4Q 2014

Market Outlook

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ECONOMIC TRENDS

U.S. Economy

The U.S. economy continued to grow during the fourth quarter. The financial community has gotten so used to slow growth that it's a pleasant surprise when it exceeds expectations. We won't see 4Q earnings estimates for a while longer but the very strong 3Q GDP growth of 5% suggests that 4Q will be solid. Energy prices began to drop at an accelerating pace near the end of the quarter and many experts expect that this helped the U.S. consumer, especially going into the Christmas shopping season. But we do have other issues that are affecting the U.S. consumer. Rising costs of healthcare and other necessities as incomes stagnate have actually forced families to cut back on discretionary spending or to continue to seek deep discounts on what they buy.

An article in the Wall Street Journal in December stated that healthcare spending by middle-income Americans rose 24% between 2007 and 2013. That has been accompanied by increases in costs for food, rent and education. Further analysis by the Wall Street Journal showed that overall spending for the middle 60% of the population (sorted by income) rose by about 2.3% over the same period, even as inflation totaled about 12%. At the same time, income for the group rose by less than half a percent—amazingly poor considering the rising costs. This brings us back to the point we have made over time—that while employment in the U.S. is up and the unemployment rate declined further in the fourth quarter to 5.6%, the quality of the job growth remains low and wage growth is stagnant. It remains to be seen how the stagnant wage growth, rising costs and lower energy prices combine to work through the economy. The average U.S. household buys about 1,200 gallons of gasoline per year. With the substantial drop in global crude oil prices putting pressure on U.S. gasoline prices, the typical family could save between $750 and $1,100 per year depending on how much lower prices drop. This has the potential to have a significantly positive effect on consumer behavior in 2015.

U.S. Dollar

The strength of the U.S. Dollar continued right through the 4th quarter. Improving U.S. economic trends along with continued weakness in other currencies pushed the U.S. Dollar Index (DXY) up approximately 4.7% during the quarter, making the gain for the year approximately 12.8%.

The DXY is a trade-weighted index that is used as a benchmark against a combination of most other major world currencies, but more specifically the U.S. Dollar strengthened versus the Euro by about 12.3%, and versus the Japanese Yen by 13.4%. This is very important as we begin 2015 because U.S. corporations compete extensively with the European and Asian companies; our prices move up as a result of the currency shifts and for some industries that will make us less competitive. Unfortunate or not, this trend is expected to continue at least through the first part of 2015 as the economies around the world are not growing as well as the U.S.

ASSET CLASS

U.S. Equity

The volatility the U.S. equity markets felt at the end of the 3rd quarter continued right into the 4th quarter before bottoming out in mid-October. The S&P 500 and the Russell 2000® indices hit the lows for the quarter on October 15th, but closed out the end of the quarter near each of their respective index highs. The S&P 500 was up 4.9% for the quarter, but was up approximately 14.7% from the October 15th lows while the Russell 2000 was up 9.7% for the quarter; it was up closer to 17% for the same period. The increased levels of volatility are mainly a result of the questions surrounding the price of commodities (especially oil), global

	economic weakness, and next steps by the U.S. Federal Reserve. Volatility will persist until markets become more comfortable with many of these various challenges.
Fixed Income Markets	The equity market was not the only market to experience substantial volatility during the quarter. The fixed income markets also had their fair share of gyrations for many of the same reasons that affected U.S. equity markets. The 10-year U.S. Treasury started the quarter at 2.5% and as Quantitative Easing (QE) was removed by the Federal Reserve, the yield surprised most investors and moved lower during the quarter, finishing out the end of the year at a 2.2% yield. Increased economic uncertainty around the globe drove investors into the U.S. Treasury market for safety and for yield, but especially for the safety. The U.S. Treasury market actually offers a much higher yield on our 10-year treasury than most other developed countries. At the end of 2014 Germany offered a 0.5% yield, Italy 1.9%, Spain 1.6% and in Asia, Japan's year end rate on their 10-year was a miserable 0.3%. With these yield differentials and the global demand for yield, the expected move higher in U.S. Treasuries was more heavily offset by the robust demand rather than an absence of government QE. The corporate debts of companies in the energy sector were also subject to extremely high volatility as the market began to adjust to lower global energy prices. It is felt that depending how long oil prices stay in the current $40-$50 range, this price will impact some companies' ability to repay their debt as their profitability suffers. This affected not only the individual bonds of companies in the energy sector, but also high yield Exchange Traded Funds (ETFs) that were invested in this area.
Commodities	**Oil and Gas -** The price of crude oil in the U.S., specifically West Texas Intermediate, was down over 40% in 2014 with almost the entire decline coming in the 4th quarter. The price of Brent crude oil, which is the benchmark for global energy markets, was down over 45% in 2014, which also had a majority of this occurring in the fourth quarter. At the writing of this letter, the slide in prices has continued right into 2015, as West Texas Intermediate is down another 15% while Brent prices are down approximately 18%. The event which triggered this massive move in global energy markets came from OPEC, specifically Saudi Arabia, with their commitment to maintain their share of the global energy market. Saudi officials announced the decision on Thanksgiving Day, indicating that they would not cut oil production as a way to support prices. Instead, they have been exceedingly vocal about letting the market decide where the clearing price for oil will go. The market began falling after their decision and has not looked back. OPEC officials refuse to even discuss where they think the oil price will go, but as the price falls, some of the global economies that rely on revenues from oil will actually have to pump even more to support their individual economies. The economies of several countries, especially Russia, Nigeria, Venezuela and Iran, with relatively high production costs and a very high dependence on oil export revenues, are being hurt and will continue to hurt until the global oil market stabilizes. Natural gas prices in the U.S. also saw a significant decline during the quarter as the winter temperatures in the U.S. came later than expected. As a result, natural gas closed the fourth quarter at $2.88 which was the lowest price of the quarter and for 2014. The year began with natural gas prices trading at $4.23 before topping out at close to $6.10 during the Polar Vortex super cold spell at the beginning of 2014.

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WHAT TO WATCH	
Geopolitics	There are several "hotspots" around the globe to which we need to remain attentive. The Russian/Ukrainian conflict remains unresolved and Russia is still occupying part of the Ukraine. Vladimir Putin has been relatively quiet as his economy and currency are getting crushed by the lower global energy prices. There are reports that Russia needs Brent oil prices up around $100/barrel in order to balance their budget. Economic sanctions enforced by the U.S. and Europe as punishment for the Ukrainian incursion are just beginning to hurt as intended, but Russian companies also have tens of billions in dollars of debt to roll over throughout 2015 and they have been denied access to global financial markets. The idea that the Russian government will probably have to help these large Russian companies while simultaneously suffering greatly due to oil prices is a situation we are watching very closely. A further invasion of Ukraine by Russia to distract the Russian populace from their own economic problems would be more destabilizing for the region, but the prospects of an all-out Russian debt default by Russia would be very destabilizing to global economic markets. The Islamic State is also a concern. ISIS movements in the Middle East continue, but their progress has been slowed. The subsequent warnings of further attacks against the West after the attacks in Paris in January has many countries around the globe on alert and is something we will be monitoring. These attacks may have been orchestrated by either ISIS/ISIL or Al Qaeda and it remains to be seen if they will escalate. Cyberterrorism has gotten much more common, and much more sophisticated. Rumors of the countries that are involved range from Russia to North Korea, to ISIS and Al Qaeda sympathizers. The U.S. and other countries are trying to escalate their ability to combat this, but any type of cyber terrorism is bad and potentially very destabilizing. The attack on Sony Pictures may just be the tip of the iceberg.
Global Economic Conditions	Mario Draghi, the head of the European Union has been telegraphing for months that they need to institute a Quantitative Easing program in order to stimulate the European economies. The economic growth conditions in the European Union have slowed significantly and there are now serious concerns that the entire Eurozone will succumb to a "triple-dip" recession. Only Lithuania—which joined the Eurozone on the first day of 2015—and Ireland are forecast to see strong growth this year. Fears are also growing that the 18-member European Union may fall into deflation. China's economic growth is still a bit of a mystery. Their housing market has been heated, reheated and overheated again so many times that the Chinese people have begun to look for other places to make money, such as their stock markets. The Shanghai composite was up over 35% in the fourth quarter and that rally has continued in 2015. This move in their market has not come on the back of any overwhelmingly positive economic news, but as Chinese authorities guide down economic growth estimates. Most forecasters expect that China will grow at 7.0% in 2015 after it is expected to grow at 7.2% in the fourth quarter of 2014.
MOVING FORWARD	
Earnings Season	The fourth quarter earnings season had its unofficial start on Jan 12th with Alcoa reporting. This quarter will be especially important as it will likely set the tone for the first half of 2015. Many of the macro discussions we have focused on throughout this outlook will impact the earnings of the companies reporting this quarter, specifically the energy, consumer discretionary and financial sectors. For the first time, energy companies

	will give current earnings and important future guidance based on the underlying severe oil and natural gas declines. Financial companies will provide guidance based on what they are seeing in interest rate spreads, loan demand and consumer activity. Market participants have built in positive earnings expectations for the consumer discretionary companies as a result of lower energy prices. Although, while we did see decent same store sales numbers for a number of mainstream retailers, that doesn't always mean the improvement of profitability will be comparable. We will just have to wait and see, but it would help the equity markets if a leading market sector could emerge from this earnings season.
U.S. Fixed Income Markets	The discussion as to whether the Federal Reserve will begin to raise rates in the first half of 2015 or later will be debated by many as we begin 2015. We feel strongly that although they may begin in 2015, they won't raise rates by much. Economic conditions, while slowly improving won't be sustained if the Fed is too aggressive in moving rates higher. "Lower longer" is a term you will continue to hear bantered around financial news stations, which means that interest rates will remain lower, when compared to 5 or 10 year averages, for a longer period of time than many expect.
U.S. Equity Markets	Sharply weaker energy prices, while largely considered a positive for consumers of energy resources globally, have changed the metrics used to determine growth and valuation of indexes like the S&P 500. Markets anticipate the future growth of earnings. The basic premise of most investment theory is that all information, past, present and future – is discounted in the markets and reflected in the prices of stocks and indexes. With this in mind, and with the substantial drop in energy prices over the last several months, forecasts for first quarter 2015 profits in the S&P 500 have fallen by 6.4% from where they were three months ago, which is the biggest decrease since 2009 according to 6,000 analyst estimates compiled by Bloomberg. The overall fourth quarter growth rate for the energy sector has flipped from a positive growth rate of +7% to a current expectation of a -19.9% decline. So, while lower energy prices are good for consumers and nations that import a majority of their energy, they will increase the volatility for markets as companies adjust to a new range of energy prices. We believe there are many companies in the portfolio that will continue to evolve their business plans, often free of any energy issues that can move higher.
Commodity Prices	**Oil and Gas -** Here is the $64,000 question--what will happen with energy prices and when will it happen? The move by Saudi Arabia and OPEC is the largest story impacting all global markets and will continue to be throughout 2015. We are not going to call a bottom in prices of commodities, but we are comfortable in saying that we will not experience the violent price decline in oil like we experienced in the 4th quarter of 2014. With that said, ICM will continue to do our homework on commodity companies and use the weakness in this space to upgrade the holdings in our portfolios. Many of the companies we own in the portfolio already had hedged all of their production for 2015, some even beyond at much higher prices. But in this nervous environment all names go down.
PORTFOLIO PERFORMANCE & ATTRIBUTION	
Small Cap Intrinsic Value	The small cap accounts underperformed during the quarter as we saw significantly more weakness in the energy sector than we anticipated. While we did expect to see weakness, many of the names we own in the sector had hedged most of their production for 2015 at higher prices; it didn't seem to matter to the rest of the market because of the violent move lower particularly in prices of oil and commodities in general. The

	ICM Small Cap Intrinsic Value strategy was flat vs. the Russell 2500™ Index being up 6.8% this put performance for this strategy up 2.9% for 2014 vs 7.1% for the R2500 Index. As we mentioned in the past, we expected to see volatility creep back into the markets as the 4th quarter started off with a 2-week selloff before rebounding from a low set on October 15th. We didn't get as much of a positive follow-through from the election results as we had hoped for and it appears that the Santa Clause rally came very early, beginning around December 15th and rallying through the end of the year. What didn't bounce with the index were companies in the energy sector as energy commodities sold sharply, right into year end. We saw good performance from select names in the technology and consumer staple sectors which occurred as a result of strategic mergers and business plans moving forward as we had expected. We continue to favor these same names for at least the beginning of 2015 as the markets continue to reward companies making big moves in turning around their businesses. We sold the inverse ETFs that we bought during the third quarter anticipating the move higher in the markets. We will go back to these on an as needed basis moving forward. We ended the quarter with more cash than we began with, in anticipation of taking advantage of names that were tax-sold during the quarter. As we continue to monitor these individual issues with a potentially tricky earnings season ahead, you will see us begin to deploy some more of this cash as we align the portfolios for the balance of 2015 and beyond.
Large Cap Globally Dominant	ICM's Large Cap Globally Dominant strategy portfolios were down a little over 1% for the 4th quarter of 2014 compared to a positive 4.9% return for the S&P 500 and a negative -3.1% for the S&P Global 100 Index. Most of the negative impact on the portfolio in this strategy occurred during the last month of the quarter where the account lost approximately -2.3%. The portfolios in this strategy ended the year up approximately 10% which was pleasing in this volatile environment compared to a positive 13.7% return for the S&P 500 and a paltry positive 0.55% return for the S&P Global 100 Index. Lower commodity prices in oil and gas as well as copper and iron ore prices had negative impacts on the names in this portfolio. Especially difficult energy markets had the largest influence on the companies in the portfolio, with crude oil prices down over 45% during the quarter. But unexpectedly lackluster growth conditions in China kept already depressed copper prices down as copper prices declined over 7% in the 4th quarter, closing at the lows for 2014. The portfolio saw a positive impact with our allocation to technology stocks in the microchip sector and to the auto and transportation sectors. The names that moved up will continue to work but are getting closer to our target prices. We put some of the cash to work that built up during the 3rd quarter into additional companies in the technology, energy and telecom sectors. We will continue to monitor the global markets looking at developments in the European Union as they continue to debate a Quantitative Easing program to try to stimulate the economic growth of this region.

All Cap Value	We saw additional pressure on the All Cap Value portfolios similar to what we experienced at the end of the third quarter with the violent -45% move in oil prices. The strategy lost approximately 1.9% vs. a positive return on the Russell 3000® Index of 5.2% and 4.9% on the S&P 500 Index. This left this strategy with a 5.1% gain for the year versus a 12.6% return for the Russell 3000 and a 13.7% return for the S&P 500. The heavy profit taking that the technology sector experienced in the third quarter reversed in the fourth quarter and provided positive returns to the portfolios. We added to our consumer staple allocation in the portfolio with select names in the energy sector. As we have stated for a couple of quarters now the names in the energy sector will continue to move lower and adjust to lower oil prices. We are using this weakness as an opportunity to upgrade the names in this sector but have yet to see the commodity find a bottom. Our cash level ended the quarter at approximately the same place we started as we trimmed names that hit our price targets while we increased our exposure to those we felt were oversold. We used the weakness at the beginning of the quarter to also sell our inverse ETF position after the market had moved lower as we expected. Allocation to smaller cap names proved both positive and negative depending on the sector. Smaller cap energy names got hit harder, but our exposure to smaller cap technology names proved to be a very positive event for the portfolios during the quarter.
Enhanced Income	The enhanced income portfolio strategy lost 1.5% in the fourth quarter, a little weaker when compared to the Barclays Capital Intermediate Gov't/Credit Bond Index which was up 0.9% and the S&P 500 Index which was up 4.9%. The strategy ended the year up just shy of 4% with the Barclays Capital Intermediate Gov't/Credit Bond Index up 3.1% and the S&P 500 Index up 13.7% for the year. The average portfolio ended 2014 with a current yield of approximately 5.3%. This income oriented strategy was not able to escape some of the negative implications that affected other strategies we manage with the violent negative move in oil and natural gas prices. We also own some corporate bonds and preferred stocks in addition to equity in names in the energy sector. But we remain comfortable with these investments, especially as we see the capital expenditure plans for 2015 from some of these companies. Although the prices of the names in the portfolio won't recover until oil and gas prices stabilize, it remains a sector we want to be in moving forward. We increased the amount of cash in this strategy during the quarter to take advantage of the weakness in new candidates for this portfolio. We will continue to add to positions in the portfolio that are not directly affected by interest rates. We continue to be more skewed towards equity instruments vs. corporate bonds but we are beginning to see attractive prices on some corporate bonds.
Fixed Income	The yield on the 10-year Treasury began the quarter at 2.5% and ended close to 2.2%. Volatility increased during the quarter for the fixed income markets as global geopolitical concerns forced those looking for safety into the U.S. Treasury markets. But with the slide in the energy commodities, investors violently sold off high yield corporate bonds in the energy sector at the same time the U.S. Federal Reserve ended Quantitative Easing (QE). The strategy lost, on average, just under half of a percent for the quarter versus a gain for the Barclays Intermediate Government/Corporate Index of 0.9%, largely because of our shorter maturities.

We had very low turnover during the quarter and ended the quarter with more cash than we started. The short term ETFs we own in the portfolio were negatively impacted by the sudden move lower in the high yield corporate bond market and this caused a little underperformance.

We feel as though interest rates in the U.S. will remain lower longer than many expect, as we have mentioned previously in our Quarterly Outlook. We continue to look for logical areas that have reasonable yields commensurate with the risks associated with that yield. The Fed continues to want to "normalize" interest rates at higher levels in the U.S. and we believe that while this is a logical idea we simply don't have the strength in the U.S. economy that would allow for this and won't for quite a while.

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