TRILLIUM | Market Commentary

COMMENTARY
December 31, 2014 (4th Quarter)

With a positive outlook for the U.S. economy, increasing consumer confidence, falling unemployment, and extremely quiescent inflation, our outlook for U.S. stocks should be extremely positive, and we are, indeed, positive.

We continue our positive outlook on U.S. financial markets, despite increased potential risks. We expect U.S. stocks to return about 5% to 6% more than U.S. bonds. While we do believe the Federal Reserve will begin to raise short term interest rates mid-year, U.S. intermediate and long term rates will likely be constrained by the very low interest rates available in other major currencies.

After a very slow start in 2014, U.S. economic growth accelerated sharply in the third quarter, propelling the U.S. economy to a 2.7% year-over-year growth rate, matched with Australia and second only to China's officially reported growth rate in the Group of 13 major industrialized economies. At the same time, the Euro-Zone continues to struggle, with a GDP growth rate of only 0.8% year over year, as continuing restrictive fiscal policies and largely powerless monetary policy restrain growth, leading to a Euro-Zone-wide unemployment rate of 11.5%. Non-Euro-Zone European countries such as the United Kingdom and Sweden achieved growth rates over 2% in 2014.

At the beginning of 2014, we anticipated an overall positive year for U.S. investors, outpacing returns for international developed equity markets, emerging equity markets, and domestic bonds. Overall, this expectation was met. Within U.S. financial markets, investors' experiences diverged significantly depending upon allocations to market capitalization, sector, and asset class. Large capitalization stocks, as represented by the S&P 500, had a total return of 4.9% for the quarter and 13.7% for the year, while the Russell 2000, a small capitalization stock index, returned 9.7% for the quarter but only 4.9% for the year. This significant advantage of large capitalization stock returns over small capitalization stock returns was a boon for passive investors; correspondingly, over 90% of U.S. active managers did worse than their benchmarks. Within the S&P 500, the best performing sector, Utilities, increased in price by 24.3%, over 34% better than the 10% price decline for Energy stocks. The Barclays Government-Credit Intermediate Bond Index managed only a 3.1% return for the year. The US dollar strengthened significantly against other currencies, so that local currency returns translated into quite negative returns for dollar based investors investing in overseas markets.

The biggest surprise of the year was commodity price declines. Copper and gold have fallen by 36% and 35% respectively from their highs in 2011, including 16% and 17% declines in 2014. But the precipitous decline in the price of oil, down 48% from its June high, has significant potential to wreak geopolitical havoc. Increased U.S. production accounts for 1.6 million barrels per day, or 89%, of the 1.8 million barrel increase in global supply in 2014 vs. 2013. Global consumption increased by only half of this, or .9 million barrels per day. Neither oil supply nor oil demand responds quickly to price changes. Usually, significant changes in either demand or supply in response to price changes require years, because they depend upon changing the infrastructure. Oil and gasoline are inputs, and their consumption in the short term depends primarily upon non-price factors — such as the fuel efficiency of existing vehicles and the coldness of the winter. Saudi Arabia has indicated that it will not reduce supply to keep the price up, and new sources of supply in the US are also unlikely to reduce production, as the price is still well above the cost to produce each additional barrel, and much of the increased production is debt financed, so the producers need the cash flow from sales to cover the debt payments.

For the U.S., the overall effect of the oil price decline is likely to be positive, particularly for lower-income consumers. In 2013, the lowest quintile of U.S. households spent 12% of their income on gasoline; the highest quintile of households spent just 2%. A 30% decline in gasoline prices would lead to a considerable 3.6% increase in spendable funds for the lowest quintile, and most budget-constrained households, which should boost other consumption spending. In addition, declining gasoline prices tend to increase consumer confidence, further supporting consumer spending. However, new spending on oil production is likely to be curtailed, which will affect employment in the oil patch states such as Texas and North Dakota. Overall, we expect U.S. economic growth to increase to about 4% in 2015. Internationally, the huge swing in the price of oil has highly differentiated effects, with OPEC countries, Russia, Brazil, Canada, and Australia losing significant revenue, and the remainder of the world, especially Europe, gaining from the price decline. Russia has already experienced significant stress. The value of the ruble has plunged, and Russia's central bank raised their key short term rate to 17% to stem cascading capital outflows. We anticipate that Russia will enter a significant recession next year, raising the risks of a Russian default.

For the Euro-Zone nations, the drop in the price of oil will partially offset the loss in purchasing power from the depreciation of the Euro. However, the bigger issue for the

Euro-Zone is its extremely low economic growth. While European Central Bank leader Mario Draghi has pledged to do "whatever it takes," and is widely expected to announce a round of quantitative easing in late January, economic growth is expected to be less than 1% in 2015. Consumer price inflation dropped below 0% in December, indicating that the European Union is not meeting its inflation target of 2%. Greek membership in the European monetary union continues to be at issue. A Syriza victory in the upcoming Greek elections may lead a so-called Grexit, or attempt by Greece to exit the Euro currency. If this is successful, it may encourage other countries struggling with the structural reform demands to renegotiate as well. However, we believe that the risk associated with a potential Greek exit from the Euro is considerably smaller than it has been in prior years, both because investors have reduced their exposure to Greece and because Syriza has been indicating that it would prefer to negotiate rather than exit.

After successfully concluding its Quantitative Easing program in September, the Federal Reserve has begun to signal that it may begin raising short term interest rates sometime in 2015. The Federal Reserve has a dual mandate to balance both inflation and unemployment rates. Inflation rates remain extraordinarily low, and employment has recovered significantly in the last three years, raising the possibility that the Federal Reserve may start reducing the level of liquidity in the market by raising short term rates. We do not anticipate significant increases in longer term interest rates in the U.S. in 2015. Rather, we anticipate that any tendency for longer term rates to rise in the U.S. will be met by capital inflows from Germany, Switzerland, Japan, and Great Britain. Currently, yields on 10 year government bonds are 2% in the U.S., 0.3% in Japan, 1.7% in Great Britain, and 0.5% in Germany. Any increase in U.S. rates will lead to capital inflows, appreciating the U.S. dollar and providing downward pressure on longer-term bond yields. The Quantitative Easing that we expect in both Europe and Japan will reinforce this tendency.

With a positive outlook for the U.S. economy, increasing consumer confidence, falling unemployment, and extremely quiescent inflation, our outlook for U.S. stocks should be extremely positive, and we are, indeed, positive. We do have two areas of concern: a more extended level of stock market valuation than at the beginning of 2014, and an increasing level of global and geopolitical risk, which is likely to increase U.S. stock market volatility. Valuation for the U.S. stock market, as measured by the price/earnings ratio for expected earnings over the next twelve months is still a reasonable 16.3, which seems appropriate in light of extremely low interest rates and a positive economic outlook. We are somewhat more concerned by the Cyclically Adjusted PE Ratio (Yale economist Robert Shiller's CAPE), which measures current stock market levels against the past 10 year average of inflation-adjusted earnings. The current CAPE of 27 indicates a limited potential for stock returns over the next three years, but does not necessarily imply a poor one-year outlook. Shiller notes that the CAPE can remain at an extended level for some time until there is a catalyst, such as a recession or financial crisis which reshapes investor opinion. In the absence of such a catalyst, we prefer to remain fully invested, particularly in view of the alternatives: cash yielding less than 0.2%, and 10 year bonds yielding less than 2%.

We do see, and take note of, an increasing level of geopolitical risk. In particular, the significant declines in oil and other commodity prices may induce political instability in commodity-sensitive economies. If this instability led continues to impede a global economic recovery, stock prices and non-dollar denominated bonds might well decline. But we would argue that U.S. equity investors are in a better position to weather such a crisis, and we are protecting against the possibility by focusing on companies with a relatively higher percentage of domestic than international revenues.