CAPITAL PLANNING ADVISORS™

Q2 ECONOMIC AND INVESTMENT OUTLOOK

Family, Business & Legacy Wealth Advisors

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CAPITAL INSIGHTS

Q1 Economic and Investment Outlook • April 2015

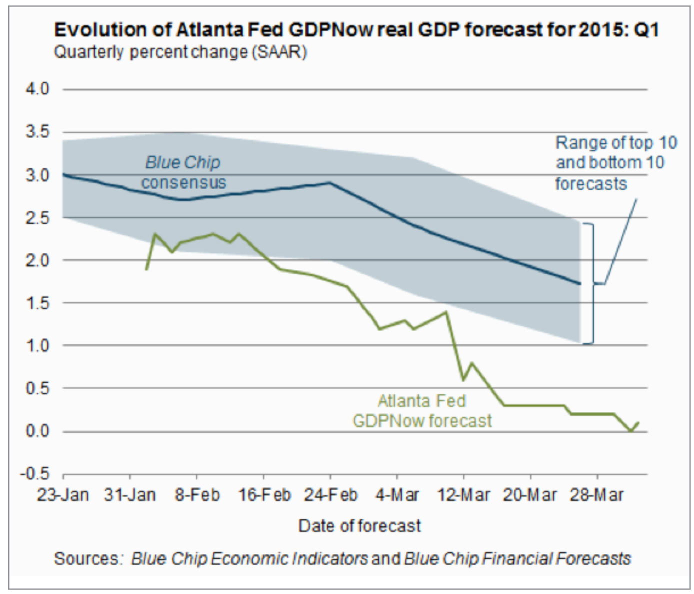
THE U.S. ECONOMY Right Here, Right NOW, There's No Place I Would Rather Be

Increasingly we live in a world of now. Instantaneous access to digital real time data and news has simply become a given in our lives of the moment. You may be surprised to know that the Federal Reserve has taken notice. To the point, GDP data that routinely comes to us from the US Bureau of Economic Analysis (BEA) arrives after the fact. From the perspective of a financial market and investors that are always looking ahead and trying to discount the future, GDP data is "yesterday's news." Moreover, revisions to GDP can come to us quarterly three months after the original data release, and sometimes even years later, essentially becoming an afterthought in terms of relevance to decision making.

Recently the Atlanta Federal Reserve has developed what they term a GDPNow model. The Atlanta Fed GDPNow model essentially mimics the methodology used by the BEA to estimate real GDP growth. The GDPNow forecast is constructed by aggregating statistical model forecasts of the 13 subcomponents that comprise the BEA's GDP calculation.

Private forecasters of GDP, such as the Blue Chip Consensus, use similar approaches to "forecast" GDP growth. These forecasts are usually updated monthly or quarterly, but many are not publicly available, and many do not specifically forecast the subcomponents of GDP that speak to the character of the top-line number. The Atlanta Fed GDPNow model acts to circumvent these shortcomings. By replicating the key elements of the data used by the Bureau of Economic Analysis, the new Atlanta Fed GDPNow model forms a relatively precise estimate of what the BEA will announce for the previous quarter's GDP prior to its official announcement. For now, the model is still young, but it is beginning to be discovered more widely among the analytical community.

The reason we highlight this new tool to you is that we've incorporated it into our ongoing top down review of the US economy. More important to our "here and now" thinking is the current reading of this new model. As you can see in the next chart, the current forecast by the Atlanta Fed for Q1 2015 US real GDP growth is 0.1%, up from 0% at quarter end. As is also clear from the chart, as of the end of the March, Blue Chip Economists were collectively predicting a 1.7% number, quite a differential relative to the Atlanta Fed real time forecast.



Data Source: Atlanta Federal Reserve

Why the sudden drop in the Atlanta Fed real time forecast for Q1 2015 real GDP? As we look at the underlying numbers in the model, we see recent weakness in personal consumption. Many had predicted an increase in consumption with lower gasoline prices, but that has not played out, at least not yet. Weakness in residential and non-residential construction has also played a part in the downward revision. Weather on the East Coast has not been kind to builders as of late, but that's a seasonal issue easily overcome by sunshine. Importantly, slowing in US exports and equipment orders meaningfully influenced the March drop off in the Atlanta Fed model.

We know global currencies have been weak, the highlight over the last six months has been the Euro. With a lower Euro, European exports have actually picked up as of late. The message is clear, the strong dollar is beginning to negatively impact US exports. We do not see this changing anytime soon. As you know, the importance of relative global currency movements has been a highlight

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of our discussions over the past half year. Finally, durable goods orders (orders for business equipment) have been soft as of late due specifically to slowing in the domestic energy industry. Again, a trend that is not about to change in the quarters ahead given dampened global energy prices.

Like any model, the Atlanta Fed GDPNow model is an estimate. Whether Q1 US real GDP comes in near zero growth remains to be seen, but the message is clear, there is downward pressure on US economic growth singularly. This is set against a backdrop of already documented slowing in the non-US global economy. Perhaps most germane to what lies ahead for investors in 2015 is what the US Fed will do in terms of raising interest rates, or not, if indeed the slowing the Atlanta Fed model predicts materializes. We believe this slowing the Atlanta Fed model shows becomes a real dilemma for the Fed this year and a potential perceptual issue for investors. The Fed has been backed into quite the proverbial corner, as we will discuss in the Interest Rate section of this letter. A slowing US economy, or otherwise, the Fed is going to need to start raising interest rates for one very important reason.

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INTEREST RATES There's A Butterfly Trapped In A Spiders Web

It just so happens that the end of the second quarter of 2015 will mark an anniversary of sorts. It will be six years since the current economic expansion in the US began. As of July, ours will be tied for the fourth longest US economic expansion on record (since the Fed began keeping official track in 1945). There have been 11 economic expansions over this period, so this is no minor feat.

The second quarter of this year will also mark the six and a half year point for the US economy operating under the Federal Reserve's zero interest rate policy. You'll remember during the darker days of late 2008 and early 2009, the Fed introduced zero percent interest rates as an emergency monetary measure. It was deemed acceptable as crisis policy. At least as per Fed policy since, the current economic cycle has not only been one of the lengthiest on record, but apparently simultaneously the longest US economic crisis period on record as per the continuation of the crisis zero interest rate policy. As we look ahead, the "crisis period" in the eyes of the Fed is coming to an end as they contemplate higher short term interest rates.

Although it still remains to be seen what the Fed will decide and when, there is one very important consideration that must be entering their interest rate policy decision making at this point in the economic cycle. A consideration they will never speak of publicly. Let's start with a look at the history of the Federal Funds rate (the shortest maturity interest rate the Fed directly controls). Alongside the historical rhythm of the Funds rate are official US recession periods in the shaded blue bars.

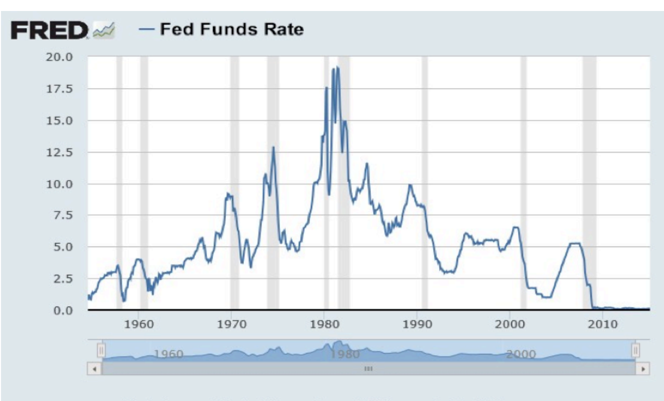

Chart Source: St. Louis Federal Reserve

Of course there is one striking and completely consistent historical commonality in the behavior of the Funds rate over time. The Fed has lowered the Federal Funds rate in every recession since 1954 at least. There are no exceptions. You can see the punchline coming, can't you? Just how does one lower interest rates from zero to stimulate a potential slowdown in the economy?

Of course in the European banking system and in the European bond market (government and corporate paper), we are witnessing negative yields. Capital is essentially so concerned over principal safety, it is willing to pay to be invested in a perceived safe balance sheet. Will we witness the same phenomenon in the US? A move to negative interest rates in the US would further punish pension funds not only starved for return, but still underfunded despite fantastic returns for financial assets over the past five years, all occurring at a time of the geometric movement of boomers into retirement/pension collection years.

The above is a key question. For without venturing into negative interest rate territory, the Fed is essentially out of interest rate bullets in its monetary policy arsenal. It's out of the very ammunition it has employed in each and every recession of the prior six decades. If the US were to enter a recession, the Fed would be unable to act on the interest rate front, as it has for generations.

Is the US teetering on recession? Not as far as we can see, despite the Atlanta Fed GDPNow model currently dipping very close to 0% growth, as we discussed. We need to remember that US GDP growth has been below average in the current cycle and the cycle is not young. The time to contemplate questions such as we are posing is well before a recessionary event. We believe the Fed is contemplating the same. If the Fed is going to raise interest rates, it should be while the economy is still growing. The current reading of the Atlanta Fed GDPNow model is simply a reminder that economic growth is cyclical. Although the Fed will never speak of this publicly, they cannot be trapped at the zero bound (0% interest rates) when the next US recession ultimately arrives. The proverbial clock of history is ticking just a bit louder as we enter the second quarter of 2015. Is this perhaps the key reason the Fed will need to at least begin raising interest rates this year regardless of the near term tone to the economy?

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THE U.S. STOCK MARKET Hear The Seabirds Crying, There's A Ghost Wind Blowing

The US stock market has encountered a bit of heightened price volatility in the first quarter of 2015. After a lot of back and forth, the S&P 500 was up just a little bit less than 1% in the period. The fact is that price volatility is much more a state of normalcy for the stock market than not. What is abnormal are markets that move straight up with little to no corrective action at all. As of now, the US equity market finds itself in one of the longest periods in market history without having experienced even a 10% correction. To a point, the Federal Reserve's unprecedented quantitative easing episodes helped create this non-corrective market environment over the last 2-3 years, but that is changing.

For now, although the Fed has stopped its money printing experiment, global liquidity creation remains strong. The Bank of Japan is printing the equivalent of $90 billion in new money each month. The European Central Bank is not far behind at $60 billion in quantitative easing of their own. From these two sources alone, we are looking at $150 billion monthly, or $1.8 trillion on an annual basis, of new liquidity entering the global capital markets. This liquidity that will be seeking a global resting place will help support many global financial markets. Although this liquidity support is artificial, it is support nonetheless for the time being.

Yet, as the Fed contemplates increasing interest rates in the US, investors are naturally behaving in the spirit of anticipation. Although we have seen a bit of a pickup in price volatility among the major stock market averages such as the S&P, activity underneath the averages has been a bit more violent. For many individual equity sectors, the seabirds have come onshore, their cries telling us change in is the wind.

What we believe is occurring with increased volatility as of late is that investors are attempting to "price in" a change in monetary policy by the Fed. They are attempting to price in what the first interest rate increase in the current economic cycle will mean to investment outcomes going forward. Remember, the markets always look ahead and attempt to discount the future. What is happening today is not as important as what investors anticipate will happen tomorrow. The anticipation of tomorrow drives the investment activity of today. So what are we seeing?

As a result of Fed policy, for the past five years investors have flocked to higher yielding stocks as a substitute for ever lower yielding bonds, CD's, US Treasuries, money funds, etc. Although the major stock market averages eked out a gain for the first quarter, dividend oriented equity sectors, such as the electric utilities, were down 5% for the quarter and down 10% from the January highs of this year. Higher interest rates are "competition" for higher yielding stocks. Above average yielding energy related master limited partnerships as a group were down close to 4% in the first quarter of this year and down close to 12% since the summer of last year. Income oriented real estate investment trusts were actually up 3% for the quarter, but down 4%+ from January highs. Beneath the major stock market averages, above average price volatility is being experienced in sectors such as those representing yielding oriented equities – the exact sectors sensitive to changes in interest rates over time.

Additionally, investors are attempting to price in what a higher Dollar relative to foreign currencies means for the forward reported earnings of the major US multinationals. We've written about the meaning and impact of relative global currency movements to financial market outcomes many a time in the recent past. Many multinational companies have significant revenue sources in global currencies that are declining, such as the Euro and the Yen, meaning pressure on their reported earnings in US dollars. Companies like Procter and Gamble, Microsoft and Johnson and Johnson have seen their stocks fall between 5-10% in the first quarter alone.

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The acceleration in volatility we have seen in the US equity market in the first quarter should not be unexpected, quite the opposite. Investors are digesting and attempting to price in changes that are and will occur in interest rates and relative currency movements. Yet set against this, the global liquidity backdrop remains very strong. Will 2015 be the year we experience the first 10% equity market correction in close to four years? It would not surprise us at all. In fact, it is already occurring in individual sectors sometimes unseen underneath the headline market averages. There is an old saying in the markets, "It's a market of stocks, not a stock market." In 2015, what we avoid as investors will be equally, if not more important, than where we participate. As crazy as this may sound, volatility is actually healthy in financial markets. It means markets are responding to change in real economic fundamentals as opposed to blindly riding waves of artificial liquidity ever higher. Some days the gales are howling and some days the seas are still as glass. Our mission as investment advisors is to respond objectively and unemotionally, knowing that price volatility is more a state of normal market behavior than not.

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