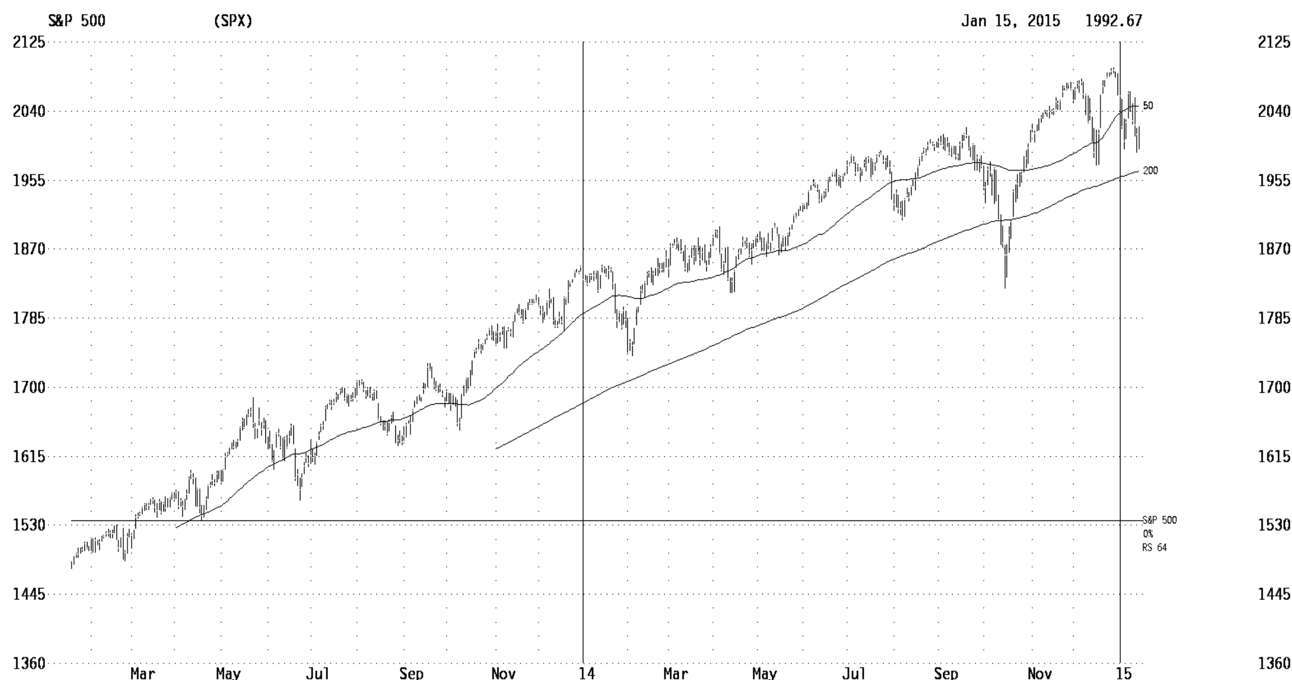
FVCM

F&V Capital Management, LLC
805 Third Avenue, 12th Floor
New York, NY 10022

H. Terrence Riley III, CFA
January 16, 2015

Contact: Karin Mueller
+1(212) 326 9533 kmm@fvcm.us



Our Outlook is Positive, but Risks and Volatility are Rising

The decision yesterday by the Swiss National Bank to remove the franc's peg to the Euro will have consequences not yet determined. The sharp decline in oil and other commodity prices since the last quarter of 2014 also will have follow-on-effects not yet determined. Many hedge funds and other investors had taken comfort in the idea the Swiss franc was fixed to the Euro, so they either sold it short or borrowed in Swiss francs to invest elsewhere. Furthermore, according to Bloomberg News, more than 40% of mortgages on the books of Poland's banks are denominated in Swiss francs. Other areas of Eastern Europe are also reported to be deep into Swiss franc denominated debt. Unfortunately, there is no way of knowing the consequences of the action by the Swiss National Bank, but the unintended economic consequences could be significant. We are reminded of Hedge fund failures like Long Term Capital Management, which blew up in 1998 after the Asian financial crisis. Two brokerage firms, London-based Alpari and New Zealand's Global Brokers NZ, have announced they have suffered catastrophic losses and will cease operations. Also, FXCM, a New York-based currency broker, warned that it "may be in breach of some regulatory capital requirements" after its clients experienced significant losses.

We have sold our position in J.P. Morgan and thus reduced our exposure to the financial sector. J.P. Morgan, in particular, is a very large bank that operates globally and has significant exposure to many areas of the financial markets, including hedge funds and foreign loans. While we continue to respect the leadership of Jamie Dimon, the trading losses in the London office in 2012 by the "London Whale" were a reminder that risks can be high in such complex banks even when internal controls are world class. The stock is down from recent highs, but we prefer to wait on the side until the current financial turmoil subsides.

The decline in bond yields in most of the larger industrialized countries is rather unprecedented and reflects a continued flight for liquidity and safety. If the ECB announces a Quantitative Easing (QE) program next week

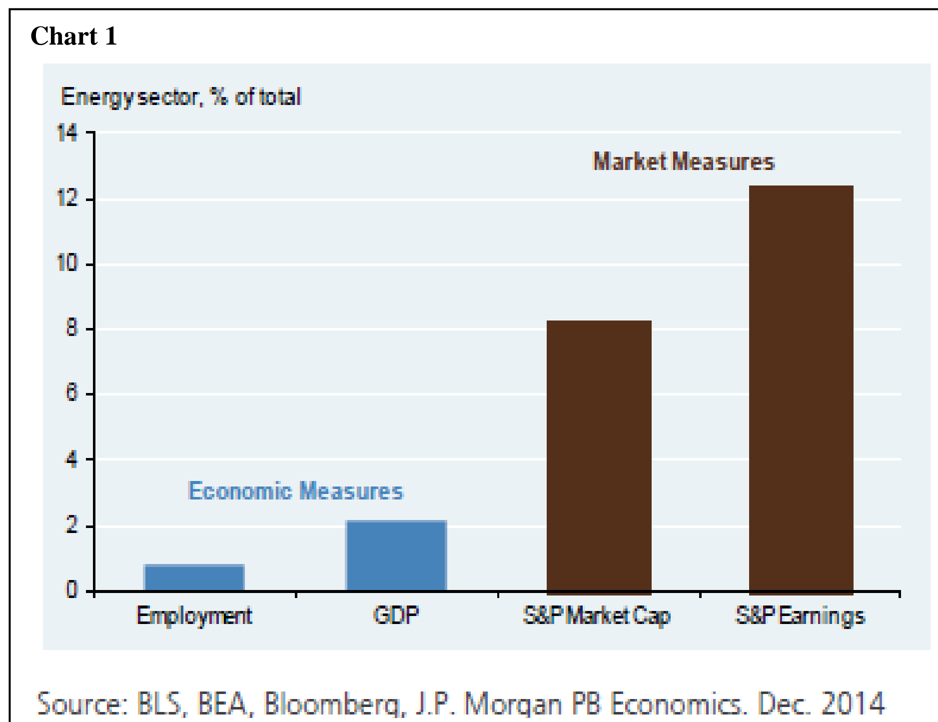
as expected, they will be buying risky assets, including sovereign debt, in exchange for newly created demand deposits, i.e., money. As we have seen in the U.S., QE is not inflationary when it is only satisfying a high demand for liquidity. Greater growth in the European money supply should help satisfy people's need for safety and hopefully stimulate modest growth in spending. This policy is bullish for risky assets and should help mitigate some of the increase in uncertainty related to energy and the banking system.

The U.S. economy will be negatively affected by the weakness in Europe and Japan, but growth should remain modestly positive. As of the September 2014 quarter (the most recent reported), the U.S. economy had grown at a real rate of 4.3%, year-over-year. Employment has been steadily increasing in excess of 200,000 jobs per month, and personal income has grown in tandem despite wage growth of only about 2% annually. There are few signs of excesses normally seen at the end of an economic cycle and 2015 should be a year of moderate growth of perhaps 2.5% to 3.0% despite the headwinds to exports. Keep in mind that the U.S. is a very large economy and exports are only about 12.5% of GDP. Imports are a couple points larger than that.

Declining oil prices have already resulted in reductions in jobs and planned capital expenditures by the U.S. energy sector but, on-balance, the fall in oil prices should be a small net positive to the overall economy. The U.S. is now the world's largest oil producer, followed by Saudi Arabia and Russia. However, the U.S. is also the world's largest oil consumer. Lower energy prices will certainly hurt the energy sector, which is why we are well underweight that area, but the benefit to consumers more than offsets that negative.

The decline in energy prices is likely to have a disproportionately large impact on earnings for the S&P 500. As seen in Chart 1, the energy sector accounts for less than 1% of U.S. employment and only about 2% of U.S. GDP, but it accounts for approximately 12% of S&P 500 earnings. On the other hand, there is likely to be offsetting improvements in other sectors, such as consumer discretionary, consumer staples and perhaps technology, as money not spent on energy flows into other areas.

Chart 1



Source: BLS, BEA, Bloomberg, J.P. Morgan PB Economics. Dec. 2014

As shown in table 1, our December 31, 2015 target for the S&P 500 remains 2,250, up 9% from year-end 2014. We happily point out that 2014 ended the year only 8.9 points away from the target we published in mid-September (2,050), and the total return of 13.7% for all of 2014 nearly reached the 15% target we set in January of last year. We expect earnings to increase at about a 7% pace both this year and next, but stock prices are likely to get less of a boost from P/E expansion than in the past.

Table 1 S&P 500	2013	2014	2015	2016(e)
Index Price (Beginning of Year)	1,426.19	1,848.36	2,058.90	2,250.00
Index Earnings (forward)	110.66	119.76	128.30	137.00
P/E Ratio	12.9	15.4	16.0	16.4

Source: Thomson Baseline, FVCM; earnings for 2015 estimated.

From a timing perspective, the ECB meeting next week could be an important turning point. Expectations seem to be that the ECB will set a target to expand its balance sheet by perhaps 500 billion Euros in order to get it back to levels seen in 2012. Anything less would likely be a disappointment. But if expectations hold, stocks could rally in the U.S. as well as in Europe. Bonds, on the other hand, can be tricky. We have no expectation of a material rise in European bond yields until nominal GDP accelerates in Europe. And U.S. yield are likely to continue to be compressed as international capital flows continue to move toward the relatively higher yielding U.S. markets. So while a short term bounce in yields may take place in reaction to the recent drop, a protracted increase in yields does not yet seem to be in the cards.

From a sector perspective, the most important decisions may be to continue to underweight financials, energy and other basic materials. It has been our experience that most major market trends take much longer to play-out than people expect. The current drop in energy prices comes only after many years of very high capital expenditures. These assets are not going away anytime soon and supply is likely to exceed demand for a considerable time. The same can be said for copper, iron and other materials. Great amounts of capital were spent in expectations of ever growing demand from China and other emerging economies. It will likely take years for these excesses to moderate. And from the financial sector, not only are there growing risks from the unprecedented changes being made by central banks, but net interest margins are now being squeezed by falling long term interest rates and the fact that short term rates are already sitting on the floor of nearly zero percent. Net interest spreads don't look like they will be improving anytime soon.

The information contained in this report is intended solely for the clients of F&V Capital Management, LLC in the United States, and may not be used or relied upon by any other person for any purpose. Such information is provided for informational purposes only and does not constitute a solicitation to buy or an offer to sell any securities under the Securities Act of 1933, as amended, or under any other U.S. federal or state securities laws, rules or regulations. Investments in securities discussed herein may be unsuitable for investors, depending on their specific investment objectives, risk tolerance and financial position.

The information is obtained from specified sources and is believed to be reliable, but that accuracy is not guaranteed. Any opinions contained herein reflect F&V's judgment as of the original date of publication, without regard to the date on which you may receive such information, and are subject to change without notice. F&V may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance.