RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

2014 YEAR-END MARKET COMMENTARY

January 2015

EXECUTIVE SUMMARY

2014 ended on a high note for equities, with the major indices closing the year with a fourth quarter rally. The S&P 500 closed 2014 at 2,058, a gain of 11.4% for the year and about 2.4% higher than our forecast at the start of 2014. The Dow also closed higher for the year at 17,823, up 7.5%, which is only 0.5% higher than our 2014 forecast. Most equity sectors finished higher for the year, with healthcare and utilities leading the way. However, a notable exception to the S&P's solid performance was the energy sector, which was down almost 16% before recovering slightly at the end of the year. RDM Capital's composite of equity-oriented client portfolios returned 8.3% for 2014, before fees.

In 2015, we expect conditions to remain favorable for equities. As we close 2014, the U.S. economy continues to improve, corporate earnings are rising, interest rates remain low, and monetary stimulus is increasing overseas. These factors suggest the U.S. equity bull market will continue for the foreseeable future. Based on projected corporate earnings and a reasonable market P/E multiple, we project 7 – 9% returns in the S&P 500 for 2015 for an estimated year-end closing price of 2,222. Going into 2015, we continue to favor equities in the financial sector, as well as quality energy companies, such as large, diversified oil companies that have been temporarily hurt by the decline in oil prices.

While we believe equities will finish the year in the green, volatility likely will increase over levels seen in recent years. Notably, the U.S. Federal Reserve probably will raise interest rates in the second half of 2015, assuming economic conditions continue to improve. Higher interest rates may lead to some P/E multiple contraction and volatile equity prices in the short term, but ultimately are an unavoidable part of the U.S. economic recovery. Additionally, stubbornly low energy prices will likely significantly impact foreign and domestic markets in ways that are difficult to fully predict. Geopolitical tensions overseas are likely to rise if low energy prices persist, as national economies built on high energy prices (e.g., Venezuela, Russia, Iran) will suffer. In the U.S., low gasoline prices will help U.S. consumers in the near term, but we remain cautious about the long-term impact of cheap oil on employment and economic expansion in the U.S. given the increased reliance on U.S. oil production in recent years.

On the fixed income side, we believe bonds will produce low single-digit returns for 2015. Higher interest rates eventually will take a toll on fixed-income investments, but we believe the Fed is unlikely to raise interest rates significantly in the next 12 months. We continue to favor short to intermediate-term investment grade corporate issues, which are likely to best withstand higher interest rates.

2014 Review

Thanks to a combination of low interest rates, accommodative central banks around the world, and rising corporate profits, equities continued their historic climb from the depths of the Great Recession in 2014. The S&P 500 reached over fifty new record highs in 2014 and finished the year with an 11.4% gain. As we predicted at the start of the year, conditions were ripe for solid equity returns. The United States economic recovery continued its modest 2 - 3% GDP growth rate, unemployment dipped to 5.8% and inflation remains subdued. In addition, central banks in Japan, Europe and China made significant monetary policy accommodations to stimulate growth in their respective economies. The use of aggressive monetary stimulus, a hallmark of U.S. Federal Reserve policy since 2008 and foreign central banks more recently, has been a catalyst for equity returns in recent years.

Despite the overall positive year for stocks, commodities endured a dramatic sell-off that began in the third quarter and continued until the end of the year. We discussed the sell-off in detail in our special market letter distributed to clients during the Fourth Quarter. Most importantly, crude oil and natural gas endured a historic slide from highs reached in July 2014 to lows not seen since the depths of the Great Recession. An abundance of global oil and gas supply, as well as OPEC's sudden reluctance to cut production to support prices, contributed to the collapse of energy prices (and energy stocks) in the fourth quarter. Speculation and panic selling within both the commodity markets and energy stocks further exacerbated losses for energy investors.

Lastly, despite widely-held expectations for interest rate hikes in 2014, the Fed maintained near-zero interest rates throughout the year. This persistently low interest rate environment caused fixed income to overall perform better than expected in 2014. While we (like many others) predicted that treasury yields would rise in 2014 due to a growing economy and the Fed's anticipated reduction of monetary stimulus, the yield on the 10-year treasury actually declined from about 3% at the end of 2013 to just over 2% at the end of 2014. In addition to Fed policy, the surprisingly strong return from U.S. treasuries is also partly due to fears over economic growth and deflation in Europe, which has made the perceived safe haven of U.S. treasuries more attractive.

2015 Outlook

Summary of 2015 Projections	
S&P 500	2,222*
Dow Jones Industrial Average	18,892
Nasdaq	5,209
Inflation	1.8 – 2.0%
Ten Year Treasury Rates	3.0%
GDP	3.0%
Oil	$70 - $80 / barrel

*based on projected 2015 P/E of 17.5 and projected 2015 S&P 500 earnings of $127.

Equities:

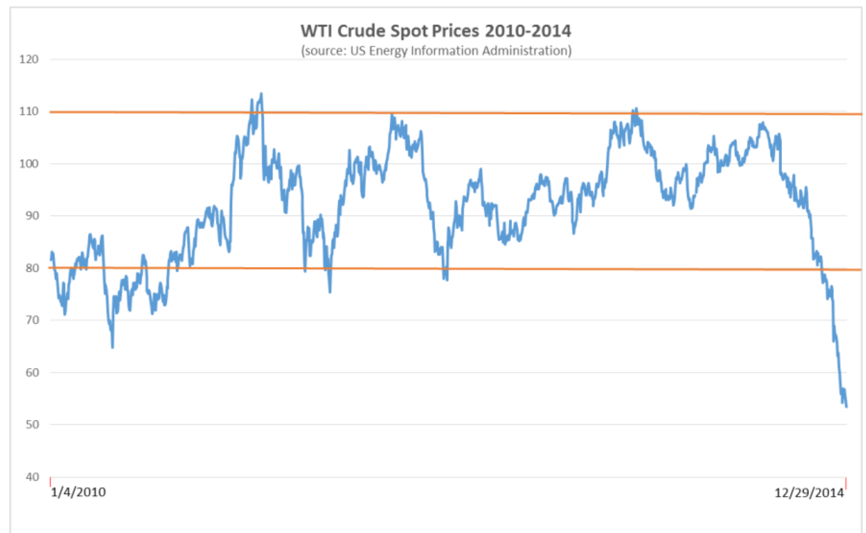
As the markets finished 2014 in rally mode, it's important to remember that 2014 started off with a pullback after a strong 2013 performance. After gaining 30% in 2013, the S&P 500 declined by over 5% at the start of 2014, partially due to the negative economic impact of an exceptionally harsh winter and the normal tendency of investors to delay taxable capital gains transactions until after the New Year. Given that 2014 was another strong year for equities, particularly in the fourth quarter, a moderate pullback in equities after the New Year is possible.

Overall, we view equities as fairly valued at the moment. At the close of 2014, the S&P 500 traded at approximately 18.7 times the previous 12 months earnings, higher than the historical average P/E ratio of approximately 15, but safely below historic "bubble" valuations containing P/E multiples of 20-30 times earnings. We expect stock market returns to generally mirror expected gains in corporate profits in 2015, with the potential for a moderation of the P/E multiple during the course of the year due to higher interest rates. S&P 500 components are expected to post on average 8.5% earnings growth in 2015. Thus, we expect the S&P 500 to rise between 7 – 9% in 2015, for a projected 2015 year-end close of 2,222, based on S&P 500 earnings of $127 per share and a reduction in the S&P 500 P/E ratio to approximately 17.5.

Potential catalysts for equity returns in 2015 include (1) solid U.S. economic momentum, (2) accommodative foreign central banks, (3) a split Congress and Presidency leading to few momentous regulatory changes, and (4) if conditions improve, recovering energy prices. Potential hindrances to equity returns in 2015 include (1) interest rate hikes in the U.S., (2) fears over the pace of economic growth in the Eurozone, China and Japan, along with fears of a Greek exit from the Eurozone (3) political brinkmanship between President Obama and the Republican-controlled Congress, and (4) if conditions persist, low energy prices. We expect that continued U.S. economic and corporate earnings growth will outweigh the potential hindrances to returns in 2015, despite some likely market volatility during the course of the year.

Commodities:

Developments in the commodity markets may cause market volatility and impact overall returns for the year, as discussed above. We believe that crude oil and natural gas prices will rebound somewhat during 2015, as producers cut production in the United States and abroad to adjust for the over-supply of crude on the market. We foresee WTI crude oil prices rising close to the $80 range in 2015, at the low end of crude's trading range since the financial crisis, but a significant gain from year-end 2014 prices (*see chart*).



We view the recent collapse of crude oil prices to approximately $50 as overdone based on supply and demand fundamentals. The collapse appears to have been exacerbated by speculation and fear in the crude oil commodity market. However, the over-supply of crude oil globally is real, albeit not as significant as the price move would suggest, and not likely to reverse course quickly. This is because Saudi Arabia has signaled that it is no longer interested in playing its historic role of global swing producer to stabilize prices, which has placed the onus squarely on other non-OPEC producers (i.e. U.S. shale, Africa, etc.) to curtail production. Even when these producers decide to curtail production, there is a lag period between the time that the

decision is made to forego investment and the time that production actually slows. Therefore, oil prices will likely remain subdued in 2015, even if oil prices rebound somewhat during the year.

While low energy prices are harmful to energy producers, they benefit consumer spending through low gasoline prices. Since the United States is primarily a consumer-driven economy, the sell-off in oil and gas prices is actually a net positive for GDP in the near term. However, over the long run, low energy prices may harm the economy as lower profits for the U.S. energy sector will impact other areas of the economy, such as employment, particularly in those regions that have flourished during the U.S. oil boom. The struggling Eurozone economy could also benefit from lower oil prices, as the Eurozone is a net importer of oil and has a much smaller energy industry than the U.S. While we do not believe that the economic impact of cheaper oil will be significant enough to alleviate the need for more aggressive monetary stimulus from the European Central Bank to spur growth, the Eurozone's middling economy can use all the help that it can get. On the other hand, some emerging markets economies and other heavily energy-dependent nations may suffer due to low oil prices. In particular, Russia, Venezuela and Iran are heavily dependent on revenue from the oil industry and rely on oil prices above $100 to balance their national budgets.

Interest Rates and Fixed Income:

Bond returns surpassed expectations in 2014, thanks to the relative economic security of the U.S. compared to many other regions of the world and the Fed's continuation of its accommodative monetary policy. Due to low inflation in the U.S., in part due to the drop in crude oil prices discussed above, the Fed declined to raise interest rates in 2014, but ended its quantitative easing program nonetheless. Through its formal statements after FOMC meetings, however, the Fed has increasingly tried to signal the likelihood that it will raise rates as soon as mid-2015. Indeed, the Fed has attempted to de-sensitize the markets to the prospect of higher interest rates, by gradually becoming more hawkish in its public communications.

While we agree with the consensus view of market observers that the Fed will likely begin hiking interest rates in 2015, we believe that the Fed will take a very cautious approach to raising rates. We view the Fed as very concerned that raising rates could derail an economy that has finally begun to pick up steam and rattle equity markets that have become accustomed to liberal monetary policy. Therefore, we foresee the Fed raising rates by only 0.25% sometime in the latter half of 2015, assuming crude oil prices have stabilized/rebounded somewhat and the outlook for more healthy inflation begins to take shape.

We believe that, in the long run, bonds will under-perform equities in a rising interest rate environment. However, given the modest rate increase that will occur as a result of the Fed's initial policy shift, we expect bonds to hold steady for much of 2015 and produce low single digit returns for the year, on a total return (i.e. including interest payments) basis. Bonds will also be supported by the fact that, relative to the economic difficulties in many corners of the globe, the U.S. is on more secure economic footing and will therefore continue to be viewed as a safe haven to invest by bond investors.

Portfolio Implications and Conclusion

Given the improving economy, low interest rates, stimulus measures by foreign central banks and rebounding commodity markets, we view 2015 as an attractive time to invest in equities. We have recommended over-weighting U.S. equities in client portfolios since the financial crisis, and we continue to hold that view going into 2015. Specifically, for those clients with a tolerance for short-term volatility, we believe that the recent pullback in energy prices has created an opportunity to invest in deeply discounted equities within the energy sector. We also favor the financial sector, due in part to the long-awaited interest rate hikes that we expect from the Fed in 2015. Banks benefit from the spread in interest rates between the rate they pay to borrow funds and the rate they receive on loans. As interest rates in the market rise, so does the interest rate spread that banks receive.

Within fixed income, we favor short to intermediate-term investment grade corporate issues. Despite paying relatively low yields currently, their yields are higher than similar duration U.S. treasuries and this segment will be impacted less than higher yielding long-term fixed income when interest rates rise. It is important to maintain as short a duration on a fixed income portfolio as possible when interest rates are rising, as the longer duration bonds will be more sensitive to rising rates and, therefore, investors in these bonds will suffer larger capital losses. While we will continue to de-emphasize traditional bond investing in 2015 for many clients, we recommend that more conservative investors who require fixed income consider the corporate fixed income referenced above, as well as several high-yielding fixed income alternatives, such as preferred stock, utilities, master limited partnerships and REITs. We favor a multi-asset class fixed income portfolio combining each of these alternatives with traditional fixed income to diversify the portfolio and reduce interest rate risk in 2015.

Finally, it's important to remember that temporary market pullbacks are a normal and healthy part of any bull market. In 2014, the S&P 500 declined roughly 5% or more on three separate occasions, which is generally consistent with the bull market historical average of three to four 5% pullbacks per year. In 2015, we expect similar opportunities to arise, whether due to geopolitical fears, negative economic headlines or interest rate hikes. As we have emphasized repeatedly in the past, we view these temporary market setbacks as opportunities to invest in attractive assets at a discount, and in 2015 we plan to continue to capitalize on them for the long run benefit of our clients.