CAPITAL PLANNING ADVISORS™

Q1 ECONOMIC AND INVESTMENT OUTLOOK
Family, Business & Legacy Wealth Advisors
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CAPITAL INSIGHTS

Q1 Economic and Investment Outlook • January 2015

THE U.S. ECONOMY | I Am Raining Down In Pieces, I Am Scattering Like Light

As we look ahead into 2015, what is the most important issue for the US economy? Yes, there are always plenty of variables and points of individual influence within the economy. But if we were to highlight a few key issues, what would they be? The "tax cut" for consumers as a result of lower oil and gasoline prices? The potential for a contraction in one of this economic cycle's brightest stars, domestic energy? The housing sector? The tech sector?

From our vantage point all of the above apply. But in remembering our globally interconnected world, how non-US economies fare will impact the US economy itself. What do economic outcomes in China, Europe, Japan and the emerging economies imply for the US? For now, the US economy stands out as showing relatively good potential set against global comparatives. You may remember back to the 2007 pre-recession period. At the time, the US had a real problem in mortgage credit markets, necessarily influencing slowing in the real economy (all things related to the housing industry, the mortgage related space in financial services, banking, Wall Street, etc.). At the time, the thinking was this problem was US specific, and that other major global economies would "decouple" from the US and be just fine. That turned out to be wildly simplistic thinking as the entire global economy swooned in 2008 and 2009.

Fast forward to the present and we are essentially watching the same movie playing in reverse. As of now, Japan, despite record money printing, finds itself with two consecutive drops in quarterly GDP. In other words, Japan is in official recession. In December the savings rate in Japan fell into negative territory for the first time since official records have been kept. In Europe, economic growth rates have slowed to a crawl, and this is not just in troubled countries such as Greece. Pronounced slowing in Europe's economic strong man, Germany, has been evident for some time. Deflation is a reality in Europe and so is the potential for a recessionary outcome.

China too has been slowing meaningfully. 14% growth rates seen half a decade ago are now half that rate, and most likely much lower than is officially announced. The telltale sign is the large drop in global commodity prices, key inputs for China's manufacturing and construction sectors. It is clear that China needs to rebalance its economy from primarily export dependency to one balanced between exports and internal consumption. This not only takes considerable time, but is certainly not a linear process. Add to this unsustainable acceleration in credit growth over the last five years, and China will be lucky to be able to pull off economic rebalancing without at least some speed bumps, and perhaps a few large potholes along the path.

Finally the emerging markets face meaningful headwinds really as a result of global monetary policy. When the Fed went "all in" with quantitative easing (QE) six years ago, the emerging markets were meaningful beneficiaries as the liquidity created by the Fed transmitted well beyond US shores. Investors used this low cost liquidity to invest in higher yielding emerging market assets. Now that QE is over, the Fed sponsored liquidity pump is no more. Moreover, a rising Dollar is very bearish for emerging economies, causing capital to flow back to the Dollar. Maybe least discussed, but quite important given the low interest rate environment created by the Fed, many a company in emerging markets borrowed cheaply in US Dollars as opposed to borrowing in respective home currencies. As the Dollar rises, the debt load actually increases for Dollar borrowers outside of the US (as they are paying off Dollar denominated debt in a home currency depreciating relative to the Dollar).

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The shoe is on the other foot in this cycle. It is the non-US global economy that has been weakening. So the question now becomes, can the US "decouple" from the slowing influence of China, Japan, Europe and the emerging economies? Again, we exist in an interconnected global economy. The global economic slowdown has been ever so slowly raining down in pieces. Pockets of former global economic strength have been scattering like light throughout the last year.

For now, the US is the lead sled dog pulling the global economic pack forward. Can the US continue to pull the entire global economic team, or will the team become some type of a drag on the lead sled dog that is the US? This is the question for US economic growth at the margin looking into the New Year.

The good news is that at present, approximately 80-85% of US economic activity is domestic in nature. The slowing non-US global economy is going to hurt, but it will in no way derail domestic growth, rather restrain it. Domestic consumption will benefit from lower energy prices, although we know an offset will be a slowing in one of the fastest growing US industrial sectors, domestic energy. Broad US payroll and wage growth take center stage in supporting domestic economic growth in 2015. Recent trends tell us not to expect leaps and bounds, but we are on solid footing. At least looking into the first half of 2015, the US will continue to show relative economic strength set against a global backdrop of scattering economic light.

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INTEREST RATES Marlene Watches From the Wall, Her Mocking Smile Says It All

For those of you among the "boomer" generation, you can perhaps remember back to a time when your bedroom may actually have been adorned with one or more of the following: black lights, incense, black light posters, and a beaded doorway hanger (the stereo setup is taken for granted). If it wasn't you, it was one of your friends. Iconic childhood/early teenage images remain in memory such as the smell of patchouli incense, the Easy Rider movie poster of Dennis Hopper offering a friendly personal hand gesture, and of course the black and white poster images of international movie star Marlene Dietrich. The likes of Hopper and Marlene watched from the bedroom wall as boomers journeyed through their own wonder years coming of age.

For those of you not among the boomer contingent, yes, these things actually happened to your parents or children. On second thought, you parents of the boomers are already more than well aware, although you've probably repressed the memories until now.

It turns out the financial markets may be repressing another memory, and that's how fast markets can move in anticipation of change. Unless something relatively dramatic occurs, 2015 will be the year for change in US interest rates as the longest period in the history of the US for which the Fed has kept short term interest rates at academic zero is coming to an end. The big question for the financial markets will be one of interest rate acceleration. It just so happens that at the time of black lights and black light posters forty years ago, the US was also on the cusp of a dramatic change in interest rates, albeit much more meaningful at that time than anything seen before or since. Nonetheless, what will be important to bond investors in 2015 will be how the financial markets react to and price in this change.

For now, the financial markets continue to rally as Fed members use terms like "patience" and "considerable period" when referring to the timing of interest rate increases to come. But at the latest meeting in December, the Fed revealed they are "a couple of meetings away" from raising interest rates. When questioned at a press conference what the phrase "a couple" meant to the Fed, in one of the most direct answers we have seen from a Fed official in some time, Janet Yellen responded "two." If we are to take Ms. Yellen at her word, the Fed could be raising interest rates as soon as April of this year, the third scheduled Fed meeting for 2015. Whether this is a certainty or not for April remains to be seen, but it is clear the days of zero percent short term interest rates are soon coming to an end. Guessing the precise Fed meeting at which this normalization process begins is beside the point.

First, it is a certainty that the Fed intends to move slowly in raising short term interest rates. The key issue for bond investors in 2015 is that the market may not. We need to remember that the Fed sets the price of the Federal Funds Rate (think money market fund rates), but in the absence of QE is no longer buying other bonds and influencing the yields of bonds other than the shortest of maturities. The key issue for us as investors looking at these circumstances in 2015 is that we cannot manage the risk in the bond portion of our portfolios by simply looking only at interest rates and Fed actions. That would be a mistake. Rather, we need to watch actual market driven bond prices that are independent of Fed influence now that QE is over. There is a very good chance the markets will move out ahead of the Fed, in fact we are seeing evidence of this now.

Historically, two year US Treasury yields have moved out in front of increases in the Fed Funds Rate. The following chart shows us this relationship. This is nothing more than markets doing what they should do – anticipating forward change. As of now, two year yields are up noticeably as of late set against a stagnant Fed Funds Rate. If this reliable historical relationship is to continue to be valid in the current cycle, the market is suggesting the Fed is already late in raising short term interest rates. In December, the two year Treasury yield spiked from .49% to .67%. That's certainly not a lot in absolute yield, but expressed in percentage change, that is a 37% increase in nominal yield in one month. Investors focus on change at the margin. This move in short term bond yields shows us clearly that the market is moving out ahead of the Fed. Again, bond investors cannot take their cues from watching the Fed. They must watch the broad fixed income markets. They must watch price. Two year Treasury yields are simply one example.

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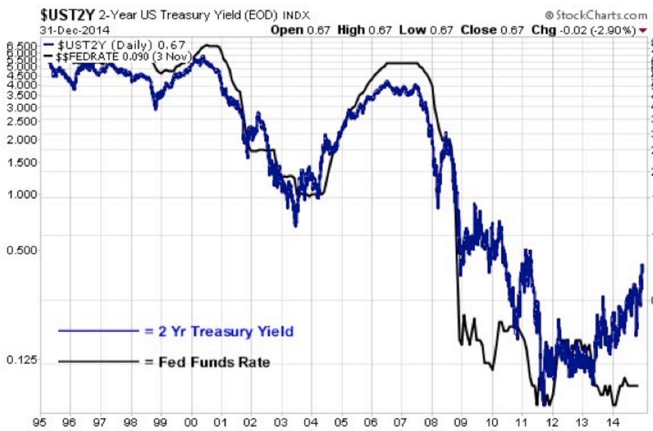
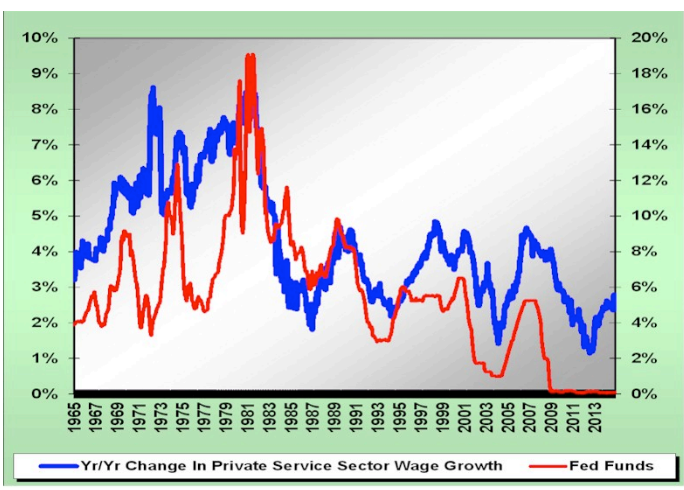


In tying interest rates to the real economy, we need to carefully watch the monthly service sector wage growth numbers. Historically, the Fed Funds Rate and the year over year change in average hourly earnings have been very highly directionally correlated. The only way by which inflationary pressures are sustainable longer term is if wages follow. In initiating QE, the Fed stated an unemployment target it wished to reach. That target was attained some time ago. So now wages are what the Fed will be watching. If for some reason wage growth accelerates with a better job outlook, the Fed may indeed be forced to raise interest rates in a much more robust fashion than investors now expect. This is a risk for bond holders as growth in wages has preceded or accompanied every Fed Funds increase cycle of the last half century. Again, this historical relationship suggests the Fed is already a bit behind the curve in raising rates.



Data Source: Bureau of Economic Analysis and US Federal Reserve

One positive for investors in US bonds in the year ahead is perhaps the key macro issue for the global financial markets – the direction of relative currency movements. For now we have a bit of a global juxtaposition. The US Fed is the only major central bank faced with increasing interest rates in 2015. The Bank of Japan, People's Bank of China and the European Central Bank are all in monetary easing mode, as well as are a number of emerging economies. As such, rising US rates relative to global interest rate levels will be very supportive of an already strengthening US Dollar. As the Dollar strengthens, it draws global capital to US assets, inclusive of stocks, real estate and bonds.

For the prior three plus decades, the US has been treated to a once in a generation decline in the level of interest rates. It has produced one of the greatest bull markets for bonds ever seen. Investors have been lavished with bond coupon yield and price appreciation. As we look forward, we expect bonds to return their coupon yield. The days of significant appreciation in value are at or near a close. In 2015, our focus is high quality issuers within the context of a slowing global economy. We need to manage risk by focusing intently on market signals, not Fed verbiage. Albeit quietly and slowly up until now, the markets are already starting to move out ahead of Fed actions in increasing short term interest rates. Can the Fed ultimately normalize interest rate policy without market disruptions, domestic or global? If the Fed had a poster of Marlene on the wall of the Mariner S. Eccles building (the Federal Reserve), presiding in judgmental silence over Fed meetings, we have the feeling she'd be displaying quite the mocking smile.

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THE U.S. STOCK MARKET I'm Fighting Things I Cannot See, I Think It's Called My Destiny That I Am Changing

Traditionally, fundamental investors in the stock market focus on company specific cash flow strength, earnings and sales growth, new business opportunities, valuation metrics, etc. when assessing investment opportunities. "Technician's," as they are often called, focus on chart patterns in deciphering stock price characteristics such as relative strength, momentum, price breakout and resistance levels, trending character of price, etc. These tools of the trade, if you will, have served investors well since the dawn of market history. Although very much important as a key input to the global asset assessment and investment process, much lesser in mainstream view has been the significance of relative currency movements in influencing investment outcomes. Why are we bringing this up? We believe one of the, if not the, key macro influencing stock market outcomes globally in 2015 will be relative currency movements, with special emphasis on the US Dollar. Currency movements will have bearing on global capital flows, either attracting or repelling global liquidity that can and will favorably influence asset prices in currency destinations of choice. Clearly the reverse is also true. In 2015, in what and where we invest will be equally important as where and what we avoid, in large part based on currency movements. Will often unrecognized currency movements be destiny in 2015? We believe they will be very important.

As we mentioned when discussing interest rates, the Federal Reserve will be the only major economy central bank raising interest rates in 2015. Academically, this would support the value of the US Dollar versus foreign currencies, especially those whose central banks remain in active monetary easing mode. Moreover, as addressed when reviewing our outlook for the economy in the New Year, foreign economies are struggling. The US economy stands out on a relative global basis as an oasis of moderate growth accompanied by relative currency strength. It may sound simple, but global capital is attracted at the margin to its greatest rate of return investment choices. This usually is not found in economies exhibiting slowing growth or a declining currency. Rising rates and moderately accelerating economic growth are two US Dollar specific fundamental investment attraction points for global investors wishing to place capital in 2015.

Technically, the recent Dollar rally versus major global currencies is very interesting from a historical perspective. The chart below is a very long term look at the Dollar index. A technician would suggest the US Dollar could "break out" to the upside from a multi-decade decline. A cross above this "declining tops" trend line would suggest much higher values for the Dollar ahead. We'll just have to see what happens, but we can assure you this is one chart many a global investor is monitoring closely at the moment.

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THE U.S. STOCK MARKET I'm Fighting Things I Cannot See, I Think It's Called My Destiny That I Am Changing Con't page 5

Both fundamentally and technically, we need to be prepared for a potentially higher Dollar in 2015. We personally believe this is coming and have, as well as will continue to act accordingly. If indeed this occurs, what should we expect?

1. Strong currencies attract global capital. This was in good part a portion of what drove US financial markets in 2014 – the weight and movement of global capital to the US Dollar at the margin. The move to the Dollar by global capital could easily accelerate in 2015. When foreign capital buys the US Dollar, this is usually accomplished by the purchase of US bonds, real estate and blue chip stocks. A strong Dollar would be a continued support for US blue chip stock prices, almost irrespective of fundamental valuation metrics. The weight and movement of global capital will again be a meaningful theme in the New Year. Relative currency movements will be the road map for this movement.

2. It has been estimated that there is over $5 trillion in Dollar denominated debt that has been taken on by non-Dollar domiciled (non US) corporations and governments. A higher Dollar essentially raises the level of debt for these non-US Dollar borrowers as they are paying the Dollar denominated debt back with their depreciating (relative to the Dollar) home country currencies. This could be an especially acute problem for the emerging economies. A higher Dollar will draw ever further capital from the emerging economies. Be forewarned.

3. A moderate growth US economy accompanied by even mid to high single digit earnings and a stronger Dollar could easily displace foreign equity investments in investor portfolios priced especially in Yen and Euro's if the Dollar continues its now measured ascent. Assets priced in relatively weak currencies whose underlying economies are struggling to grow will not be seen as favorably as investment assets priced in strong currencies.

4. A strong Dollar will increasingly attract global capital to US financial assets. But we also need to remember that a strong Dollar can ultimately play havoc with the earnings of large multinational companies – the very blue chips that are the initial global investment beneficiaries of the stronger Dollar itself. We need to remember that these companies have significant non-Dollar revenue streams, denominated in currencies weakening relative to the Dollar. A strong US currency can cut both ways, but the positive versus negative impacts are found in the timing. Assuming a strong Dollar again in 2015, we see in the first half to two thirds of the year the strong Dollar being a positive support for large cap US equities. Depending on rate of ascent in Dollar strength, a rising Dollar could begin to hurt large blue chip company reported earnings (currency translations) by late in 2015.

In prior discussions. we have chronicled that the current is not a young equity bull market. In fact, set against historical precedent we find ourselves in a mature equity market environment. Throughout bull markets, stock prices are propelled by various factors. An initial lift off in earnings post a prior cycle recession is usually the initial bull market spark. As earnings grow and economies recover, stock valuation multiples expand as investors become more comfortable in anticipating continued growth and become more willing to "pay up." Earnings, valuation metrics, interest rate levels and direction all play a part in propelling stock prices higher in a bull market. As we look into 2015, we believe relatively global currency movements will be the key driver of investment outcomes. Although not well covered or analyzed in the mainstream financial media, currency will be investment destiny as we embark into the New Year.

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