Q2 2015 LOOK AHEAD
Disclaimer

Certain information in this presentation constitutes forward-looking statements. Due to various risks, uncertainties, and assumptions made in our analysis, actual events or results or actual performance of the markets covered by this presentation may differ materially from those described. The information herein reflects our current views only, is subject to change, and is not intended to be promissory or relied upon by the reader. There can be no certainty that events will turn out as presented. Data are from sources deemed to be reliable. No representation or warranties either expressed or implied are made as to the accuracy of the information presented.
First Things First: Are Stocks Overvalued?

- The S&P 500’s 10-year CAPE ratio (Cyclically-Adjusted Price-Earnings) is at one of its highest levels, but only 6.7% above its 25-yr average.

  **Shiller P/E Historical Avg:**
  - 10-yr = 22.9
  - 25-yr = 25.4

- US stocks have high valuation relative to their historical forward P/E, due in part to financial repression.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>CAPE</th>
<th>Fwd PE</th>
<th>10-yr Avg</th>
<th>Fwd PE</th>
<th>Fwd PE % of Avg</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>28.8</td>
<td>17.1</td>
<td>14.0</td>
<td>122%</td>
<td></td>
</tr>
<tr>
<td>International Developed</td>
<td>21.1</td>
<td>15.9</td>
<td>12.7</td>
<td>125%</td>
<td></td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>15.8</td>
<td>11.9</td>
<td>11.2</td>
<td>106%</td>
<td></td>
</tr>
</tbody>
</table>

- The mean reversion on the S&P 500 would be about -5.3%, based on estimated earnings growth of 11.8% in the next 12 months.

- **This quarter’s main question:** Will earnings support this valuation?

Sources:
Strength and Weakness: The Economic Impact of a Strong US Dollar

- The US Dollar has risen strongly against the Euro and the Yen, making US products more expensive to overseas markets.
- Exports have declined, and manufacturing and GDP growth are slowing.
- Manufacturing accounts for 12% of US GDP and supports 17.6 million jobs (1-in-6 private sector jobs).

Sources:
Energy Prices – Challenges and Benefits

- Low crude oil prices have negatively impacted energy company earnings. Energy producers are reducing CapEx and focusing on lower-cost wells. In 2014, Energy companies contributed 11% of 2014 S&P 500 earnings.
  - On average, producers have hedged ~31% of 2015 production at ~$83.80 per barrel.*
  - World oil demand has declined and is not expected to rebound until the second half of 2015.
  - US consumers are benefiting from lower fuel costs and low inflation, but are saving instead of spending.

*Average hedging estimate and price from Simmons & Co. International, which tracks about 40 producers.

Sources:
Q1 Earnings: Opportunity to Exceed, Unlikely to Disappoint

• Analysts’ consensus Q1 S&P 500 earnings growth estimates have declined sharply since October 2014.
• Excluding energy companies, earnings growth is estimated at 4.1% down from 12.3%.
• The magnitude of the negative revisions is the largest in recent quarters and nearly 3 times the 7-quarter average.
• CFO’s slightly optimistic – average Q1 guidance of 9.2% below analyst expectations vs 5-yr average of 11.3% below.

Can Wall Street tell the difference?
• Is there an opportunity to surprise to the upside?

Sources:
Small Cap Stocks and the Dollar

- During periods of dollar increases of 15% or more, Russell 2000 small caps achieved an annual total return of 13.6% versus 10.7% for the S&P 500 large caps.
- Foreign-generated revenues account for 46% of S&P 500 company sales compared to <20% for Russell 2000 small-cap company sales.
- From 8/1/14 to 3/31/15, the Russell 2000 gained 12.9% versus 8.6% for the S&P 500.

**Sources:**
The Fed Gets Ready to Wait

• The Fed’s recent policy statement cleared the way for future interest rate increases, however Fed Chair Janet Yellen said, 
  “Just because we removed the word ‘patient’ doesn’t mean we are going to be impatient.”
• Fed rate hikes will be driven by economic data, which has been weak and inflation is low.
• The Fed’s median 2015 target rate was lowered to 0.50% from 1.0%.
• A global slowdown and low international rates could keep US interest rates lower for a longer timeframe.

Sources:
Federal Reserve Board. (3/18/15).
Fixed Income: Don’t Fear Bonds, Fear Liquidity

- From 1955 to 1981, when 10-yr interest rates rose to 15.13%, 10-yr Treasuries returned 3% annually.

- In the 2013 Taper Tantrum, Treasury and High-Yield rates rose sharply in a matter of weeks. Longer-term bond prices declined more than shorter-term bonds.

- Total corporate bond assets are at a record high [A], while trading volume and dealer inventories decline, and high-yield funds have a lower share of liquid assets [B].

Sources:
Hedgewise. (4/1/15). This is Why You Are Diversifying Wrong. SeekingAlpha.com.
Fender, I. and Lewrick, U. (March 2015). BIS Quarterly Review.
Foreign Markets – Be Selective

- Greece faces reality and plays brinkmanship while the EU defends the Euro.
  - “The ECB is ready to do whatever it takes to preserve the Euro.” (ECB President Draghi, 2012)
- The strong dollar may fuel China to invest more in US Treasuries/Real Estate and propel its export-sensitive economy.
- Japan’s reforms are not gaining traction on inflation.
- Brazil may have turned the corner on GDP growth.
- Russia is destabilized with no path to recovery. Foreign lenders have reduced exposure to Russia.

Sales of U.S. Real Estate to Foreign Buyers

<table>
<thead>
<tr>
<th>Country</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>$12.8b</td>
<td>$22.0b</td>
</tr>
<tr>
<td>Canada</td>
<td>11.8</td>
<td>13.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4.2</td>
<td>5.8</td>
</tr>
<tr>
<td>India</td>
<td>3.9</td>
<td>5.8</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.0</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Sources:
- TradingEconomics. (4/1/15). Japan Inflation Rate, Brazil GDP Growth Rate, and Russia External Debt.
Middle East Interfaith Turmoil – Scary and Small for Now

• If Middle East turmoil impacts oil production, higher energy prices could slow global growth.

• The Middle East region* represents about 5% of the world’s GDP with projected average GDP growth of 3.5% (2015) and 4.1% (2016).

• The Middle East region* produces 31% of the world’s oil.

---

*Includes: Egypt, Turkey, Syria, Jordan, Iraq, Saudi Arabia, Kuwait, Yemen, Oman, UAE, Bahrain, Qatar, Iran, Afghanistan, Lebanon, and Israel. No GDP data available for Syria.

Sources:
International Monetary Fund. (Oct 2014). World Economic Outlook: Global Data.
# Mean Reversion Dashboard

## Style Current P/E as a % of 20yr Avg. P/E

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Blend</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>116.4%</td>
<td>104.3%</td>
<td>91.7%</td>
</tr>
<tr>
<td>Mid</td>
<td>124.4%</td>
<td>118.1%</td>
<td>98.5%</td>
</tr>
<tr>
<td>Small</td>
<td>114.3%</td>
<td>107.1%</td>
<td>97.4%</td>
</tr>
</tbody>
</table>

## Regional Fwd P/E as a % of 10yr Avg. Fwd P/E

<table>
<thead>
<tr>
<th>Region</th>
<th>ACWI</th>
<th>EAFE Index</th>
<th>EM Index</th>
<th>United States</th>
<th>Germany</th>
<th>U.K.</th>
<th>China</th>
<th>Brazil</th>
<th>India</th>
<th>Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>122.1%</td>
<td>125.2%</td>
<td>106.3%</td>
<td>122.1%</td>
<td>123.2%</td>
<td>133.0%</td>
<td>89.7%</td>
<td>119.6%</td>
<td>112.0%</td>
<td>73.0%</td>
</tr>
</tbody>
</table>

## Sector Trailing P/E as a % of 20yr Avg. P/E

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100.0%</td>
<td>70.6%</td>
<td>98.3%</td>
<td>91.6%</td>
<td>76.9%</td>
<td>105.7%</td>
<td>107.5%</td>
<td>118.5%</td>
<td>125.2%</td>
<td>108.2%</td>
</tr>
</tbody>
</table>

Economic Dashboard

Source: Bloomberg LP and Federal Reserve. Data is from sources deemed to be reliable. No representation or warranties either expressed or implied are made as to the accuracy of the information presented. Data retrieved on 3/31/2015.
Summary

• Expect interest rates to rise in late 2015, but by less than previously anticipated.
• The strong US dollar is slowing exports and GDP growth.
• Q1 earnings expectations are weak due to the dollar and low energy prices.
• US consumers are saving more – will they start spending?
• Be selective in foreign markets.
• Don’t fear bonds, fear liquidity.
• **Earnings are the critical factor.** If expectations are not met, there could be a dramatic negative effect as the market is fully valued to meet expectations.

**Recommendations:**
• Continued weighting to the US with tilts toward US Small and Micro Caps due to the strong US dollar.
• Increase exposure to exporters like Germany and China.
• Buy Emerging Markets growth in India, China, Brazil, and Indonesia. All are demonstrating a drive to a consumer-focused economy.
• In Fixed Income, actively manage duration, potentially extend beyond the Barclays Aggregate Bond Index duration of 5.5 years.

Source:
THANK YOU

Phillips & Company
1300 SW Fifth Avenue, Suite 2100
Portland, OR  97201

503-224-0858 (Local)
800-572-4765 (Toll Free)
503-224-8207 (Fax)