DMS

Discretionary **M**anagement **S**ervices, LLC

What We Are Telling Clients

By James F. Dykstal, CFA, Portfolio Manager, January 2015

Below is a summary of our views on the economy and markets, which we are sharing with discretionary clients.

Economic Outlook

- GDP growth will continue to grow modestly, slightly above a 2.5% annual pace. Personal consumption has improved, settling at a growth rate above 2.5%, which is positive for GDP growth.
- Low oil prices contributed to a strengthening U.S. dollar and to a growing domestic economy. The yield on the ten year Treasury opened the quarter at 2.51% and ended at 2.17%. Lower interest rates are the result of a "flight to quality" of global capital flows.
- International economies will continue to struggle to grow throughout 2015. Both the European Central Bank and the Bank of Japan will move forward with quantitative easing. The trend of the stronger U.S. dollar will persist, due to the removal of Fed stimulus and modest, but firm, economic data.
- Growth in emerging markets will be higher than developed markets, even with slowing GDP growth in China. Consumers in emerging market countries continue to increase their percentage of global consumption. Lower energy prices will be a longer term benefit to energy importing developing economies.

Strategic Market Outlook and Tactical Allocations

Fixed Income: The trend toward higher interest rates should continue, but expect "flight to quality" events as the markets readjust to more volatility in the equity markets.

- High yield should outperform in a rising rate environment. Lower oil prices have impacted energy company debt, and credit spreads have widened, presenting a buying opportunity. Credit is weighted more heavily than Treasuries, and duration is tilted shorter than benchmarks.
- Commercial real estate is viewed as an attractive yield alternative to bonds; however, queues can delay additions to positions, and an increase in interest rates could dampen valuation improvements.
- International bonds are viewed as an attractive complement to domestic bonds, due to a mismatch in interest rate cycles. Emerging market debt provides diversification and yield potential.
- Hedge funds with a non-directional (or absolute return) focus are viewed as an attractive uncorrelated option.

Equities: The domestic stock market looks to be fully valued as earnings growth slows. We expect more volatility in domestic equity markets as companies' earnings momentum slows. International developed stocks appear to be undervalued relative to domestic stocks despite continued slow growth in those countries. Emerging market stocks are viewed favorably, due to stronger economic growth and attractive valuations relative to developed nations.

- Small cap stocks are weighted less than large cap stocks, due to above average P/E multiples. Equities are tilted toward lower beta, higher dividend stocks to reduce volatility, and to generate income. We are looking for corrections in the market as points to "buy in" and bolster small cap positions.
- Stock allocations in developed markets lean toward high quality stocks as they appear to offer relative safety. The relative attractiveness of multinational stocks takes into account the lackluster economic growth in Europe and Japan. The European Central Bank and the Bank of Japan will continue their quantitative easing programs.
- Within international equities, emerging markets stocks, comparatively attractive due to their low relative P/E multiples, are equally weighted to target. Unfavorable economic news has been priced into valuations.