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THE OUTLOOK

In this issue of THE OUTLOOK. . .

The U.S. reaffirms its economic leadership role and prospects are good for continued economic growth in 2015

Volatility and risk are on the rise in international markets, driven by secular headwinds, plunging oil prices and a strong US dollar

Portfolio implications of the recent wireless spectrum auction

Current investment research focus

The United States has reaffirmed its role as the most vibrant and dynamic major economy after several years in which global growth was driven by the developing world ... At the same time, risks to the international economy are growing

Amid Global Divergences, the U.S. Reaffirms Its Role as Engine of Global Growth

As we enter 2015, the fundamental economic forces in the developed world are the strengthening of the U.S. dollar against the euro and yen, declining interest rates, collapsing oil prices and falling inflation rates. In the developing economies, we are witnessing decelerating growth accompanied by declining currencies and rising interest rates. These forces have led to increasing market volatility and are defining our current Outlook for investors. Against a backdrop of a prolonged period of slowing global growth, the United States has reaffirmed its role as the most vibrant and dynamic major economy after several years in which global growth was driven by the developing world. The U.S. resurgence is a consequence of its resilience and technology leadership as well as its reduced dependence on imported oil which are contributing to its growing productive capacity. The U.S. is better positioned to meet its energy needs today than at any time in the past 45 years.

At the same time, risks to the international economy are growing. In the developed world, secular deflationary challenges remain, including heavy government debt burdens, aging populations and inflexible labor markets. We expect these headwinds to persist for some time. In spite of efforts around the world to reduce debts and deficits, the ability of many governments to meet their obligations is being hampered by anemic growth rates and a strengthening U.S. dollar, which is making it more expensive to repay dollar-denominated debt. Emerging economies are holding some $1.95 trillion of dollar-denominated debt out of an estimated total debt of $2.6 trillion, making debt servicing more difficult for many of these borrowers. Moreover, many emerging and developing economies are oil exporters who depend on oil sales to help balance their budgets. The recent 50% decline in oil prices is raising concerns about the ability of these countries to service their debts. This Outlook describes the competitive advantages supporting the U.S. growth in productive capacity relative to other nations, the ripple effects of the oil price collapse on the global economy, the near-term risks to the economic outlook and the

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subsequent investment implications for client portfolios. The U.S. equity markets have performed well for several years and should continue to do so in the intermediate term because the outlook for the three elements that drive equity valuations, which are corporate profits, interest rates and inflation rates, remain favorable. We would use any pullbacks related to international concerns as a buying opportunity because we view the current outlook to be very favorable for the US economy. This Outlook also discusses the importance of the recent wireless spectrum auction on client portfolios.

The Growing Productive Capacity of the United States

The productive capacity of a nation is reflected in the strength of its currency, and the U.S. dollar has recently hit multi-year highs

In a world of uncertainty and economic disequilibrium, capital is flowing to the United States. The U.S. has long been the leading economy in the world due to its productive capacity. Productive capacity is defined as the maximum amount of products and services a nation can produce given a set of resources and constraints. It is the relationship of what a nation is capable of producing to what it actually produces. The productive capacity of a nation is reflected in the strength of its currency, and the U.S. dollar has recently hit multi-year highs. Productive capacity varies greatly from country to country as it depends on several factors including:

- The quality, size and growth dynamics of its workforce
- The productivity or output of each worker which depends on education levels, training, worker skills and entrepreneurial culture
- The capital used in the production process including machinery, factories and transportation infrastructure
- The availability of raw materials and natural resources such as oil, gas, coal and iron ore
- The ability to innovate and use technology efficiently
- The institutional structures that allow business to function with dependability such as the rule of law
- The strength, depth and effectiveness of its financial and capital markets systems

The United States has many advantages over its competitors starting with the Constitution which provides the foundation for our laws as well as our social, political and economic platforms

While far from perfect, the United States has many advantages over its competitors starting with the Constitution which provides the foundation for our laws as well as our social, political and economic platforms. The U.S. also ranks highly on all of the factors listed above that determine productivity. Periodically, other major nations will excel in one or two of these factors, but no nation has been as consistently represented across

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all of these factors as the U.S. has been. In the 1980's, Japan challenged the U.S. economic role for a period, but its economy has been without any meaningful growth for two decades as it struggles to fight deflation and an aging population. For most of the past decade, China's double-digit GDP growth was achieved through its policy of undervaluing its currency to foster export-driven growth enabling the government to accumulate more than $3 trillion of currency reserves. This, combined with a weaker U.S. dollar and easy Federal Reserve monetary policy, drove massive capital flows to other emerging economies. Those nations are now experiencing a painful economic adjustment as China's growth has steadily slowed in the past two years and it is now focused on domestically-driven growth rather than export driven. China's success was in part due to its low labor costs which have risen significantly and no longer provides the same competitive advantage. On the other hand, the reduced reliance on foreign oil imports and the reduction of energy costs has benefited the U.S. manufacturing sector and the consumer who accounts for 70% of the U.S. economy. Today, the U.S. is more economically autonomous than it has been in many years.

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Europe has been struggling since the financial crisis to avoid deflation as its complex and fragmented governance structures make it difficult to form consensus on fiscal and monetary policy among the 18 member nations (19 with the recent addition of Lithuania). The diverging economic fortunes of its member nations continue to foster political and social stresses which are adding to the inability to gain traction in the Eurozone and are creating instability in the region. Europe's financial system is not functioning effectively as efforts by the European Central Bank (ECB) to stimulate lending with record low interest rates have not proven effective as banks are not lending enough. On January 22, 2015 the ECB will meet again and could announce a program to make large-scale asset purchases to pump money directly into the economy. This policy action, depending on the amount, could well provide a boost to European asset prices. So while Europe benefits as a commodity consumer from lower energy prices, the drop in oil prices also adds to the deflationary forces the ECB is trying to counteract. Europe continues to face restructuring issues which are limiting its ability to improve its productive capacity. It continues to be hampered by a lack of investment, an aging labor force, high labor costs and lack of labor mobility, skills mismatches and poor demographics. Chronic youth unemployment in many European nations not only impacts the current outlook for growth, but also mortgages the future productive capacity of the region.

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The global divergences are being expressed by different central banks' policy actions. The Federal Reserve has kept a low interest rate policy to stimulate growth, the ECB has implemented an inadequate policy to prevent deflation, while the Bank of Japan has embarked on a highly accommodative policy to end deflation and promote growth. Further limiting

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Divergent policies are leading to greater market volatility, and we view any market weakness as opportunity to benefit from the continuing growth of the U.S. economy

Data usage has grown fivefold over the past five years and is expected to triple over the next five years

the growth potential of Europe are the economic sanctions imposed on Russia which are particularly difficult for the German economy, Europe's biggest and most productive. These divergent policies are leading to greater market volatility, and we view any market weakness as opportunity to benefit from the continuing growth of the U.S. economy.

The Importance of Wireless Spectrum Auction for Portfolio Strategy

"We're talking about a platform that is still growing by leaps and bounds – five times as many devices in front of us – and the categories of devices are undergoing a huge evolution, I really try to look at what are the sensors on these new devices, as they enable us to reimagine experiences."

– Adam Cahan, Senior VP of Mobile for Yahoo on mobile devices

People living in major cities or rural areas of the United States have experienced the frustration of dropped phone calls, crossed lines or delays in downloading data and videos also known as "buffering" as the demands on the system have been overwhelming the networks. Data usage has grown fivefold over the past five years and is expected to triple over the next five years according to network-equipment maker Cisco. Looking ahead, Cisco projects that global internet traffic in 2018 will be equivalent to 64 times the volume it was in 2005. An industry trade group CTIA report cited that U.S. data usage grew over 700% to 388 billion megabytes from 2010 to 2013. As 3G and 4G networks advance globally and as wireless traffic increases, carriers need to increase the amount of wireless spectrum because we are consuming and sharing far greater volumes of data over smartphones, tablets and increasingly in cars and other devices.

Gartner, a technology research firm, predicts that device shipments will exceed 2.5 billion in 2015 according to a June 2014 research report with PCs and tablets exceeding 600 million and mobile phone shipments over 1.9 billion. The use of these devices and the associated demand are having a profound impact on capital expenditures of businesses as evidenced by the recent wireless spectrum auction in the U.S. To help service providers meet the growing needs of U.S. businesses and consumers, the Federal Communications Commission (FCC) recently held an auction this past November and December for licenses for wireless spectrum to allow service providers to handle increasing growth of data usage and to offer more reliable wireless service. The auction was for spectrum designated as Advance Wireless Services or AWS-3 spectrum, which is well suited for downloading videos, and works particularly well in densely populated cities. The wireless spectrum auction was expected to

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raise about $18 billion, but actually raised over $44 billion with Verizon, AT&T, T-Mobile, and Dish likely among the major bidders. These companies are under intense competitive pressure to provide customers with faster speeds, increased data volumes and all at lower costs. The telecom industry is experiencing powerful deflationary pressures with consumers increasingly wanting more services and paying much less as companies compete with each other to lower prices to maintain and increase market share. Businesses are consuming greater amounts of data each day and need to store and retrieve far more data than before. The beneficiaries of these trends are content providers, data storage and cloud-computing companies, semiconductor manufacturers, and those that make amplifiers and filters that allow data to be transmitted without interference. Some industry estimates suggest that there will be 5 billion mobile phone users globally in 2017 with 2.5 billion smartphone users. These devices are changing the way we live our lives and conduct business, and therefore portfolio strategy should reflect shifts in mobile technology.

The Ripple Effects of the Oil Price Collapse

"It is not in the interest of OPEC to cut their production, whatever the price is. Whether it goes down to $20, $40, $50, $60, it is irrelevant."

– Mr. Ali al-Naimi, Saudi Arabia's Oil Minister speaking to the Middle East Economic Survey

Importantly for investors, the ripple effects of the oil price collapse are just beginning to be felt by the global economy

As the quote above indicates, there is a high probability of oil prices remaining lower for longer than many expect. In the October 31st Outlook, we described the supply and demand dynamics of the oil market putting downward pressure on oil prices. The supply-demand imbalance that caused the sharp decline in prices does not seem likely to be corrected any time soon barring a major supply disruption, which given the geo-political situation in the Middle East should not be underestimated. Importantly for investors, the ripple effects of the oil price collapse are just beginning to be felt by the global economy as revenues shift from oil-producers, countries and companies, to oil-consumers. The U.S., Europe, India, China, Japan and Turkey are large oil importers and the lower costs will help their economies and improve their trade balances all other things being equal. Some oil exporters, on the other hand, are in a highly compromised and significantly weakened financial position as outstanding dollar debts will be difficult to service as the dollar continues to strengthen and their oil receipts decline.

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The reversal of a commodity boom is painful and swift, and the adjustment process is even more challenging for economies with an over-reliance on commodity prices to meet their budget and debt obligations

The ability to service debt comes into question particularly if those debts are denominated in appreciating U.S. dollars as evidenced by the recent downgrade of Russia by S&P

Beneficiaries

Among the biggest winners is the United States which is best positioned to take advantage of the price decline as the world's largest energy consumer. Additionally the lowest-cost OPEC producers (Saudi Arabia, Kuwait and the United Arab Emirates) have the largest monetary reserves, $1.5 trillion collectively and have the ability to maintain and gain market share in a low-price environment which could last longer than many believe. The U.S. industries benefitting from lower prices include specialty-chemical, packaging and container, housing and home-furnishing, restaurants, financials, automobile and auto-related, transport and travel-related companies. Manufacturing plants are also benefitting from lower energy input costs which are helping to attract foreign companies to relocate plants to the United States. For the U.S. consumer, it is estimated that the lower prices for gasoline at the pump, below $2.00 in parts of the country, are adding an estimated $200 billion this year to consumers' wallets.

The Challenge for Commodity Producers

The reversal of a commodity boom is painful and swift, and the adjustment process is even more challenging for economies with an over-reliance on commodity prices to meet these nations' budget and debt obligations. According to the Russian Finance Minister Anton Siluanov, the Russian economy could contract by 4 percent next year and their budget could have a deficit of more than 3 percent of gross domestic product if Brent oil prices average $60 a barrel. For oil producing nations, the decline in prices means lower revenues which tend to increase deficits while reducing investment and increasing unemployment and social stresses. For nations that require higher oil prices to balance their budgets, the ability to service debt comes into question particularly if those debts are denominated in appreciating U.S. dollars as evidenced by the recent downgrade of Russia by S&P. The effect of the rapid decline in oil prices is also being seen in Russia's currency, the ruble, which has declined over 40% recently and forced its central bank to raise its benchmark interest rate to 17%. Russia is flirting with economic disaster due to the combined effects of economic sanctions imposed by the Western governments and the impact of the oil price decline as oil revenues account for between 50-60% of its budget. Another "bad actor" is Iran which is losing $1 billion a month in oil revenues for an already troubled economy. Additionally Brazil's currency, the real, has lost more than 17% of its value and pushed the central bank to increase interest rates by 4.5%. The nation has also experienced massive capital outflows with rising inflation and growing social and political stresses. At home, the states that have been involved in the U.S. energy renaissance the past few years such as Montana, North Dakota, Colorado,

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The impact of lower oil prices is also beginning to be felt in the capital markets … Lower oil prices call into question the ability of some of the producing nations and marginal producing companies to meet their debt obligations

Oklahoma, Louisiana and Texas will be impacted as lower prices translate into lower revenues, slowing growth, less investment spending and diminished employment opportunities.

The Capital Market Impact

The impact of lower oil prices is also beginning to be felt in the capital markets as energy companies have borrowed more than $550 billion since 2010, and have recently represented over 15% of high yield debt issuance. Lower oil prices call into question the ability of some of the producing nations and marginal producing companies to meet their debt obligations which could lead to write downs for the lenders (banks). The high-yield bond market is projecting that default rates on energy-related bonds will increase dramatically. The knock-on effect will impact banks and some foreign governments as well. For example, the Brazilian government with its high levels of dollar-denominated debt is exploring ways to assist Petrobras, its leading oil company, to meet its debt obligations. Petrobras has approximately $189 billion in debt, much of which is held in bond funds at major U.S. mutual fund companies. In addition Russia's state-owned oil companies are tapping into the government to help meet debt obligations, and its two sovereign wealth funds will be stretched to meet these debt obligations as well as support the broader economy. It is estimated that Russian banks and companies owe foreign creditors more than $600 billion, a problem that becomes more serious as western sanctions bar most of these borrowers from refinancing with U.S. or European banks. For Venezuela, oil accounts for an estimated 90% of export revenues and some estimate that the country needs oil prices of around $100 a barrel to balance its budget. In order to help offset the revenue losses, Venezuela must increase its production. Credit default swaps suggest that the likelihood of a Venezuelan default within the next two years is around 70 per cent. As oil prices rose the past few years, debt investors have benefitted. The question on the minds of creditors now is what happens if prices remain low for an extended period?

A Potential Game Changer for the Middle East

The potential exists for a redrawing of the map of the region which was established by the Sykes-Picot Agreement of 1916. This agreement was the basis for the subsequent carving up of the predominantly Arab countries of the region between the British and French following the anticipated collapse of the Ottoman Empire. One of the flaws of the agreement was establishing arbitrary borders for the people of the region without understanding the existing religious, tribal and sectarian differences. As we enter 2015, the economic hardships created by the decline in oil prices will add to the social stresses in the region as

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Iran could significantly increase production adding up to 2 million barrels per day into the market … The Saudis might counter by increasing production to drive prices down even further in order to protect their national interests and market share

government instability, high unemployment, rising inflationary pressures, ongoing corruption and growing sectarian differences are the tinder for a potential blow up that could draw economic and military powers into a conflict.

While promoting aggression and instability with its neighbor states, Iran is negotiating to have the western sanctions that were imposed over its nuclear program lifted by the June 2015 deadline. Even before the oil price collapse, these sanctions were having a devastating effect on the economy. Given the potential for prices to remain low or even go lower, the incentive for Iran to strike a deal with the west to remove sanctions is high as it would allow Iran to sell more crude and access its frozen foreign exchange reserves. With the world's fourth largest oil reserves, Iran could significantly increase production adding up to 2 million barrels per day into the market. The Saudis might counter by increasing production to drive prices down even further in order to protect their national interests and market share. The Middle East has been one of the most volatile regions in recent years as the economic consequences of the Arab Spring, the ongoing civil war in Syria, the rise and aggression of ISIS or ISIL, and many leadership changes in almost every nation have sown the seeds for major changes in the area.

Near-term Risks to the Global Economic Outlook

Another risk is that the lower oil prices prompt a physical or cyber-attack on a leading oil producer which would immediately cause prices to spike

As a result of the current divergences in the global economy, the near-term risks to the outlook involve depreciating currencies against a strengthening dollar. This could increase credit default risks by oil exporting nations such as Russia, Venezuela and Malaysia, and have the potential to roil credit and derivatives markets. Another risk is that the lower oil prices prompt a physical or cyber-attack on a leading oil producer which would immediately cause prices to spike. Budget needs will force some countries, with excess production capacity, to put more oil into the market to compensate for the lower prices which will add further to downward price pressure on the oil market. In either case, lower oil prices or a price spike will cause further economic adjustments.

For many emerging economies, a rapid rise in the U.S. dollar will be a negative, raising the cost of imports

From a geo-political perspective, Europe risks a change in the status quo if the anti-austerity movement gathers momentum and gains political traction against current European austerity policy. This will likely accelerate the deflationary pressures, further weaken the euro currency and make it more difficult for the ECB to have a more aggressive monetary policy. The anti-austerity movement could force a modification or less likely a break-up of the European Union.

For many emerging economies, a rapid rise in the U.S. dollar will be a negative, raising the cost of imports, increasing inflationary pressures and further promoting capital outflows. As a result, the markets face the potential for increased volatility early in 2015.

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Investment Implications

Notwithstanding the potential for a market pullback in the first half of 2015, the conditions for 2015 are positive for equity markets as an enduring low interest rate structure coupled with rising corporate profits is constructive for equity valuations

We expect the current low growth, low inflation and low interest rate environment to persist for a considerable period of time – perhaps even through the rest of the decade. The aforementioned risks to the global economy may well make the Federal Reserve hesitant to increase interest rates this year. Notwithstanding the potential for a market pullback in the first half of 2015, the conditions for 2015 are positive for equity markets as an enduring low interest rate structure coupled with rising corporate profits is constructive for equity valuations. We would use higher than normal cash positions to take advantage of any pullbacks stemming from potential capital market disruptions. Current economic conditions are supportive of U.S. corporate profits, which should in turn lead to increasing capital expenditures, gradual improvement in employment, and a further strengthening in equity returns relative to other investment choices. Short of an exogenous event, the current positive trends in place are supportive of equity valuations and further multiple expansion, particularly in the second half of 2015. After the strong returns in the stock and bond markets in recent years, today's investment opportunities will require greater selectivity, with bond investing offering little in the way of current compensation due to the low level of today's yields.

The persistent deflationary pressures present in the global economy argue for a broadening of portfolios targeting the drivers and beneficiaries. This past quarter, we have reduced our weighting in energy holdings. Technology remains a disruptive and deflationary business as it increases productivity and hence demand for its products, and as such will remain an overweight in the portfolio. As corporate profits continue to improve and companies take advantage of low rates to finance debt, investors should expect increasing capital expenditures with tech and infrastructure companies to be among the primary beneficiaries as well as continued merger and acquisition activity. Client portfolios will reflect the beneficiaries of this Outlook including:

– Technology companies benefiting from the dynamic growth in search, device sales, memory and storage, amplifiers and filters;

– Industrial investments in defense (including cyber security), transportation, power generation and aerospace companies;

– Consumer companies with pricing power that benefit from lower input costs and stronger consumer spending;

– Financial companies that benefit from increasing consumer discretionary income, the stronger U.S. economy as well as company specific dynamics;

– Health care companies with breakthrough drugs, strong product pipelines and growing dividends

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Since the Outlook for low interest rates and rising corporate profits should be with us in 2015, dividend yielding securities with the prospect of dividend increases should continue to be beneficiaries. Companies that can utilize new technology to take market share from companies employing traditional ways of doing business would warrant strong consideration for portfolio inclusion. We expect the U.S. economy to continue on its current growth trajectory, but market participants should favor greater selectivity in investment choices. The U.S. equity markets have performed well for several years and should continue to do so, despite periods of market pullbacks, because the outlook for the three elements that drive equity valuation, which are corporate profits, interest rates and inflation rates, remain favorable in 2015 and likely beyond.

On behalf of the team at A.R. Schmeidler, we thank our clients and deeply appreciate the trust they place in us each day. We are particularly excited about the future for our firm as we look forward to our new partnership with Pine Street Asset Management. We wish you and your families a happy, healthy and prosperous New Year.

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