2015

Economic Outlook

A Long-Range Economic Look at the Year 2015

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Economic *Outlook*

Economy

POSITIVES

- Natural resource leader
- Cheap energy
- Consumers gaining confidence
- Pre-election year strength

NEGATIVES

- Scarcity of full time jobs
- Strong U.S. dollar hinders exports
- High tax rates
- Burdensome regulations

2014 brought a close to the Fed's Quantitative Easing (QE) program. Interestingly, these efforts were mostly ineffective as the Federal Reserve (Fed) pumped in $3.4 trillion into our system since 2007 but we only saw growth of $1 trillion of Gross Domestic Product (GDP).

There are concerns going forward. The full time jobs situation has been underwhelming and median household income has generally been falling. The U.S. Dollar has been strengthening versus many of our trading partners. While this helps importers manage costs, it might be detrimental for exports, which comprise 13% of our economy. Corporate tax rates remain largely uncompetitive as other developed nations enjoy a top corporate tax rate that averages 14% lower.

Still, we remain a land of opportunities. We are a leading nation in producing energy, agriculture, industrial metals and ideas (patent grants). Consumers, who comprise roughly two-thirds of our economy, are now at their most optimistic levels in five years. Additionally, pre-election years, like 2015, are historically strong for the economy and recessions are rare.

Overall, we anticipate economic growth in 2015. Unfortunately, such growth will remain below our nation's true capacity.

Stocks

POSITIVES

- Macroeconomic factors favorable
- Modest economic growth
- Mid-term year
- Divided government

NEGATIVES

- Valuation levels elevated
- Optimism running high
- Growth in passive investing
- Wall Street enthusiasm

After three years of low volatility and record highs, the market has moved to elevated levels of valuation. These valuations methods include Cyclically Adjusted Price Earnings (CAPE), Price to Sales, Price to Book, Dividend Yield, Tobin's Q ratio (based on replacement value), and others. One of the few positive valuation measures is Relative Earnings Yield, which is earnings divided by price, compared to bond yields.

We are also concerned that Wall Street and Main Street investors have become too bullish. Companies are issuing Initial Public Offerings at a blistering pace and the public is borrowing (margin debt) to buy stocks at an alarming rate. Investments in ETFs (Exchange Traded Funds) have also increased dramatically. In some ways, the massive shift to passive investing reminds us of 1987.

The market is likely to undergo style rotation as smaller cap stocks are now cheaper than large cap stocks and this has been favorable for them historically. We also see a move away from Wall Street favorites toward Bargain stocks (relative value, solid earnings, rising prices). It may well be a year of greater volatility, but active management could be a key to generating positive returns.

Bonds

POSITIVES

- Inflation to remain stable
- Fed still accommodating
- U.S. bond yields offer relative value
- Bonds tend to do well in crises

NEGATIVES

- Repeat of 2014 returns unlikely
- Current low yields point to modest returns

Last year we thought strong returns for long term bonds were possible. We do not believe strong returns are likely in 2015 for long term bonds. Bond yields are too low, investors are too optimistic, and the Fed is forecasting a shift to higher interest rates.

However, bonds are likely to be a good defensive strategy, generating income and preserving capital even in the face of crises and threats from overseas. We believe that active management of the bond portfolio may generate higher returns than "buy and hold."

With the current yield on the 10 year U.S. Treasury Bond around 2.25%, do not rely on returns much stronger than 2.25% over the next 10 years. We would focus on domestic Treasury bonds, high quality Municipal and Corporate issues and we would avoid European and Chinese bonds.

International

POSITIVES

- Pro-business governments favorable for India and Indonesia
- Norway, Finland and Singapore have Technology Advantage
- Ebola vaccine may lead to rally in African markets
- Taiwan, Turkey and Canada show good strength

NEGATIVES

- Russian sanctions may put Russia in recession
- Russia's Cold War militarism is a threat to Europe's economies
- Japan's quadrillion yen debt risks economic meltdown
- Civil unrest a rising threat in China

The International Monetary Fund (IMF), the Organization for Economic Co-operation and Development (OECD) and others have lowered their forecasts for global growth in 2015. Much of the fear stems from slower growth in China, Japan's surprisingly weak economy, and the negative impact of sanctions on Russia. Each of these has the potential to disrupt the global economy in ways greater than the current consensus believes.

However, we note the rising use of technology offers real opportunities in some economies that are tech proficient, innovative, and business friendly. In addition, the 2014 election of pro-business leaders with new ideas in India and Indonesia may lead to a wave of growth in Asia. This will partially offset weakness in China and Japan.

We believe nations which import commodities will continue to benefit from low oil and mineral prices, favoring economies such as Turkey and India.

Conclusions *for* 2015

For Business Executives

- Regulatory problems will persist:
  - High taxes
  - Excessive regulations
  - Excessive government oversight
- Domestic markets could perhaps offer better near-term opportunities:
  - Stronger dollar will hurt overseas sales and earnings
  - Cheaper imports may help contain costs
- Change product mix to generate more sales:
  - Consumer fickle but can be tempted
  - Luxury items face setbacks
  - Seek opportunities in staples
- Skilled Labor: anticipate pressure for higher wages:
  - Skilled craftsmen shortages will persist
  - Sponsor education and training for the best of your labor force
- Innovate to survive:
  - Use cash to invest in technology
  - Inexpensive financing available
- Cheaper energy:
  - Higher profits
  - Lower costs of production and delivery

For Investors

- Caution: a volatile year is likely
- Good news: no financial collapse
- Domestic Stocks:
  - Prices elevated; increased vulnerability
  - Good stock selection crucial
  - Opportunities in bargain stocks
  - Small caps likely to lead next bull market
  - Lower energy costs could lead to higher profits
  - Favor active management over passive stock investments
- Long Term Bonds:
  - Current low yields may point to modest returns
  - Favor: Treasuries, Corporates, and Municipal bonds
- Foreign Investments:
  - Strong dollar hurts foreign stock returns
  - Economies in Russia, Europe, Japan, and China faltering
  - Opportunities in Norway, Finland, Singapore, Taiwan, Turkey, and Canada

CAPE *– (cyclically adjusted PE) a valuation measure, generally applied to broad equity indices, that uses real per-share earnings over a 10-year period.* ***Price to Sales*** *– a valuation ratio that compares a company's stock price to its revenues.* ***Price to Book*** *– a ratio used to compare a stock's market value to its book value.* ***Dividend Yield*** *– a financial ratio that shows how much a company pays out in dividends each year relative to its share price.* ***Tobin's Q Ratio*** *– The Q ratio is calculated as the market value of a company divided by the replacement value of the firm's assets.* ***QE*** *– (Quantitative Easing) an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.* ***Relative Earnings Yield*** *– the earnings per share for the most recent 12-month period divided by the current market price per share compared to interest rates.*

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