Ashdon Investment Management

Q4 2014 ECONOMIC COMMENTARY

January 2015

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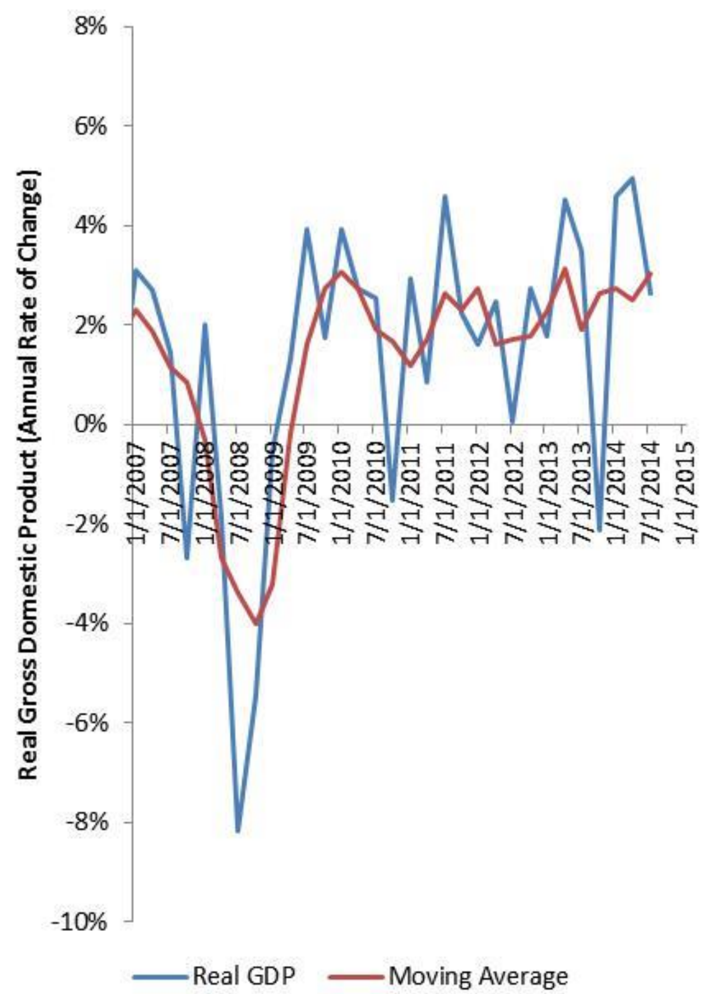
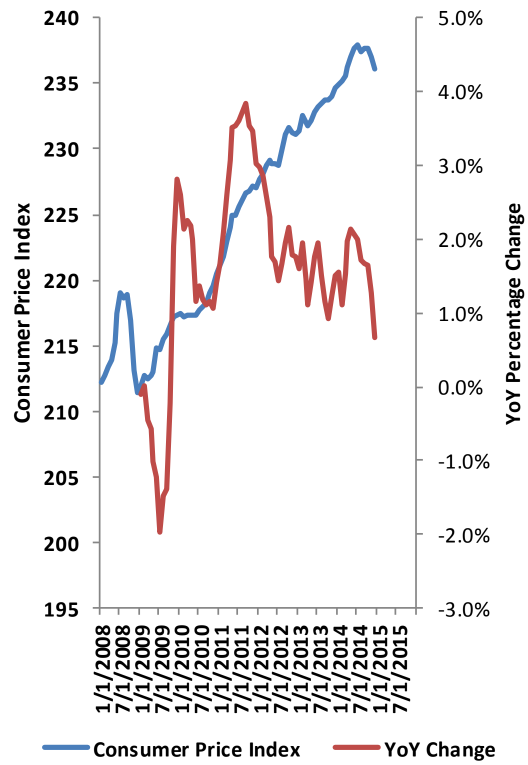
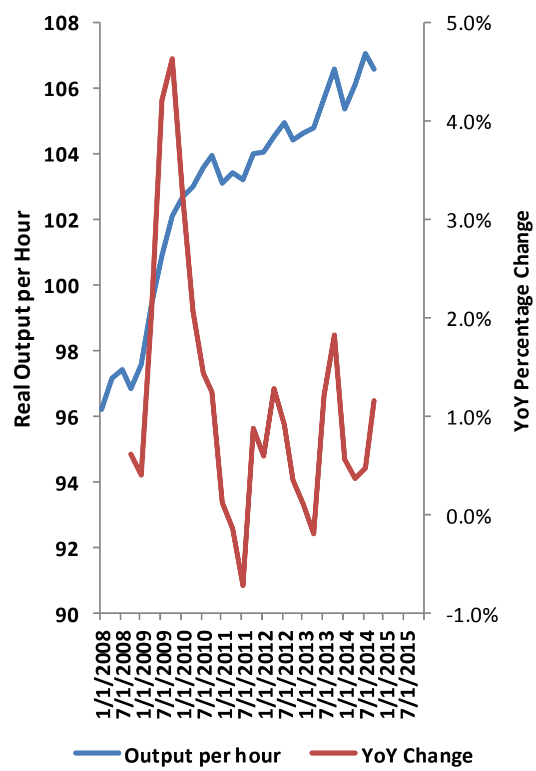
Fourth Quarter 2014 Economic Commentary

By all accounts, the growth trajectory of the US economy continued during the fourth quarter. However, developed economies lagged with only a few bright spots in Asia and Europe. Gross Domestic Product for Q4 2014 grew at 2.64% (quarterly change at an annual rate). By this measure, the US economy appeared to decelerate after two quarters delivering greater than 4% growth rates. It is important to keep in mind that quarter to quarter volatility can obscure the more important underlying trend. The more appropriate metric of change (percent change from a year ago) shows that the overall economy continues to grow at a moderate rate.

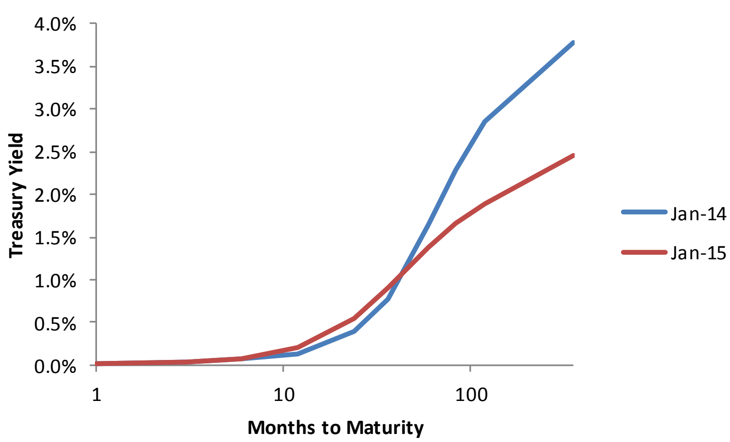


This conclusion is supported by a broad range of economic data. Workers are the essential productive elements of the economy. Employment roles have increased in the US while the unemployment rate has declined to around 5.5%. At the same time, the recovery has been characterized by very subdued growth rate of real output per worker. The lack of inflation in the economy is the final supporting data point. Even with growing employment rolls, increasing wages, and fully accommodative monetary policy, US inflation is very low – the annual rate of change was below 1% on the last reading, well below the FOMC's goal of 2%. In the wake of the recession, the US has been working through excess productive capacity, including workers. The process will require more time to complete, quite likely several years.





The bond market clearly agrees with this interpretation of the data. The long end of the US Treasury yield curve collapsed during 2014. The chart below shows how yields have collapsed for the long duration (10-year and 30-year) treasury bonds. The 30-Year bond yield fell about 130bps, ultimately to a historically low level of 2.2% before stabilizing. The yields on these bonds are very sensitive to inflation expectations, so it is clear that the bond market expects low inflation. The monetary actions of the Japanese and European central banks must be factored into developing a complete economic picture. Quantitative easing programs were instituted in Japan (October 2014) and Europe (January 2015). We believe that these programs, if executed well, will work nearly as well as the FOMC's QE programs. However, they will work with significant lags. This sets the stage for low rates on sovereign long bonds for *at least* one year ahead. We are in the middle of a long path toward the next phase of "normal" economic expansion.



Our expectation is that this state of economic affairs will persist into the future for many quarters – and conceivably many years. We believe that in this environment extremely low interest rates, falling commodity prices and *moderated* growth - US equities as an asset class should perform well over any actionable investment period. We are also cognizant of risks of many kinds (political events, policy errors, etc). Investors can best mitigate these risks by focusing on high quality US equities and highly competitive companies with dominant brands of services or products. Additionally, "dry powder" in the form of high quality fixed income investments or other cash equivalents will add portfolio value for the patient investor.

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