

Second Quarter Commentary - April 2015

In this commentary, we will comment on several areas, all of which are interlinked:

- The first is the overall economy, which deals with economic and job growth.
- Next, we will discuss some of the current turmoil in the world, and how they are affecting financial, energy, and currency markets.

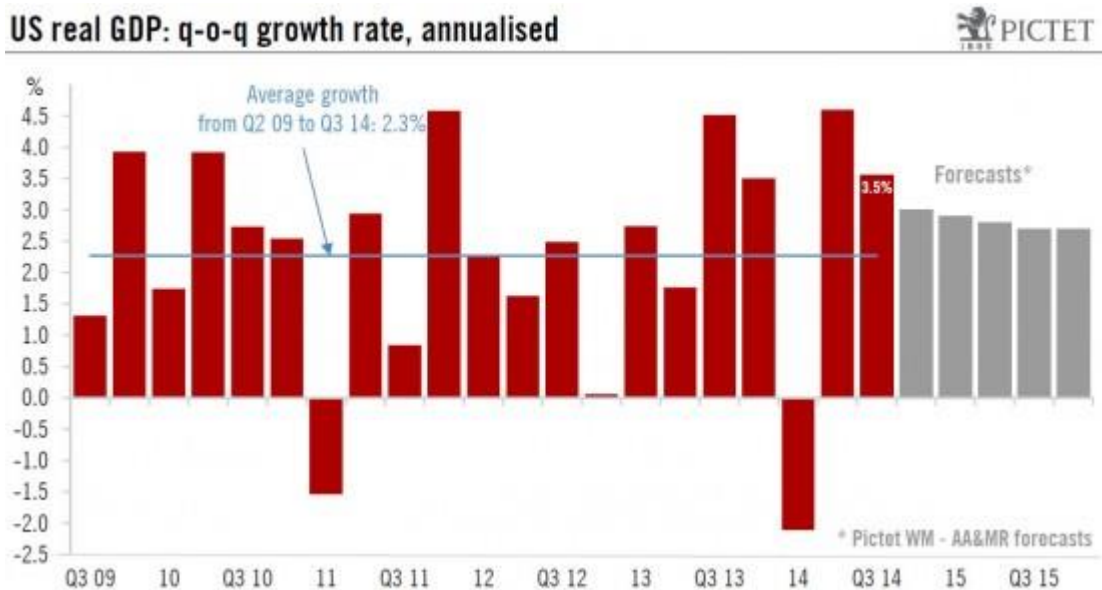
Economy

The economy has continued to steadily and slowly improve since the Great Recession, albeit with a few minor setbacks. However, recent data has begun to raise some red flags which could have an impact on the stock market going forward, and which we will discuss shortly.

First a quick review, the American economy has generally been improving at a faster rate than the rest of the world. Even China, which has had the world's most enviable growth rates, has now had several years of slowing, but still fast growth. Thus, to many investors, America and American companies have been a bright spot in a troubled world. Our growth was engineered by the largest quantitative easing (money printing) in American history by the Federal Reserve Bank. This printing of money, and the simultaneously lowering of interest rates, led to an increase in asset prices including stocks and real estate, as more dollars chased the same amount of assets. Moreover, the subsequent fall in the value of the U.S. Dollar because of the printing of money made U.S. based manufacturers more competitive because they could undercut many foreign based companies on price, since we then had a weaker dollar. Thus, the twin

Federal Reserve policies of printing money and lowering interest rates, which in normal time periods would be highly inflationary, helped to strengthen our markets because the economy was so weak after the Great Recession.

Nevertheless, the United States has experienced a steadily improving economy as measured by GDP growth from early 2013 through the third quarter of 2014. This was interrupted only by the first quarter of 2014 when winter storms produced negative growth.



Most economic indices have improved over the past two years, albeit slowly, but not vigorous enough to allow the Central Bank to increase rates; so even though most investors have been aware that rates would ultimately rise, it was only a question of when not if. The economic rise we experienced over the past two to three years were led by home construction, rising auto sales, and a huge gain in domestic oil and gas production.

These economic gains were also attained alongside strong employment gains. Since the beginning of 2014, job gains hovered close to 260,000 per month for several months. Beginning from early 2015, however, while the economy is still growing, it is doing so with signs of slowing. Job numbers for the first quarter 2015 averaged just under 200,000, and the March numbers just released were just 126,000 new jobs, only half of what was expected. While those numbers have held the official unemployment rate down at 5.5%, the underlying job participation rate is still very low. It's currently running at just 65%, still near the lows of 1979.

The Stock Market

The first quarter of 2015 witnessed one of the more volatile markets in recent years. There was one period wherein nine out of ten consecutive trading days had 300 point intraday swings in the Dow Jones Industrial Average. That's approximately 1.7% per day, one way or the other.

Much of that volatility was the result of Janet Yellen, Fed Chairwoman, indicating to investors that the next move in interest rates was likely to be up, and that it could occur as early as June. Rates are important because they are the biggest competitor of funds to the stock market.

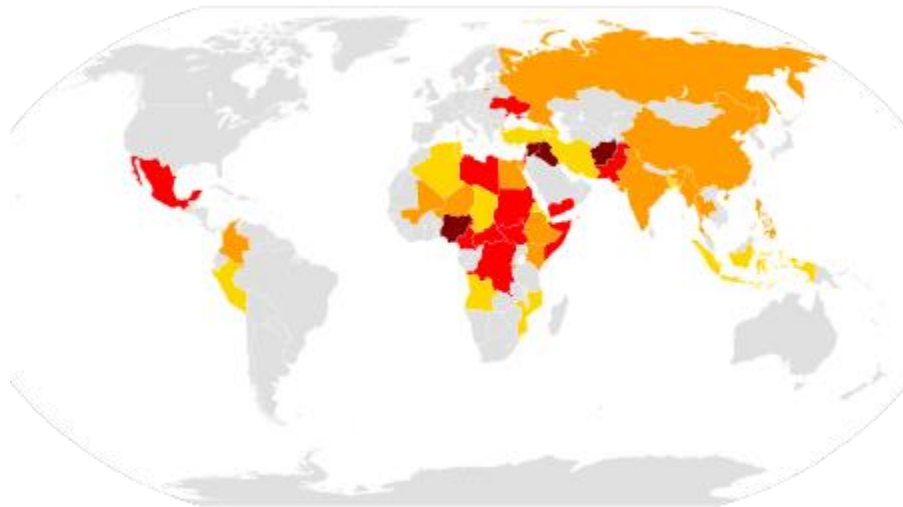
Now that we are in April, the outlook for interest rates is almost the same. Wall Street analysts still expect the next move of interest rates will be up, but Wall Street estimates are now looking for this to occur in the September – December timeframe, probably on the nearer end of that range, because of recent weakness of employment numbers.

Global Turmoil

One does not need to look further than the headlines of the morning paper to see widespread discontent among many factions all over the world. The Middle East is a mess, from almost any perspective. Russia appears to be working toward re-establishing the old Soviet empire, at the expense of the Ukraine, and quite possibly the NATO aligned Baltic States. China is setting up man-made islands in the South China Sea, too many of its neighbors dismay, who are complaining that their territorial rights are being compromised.

Amidst all this, people around the world are sending money to the U.S., and this is one reason for the strengthening of the dollar. We suppose that we would do likewise given their situation.

Current Conflicts- March 2015



Locations of ongoing conflicts worldwide, March 2015

- Major wars, 10,000+ deaths in current or past year
- Wars, 1,000–9,999 deaths in current or past year
- Minor conflicts, 100-999 deaths in current or past year
- Skirmishes and clashes, fewer than 100 deaths in current or past year – BBC News

Global turmoil also has an oil component. As most people realize, the price of crude oil fell sharply from the third quarter 2014, when oil was priced at over \$100 per barrel, to where it sits currently, just above \$50 per barrel. We commented briefly on this in our last commentary, which at that time, oil was still in the \$70-\$75 range. It fell much further in the fourth quarter 2014 and into first quarter 2015, even dropping for a few days in the low \$40 range.

We viewed the drop in oil to the \$70 range as being a net positive, in that there is a direct correlation to the drop in the price of gasoline at the pump, versus an increase in consumer spending. We have seen various estimates of analysts trying to quantify this relationship, but they vary widely, only in agreement to the direction of economic growth being higher, when oil prices drop.

We now have a situation, however with oil at \$50 that is beginning to affect the economy on the downside. This is because over half the increase in job growth over the last few years has had some correlation with oil. This is true not just for the fracking of natural gas, but heavy oil as well.

This has been reflected in a sharp drop in employment in primary oil producing states such as Texas, and North Dakota, and that translates into weaker demand for oil drilling rigs, steel rods, pumping equipment and the like, as well as the man power to operate equipment. However, the oil patch can change quickly. We wrote in our last commentary that despite the large drop in the price of oil, the world wide surplus of oil is only about 1.5 million barrels per day, 2% of world production (that could evaporate quickly if additional problems develop with the shipment of oil out of the Middle East).

The Middle East accounts for close to 25% of the world's oil production, and approximately half of that is produced by Saudi Arabia. A high percentage of this Middle East oil passes through a nine mile wide area identified as the Straits of Hormuz. Iran is on one side of these straits, and Yemen on the other. So on top of the price volatility and unrest caused by the large drop in the price of oil, investors worry that a temporary surplus could become a shortage, if in fact, there are any attacks on ships passing through this area.

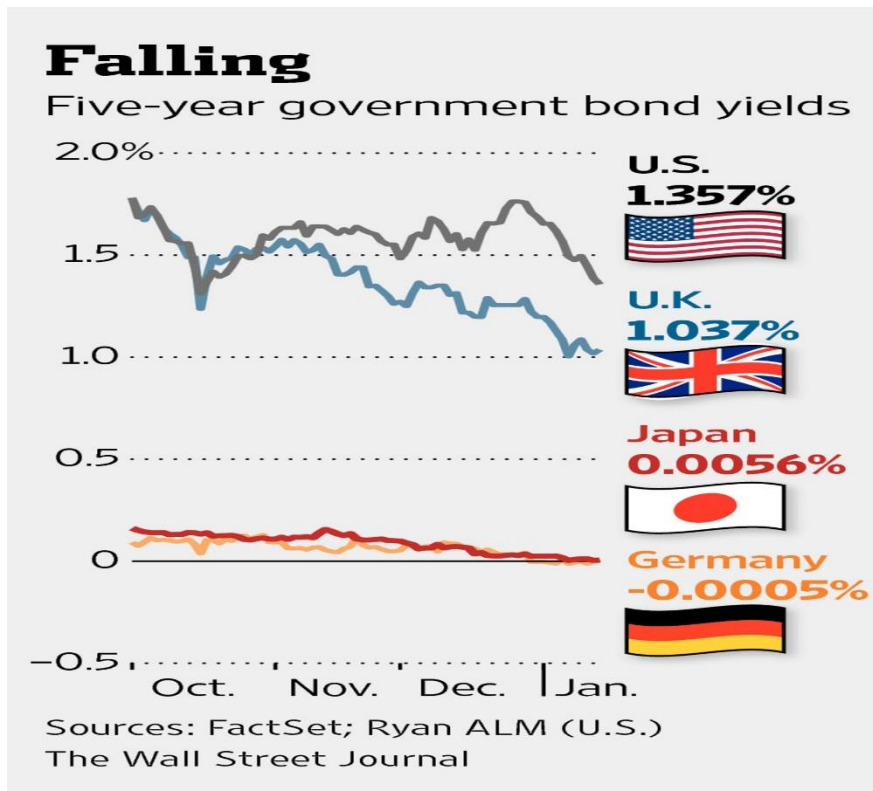
Dollar

Alongside the fall in the price of oil as mentioned previously, is a rise in the value of the U.S. dollar versus other currencies of our trading partners. In fact, the value of the dollar in international trading is up 22%¹ since January 2014. A strong dollar makes it more expensive for foreign customers to buy U.S. made products, and this is beginning to take a toll on large multi-national corporate earnings. Further, because earnings are a primary driver of stock prices, a strong dollar and soft growth have sapped earnings strength in the first quarter 2015.

Foreign Economies Devalue their Currencies

Given the global turmoil mentioned above, and the relative success of the U.S. economic recovery orchestrated by the Federal Reserve Bank, many of our largest trading partners including Japan, Europe, and even to some extent China, have now started new rounds of currency devaluation and lowering of interest rates to boost their own economies.

¹ William O'Neil & Co.



In fact, as a side note, interest rates in Europe, while also low, have both Germany and Switzerland offering negative yields on 10 year paper. That means the creditor (depositor) pays the bank to hold their money. Thus, along with the world turmoil mentioned above, the stronger American economy, and the printing of money by major trading partners has caused investors around the world to start buying dollars. This has caused the U.S. Dollar Index to rally.

However, the rising U.S. Dollar is starting to propagate some red flags in recent economic reports, and will be a drag on corporate earnings going forward. The rising U.S. Dollar hurts corporate earnings in two ways. First, the average U.S. company in the S&P 500 gets about 50% of their earnings overseas, with Europe being the largest foreign market. As the dollar rises, earnings from overseas subsidiaries are translated back into fewer dollars, which means earnings decline in dollar terms for U.S.

companies. Indeed, According to S&P Capital IQ, S&P 500 earnings growth is expected to decline 3.2% in the first quarter, versus the same quarter a year ago. This is significant, in that there has not been a year-over-year- decline in quarterly earnings since 2009.

Next, a rising U.S. dollar also makes U.S. products more expensive to overseas buyers, and imported products less expensive to American buyers. American companies have responded to this competitive threat by closing factories and offices in America and relocating overseas so that they can compete in the same currency as their competitors. Indeed, the U.S. Census Bureau now has factory orders declining in 4 out of the last 5 months (which is rare in an economic expansion), and employment gains and ISM Purchasing Managers reports have also turned sluggish.

While the economy is still growing, the rate of growth has slowed, and the competitive position of many American companies has deteriorated with the rising currency. U.S. Consumers, on the other hand, are doing better and are benefitting from low oil prices, and cheap interest rates. Increased consumption from American consumers will keep the expansion going, but the sectors of growth are shifting to retail, service, and domestically centered medical businesses, and away from oil, gas, and manufacturing.

With the sluggish economic reports, many investors now expect the Federal Reserve to keep interest rates low, or at least not raise rates much, so that they do not derail our economic expansion. Low interest rates directly benefit stock market valuations because interest rates are the greatest competitor for investor funds. If bank CD's or corporate bonds rates are high, many investors will opt for a safer, secure fixed return. When interest rates are low, investors are forced to take on more risk to attain

desired returns, and see stocks and real estate as a way to achieve it. The debate on the directions of interest rates has caused a lot of gyrations in the stock market this year.

Conclusion

Given the current level of stock prices, we see the equity market as being neither cheap nor expensive. As we go to press, the S&P 500 is selling at 16x forward earnings, right in line with its historical average. According to Bloomberg, analysts estimate for S&P 500 earnings for 2015 is \$133 per share. If the S&P 500 earnings come in at \$133, and valuations remain constant, this implies that the S&P 500 will be at 2,128 ($\$133 \times 16$) by the end of the year. Given that the S&P 500 started the year at 2,058 this implies a roughly 5.3% total return on the year (3.4% earnings growth + 1.9% dividend).

Thus, we expect another positive year, but not as strong as last year. Where things become a lot more favorable for stocks, is that dividend yields at 1.9% are very competitive with 10 year Treasury yields of 1.9%, and 30 year Treasury yields of 2.55%.

At the same time, if interest rates do begin to rise, that would temper the stock market, but only if increases in rates are significant enough to change the yield parameters described above. We don't believe that will occur, if only because of the huge Federal debt level of \$18 trillion, and the realization that every 1% change in the yield of interest rates would create an incremental \$180 billion incremented cost to the government. So we believe the Fed will be very slow to change rates, but even when they do, we believe the change will be relatively small, small enough to be offset by dividend income in the equity sector.

As a result, we continue to favor high quality, blue chip, brand name companies that are globally diversified, with a strong balance sheet, and who are returning cash

back to investors through both dividends and stock repurchase for the best risk adjusted returns in an uncertain world.

As always we thank you for your continued support.

Sincerely,



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