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2014 Review: Economy & Markets

Despite a bumpy ride throughout 2014, the U.S. economy gained pace while the U.S. equity and fixed income markets outperformed most markets around the world. This performance came with higher market volatility in the U.S., a rallying dollar, slowing economies in Europe and Asia, and rising geopolitical tensions, including conflicts in Ukraine and the Middle East.

The Dow Jones Industrial Average rose for the sixth straight year, posting a 7.52% gain (price-only return). The S&P 500 Index rose 13.69% (including reinvested dividends), marking the third straight year in which the benchmark has returned more than 10%. The Dow closed at a record high on 38 calendar days, while the S&P 500 had 53 record closes. The non-U.S. markets followed a much different track: All major indices logged negative performance for the year (in USD). The MSCI EAFE Index had a -4.90% return and the MSCI Emerging Markets Index a -2.19% return (net dividends, in USD). The dollar's strong performance relative to major regional currencies contributed significantly to the lower returns for U.S. investors.

Government bond yields fell across major markets, including the U.S., where many expected higher rates in response to improving economic growth and an eventual rate increase due to the end of quantitative easing by the Federal Reserve. The yield on the 10-year Treasury note declined to 2.17% by year-end, down from 3.03% in 2013, with lower prices boosting its return to over 4.0% for the year. The Barclays U.S. Government Bond Index returned 4.92%. World government bonds had slightly positive returns: The Citigroup World Government Bond 1–5 Year Index (hedged) returned 1.90%.

US Stock Market Performance

Russell 3000 Index with selected headlines from 2014



Source: Russell Investment Group.

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news. Past performance is not a guarantee of future results. In US dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

The chart above highlights some of the year's prominent headlines in the context of broad U.S. market performance, measured by the Russell 3000 Index. These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.



The chart below offers a snapshot of non-U.S. stock market performance (developed and emerging markets), measured by the MSCI All Country World ex USA Index. Again, the headlines should not be viewed as determinants of the market's direction but only as examples of events that may have tested investor discipline during the year.

Non-US Stock Market Performance

MSCI All Country World Index ex USA (net div.) with selected headlines from 2014



Source: MSCI.

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news. Past performance is not a guarantee of future results. In US dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

Economic Backdrop

Accelerating U.S. Recovery

The economy showed signs of weakening in early 2014, with Q1 GDP growth reported at an annualized -2.9%. In Q2, GDP rebounded strongly at a 4.6% annual growth rate (seasonally adjusted)—the highest since 2003. Growth in Q3 was even stronger at 5%, capping its best six-month stretch since 2003 and reaching the highest annualized growth rate in 11 years. If the Fed's Q4 estimates hold, 2014 GDP growth will have been in the 2.4% range.

A host of indicators pointed to improving conditions during the year, including:

- ❖ **Employment**—The U.S. economy added 2.7 million jobs through November, the best employment growth in 15 years. Claims for jobless benefits ran lower than at any point since 2000. By year-end, the U.S. had recovered all jobs lost to the past recession, and joblessness was at a six-year low. Despite the lowest labor force participation rate since the 1970s, the economy entered 2015 with record employment.
- ❖ **Manufacturing**—Economic activity in the manufacturing sector improved throughout most of 2014. The Institute for Supply Management (ISM) reported its purchasing managers index (PMI) at 59.0 in October, 58.7 in November, and 55.5 in December. (A reading above 50% indicates general expansion.) For the year, the PMI averaged 55.8, the best reading since the first full year after the recession in 2007–09.
- ❖ **Consumer spending**—An improving labor market and lower energy prices translated into higher income and purchases among American workers. Real personal consumption expenditures increased at a seasonally adjusted 3.2% rate in Q3, compared to 2.5% in Q2. U.S. equity market gains over the past three years have added \$7 trillion to household wealth, which many believe has helped fuel spending.
- ❖ **Company earnings**—The Department of Commerce reported a 2.8% rise in U.S. corporate profits in Q2, followed by a 5.1% increase in Q3, marking 12 straight quarters of year-over-year growth. According to GDP data, Q2 after-tax profits hit a record high. However, after adjustments for depreciation and inventory changes, profit margins—particularly among smaller companies—appeared to be declining due to rising labor costs and capital expenditures.

Declining Oil Prices

Oil prices fell by almost half during 2014, a victim of excess supply due to rising production—particularly in the U.S., where production soared to its highest level since 1986—and to weakening demand from the economic slowdown in Europe and Asia. In the U.S., prices dropped from \$107 per barrel in June to just over \$53 at year-end. For the year, Brent crude was down 48% and West Texas Intermediate crude down 46%. The price decline most affected the economies and currencies of oil-exporting countries, especially Russia.

Soaring Dollar

In 2014, the U.S. dollar rose against every developed markets currency. Overall, it gained 12.5% against a basket of widely traded currencies, measured by the *Wall Street Journal* dollar index. This was the dollar's best gain since 2005 and second-best on record. The rise was attributed to stronger U.S. economic data, falling global oil prices, expectations of higher interest rates, and weakened currencies resulting from monetary easing by the Japanese and European central banks.

Weak Inflation

Despite rising to an 18-month high in May and June (2.1% each), average U.S. inflation remained low throughout 2014. In November, year-over-year inflation fell to 1.3%. Since rising inflation is normally viewed as a sign of an economic uptick, some believe that weak inflation influenced the Fed's decision to not raise interest rates. Across the world's largest economies, inflation eased for the sixth straight month in November, with the Organization for Economic Cooperation and Development (OECD) reporting average annual inflation for its 34 members at 1.5%.

Diverging Returns

While U.S. equity returns were high relative to those of other regional markets, returns within various U.S. market segments diverged. Based on the respective Russell 1000 and 2000 indices, U.S. large cap stocks significantly outperformed small cap stocks, and within the relative price dimension, large value slightly outperformed large growth. Among small cap stocks, growth outperformed value.

In the non-U.S. developed markets (based on the MSCI indices in USD), all segments had negative performance. Negative returns among large and small caps stocks were similar, while large growth slightly outperformed large value. In the emerging markets, small cap, which had a slightly positive return, outperformed large cap, and growth outperformed value, although both returns were negative.

Currency Impact

The strength of the U.S. dollar had a negative impact on returns for U.S. investors with holdings in unhedged non-U.S. assets. (As a general principal, investors gain when their home currency falls relative to the local currency of the foreign asset they own, but lose when a rise in their home currency reduces the value of the foreign investment in the local currency.)

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