From right to left:

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Strong Data; Strong Dollar

The US economy continues to display strength versus the rest of the world, raising expectations for monetary tightening next year and inducing a multi-year high for the US dollar. November purchasing manager indexes (PMIs) for both manufacturing and non-manufacturing sectors beat expectations last week and remain at high levels, reflecting expanding business activity. The 'new orders' components for both indexes were particularly strong and suggest accelerating growth.

Meanwhile, the nonfarm employment report showed the US added 321,000 jobs in November, the most since January 2012, with ten consecutive months of more than 200,000 job gains, the best stretch of job growth since before the Great Recession. Take-home pay also accelerated, with aggregate payrolls (hours worked multiplied by hourly earnings) rising to 4.7% year-over-year.

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As Federal Reserve Chair Janet Yellen said last summer, "if the labor market continues to improve more quickly than anticipated by the Committee, resulting in faster convergence toward our dual objectives, then increases in the federal funds rate target likely would occur sooner and be more rapid than currently envisioned." The US unemployment rate stood at 5.8% in November, below the Fed's 5.9%-6.0% year end projection. If the unemployment rate to continues to fall towards 5.3% — around which the Fed considers 'full employment' — then rate hikes become more likely next year, perhaps as early as mid-2015.

We expect continued dollar strength relative to the yen and euro. Our portfolios should continue to benefit from US dollar strength because we have hedged out most of our foreign currency exposure.

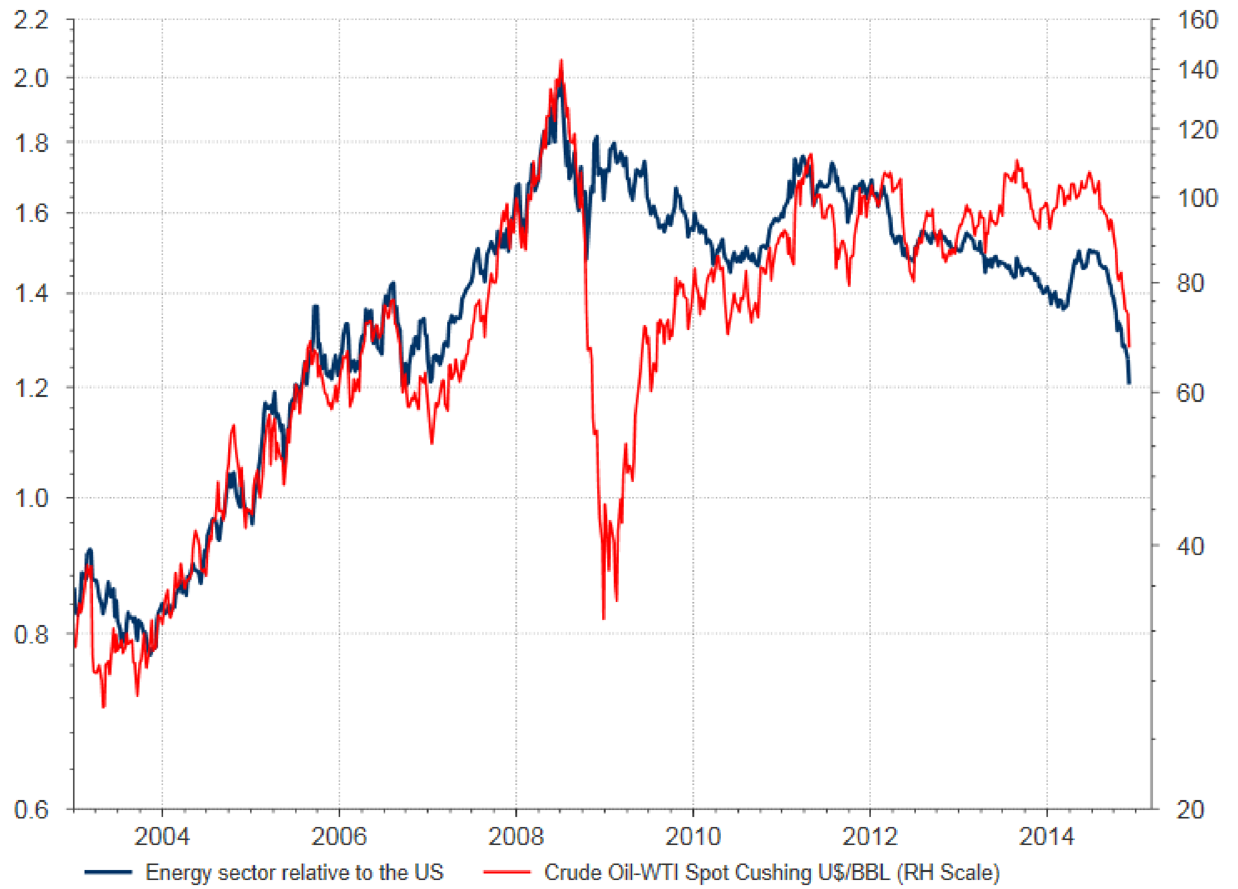
With most of the rest of the developed world mired near recession, other central banks — namely the Bank of Japan and European Central Bank — are boosting monetary accommodation through quantitative easing as the Fed's QE program has ended. Hence, we expect continued dollar strength relative to the yen and euro. Our portfolios should continue to benefit from US dollar strength because we have hedged out (i.e., eliminated the impact of) most of our foreign currency exposure. Indeed, last week we further increased our European exposure on a currency hedged basis, funded by the sale of some of our US stocks. We made a tactical decision to increase US stock exposure during October's 7% correction, but with major US indices again making record highs and the ECB adding to their balance sheet in recent weeks, we believe a greater, currency-hedged weighting to Europe is warranted.

Empirical Research Partners' analysis shows that the sector is as cheap as at any time in the last 80 years on a relative price to book value basis.

Energy sector and oil prices:

The speed and magnitude of the decline in oil prices, while not unprecedented, has been dramatic and unexpected. From a high of over $100/bbl in late June, the price of West Texas Intermediate has fallen to last Friday's closing price of $66 (see Weekly Chart). Based on our research sources, our best assessment of the impact of this 38% decline is a transfer of wealth from oil producers to consumers of around 1.3pp (percentage points) of global GDP, and a potential boost to global growth of between 0.25pp and 0.5pp if prices remain around current levels.

WEEKLY CHART: ENERGY RELATIVE PERFORMANCE BACK TO 2007 LEVELS



Source: Thomson Reuters Datastream

Our chart compares oil prices with US energy stocks' total return performance relative to US large cap stocks (Datastream indexes). The two were closely correlated between 2003 and mid 2008, but since 2011 the energy sector has underperformed despite stable-to-rising oil prices as energy companies struggled to maintain profit margins. Correlation has increased in 2014, with the recent decline in oil prices matched by a proportionate decline in the energy sector's relative performance. This simple analysis suggests that $60-70 oil is already reflected in the sector's price. Furthermore Empirical Research Partners' analysis shows that the sector is as cheap as at any time in the last 80 years on a relative price to book value basis. With oil prices still trending lower, we think it is premature to overweight the sector, but with valuation at extremes, we do not want to be underweight. Last week we added to our US energy exposure and removed our exposure to Norway which hit a risk management trigger.

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