April 8, 2015

Lane Asset Management

Stock Market Commentary

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

March was another busy month for the market, this time taking back some of the gains from February for the S&P, leaving the index up about 0.9% through March. The month opened with weak factory orders and a spurt in jobless claims. However, this was quickly followed by a much-better-than-expected employment report and a JOLTS report of job openings reaching levels not seen since 2001. Good news was taken as bad news as the market interpreted the economics as increasing the likelihood of an early increase in the Fed funds rate.

Around the middle of the month, the economic news began to weaken with a drop in consumer sentiment and factory output. The Producer Price Index declined signaling a softness in demand, U.S Leading Economic Indicators slowed, the Philly Fed Business Conditions Index fell to a 13 month low, and both the Empire State Factory Index and the Chicago National Activity Index fell. Bad news became good news as the S&P reversed course to the good. This was met with the release of the FOMC meeting minutes from January which, while removing the word "patient," still left the impression that the Fed was in no hurry to increase rates.

The employment report for March came out last Friday and was surprisingly weak with less than half the number of jobs created as in recent months. Perhaps this should have been expected on account of the cold winter and the major labor slowdown on West Coast docks. After an initial shock in equity futures (the report came out on Good Friday and the market was closed), once the market opened on Monday, the S&P more than recovered as this time bad news was taken as good news and the view of postponed rate increases fed the market.

It seemed apparent that anticipation of Fed funds rate increases provided the impetus for movement in the S&P throughout the month.

Market Outlook

My 2015 outlook for the S&P 500, described in my Fearless Forecast from January, was for a 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. With a YTD increase for the S&P 500 through the date of this writing of about 1.6%, we're running a little short of my estimated pace.

I believe the S&P will continue to be driven by corporate earnings (projected to be weak), adjustments to the Fed funds rate (probably coming later in the year but likely to depress the S&P whenever it comes), and increasing strength in the dollar (driven not only by anticipation of increase in the Fed funds rate, but also by accommodative monetary policy in Europe, Japan and elsewhere). For this 2nd quarter of the year, I expect little change to the S&P with risk to the downside.

On the other hand, where I originally forecast about 5-8% total return for international equities, the YTD result of over 7% (at this writing), probably driven by the loose monetary policy in Europe and elsewhere along with a stronger dollar, has exceeded my expectations and causes me to raise my 2015 estimate to, say, 10% with risk to the upside.

Meanwhile, there's a real question about the prospects for economic growth in the U.S. and abroad. Fed Chair Yellen's speech on March 27th gave a sober outlook to the U.S. economy on account of relatively weak wage and employment data while the IMF just signaled that the world faces lower potential growth (http://www.imf.org/external/pubs/ft/survey/so/2015/NEW040715A.htm). While I try to avoid political statements in my Commentaries, it seems to me that without more robust fiscal policy here and abroad, we could be facing a long period of disappointing growth and investment performance (what Larry Summers calls "secular stagnation").

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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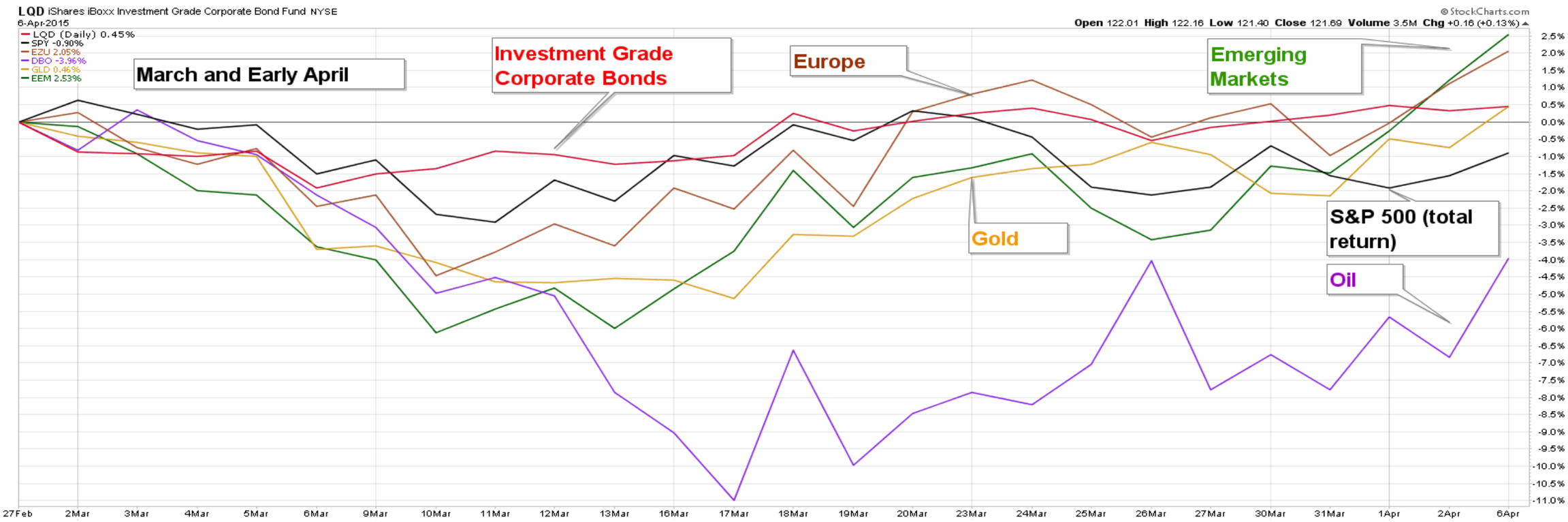

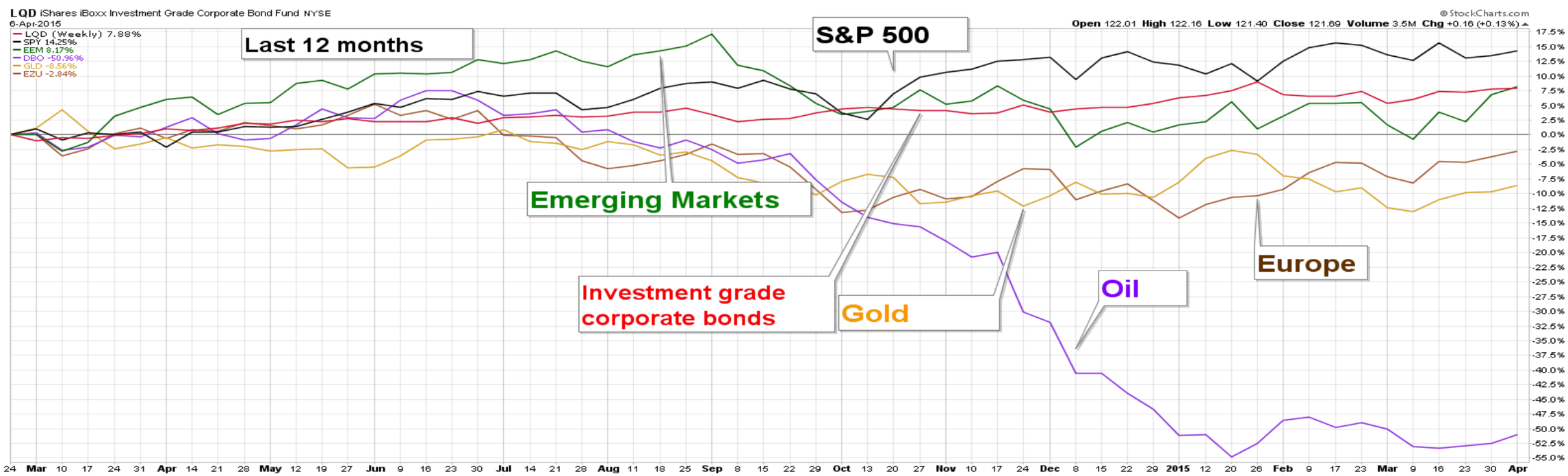

2015 PREDICTIONS (UPDATED)

As the year unfolds, I'll offer updates to my 2015 predictions. Here's where I come out after three months. 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 (SPY) had a difficult (losing) March but is back in the black in the early days of April with a total YTD return just shy of about 1.6% — a bit below target for my expected pace for the year.

All sectors identified above have outperformed the S&P so far this year. Energy is making a comeback, but still lags the broader index.

Zacks reports "Earnings estimates have come down sharply over the last few months and the negative revisions trend has been particularly pronounced for Q1. As a result, earnings growth has turned negative for the first half of the year and remains barely in the positive territory in the back half. In a way, all the prior growth hopes for 2015 have disappeared and now show up in next year's estimates." The energy sector can be blamed for the negative outlook while health care and finance are driving the positive ex-oil outlook.

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 extended its lead on U.S. equities March and, as of this writing, stands over 6 percentage points ahead YTD — and that's on an unhedged basis (dollar hedged results are even stronger). I think it's just about time to revise my outlook for international equities owing, I think, to the central bank stimulus programs in Europe, Japan, China, and elsewhere. It doesn't hurt that Q1 set a record in terms of flows into European equity funds. At this pace, VEU could actually turn in a total return above 25% for the year!

On a country-specific basis, aside from a few places, like Brazil and Canada, a great deal of positive results are emerging, even more so on a dollar-hedged basis. Europe (esp., Germany and Italy), China, South Korea, India, and Japan are all outperforming both VEU and SPY. Dollar strength masks local country returns for most funds (the German DAX and the India Bombay Stock Exchange reached all-time highs again last month).

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 drooped in March and now stands at 1.92%, down from 2.24% last month. Investment grade corporate bonds strengthened with weakness in yields and now sit with a 2.5% gain YTD as of this writing, about 0.5% above the S&P and on track with the forecast. Preferred stocks (PFF) and REITs (IYR) all added strength in March while dividend-paying corporate stocks weakened.

I anticipate any increase in the Fed funds rate this year will be modest.

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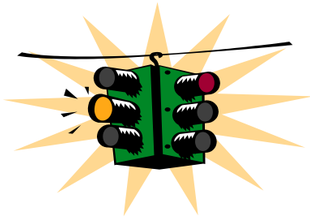
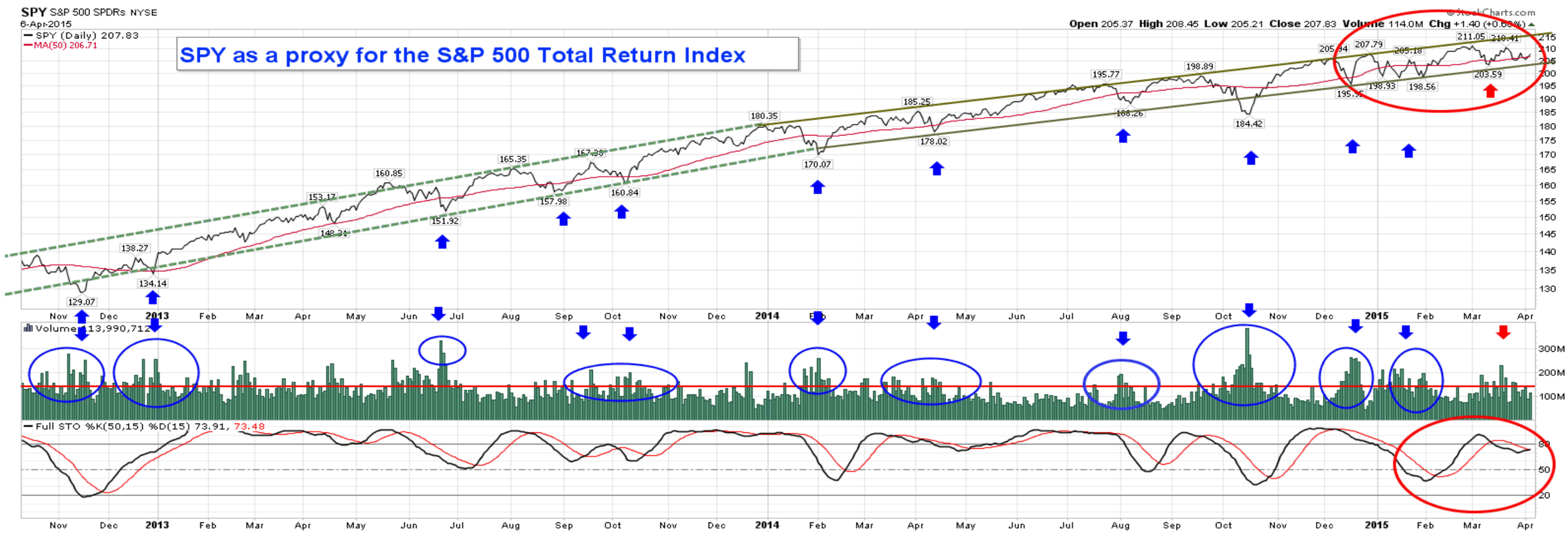
S&P 500 Total Return



The S&P 500 (SPY) slipped in March and now stands at a total return gain of just under 1.6%. The pattern that is emerging in 2015 could be characterized from a technical perspective as: high volatility, weakening volume, and holding positive trend. In my mind, this reflects the uncertainty in the market caused by anticipation of rising U.S. interest rates, anticipation of weak first and second quarter earnings, a rising dollar, and accommodative central bank policy both inside and outside the U.S — along with awareness that valuation measures are stretched. Even the "buy-the-dip" crowd seems to be losing steam.

Looking out from here, from a purely technical perspective, it appears we are a bit below track for my estimated 8-10% total return this year. With the weaker-than-expected employment report for March and if the anticipated weakness in Q1 (and even Q2) earnings materializes, the bad news will be interpreted as good news in terms of Fed action and this *MAY* help the S&P remain on its current trend. That said, I still believe we are 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.)

It's been a long time coming, but I now have the kind of technical and fundamental results I need to become constructive on international equities — as long as we're careful in country/region selection. The upward sloping 50-day moving average trend that I was watching last month became further extended in March. In addition, the price of VEU seems to have escaped the line of resistance at $49 having tested it several times, a positive sign. Finally, while momentum seems to be wavering, the near term outlook looks stable to improving.

There are macroeconomic reasons for this optimism including the rising value of the dollar (making foreign exports cheaper) and the QE programs in Europe and Japan, along with what's being referred to as "stealth easing" in China. Some of the best opportunities on a country basis seem to be Germany, Italy, Spain, Belgium, Japan and China. There is concern about the rising dollar's impact on emerging market economies where debt is held in U.S. dollars, so I'd be careful there. Also, while oil exporting regions are oversold on a technical basis, they are not out of the woods yet. There are more promising opportunities elsewhere.

As we live in interesting times, it is well to keep in mind that dollar-cost averaging is always a good way to control risk, especially with the kind volatile markets we find internationally.

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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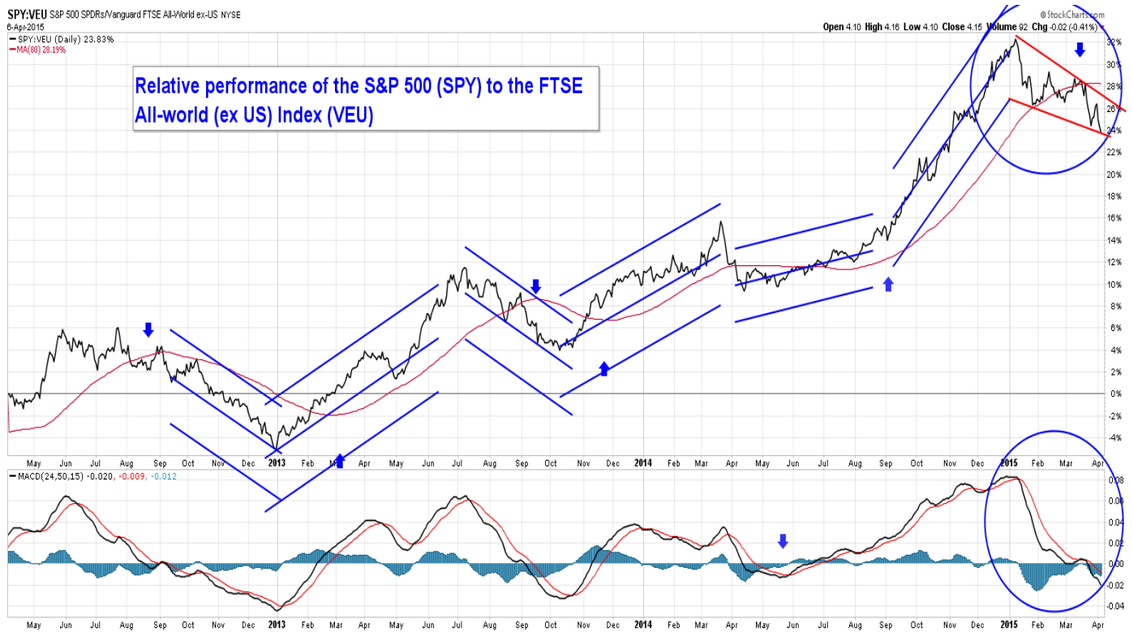
Asset Allocation and Relative Performance

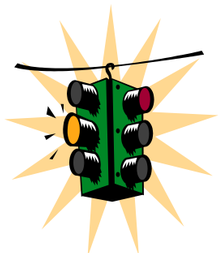
Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show 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 U.S. equities over investment grade corporate bonds lost ground in March with a decline in both trend and momentum. On a YTD basis, the bonds are outpacing the equities by about 1.5%. 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 challenging 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 relative to international was finally overcome in January, as expected. The equilibrium that appeared present last month gave way to outperformance by international equities in March and now appears ready to extend itself. VEU has now outperformed SPY by over 6% YTD, contrary to my expectations. If Europe is examined on a dollar-hedged basis, the outperformance so far in 2015 is over 20%! While international outperformance usually only goes for a matter of months since 2007, there is no apparent weakness at this point.

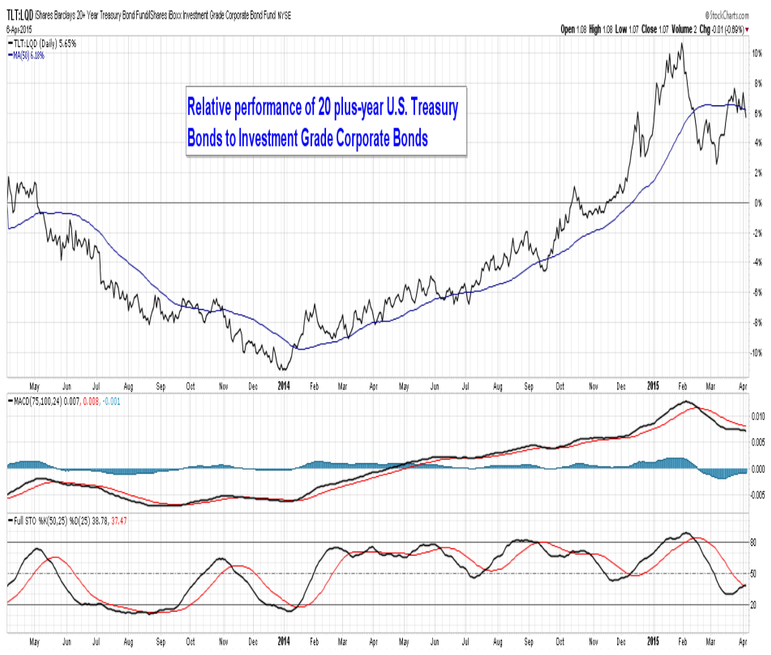


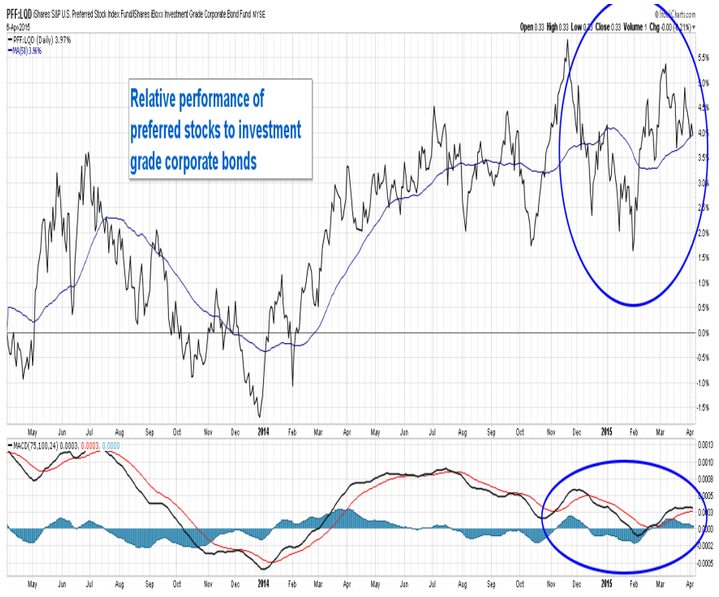
SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**



(I apologize if the charts below are hard to read, but it's the pattern that is most important.) Investment grade corporate bonds (LQD) had a busy month in March, but remained essentially flat. On a technical basis, the trend remains positive and momentum has just made a turn in the positive direction. Time will tell if this is the market telling us that expectations for an increase in interest rates are farther in the future than some have thought.

While we wait to see how the 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 (TLT) relative to corporate bonds hit a speed bump in February with a partial recovery in March. With the longer duration of the 20-year Treasuries vs. LQD, greater sensitivity to the expectation of future rate increases is to be expected. I would shy away from 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 corporate bonds (the variations are smaller than they appear because of the scale of the chart). Here we see preferred stocks (PFF) outperforming corporate bonds with both positive trend and momentum. I expect this relationship to continue as the preferreds have a higher current yield and, for the most part, lower volatility. While PFF outperformed LQD in a one-, three– and five-year look-back periods, there's no guarantee this will continue.





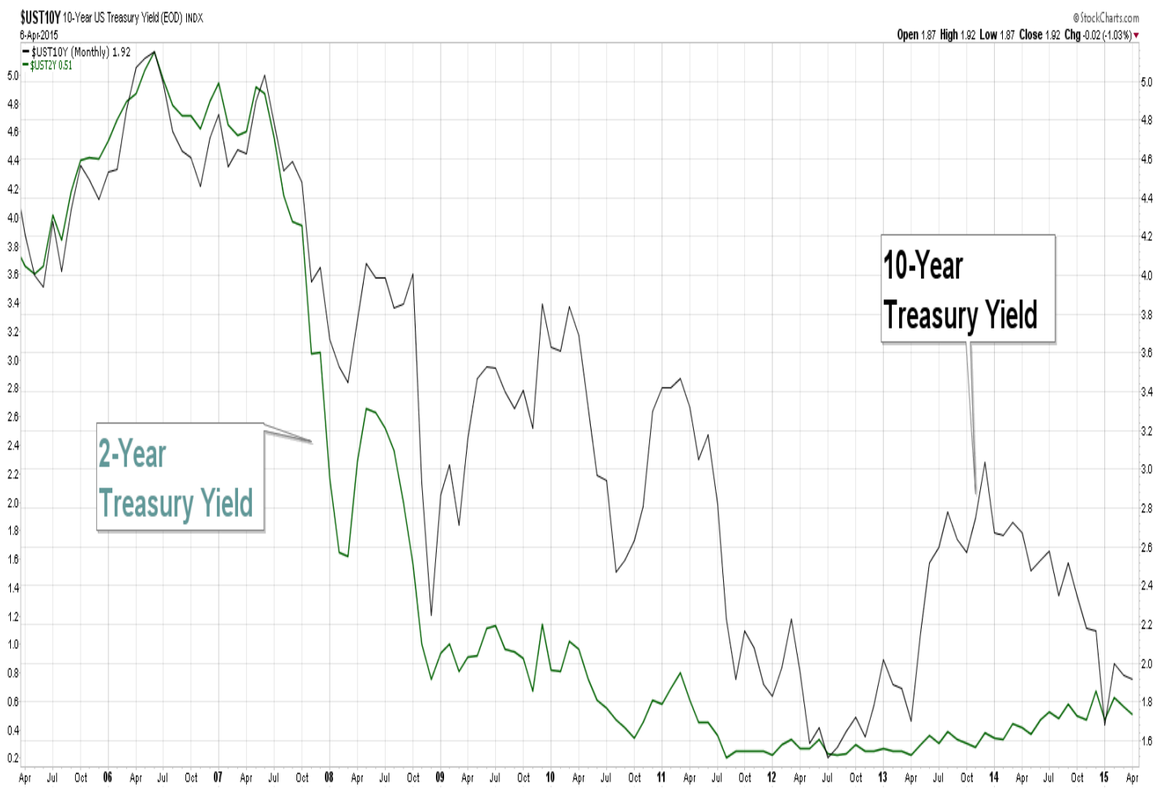
LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. TLT seeks to track the investment results of an index composed of U.S. Treasury bonds with remaining maturities greater than twenty years. PFF seeks to track the investment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

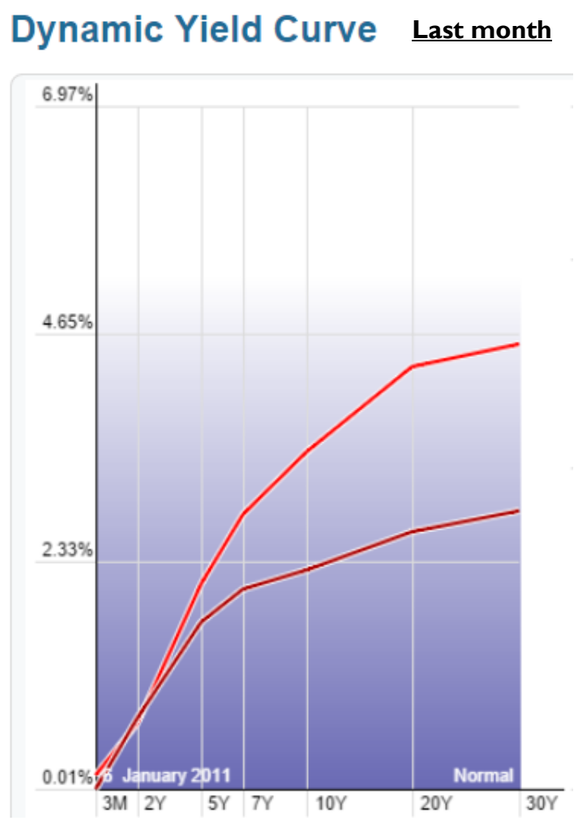
Interest Rates and the Yield Curve

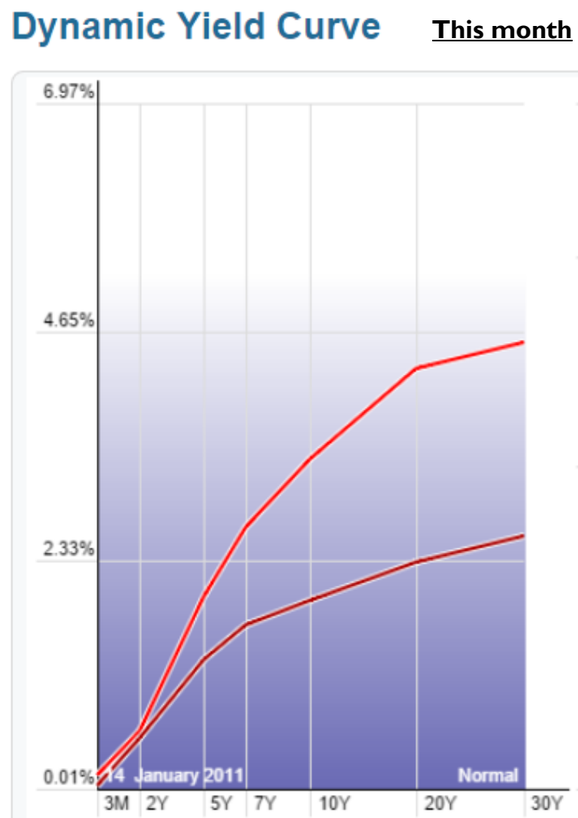
Shown on the left below is a 10-year comparison of the 10-year Treasury bond yield to the 2-Year Treasury yield. What's interesting about the chart this month is that both rates retreated, and this occurred even before the weak March employment data. Since last month's report, the 10-year yield has fallen back from 2.24% to 1.92%, below its level at the 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 2011 and 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. Last month, with an improving U.S. economy and increasing hints from Fed Chair Yellen, investor behavior reflected anticipation of a Fed funds rate increase sooner than previously anticipated. In March, even before the weak employment numbers, that situation reversed a bit, perhaps with the growing anticipation of weak corporate earnings and/or reflecting the even lower yields of foreign sovereign debt and a flight to the dollar. My 2015 forecast for the 10-year Treasury yield was 2.5%, but I now feel it will be below that, let's say closer to 2%. As for the Fed funds rate, I still believe any rate increase will come late in the year and be quite modest.







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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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