Martin J. Armbruster
CPA/PFS, CFP®

Stephanie L. Willison
CPA/PFS, CFP®

Our News

1st Qtr. 2015

Happy spring! We are ready for the change in weather and the new life that spring brings. We are also glad the tax filing deadline is behind us and schedules in the office normalize a bit.

We spent part of this quarter evaluating a new web-based software called eMoney. After doing a trial with the software, we decided the software would be of value to our clients. So we decided to purchase the software and move forward with training. eMoney allows you to organize your financial accounts, store all your valuable documents, watch your financial picture come to life, access your accounts 24/7, and simplify with one platform. We are excited to introduce this software to you once we are trained and adept at using it.

During the first quarter, we do our annual filings with the Securities Exchange Commission. These filings are always available upon your request and can also be found on our website.

We also received several new referrals. These are so valuable to us. We work hard each day for our clients, and we appreciate when this hard work leads to a client telling someone else about us.

We are grateful for the continued relationship we have with you and the trust you put in Treybourne Wealth Planners.

Key Takeaways

International stocks led in the first quarter with Europe, Japan, and China posting especially strong gains. U.S. stocks were also positive, with smaller caps outpacing larger caps, and growth beating value. Some of the quarter's big-picture themes included global central bank policy, the strength (or lack thereof) in economic growth, U.S. dollar dominance, and the ongoing decline in oil prices.

Starting first with the United States, overall the U.S. economy appears to be in pretty good shape and on a positive uptrend. However, various forces have clouded the economic picture at least over the near-term. Some of these forces are temporary (e.g., harsh weather in the Northeast), but others, such as the rising U.S. dollar and the decline in oil prices, could have spillover effects on the broader economy.

The stronger dollar is dampening export growth and has already prompted a spate of downward earnings and revenue estimates. And, while the decline in oil prices is a positive for U.S. consumers, it will weigh heavily on energy companies, their earnings, and their willingness to spend on new projects and hire additional workers.

All of these issues complicate the outlook for U.S. economic growth and are among the factors that the U.S. Federal Reserve has to weigh as it contemplates raising interest rates. The Fed's March statement took the much-watched step of removing the word "patient" from the official text, yet Chair Janet Yellen continues to suggest the Fed will exercise exactly that quality as it moves toward its first rate increase and considers the pace of subsequent hikes. Markets appeared to take the Fed's update to mean rates would remain low, potentially into the fall.

Meanwhile, other major central banks are expanding their support, with Japan in stimulus mode and the European Central Bank the latest entrant to the mix. The ECB announced a quantitative easing program in January and launched its bond buying in early March. European stocks rallied during the quarter on the hope that this stimulus would have a similar effect in Europe as it has had in the United States. For U.S.-based investors, strong local-equity returns in international stocks were largely offset by currency movements due to an appreciating U.S. dollar.

In emerging markets, China's growth continued to slow even as the government undertook monetary stimulus measures including changing reserve requirements and cutting rates. Nonetheless, emerging markets in aggregate were positive.

On the fixed-income front, with a pronounced lack of competition from other developed-market bonds, U.S. Treasuries continue to look relatively

appealing even with a 10-year yield below 2%. This factor, along with investors' sense that the Fed might be slower to scale back its accommodation, helped government bonds to their fifth consecutive quarterly gain.

Investors' search for yield has helped support returns for both investment-grade and high-yield corporate bonds as well. Floating-rate loans, which tend to do well when rates rise, had a very strong quarter as investors girded for future rate hikes.

Investment Commentary

The strength of the dollar is a significant force affecting the economic landscape. The dollar has appreciated 23% over the past 12 months. Moreover, based on the concept of purchasing power parity (PPP), the dollar now looks to have significantly overshot its longer-term fundamental value relative to the basket of other major currencies in the dollar index. The converse is true as well—other currencies have undershot their fair value versus the dollar.

The DXY index constituents include Euro (57.6%), Yen (13.6%), Pound (11.9%), Canadian Dollar (9.1%), Swedish Krona (4.2%), and Swiss Franc (3.6%). Data as of 3/17/2015. Source: Bloomberg, L.P.

There are several cross currents from the rise in the dollar in terms of its impact on both the real economy and financial markets. On the positive side, a strengthening dollar reduces the cost of imported goods and is also associated with falling oil and commodity prices that are priced in dollars on the global market. This will tend to depress domestic inflation—a positive result unless an economy is at risk of a deflationary spiral, which the United States is not. All in all, these things benefit U.S. consumers, increasing their purchasing power and leaving them more money available for spending (or saving). A stronger dollar also tends to attract more foreign investment. To the extent this foreign capital flows into U.S. Treasury bonds or corporate debt, it helps keep interest rates lower, and it may also support higher U.S. stock prices. All of these factors are reasons why investors cite the stronger dollar as another reason for optimism about U.S. stocks. However, a dollar that is too strong is not necessarily good for U.S. stocks, as investors start to weigh the negative impacts more heavily. So far this year, the daily correlation between the dollar and U.S. stocks has been negative.

On the negative side, a stronger dollar has a negative impact on U.S. exports, U.S. manufacturers, and U.S. multinational company profits. And by also making imported goods more attractive it typically leads to a worsening of our trade deficit. This has a negative effect on overall economic growth, because GDP is defined as the sum of consumer spending, investment spending, government spending, and net exports. Also, from a dollar-based investor's perspective, a rising U.S. dollar hurts foreign asset class returns as they are translated back into dollars from weaker currencies.

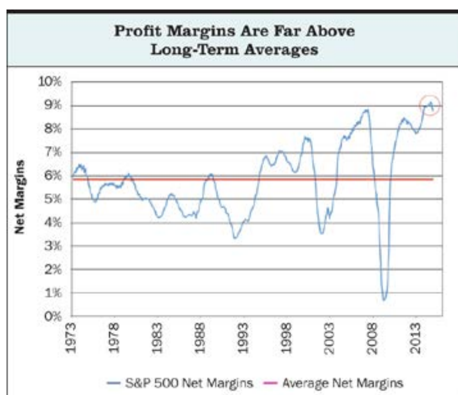
All of these impacts are reversed for the investors, consumers, and economies whose currencies are depreciating versus the dollar. When we talk to our international stock managers, for instance, most of them echo a few key points with regard to the recent currency volatility. First, they acknowledge that the negative currency translation effect creates an immediate negative impact on their dollar-based returns. But the managers typically do not try to hedge against this translation risk. Several of them state (as do we) that they don't believe they have an edge in predicting currency movements, so they are doubtful they would add value to client returns over time from doing so. Second, while they rarely hedge currencies, our international managers do consider potential currency impacts as part of their fundamental, company-specific analysis and valuation. For example, they say that over the medium term a weaker currency should begin to positively impact the profit margins and earnings of foreign companies that do business globally.

Asset Class Views & Portfolio Positioning

***U.S. Stocks*—**Our five-year outlook for U.S. stock returns is quite subdued. This reflects our view that 1) corporate earnings are substantially above their long-term "normalized" trend; and, (2) stock market valuations are also above normal. We don't think either trend is sustainable.

Profit margins are a key driver of earnings and earnings growth. The adjacent chart shows profit margins for the S&P 500 are at all-time highs. The chart is also very clear in showing that profit margins are cyclical. That is, neither the trend nor the level of margins is sustained for very long. Moreover, history has shown that high profit margins are negatively correlated with subsequent five-year earnings growth (i.e., foretell lower future earnings growth). We don't think this time will be different. We believe margins and earnings growth will come down from their current levels and revert toward their longer-term norms.

In addition to the natural forces of competition, a big reason profit margins are likely to decline is from increased labor and wage costs, which have yet to really kick in. Another factor is the sharply rising dollar, which, as we highlighted earlier, is hurting the profits of U.S. multinational companies.



Historically, very high profit margins have been followed by sharp declines in company profitability. Data as of 12/31/2014. Source: Robert J. Shiller and Standard & Poor's.

We seem to be seeing this impact already, as earnings-per-share estimates for the first quarter have dropped sharply to a 5% year-over-year decline, compared to the positive 4% growth that was expected for the first quarter at the beginning of the year. The plunge in oil prices, which hurts earnings for energy companies specifically, is also a significant driver of these negative results.

The second key piece to our negative view on U.S. equities is elevated valuations. We measure valuations in a number of ways and across many different metrics, and they all tell pretty much the same story: U.S. stocks are expensive. While valuations are not a good short-term market indicator—overvalued markets can get even more overvalued for a while—history shows that high valuations are a deterrent to future long-term returns, which is our focus.

If our view on earnings is correct, we'd expect a meaningful market correction at some point. All else equal, we would view such a decline as an opportunity to shift some capital back into U.S. stocks (which at that point should be offering attractive return potential commensurate with their risk) and out of our more defensive fixed-income holdings.

In the meantime, many of our active equity managers are still able to find some great stock-picking opportunities within what we (and many of them) see as an overvalued and relatively unattractive overall market opportunity set. One area where many of our managers are carefully picking amongst the rubble is energy—the S&P energy sector is down 22% compared to a 9% gain for the overall market over the past three quarters.

European Stocks—Moving to developed international stocks, and Europe in particular, our top-down asset class view is almost a mirror image of the United States. Unlike in the United States, where we see unsustainably high profit margins, earnings growth, and valuation multiples, in Europe we see earnings that are below trend and relatively attractive valuations.

Over the next five years, we think European stock market earnings growth will be higher than the market is currently expecting, and more in line with its long-term trend, as the economy recovers and companies benefit from operating leverage, cost cutting, and the weaker euro currency. We also believe European stock market valuation multiples will at least be in line with their longer-term norm, consistent with an economic and earnings recovery. As such, when we model out expected five-year returns for developed international stocks, we get numbers around 10%–11% (annualized) in our most likely scenarios. This is an attractive spread relative to the low single-digit expected return for U.S. stocks. And it is the type of absolute return we want to see in order to take on full equity-risk exposure in our portfolios. As such, we are at or near a full weighting to international/European stocks in our balanced portfolios.

Emerging-Markets Stocks—Our top-down analysis for emerging-markets stocks is similar to Europe, in that their valuations look attractive and earnings appear to be depressed relative to our longer-term expectations. Of course, emerging markets face some unique risks, which we have discussed frequently in past commentaries. These include most prominently:

1) The potential for a sharper-than-expected economic slowdown in China, as the authorities try to gently deflate their infrastructure/credit bubble and engineer a transition to a consumer-led economy.

2) The potential negative contagion effects from the impact of continued strong dollar appreciation on the high levels of dollar-denominated debt on emerging-markets companies' (and some governments') balance sheets.

While we don't claim to have unique insight into how these complex and multifaceted (and, really, unknowable) situations will unfold, we look at emerging markets—as we do all the asset classes we evaluate—across a range of scenarios that try to take into account a number of eventualities that could result from combinations of these and other macro factors. Moreover, in determining our emerging-markets allocation, we seek a high margin of safety before overweighting the asset class. In other words, we'd want to have such a strong positive case that we could have a lot of things go wrong or differently and we'd still expect good investment results. Today, as we weigh what we believe are the most likely scenarios, we derive expected five-year annualized returns for emerging-markets stocks in the mid-single to low double digits. The low end of that range incorporates what we believe to be pretty bearish assumptions, yet if they played out we would still earn at least decent returns. The upside in the more neutral or positive scenarios is significant. Therefore, we maintain a full or slightly more than full allocation to emerging-markets stocks in our balanced portfolios.

Investment-Grade Bonds—With the U.S. core bond index yielding only 2%,

any reasonable interest-rate or macro scenario implies very low returns over the next five years. There is no refuge to be found looking to core bond markets outside the United States either. In Europe, the comparable index has a yield of only 0.5% and almost a third of European government bonds actually have a negative yield-to-maturity, meaning investors who hold these bonds to maturity are locking in a certain loss.

We think there are relatively more attractive—and more durable—options within pockets of the bond market, and we've tilted the portfolios to take advantage of these. Specifically, we have shifted more than half of the fixed-income exposure in our balanced accounts into active funds that have significant flexibility to manage their interest-rate risk as well as other risk exposures, and that we believe are run by skilled, proven managers. The funds' much lower duration means they face less of a negative price impact from rising interest rates. Our investments in floating-rate loan funds will actually benefit from rising rates, and their higher yields provide a head start in terms of their multiyear total return potential.

Concluding Comments—In this commentary we highlighted a few of the investment opportunities we are seeing as we look out over the next five years. But broadly speaking, we continue to view this as a low-return environment across most asset classes and we don't think our portfolios will be rewarded by taking on additional risk at this time.

As market prices, valuations, and fundamentals change, our views and positioning may change. We expect (rationally so, we believe) that markets will be volatile in the future. And when market prices and underlying asset values diverge due to the inevitable and enduring cycles of investor herd behavior driven by greed and fear (or excessive optimism and pessimism), our disciplined, patient, tactical, long-term investment approach will be in prime position to take advantage of those cycles.

Market Data

(From various sources. Data as of March 31, 2015.)

Index	*March 2015*	*1st Qtr.*	*12 Mos.*	*5 Yrs.**
Dow Jones Industrial Average TR	-1.90%	0.30%	10.60%	13.20%
S&P 500	-1.58%	0.95%	12.73%	12.79%
Russell 2000	1.70%	4.30%	8.20%	14.60%
Barclays US Agg. Bond	0.46%	1.61%	5.72%	4.41%

***Annualized**

Past performance is no guarantee of future results. Indexes are not available for direct investment.

Contact Us

Located at: 609 Treybourne Dr. , Suite A
Greenwood, IN 46142
Phone: (317) 881-6670
Fax: (317) 887-5692

E-Mail: ***Marty Armbruster***
mja@treybournewealth.com
Stephanie Willison
slw@treybournewealth.com

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