Wealth Management & Trust LLC

Market Outlook — January 2015

As we move into 2015, we at AAFMAA Wealth Management & Trust thank you for a very successful 2014! The responsibility of managing your hard earned assets and your trusts is our passion, and we thank you for your continued support and confidence in us.

Earlier this month, our President, Rick Convy, presented his 2015 Market Outlook as part of our monthly webinar series. Rick took some complicated market and economic data and broke it down into understandable, usable information. If you were not able to attend the sessions, consider key takeaways from Rick's presentation looking into 2015, as seen below.

Economic Growth - GDP

When conducting analysis for market forecasts, we rely heavily upon market and financial history. Given similar conditions (valuation, Fed policy, etc.), the market will act similarly, but not exactly. In other words, the market does not mirror itself but it does rhyme. Using debt to GDP, wage growth and unemployment, we forecast a 2 ½ to 3% GDP growth rate.

Our forecast would be even lower for 2015 were it not for the wild card of oil prices. Each one dollar decline in gasoline saves consumers about $140 billion. The stimulus from a nearly $50 per barrel plunge in oil will give the economy a boost, even after factoring in energy related cuts to employment and capital expenditures. We do not know how low oil may decline or for how long oil prices will stay at these levels, but the stimulating effect justified increasing our forecast from 2% or less to the 2 ½ to 3% level.

Economic Outlook – Inflation

The same factors that will keep GDP growth at a sub-par level will also limit inflation over the short to intermediate time period. Lower energy prices, the inability to demand raises and Fed policies will limit inflationary pressures in 2015. Inflation in 2015 should remain subdued in the 2% range. However, over the longer term, inflation could accelerate if the government maintains current policies and continues the current rate of printing money. We will keep an eye on this.

Markets - Stocks

Stocks are fairly valued. We expect 2015 total returns (price + dividend) in the upper single digit to lower double digit range. Historically, with inflation in the 2 – 3% range, stocks have traded at an average price to earnings multiple (P/E) of 18 and produced returns in the 12% range. With the market already trading at around a 17 P/E, we see minimal room for P/E expansion. Thus, stock prices will be driven mostly by earnings, which we expect to grow in the single digit range.

Markets - Bonds

Bonds are overvalued. When inflation has been in the 2% to 3% range, interest rates (as represented by T-bills and 10 year Treasuries) have traded at an average of 3.6% for T-bills and 5.3% for 10 year treasuries. Due to its financial repression, the Fed seems to have decoupled the historic relationship between inflation and interest rates. T-bills yielding almost zero and the 10 year Treasury yielding 1.8% concerns us. We remain defensive. The Fed does not need to start a program to increase rates for current rates to rise dramatically. They just need to stop artificially pushing rates down. With the 10 year Treasury trading at a 1.8% yield, the snap-back to "normal" historical yields could result in dramatic negative bond prices.

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MARKET OUTLOOK — JANUARY 2015

2014 Year in Review

Calendar year 2014 turned out to be mixed bag of tricks when looking at the core components that make up the world markets. Real Estate stocks topped the charts with a 28% annual return. Domestic large cap stocks rose 13.7%, with Mid-Caps slightly trailing at 13.2% for the year. U.S. Small-Cap stocks lagged their brethren rather significantly with a modest, yet positive return of 4.9%, a stark change from 2013, when Small-Cap stocks returned almost 40%. The real show stopper in last year's market participants was undoubtedly Long-Term Government Bonds, which stunned everyone with a whopping 19.3% return! International equities (including both established and emerging markets) declined for the year. The laggard of all categories in 2014 was Commodities, with a negative 17% return, of which 70% occurred in the fourth quarter alone.

Calm Year for Vanilla U.S. Assets, Mixed Results Elsewhere

	2014 (%)	Q4 2014 (%)		2014 (%)	Q4 2014 (%)
Real Estate Stocks	28.0%	12.9%	U.S. Small-Cap Stocks	4.9%	9.7%
Long Government & Credit Bonds	19.3%	5.6%	High-Yield Bonds	2.5%	-1.1%
U.S. Large-Cap Stocks	13.7%	4.9%	Gold	0.1%	-0.9%
U.S. Mid-Cap Stocks	13.2%	5.9%	Emerging-Market Stocks	-1.8%	-4.4%
U.S. Corporate Bonds	7.5%	1.8%	Non-U.S. Developed-Country Stocks	-4.5%	-3.5%
Investment-Grade Bonds	6.0%	1.8%	Non-U.S. Small-Cap Stocks	-4.6%	-2.2%
Emerging-Market Bonds	5.5%	-1.6%	Commodities	-17.0%	-12.1%

Ignore the Noise

As we have repeatedly stated, the secret to successful long-term investing is your own individual asset allocation, based upon your time horizon (how long you will be invested in the market), risk tolerance, liquidity needs, tax situation and any unique constraints you may have. Once you have established your target asset allocation, remaining stead-fast to your portfolios will ultimately yield the best success.

Ignore short term events. Ignore short term market volatility. This "noise" can only distract you from your long term plan. Remember that the market is volatile! On average, the market experiences three 5% declines a year, one 10% decline a year, one 15% decline every 2 years and a 20% or more decline every 4 years. That means that you should expect every fourth year to be a down year. This is normal. In 2014 we had a 5% decline in January (caused by unusually cold weather across the nation) and then an almost 10% decline in the fall (which seemed to have been triggered by the Ebola scare). You never know when or what will cause volatility. It will happen; ignore it.

What we do...

Very personal conversations with you determine a unique asset allocation that will allow you, whether an individual, couple or family, to cope with these inevitable events. You must be in a unique allocation that suits your personal appetite for risk. With AAFMAA Wealth Management & Trust, you're a member, not just an account.

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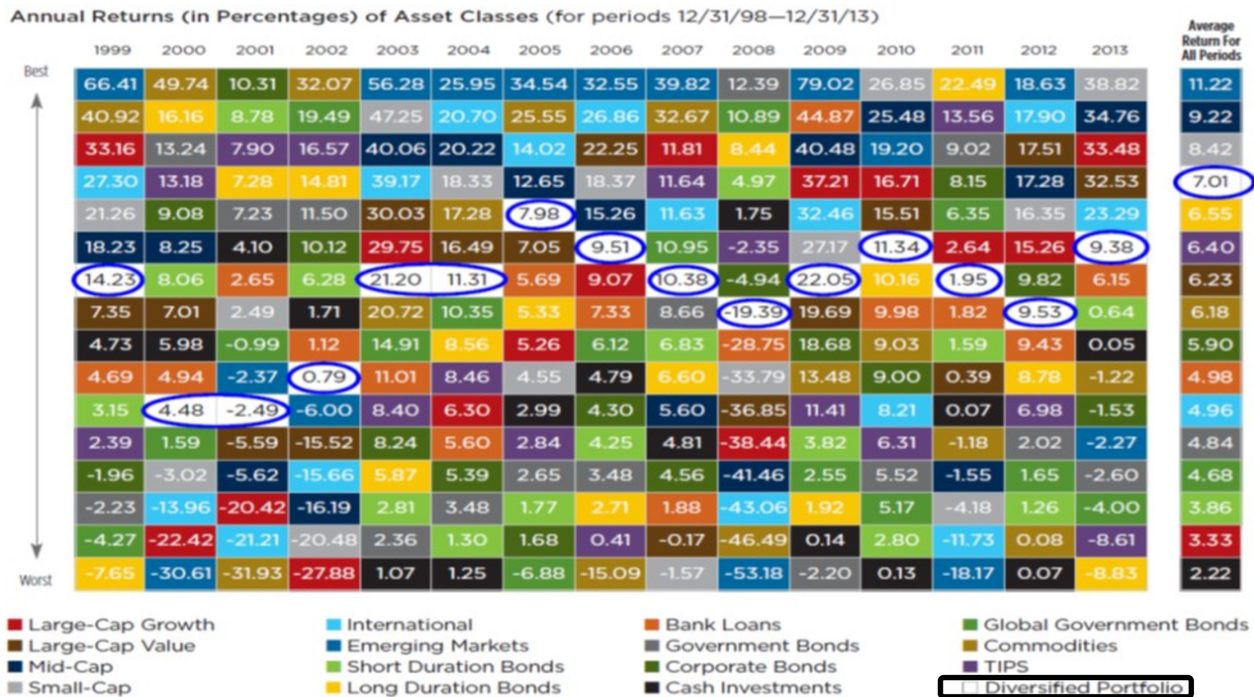
The Callan chart below illustrates (and reiterates) that the market beats to its own drum. Let's look at how Global Markets, Real Estate and Commodities have performed over time and how the annual "Winners and Losers" seemingly have no rhyme or reason as to why they have ended up there.



Annual Returns (in Percentages) of Asset Classes (for periods 12/31/98—12/31/13)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Average Return For All Periods
Best	66.41	49.74	10.31	32.07	56.28	25.95	34.54	32.55	39.82	12.39	79.02	26.85	22.49	18.63	38.82	11.22
	40.92	16.16	8.78	19.49	47.25	20.70	25.55	26.86	32.67	10.89	44.87	25.48	13.56	17.90	34.76	9.22
	33.16	13.24	7.90	16.57	40.06	20.22	14.02	22.25	11.81	8.44	40.48	19.20	9.02	17.51	33.48	8.42
	27.30	13.18	7.28	14.81	39.17	18.33	12.65	18.37	11.64	4.97	37.21	16.71	8.15	17.28	32.53	7.01
	21.26	9.08	7.23	11.50	30.03	17.28	7.98	15.26	11.63	1.75	32.46	15.51	6.35	16.35	23.29	6.55
	18.23	8.25	4.10	10.12	29.75	16.49	7.05	9.51	10.95	-2.35	27.17	11.34	2.64	15.26	9.38	6.40
	14.23	8.06	2.65	6.28	21.20	11.31	5.69	9.07	10.38	-4.94	22.05	10.16	1.95	9.82	6.15	6.23
	7.35	7.01	2.49	1.71	20.72	10.35	5.33	7.33	8.66	-19.39	19.69	9.98	1.82	9.53	0.64	6.18
	4.73	5.98	-0.99	1.12	14.91	8.56	5.26	6.12	6.83	-28.75	18.68	9.03	1.59	9.43	0.05	5.90
	4.69	4.94	-2.37	0.79	11.01	8.46	4.55	4.79	6.60	-33.79	13.48	9.00	0.39	8.78	-1.22	4.98
	3.15	4.48	-2.49	-6.00	8.40	6.30	2.99	4.30	5.60	-36.85	11.41	8.21	0.07	6.98	-1.53	4.96
	2.39	1.59	-5.59	-15.52	8.24	5.60	2.84	4.25	4.81	-38.44	3.82	6.31	-1.18	2.02	-2.27	4.84
	-1.96	-3.02	-5.62	-15.66	5.87	5.39	2.65	3.48	4.56	-41.46	2.55	5.52	-1.55	1.65	-2.60	4.68
	-2.23	-13.96	-20.42	-16.19	2.81	3.48	1.77	2.71	1.88	-43.06	1.92	5.17	-4.18	1.26	-4.00	3.86
	-4.27	-22.42	-21.21	-20.48	2.36	1.30	1.68	0.41	-0.17	-46.49	0.14	2.80	-11.73	0.08	-8.61	3.33
Worst	-7.65	-30.61	-31.93	-27.88	1.07	1.25	-6.88	-15.09	-1.57	-53.18	-2.20	0.13	-18.17	0.07	-8.83	2.22

Large-Cap Growth
Large-Cap Value
Mid-Cap
Small-Cap
International
Emerging Markets
Short Duration Bonds
Long Duration Bonds
Bank Loans
Government Bonds
Corporate Bonds
Cash Investments
Global Government Bonds
Commodities
TIPS
Diversified Portfolio

The white blocks (circled in blue) represent how a diversified portfolio of all 15 components, equally weighted at 6.7%, have performed annually. This diversified portfolio has never been at the top of annual returns, however, more importantly, it has never been at the bottom of returns. It is a fair assumption that no one would like to look at this chart in any year and find his portfolio at the bottom. Aside from believing whole-heartedly in asset allocation and effective diversification, we at AWM&T take it one step further. We build our portfolios and select individual funds to mimic the chart above. Our goal is to produce returns while diversifying so we do not find ourselves at the bottom of the chart. In other words, "maximum returns with limited downside risk".

We look forward to having you participate in one of our future webinar presentations and welcome the opportunity to discuss our investment management philosophy further.

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