Forging Ahead

As we look to the year ahead, it's worthwhile to consider how far we've come. A few years ago, credit markets seized up, stock indexes plummeted and unemployment approached levels not seen in a generation. Against this backdrop, the prospect of a favorable investment environment six years hence seemed almost unimaginable. Yet, as 2014 drew to a close, all major US equity indexes were trading near record highs. And, despite massive stimulus injected into the economy since 2008, inflation barely registers as a concern. Companies are in good financial shape, and positive wage and employment figures suggest consumers are improving, too. More important, this favorable environment appears likely to continue.

Interest Rates and Employment

Perhaps the biggest surprise of 2014 was the decline in long-term interest rates despite continued strengthening in the overall economy and the gradual elimination of bond buying by the Federal Reserve. Evidence continues to suggest interest rates will remain low. Consumer price inflation, which has been below the Fed's target for several years, will likely head lower on reduced oil prices. Lower inflation readings will permit the Fed and central banks around the world to remain accommodative.

However, the Fed will almost certainly need to adjust its posture at some point in 2015. Recent employment data have shown broad-based improvement. Headline unemployment has trended below 6% and "under-employment" measures—which include involuntary part-time workers and those considered marginally attached to the labor force—continue to move in the right direction. Hours worked, production and wage gains support the thesis that the US economy is strengthening. A Fed Funds rate increase—the first since May 2006—is likely by year end.

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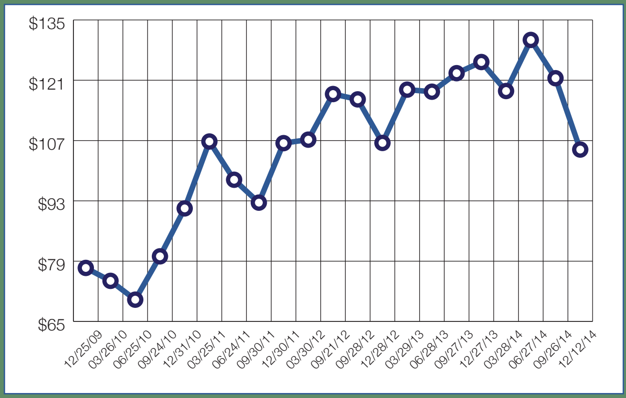
Stock Focus: Chevron (CVX)

Stock Symbol: CVX
Market Capitalization: $198B
Dividend Yield: 4.1%
Long Term Growth: 2.8%
P/E (2015 Est.): 10.6x
Return on Equity: 13.8%

San Ramon, California-based Chevron is an integrated energy company with exploration, production and refining operations worldwide. It is the second-largest US energy firm, behind ExxonMobil. The company's expertise in deep-water production is a key part of its competitive advantage. Chevron's refining operations are attractively positioned to benefit from growing demand in Asia and South America. With very little debt and a significant cash balance, Chevron has the wherewithal to invest through commodity price downturns. Moreover, the company considers its dividend a priority, and its financial strength should enable it to sustain and grow its dividend through the commodity price cycle.



Oil

The price of oil has fallen by more than a third since June. And, OPEC's decision in November to maintain current production could keep oil prices low for some time. Consumers—squeezed by years of stagnant wages and steep increases in health care and education costs—will benefit from this unanticipated drop in energy prices. Household spending on energy could fall a full percentage point as the price of gasoline declines. Resurgent auto sales suggest lower fuel prices are having a positive impact on consumer buying power. At a 17.5 million annual rate, sales of cars and light trucks have returned to levels last seen during the housing market boom.

Not everyone will benefit from lower oil prices. Energy firms and oil-producing countries that are dependent on a higher per-barrel price to justify production or burdened with heavy debt may not fare well in this environment. Consolidation within the private energy sector is likely to increase as weaker firms are forced to merge. Financially strong firms and those less dependent on commodity prices will survive and may find themselves better positioned once energy prices swing back the other way.

Fiscal Policy

Hopes of a better working relationship between Congress and the President following Democrats' clear defeat in November's Mid Term elections were quickly dashed with the President's executive order on immigration. More executive orders are likely—particularly in the area of climate change—as the President, unconcerned with the prospect of reelection, focuses on securing a progressive legacy. In 2014, investors benefitted from a reduction in policy uncertainty, which boosted capital spending and improved hiring activity. However, in 2015, volatility associated with an uncertain fiscal policy outlook could return as a market headwind. While the risks of government shutdown or debt-ceiling brinkmanship are low, retaliatory budget battles focused on defunding the President's orders could dominate the headlines.

Investment Outlook

Low interest rates and the prospect of a Fed Funds rate increase later in the year will make bond investing a challenge. While bonds should continue to play a role in most portfolios, a diverse selection of high-quality, dividend-paying stocks continues to offer the most attractive risk/reward tradeoff and should be a part of almost every investor's portfolio. Dividend-paying stocks are less dependent on price appreciation to generate returns. And, while stock prices—subject to an almost infinite variety of influences—change continuously, dividends remain fairly predictable.

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