GODSEY & GIBB
WEALTH MANAGEMENT

INVESTMENT WATCH

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As 2015 begins the outlook for the U.S economy appears solid, but global economic weakness, deflationary pressures and continued geopolitical risks will likely lead to increased volatility in the financial markets.

After a weather-induced slow start to 2014, which saw U.S. GDP contract by -2.1% in the first quarter, the economy gained momentum throughout the rest of the year, expanding by more than 4.0% in the final 3 quarters. Equity markets responded positively to the improved economic situation. The S&P 500 rose 13.7% for the year, its 3rd consecutive year of double digit gains and 5th since the financial crisis in 2008. The momentum in the economy and financial markets is expected to carry over into 2015 as improvement in the labor market and increasing disposable income boosts consumer confidence and spending. However, the increase in volatility we experienced in the latter part of last year is likely to carry over as well due to increased geopolitical risks, concerns about growth in the Europe and Japan, weakening in China and the end of synchronous central bank action.

The dramatic decline in oil prices was one of the big stories of 2014. After peaking at just over $107 a barrel over the summer, oil prices have fallen to less than $50 a barrel. Much of the decline has been attributed to the recent increase in oil production in the U.S. as well as to higher levels of production in hot spots such as Libya and Iraq. While the decrease in oil prices will negatively impact the earnings and capital spending plans of energy companies, it is on balance, a positive factor for U.S and global economic growth. The boom in U.S. energy production has led to higher capital spending and strong growth in energy related jobs. However, those impacts are somewhat smaller when looked at in the context of the broader U.S. economy. Capital spending by U.S. energy companies makes up less than one percent of total U.S. GDP, and employment in the energy sector accounts for about one half of one percent of total U.S. employment. While the negative impact will be felt in some regions of the country, the overall impact is positive not just for the consumer but also for businesses that utilize large amounts of energy. On a global basis lower energy prices are in effect a transfer of wealth from oil producers to oil consumers and from exporters to importers. Outside of the U.S., China, India and Europe are likely to be some of the biggest beneficiaries of cheaper oil. Demand for oil is expected to rise this year, albeit at a slower pace than previously expected. Thus far, OPEC nations have not cut production in the face of lower prices. Production cuts in the U.S. and other non-OPEC countries will eventually bring supply and demand back in balance and put a floor on price declines. Much has been made of the low cost of production in Saudi Arabia and other OPEC nations; and while this is true, these country's fiscal budgets require significantly higher oil prices to support social welfare programs. Sustained low oil prices could lead to further instability in those areas which could translate to higher volatility in our markets.

Consumer activity accounts for two-thirds of U.S. GDP. In addition to the benefits of lower oil and gasoline prices, the consumer will also benefit from a stronger labor market. The unemployment rate fell to 5.6% in December, down from 6.7% a year ago. The U.S. added an average of 246,000 jobs per month for a total of 2.95 million jobs in 2014. While some slack still remains in the labor market with the level of the underemployed and part-time workers still elevated, the overall trend in new jobs is positive.

Activity in the housing sector remains uneven as months of strong sales seem to be followed by drops in activity. Home prices are still rising but the pace has slowed significantly this year. The Case/Shiller Home Price Index indicated that home prices rose 4.5% on an annualized basis in December, down from a 13.4% pace a year ago. Housing is not likely to be a strong catalyst for the economy this year.

As expected, the Federal Reserve ended its quantitative easing program during the 4th quarter. The Fed plans to maintain its balance sheet near the current $4 trillion level for the foreseeable future. The Fed is expected to begin raising short-term interest rates at some point this year, but the timing and magnitude of any moves will be data-dependent. Policy makers will have to weigh the solid economic growth and strengthening labor market with the potential that a global economic slowdown could spread to the U.S. and increase deflationary pressures. Inflation has remained persistently below the Fed's 2.0% target and recent declines in energy prices have pushed it even further from the target. The Consumer Price Index (CPI) reached a peak of 2.1% in June but has since declined to 0.8% year-over-year. Core CPI, which excludes food and energy was up 1.6% for the year. It is important to note that even with modest increases in the Fed Funds rate, monetary policy would still be accommodative and supportive of the U.S. economy and markets.

There is a divergence in the outlook for economic growth and central bank activity across the globe. The U.S. is expected to see GDP growth again in the range of 2.5-3.0% this year and the U.K. is also experiencing modest but positive growth. However, much of the rest of the world is weakening. Europe continues to struggle and the odds of a recession in the Eurozone have increased. The European Central Bank is expected to announce new measures in January, to stimulate growth. Japan's aggressive monetary and fiscal stimulus programs were designed to increase wages and inflation and accelerate growth. Thus far the results have been mixed. Growth in China slowed to 7.4% in 2014 and, despite government stimulus, is expected to decline to 6.8% in 2015. Major emerging market economies are also seeing slower growth and the stronger U.S. dollar is an additional drag on these economies. This divergence in global growth should benefit U.S. markets relative to overseas markets but it will be a headwind for U.S. companies operating globally and could add to volatility this year.

Already we have seen an increase in volatility in the U.S market in 2015 with 4 of the first 12 trading days showing a move of greater than 1.0%. While volatility can cause uncertainty in the short run, we believe the longer term fundamentals of the market remain compelling. Valuations remain very close to long-term averages and U.S. companies are expected to continue to grow earnings in the mid to high single digits this year. The market has performed very well over the last several years led primarily by the more defensive sectors of the market. We expect that this year the market will be led by more cyclical sectors, particularly those that are consumer related or are beneficiaries of lower energy prices. We continue to focus on high quality companies that can consistently grow earnings. With price returns likely to be more moderate going forward, we believe dividend paying companies will provide an additional source of stable return. Interest rates have continued to decline as higher volatility and global uncertainty leads investors to the relative safety of U.S. Treasury Bonds. Even as U.S. rates have declined, they maintain a sizable yield advantage over the sovereign debt of other developed markets making them more attractive to foreign investors. At some point, as the U.S. economy continues to grow and the Fed begins to normalize short-term interest rates, longer-term rates will begin to rise; but for now slowing global growth and deflationary pressures are likely to keep them relatively low. We continue to keep the duration of our fixed income exposure short, with a focus on generating incremental yield. As always, we continue to monitor the fundamentals of the economy and the market and stand ready to make adjustments to portfolio positioning as necessary.