competing against Europe and Japan, in our judgment investors will eventually place more value on the benefits of lower energy and commodity prices.

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Source: Blackrock
Source of data not specifically cited: Bloomberg. Bond yields, growth estimates and graph data are as of April 15, 2015.