Written by
Brian J. Pretti CFA, CFP®
Partner & Chief Investment Officer
Capital Planning Advisors

CAPITAL INSIGHTS

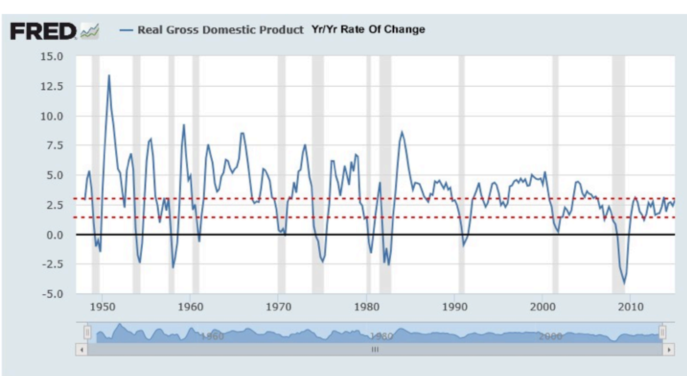
Q3 Economic and Investment Outlook • July 2015

THE U.S. ECONOMY WANTED: DEBT OR ALIVE

You may remember that in our quarterly commentary regarding the US economy in April of this year, we highlighted the relatively new Atlanta Federal Reserve GDPNow model. At the time, the consensus among Blue Chip economists was that Q1 US GDP would approximate a 1.7% growth rate for the period. Alternatively, the Atlanta GDPNow model was predicting 0.1%, which was quite a difference. The first Q1 GDP report actually came in at 0.2%, almost right on top of the Atlanta Fed model prediction, having recently been revised into negative territory.

So what is the Atlanta Fed model saying about US GDP growth in the recently completed second quarter? On a much happier note, the current model reading stands at a 2.2% growth rate. It is clear the US economy is picking up quarter over quarter. What has helped a bit in Q2 was a better tone to employment and capital spending, as well as auto and retail sales.

Before getting too excited about near term economic improvement, we need to remember that we have seen this movie before. In fact we've seen it on a number of occasions in the current cycle. The economy perks up a bit, only to fall back a quarter or two down the road. At this point, we are all certainly aware that the current economic recovery is quite unlike anything we have seen really over the official period in which the US has been calculating GDP (since 1947) to present. The following chart shows us this range of tepid year over year growth rates in GDP we have seen consistently throughout the cycle. So far, we have been unable to break to higher rates of GDP growth that were so common an experience over the past six decades.



What has been the historically differentiating factor for the current cycle has been the inability of the economy to achieve what economists like to call "escape velocity." Escape velocity means the ability of the economy to grow at a rate above its very long term trend. In today's world that means real (inflation adjusted) economic growth for multiple quarters above the approximate 2.5% level. So although within the context of the current cycle and the slowing seen last quarter, it's good news to see a bit of firming in the quarter just completed. Yet escape velocity continues to remain elusive on what is now the sixth birthday of the current US economic expansion cycle. Why?

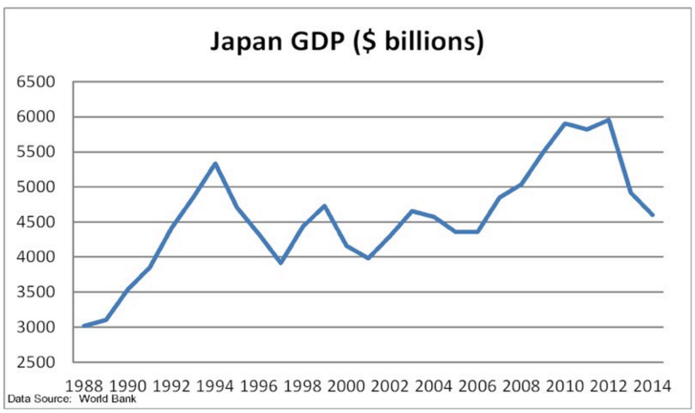
Although there are many reasons for why the current economic cycle is quite different than historical experience, one important issue that transcends the global economy as a character point is the highest level of systemic leverage/debt ever seen. We especially see this at the government levels in Japan, China, Europe and the US. Rising debt levels demand ongoing interest cost servicing that removes precious capital from what may otherwise be initiatives/investments for economic growth. Excessive leverage is a constraint on economic activity. We all know that governments deal with rising debt costs in very much one manner – raise taxes. Of course taxes are yet another tourniquet around the heart of economic acceleration.

The below trend GDP growth we are seeing is not confined to the US, in fact it is quite the opposite. We have seen China slow from double digit GDP growth rates five years ago to mid-single digit numbers. The truth is probably something even lower. Japan has been in and out of recession many times since its peak in 1990. Europe has been slowing for the past three years, improving only recently on the back of a 30% drop in the value of the Euro. What is the commonality of all of these key global geographic economies? The highest level of systemic leverage ever experienced.

The only modern era example of a country that has consistently run very large debt ratios for an extended period of time is Japan. Not only has Japan leveraged the government balance sheet to levels historically considered unthinkable, but their banking system never

THE U.S. ECONOMY WANTED: DEBT OR ALIVE Continued from page 1

took the bad debt write offs that seemed so necessary post the 1990 bubble in their financial markets and economy. Isn't Europe attempting to repeat exactly that with Greece right now? Hence, systemic leverage has been an issue in Japan for decades. Their prescription has been to keep domestic interest rates at zero for well over a decade and continue to borrow. And what has been the result of this persistently high and growing debt load? Although this clearly seems hard to believe, the level of Japanese GDP today approximates the level of Japanese GDP experienced in 1993! In part, the growing burden of debt servicing has "crowded out" the ability of the real economy to grow. Its "fuel" for growth has been syphoned off to service ever higher interest costs.



The above chart represents Japan's GDP experience over the last few decades. Is it a lesson for China, the US and Europe in the current cycle as government balance sheets continue to balloon? It's not just the US, but the global economy struggling to approach GDP growth rates so easily achieved in prior cycles.

As we'll discuss in the next section on interest rates, fissures are starting to appear in government balance sheets globally. The political prescription so far has been to increase taxes, yet higher taxes are an academic constraint on private sector expansion. The global economy finds itself in a unique circumstance never before experienced. Globally, debt levels are very high, having grown substantially since 2009. As we contemplate higher interest rates at some point, that necessarily means yet ever higher interest costs in debt servicing. At least in part, we believe interest costs in debt servicing is exactly why economies globally have struggled to achieve GDP growth rates of past cycles. This constraint is not going to magically disappear any time soon.

CAPITAL PLANNING ADVISORS

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief
Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA (INACTIVE), Partner & Advanced Planning Counsel

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180

INTEREST RATES DARKNESS ON THE EDGE OF TOWN

As you are fully aware, the drama playing out in Greece has dominated news headlines as of late. We devoted an entire monthly commentary to Greece in March of this year. At 1% of total Eurozone GDP, our assertion was that the issue of Greece had absolutely nothing to do with the real Greek economy and everything to do with avoiding a potential spread of periphery European government debt defaults and/or restructurings. In essence, if Greece were granted debt forgiveness, Italy, Spain, Portugal and potentially France would line up right behind them asking for the same. This would be a nightmare scenario for greater Europe. As of this writing, final resolution for Greece remains a question mark. The endgame of some type of debt default or restructuring is virtually assured, the only unknown is the timing.

We believe it is very important to step back and realize that the current events in Greece may be the very first hints of darkness at the edge of town in terms of a very important theme that certainly is not specific to Greece alone. The theme is global. The theme is excessive sovereign (government) debt levels.

The current plight of Greece is not new. Excessive debt levels were an issue three years ago, temporarily held at bay with yet ever more loans. One of the key issues for Greece is pension payments relative to government tax inflows. The numbers simply do not work. Sound familiar? Just four weeks ago the City of Chicago had its credit rating downgraded to junk status. Why? Because a judge reaffirmed that Chicago could not renegotiate (hint: reduce) its pension obligations. The credit rating agencies, Moody's and Standard and Poors, knew full well there is a mismatch to come between forward tax revenues in Chicago and expected pension payment obligations, and acted accordingly in downgrading the credit. How will Chicago "fix" this issue over time? There is only one avenue, higher taxes. Chicago property owners, you have been warned. What is the European Central Bank's prescription for fixing Greece? Higher taxes. Are the financial issues facing Greece and Chicago that dissimilar? Not at all. Excessive leverage inclusive of forward unfunded social obligations, relative to the ability to pay. Take away the names and conceptually the problems are the same.

Lastly, although somewhat drowned out by the media cacophony over Greece, the Puerto Rican government announced a few weeks back that it also could not meet its forward debt payments. Like the issues facing Greece and Chicago, the Puerto Rican news over debt difficulties is nothing new. Problems surfaced in Puerto Rico years ago, temporarily held at bay with increasing loans.

The similarity among these simultaneous situations of the moment is obvious. The issue is three government entities who have lived beyond their means. They have promised too much to their citizens, promises made decades ago by politicians who knew they would never be around to experience the longer range consequences of their decision making. These problems of the moment were in plain view years ago. Again, there is no new news here. What is new is that financially, time is finally up for all three. They had years to attempt to deal with these issues. Nothing substantive was done and now they have simply run out of time and resources. There is an old saying on Wall Street – "Bankruptcy happens slowly, and then all of a sudden."

If Greece, Puerto Rico and even Chicago were wiped off the map tomorrow, would the global economy survive and move forward? Without even blinking. But the key concept we need to keep in mind is that the current issues facing Greece, Puerto Rico and Chicago are a microcosm of the same issues faced by major governments, states and municipalities globally. These issues are excessive leverage, significant forward unfunded social obligations and the need to raise taxes to fund ongoing expenses. Greece, Puerto Rico and Chicago are experiencing a sovereign/government debt crisis on the edge of the global economy. They will not be alone, they are simply the first.

What does this have to do with interest rates? Put yourself in the shoes of a lender who has just found out the financial condition of one of its borrowers has deteriorated meaningfully. Would they lend that borrower more money at a lower interest rate or a higher interest rate to compensate for increased risk? The issue for investors is that the capital markets deal with troubled borrowers by increasing their cost of capital – higher interest rates. This is exactly what has occurred with the bonds of Greece, Chicago and Puerto Rico over the past few months.

Capital Planning Advisors

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA (INACTIVE), Partner & Advanced Planning Counsel

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180

INTEREST RATES DARKNESS ON THE EDGE OF TOWN Continued from page 3

Over decades gone by, major developed government bonds have been considered risk-free securities. Will that continue to be the case ahead given the substantially levered global government balance sheets of the moment? During the 2008/2009 downturn, governments globally “bailed out” many a private sector problem, such as TARP for the US banks. What we are now seeing is three government balance sheets – Greece, Puerto Rico and Chicago – who are in need of bailouts. We believe a very important theme for investors ahead will be how the global capital markets deal with increasingly problematic government balance sheets. Greece, Puerto Rico and Chicago are warning signs to investors in government debt. Do government bonds still represent risk free return? Or is it rather now return free risk at current generational low interest rate levels? Unless governments globally address their leverage and unfunded liability issues and make what are now necessarily a set of hard choices, we will not have to wait for Central Banks to raise interest rates. The capital markets will do it for them. The fact that certain government balance sheets have not yet been reprimanded by the capital markets does not mean their underlying problems have gone away. Financial stress happens slowly, and then all of a sudden, even though it has been in plain sight for years. The bottom line is that as an asset class, global government bonds are no longer the safe instruments they were in prior cycles.

Capital Planning Advisors

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA (INACTIVE), Partner & Advanced Planning Counsel

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180

THE U.S. STOCK MARKET THE MANY FACES OF VOLATILITY

The current year has been characterized by increasing daily volatility in financial asset prices. This is occurring in bonds as well as stocks. In fact, through the first six months of this year, the major equity markets have been trading within a narrow price band, back and forth, back and forth. Enough to induce seasickness among the investment community.

On December 31 of 2014, the S&P 500 ended the year at 2058. On June 30 of the current year, the S&P closed the mid-year session at 2063. In other words, the S&P spent six months going up all of 5 points, or 0.2%. Yet if we look at the daily change in the S&P price, the S&P actually travelled 1544 points, daily closing price to daily closing price, in the first six months of the year to close up that same 5 points. Dramamine anyone?

Perceptually, price volatility "seems" to have increased, but as we look at the total point to point percentage price moves, they have been very small. When looked at within the context of an entire bull market cycle, a 3.5% price move in either direction is close to a rounding error in importance. This is the face of volatility we have experienced over the first half of 2015. Not quite as scary as is portrayed in the media, right?

In one sense, what we have really experienced this year is what is termed a "sideways correction." Financial markets can correct in any number of ways. We usually think of a correction in prices as a meaningful drop. That is certainly one form of a correction, and usually never too much fun. Markets can also correct in sideways fashion. They spend a fair amount of time going back and forth, but really moving nowhere point to point. In a sideways correction, the markets are often waiting for real fundamentals of the economy and corporate earnings to catch up with price that has already moved. The markets are digesting their prior period gains. Time for a "time out." At least so far, this is what appears to be occurring this year. Make no mistake about it, sideways corrections heighten the perception and "feel" of price volatility. That's why it is so important to step away from the day to day and look at broader and longer term market character. A key danger for investors is allowing day to day price volatility to influence emotions, and heightened emotions to influence investment decision making.

Two perceptions we do believe to be very important at this stage of the market cycle are safety and liquidity. We live in a world where Central Banks are openly debasing their currencies, where government balance sheets are deteriorating, where individual governments to greater or lesser degrees are increasing the hunt for taxes, and where cash left in certain banking systems is being charged a fee (negative interest rates) just to sit. None of these actions are capital friendly, which is why we see so much global capital on the move, it's simply seeking safety and liquidity. Is that too much to ask?

Capital Planning Advisors

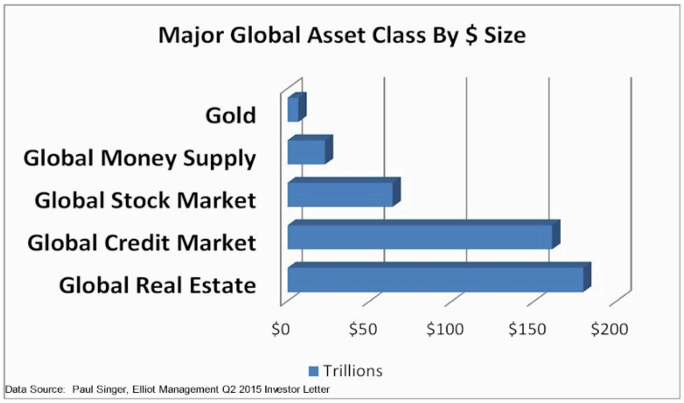
Written by
Brian J. Pretti CFA, CFP®
Partner & Chief
Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA (INACTIVE), Partner & Advanced Planning Counsel

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180

THE U.S. STOCK MARKET THE MANY FACES OF VOLATILITY Continued from page 5

As such, it is very important to look at the size and character of major global asset classes. In the chart below, we look at the global size of the real estate, bond (credit) and stock markets. We've additionally shown the global money supply and gold.



One of the key takeaways from this data is that the global credit/bond market is about 2.5 times as large as the global equity market. Not only in this letter, but in past commentary, we have expressed our longer term concern over bonds, especially government bonds. After 35 years of a bull market in bonds, will we have another 35 years of such good fortune? Not a chance. With interest rates at generational lows, the 35 year bond bull market isn't in the final innings, it's already in extra innings thanks to the money printing antics of global central banks. So as we think ahead, we need to contemplate a very important question. What happens to this $160 trillion plus investment in the global bond market when the 35 year bond bull market breathes its last and the downside begins?

One answer is some of this capital will go to what is termed "money heaven." It will never be seen again as it will be lost. Another possible outcome is the money reallocates to an alternative asset class. Could 5% of the total bond market move to gold? Probably not, as this is a sum larger than total global gold holdings. Will it move to real estate? Potentially, but real estate is already the largest asset class in nominal dollar size globally. Could it reallocate to stocks? This is another potential outcome. Think about pension funds who are not only underfunded, but have specific rate of return mandates. Can they stand there and watch their bond holdings decline, materially hurting their hopes of attaining mandated rates of return? Never. They will be forced to sell bonds and reallocate the proceeds. The question is where. Other large institutional investors face the same issue. Equities may be a key repository in a world where global capital is seeking safety and liquidity. Again, only a potential outcome.

We simply need to watch the movement of global capital and how that is expressed in the forward price of these key global asset classes. Watching where the S&P ultimately moves out of this currently tight trading range seen this year will be very important. It will be a signal as to where global capital is moving at the margin among the major global assets classes we have shown you.

Although this is very easy to say, checking our emotions at the door is essential in investment decision making. Not getting caught up or emotionally influenced in the up and down of day to day price movement is essential in investment decision making. Putting price volatility and market movement into much broader perspective allows us to step back and see the larger global picture of capital movement. These are the important issues, not where the S&P closes tomorrow, or the next day. Or for that matter, the day after that.

CAPITAL PLANNING ADVISORS

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief
Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA (INACTIVE), Partner & Advanced Planning Counsel

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180