SCHNIEDERS
CAPITAL MANAGEMENT, LLC

First Quarter Commentary - January 2015

A Review of 2014

Introduction

In this report, we will reflect back on 2014, and report what we believe were some of the significant events and/or policies that affected the economy and the financial markets during the past year. This includes comments on the rising dollar, international economic conditions, and the precipitous fall in the price of oil.

The Economy

2014 begun with a first quarter of extremely cold winter conditions across much of the United States. Freezing temperatures and heavy snow conditions led to a negative (0.1) GDP growth in the early months of the year. From then on, however, the economy has grown at a steady pace. GDP growth was 3.2% in the second quarter, a revised 5.0% in the third quarter, and estimates run nearly as high in the 4th quarter just ended. This steady increase from second quarter 2014 through December has been driven by strong earnings growth across most segments of the economy. Further and perhaps more important, is that we have also been seeing strong employment growth.

Employment

We view this development as very important, because over the past year or two, we have often commented on weak job numbers as a structural unemployment problem. The good news is that we are finally seeing significant improvement in job growth. The U.S. has averaged over 200,000 new jobs per month in 2014, with the last three months coming in on average at 237,000 per month, with 274,000 in December, indicating somewhat of an acceleration as the year draws to a close. Other economic indicators have also been turning positive. Particularly relevant to job growth is consumer confidence. Consumer confidence rose to 92.6 in December. The rise in consumer confidence is significant, because consumer sentiment correlates directly with consumer spending, which in turn, is approximately 2/3 of the economy.

Much of the economy's gain has been building ever since the "Great Recession" of 2007-2009. Housing, along with manufacturing were two of the primary drivers of an improving economy over the past 3 – 4 years. The pace of new home sales has risen to an average of 438 thousand units over the prior three months[1]. This is well below the peak of almost 1.4 million in 2007, but above the average of approximately 350 thousand units since 2010.

Manufacturing, as measured by the Institute for Supply Management (ISM), continued to expand for the 19th consecutive month. Auto and truck sales have also been a key driver of the economy, and their combined industry sales have been inching up to approximately 17 million units per year, near the highs of 2000 and 2002.

Now, however, as we enter 2015, concerns are being vocalized as to the real staying power of this recovery. These concerns primarily revolve around the current drop in the price of oil from $100 per barrel to $45 per barrel, and what the ramification of lower oil prices might be. Secondly, the value of the U.S. dollar has risen, which make our exports more expensive, and this is occurring as the global economy appears to be weakening.

Despite these concerns, however, most economists remain positive for 2015, citing the fact that the United States, while not yet running on all cylinders, is still in better shape than other countries around the globe.

[1] Forbes – December 23, 2014

International Economy

China has been reducing its forecast of 2015 growth, however, it is still high relative to the rest of the world. They have built an economic foundation of exporting manufactured goods to other counties in conjunction with domestic construction projects. With China's end markets slowing down, and an already high penetration rate, China is slowing down also. In addition, China's domestic construction market is becoming saturated in many industries such that many locations feature empty buildings. Thus, the economic viability of many of these projects is in question. More to the point on China, their banking system appears to be loaded with bad debt, and in many cases real estate was used to back up bank loans, as opposed to strong financial statements. Thus, as the value of real estate assets declines, money becomes trapped in buildings not worth what they cost to build and are not generating enough income to support the cost.

Nonetheless, China remains a major factor in the world economy, it is just going to be more restrained until they get their house in order, and convert more of their economy towards internal consumption and away from economic growth by borrowing money to build fixed assets like partially used factories and buildings.

Europe

The 19 countries comprising the Eurozone, as a group, are hinging on the cusp of recession. Mario Draghi, President of the European Central Bank, has been desperately trying to jump start the Eurozone by printing money, i.e. by taking a page out the United States Federal Reserve playbook. So far, it's kept everything at a flat to slightly positive GDP growth, but the weight of heavy debt for many of the Euro countries is weighing down the recovery, particularly in the Southern – so called PIGS nations – Portugal, Italy, Greece and Spain. We believe problems in Europe will act as somewhat of a brake on global growth, as the Eurozone is very close to a deflationary environment.

Russia

Russia's economy is highly dependent on oil. Russia depends on oil for almost 50% of its annual budget and an even greater percentage of its foreign exchange earnings. As we will note shortly, a falling price of oil could be the kiss of death to Russia's economy. Russia's currency, the ruble, has already fallen 56% from its price three months ago (not too dissimilar to the drop in the price in oil). U.S. and European sanctions against Russia because of their intrusion into Crimea and Eastern Ukraine magnify the inherent weakness in their economy.

Oil

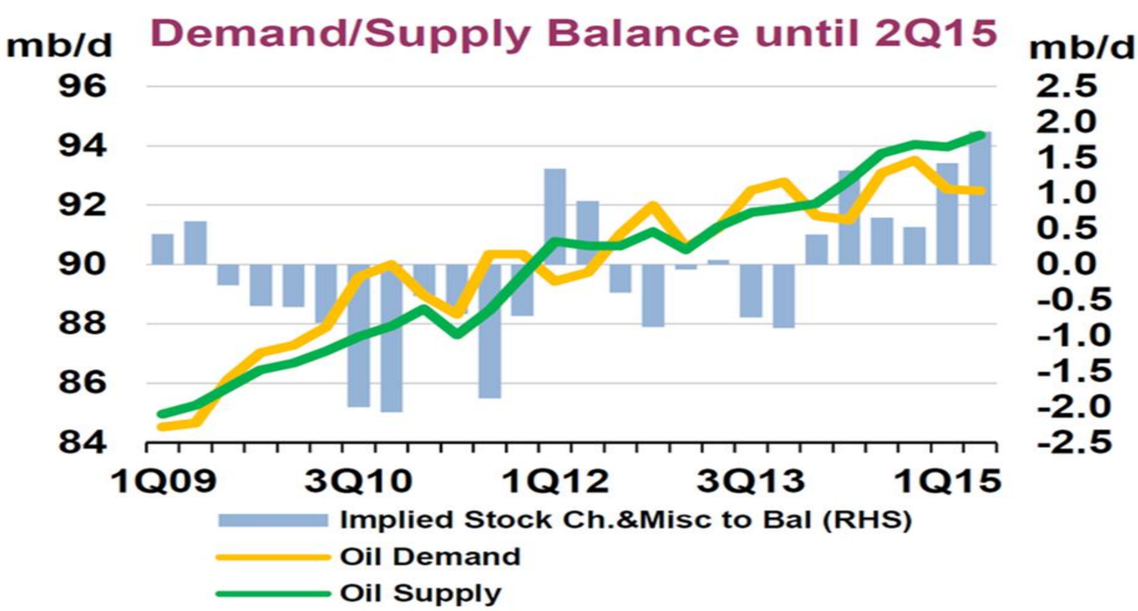
As mentioned above, the price of oil has dropped from over $100 per barrel last summer to $45 per barrel today. The most dramatic outcome of this is a commensurate drop in the price of gasoline. The national average for the price of gasoline was $3.25 in October, and $4 plus per gallon throughout Southern California was not unusual. Those numbers are now $2.25 per gallon nationally, and $2.50 plus or minus in California. The immediate impact of this will be to stimulate the consumer sector of the economy, but hamper some of the growth in the industrial sector of the economy.

The sharp drop in oil has been felt first and foremost by a sharp drop in the price of oil related securities. In turn, the fall in oil stocks has acted as a catalyst for a drop in the overall market, since the energy sector comprises 10 % of the S&P 500. At the same time, energy has been a key driver of profitability for the entire country, and not only profitability, but jobs as well. The immediate ramifications of this drop has been large enough as to set practically all of our financial markets in turmoil; so we believe that there will be increased volatility over the near term until the market price of both oil and natural gas stabilize as there will be major positives and major negatives arising from those new developments.

The key question arising from the quick and precipitous drop in oil is two fold: a) what caused it, and b) what is the price outlook for all for the balance of the year. The facts would imply that the (worldwide) supply of oil has been growing faster than worldwide demand. The

U.S. is primarily responsible for the incremental change in supply, in that U.S. production of oil and gas has risen by 4.2 million barrels of oil per day, so that we now produce 8.9 million barrels of oil per day, up from 4.7 million barrels in 2008, according to the Wall Street Journal.[2] In turn, the vast majority of the increase has come from the hydraulic fracking of shale deposits, and using horizontal drilling to exploit widespread deposits here in the U.S.

On a broader picture, worldwide oil production in 2014 was approximately 94 million barrels of oil and oil equivalents per day; but worldwide consumption was approximately 92 1/2 million barrels per day, suggesting a demand / supply imbalance of between 1.5 and close to 2 million barrels per day, or less than a 2% variance between demand and supply. That variance however, is what caused a 50% drop in price.



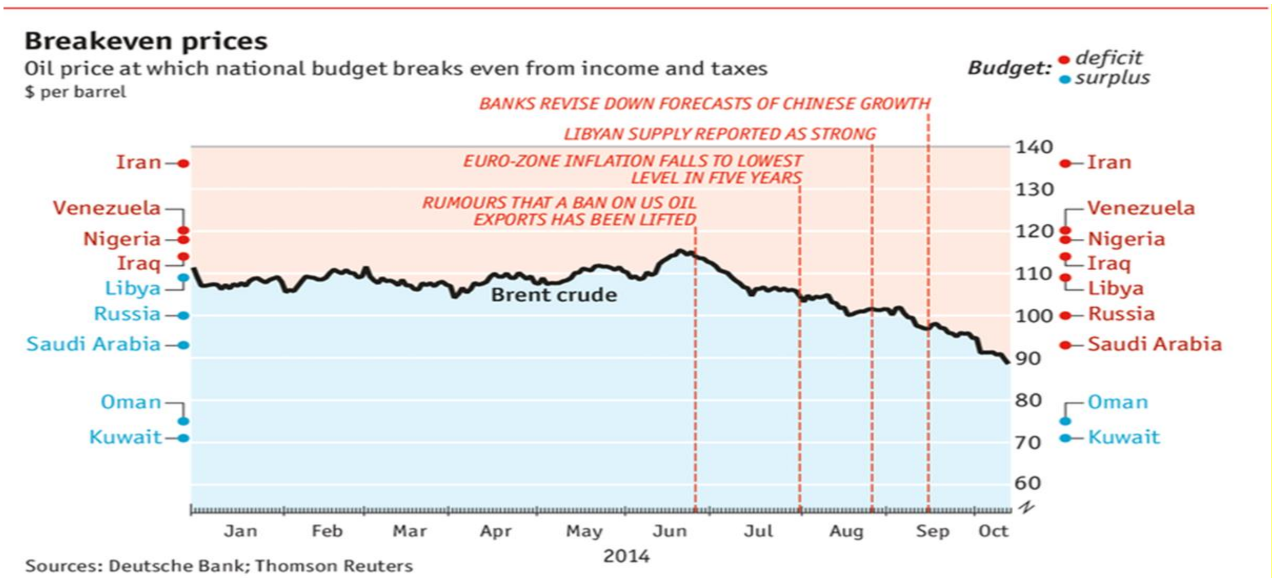
Source: International Energy Agency

The jury is out as to when prices will rebound. The oil surplus that has caused prices to drop has also forced oil exploration companies to cut their drilling projects for 2015 and beyond, and some have canceled major development plans as long as prices hover around

[2] Wall Street Journal – December 13, 2014

current value. Since oil has been a primary driver of economic growth in the U.S., the dislocations mentioned above could act as a near term drag on our economy, potentially offsetting growth elsewhere.

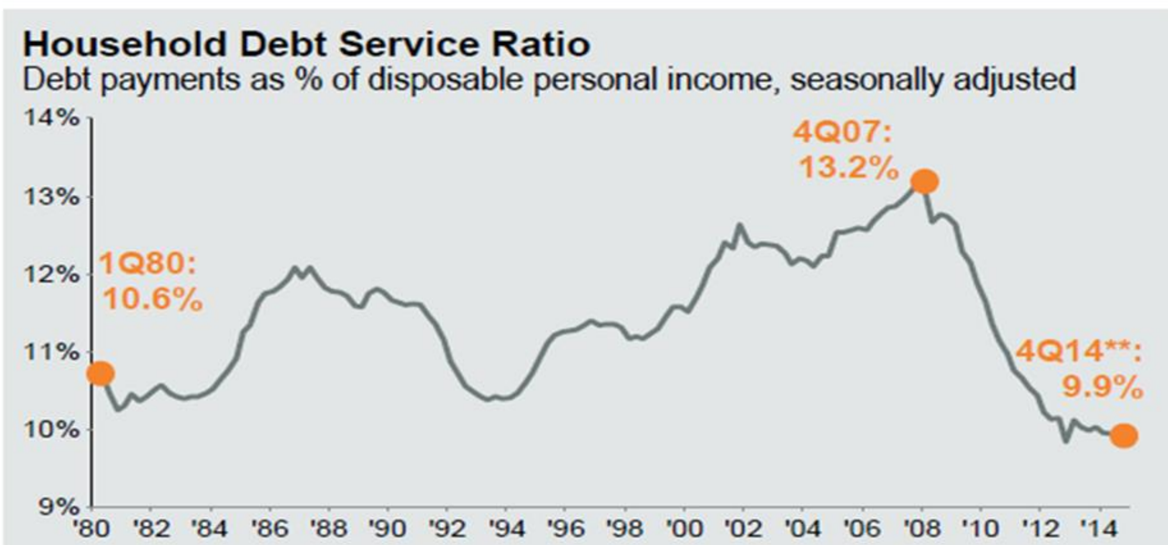
Further, OPEC as a unit is in disarray, and all appear to be significantly dependent on oil to keep their economies going. Saudi Arabia, in particular, has refused to cut production, much to the dismay of countries like Iraq, Venezuela and Nigeria, who all depend on higher prices to justify maintaining production at current levels, and to balance their budgets.



With world GDP growth expected to be flat to modestly positive for 2015, one can assume oil consumption will remain fairly constant. Against that backdrop, there will be increasing pressure on suppliers to cut back production. Projects in motion, however, will continue in order to generate income irrespective of whether it is profitable, in order to generate cash flow on sunk investments. So it may be 4 – 6 months out or longer to see where this balances out. Our guess would be higher prices, but not back to anywhere near the recent highs. We will continue to monitor these events as the year continues.

2015 Major Positives

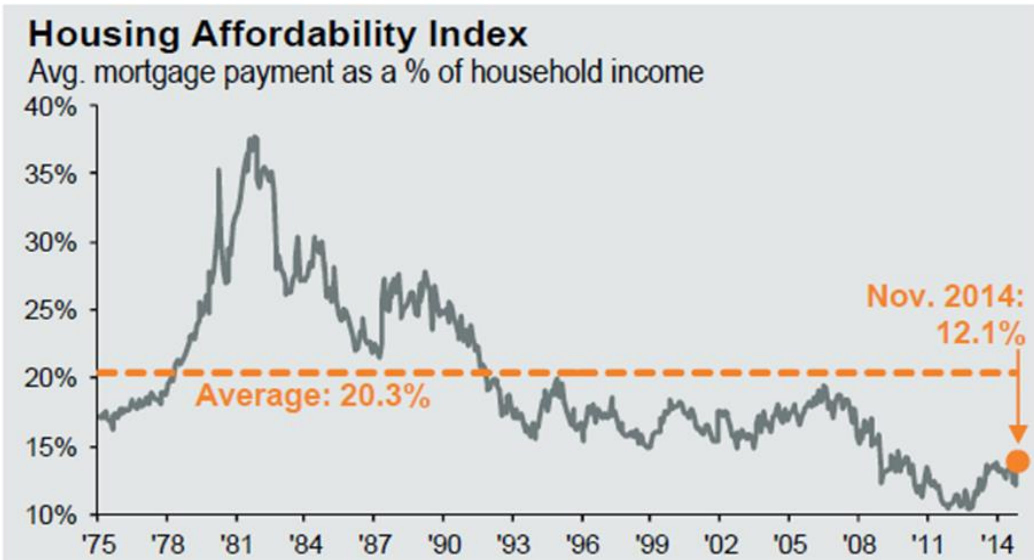
The biggest driver for the economy remains the US consumer. With gas prices falling, and interest rates still low, retail sales will likely be strong this year. There is a direct correlation between lower gasoline prices at the pump, and higher retail sales. There is also a direct correlation between higher retail sales, and consumer confidence, which as mentioned earlier, has also become more positive. Furthermore, after years of writing off bad debt, a contraction in the mortgage industry, and ultra-low interest rates, consumer balance sheets are the strongest they have been in many years. Low interest rates have caused debt payments as a percentage of disposable income to fall to the lowest level they have been since the 1980's. Thus, with the economy starting to pick up, consumers will likely put their new found buying power to work.



Source: National Association of Realtors

Interest Rates

In addition, with low interest rates, and an improving job market, the housing industry will likely also get a boost in 2015. With the fall of interest rates to near record lows, average mortgage payments as a percentage of household income are the most attractive point they have been in 40 years (please see chart). Housing is important because it spurs demand for many ancillary industries including construction materials like glass, wood, steel, carpets, pipes, shingles, cement, cabinets, doors, etc., and housing is the average consumer's largest and most valuable asset.



Source: National Association of Realtors

2015 Major Negatives

The Dollar

Along with the good news that the American economy is improving, the Federal Reserve feels it is no longer necessary to continue to print money and artificially lower interest rates to support our economy. However, as the American economy continues to improve faster than the rest of the developed world, and as foreign economies continue to print money to stimulate their economies (copying the strategy of the Federal Reserve), the value of the American currency has begun to rise versus our trading partners. The dollar has begun to increase because foreigners want their assets invested in the USA to capitalize on our relatively higher growth, and the relative safety of both the US dollar and the U.S. itself.

While the stronger dollar is good for Americans who want to take an overseas vacation, it also makes US exports more expensive, and foreign imports less expensive to US buyers. In fact, the dollar has risen over 10% in just the last few months. The reciprocal of this also means that US exports are now 10% more expensive to our overseas customers, and shiny new foreign cars are 10% less expensive to American buyers. Combined with a drop in oil prices, which decreases the transportation cost of imports into the US, and a growing American economy, we can probably expect our merchandise trade deficit to start rising again as well.

Last but not least, a rising dollar has been accompanied by a declining demand around the world for major commodities, including copper, metals, and agricultural commodities. Historically this is usually indicative of a global slowdown.

The Federal Reserve

The actions taken by the Federal Reserve Bank over the last three to four years have been very accommodative to a rising stock market. Multiple doses of Quantitative Easing have provided liquidity to the financial system, and a good part of that liquidity has ended up in the financial markets.

The bond market has moved higher because the Fed has kept interest rates low; (and bonds and interest rates are inversely correlated). Further, because of the low interest rate environment, yields on "risk free" assets such as U.S. Treasury Bills and Notes have not been as competitive versus dividend yields on a good many high quality blue chip stocks. The Fed easing described above is coming to a close, and while interest rates will probably remain low, the Fed has already signaled that the next move in interest rates will be up. It didn't say when, except that it is likely to be later this year, and be a relatively small increase. Nonetheless, just the hint of higher rates, and speculation as to its timing, in and of itself has created major swings in stock indices over the past six to nine months.

Conclusion

Common stocks, as measured by the S&P 500 Index, are selling at 16 times expected 2015 earnings, which is in line with historical averages. The strengthening American economy will help earnings growth, but the weak international economy, which is responsible for almost 50% of the S&P 500 earnings, will act as a drag. When combined with erratic commodity prices, we expect to see more volatility this year. However, the biggest driver for stocks remains low interest rates. In fact, with interest rates on interest bearing securities paying very little and near historic lows, and with the outlook for rates not to rise very much, investors may be willing to push equity valuations higher. Indeed, large numbers of investors including pension funds, retirees, and endowment funds need income to meet their budgets and fund their operations. These groups may turn to equites just to meet their operating needs. We believe yield will become an increasingly important focus in 2015. Thus, we continue to believe that a portfolio balanced with income investments and high quality blue chip stocks, with strong balance sheets that are returning cash to investors through dividends and stock buy backs are the best risk adjusted return vehicles for an uncertain world.

As always we thank you for your continued support.

Sincerely,

Bill	Jim	John
William H. Schnieders Principal	James F. Schnieders, CFA Principal	John C. Schnieders, CFA, CFP® Principal