EGLSEDER
WEALTH MANAGEMENT GROUP, INC
THE RETIREMENT SPECIALISTS

8694 Commerce Drive, Suite 2
Easton, Maryland 21601

TEL 410-822-9143
FAX 410-763-7264

www.eglsederwealth.com

Half-Time Report

June 2016

Where have we come from and where have we arrived?

Unbelievably, I started my career in the summer of 1984 - thirty two years ago. Upon reflection, I have realized several things that I found very interesting. With only one exception, I have worked through all of the worst declines for the stock market since 1929! The one exception was a very large decline in the stock market that occurred between 1973 and 1974. As I examined all of these declines, I noticed something that I found to be significant. Not surprisingly, all of the large declines in the market were caused by either a singular event or a series of events that scared the hell out of investors – which is what caused the stock market to go down. Interestingly, however, while all of these events caused an extraordinary amount of fear, most of these events actually did very little damage to the economy. So these events scared people, but most of them did very little damage.

In the century in which we are located, we have suffered through the worst and the third-worst declines for the stock market since 1929. The first decline in the stock market in this century was actually caused by a series of events, the most significant of which was 9-11-2001. As horrible as 911 was, 911 actually did very little damage to the broad U.S. economy. Now, there were two industries that were severely damaged: 1) Airlines – many U.S. carriers went into bankruptcy and some, like TWA, did not emerge. 2) Travel and tourism – it took 18 to 24 months before business in these industries got back to their pre-911 levels. Outside of these two sectors, however, very little damage was done to the broader economy. Case in point: 30 days after 911, U.S. Consumers spent more money than the 30 days before 911.

Then, starting in early 2013, for various reasons, 30 year mortgages interest rates began to drop. Over roughly the next two years, the rate on the average 30 year mortgage dropped from about 6% to about 4%, with a very significant economic result: A single individual or a married couple could, for the same monthly mortgage payment, borrow 50% more money to consummate their purchase. It's not that these people wanted to borrow 50% more money, it's just that everyone else bidding on the same home that they wanted to buy could do the same thing – so they did. So, depending on where you were located, in just a few short years, we saw home values going up by 30%, 40%, 50% even 60% or more! When you start with the reality that most home are not inexpensive to begin with, this resulted in people making a lot of money with their homes!

And, as I have mentioned in my previous semi-annual reports, people like to invest their money where <u>other</u> people are making money with their money, so it seemed like everyone jumped on the invest-in-real-estate bandwagon and property values continued to escalate as there were more and more participants in the real estate market. We now know that all of these increases and excesses were exacerbated by and, in many cases, made possible by, the creation and re-packaging of all of the sub-prime and adjustable-rate mortgages that are now part of our cultural lexicon.

As a result, we end up with the housing bubble, the housing crisis, the financial crisis and The Great Recession. It is fair and accurate for me to say that the housing bubble and its aftermath caused severe, wide-spread damage to most sectors of the U.S. economy. 8,750,000 lost their jobs – the most since 1929. As a result, millions of individuals and families also lost their homes. Additionally, millions of businesses across the country, most especially small-to-medium size businesses in small towns like Easton – were forced out of business. Remember all of the vacant store fronts? The banking system was severely damaged and the financial system was badly damaged.

Any time you have such severe, wide-spread damage to an economy that is as large and diverse as ours, there is a repair process that has to occur. When you stop to consider the depth and breadth of the damage that was done to our economy, this repair process was <u>not</u> going to happen overnight. It was going to take a long time – years.

As you know from our many in-person discussions and my previous semi-annual reports, during the repair process, I was <u>very</u> reluctant to recommend to you what most advisors seem to recommend for your asset allocation regardless of what has happened in the world or what is happening: 60% stocks and 40% bonds. During the repair process, my concern was this: If I had simply turned a blind eye to the severe damage that had been done and simply followed the herd and did the usual 60% stocks and 40% bonds – what if we, before the economy was repaired, were to experience yet another significant economic blow? My belief was that this could very well deal a financial blow to my clients, 95% of whom are retired, from which they might not be able to recover. From that perspective, it simply didn't seem worth the risk to me.

You may also remember that I had a second concern. In my very first semi-annual report in June of 2014, I asked and examined what I thought was a very important question: In 2013, when the economy grew only 1.90% for the year (54% of its historical average of 3.50%), why in the world did the Standard and Poor's 500 index increase by 29.60%? Then, in 2014, when the economy grew only slightly faster (2.43%), why did the Standard and Poor's 500 index increase by another 11.74%?

When I drilled down to try to find the answer to why this “disconnect” between the performance of the economy and the stock market was occurring, what I discovered was pretty straightforward: The stock market going up seemed to have very little to do with how the economy was doing or how corporate earnings were being booked, and almost everything to do with the fact that the Federal Reserve and Central Banks around the world had lowered interest rates down so far that, by 2013, investors had become frustrated. They simply couldn’t earn very much interest on their traditional “safe” investments such as money markets and C.D.’s and high quality short-term bonds.

By 2013, most of the intense fears over whether or not the economy was going to be ok or whether or not the banking system was going to survive – were gone. The fears over the possibility of another recession were waning. The market had a pretty good year in 2012 with not much volatility. By the end of 2012, the Standard and Poor’s 500 Index had recovered most of its losses, so the pain of its previous 56.97% decline was also waning. Then, for various reasons, the stock market had an extraordinary month in January of 2013. If memory serves me correctly, I believe that the Standard and Poor’s 500 Index was up about 8% for the month! It was the best January for the stock market since 1993 or 1994. And it got a lot of press. And we know that people like to invest their money where other people are making money with their money……

As a result of January’s extraordinary stock market results, a lot of people who had either gotten out of the stock market when it went down as well as others who had not invested any new money for a while, did a complete about-face! So a lot of people had the following point of view: “I only earned ½ of 1% in my money market over the last 12 months. My buddy, Bob – he earned 8% in a month! I’m tired of not making any money on my money, I’m getting back in to the stock market!” You may recall from my 2014 End of Year Report, that in 2013 a record amount of money – both previously saved and invested money as well as borrowed money – remember all of the margin debt? – went into the stock market. At the same time, the supply of stocks available to be purchased by the U.S. consumer had been rising by only 1.30% per year since the crisis in the fall of 2008. Like any other commodity, if demand exponentially exceeds the increase in supply – the price is going to go way up!

So, you see, I was also very uncomfortable with why the stock market was going up because it seemed to have very little to do with how the economy was doing or how corporate earnings were being booked. So when I put this concern together with my previous concern regarding doing the 60% / 40% thing during the repair process, my opinion was firm: Having a heavy exposure to the stock market during the repair process simply wasn’t worth the risk.

Now, looking in the rear view mirror, it's always easy to know what you should have done. If I had turned a blind eye to all of the damage that was done and simply followed the herd and did the 60 / 40 thing during the repair process, you'd be richer and I'd be richer. But, to me, wealth management and risk management isn't about doing what everybody else is doing and "hoping" that things will work out for your clients. What kind of a strategy is that?

If I had done that which I was not inclined to do and if something bad had happened, I am quite certain that, financially, in my early 50's I would have been just fine. But this is not about me. What about my clients, 95% of whom are retired and many of whom are now in their 70's and above? Would they have been ok if we had suffered yet another economic blow before the economy had been repaired? I wasn't convinced that that would have been the case if I had taken too much risk with your investments. So, for all of these reasons, I decided that I would limit my client's – your - overall investment risk. The last time I checked, I am supposed to operate based on what is in <u>your</u> best interest.

Fast forward to 2016: We have now had six consecutive years of modest, roughly 2%, annual growth. Based on our historical average of 3.50%, 2% is <u>not</u> great (about 57% of our historical average). At the same time, we have an economy with a gross domestic product of about $18 trillion. It is massive. Increase that by 2% and you get a very big number. So, the truth is, 2% growth is neither great <u>nor</u> is it awful. It is just ok. In my opinion, what <u>is</u> significant, is that we have now had six consecutive calendar years of this consistent, albeit modest, growth. One year of modest growth is not a trend. Two years is not a trend. Three years, things are looking up. Four years seems to feel like you are pointed in the right direction. Five years confirms what you thought in year four. After six years, I would argue that a trend has been defined. From my previous reports, you may recall that I don't see anything happening over the next five to six years that will cause our economy to grow much faster than it is right now. Below, I have included just a few statistics regarding the U.S. economy for you to peruse.

	Gross Domestic Product (GDP)	Average New Jobs Per Month
2009	- .175%	- 422,500
2010	2.70%	88,833
2011	1.70%	173,916
2012	1.75%	179,083
2013	1.90%	192,583

2014	2.43%	251,250
2015	1.98%	228,667
2016	1.10% *	171,500 **

* 1st quarter 2016 - annualized

** 1st six months 2016

In addition to the six consecutive years of modest growth mentioned above, I also believe that most of the businesses that survived the Great Recession are in pretty good shape. In addition to all of the reading and research I do on publicly owned companies, whenever I see or meet a small business owner, I always ask them how they are doing relative to the previous calendar year. With only one exception, a local travel agent, everyone with whom I have spoken, in 2015 they had done as well or better than they had done in 2014. When I travel on vacation or business, to my wife's chagrin, I also ask small business owners in other parts of the country. Results: The same. One last note on small businesses: Over the past several years, I have noticed that the number of vacant storefronts in small local towns like Easton and St. Michaels and Chestertown have dropped dramatically. There are still more vacancies than I would like to see, but their numbers really have dropped.

Number three – and to me this is <u>extremely</u> significant: I believe that the banking system, which was so severely damaged as a result of the financial crisis, is in pretty solid shape at this point. In the aftermath of the crisis, the banking regulators that work for the FDIC and the Office of Thrift Supervision audited all of the banks across the country and, as a result, shortly thereafter <u>stopped</u> the overwhelming majority of them from paying out dividends to their shareholders. There were bad loans and there were problem loans. Sufficient capital to survive another economic downturn was not there. Instead, the regulators required the banks to use what would have been paid out as dividends to be used to increase the bank's capital reserves. Legislation and the regulators created something called "stress tests" to simulate and tell them when a bank's reserves were sufficient to meet economic downturns of varying intensity – including severe economic shocks like a second housing crisis.

In 2016, for the second straight year, every one of the 33 largest banks that are considered to be so systemically important that they have been deemed "too big to fail" passed their stress tests.

Only three were asked to revise their capital plans by the regulators because the regulators believed that there were weaknesses that should be corrected. In 2015, for the first time since the new regulations were put in place, most banks across the country, including most small local banks, were finally allowed by the regulators to start paying dividends again to their shareholders because their capital was finally sufficient to meet a severe economic downturn. For these reasons, I believe the banking system is in good shape. Finally, I believe that the financial system is in good shape at this point as well.

The bottom line is this: While the economy is not very vibrant, nor do I believe that that will change much for another five to six years, I do believe that the economic foundation upon which we are situated is pretty solid at this point. I believe that significant and substantial repair to the economy and banking system has taken place. As a result, I believe that we can <u>begin</u> to take a little bit more risk than we have been taking.

At some point in the future, we will have an unexpected negative event that will cause the stock indexes to drop by 20% or more – a "bear" market. We have always had unexpected negative events and we always will. In the 78 year period between 1931 and 2009, we have had a total of 10 bear markets, an average of every 7.8 years. The last time we had an event that caused enough fear to cause a bear market was on September15, 2008 when Lehman Brothers collapsed - 7.75 years ago. Here is what I believe will be different moving forward in time now that significant and substantial repair to the economy has taken place: When we do have the next unexpected negative event that causes a 20% decline, I believe that the amount of time that it takes for the stock market to recover will be significantly <u>less</u> than we have grown accustomed to since the year 2000.

To illustrate my point, the first very large stock market decline that I worked through was the Great Crash in October of 1987. Over 4 business days, the Dow Jones dropped by slightly more than 33%. It was awful! However, it only took a little bit more than 15 months for the Dow to get back to its pre-crash level. Why did it only take 15 months? Well, The Crash certainly scared the hell out of people, but no real damage was done to the economy. In the first paragraph of this report, I started out by saying that all of the large declines in the stock market were caused by events that scared people, but very few of them actually did any real damage. So my first big decline was a "doozy", but within about 15 months the markets had recovered because no real damage was done.

Now fast forward – housing bubble, housing crisis, financial crisis and Great Recession – it took five and a half years for the stock market to recover. Why? Serious damage was done. So, in the future, we will have an unexpected negative event, and like every other time in history fear will cause the stock market to go down. I think the difference this time will be that the amount of time it takes for the stock market to come back up will be shorter because I think significant and substantial repair to the economy and banking system has occurred and the foundation upon which we are resting in 2016 is pretty solid. While Britain's recent referendum to leave the European Union - "Brexit" - does not qualify as an "unexpected" negative event, the rapidity with which the stock market recovered does further illustrate my point.

At any given time, there is only one thing that an investor can control and that is the amount of investment risk that they are taking. It is therefore imperative that the following question always be asked: "In the environment in which I am located right now – forget that incredible 20-plus year economic expansion that we had – is the amount of risk that I am taking worth it in the current economic environment?"

Because significant and substantial repair has taken place, I believe that we can begin to take a little more risk than we have been taking, but for most people, not the industry standard of 60/40.

Europe, Japan and China

None of the concerns that I have mentioned in my four previous semi-annual reports have changed regarding any of the above countries, because none of the facts that caused those concerns have changed. I will continue to monitor what is happening in these countries.

Deflation?

Based on all of the information I have collected and continue to collect, I believe that global deflation remains a very real risk. Japan has had multiple long bouts of deflation over the past 25 years and after more than 7 years of record stimulus, Europe continues to teeter on the verge of deflation. Producer prices in China continue to fall. The populations of most of the world's major developed economies continue to age and, as a result, their economies continue to grow very slowly. In the U.S., our demographics and, as a result, our economy, I believe, are not going to change significantly for the better for another five or six years.

As I mentioned in my last report, if in the U.S. we continue to have very low inflation or, if we have deflation, we must be prepared to move money into the stock market if we have an event or series of events which cause the Standard and Poor's 500 Index to drop by 20% or more from its recent all-time high. If we have deflation, interest rates would probably not go up. More likely than not, they would either stay the same or long term rates could possibly go even lower. If interest rates do go lower, we need to have more money at lower rates of interest to provide you with the income that you need.

In my last report, I had mentioned that for most of our clients who have fee-based accounts, using very specific measurable purchase criteria, I have begun the process of selectively buying shares of companies in the Standard and Poor's 500 Index that have raised their dividend every year for at least the past 25 years. The goal, over time, is to hopefully build a stream of rising income to help meet rising expenses during retirement. For the record, it should be noted that dividends are not guaranteed, much less annual increases in those dividends. So, I will continue to do my best and try to select well.

For those of you who do not have fee based accounts, we have discussed with many of you the idea of beginning to slowly move money every month over the next 18 months into the stock market. I am comfortable now recommending this because I believe that significant and substantial repair has occurred in both the economy and the banking system. At the same time, I remain cautious because it has been so long since we have had an event that has caused a 20% decline in the stock market. In the absence of a fear-based event that causes such a 20% drop and in light of our low-growth environment, I only want to make small changes over time. I promise to keep you posted regarding any facts or developments that would change my current thinking and strategies.

Thank you for your ongoing business and support.

Respectfully yours,

Scott W. Eglseder

Note: Unless otherwise indicated, Bloomberg is the source of the information contained in this report. All indices are unmanaged and investors cannot actually invest directly into an index. Unlike investments, indices do not incur management fees, charges or expenses. Past performance does not guarantee future results.