Proficient Wealth Counselors, LLC

77 Access Road, Suite 6
Norwood, MA 02062

proficientwealth.com

Phone: 781-278-9488
Toll Free: 877-582-1881
Fax: 781-278-9489

Financial Market Commentary: 4th Quarter Summary and Year Review 2014

There May Be Things to Worry About; There Is Also Good News

During the year various issues pressured market sentiment. The "wall of worry" included uncertainty over higher interest rates linked to the end of the Fed's bond-buying program, economic slowdowns in Europe and China, a 50% plunge in oil prices, geopolitical tension, and Ebola fears. These concerns were trumped by the U.S. economy which improved as the year progressed. U.S. GDP, after stumbling out of the gate to start 2014, grew 4.6% in the second quarter and 5% in the third quarter to mark the strongest back-to-back growth in more than a decade. In addition, the employment situation improved as the economy added an average of 240,000+ jobs per month through November and the unemployment rate fell to 5.8%, the lowest level since 2008. The service and manufacturing sectors continued to expand while housing data, despite monthly fluctuations, trended upward.

Some indices recorded strong gains for 2014 despite several sharp, but short-lived, pullbacks along the way. The Dow Jones Industrial Average (DJIA) ended the year at 17,823.07 - up 1,246.41 points or 7.52% over 2013. The closing level was a few days and a few hundred points off the high for the year and the all-time record close: 18,053.71, a milestone set on December 26. Indices reflected improved investor confidence as U.S. economic growth accelerated and companies reported strong earnings results.

The best day in points and percent for the DJIA – up 421.28 points or 2.43% on December 18th as investors were excited that the Federal Reserve would maintain a dovish stance. The worst day in points – down 334.97 points (or -1.97%) on October 9th as investors expressed concerns about European and Chinese economies. In percent – down 2.08% (or -326.04 points) on February 3rd after US manufacturing activity registered worse than forecasted.

Yearly Financial Market Review

Q1: Results Were V-Shaped Among Most Indices

After a positive 2013, the first quarter of 2014 proved to be challenging for equities. Concerns about economic growth in emerging markets, geopolitical turmoil in Ukraine, and somewhat softer macro data in the U.S. injected more risk aversion into markets. However, profit-taking and tempered expectations for a repeat performance of stellar 2013 returns drove down investor risk tolerance in the first quarter. With investors taking a more cautious approach toward equities, it was not surprising to see markets get off to a rough start in January, though most major global indices rebounded in February and March, finishing the quarter in positive territory, led by U.S. equities.

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Q2: Strong Results from Equity Markets during the Quarter

Equity markets weathered a rise in geopolitical tensions during the second quarter, as all major global equity indices posted strong returns despite increased turmoil in the Middle East and continued conflict in the Ukraine. Macroeconomic data showed the U.S. economic recovery regained its footing after a disappointing first quarter, while easing measures announced by the European Central Bank (ECB) were also a welcome development. Meanwhile, signs that economic growth in China was stabilizing helped emerging markets rebound after a rough start to the year.

Q3: Continued Divergence between Economic Conditions in the U.S. and the Rest of the World

The Dow Jones Industrial Average and S&P 500 achieved new highs in the 3rd Quarter while the Russell 2000 of small companies struggled. During several periods of market volatility, each of the indices went into negative territory. The performance gap reflected investor anxiety over the end of the Fed's accommodative monetary policies; investors favored the "safety" large cap stocks over "risky" small cap stocks. Small cap underperformance was inconsistent with the strengthening domestic economy; in general, small cap companies generate most of their revenues and earnings in the U.S.; a strengthening domestic economy should benefit small caps more than their globally diversified large cap counterparts.

Q4: A Significant Drop in Oil Prices

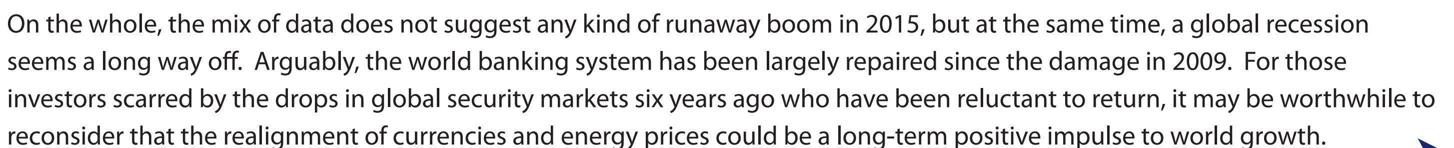
The biggest economic regions China, Japan, Europe, and the United States, are net importers of energy, and now that the price of crude oil has been roughly cut in half, their costs of doing business may also fall. Further, the drop in commodity prices may likely spur overall spending. Historically, going back over 50 years, a 20% decline in oil prices has signaled a 0.5% to 1% rise in the rate of real global GDP growth during the subsequent 12 months. The current drop in oil has been about twice that.

The Global Economy isn't Being Pulled Apart; Low Energy Prices, Interest Rates and Inflation Could Push the World Ahead

Many anticipate that the bull market may extend into 2015 on the expectation of more expansive U.S. economic growth and monetary stimulus in Europe. Wage gains and reduced energy costs here at home should broaden the economic recovery to lower and middle-income households. In Europe, ECB President Mario Draghi is gaining support for a QE-styled bond-buying program, including the purchase of government debt.

A Likely Revival of the World Consumer

Admittedly, global growth has been sluggish, but the world population has continued to expand. Household formation, along with its related spending, was deferred during the slowdown. The demand for goods driven by growing populations — especially in developing countries — is likely to re-emerge. Thanks to currency moves and lower energy prices, many goods are now cheaper, while world wages are generally rising. The emergence of the global consumer, a popular investing theme a few years ago, has been given an added boost.



On the whole, the mix of data does not suggest any kind of runaway boom in 2015, but at the same time, a global recession seems a long way off. Arguably, the world banking system has been largely repaired since the damage in 2009. For those investors scarred by the drops in global security markets six years ago who have been reluctant to return, it may be worthwhile to reconsider that the realignment of currencies and energy prices could be a long-term positive impulse to world growth.

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Risks Remain

The timing of the Fed's decision to raise interest rates, the strength of the U.S. dollar, and geopolitical volatilities may challenge investor sentiment. Strongly-appreciated stock prices may already reflect future growth. Some of the notable trends that helped certain investment sectors last year may not repeat this year: for example, dividend-paying stocks benefited disproportionately from the persistently low interest rate environment. Over $136 billion in dividends was declared for the 30 DJIA components in 2014. Regardless, the momentum of the U.S. economy may sustain markets for an extended period of time.

In 2015, be grateful for slow and steady growth, not leveraged boom-like growth. Cheer for lower, not higher, energy prices. Bear in mind that when low interest rates rise, it will be a sign that normalcy is coming back to economic and financial markets, not that disaster is looming.

Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moodys, Fitch, and S&P is Ba1/BB+/BB+ or below.

Equity Performance

Equity Index	Style	1 Year Return As of 12/31/2014	3 Year Return As of 12/31/2014	5 Year Return As of 12/31/2014	10 Year Return As of 12/31/2014	15 Year Return As of 12/31/2014
Russell 1000 TR	U.S. Large Cap Stocks	13.24%	20.62%	15.64%	7.96%	4.62%
Russell MidCap TR	U.S. Mid Cap Stocks	13.22%	21.40%	17.19%	9.56%	8.90%
Russell 2000 TR	U.S. Small Cap Stocks	4.89%	19.21%	15.55%	7.77%	7.38%
MSCI EAFE NR	Foreign Develop Stocks	-4.90%	11.06%	5.33%	4.43%	2.54%
MSCI EM NR	Foreign Emerging Stocks	-2.19%	4.04%	1.78%	8.43%	7.05%
DJ US Real Estate TR	Real Estate	27.24%	15.48%	15.70%	7.05%	11.68%
Bloomberg Commodity TR	Commodities	-17.01%	-9.43%	-5.53%	-1.86%	2.73%

Fixed Income Performance

Fixed Income Index	Style	1 Year Return As of 12/31/2014	3 Year Return As of 12/31/2014	5 Year Return As of 12/31/2014	10 Year Return As of 12/31/2014	15 Year Return As of 12/31/2014
BarClays US Aggregate Bond TR	U.S. Core Bonds	5.97%	2.66%	4.45%	4.71%	5.70%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	2.45%	8.43%	9.03%	7.74%	7.48%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	0.59%	0.73%	2.65%	3.60%	5.20%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	3.47%	5.06%	6.53%	7.04%	N/A
CitiGroup 3-Month T-Bill	Cash	0.03%	0.05%	0.07%	1.46%	1.91%

Source: Morningstar®

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