INVESTMENT OUTLOOK

DIXON, HUBARD, FEINOUR & BROWN, INC. *investment counsel*

- Strong fourth quarter for U.S. stocks.
- Oil prices plunge.
- Economy improves in U.S., weakens in Europe and other major economies.
- Trends still favor U.S. markets.

Also in This Issue

Fourth Quarter 2014 Review & Outlook for 2015

by Whitney Brown

The major U.S. market indexes logged solid gains in the fourth quarter. Among large capitalization indexes which have dominated the market action over the past year, the tech-heavy NASDAQ edged out the broader-based S&P 500. After dropping into negative territory several times over the course of the year, the small cap Russell 2000 Index roared back to life with a gain of over 9% in the final quarter. Foreign market indexes finished on a down note as plummeting energy prices, general commodity price weakness, and the declining value of the euro took a toll on developed country markets of Europe and Japan as well as emerging ones such as Brazil.

The predominant economic theme of the past year or more has been the divergence between the positive trends in the U.S. economy and the deteriorating performance of much of the rest of the world. That divergence is illustrated very clearly by the dramatic difference in equity market returns. The S&P 500 Index bested the MSCI EAFE, a widely followed developed foreign market index, by 18 percentage points, one of the widest spreads in the past 20 years. In part, the divergence relates to the fact that the U.S. is much further along in the process of shoring up our banking system and deleveraging our economy in the aftermath of the 2008 financial crisis. In fact, those processes are largely complete in the U.S. and only in the middle or early stages in Europe and China.

Market jitters since the start of 2015 have centered on whether or not the U.S. economy can continue to make progress while weakness persists in most of the rest of the world. We'll have to wait for the answer, but the equity markets are typically very good indicators of future economic developments; and the longer trend for the U.S. is still very positive.

Twists and turns in the equity markets have been interesting to negotiate, but the most dramatic developments of recent months have occurred in the commodities and bond markets. Notably, crude oil prices have dropped over 50% in six months (please see article on page 2). A good bit of the drop can be explained by supply and demand, but the strength of the U.S. dollar plays an important role as well. Globally most commodities including crude oil are priced in U.S. dollars. Since, as mentioned above, the U.S. is much further along than most of the world in recovering from the financial crisis, our currency has strengthened relative to others. It follows that it takes fewer dollars to buy a barrel of oil than it did before, driving the global price lower.

The steep decline in bond yields was largely unexpected at the start of last year. The yield on the 10-year U.S. Treasury note fell from 3.0% to under 2% in a year's time. Most expected

Market Measures	4th Qtr.	YTD
S & P 500 (price)	4.4%	11.4%
Dow Jones Industrial Average	4.6%	7.5%
NASDAQ Composite	5.4%	13.4%
Russell 2000	9.3%	3.5%
MSCI EAFE	-3.9%	-7.4%
Barclays Capital Inter Gov't/Credit Bond Index	0.9%	3.1%
	12/31/14	12/31/13
10-Year Treasury Bond Yield	2.17%	3.03%
Three-month Treasury Bill Yield	0.05%	0.07%

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Oil Prices - What's Happening? by Jim Hall

The stock market and energy futures have endured some wild swings over the past few weeks. To a great degree, these wild swings seem to have been tied to a precipitous decline in the price of oil. During the first six months of 2014, we saw the price of a barrel of West Texas Intermediate Crude oil (WTI) rise from roughly $90 to a peak of $101; however, from this June high, oil plunged to the 12-31-14 closing price of $53.75 (roughly 53% of its peak value).

It is highly unusual for oil to drop so far so quickly, and unfortunately the quick drop caused an equally sharp decline in the price of many energy stocks. This rapid decline "spooked" the equity market just enough to cause a quick sell-off across the board until folks had a chance to evaluate and determine the lower price of oil might actually create a "tailwind" that could serve to boost the market.

As is the case with most every investment, we can look to the theory of supply and demand to explain why the price is down so sharply. Many of us can remember those days in the 1970s when OPEC (Organization of Petroleum Exporting Countries) cut their production and successfully drove up global prices because they controlled a majority share of the oil produced in the world. At the time, the non-OPEC members were not able to raise their production sufficiently to offset the amount of production OPEC had curtailed which caused the global supply to be less than the global demand. Once the price rose enough, the OPEC countries increased their production enough to just equal or only slightly exceed demand.

Over the years, Saudi Arabia has become the dominant producer inside OPEC and seems to control or at least steer most of the decisions the organization makes. Russia is the world's largest non-OPEC oil producer. However, due to technological gains in detection, fracking and drilling, the United States has become the 3rd largest producer in the world (see chart).

In accordance to an estimate held by IEA in 2011 , 63% of the world's total oil output is obtained by the top ten largest producers which are given below:

Rank	Country	Production (bbl/day)	Share of World's output (Percentage)
1.	Russia	10,730,000	12.65%
2.	Saudi Arabia	9,570,000	11.28%
3.	United States	9,023,000	10.74%
4.	Iran	4,231,000	4.77%
5.	China	4,073,000	4.56%
6.	Canada	3,592,000	3.90%
7.	Iraq	3,400,000	3.75%
8.	United Arab Emirates	3,087,000	3.32%
9.	Mexico	2,934,000	3.56%
10.	Kuwait	2,682,000	2.96%

The extra volume the United States has been producing combined with a shrinking global demand due to the economic slowdown over the past few years has served to push the available supply beyond the global demand. It is estimated the supply now exceeds demand by as much as 2 million barrels/day. Any country that has extra storage capacity has stockpiled as much oil as their tanks can hold so any extra supply now serves to drive the price down until it reaches a level where someone will buy.

All of the oil producing countries have become heavily dependent on the income generated from the sale of their oil—so much so, that they can't bear the idea of cutting production and temporarily earning less money in the hopes that lowering supply below demand would eventually cause the price to increase again. Their fear is the United States would continue to ramp up production and garner an even larger share of the market.

It now appears the strategy being pursued is one of allowing the market to determine the price of oil. Because Supply is outpacing Demand, as the price of oil naturally drops, it may not be as cost-efficient to continue producing and selling for lower prices. Every oil well has a certain "cost-of-production" associated with each barrel of oil being produced. Although no countries will formally admit what their "average cost" to produce a barrel of oil is or might be, depending on the accessibility and complexity of extraction, it is speculated to range from a high of about $90/barrel for countries drilling in the Arctic down to about $10/barrel in Saudi Arabia. The theory is as the price falls, companies will cease production from the more expensive wells and thus eventually find a point where production lines up with demand. In a normal "free market" this process would happen in fairly short order. Because the Saudis have some significant production cost advantages, they appear to be applying an extra bit of downward pressure on prices in an effort to slow our "fracking" production; they have lowered the price of oil sold to the United States.

Unfortunately, to further complicate the process, the oil-producing countries' governments have grown so economically dependent on the cash their oil generates, they may not cease any production; in fact, they may have to produce more. An analysis of many of the oil-producing countries' break-even price, based on current production levels, would indicate several are already needing oil to be north of $100/barrel to meet their financial obligations. Their only option would be to try to produce and sell more to generate the

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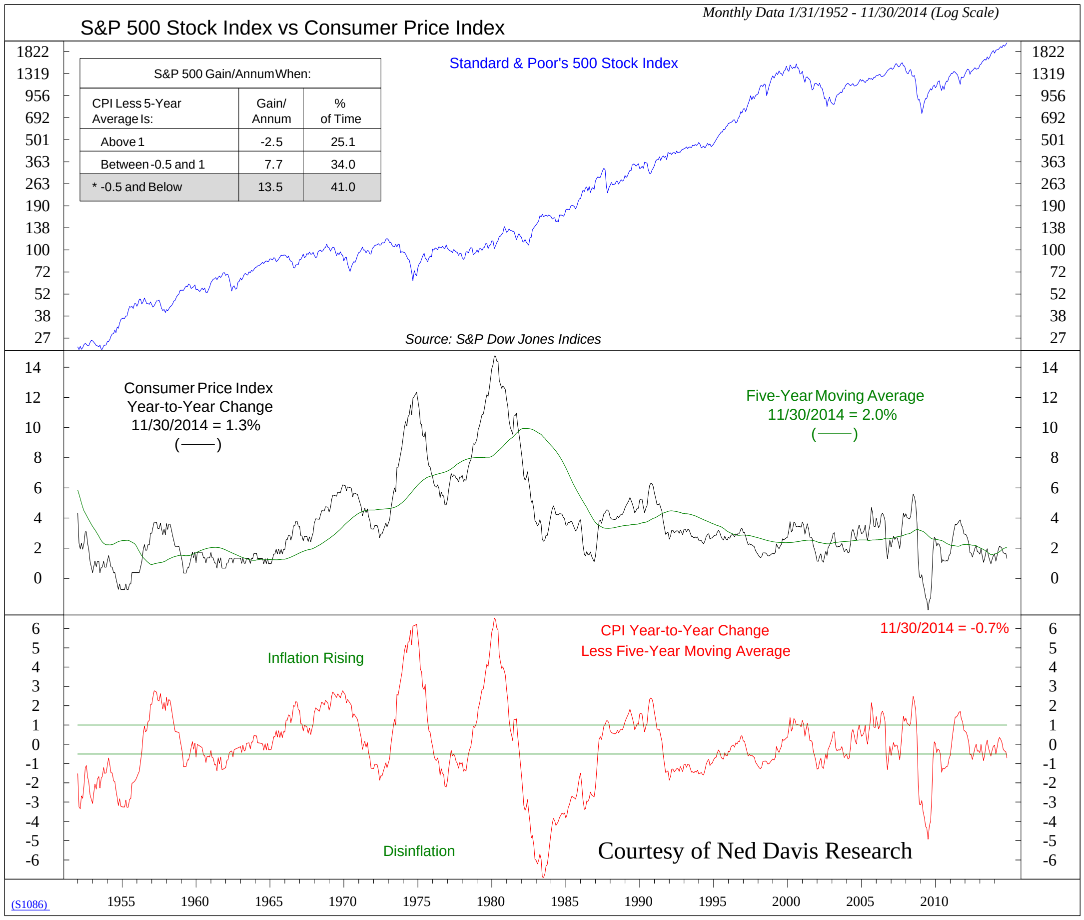
Stock Prices Affected More By Earnings or Inflation? by Stebbins Hubard

Earnings are universally believed to be a principal driver of stock prices. When examining earnings since 1927, the median earnings gain over 4 quarters was 8.0%. Looking at returns of the S&P 500 index shows that when earnings were below the median, the S&P rose an average of 7.1% annually. However, when earnings growth was above the median, the S&P advanced only 4.6% annually.

Examining inflation over this same time period shows that the Consumer Price Index (CPI) has had a median annual rise of 2.8%. During the periods when the CPI was less than the median, the S&P rose at an annual rate of 9.3%, but when inflation was above the median, the S&P averaged only 2.3% annually.



Therefore, it appears clear that low inflation is better than strong earnings for the stock market. This relationship holds for the current bull market (January 2009 to present) as CPI has averaged 2.05% annually (below the median) with earnings of the S&P averaging 6.4% (below the median) while the S&P 500 index has risen an average of 15.1% annually. The chart above of the S&P vs the CPI shows this relationship from 1950 to present.

Fourth Quarter 2014 Review and Outlook for 2015 (continued)

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rates to rise as the U.S. economy improved and the Federal Reserve withdrew excessive stimulus. Again, the relative strength of the dollar and weakness abroad supported demand for Treasuries and drove rates lower.

Economists and the markets are in the process of sorting out whether or not lower energy and commodity prices are a net positive or negative for the U.S. and global economies. Most individual, business, and government consumers of energy will benefit from lower prices, but on the other hand, the U.S. shale oil boom has made energy a bigger part of our economy, and a number of developing country economies are heavily dependent on the export of oil and other commodities. There are different winners and losers when energy prices are high or low, but it is safe to say that low prices put more money in the pockets of those who need it most.

Current trends would favor U.S. markets leading again this year as low inflation and moderate-to-slow growth continue. A recent broadening of the market indicated by the resurgence of small cap indexes also implies underlying strength. If indeed the Fed does begin raising rates this year, it would be a vote of confidence in the economy, and it would be done very gingerly so as not to create market turmoil or undo the painstaking economic progress of recent years. There are more attractive equity valuations in other areas such as Europe and Japan that could lure investors away from U.S. stocks, but absent signs of economic growth there or further European Central Bank easing, investors are more likely to stick with what has been working.

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Tax Increase Prevention Act by Ted Feinour

The Tax Increase Prevention Act, which was enacted December 19, 2014 extended the provision for IRA owners 70 ½ or older to make direct charitable contributions as part of the required minimum distribution. The gifts had to be made directly from the individual retirement accounts to charitable organizations.

This act, however, only allowed or extended this provision until December 31, 2014. It **did not** authorize this practice for 2015 or beyond. Once again individuals will have to proceed through the year hoping that by year-end the provision will be re-approved. The new Congress hopes to work to initiate tax reform this year, so it is possible that this provision will be allowed on a more permanent basis.

The annual gift exclusion amount that one person may give to another person remains at $14,000 for 2015. A husband and wife may join together in making a gift of $28,000 to a single individual. Gifts may also be made to establish 529 college fund accounts, and front loading provisions are also available. This means that an individual may make an initial contribution of up to five times the annual gift exclusion amount at one time.

Members of our firm are happy to discuss the creation of 529 plans for children and grandchildren and are pleased to work with our clients' attorneys or accountants when planning these accounts.

Oil Prices — What's Happening (continued)

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Budget breakeven prices:

Fiscal break-even price (Brent, USD bbl)

	2006	2007	2008	2009	2010	2011	2012	2013	2014f	2015f
GCC	32.5	43.1	43.8	70.3	68.4	78.8	73.3	83.6	89.0	94.0
Bahrain	57.9	66.9	80.0	82.9	103.9	118.1	127.1	134.4	136.2	138.1
Kuwait	26.4	32.6	42.1	47.0	45.7	47.4	53.6	68.3	75.5	78.4
Oman	80.7	99.3	96.4	69.9	80.2	112.3	112.5	106.5	100.7	110.0
Qatar	43.4	41.8	49.1	27.2	61.7	80.1	65.5	60.5	71.3	76.8
S. Arabia	38.7	52.7	47.0	72.6	70.6	84.5	80.9	93.1	99.2	104.4
UAE	18.3	24.5	43.7	105.7	86.3	94.6	77.3	82.7	80.2	80.8
Nigeria	56.3	75.1	79.9	125.3	105.3	128.5	112.3	141.7	126.2	122.7
Russia	21.4	28.1	59.7	109.5	116.7	102.8	112.0	113.9	100.1	105.2
Venezuela	81.7	76.9	134.2	140.7	194.4	145.7	151.5	149.9	162.0	117.5
Brent price	65.4	72.7	97.7	61.9	79.6	111.0	111.7	108.9	106.5	103.3

Source: Deutsche Bank estimates

cash they require to operate their governments (see chart above).

Barring any cataclysmic events, it may take a year or more to wean production down to a level to be roughly equal to demand or have the global economy grow enough that demand roughly equals supply. In the meantime, we can directly enjoy lower gas prices when we fuel our cars, and we can indirectly enjoy the reduced prices as goods that require petroleum products in the manufacturing process will cost less to produce.