March 8, 2015

Lane Asset Management

Stock Market Commentary

Market Recap for February and Early March 2015 (1– and 12-month charts are provided on the next page)

If all we had to look at were the results for February, the picture wouldn't have looked so bad. With the S&P 500 up 5.6% for the month and 2.5% for the year-to-date through February, and with international equities doing about the same, a full recovery from January had been made and then some. And why not?

- January payrolls came in higher than expected along with upwards revisions to prior months;
- Average hourly earnings rebounded to their best level since last August;
- The JOLTS survey set a record high rate of increase in the rate of new job openings and a post-recession high in the new hire rate;
- German trade surplus reached a record high;
- German consumer climate reached an all-time high, as reported by GfK;
- Oil prices stabilized;
- S&P 500 companies, excluding oil, reported strong earnings and decent revenue growth on a year-over-year basis for the first quarter (see page 3); and
- Minutes from the January FOMC meeting were interpreted as dovish.

That was February. Early March was a different story for the markets as the S&P 500 lost about 2.5% in the first week. Much of decline was attributed to a strong payroll report for February which has given investors the impression that the Fed funds rate may be increased sooner than previously expected, now sometime in the summer. We'll have to see about that (see page 8). International equities (VEU) lost over 2.5%. In some ways, the news was as good as the opening of February, but with different results. It will be interesting to see how the balance of March goes and, especially April as 1st quarter earnings reports start to come out.

Market Outlook

My 2015 outlook for the S&P 500, described in my Fearless Forecast from January, was for aa total return of 8-10%, lower than 2014's gain of 13.5% based, in part, on my subdued outlook for corporate earnings relative to consensus analyst opinions late last year.

Today, the 2015 earnings outlook has come down quite a bit. According to FactSet's weekly summary: "*the forward 12-month P/E ratio for the S&P 500 stood at 17.1x going into Friday, well above the five-year and ten-year averages. The earnings component attracted some scrutiny in the press with the Street now looking for y/y declines in earnings (and revenues) for both Q1 and Q2. According to FactSet, Q1 and Q2 earnings are expected to decline 4.6% and 1.5%, respectively. At the start of the year, they were expected to grow 3.8% and 5.0%.*" (These estimated declines are different from Zacks' reported on page 3, but are consistent in their message.)

The open question in my mind is whether the market has already adjusted to these expectations or is waiting for more "facts on the ground" which could lead to further deterioration in the market averages. From a technical perspective, I don't see capitulation on the near term horizon. On the fundamentals, however, I believe the risk remains to the downside.

Longer term, I am not in the camp of expecting a major market meltdown, say one of over 15%. Anything over 5%, however, deserves some risk control measures, in my view. That said, aw things stand today, I'm less concerned about long term losses than I am interested in setting some funds aside along the way down to capture a greater part of an eventual recovery.

On a sector basis, pharmaceuticals, biotech, and the NASDAQ 100 continue to outperform for equities, preferred stocks for income.

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The charts on the following pages use mostly exchange-traded funds (ETFs) rather than market indexes since indexes cannot be invested in directly nor do they reflect the total return that comes from reinvested dividends. The ETFs are chosen to be as close as possible to the performance of the indexes while representing a realistic investment opportunity. Prospectuses for these ETFs can be found with an internet search on their symbol. Past performance is no guarantee of future results.

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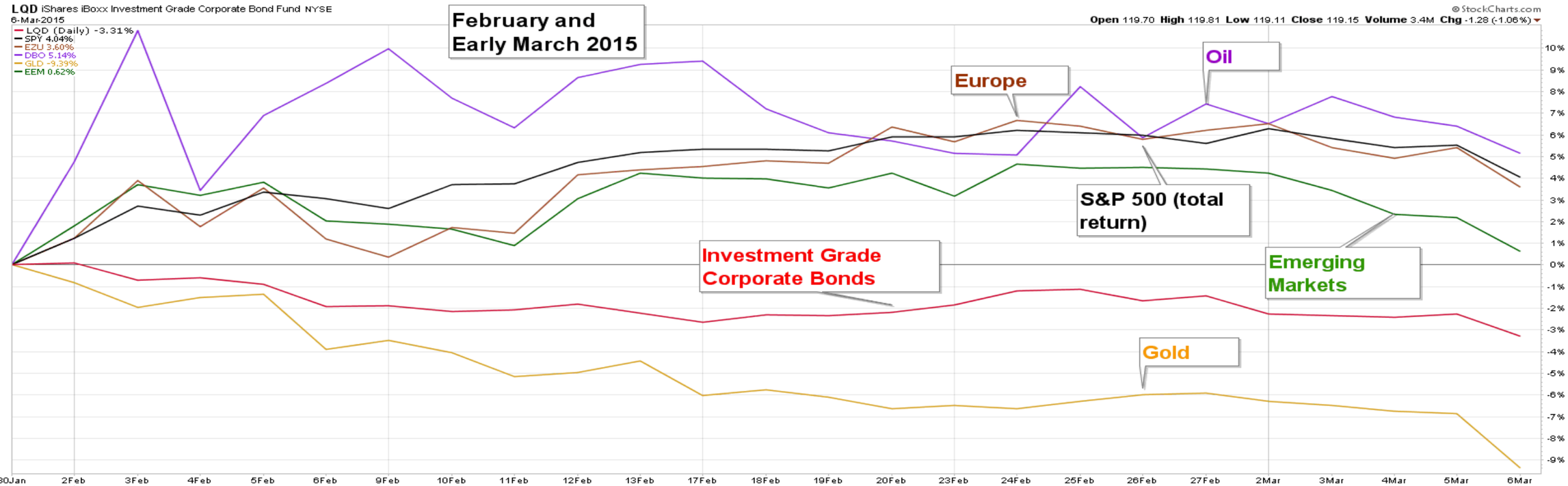

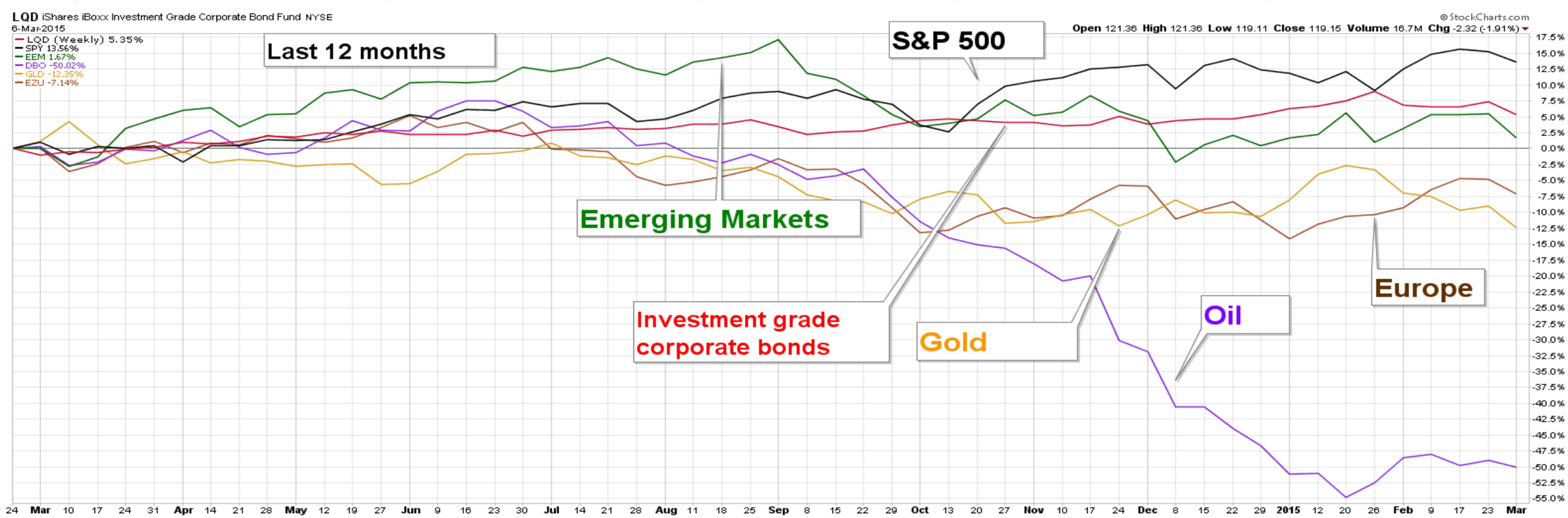

2015 PREDICTIONS (UPDATED)

As the year unfolds, I'll offer updates to my 2015 predictions. Here's where I come out after only one month. Revisions/comments are shown in *blue italics*.

U.S. Equities

As I believe the primary drivers of stock market returns in 2015 will be corporate earnings and modest, if any, movement on the federal funds rate, my expectation for the S&P 500 for 2015 is for a total return of 8-10% (measured by SPY) with risk to the downside on account of international considerations. On a sector basis, I expect healthcare, technology, consumer discretionary and small cap stocks to outperform. There may be a rebound in energy, but I'm not prepared to go there now.

The S&P 500 recovered from its January dip with a YTD (as of this writing) total return just shy of 1% — a little below my expected pace for the year. Based on Zacks Research, for 493 reporting companies of the S&P 500, nearly 65% beat their earnings expectations and year-over-year increases were 6.9% for earnings and 1.7% for revenue (excluding Apple and the oil companies, the percentage increases were a healthy 8.1% and 3.6%, respectively).

From a sector standpoint, I still favor healthcare, consumer discretionary and technology. I'm dropping utilities as they have disappointed, especially as Fed fund rate increases appear on the near horizon.

The issue of concern is the rapidly declining outlook for the 1st half 2015 earnings as Zacks reports negative estimates of –4.9% and –5.3% for Q1 and Q2, respectively (-4.9% and +3.0%, respectively, excluding oil).

International Equities

My estimate for total return from international equities, as measured by the Vanguard All-world (ex U.S.) fund, VEU, is 2-3% less than SPY which, given the above estimate, is 5-8% for VEU. I believe the international equity returns will be very region specific with India and China leading the way and commodity-producing regions lagging. Europe is a wild card as the broader economy struggles while the ECB may come to the rescue. I'd keep an eye on Germany as Europe's bellwether country.

VEU recovered strongly in February and is now about 2.5% ahead of the S&P 500 rather than 2% behind as I forecast for all of 2015. While I can understand the recovery on account of stabilization in the dollar and improved fundamentals in Europe, I'd like to see another month or so of this before revising my forecast.

On a country-specific basis, China weakened in February while Japan had a strong month. Germany continues to look good as does India.

Dollar strength masks local country returns for most funds (the German DAX reached another all-time high last month, for example, and is up over 17% (!) YTD). Therefore, an opportunity exists for improved relative international performance via funds that are hedged for currency risk. My examination of a few of these funds shows a fair degree of volatility, so caution is advised.

Bonds and Other Income Securities:

The 10-year Treasury yield surprised everyone in 2014, especially after its rapid increase in 2013. The yield currently rests at about 2% and I believe it will end the year near 2.5%. Total return for 7-15 year U.S. government bond funds in 2014 was a bit over 9% while investment grade corporate (IGC) bonds funds returned a bit over 8%. For 2015, I expect total return for IGC bonds between 6% and 8%, still better than current yield. I believe the best opportunities for income investing will come from preferred stocks, REITs and established, long term dividend paying common stocks.

The 10-year Treasury gathered steam in February and early March and now sits at 2.24% vs. 1.68% last month. Investment grade corporate bonds weakened in February and now sit with a 0.3% YTD total return as of this writing. The recovery expected for preferred stocks (PFF) came through in February with a YTD total return of 1.6%. REITs, established dividend-paying corporate stocks and the 20+ year Treasury bond index fund all weakened in February and took a further beating following the February jobs report that left investors concerned about an earlier than expected Fed funds rate hike.

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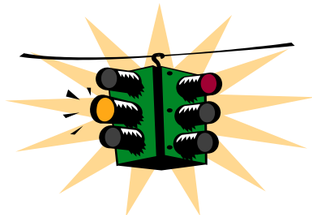
S&P 500 Total Return

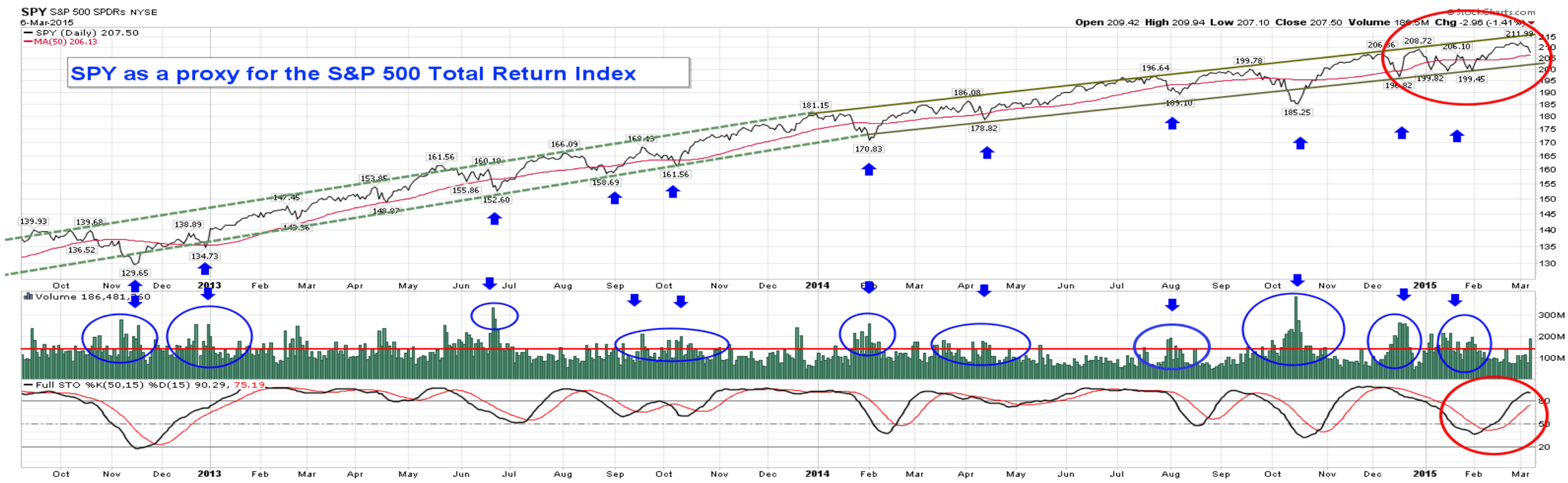


The S&P 500 (SPY) recovered in February, though a little later than I expected based on the pick-up on volume that occurred in January. Early March took back some the gain, however, especially following the February jobs report that had investors fearing a more imminent Fed fund rate increase.

The technical picture for the S&P 500 took on a bit of a reversal in February with an upturn in trend and an even stronger upturn in momentum (somewhat easing now). That said, we remain in the relatively narrow channel (under 5% top to bottom) as drawn below. At this pace, we will come close to realizing my expected 8-10% gain for the year depending where in the channel we end up at the end of 2015.

Based on the expected weak first half 2015 earnings outlook, we're going to need to watch the unfolding technical pattern very closely. Obviously, it would be best if we could remain in the established trend, but that may be hard to do. A dip below that trend such as occurred last October, will be disconcerting, to say the least, and may signal a time to lower risk exposure if the longer term outlook appears in jeopardy.

I believe we are still at a point where it would be wise to avoid taking on more risk and, for those with less tolerance, consider taking a little risk off the table.



SPY is an exchange-traded fund designed to match the experience of the S&P 500 index adjusted for dividend reinvestment. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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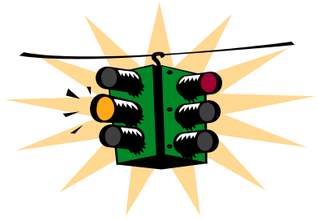
All-world (ex U.S.)

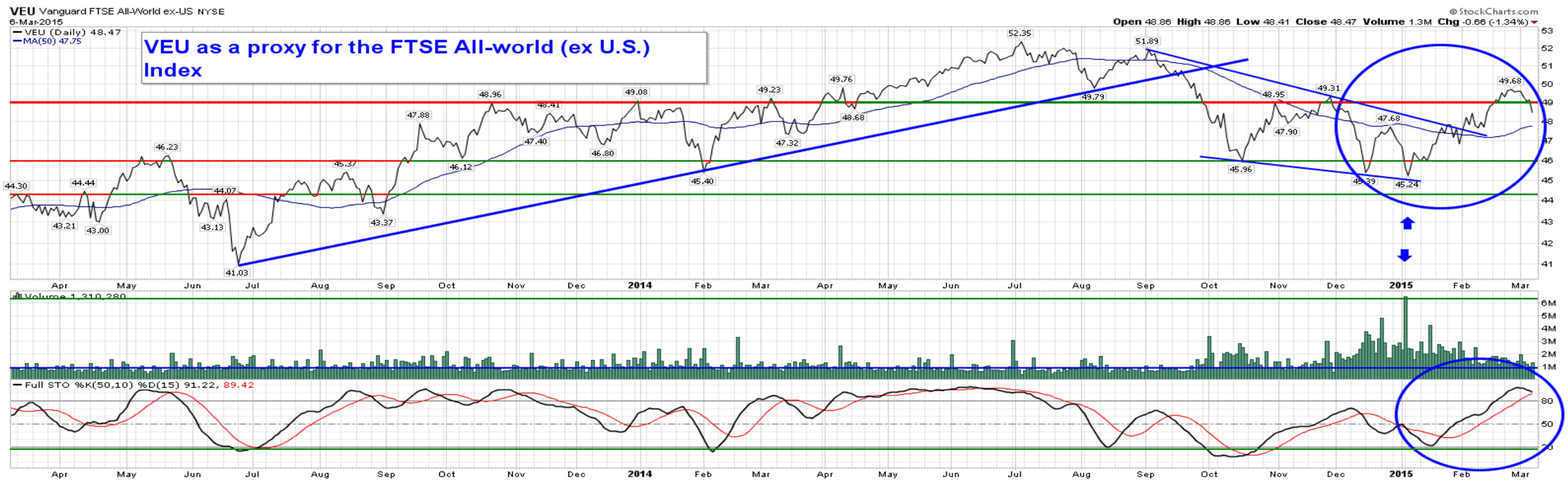
International equities continue their post-2014 advancement, even escaping, if briefly, the long term channel bounded by $46 and $49. While a stable dollar during February helped move VEU forward, recent dollar strength along with Fed fund rate hike concerns have brought the index fund back down to test the prior resistance at $49.



Technically, we have something new that we haven't seen since last August — an upward sloping 50-day moving average trend line. While I would like to see a definitive move above $49 before I could get very enthusiastic for the broad index, I think we are now developing a reason to become more invested in international equities, especially on a selective country or currency-hedged basis.

Repeating last 2 month's comments, there are few individual countries worth a place in a diversified portfolio. As was the case last month, one of the best among the lot would be India where the Bombay stock exchange has been in an uptrend for most of last year and this, achieving an all-time high. As long as the dollar continues to strengthen, the choices will be limited on an un-hedged basis.

Flying under the radar for me until recently, are newer ETFs that hedge dollar currency risk. Noting that the German DAX and the Japan's Nikkei exchanges are reaching all-time and 15-year highs, respectively, these markets are worth a look. The funds are new, however, so be careful.



VEU is an exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. As of 12/31/14, VEU was allocated as follows: approximately 19% Emerging Markets, 46% Europe, 28% Pacific and about 7% Canada. **Past performance is no guarantee of future results.**

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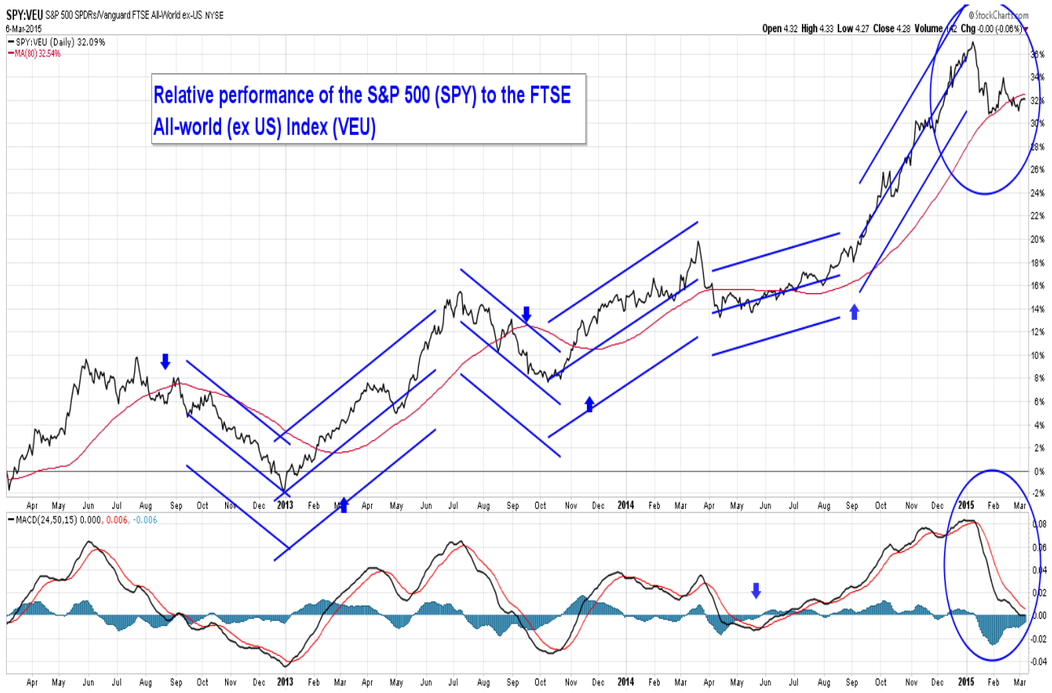
Asset Allocation and Relative Performance

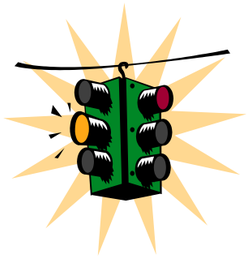
Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show the relative performance of the S&P 500 (SPY) to an investment grade corporate bond index (LQD) on the left, and to the Vanguard All-world (ex U.S.) index fund (VEU) on the right.

On the left, the relative strength of equities over investment grade corporate bonds resumed the trend in place since the beginning of 2014 as well as the volatility in place since last Fall. While I still do not see a reason to change my longer term outlook of outperformance on the part of equities, the instability in the current economic environment requires careful monitoring. The next couple of quarters with low or negative S&P 500 earnings will prove challenge to equity supremacy. Once that's behind us, we'll have a better picture of the longer term outlook.

On the right, the extreme outperformance of U.S. equities was finally overcome in January, as expected. The relationship stabilized in February and, on a purely technical basis, appears to me to be in a period of rough equilibrium. A critical issue will be role of currency strength. If the dollar gains more ground against the Euro as the ECB pursues its QE program, that will mitigate the expected gains in the European economies when measured in dollar terms. The stronger relationship of certain international equities, Germany and Japan, for example, is better seen on a currency-hedged basis.

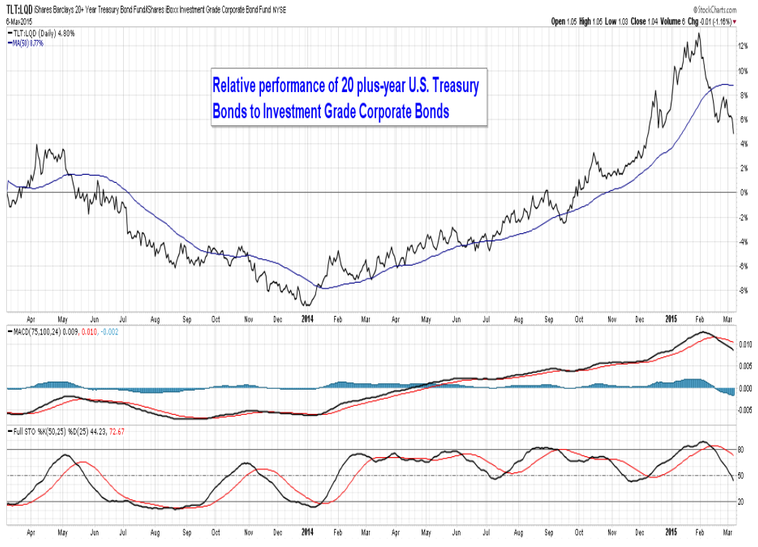


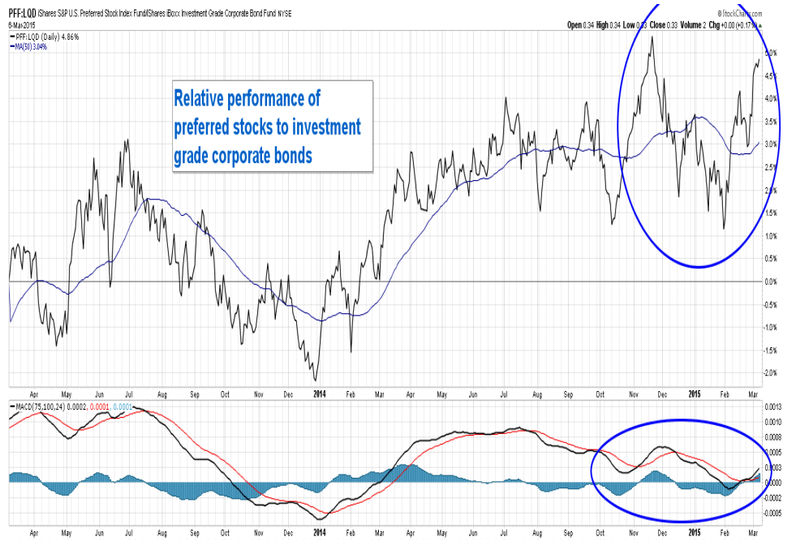
SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**



(I apologize if the charts below are hard to read, but it's the pattern that is most important.) Investment grade corporate (IGC) bonds fell unexpectedly (for me) in February and again in early March. Not only did last month's technical analysis fail me (no one ever said it was perfect), I was further surprised by investor reaction to the apparent increased likelihood of a Fed fund rate increase this summer. After all, I thought, hasn't a rate increase been telegraphed for months as the U.S. economy has steadily improved? Will the inevitable rate increase punish bonds further and longer? Or, am I reading this wrong and the February/March reversal was just an "adjustment" to the extraordinary strength shown in January, bringing us back to the more measured pace established in the last quarter of 2014?

While we wait to see how the IGC bond picture unfolds, two of the diversifying alternatives I've presented in recent months tell an interesting story. In the center chart below, we see that the extended outperformance of 20-year Treasury bonds relative to IGC bonds hit a speed bump in February. With the longer duration of the 20-year Treasuries vs. LQD, this greater sensitivity to the expectation of future rate increases is to be expected. I shy away from the longer dated Treasuries and most other longer-duration fixed income securities at this point...but not all, as the chart on the right shows with a comparison of preferred stocks (essentially perpetuities) to IGC bonds. Although the volatility looks great, the variations are actually rather small. The larger "danger" with preferred stocks is fear of a major weakness with banks that form a large part of the underlying index and fund as occurred in 2008/9. While this is worth watching, it's not something I would let dictate my investments here.





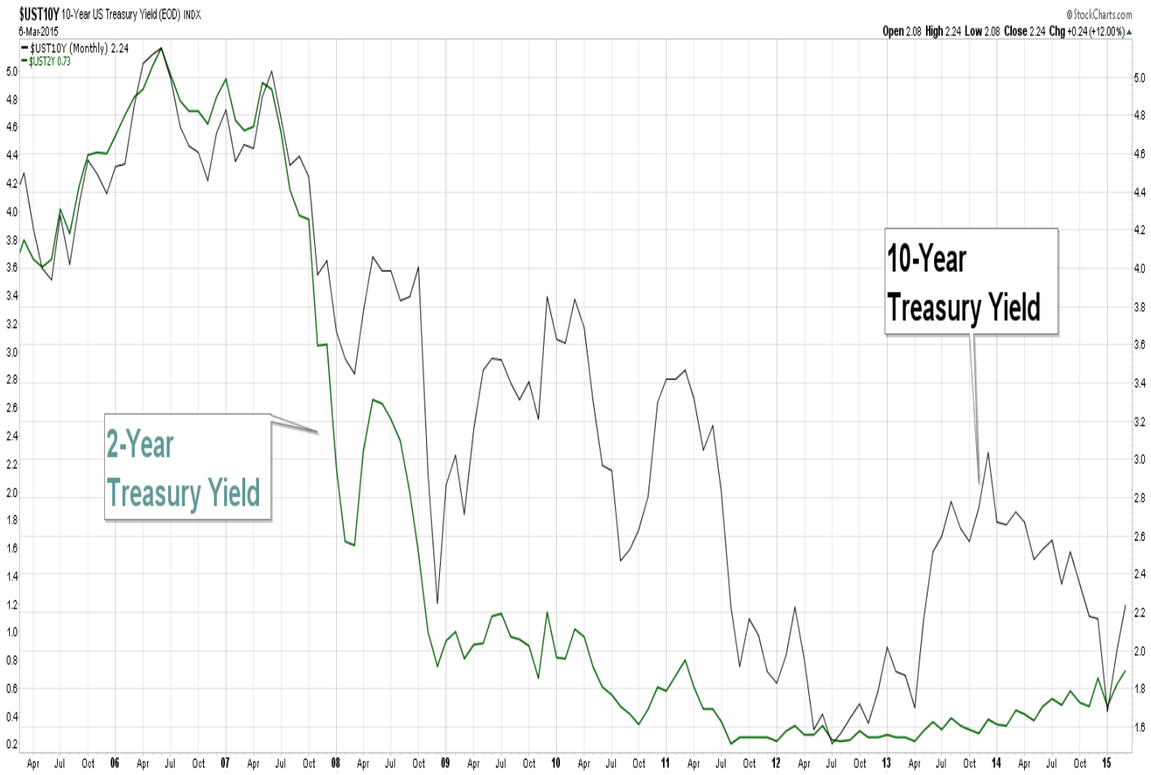
LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. TLT seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years. PFF seeks to track the investment results of the S&P U.S. Preferred Stock Index (TM) which measures the performance of a select group of preferred stocks. **Past performance is no guarantee of future results.**

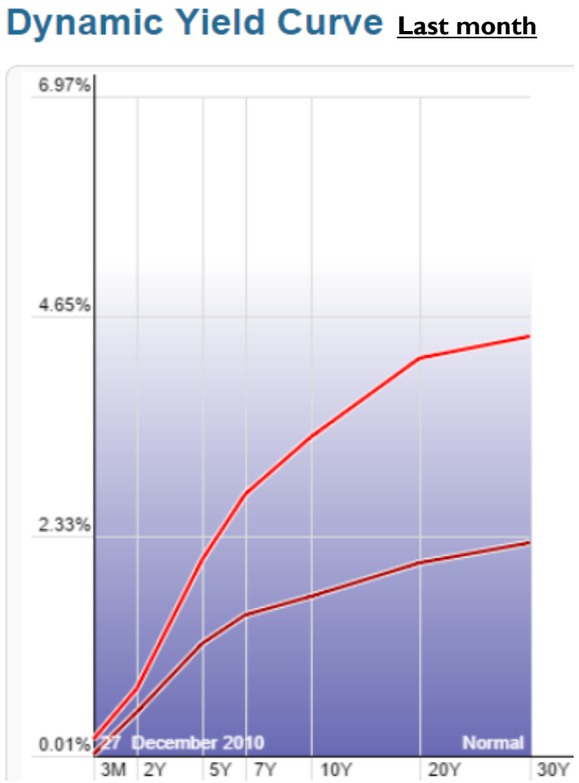
Interest Rates and the Yield Curve

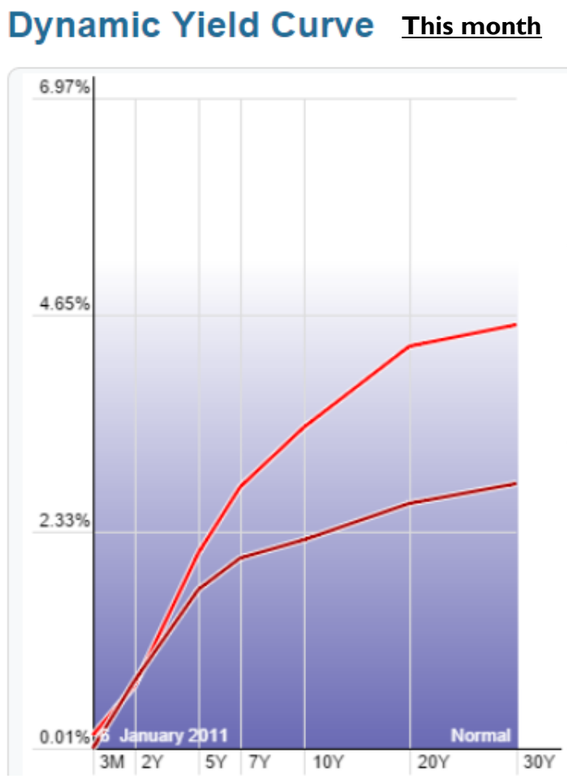
Shown on the left below is a 10-year comparison of the 10-year Treasury yield to the 2-Year Treasury yield. What's interesting about the chart this month is the broken fall in the 10-year Treasury yield curve. Since last month's report, the 10-year yield has risen from 1.68% to 2.24%, very close to its level at he beginning of the year.

The middle chart shows the Treasury yield curve last month and the chart on the right shows the yield curve today (in each chart, the upper line is the yield curve at the beginning of 2011and the lower, darker line is the more recent yield curve).

Investors move the Treasury yields through changes in demand. As demand falls, yields rise and vice versa. And demand reflects anticipation of the direction of future interest rates. Today, with an improving U.S. economy and increasing hints from Fed Chair Yellen, investor behavior reflects anticipation of a Fed funds rate increase sooner than was anticipated just a month ago. My own feeling, expressed in my Fearless Forecast in January, was that the strength of the dollar and inflation well below the Fed's target rate of 2% could suppress the Fed's desire to increase the Fed funds rate this year. On the other hand, I noted, the Fed may move in 2015 anyway since a first move in 2016, an election year, was less likely for the potential havoc it might cause. Now, with the U.S. economy, especially employment, continuing to improve, like others, I believe the chances for a Fed funds rate increase this year, possibly this summer, has improved. The charts below would support that.







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Investors should consider the investment objectives, risks, and charges and expenses of mutual funds and exchange-traded funds carefully for a full background on the possibility that a more suitable securities transaction may exist. The prospectus contains this and other information. A prospectus for all funds is available from Lane Asset Management or your financial advisor and should be read carefully before investing.

Note that indexes cannot be invested in directly and their performance may or may not correspond to securities intended to represent these sectors.

Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

The charts and comments are only the author's view of market activity and aren't recommendations to buy or sell any security. Market sectors and related exchanged-traded and closed-end funds are selected based on his opinion as to their usefulness in providing the viewer a comprehensive summary of market conditions for the featured period. Chart annotations aren't predictive of any future market action rather they only demonstrate the author's opinion as to a range of possibilities going forward. All material presented herein is believed to be reliable but its accuracy cannot be guaranteed. The information contained herein (including historical prices or values) has been obtained from sources that Lane Asset Management (LAM) considers to be reliable; however, LAM makes no representation as to, or accepts any responsibility or liability for, the accuracy or completeness of the information contained herein or any decision made or action taken by you or any third party in reliance upon the data. Some results are derived using historical estimations from available data. Investment recommendations may change without notice and readers are urged to check with tax advisors before making any investment decisions. Opinions expressed in these reports may change without prior notice. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this report may be unsuitable for investors depending on their specific investment objectives and financial position. The price or value of the investments to which this report relates, either directly or indirectly, may fall or rise against the interest of investors. All prices and yields contained in this report are subject to change without notice. This information is intended for illustrative purposes only. **PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.**

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