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2014 End of Year Report

Summary and Strategy Moving Forward

Summary

In June of 2014, I mailed to you a letter I called the "Half-Time Report". In that letter, using facts and information, I tried to make an argument which, in retrospect, has confirmed a conclusion my clients had already made by simply paying attention to the world around them: On the economic front, it's not the "good old days" anymore.

From roughly 1987 to 2007, we were blessed with 20 years of unprecedented growth and prosperity. Then on September 15, 2008 Lehmann Brothers collapsed, resulting in not only the worst financial crisis, but also the worst recession since the Great Depression. Here we are more than six years later and despite the fact that we have had more than six years of record fiscal and monetary stimulus by the Congress and the Federal Reserve, our economy, by far still the largest on Earth, through the first three quarters of last year, is only growing at 71.4% of its historical average.

From 1945 through 2007 the U.S. economy, as measured by gross domestic product (GDP), grew at an average annual rate of 3.5%. In 2011, we grew at a rate of 1.70%. GDP was 1.75% in 2012. For 2013, it was 1.90%. For the first three quarters of 2014, GDP annualized at 2.50%.

Now, 2.50% is not bad, but it is only 71.4% of the historical average. And while it is not bad, it is somewhat disappointing when you stop to consider that we have had more than six years of record stimulus to get us to this point of very modest growth.

In 2014, an average of 246,000 jobs per month were created. This is an average of 8,088 new jobs per day. To accommodate those who are graduating from high school and college and seeking full time employment, the economy needs to create 200,000 jobs per month. At the same time, an average of 10,000 baby boomers per day voluntarily retired.

Every day, 10,000 people who have made most of their major lifetime purchases stop working and their income and spending goes down. At the same time, 8,088 people find work and their income goes up. In other words, for every 8 people whose incomes are going up, there are 10 people whose incomes are going down – and they have bought most of their "stuff". When you stop to consider that consumers spend 70% of all the money that is spent in our economy, this is not a recipe for vibrant, dynamic growth – and we are not experiencing vibrant, dynamic growth.

(Unless otherwise indicated, Bloomberg is the source of the information contained in this report).

Europe

In the 2014 Half-Time Report, I talked about what is happening in Europe. As a group of countries, Europe is our largest trading partner. As a result of the financial crisis in 2008, Europe went into a terrible recession. Then they had a second recession. Now, they are teetering on the verge of a third recession. For the first time in five years, they had a 0.2% annual drop in prices (deflation). The European Central Bank is so concerned about the possibility of a deflationary spiral that on January 22, 2015 they announced that they would soon begin a 1.1 trillion Euros ($1.3 trillion U.S.) bond buying program similar to those that the U.S. Federal Reserve has done (this type of program has been labeled "quantitative easing" or "QE"). Additionally, the fiscal imbalances in Europe (governments spending more than they are taking in) that led to the Greek and European Debt Crisis have not been resolved.

Like the U.S., most of the countries in Europe (with the exception of Spain and Italy) have aging populations. Like the U.S., most of the countries in Europe have either begun, or are about to begin, the same demographic shift that we started on January 1, 2008 as the Baby Boomers began to move into retirement. In 2013, Germany and Britain, Europe's #1 and #3 economies (as measured by GDP), both began the same demographic shift we began on January 1, 2008.

As the population of Europe continues to grow older and more and more people move into retirement and spend less money, I can easily see how Europe could fall into yet another recession. As a result Europe, our largest trading partner, would buy less of what we produce, thereby reducing our GDP by some measure.

Japan

Japan is the world's third largest economy. Japan started their demographic shift in 1990. 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. The Japanese are very xenophobic, so they allow very few people to immigrate to their country. 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, Japan's central bank, The Bank of Japan, has continued with its decades-long program of monetary stimulus. The Bank of Japan was the first to ever engage in the aforementioned "quantitative easing". Despite the fact that (for decades) it doesn't seem to be achieving the desired result of fostering and creating economic growth, they have recently increased the stimulus in the hope that it will.

Very low interest rates (short term and long term interest rates in Japan have been below 1% for more than 20 years) do not help retirees to have more interest income to spend. It provides them with less income to spend. While low interest rates allow for businesses to borrow money cheaply, I don't know of any retiree who is 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! Because businesses exist to sell things to the consumers who want those things, it doesn't really matter too much that business loans are cheap. As a business person, why would you want to go out and borrow a bunch of money to fund your business, if the group of customers to whom you are selling is not only aging and spending less, but also <u>shrinking</u>? It doesn't make sense. And yet, the Bank of Japan recently launched its most massive stimulus program to date.

Central bankers in the U.S., Europe, Japan, and around the world really have very <u>few</u> tools in their toolbox available to try to modify and <u>hopefully</u> impact economic outcomes. Raising and lowering interest rates at the bank has historically been their primary tool. More recently, quantitative easing was used for the first time. 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 efficacy or impact on the borrowing and spending habits of <u>aging</u> populations. "If the only tool you have is a hammer, then every problem begins to look like a nail".

<u>China</u>

And then there is China. China is the world's second largest economy. Because a large percentage of China's GDP is due to the enormous amount of exporting that they do, as global growth has slowed, China's growth has also slowed. GDP in China has contracted to its lowest point in 29 years. <u>China is a communist country with millionaires and billionaires</u>. A communist country with millionaires and billionaires?

And then there are the grave concerns over what is happening in the Chinese residential real estate market. I read a report several years ago, which if it had not been from a credible source, I simply wouldn't have believed what they said. The report estimated that somewhere between 25 to 33% of all of the residential housing units in China do not have electricity flowing to them. They <u>are</u> wired for electricity. The problem is that <u>nobody</u> lives in them. Just imagine what it would be like if 25 to 33% of the homes and condos and apartments in the U.S. were currently <u>vacant</u>.

In August of 2014, 60 Minutes did a 20 minute time slot on China's housing market. Lesley Stahl was the correspondent. In one of the scenes, she was walking on an overpass which straddled a six or eight lane highway which ran through a large, gleaming, brand new city. There were no cars. None. Why? <u>Because no one lives in that city</u>.

60 Minutes reported that anywhere from 12 to 24 of these brand new unoccupied cities are being built every year.

It is the plan of the Chinese Communist government to move approximately 180 million people from the farms into these cities over the next 10 years. No one is sure what these peasant farmers will do for work when they get there or how they will pay for their accommodations. Approximately 10 years from now is when China will begin their demographic shift.

To provide the accommodations for the farmers, the Chinese Communist government has allowed for limited capitalism to exist within its borders. Over the past 30 years, as more and more people have moved in to the cities, a large middle class has emerged with savings from work that needs to be invested. China <u>prohibits</u> most investment <u>outside</u> of China.

The basic investment options for most Chinese citizens are similar to those here in the U.S. 1) Bank instruments like C.D.'s and money markets. Interest rates in China are not much higher than they are here, however. Not a great investment. 2) The Chinese stock market is a rollercoaster and many Chinese corporations use questionable accounting practices, so most Chinese people do not invest there. 3) That pretty much leaves one thing: Real estate.

Most Chinese families have most of their net worth invested in real estate and continue to do so. Over the past three decades, real estate has done well as more people have moved from the farms into the cities, which attracts more investment, which causes prices to go higher and the demand for the building of these unoccupied residential units outstrips the ability of builders to build them fast enough, which causes prices to go higher still, which attracts more investment, which causes prices to move higher…..

The tremendous concern is this: What happens if what appears to be a significant bubble in the Chinese housing market – remember, 25% to 33% of all residential units are unoccupied – <u>bursts</u>?

The net worth of the average Chinese family would plummet, which would jeopardize their ability to participate in the economy, massive job losses would result and what would happen to the Chinese banking system if there are massive defaults like there were here in the U.S. in the last decade? What would the implications be for the global economy? Remember, China is the world's second largest economy.

So here's a quick recap:

1) The U.S. economy is growing at only 71.4% of its historical average after more than six years of record stimulus.

2) Europe, our largest trading partner, is on the verge of its third recession since the financial crisis, which would slow growth here in the U.S. as Europeans buy fewer and fewer of our goods. The European Central Bank has just announced a 1.1 trillion Euros bond-buying program.

3) Japan, the world's third largest economy, just started yet another recession with a population that is growing older <u>and</u> shrinking. The Bank of Japan nonetheless continues to engage in massive monetary stimulus programs.

4) The GDP of China, the world's second largest economy, recently hit a 29 year low as a result of the global economy slowing down. Furthermore, there appears to be a significant bubble in their domestic real estate market, which could have significant negative global repercussions if this apparent bubble bursts.

With this as a backdrop, in 2014, the Standard and Poor's 500 index increased by another 11.74%!

In 2014, I spoke with everyone about the "disconnect" that had occurred between the economy and the stock market in 2013. The economy grew at only 1.90% (54% of its historical average of 3.5%) and yet the Standard and Poor's 500 increased by 29.60%.

The stock market "disconnected" from the economy in 2013. The "disconnect" continued into 2014, albeit not as dramatically as the year before.

In last June's Half-Time Report, I said something like this: "When the economy is growing at roughly one-half its historical rate, despite more than 5 ½ years of record stimulus, and the stock market goes up by almost 30% in the same year, something <u>other</u> <u>than</u> prudent investing has taken place."

<u>Great Headlines</u>

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 <u>shocked</u> when I committed the numbers to paper. I have listed them below.

<u>S & P 500 Index</u>

	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 what was at the time, 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 goes from 1,552.87 to 1,569.19, <u>an increase of only 1.05% in 13 years</u>! 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 barely 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: Why?

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 can't be for reasons of economic growth.

So what caused it?

Investment Alternatives

I think the answer is very simple. Look at the small handful of places where investors can put their money.

1) Bank instruments like C.D's and money markets. With interest rates where they are, after taxes and inflation, you are actually losing money.
2) Real estate. In most places across the country, real estate is not appreciating very much at all, so most people aren't investing very much in real estate.
3) Bonds. Most investors don't see 3-5% returns as very exciting. That leaves just about one thing:
4) Stocks.

Over my career, I have seen the same thing happen over and over again, but in different markets. Sometimes it's gold, sometimes it's oil, sometimes it's real estate and sometimes it's stocks. But what is always the same is this: Investors like to invest their money where they hear about other people making money with their money!!

The most recent example that I can give that everyone can relate to is U.S. real estate from 2001 to 2007. I can't tell you how many people I met who said to me something like this: "Scott, I have this buddy in Florida – he is no rocket scientist – he bought a house there last year and sold it a year later and made $100,000! I can't afford to miss out on opportunities like these, I need to invest in real estate! Where can I get some money?"

As we all know, there was plenty of cheap, abundant money available to be lent and we all know how that story ended. But here is how the story began: From 2001 to 2003, for various reasons, mortgage rates dropped from about 6% to about 4%. What this meant was that someone who wanted to buy real estate could borrow 50% more money at 4% that they could at 6%. It's not that people wanted to borrow that much more money, but they were bidding for real estate that they wanted against other people who could borrow 50% more money as well. So they did. So as a result of mortgage rates dropping, in a few short years, much of the real estate in this country went up in value by 30, 40 or even 50%! That is real money! It got lots of media attention, everybody was talking about it and……investors like to invest their money where other people are making money with their money. Investors turned their attention to real estate. Record numbers of people bought homes or became real estate investors and a record amount of money was invested in real estate. The supply could not keep up with the demand, so prices went up.

January 2013

For various reasons, January of 2013 was a great month for the stock market. It was the best January for the stock market since 1993 or 1994.

The market had had a pretty good year in 2012. January's returns got a lot of press. People everywhere were talking about it. The fear over another recession was waning. Investors who had gotten out of stocks when they plummeted, became impatient and tired of not earning any money in their money markets. Money was being made in the stock market again. Investors began to turn their attention – and money - to the stock market. The supply of stocks available to be purchased by the consumer had been rising by only 1.3% per year since the crisis in the fall of 2008. Record sums of investor money began to pour into the stock market. Additionally, investors began to borrow record sums of money to buy more stocks using their existing investments as collateral – it's called margin debt. From July of 2012 to December 31, 2013 – 18 months - the amount of money that investors borrowed on margin to buy more stocks jumped from $277.7 billion to $444.9 billion. Today, almost $500 billion – a half trillion – dollars has been borrowed by investors to buy more stocks – using their existing stocks as collateral for the loan.

So in 2013, an enormous amount of both borrowed and non-borrowed money flows into a market where the supply of what is being purchased has only increased by 1.3%. Is there any wonder why stocks went up so dramatically? From 12-31-12 to 12-31-13, the amount of borrowed money that was used to buy stocks increased from $330.356 billion to $444.931 billion, an increase of 34.68%. In that same time frame, the S&P 500 index goes from 1426.19 to 1848.36, an increase of 29.60%. See the connection?

Strategy Moving Forward

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

As far as the stock market goes, there is no question that it has been going up. The reasons behind why the stock market has been going up are what makes me very 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 not to lose money. When most people retire, their investments become irreplaceable.

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 is 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 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 years since we have had one of these events. Every month that goes by without something happening puts us closer to that inevitable 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. Happy New Year to all!!

Respectfully yours,

Scott W. Eglseder