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Half-Time Report

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Current Situation and Strategy Moving Forward

Current Situation

On the economic front for the U.S. and abroad, it is still not "the good old days" anymore. In fact, in their ongoing desperate efforts to stimulate economic growth in countries and regions with aging populations, the behavior of Central Banks around the world - currently the most notable are The Bank of Japan and the European Central Bank – continues to cause concern with what is happening to global stock prices.

The United States

For all of 2014, Gross Domestic Product (GDP) for the U.S. came in at 2.43% - only 69% of the historical average of 3.5% - after six and one-half years of record stimulus. 2011 GDP was 1.70%, 2012 was 1.75% and 2013 was 1.90%.

For the first quarter of 2015, GDP shrank at an annualized rate of 0.70%. (-0.70%).

Between World War Two and the Great Recession, we had ten other recessions. Within two years of the beginning of each of these recessions, all of the jobs that were lost had been recovered. As a result of the Great Recession, about 8,750,000 jobs were lost. It took from December of 2007 until March of 2014 – six years and three months - for all of the jobs that were lost to be recovered.

According to former President Reagan's Budget Director David Stockman in a January 2015 interview with *Newsmax Finance,* "As is by now well-known, all the net gain in U.S. payrolls since January 2008 have been attributable to the five shale (oil) states."

Over the past 10 years, technologies developed by U.S. oil producers – horizontal drilling and hydraulic fracturing ("fracking") – have allowed these producers to extract oil from domestic sources that were previously considered non-recoverable, allowing them to produce 9.3 million barrels of oil per day or approximately half of the 18 million or so barrels we need each day to run our economy. At the height, there were about 1,600 producing oil rigs in the U.S., many of which were developed and brought online in the past four years – and lots of jobs were created in the process.

For various reasons, since October 2014, oil prices have dropped dramatically. The number of producing oil rigs in the U.S. has dropped by 50%, down to about 800 rigs. The problem is that due to the dramatic drop in oil prices, there is very little money going to develop new wells, and the one bright spot for real net U.S job growth is waning.

For the 39 month period ending March 31, 2014, the average number of monthly jobs created was approximately 165,000 or 5,500 new jobs a day.

In 2014, on average, 246,000 jobs per month were created. This translates to 8,088 new jobs per day.

For the first four months of 2015, however, there has been a significant decline. Only 193,000 jobs have been created per month, or 6,345 new jobs a day.

To accommodate people who are graduating from high school and college and looking for full-time work, we need to create about 200,000 jobs per month or 6,575 new jobs per day.

Every day, about 10,000 Baby Boomers retire. They have made most of their major purchases and, in most cases, their income and spending go down when they retire.

In 2014, on a daily basis, for every 8,088 people who found full- time work and their income went up, 10,000 people retired and their income and spending went down. For a brief time since the Great Recession, we had just one full year where we created slightly more jobs every day (8,088) than were needed to provide jobs for people graduating from high school and college (6,575). For the first four months of 2015, however, we are now back down to a number (6,345) that is below what is needed for graduates (6,575). And for various reasons, it does not look like oil prices will go back to where they were for quite some time to come – perhaps years - which means that it could be quite some time before the energy sector – the one bright spot for job growth - gets back to creating more jobs. Finally, the labor participation rate – the percentage of adults who are available to work who are actually working – has dropped to 62.8%, the lowest it has been since 1978.

As I mentioned in the 2014 End of Year Report, when you stop to consider that consumers spend 70% of all the money that is spent in the economy, this is not a recipe for vibrant, dynamic growth – and we are not experiencing vibrant, dynamic growth - despite six and one-half years of record monetary stimulus by the Federal Reserve. As I have mentioned in previous reports, the demographic situation we are in – The Baby Boom Generation retiring – will not change for another six to seven years.

The Federal Reserve has finished its third round of "quantitative easing" or creating new money to buy U.S. Treasuries and Mortgage-Backed Securities (MBS). They continue to reinvest principal payments from the mortgage-backed securities (which were bought with this newly-created money) into new mortgage backed securities and, upon maturity, they continue to rollover the proceeds of the Treasuries that were purchased with this newly created money into new treasuries at auction. They do this to help keep long-term interest rates low in the hope that low mortgage rates will allow people to borrow and spend more on housing. Additionally, the Fed continues to keep short-term interest rates at the bank at historic lows – in the hope that individuals and businesses will borrow and spend and stimulate the economy. We have an aging population – so does Europe – so does Japan.

As I mentioned in the 2014 End of Year Report, while low interest rates allow for businesses to borrow money more cheaply, I don't know of too many retirees who are motivated by low loan interest rates to go out and get a loan so that they can spend more and have more debt when they are retired! Most people want to be out of debt when they retire.

While the Federal Reserve has finished its third round of quantitative easing, they are still trying to stimulate the economy by keeping short and long term interest rates low. Japan – which has engaged in quantitative easing many times over the past 20 years – has just started a new round of massive stimulus.

Europe has just begun, for the first time, a massive round of quantitative easing. Both the Bank of Japan and the European Central Bank have forced short and long term rates close to zero – and in some countries in Europe – below 0%, in the hope that they can provide an incentive for aging populations to borrow and spend to help grow the economy.

As you will see in just a moment, they have met with limited success in terms of increasing economic growth, but because investors no longer have many places to invest their money to get a decent return, money is rapidly flowing into Japanese and European stocks, causing the various stock indexes in these countries to soar dramatically in recent months, just like they did here in 2013 and to a much lesser degree in 2014. This was the "disconnect" that occurred between the economy and the stock market that I mentioned in my last two reports – the economy is barely growing and yet - the stock market soars. This has little to do with economies and businesses growing – fundamentals – and more to do with the sentiment of "the stock market is the only thing that seems to be going up, and I can't get much of a return anywhere else, so I'll put my money there" - *which causes it to go up*.

Europe

As I mentioned in the last report, Europe has been teetering on the verge of a second recession since the Great Recession. Of even greater significance to European Central bankers is a concern over preventing a deflationary spiral. In Europe, consumer prices had fallen for four consecutive months – from December of 2014 through March of 2015. In January they announced a $1.1 trillion Euros bond buying program – "quantitative easing" – similar to those that the U.S. has done and Japan has done and is doing (again). They started their buying in March.

The result: Prices rose slightly in April. Obviously, more time is needed to determine if a deflationary spiral has been averted.

First quarter GDP came in at an annualized rate of .40% - four tenths of one percent. Bank lending increased for the first time in March since 2012. The unemployment rate in Europe still exceeds 11%. Like the U.S., most of the countries in Europe (with the exception of Spain and Italy) have aging populations.

Not great. And yet, the major stock indexes in Europe are soaring. Is it because the economy is doing great, or is it because investors – with short and long term interest rates in Europe near, at or below 0% - don't have any other place to get a good return on their money, so they're putting their money there, *which is causing it to go up?*

Don't forget about the problems in Greece – remember the European debt crisis? The fiscal imbalances in Europe (governments spending more than they are taking in) that led to the Greek and European debt crisis are far from being resolved.

Anticipating the unprecedented stimulus of the European Central Bank, central banks around the world cut their Euro holdings by the most on record last year. As a result, the Euro dropped by 12% versus the U.S. dollar last year. Technically, this is good for the European economy because it makes their exports less expensive for countries like the U.S. to buy, which would help their economy to grow. But it is bad for the U.S. – Europe is our largest trading partner – because it makes the goods we sell to them more expensive, reducing our exports, which could slow our economy down.

Japan

In the third quarter of 2014, Japan slipped into yet another recession, one of many since 1990. The demographics in Japan are perhaps the worst in the world. Like the U.S. and Europe, Japan has an aging population. The major difference, however, is that their death rate exceeds their birth rate. The Japanese population is actually shrinking. In economic terms, not only are their consumers growing older every year and spending less money, the total number of consumers who can spend money drops every year. While Japan is not currently experiencing deflation, inflation is very low and they have had many protracted periods of deflation, the longest of which lasted almost seven years.

Because of Japan's demographics, it simply isn't possible for them to have very long periods of growth. At the same time, The Bank of Japan has continued with its decades-long program of monetary stimulus. Despite the fact that (for decades) it doesn't seem to be achieving the desired result of fostering and creating sustained economic growth, they have recently increased the massive stimulus in the hope that it will.

The result: Japan has emerged from the most recent recession. GDP for the first quarter of 2015 came in at an annualized rate of only 1.4%. Again, inflation in Japan is very low.

Something else in Japan has happened.

When the recession began in Japan in the third quarter of 2014, the world's largest pension fund – Japan's $1.26 trillion Government Pension Investment Fund (GPIF) – announced that it would be dramatically reducing its holdings of near 0% interest Japanese government bonds and dramatically increasing the amount of stock (Japanese and foreign) that it owns. Their investment model was as follows:

- Domestic bonds: 60%
- International bonds: 11%
- Short-term debt: 5%
- International stocks: 12%
- Domestic stocks: 12%

Their new investment model is:

- Domestic bonds: 35%
- International bonds: 15%
- International stocks: 25%
- Domestic stocks: 25%

Was: 76% bonds, 24% stocks Will be: 50% stocks, 50% bonds.

Why did they do this? Because 60% of their pension fund was in Japanese government bonds earning less than 1%, they were having trouble covering payouts for the pensioner's of the world's fastest-aging population.

Due to their decades-long program of buying Japanese government bonds to keep long-term interest rates low - in the hopes that an aging population would feel compelled to borrow more money while in retirement - and spend it to help the economy, the Bank of Japan caused Japan's Government Pension Investment Fund to be underfunded because they couldn't earn very much money on those bonds. So they decided to move into stocks in a very big way. When you do the math, increasing stock exposure from 25% of $1.26 trillion to 50% of $1.26 trillion means investing $315 billion more in stocks – half foreign, half in Japanese stocks. Guess what has happened to Japanese stock indexes? They have surged!

Are the Japanese stock indexes soaring because the Japanese economy is all of a sudden doing great and on the road to long term economic health or is it because there was a sudden and massive increase in demand for Japanese stocks due to a decision by the world's largest pension fund to invest almost $158 billion in Japanese stocks to try to get higher returns *which has caused it to go up?* Can you imagine any individual Japanese investors who may be investing money in Japanese stocks just because they are going up – *which causes them to go up higher*?

So who bought all of the near 0% interest Japanese government bonds that Japan's Government Pension Investment Fund had to sell to come up with the cash to buy all of the stocks? Why, the Bank of Japan, of course! What a coincidence!

The Bank of Japan also buys – with money that they create - the overwhelming majority of all new Japanese government bonds that are issued by the Japanese government, through their decades-old quantitative easing program.

The Bank of Japan has also begun to buy Japanese stocks. They tend to limit their purchases to days when the Japanese stock market opens lower in an effort to keep demand for stocks – and stock prices – up. How convenient.

Does any of this seem artificial or contrived or speculative?

A New Pattern?

As I mentioned in the 2014 Year End Report, central bankers in the U.S., Europe, Japan, and around the world really have very few tools in their toolbox available to try to modify and hopefully impact economic outcomes. Raising and lowering interest rates at the bank has historically been their primary tool. More recently, quantitative easing has been used. Used first by Japan, and then followed by the U.S. and now Europe, quantitative easing is nothing more than central banks creating money and using this money to buy massive amounts of government bonds and mortgage backed securities – in effect, creating artificial demand which causes bond prices to go up and interest rates to go down. But that's about all they have to use. And they persist in using them because that is all they have to use.

Evidence suggests that these tools have been very useful in preventing crisis situations from becoming far worse. At the same time, however, they seem to have very little impact on the borrowing and spending habits of aging populations. Simply put, regardless of where they live, most retirees don't want to go into debt during retirement. It doesn't matter how low interest rates are. As far as the central banks go, however, you've heard from me the old saying: "If the only tool you have is a hammer, then every problem begins to look like a nail".

The concern I have had since U.S. stock prices surged in 2013 has to do with what investors are doing with their money as a result of central banks around the world having lowered interest rates as low as they have: Both individual investors and institutional investors - such as Japan's Government Pension Investment Fund - have been moving massive sums of money into stock markets around the world in an effort to get better returns. Investors in the U.S. have borrowed almost $500 billion – almost a half-trillion – dollars to buy more stocks – using their existing stocks as collateral for the loans – it is called margin debt. The resulting demand for stocks, combined with only a slight increase in the supply of stocks that could be purchased, has sent global stock prices soaring.

The reasons behind <u>why</u> global stock markets have been going up is what makes me <u>very</u> uncomfortable, because those reasons seem to have so little to do with how the domestic or global economies are actually doing – or are likely to do in the foreseeable future.

But there is more….

<u>Back to the United States – Record Stock Buy Backs</u>

In my last letter, I mentioned that the supply of domestic stocks available to be purchased had been rising by only 1.3% per year since the crisis in the fall of 2008. While there have been a fair amount of initial public offerings (IPO's) which increase the supply of stocks available to be purchased, taking away from the supply has been a record amount of stock that has been bought back by the companies that initially issued the stock.

I had not seen any data on the actual dollar amounts that companies have actually been spending to buy back their own stock until March 4, 2015. I was <u>stunned</u> by the following headline and information that I read in an article from *Bloomberg* on that day:

"Buybacks at $46 Billion a Month Dwarf Everything in U.S. Market"

"The biggest source of fresh cash in American equities isn't speculators or exchange-traded funds……it's companies buying their own stock, by a 6-to-1 margin."

"Chief executive officers, who just announced the biggest round of monthly repurchases ever, executed about $550 billion of buybacks last year, according to data compiled by S&P Dow Jones Indices. That compares with a <u>net</u> $85 billion of deposits by customers of mutual and exchange-traded funds, the biggest gap since 2012, data compiled by Bloomberg and the Investment Company Institute show."

"Repurchases by U.S. companies averaged $46.1 billion a month in 2014, compared with $7.1 billion per month in ETF and fund inflows."

Translation: <u>In 2014, approximately 6 out of every 7 stock purchases that were made were companies buying back their own stock</u>. In other words, six out of every seven bidders at this auction we call the stock market were companies buying their own stock.

I like to remind people that the stock market is an auction: There is an asking price and there is a bid price. Here's what I think is important: 1) Companies do not have to buy back their own stock. 2) Companies do have a lot of cash. But… 3) These companies do not have an endless supply of cash.

I am sure that most of you have been to an auction. What would happen to prices at the auction if six out of seven bidders stopped bidding? It would <u>not</u> be good.

I mentioned in the past two letters that the economy and stock market had "disconnected" from each other in 2013. In the last letter, I had mentioned that the "disconnect" between the two had continued into 2014, albeit not as dramatically as the year before.

Based on the above information, it is now quite clear to me what caused the Standard and Poor's 500 Index to go up 11.74% in 2014 - it wasn't individual investors – it was companies buying back their own stock.

So the question is, why would companies do this?

Before we address that question, I think it is important to recognize the significance of what these CEO's are <u>not</u> doing with the shareholder's money and what reasonable conclusions can therefore be drawn.

By virtue of the fact of what they <u>are</u> doing with the shareholder's money, I believe that they agree with our assessment of how the economy is actually doing, which is – while it's not horrible, it's not that great.

If they really believed that the domestic or global economy were doing great <u>or</u> were poised to do better, they would be <u>investing</u> in plants and equipment, research and development, opening new markets and – hiring more people to make these things happen – <u>not</u> buying back record amounts of their stock with record amounts of corporate cash.

The primary job of a CEO is to maximize shareholder value. There are two basic ways to do this: 1) Invest in the growth of the business. You open new markets and increase market share. As revenue and real profits rise, over time, the value of the company's stock will go up. 2) You can buy back the company stock. When a company engages in a stock buyback, the supply of stock available to be purchased by the public goes down. If demand remains the same or increases, the price of the stock will go up. Shareholder value is maximized and shareholders are happy that their stock has gone up in price.

<u>This is when corporate accounting comes into play and makes things appear better than they actually are – understanding how corporate accounting works with earnings is critical</u>.

Let's say that your company has $1,000 of earnings. Let's also assume that there are 1,000 shares outstanding and owned by the public. $1,000 of earnings divided by 1,000 shares outstanding gives you $1.00 of earnings per share.

Over the next twelve months, your sales are flat. Earnings remain at $1,000. During the same twelve months, however, the company has repurchased 500 shares. Now you have the same $1,000 of earnings divided by the now 500 shares held by the public – your earnings are now $2.00 per share. It appears that your earnings have doubled! In reality, nothing for the company has really improved. Additionally, most CEO's compensation packages are tied to increasing – you guessed it – earnings per share.

Back in October of 2014, I found research that indicated the following information: For companies in the S&P 500, corporate earnings have grown at an annual rate of 14% since 2009, <u>about three times faster than sales</u>.

Now, how in the world can your earnings grow three times faster than sales? For a normal business like yours and mine, it simply is <u>not</u> possible. With publicly owned companies, on the other hand, it <u>is</u> possible when you understand how earnings per share are computed - companies are buying back record amounts of their stock <u>and</u> engaging in record cost-cutting. But there is only so much of both that can be done – there is a limit to how much cash you have to buy back stock and there are only so many expenses that can be cut. What happens then?

Here's the point I am trying to make. Since the crisis, I can't tell you how many times I've read headlines about "record" earnings and profits. Once you understand how that can be accomplished from what you have just read, these "records" don't necessarily mean that these companies have actually increased their revenues or actually grown their businesses! Not everything is as it appears to be.

Great Headlines

I included this section in my last letter, but in light of what we have just discussed, I think it is worth reviewing again.

Early in July of 2014, I read an incredible-sounding headline. It went something like this: As of July 3, 2014, the Standard and Poor's 500 index has hit 27 new all-time highs this year alone!

Sounds great, right?

When I read this headline, I made the decision to go back in time and catalogue previous all-time highs for the S&P 500 Index, with a very good idea of what I thought I would find. I was actually shocked when I committed the numbers to paper. I have listed them below.

S & P 500 Index

	3-24-00	1,552.87	
	10-10-02	768.63	-50.50%
	10-9-07	1,565.15	+103.63%
	3-9-09	673.53	-56.97%
+1.05%	3-28-13	1,569.19	+132.98%
	7-13-14	1,985.44	+26.53%

On 3-24-00, the S&P 500 hits an all-time high of 1,552.87. This was the apex of the bubble in technology stocks that occurred in the late 90's. Then the tech bubble burst. It was followed by accounting scandals, 9-11, anthrax attacks, a sniper on the loose in the D.C metropolitan area and SARS (Sudden Acute Respiratory Syndrome). By 10-10-02, the S&P had declined by 50.50%.

The next time the S&P 500 hits a new all-time high is not until 10-9-07, when it reaches only 1,565.15, more than seven and a half years after the previous all-time high of 1,552.87, an increase of only .79%!

About a year later, we have the financial crisis and by 3-9-09 the S&P 500 drops by 56.97%. The next time the S&P hits a new all-time high is not until 3-28-13, when it reaches only 1,569.19, five and a half years after the previous all-time high of 1,565.15, an increase of only .26%!

So from 3-24-00 to 3-28-13, the S&P 500 only goes from 1,552.87 to 1,569.19, an increase of only 1.05% in 13 years! To be fair and accurate, this does not include dividends of probably 1.5 to 2.0% per year. So if you had an S&P 500 index fund and were taking the dividends, your account was up only 1.05% in 13 years!

The reality is that the stock market <u>barely</u> went up at all in 13 years!

It is absolutely true that the S&P 500 really did go up from 1,569.19 on 3-28-13 to 1,985.44 on 7-3-14, an increase of 26.53% in 15 months. When the stock market goes up so sharply in such a short period of time, I am always compelled to ask the question: <u>Why</u>?

Is it because the U.S. economy is growing by leaps and bounds? With our rate of growth, that clearly can't be the case.

Is it because investors had ample evidence in 2013 that the U.S. economy was poised for a rapid expansion? It can't be that. There was no such evidence.

Or is it because the global economy is growing rapidly or poised for rapid expansion? No, the global economy has been slowing down.

Clearly the stock market went up rapidly and sharply, but it <u>can't</u> be for reasons of economic growth.

So what caused it?

With what you have read in this and the last letter, I think you now have a good idea.

<u>Strategy Moving Forward</u>

As far as the economy goes, it is easy for me to say that it is <u>not</u> the "good old days" anymore.

As far as the stock market goes, there is no question that it went up a lot between 2013 and 2014. The reasons behind <u>why</u> the stock market has been going up are what makes me <u>very</u> uncomfortable, because those reasons seem to have little to do with how the domestic and global economy are actually doing – or are likely to do in the foreseeable future.

So when you take into account everything we have just discussed and combine that with who my clients are – approximately 95% are retired - my primary focus remains simple and consistent: Try <u>not</u> to lose money. When most people retire, their investments become <u>irreplaceable</u>.

With non-guaranteed investments like stocks and bonds, there is always the potential for investment loss. No one can control the financial markets, but it <u>is</u> possible to limit the amount of overall investment risk that you are taking in any given economic environment.

Because of inflation, it is imperative that we achieve growth of investment capital. Is it possible that the stock market could go higher still? It could indeed. Do I think it would continue to go up because the economy is improving dramatically or because people – and institutions - are putting their money there because that's where people are making money? I think it would be the latter.

In this somewhat fragile economic environment, I think that it makes more sense to protect investment capital and to patiently wait for a buying opportunity in the stock market that is precipitated by an unexpected negative event. We have always had them – we always will. There is no predictable pattern to these events and no one can predict them. It has now been more than six and one-half years since we have had one of these events. Every month that goes by without something happening puts us closer to that inevitable, but unpredictable point in time where something will.

When it does occur, investors in the stock market will do what they have done throughout history without exception: They will become fearful and they will sell and stock prices will drop accordingly. At that point in time we should take advantage of this buying opportunity to move more of your money into the stock market. As the fear surrounding this event goes away, we will see an increase in stock prices. At that point in time, we will need to assess our new investment risk level and if we feel that we then have too much allocated to stocks, we can adjust our overall risk level back accordingly.

When we get back to the business of trying to make money again – versus our current focus of trying not to lose money – I actually want to be making money again – not at the task of getting you back to where you are today because I wasn't paying attention to how much investment risk we are taking in what is by all measures a very different economic environment.

Between our scheduled meetings, rest assured that if we are presented with a good or golden buying opportunity in the stock market that is precipitated by an unexpected negative event, I will contact you promptly with my recommendations.

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.