WOLF GROUP CAPITAL ADVISORS
GLOBAL WEALTH MANAGEMENT

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Not too long ago someone suggested that the current bull market is the most hated one in history. That is to say, that despite negative political rhetoric, and dismal headline news, the equity market continues to move higher, apparently oblivious to the doom and gloom surrounding it. Contrary to many widely held and simple reasons for the market's rise (the Fed's easy money, a "dead cat bounce" from the recession lows, etc.), the market has risen on the back of solid fundamentals. Steady earnings growth, modest (but consistently positive) economic growth, low inflation, employment growth (all the jobs lost during the recession have been added back), improving consumer sentiment and spending, low interest rates (the one fundamental positive linked to the Fed) and now lower oil prices have all helped to move stock prices higher.

The recent decline in the price of oil has surprised nearly everyone. Its rapid fall is a timely reminder of the complexity of the global economy and the capital markets. Over the last few months, we have fielded many questions about oil's precipitous drop - "Is it just a supply/demand imbalance?" "What is OPEC doing about it?" "Can fracking be the root cause?" "What's the future of oil?" "What other important implications are there besides lower gasoline prices?" We will share with the reader what we have learned about oil right after the review.

Fourth Quarter Review

For the quarter (and the year), the major indices did well and outperformed nearly everything else. European markets, emerging markets, small caps and commodities all continued to struggle. Active management also took a back seat to the major indices last year – *Barron's* estimates only 15% of active portfolio managers beat their respective benchmarks in 2014. The strong U.S. dollar appears to be fueling some incremental demand for U.S. stocks and particularly bonds. The 10-year U.S. Treasury bond currently trades at levels normally associated with recessions. With U.S. GDP consistently above 3% over the last few quarters, one must conclude that the recession can only be seen far away in the rearview mirror.

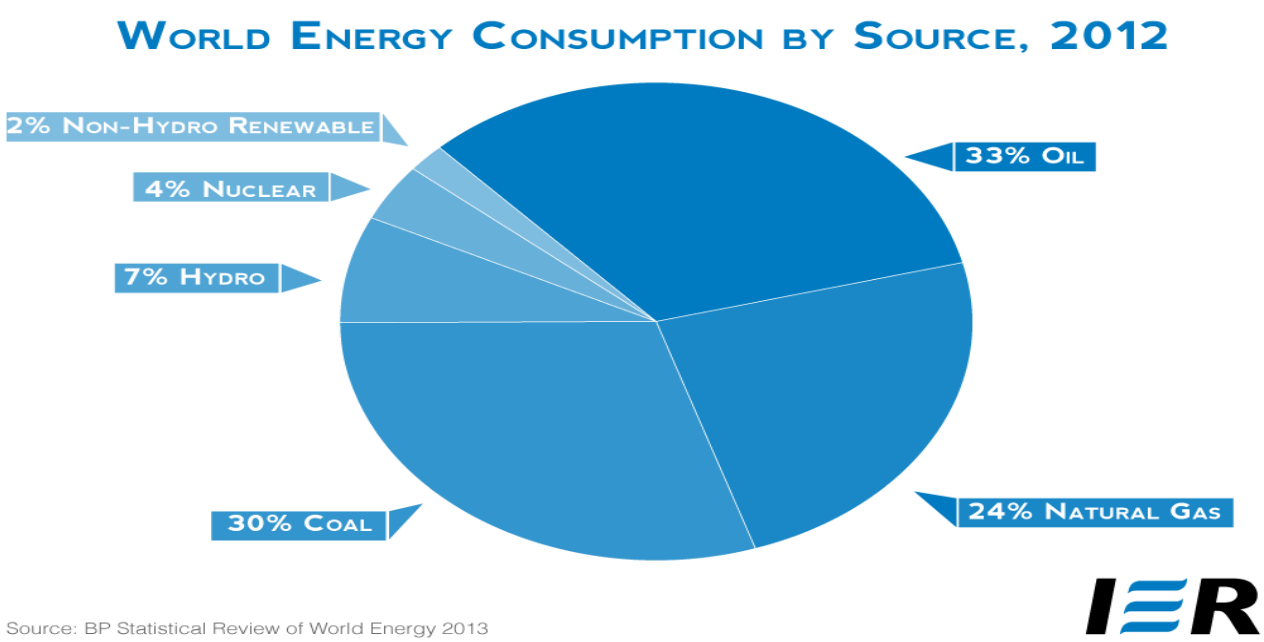
In our view, the most outstanding feature of the quarter was the massive decline in commodity prices. A slower Chinese economy is clearly one factor to this, but the fall off in energy prices (a big component of this commodity index) is also important here.

Here is what the fourth quarter looked like by the numbers:

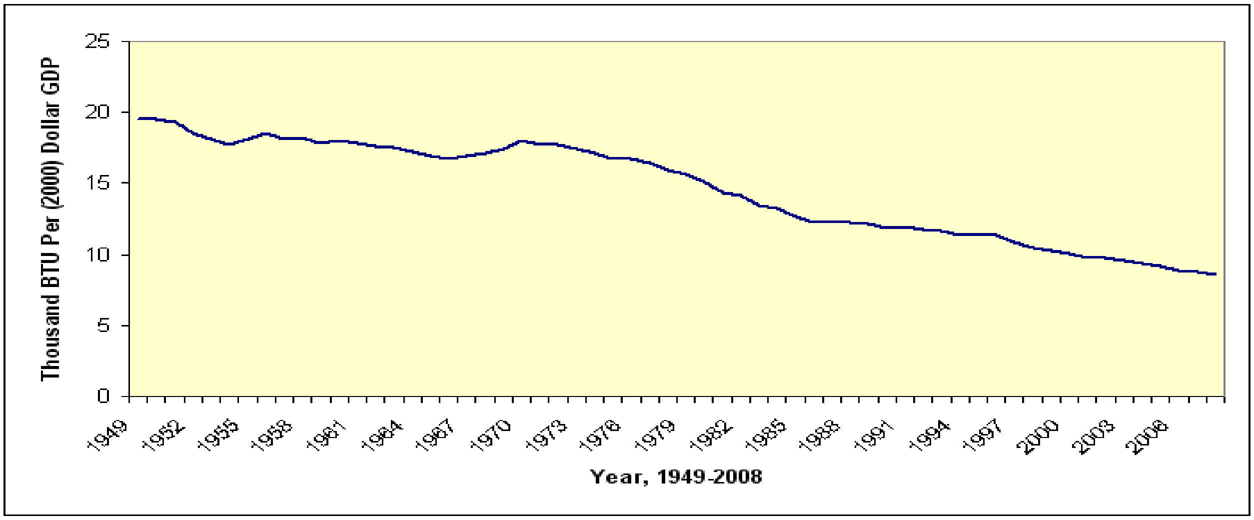
Index	4th Qtr 2014	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	5.2%	10.0%	10.0%
S&P 500	9.7%	13.7%	13.7%
NASDAQ	5.4%	13.4%	13.4%
Russell 2000	9.7%	4.9%	4.9%
MSCI EAFE	-3.5%	-4.5%	-4.5%
MSCI EAFE Small Cap	-2.2%	-4.6%	-4.6%
MSCI Emerging Markets	-4.4%	-1.8%	-1.8%
Barclays Aggregate Bond	1.8%	6.0%	6.0%
Barclays Municipal Bond	1.4%	9.1%	9.1%
Dow Jones Commodities	-11.9%	-18.8%	-18.8%

Oil, Not Love, Makes the World Go 'Round

Despite the huge push toward alternative/reusable fuels, those extracted from the ground still comprise over 85% of the energy used globally. The Institute for Energy Research estimates that by 2040, coal, oil and natural gas will continue to capture a majority share (78%) of the world's energy consumption.



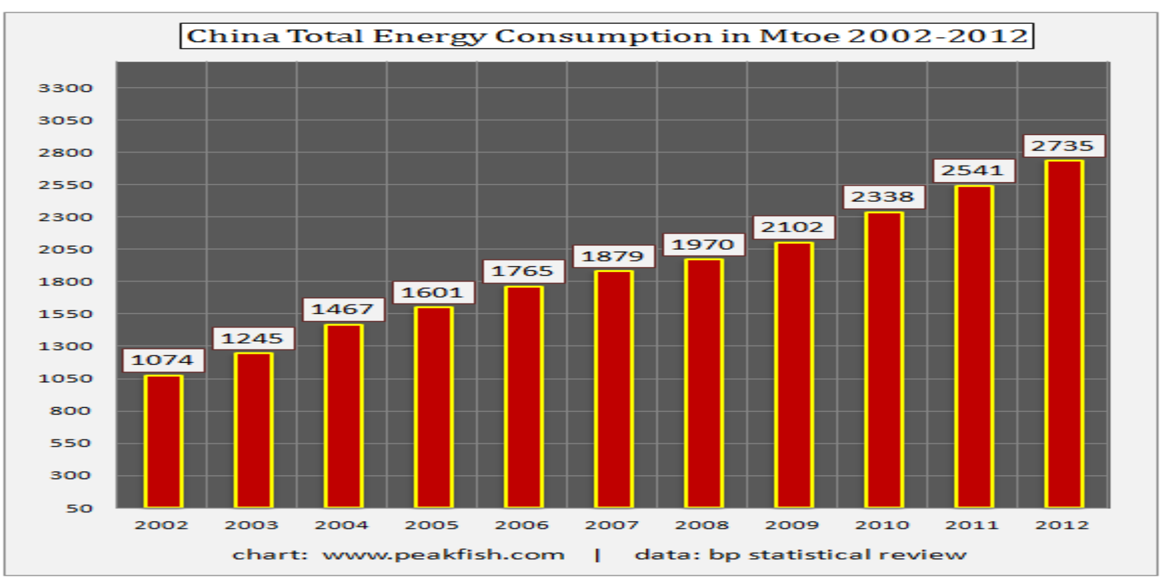
In developed, more service-oriented economies such as the U.S., oil consumption is a smaller part of the economy than it was 40 years ago, when the first "oil shock" occurred. The chart below indicates the amount of energy (in BTU) required to produce a dollar of GDP.



Source: Praveen Ghanta Seeking Alpha "U.S. Economic Energy Efficiency: 1950-2008"

This increased energy usage efficiency by the United States was the main reason we (among others) were not overly concerned by the impact the large spike in energy prices back in 2008 might have on the economy. We concluded back then that because the cost of energy was a much less important input to the overall U.S. economy, higher oil was unlikely to create a recession.

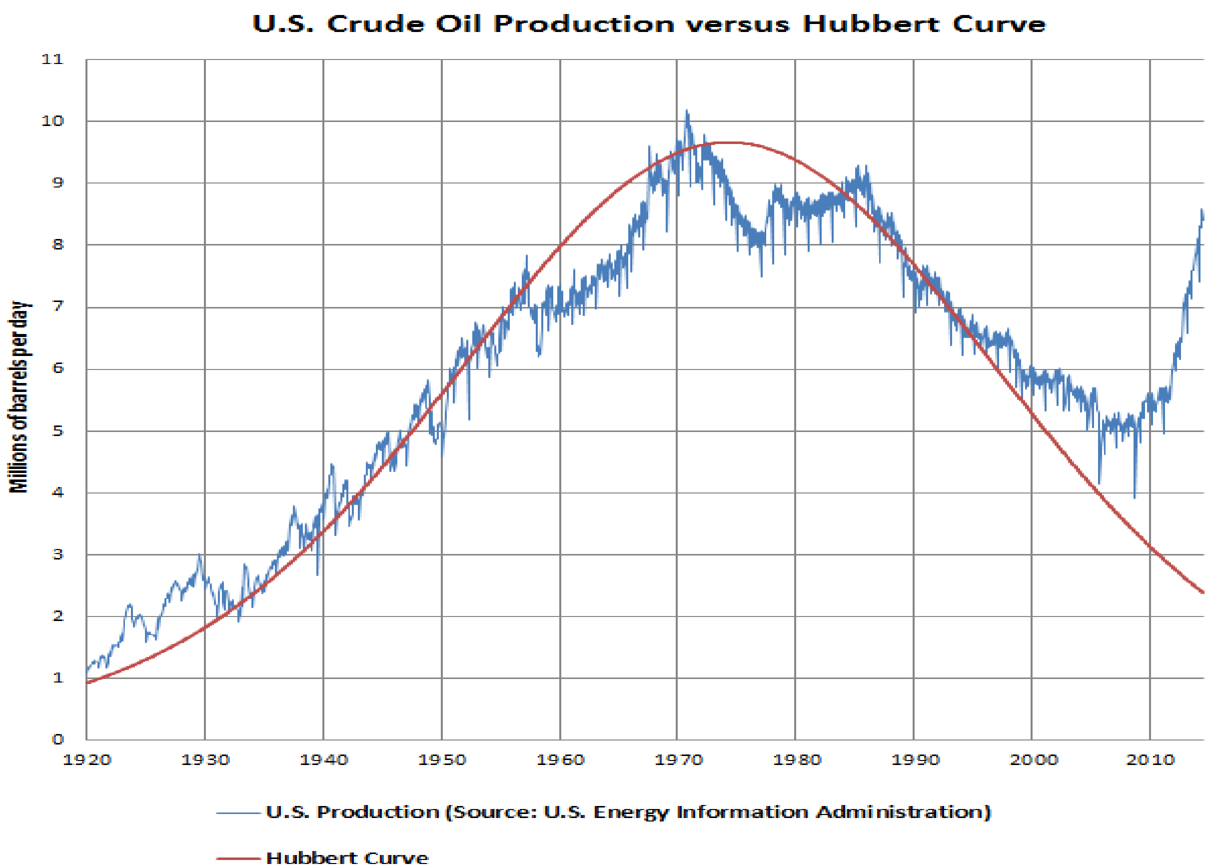
The situation is just the reverse for emerging economies, especially China, which has consumed an increasingly large amount of energy over the last decade. The experts expect China, India, Brazil and their peers to continue to use a disproportionate measure of energy as they move past this current slow patch and resume their paths to modernization.



"Peak Oil" Moves to "Cheap Oil"

This might be a good time to review some history of oil production. In 1956, M. King Hubbert, a geoscientist working for Shell, created the theory of "peak oil." By analyzing the size of oil fields and natural gas reserves, he predicted that the rate of petroleum production would over time look like a bell curve. The high point of oil production, according to this theory, would occur sometime early in the new century. As oil prices climbed to $140/bbl in 2008, many observers were quick to declare Hubbert's theories as fact and that oil prices would increase further as oil production fell.

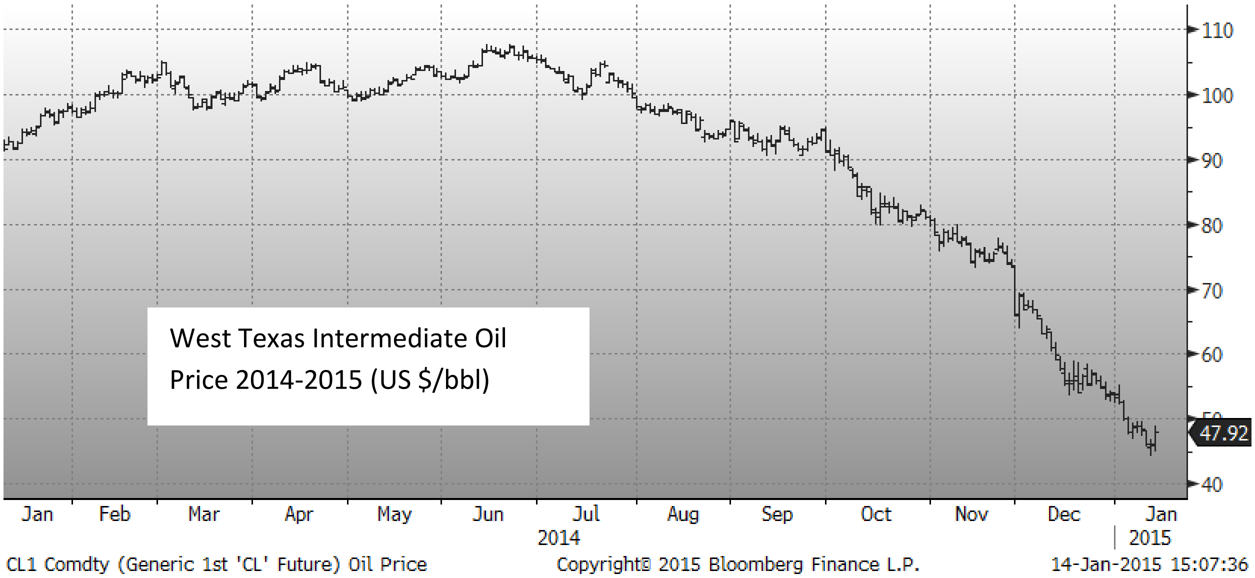
What Hubbert and many other experts could not predict was the vast improvements in oil extraction technologies that has allowed the capture of fossil fuels from hard to reach places (oil sands/shale, deep water, etc.). The chart below shows what has happened to oil production in the U.S. versus Hubbert's theory.



We have seen many "doomsday" theories (population, food consumption, etc.) upset by changes in technology. Many of these theories rely on the "ceteris paribus" ("with other things the same") logic that inevitably fails as important factors do indeed change. It is nearly impossible to hold all other things constant in a dynamic, complex, and fluid world. This is one of the great benefits of Adam Smith's invisible hand – where money can be made, companies will deploy technology to this end.

So Why the Big Decline in Oil?

The first and simplest reason is that supply has gone up and at the margin, demand has fallen a bit. In the view of most energy experts, supply and demand alone cannot account for the 50% drop in oil prices since June of 2014.



The second reason may be harder to quantify, but clearly has had an impact. When a large consumer of energy, like an airline for example, worries about the future price of oil (due to its potentially big impact on profitability), it can hedge future costs in a number of ways. The cheapest and easiest way is to buy a futures contract, which is a financial instrument that protects the energy consumer when energy prices rise. In addition to large energy consumers, investors and speculators can also use futures and other financial instruments in an effort to make money betting on the price of oil. When oil begins to dramatically decline, big energy users and speculators may reduce their hedging or long energy trades. They may even sell short oil futures betting on further price declines. Regardless of the exact details, a reduction in hedging/speculative activity probably put incremental pressure on the price of oil as it began to fall. Back in 2008, some experts estimated that as much as 60% of the price of oil could be attributed to financial speculation. Although we cannot quantify this impact now, undoubtedly, it has had an impact on oil's recent price action.

A third important contributing factor is the Organization of Petroleum Exporting Countries (OPEC). In a recent meeting, OPEC decided to not cut production (as it has in times past) to support the price of oil. Although the organization did not clearly explain this non-action, OPEC watchers speculate that the organization welcomes lower oil prices (as least for a period of time) in order to hurt the new entrants into the oil production game – North American drillers in oil sands/shale.

Other reasons for the decline in oil are out there (a concerted effort by Western nations to punish Russia or Venezuela, etc.), but in our view seem a bit too much like conspiracy theories to be taken seriously.

Implications of Lower Oil Prices

Here are a few of the impacts we see from lower oil prices:

1) Tax cut for consumers – Goldman Sachs estimates that U.S. consumers will pocket $125-150 billion of energy savings that might add 0.5% to U.S. GDP.
2) A pick up in driving in the U.S. this summer.
3) Negative impact on earnings for energy companies, banks that lend heavily to the energy industry and other suppliers to the industry.
4) Potential increase in political volatility in Russia (50% of the nation's fiscal budget revenue comes from energy exports), Venezuela (which the Energy Information Administration says has 93% chance of defaulting on its debt over the next five years), Nigeria, et al.
5) Big positive for China. China has extended new credit to Venezuela and Ecuador in an effort to secure cheap oil flows into the future.
6) Fed's 2% inflation target – probably not reachable with the next 12 months. Could this affect the timing of the less accommodative monetary policy?

Finally, we may be actually witnessing the birth of a free-market in oil, where market forces (and not OPEC production quotas) determine its price.

Therefore, What?

Back in 2008, we felt that oil prices had peaked when a well-known Wall Street research group predicted that oil would reach as high as $250/bbl. Oil prices began to fall soon after that. This week, Saudi Prince AL Waleed may have given us a "buy signal" in oil when he declared,"… we're never going to see $100-a-barrel oil prices again."

We rarely make sector adjustments to our portfolios. In fact, the last time we did was to underweight the energy sector in 2008. We are now recommending the opposite, and would move to overweight the energy sector in our individual equity client portfolios. We expect that the portfolio managers who run the mutual funds owned by our clients will likely adjust their portfolios to a higher exposure to the energy sector over time.

This move is in line with the comments of Andrew J. Hall, one of the most successful energy investors, who recently said, "Oil prices will stay under pressure in 2015, however, current prices are not sustainable longer term. The interplay between extreme weakness in the short term and the potential for supply shortfalls in the medium term should create attractive trading opportunities over the course of the next 12 months."

The Outlook

In our view, the fundamentals remain positive for the U.S. equity market. Consensus GDP growth for 2015 looks to be around 3.0%, a modest acceleration from the 2.3% average since the recession ended in 2009. A modest pickup in wages in the U.S. (which were up 1.3% in 2014) also appears likely, and would be a big positive. Inflation will likely remain muted throughout the year. This could lead the Federal Reserve to postpone raising interest rates until 2016. Stronger economic growth and unexpectedly low interest rates could create an environment similar to 1998 – a very positive time for

U.S. stocks. In past recoveries, low interest rates provided a strong incentive for consumers and businesses to borrow more. This time around, we have not seen a big increase in borrowing relative to asset values, cash flows or incomes. All told, the U.S. economy and stock market look to be in great shape.

For Europe, we might expect additional monetary stimulus. The emerging economies seem to be struggling right now, but in general, their balance sheets are healthier than before and are less reliant on foreign capital. A stronger U.S. dollar is a strong positive for export nations. Jim Swanson, a strategist for MFS Investment Management reminds us that a lower oil price is a huge positive for 70% of the world's nations. Historically, a 20% drop in oil prices has increased global real GDP by 0.5-1.0%. We think current global share prices may not yet reflect this potential positive.

Jeffrey Kleintop, a market strategist at Charles Schwab, recently published a report outlining five contrarian surprises for 2015. Because so many forecasts we see fall safely into the comfortable range of the consensus, we always like to consider these out-of-the-box ideas. Here is his list: 1) China's economic growth accelerates, 2) the Fed does not raise rates in 2015, 3) Europe enacts aggressive fiscal stimulus (as opposed to just talking about it), 4) the U.S. dollar weakens and 5) stock market volatility increases. We have no strong opinion about the likelihood of these things coming to pass, but they would all be positives (except #5 perhaps) for the U.S. stock market.

We continue to think that stocks are likely to outperform bonds and cash in a slowly rising interest rate environment. For investors owning bonds we see no reason for excessive worry. In a balanced portfolio, bonds lower volatility and enhance yield. We continue to think that cash (beyond some reasonable "rainy day" reserve) is the worst asset for investors to hold. We would remind our clients that bull markets do not die of old age, but they usually end just before a recession begins or when investor sentiment reaches euphoric levels. We sense we are still far away from either of these situations.

Sincerely,

Wolf Group Capital Advisors