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2015 End of Year Report

For this, my fourth semi-annual report, I would like to have three separate-but-related discussions with you. First, I would like to discuss what we've been doing and why we've been doing it. Secondly, I would like to talk about what happened in the stock market last summer. Finally, I would like to discuss a concern that I began to discuss with clients starting back in October, which may have an impact on what we do in the future.

From mid-September to mid-December, I met with approximately half of my clients. I promised those of you with whom I met that I would condense our discussion into this report. So for roughly half of you, this information will sound familiar. For the other half of you, roughly two-thirds of this will be relatively new. I hope that all of you will take the time to read this report. You may also find it very helpful to review the last three reports.

Summary

When you put together everything we have discussed in our meetings with everything I have written about in my past three semi-annual reports, my primary focus when it comes to your investments remains very simple and straightforward: Try <u>not</u> to lose money. This expression can mean many different things to many different people, so it is important that I communicate to you what it means specifically to me. What I have been trying to avoid are the types of losses or negative numbers that are historically attributable to the usual 60% stock 40% bond allocation to which practitioners of Modern Portfolio Theory subscribe most of the time.

The way that I have chosen to try not to lose money is by limiting your overall investment risk. Stocks as a group of investments tend to have far more of what we call "market risk" than bonds as a group of investments. In plain English, generally speaking, stocks as a group of investments can drop in price a lot farther and a lot faster than bonds as a group of investments. We have had two extraordinary drops in the stock market since the year 2000. The first time, it took seven and one-half years for the Standard and Poor's 500 Index to recover. The second time it took five and one-half years. I don't care if you are 75 or 35, that's a long time to wait for prices to recover.

While bonds can and do fluctuate up and down in value, as a group of investments, they have generally less market risk than stocks for one very simple reason: Bonds pay a guaranteed income. So whether you own an individual bond or, indirectly, perhaps hundreds of bonds through mutual funds, each of those underlying bonds pays a certain amount of interest every three to six months and will continue to do so until a pre-determined point in the future when the bond either matures or is "called" by its issuer.

Many of you are either receiving monthly interest checks in the mail from your bond funds or they are being directly deposited to your bank account. I am sure you have noticed that this is real money that you can really spend. So, by virtue of the fact that bonds pay a guaranteed income and this income has real value to real people, this is what tends to prevent bonds from going down as far or as fast as stocks.

Because of inflation, it has always been my specifically stated intention to increase your exposure to stocks. It has never been an question of if it will happen, it has always been an issue of when. At some point in the future - I can't tell you when it is going to happen or what is going to cause it, but at some point, we will have an unexpected negative event. If you look back through history, we have always had them. Human beings are still involved in the process of life, which means that we will continue to have them. It's just that there is no one who is able to accurately forecast their future occurrence, nor is there a particular pattern upon which investors can rely to make good investment decisions. With that as a backdrop, it has now been roughly seven years and four months since we have had an unexpected negative event. The last such event occurred on September 15, 2008 when Lehmann Brothers collapsed. In the financial world, that's a long time. A statistician might very well tell us that we are either overdue or about due. While that may be statistically true, the reality is it might be still quite some time before such an event occurs. No one knows for sure.

Whenever the unexpected negative event does occur, investors in the stock market will do what they have always done – they will become fearful and they will sell and stock prices will drop accordingly. At this 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, depending on the economic conditions that exist at that future moment in time, if we feel that we then have too much allocated to stocks, we can adjust our overall risk level back accordingly.

When we finally do transition from my ongoing focus, which is trying not to lose money by limiting your overall investment risk – to actually trying to make money – I actually want to be making money again, not just getting your account value back to where it is right now. With the usual 60% stocks 40% bonds that many people recommend seemingly most of the time, in the aftermath of a fairly significant negative event, it would be very easy for such an account to drop by 25% in value. The problem with an account dropping by 25% in value is this: You have to make 33% to get back to where you were before. My bottom line is this: I do not want the first

33% that we make getting you back to where you are today. I would prefer to add to the current value of your account.

If you review my last three semi-annual reports and reflect on our personal discussions in our meetings, I have been concerned that the demographics of the world's major developed economies would lead to slower global growth over the next five to six years. Additionally, I have been very concerned (most notably in 2013 and 2014), that central banks around the world, by lowering short and long-term interest rates (in an effort to stimulate economic growth), have artificially caused stock prices to go far higher than they would have otherwise gone, because investors haven't been able to earn very much on "safe" investments such as bonds and certificates of deposit.

As a result, both individual and institutional investors have poured money into the stock market that they typically would not have invested, in search of higher returns, because interest rates have been so low. In my previous reports, I said that both here and abroad, I thought that the world's various stock markets had "disconnected" from the fundamentals of the underlying economies that they are ultimately supposed to reflect. Historically, prices that are artificially high tend to go down to where they should actually be priced.

Here's a brief snapshot of 2015: For the first three quarters of 2015, U.S. Gross Domestic Product (GDP) is annualized at 2.17%, which is only 62% of our pre-financial crisis average of 3.50% going back to 1945. For Europe for the first three quarters, GDP is annualizing at .40%, for Japan, it is annualizing at .43%. China is growing at its slowest pace since 1990. In the next several months we will have the fourth quarter results. Many initial estimates show U.S. growth for the fourth quarter bringing GDP for 2015 well below 2%. We'll see.

For the first time in almost 10 years, the U.S. Federal Reserve raised interest rates by .25%, causing disruptions in both stock and bond markets as well as currency valuations. In both Europe and Japan, short and long term interest rates continue to be very low, in many cases close to 0% and in some cases interest rates are negative (that's not a misprint).

Since my first semiannual report in June of 2014, where I described what I called the "disconnect" between the economy and the stock market, many in the financial media have subsequently labeled this flow of money into the stock market due to very low interest rates in traditional "safe" investments such as bonds, the "wealth effect". Recently, in an e-mail to investors, famed billionaire bond fund manager Bill Gross said the following: "0% interest rates and quantitative easing created leverage that fueled a wealth effect and propped up markets in a way that now seems unsustainable." In plain English, when you look at the actual very low growth rates in the world's major developed economies – the U.S., Europe and Japan – low interest rates seem to be having little impact on the intended goal of promoting economic growth, but have caused stock prices to go higher than they probably would have otherwise gone. As I mentioned earlier, prices that are artificially high have a tendency to go back down to where they should actually be priced.

What Happened in the Stock Market Last Summer?

With roughly half of you, I had the following discussion between September and Christmas. For the next little bit, let's pretend we're still back in December. Here's how I would have started this conversation…..

Between the end of June and the end of August, the Standard and Poor's 500 Index dropped roughly 12.4%, which is not an insignificant drop in stock prices. The drop was not caused, however, by an unexpected negative event, but rather by a series of investor concerns. For the following very simple reasons, I believe that the global economic conditions that caused the investor concerns which then caused the stock market to go down…..I believe that those global economic conditions are going to get worse before they get better. So, call this past summer a foreshadowing of things to come or a "shot across the bow", but for the following reasons, I think we will see this past summer happen all over again.

For quite some time, we have discussed how the U.S. - the world's largest economy - has an aging population. Since January 1, 2008, 10,000 Baby Boomers retire every day. When you think about it, by the time most people stop working, with only a few exceptions moving forward in their retirement, they have made most of the major purchases that they will make in their lifetime. Over the past thirty years, I have watched many clients – and now my parents – move into their mid-to-late 80's. Many of the things that the rest of us purchase on a very regular basis, like food and clothes and car-related expenses, people in their mid-80's and above tend to buy less and less of these items as well.

From my June 2015 Half Time Report, you may recall that the best year for job growth creation since the crisis was 2014. Additionally, through the end of 2014, all of the net new jobs created since the financial crisis have been attributed to the five shale oil states. With oil at $100 per barrel, in the U.S., it made economic sense to drill new oil wells. At $30 per barrel, it does not. As I mentioned in the June 2015 Half Time Report, the one bright spot for U.S. job growth – oil production - has waned. For all of 2014, we are back down to an average of 7,260 new jobs per day.

So right now, about 10,000 retire every day, their income goes down and they have made most of the major purchases that they will make in their lifetime. About 7,260 find work and their income goes up.

Despite the best efforts by the Federal Reserve over the past seven years and four months to promote economic growth by providing record monetary stimulus, the fact is that the U.S. economy is growing at only 62% of its historical average – *because we have an aging population*. Neither the Fed nor the Congress can do anything about that.

But it's not just the United States which has an aging population. With the exception of Spain and Italy, Europe's demographics are very similar to ours. And then there is Japan, which probably has the worst demographics in the world – not only is their population aging, their death rate exceeds their birth rate.

When you put these three very large economies together, they constitute a very large percentage of all of the <u>developed</u> economies of the world. For the next minute or so, please picture dominos standing on end and toppling over one after the other…..

Here we go…….as the populations of the world's major developed economies continue to age and, as a result, their economies continue to slow down…..and because a large amount of what we now purchase is made in Southeast Asia and particularly China, global growth and China's growth have slowed (China is now the world's largest manufacturer). Furthermore, while China does have a fair amount of natural resources, the fact is that most of the raw materials they need to put into the products that they manufacture and sell, they purchase from resource-rich countries such as Australia, Canada and Russia. All three of these economies are now in steep recessions as they sell fewer and fewer raw materials to the manufacturing countries of the world. Do you see how water rolls downhill??

In the latter part of August, as U.S. stock market indexes were hitting their low point for the year, I told my wife the following: "Sweetheart, I know my industry very well and it wouldn't surprise me one bit if by the end of the year the U.S. stock market was right back to where it was before." (The Standard and Poor's 500 Index ended the year down .73% from 12-31-14). I went on to say, "Even if the U.S. stock market hits a new all-time high, that will have <u>zero</u> impact on these larger economic forces that are at play."

Think about it. If the U.S. stock market hits a new all-time high, will that stop people from growing older and retiring?

So this is why I said: I believe that the global <u>economic</u> conditions that caused the investor concerns which caused the stock market to go down…..I believe that those global economic conditions are going to get <u>worse</u> before they get better.

So, for these reasons, I believe that we will see what happened this past summer happen all over again. Perhaps multiple times as we move forward.

Now, fast forward to Monday January 4, 2016, the first business day of this year. I was boarding a plane to come back to Maryland from Los Angeles where I typically visit my wife's family for Christmas. I decided to check my smart phone to see what had happened in the overseas markets while I was sleeping. Overnight, another horrible manufacturing report in China had been released and the Shanghai Composite Index had fallen 6.90% and trading had been suspended for the day in China. The declines in China began to ripple through global financial markets.

Year-to-date, as of Friday, January 15, 2016, the Standard and Poor's 500 Index is down 8.00%. The index is off 11.76% from its all-time high on May 21, 2015.

This leads me to the last topic I have for this report.

Deflation?

For the past 25 years, Japan has had horrible problems with deflation. About 10 years ago, I began to look for signs that deflation might be emerging elsewhere. My thinking was pretty simple: Japan was the world's second largest economy. They have a huge demographic problem. They are a democracy, capitalistic, highly industrial and technologically advanced. If it can happen there, it can happen anywhere.

Over the past two years and especially the last year, almost everywhere I look – not everywhere, but almost everywhere – I see more and more of the following: Falling prices. Rising prices is inflation, falling prices is deflation.

I'll give you four quick examples. Over the past year, oil and gasoline have dropped in price by 50% or more. That's deflation. Granted, it's only one budget item, but it's a fairly large budget item for many families. As global growth has continued to slow and demand for raw materials from resource-rich countries has waned, commodity prices have dropped dramatically. That's deflation. For the past 44 consecutive months, every single month for almost four years, producer prices in China have fallen. That's deflation.

The last one you may have read about. On August 11, 2015, China made a strategic decision in an effort to make their economy grow. They decided to devalue their currency – it's called the Yuan. Why would they do this?

If the value of their currency drops in value relative to the U.S. Dollar, the Euro and the Yen, the prices of the finished products that they sell to us would drop, providing us an incentive to buy more of their finished products, which would speed up their economy. The key phrase here is that prices would drop – that's deflation. But here's where it gets even more interesting. While China is now the world's largest manufacturer, they don't manufacture that much more than the number two country – the United States. What this means is that many U.S. manufacturers compete globally for the same customers. So, if the Yuan drops in value relative to the U.S. Dollar, U.S. companies will have to drop their prices to get or keep the business. That's deflation and that's bad for corporate profits. If you were making $5 in profit for every widget you sell and you have to cut $2 off of you price to keep or get the business, your profits just dropped by 40% !

So, I am not sure, but it is conceivable to me that we could be on the verge of something that we haven't seen globally since the 1930's and that is – global deflation.

I am not sure if the ship is actually headed in that direction, but it looks like the bow is trying to turn and go in that direction. I promise to keep a close and careful eye on any developments. It could have an impact on what we do and how we do it. I'll keep you posted.

If – and it is still a big if at this point. If we are headed towards deflation, there are two sets of considerations: Macroeconomic and microeconomic - your investments. On the macroeconomic level, in many ways deflation is far worse than inflation and, as we have mentioned, it is bad for corporate profits. If it's bad for corporate profits, it's generally bad for the stock market.

So what about your investments? Growing up and for my entire career, I have been taught that when you retire, your biggest enemy is inflation. It makes sense. Next month when you get your normal retirement check, it has gone up by zero dollars and zero cents. The problem is, the prices of the things you have been buying continue to go up and you can't buy as much stuff. So, fixed income and inflation is bad.

But what if we have deflation? Next month you get your normal retirement check which has gone up by the same zero dollars and zero cents, but, to your delight, the price of the things you have been purchasing have gone down which means you can buy more stuff. So, while fixed income and inflation is a bad thing, fixed income and deflation is a good thing. The value of fixed income streams tends to increase when you have deflation. A large percentage of what we have pays a fixed income and would likely benefit if we have deflation.

Now even 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 all-time high. If we have deflation, interest rates will probably not go up. More likely than not, they would either stay the same or long term rates could possibly even go lower.

If interest rates go lower, we need to have more money at lower rates of interest to provide you with the income that you need.

Finally, over the past year or so, I have noticed that when the Standard and Poor's 500 Index has gone up, the averages have been supported and been driven upward by a relatively small number of companies in the index itself. At the same time, many of the companies in the Standard and Poor's 500 Index are now at prices which are 20% or more below their 52-week high price. For those of you who have fee-based accounts, I have begun the process of selectively buying shares in companies in the Standard and Poor's 500 Index that have raised their dividend every year for the past 25 years. The goal 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 do my best and try to select well.

For those of you who do not have fee-based accounts, I would like to continue to patiently wait for the 20% drop in the Standard and Poor's 500 Index we have discussed before we begin to move more money into the stock market.

If you do not have a fee-based account, it is possible that a fee-based account <u>might</u> be suitable for you in your particular set of circumstances. Let's review that possibility when you come in for your next meeting.

Thank you for your ongoing business and support.

Respectfully yours,

Scott W. Eglseder

<u>Note</u>: 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.