

February 2015

Market Update

At the Sebold Capital Management Annual Meeting, we discussed what an odd year 2014 was in the US Large Cap space. Over 17% of trading days for the S&P 500 recorded new market highs; 42% of the time the market was within 1% of market highs; and 78% of the time the market closed within 5% of the market highs. With these amazing numbers, one would think the economy is booming, interest rates are rising, and peoples' places in life just keeps getting better. That may be true for a few, but for most, it is a bit misleading. This is also true for the performance of the S&P 500.

In 2014, 40% of the stocks in the S&P 500 were actually negative, 27% underperformed, and only 33% outperformed. It was an uneven year at best. So why did the average seem to do so well, recording a 13.7% return on the year? The reason is because of the structure of the index. The S&P 500 is a capitalization weighted index; meaning that the largest companies have a greater weight in the return. In 2014, the largest companies in the S&P 500 did very well. Here is how that impacted the overall return: Apple supplied 1.41% of the overall market return, Microsoft provided 0.58%, and the next eight largest stocks provided 1.49%. The balance of the 500 stocks was responsible for 10.22% of the index.

January Benchmark Returns		
Domestic Benchmarks	Jan	2014
Large Cap: S&P 500	-3.0%	13.7%
Small Cap: Russell 2000	-3.2%	4.9%
International Equity Benchmarks		
Developed: MSCI EAFE	0.4%	-7.4%
Emerging: MSCI EM	0.6%	-1.8%
Fixed Income Benchmarks		
Domestic: Barclays Aggregate	2.1%	6.0%
Foreign: Barclays Global Aggregate	1.3%	3.8%
Other Benchmarks		
Municipal: Barclays Municipal Bond	1.7%	7.0%
High Yield: ML High Yield Bond	0.5%	1.3%
Commodity: Dow Jones UBS Commodity	-3.3%	-17.0%
Real Estate: FTSE NAREIT All REITS	6.2%	28.0%
Risk Free: US Treasury CD 3 Month	0.0%	0.0%



The New Year has brought about some different numbers. The league leading S&P 500 is now lagging for 2015, whereas the foreign markets are taking over. Large Cap domestic stocks fell 3%, while the International Markets rose 0.4%. Small Caps continued their underperformance putting in a -3.2% decline for the month. Once again the bonds have surprised the market by recording a 2.1% gain on the month. There are many impacting factors that are having an influence on these short term numbers.

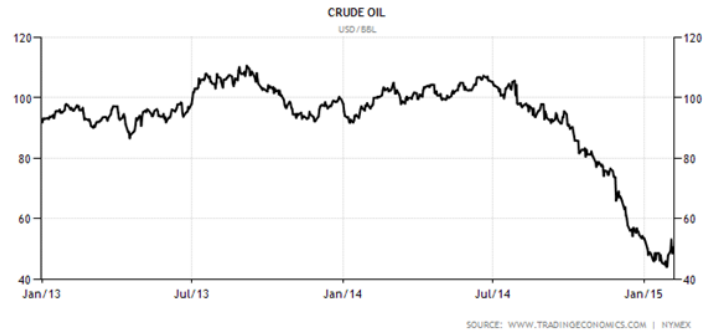
Central Banks throughout the globe continue to make front page news with new monetary policy. The EU's quantitative easing program was greeted with great applause by the markets, whereas the Swiss National Bank surprised the world with its decision to no longer keep the cap in place on the currency. The US Fed's most recent statement suggested that there was no change to their opinion of economic growth and employment figures. There remains a small likelihood that the Fed will raise rates within the first half of the year.

Europe is by no means out of the woods just yet. The Greek exit, or "grexit", from the Euro continues to be behind the scenes chatter among market participants. If the ECB does not back stop the Greek debt, the messaging becomes unclear. Who will be the lender of last resort? What is clear, is that Northern Europe (read Germany) is not going to be happy continually bailing out failing countries.

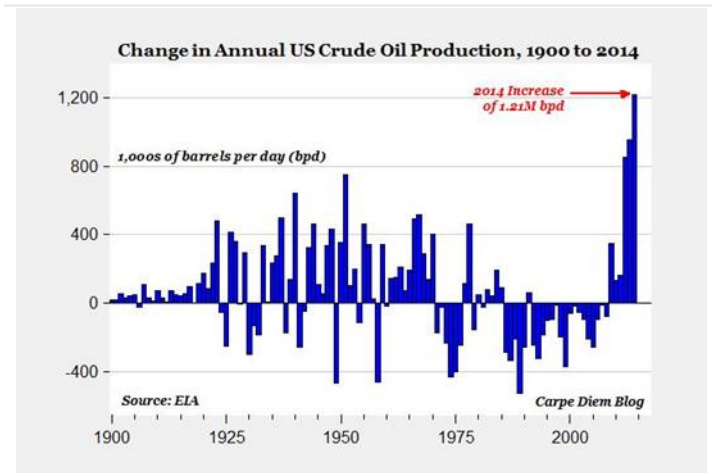
Oil Prices Fall

There has been much speculation, literally, in the last couple of months about the future price of oil. While short term, the price will continue to be volatile, the supply/demand story on oil is pretty clear. For the past several years, the added production of oil through the fracking process in the United States, has not met with any added global demand. Our big question has been why did it take so long for the market to realize this? Once again showing how difficult it is to predict short term movements in the market. The big picture question is how this will impact the economy moving forward.

The real winner will be consumers. On that front, the decline in oil prices can be seen as a great big, immediate tax cut. On what seems to be a weekly basis, we have seen prices at the gas pump, plummet. That great big SUV that used to take \$90 to fill is now around \$50. That is \$40 that can now be spent in different areas of the economy- most likely restaurants and coffee shops.



Could there be a loser in this game? Yes. In addition to the new fracking companies that have sprouted up all over the Dakota's, clearly the producers will be heavily impacted by this drop. These producers, however, are not a major contributor to the overall economy. Where there can be a ripple effect is in the high yield bond market. Many of these new producers are highly levered and have borrowed to finance the equipment needed for this new gold rush. With the plunging prices, this will have a meaningful impact on their ability to make their loan payments- which many will not. This should be a cautionary tale for high yields in general.



Europe

Over the past month, we have seen a divergence of returns in Europe relative to the United States. Much of this has been as a result of the Quantitative Easing that was announced in January. It seems the markets were moderately surprised with the ECB's announcement. Beginning in March and lasting at least through September 2016, the QE program consists of €60 billion per month in bond purchases (both public and private sector securities), with the potential to continue if inflation expectations remain below the ECB's target at that point. So that implies at least one trillion euros worth of bond purchases. That was at the upper end or beyond most investors' expectations, based on the ECB signals in prior days and weeks.

European stock markets gained around 1%–2% on the news; European government bond yields fell, hitting all-time lows—Germany's 10-year bond yield is now around 0.4% and Spain's is around 1.4%; and the euro currency fell, hitting an 11-year low versus the dollar.

While this has been helpful in the short run, the effectiveness of QE spurring economic growth has mixed results. So while we are happy the markets like it, we are not sure that it is a panacea. The tertiary impact may have more meaning; the decline in the Euro. This continues our thesis on the global currency war. While the Euro weakens, this puts European manufacturers in a much better global price position than when the Euro was overvalued due to tighter monetary policy. With a hedged position, the currency should provide profit growth from euro denominated exporters. While this is not the stated reason for QE, it will have the same impact.

The big picture question that continues to remain on the market's mind is that of interest rates and interest rate policy. While US investors continue to say that equity prices must rise as a result of interest rates that are too low, a quick peak at developed economies interest rates tells a different story. The US has the highest interest rates in the developed world, not the lowest. There is very little indication that US equity markets will rise solely on the rationale that interest rates are low. This has been proven quite clearly by the Japanese experiment. The US is quite different from Japan economically so we will dismiss the US following the comparable stock story.

The Federal Reserve, however, still seems to be on track for an interest rate raise in 2015. The employment numbers that came out in early February give the necessary cover for Fed Governors to justify "normalizing" interest rates. There are other considerations than just the US economy. The world economy is quite connected. The Fed governors would be amiss if they did not take this into consideration lest their rise in interest rates bring about a costly bout of deflation in the near future.

The US is already the safe haven of world currencies. Because of this position, and the fact that we have the highest interest rates in the world, the US will continue to attract global capital flows. Should the Fed consider raising rates in the near future, they would be encouraging additional inflows into US dollars. The subsequent reaction would be to see a strengthening US dollar against world currencies. As a large importer nation, the US would be importing foreign products with a stronger dollar. This would keep any hope of inflation at bay, and may, but to a lesser extent, encourage the importation of deflation. This is something that the US Fed should be very wary of.

Emerging Markets

While the Emerging Markets have not made it to the headlines, our positions in the space warrant explanation relative to the above. While not out of the woods yet, the EM space already has outperformed 2014 in the past month. Our expectations are that the risk/return opportunities in this space continue to be much better than in the developed world. We have, however, moved from a cap weighted exposure to a more active exposure in the space. Currencies in the EM space can have both a headwind and tailwind. There have been some companies in the space issuing more dollar denominated debt, to obtain better rates. If their currency goes against them, this could provide a headwind. The issues of local currency debt with a high export business will create a very nice tailwind to earnings. These decisions will be best made by an active manager in the space. We are working with two new managers Causeway and Baron for our emerging market exposure. We will continue to update their progress along the way.

As always, thank you for your continued support.

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