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# Half-Time Report

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Current Situation and Strategy Moving Forward:

## Current Situation

When I met or spoke with each of you during the first six months of 2013, I began the economic portion of our discussion by saying something like this: "I am aware that the stock market had a decent year in 2012, and so far in 2013, the stock market is off to a phenomenal start. When I compare, however, how well the stock market is doing to how the U.S. economy is actually doing, I see a very large disconnect between the two." As 2013 progressed and ended, this "disconnect" did nothing but grow larger and larger.

By contrast, as of Friday, May 9, 2014, the Dow Jones Industrial Average and the Standard and Poor's 500 Index are up, respectively, only .04% and 1.63% year-to-date.

When I look at the economy today, while I do not see "doom and gloom", here is what I do see: After more than five and one-half years of record fiscal and monetary stimulus by the Congress and Federal Reserve respectively, the simple truth is that the U.S. economy has been and is currently growing at approximately one-half of its historical rate. Between 1945 and the beginning of the last recession, the average annual growth rate of the U.S. economy, as measured by Gross Domestic Product (GDP), was approximately 3.5%. For calendar year 2011, GDP was 1.70%. For 2012, it was 1.75%. For all of 2013, GDP was 1.90% for the year.

When I look at employment, between the beginning of the last recession and the depth of that recession, the total number of jobs lost in the U.S. (net) was about 8,750,000. When the March 2014 monthly jobs report was delivered by the Labor Department, the total number of people working in this country finally got back to where it was on December 31, 2007 (when the last recession is deemed to have begun). It took six years and three months for the total number of people working in this country to get back to where it was before the last recession began!

Without a particular frame of reference, that doesn't sound very good. When you add the following frame of reference, the length of time that it took to get those jobs back becomes absolutely awful! Between World War II and this last recession, we had ten other recessions. Within two years of the beginning of each of these other recessions, the total number of people working in this country equaled or exceeded the number that were working before each of these other recessions began. This time it took 6 ¼ years! This should indicate to the analytical mind that there has probably been some type of fundamental change. We have spoken many times about what I believe this change to have been, but it has received very little press coverage. We'll discuss this change further in just a bit.

When I look at the monthly job figures, the U.S. economy needs to generate approximately 200,000 new jobs (net) every month just to accommodate people who are graduating from high school and college and seeking full-time work for the first time. For the 39 month period ending March 31, 2014, however, the average number of monthly jobs created was approximately 165,000 or about 5,500 new jobs a day. At the same time, however – and you have heard this many times from me before – since January 1, 2008, almost 6 ½ years ago – every single day approximately 10,000 Baby Boomers retire.

So we continue to be in a demographic situation where every single day about 10,000 people retire, but only roughly 5,500 people each day are finding full-time work. In almost all cases when people retire, their income goes down, their overall spending drops as a result, and by the time that most people retire, they have usually made most of the major purchases that they will make in their lifetimes. The usual exception is, every five to ten years, they will purchase a new car.

The simple fact is that the U.S. economy is a consumer-driven economy. Consumers spend approximately 70% of all of the money that is spent. Please understand that business spending is important – it all adds up – but almost always, increases in business spending <u>follow</u> increases in <u>consumer</u> spending. Therefore, in order for the economy to grow, total consumer spending must consistently increase as the years go by. The only way that consumers can <u>consistently</u> increase their spending as the years go by is if total consumer income is also increasing as the years go by.

To me, it really boils down to a <u>mathematical</u> problem: We continue to be in a demographic where, daily, roughly twice as many people retire as compared to those who are finding work. That is, every day you have roughly twice as many people whose incomes are going down as compared to those whose incomes are going up. When you stop to consider that consumers spend about 70% of all the money that is spent in our economy - and when you do the math, I just don't think that it is mathematically possible for the economy to grow a whole lot faster than it is right now.

According to demographers, this particular demographic that we are in probably isn't going to change for another seven to eight years: This is when the generation below the Baby Boom Generation begins to turn age 46 – that's the peak spending year for the average American – and at that point in time the next generation begins to move into their peak earning-and-spending years, just like we Baby Boomers (of which I am one) began to do in about 1990. As we moved through our peak earning-and-spending years, this explosion of spending helped to create the best twenty years of growth that this – or any other country – has ever experienced.

In my opinion, the fundamental problem for the economy has been – and it has been completely overshadowed by the Global Financial Crisis and The Great Recession – that on January 1, 2008 the largest group of consumers ever born in U.S. history (when combined with immigrants during the same time frame) – began to move out of their peak earning and spending years and into retirement where both income and spending go down.

In addition to this fundamental problem, the economy continues to face other "headwinds". For example, wages for workers continue to be relatively stagnant across most of the country. As a result of what the Federal Reserve has done with short-term interest rates at the banks and the downward pressure they have exerted on long-term interest rates through their three sets of asset purchases since the financial crisis, investment income has dropped for many people who have been living off of that income. Since WWII, household formation - which is a fancy term for getting out of school, finding a mate, starting a family and (most importantly for the economy) buying a house – has been the single largest contributor to GDP.

Household formation has been very stagnant as very large numbers of college graduates are discovering that even if they can find a job (which roughly 25% cannot), their monthly student loan payments (total outstanding student loans now exceed more than $1.1 Trillion) are either preventing them from qualifying for a mortgage altogether, or, it reduces the amount that they can borrow to the point where they can't borrow enough to buy their first home.

When you look at the record number of new and used homes that were purchased from 2001 to 2007 due to falling mortgage rates and easy-to-get mortgages and stop to consider that every year during that time frame for both categories a new sales record was set each year relative to the year before, that even though a record number of people did end up losing their homes, most people did not. Therefore, I believe that a lot of people who would be purchasing homes now already did during that incredible seven year period.

On top of this, most people know someone – or know someone who knows someone - who has lost their home since the Financial Crisis. As a result, many households continue to focus on increasing their savings and paying down their debts, just in case something else bad happens. To the extent that households are currently spending less today as a result, this does not currently help the economy to grow.

As the population of the world's largest economy continues to age and, as a result, the growth of total spendable consumer income continues to be well below the rates we experienced between 1945 and 2007, I just don't see much over the next seven to eight years that is going to cause our economy to grow a whole lot faster than it is right now.

For every potential bright spot that I see that might contribute to GDP, I see something else that could easily take it away. For example, I have read quite a bit which indicates that domestic energy production is indeed a bright spot for the economy. At the same time, domestic energy production and its related components account for a little bit less than 10% of domestic GDP.

If we round that up to an even 10%, then domestic energy accounts for .19% of the total GDP, which for 2013 was 1.90%. Even if total output from domestic energy were to <u>double</u> in the next year or two, this would add only another .19% to GDP! 1.90% + .19% = 2.09%. The historical average for GDP from 1945 to 2007 was approximately 3.50%.

While I see energy as a bright spot for the U.S. economy, here is the one obvious thing (to me) that might detract from the small amount that energy might add to U.S. GDP. As a group of countries, Europe is our largest trading partner. Like the U.S., Europe has an aging population. With the exception of Italy and Spain (which enjoy a demographic similar to that which we experienced in the 1990's up through 2007), most of the countries in Europe have already 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), <u>both</u> began the same demographic shift that we began on January 1, 2008.

As a result of the Global Financial Crisis, like us, Europe had a Great Recession. Like the Federal Reserve here, the European Central Bank engaged in massive stimulus and bailout programs - remember the Greek and European Debt Crisis? Like the U.S., Europe did emerge from that recession. Since their Great Recession, they have had another recession which they have also emerged from, only to find themselves teetering on the verge of another recession. As the population of Europe as a group of countries continues to grow older (and more specifically Germany and Britain – their #1 and #3 economies) and as more and more people there move into retirement and spend less money, I can easily see how Europe could fall into another recession and as a result Europe (our #1 trading partner) buys less of what we produce, reducing US GDP and the small gains to US GDP that domestic energy production hopefully will create.

To me, it boils down to the following basics: In 2009 (when I last looked at the numbers), retirees in the U.S. were about 16% of the <u>total</u> population. The Baby Boomers were about 26% of the <u>total</u> population. When I subtracted out the under age 18 population, however, retirees and the Baby Boomers represented 61% of the over age 18 population. Remember, consumers spend 70% of all the money in our economy. The simple question therefore, I believe, is this: Moving forward in time, how can the U.S. economy grow in a historically significant fashion if 61% of the adults have less income and they have already made most of their major purchases? I believe that the answer is: It can't, it isn't and it hasn't been.

Despite the above realities, in 2013, the stock market had a great year. This was the "disconnect" that I mentioned earlier in this letter.

For almost 20 years, I would finish up at the office and see that the stock market was up for the day, week, quarter or year. Then on my way home, I would drive past six shopping centers where the parking lots were filled with cars, downtown Easton was bustling with very few vacant storefronts. I saw new homes going up everywhere, I saw existing homes being renovated. I saw new commercial buildings going up, I saw existing buildings being renovated. In short, when I would drive home, what I saw on the computer screen about how the stock market was doing matched what I saw when I drove home.

Last year, on the other hand, I would see that the stock market was up another 200 points for the day and on my way home, here is what I saw: Those same 6 shopping centers, the parking lots were maybe 25% filled with cars. Not only was downtown Easton not bustling, there were (and still are) 4 to 5 times as many vacant storefronts as I have seen in the past 53 years – and there are more this year than last year – 5 ½ years after the crisis. I see very few new homes going up, I see even fewer existing homes being renovated. For the first time since the Crisis, I see two new commercial buildings going up (just down the street from my office – one is a big box store, the other is a local company with is consolidating several of if its offices here in Easton to one location – more vacancies!). In the past 5 ½ years, I have only seen two buildings in downtown Easton being renovated – The Talbot Bank had foreclosed on each and the new purchasers got them for the amount that was owed to the bank and have renovated them nicely. In short, when I drove home last year what I saw on the computer screen did not match what I saw when I drove home.

When the economy is growing at roughly half its historical rate - despite the fact that we have had more than 5 ½ years of record fiscal and monetary stimulus by the Congress and the Federal Reserve - and yet regardless of this reality the Standard and Poor's 500 Index goes up by almost 30% for the year, I would argue that something other than prudent investing has taken place.

Throughout last year when we met, I did provide you with very detailed reasons why I believed that the "disconnect" between the economy and the stock market was occurring. If the details of those discussions are a bit fuzzy due to the passage of time, please ask me for a "refresher" when you come in for your next meeting.

As you have heard me say at our meetings, I attend two to four educational conferences per year. At these conferences, I cannot remember the last time I ever heard anyone mention the retirement of the Baby Boom Generation and the resulting demographic circumstances in which we find ourselves located. It as if this shift were not occurring, or if it was, it's not important enough to discuss.

Rather, the overwhelming majority of my industry subscribes, in one form or another, to something called Modern Portfolio Theory. In my experience, what I have observed is that this usually results in a recommendation of an allocation of roughly 60% stocks and 40% bonds. To demonstrate how pervasive this is, according to the Employee Benefit Research Institute, the average 401(k) plan participant had 61% of his or her retirement dollars in the stock market as of 12-31-11. These 401(k) plan participants didn't get to that number by chance.

Since I began to selectively market for new clients again in January of 2012, with almost every single new client I have brought on, their previous firm had them at almost exactly 60/40 – regardless of their age - and they were all retired before they became clients of my firm.

For a large portion of my industry, it would seem that the following statement could be true: It doesn't matter how the economy is doing, you should always invest the same way. That doesn't make sense to me.

## Strategy Moving Forward

When you combine all of my past and current concerns with who my clients are – 95% are retired, my primary focus remains simple: Try not to lose money.

When people retire, their investments become irreplaceable. If you are working and if you suffer a permanent investment loss, you can take some of your extra income and make new investments. With that and time, there's a good chance that you will fully recover. When people retire, however, that luxury goes away for most people.

So here has been my mantra for the past several years: Try not to lose money. More specifically, I am trying to avoid the type of losses that are historically attributable to that 60 /40 split between stocks and bonds. With that particular allocation, if you have a fairly significant negative event, it is very easy for your account to drop by 25%.

The problem with an account that drops by 25% is this: You have to make 33% to get back to where you used to be. And if you are making withdrawals, you have to make even more.

Now, back in the good old days, let's say roughly 1987 to 2007, you had a relatively short waiting time to get back to where you were before – 6 months to 12 months was usual, on rare occasions, 18 to 24 months was just about the longest time you had to wait to get back to where you were before. Remember?

I try to pay attention. The last time we had a large, unexpected negative event was in the Fall of 2008. It started on September 15, 2008, when Lehman Brothers collapsed. Eight and a half months earlier, on January 1, 2008, a very significant event in U.S. history started - the Baby Boom Generation began to retire. Prior to that, the Dow Jones and the Standard and Poor's 500 (S&P 500) indexes had hit what was their then all-time high on October 9, 2007.

So, the Dow and the S&P 500 hit their all-time high on October 9, 2007. About a year later, we had the financial crisis and the stock market dropped sharply. It took until March of 2013 for the Dow and the S&P 500 indexes to get back to where they were on October 9, 2007. That's not 6, 12, 18 or 24 months – that's 5 ½ years!

If I were simply to "drink the Kool-Aid" and recommend that 60 /40 split between stocks and bonds and hope that it all works out for you – and when you think about that, that doesn't sound like such a great strategy: Do what everybody else is doing and hope that it works out for your clients…….

But if I were to nevertheless recommend the 60/40 split and we then experienced a fairly significant negative event and, as a result, if your account were to drop by 25%, I can tell you this for sure: There's one thing I know and one thing I don't. What I am sure of is this: Math doesn't change with time. Whether it's "the good old days" or today, if your account should drop by 25% in value, you still have to make 33% to get back to where you were before. If you are making withdrawals – which most of you are – you have to make even more.

What I don't know is this: How long would it take for us to get back to where we were before? It is not the "good old days" anymore. When I can't see the bottom of the pool, I never dive in head first.

So, here is the strategy: Because of everything we have just discussed, my primary focus remains quite clear – try not to lose money by limiting your current, overall investment risk. More specifically, I am trying to avoid the types of negative numbers that are historically attributable to that 60/40 split between stocks and bonds. I want to continue to take a reasoned amount of risk to achieve a reasonable return, with a goal – this is not a guarantee – for your total return (dividends and interest paid plus price increases or decreases) of 3% to 6% per year, while we are patiently waiting to get back into the stock market.

Because of inflation, getting you more heavily into the stock market has always been the stated goal, intention and objective. It is not a matter of if. It is a matter of when. At some point – and I simply cannot tell you when it will happen or what is going to cause it – but at some point in the future, we will have an unexpected event of a negative nature. When it does occur, investors in the stock market will do what they have done in 100% of the cases throughout history: 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 hypothetical 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 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, I actually want to be making money again – not just 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, I will contact you promptly with my recommendations.

Despite everything we have discussed, if you are "chomping at the bit" to try to increase your investment returns by moving more money into stocks right now (and increasing your overall investment risk as a result), please call Bertha and we will move your next meeting so that we can meet sooner rather than later to make the necessary changes.

Thank you for your time and attention to this letter. I take the amount of investment risk that my clients are taking - your money - quite seriously. Financially and otherwise, I care deeply about what happens to you and your family.

In closing, I want to thank you for your ongoing business. My company's revenues are based on the value of your accounts here with me. You are working with a guy who knows exactly where his paychecks come from. I do not take them – or you – for granted. I am very grateful to have your business. It is meaningful and I am very lucky to have it. I am very grateful and I want to earnestly and sincerely thank you for it.

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.