OVERVIEW

Economic Analysis and Market Review

Q1—2015

BRIEFLY...

- Economy slows in Q1
- Economy gets help from jobs

Sometimes I wish I was an economist. All the economists I read say we're in a recovery. Recovery? I guess it depends on when you look at the data. That's because this recovery has been stopping and starting continuously. Last year our real gross domestic product, the total of all the goods and services produced in the U.S., grew around 2.5%. This was in line with the 2.3% average since the recovery started in 2009. Keep in mind that growth in the US has run, typically, around 3.4%. Now we get into the first quarter of 2015 and growth has slowed considerably to around 1%. And our economy began to recover from the financial mess of 2008 a lot sooner than the rest of the world. Pity the rest of the world, but more on that later.

On a closer look at our economy, there are some good reasons for the slowdown we experienced in the first quarter:

1. The dollar has got a lot stronger which gave imports a boost but didn't help our trade deficit.
2. We suffered through a long and severe winter which kept many consumers at home or at least out of the malls.
3. OPEC (really Saudi Arabia) didn't cut production in the face of an over-supply and instead opted to keep production at current levels thus creating a huge glut of oil on the market causing prices to halve — from $100/barrel to current levels of around $50/barrel. Their strategy obviously is to make it unprofitable for the many small drillers in the Bakken shale, Eagle Ford and Marcellus shale that are leading the US to OPEC independence. Their strategy may be working in the short term as over $150 Billion in exploration and development projects worldwide have been cancelled. At $25/barrel, Saudi Arabia can still make a profit. Not so for the drillers working newer wells in difficult locations.
4. West coast ports went on strike which disrupted supplies coming in from Asia and the Far East.

BRIEFLY...

- QE goes International
- Stocks follow the economy

The US economic recovery is gaining momentum and its strength is tied to consumer income. In total, US businesses created over 3 million jobs in 2014. The increase in private non-farm employment was the biggest for any year since 1997. The average monthly increase in employment was over 280,000 jobs. Total employment is at a record high and unemployment has fallen dramatically to its lowest level in almost seven years. At 5.5% unemployment, this is close to the level where the Fed has said will be sufficient to raise rates. Hopefully, the Fed will look at other data such as inflation as the quality of the jobs being created isn't high. The largest surge is coming in the restaurant trade's 66,000 new jobs. As a matter of fact, jobs in the oil service sector, which pay around $100,000 per year, are in decline as drillers are idling unprofitable wells in the current slump. However, hiring in the oil fields should resume when the price of oil rises.

Economic growth with some of our key trading partners still isn't up to par. Japan is struggling to end years of stagnation with "Abenomics" — their form of quantitative easing named after Prime Minister Shinzo Abe, who initiated the program. In the Eurozone, the European Central Bank President, Mario Draghi, has begun a program of quantitative easing to accelerate their growth. Europe should get some help from a weaker currency as should Japan, as the Euro has declined 19% in the past year and the yen has fallen 36% over the last 3 years. The Dollar/Euro exchange rate is currently at $1.06 to the Euro but many shopkeepers will take a dollar in exchange putting the Dollar/Euro at parity. Even with the weaker currency making their products less expensive, the euro area is forecast to grow just 1.2% in 2015 as Draghi tries to do a balancing act between a fragile Greece and a strengthening Germany. By comparison the International Monetary Fund forecasts the US to grow at 3.2%, close to our post-WWII norm.

As our anemic recovery shifted like rush-hour traffic from start to stop and back again, so did the stock market. Since late December, the Dow Jones has traded in a range, bouncing several times between 17000 and 18000 where it currently stands. This was a response in large part to investors' anxiety about the timing of the Fed's rate hike. To my mind, a rate hike would indicate that the economy is gaining strength and able to continue on its own without any help from low interest rates but apparently, the market thinks otherwise. There is also concern that the strong dollar will have a negative impact on corporate profits when other currencies are converted to dollars. This may account for the out-performance of small cap stocks during the quarter (+4.32%) as they typically don't have a large exposure to overseas trade. The quarter also witnessed the strong performance of the international markets (EAFE +4.88%), notably the markets where quantitative easing is taking place.

Overweighting Europe and Japan while quantitative easing is the policy of the day is good advice just as it was for the US as Bernanke launched his QE programs in the financial crisis of 2008.

Market Indexes
First Quarter, 2015

INDEX	Q1'15	3 YEARS	5 YEARS	10 YEARS
S&P 500	.95%	16.1%	14.5%	8.0%
Russell 2000	4.3%	16.3%	14.6%	8.8%
EAFE	4.9%	9.0%	6.2%	4.9%
Aggregate Bond	1.6%	3.1%	4.4%	4.9%
Treasury Bills	0.0%	0.07%	0.09%	1.5%
REIT Index	4.7%	13.9%	15.9%	9.4%

- S&P 500 is an index of large capitalization stocks
- The Russell 2000 is an index of small companies
- EAFE (Europe, Australia, Far East) is an index of developed international markets
- Aggregate Bond is an index of investment grade corporate bonds
- Treasury bills are short term (3 mo.) debt obligations
- REIT Index is an index of commercial properties