OVERVIEW

Economic Analysis and Market Review

Q2 — 2014

A LOOK AT Q2

- Cold war redux
- US economy rebounding
- ECB shocker

In the last quarter, the events in Crimea and Ukraine took center stage as Vlad Putin once again attempted to restore the former U.S.S.R. by annexing the two. He succeeded with Crimea, the jury is still out on Ukraine. This is an important region for Russia as so much of their oil passes through these countries on its way to Europe. Once again the U.S. economy takes a back seat as economies around the world take the spotlight.

The U.S. economy continues along the road to recovery as interest rates remain at historic lows aiding the housing industry and employment growth. U.S. payrolls climbed past their pre-recession peak and the unemployment rate is now close to a six-year low at 6.1%. The addition of 288,000 jobs in June followed a gain of 224,000 in May which was bigger than previously estimated. The number of long-term unemployed fell to 3.1 million, showing they're having greater success finding work.

A report on industrial production in the U.S. showed that capacity utilization is on the increase. As that continues, companies will add jobs and new plant and equipment. With more people receiving paychecks, demand for goods and services will increase and companies will ramp up production to meet this demand. In a press conference, the new Chairwoman of the Federal Reserve, Janet Yellen, said, "Economic activity is rebounding in the current quarter and will continue to expand at a moderate pace thereafter." The "moderate pace" is expected to be in the range of 2–2.3% for 2014 and accelerate to 3% in 2015.

While jobs are increasing slowly in the U.S., Europe is stuck in a slow-growth funk and is now concerned with potential deflation as opposed to inflation. The financial crisis was a global event and the U.S. acted quickly and correctly to lower interest rates and supply liquidity to the system, but Europe took the other approach and launched austerity measures and raised taxes. Perhaps they took this approach out of an innate fear of inflation. Only later did the European Central Bank (ECB) provide monetary stimulus. While the euro area's economic recovery continues, albeit at a slow pace, consumer price inflation has remained at very low levels. Inflation is currently expected to be at a pitifully low 0.7% for 2014.

LOOKING AHEAD

- Central banks take action
- Low rates will continue
- US stock market not overvalued

With the euro market still in the doldrums and disinflation a nagging concern, the ECB took some dramatic steps in an attempt to kick start their economy., ECB President Mario Draghi, like former Fed Chairman Bernanke , studied at M.I.T. under Professor Stanley Fisher who espoused printing money if prices are in danger of falling (deflation): As more money circulates in the economy, prices rise and people start buying again. Now Draghi is printing money. Loans to non-financial corporations have continued to fall during this recovery and, given the euro zone's strong dependency on banks as credit intermediaries, the ECB is concerned that a lack of credit is hampering economic activity. With this in mind, Draghi took the unprecedented step of lowering the deposit rate paid by the ECB to banks for parking funds with it overnight. The ECB will now CHARGE — not pay banks — 0.1% for holding their money! This is a first time ever. Hopefully it will encourage banks to lend more to credit-starved businesses spurring growth across the region. This will be good for them and for us as well.

Elsewhere across the globe, central banks are seeing the wisdom in monetary stimulus and enacting their own versions. China's Xi Jinping, India's Narendra Modi and Japan's Shinzo Abe are all providing some stimulus to their economies. As these measures gain traction, the world will benefit as these countries have been and should continue to be the global growth engines.

There are many economies but one world economy. Maybe this helps explain why our interest rates have remained low while our economy slowly gathers momentum. If interest rates are at 2% in Europe and our 10-year Treasury yields 2.5%, any money manager worth his/her stripes will place money in our Treasuries. Money is attracted to the higher yield if it's safe. As long as that discrepancy exists, our rates should remain at these levels.

And low rates are good for the stock market as well. After the bull run our stock market has experienced, the "talking heads" on CNBC and elsewhere are speculating on its demise. We're due for a 10% correction, they say. Perhaps, but one gauge indicates to me that the stock market is still a good value. A commonly used measure of stock market valuation is Earnings Yield, which is the inverse of the Price Earnings (P/E) ratio. The earnings yield of the stock market usually trades at a 3% premium over the 10-year Treasury note. Currently the 10-year Treasury yields 2.56% so the earnings yield should be around 5.6% to be at parity. If it's higher than that, stocks are considered cheap; if lower, they're not. Presently, earnings expectations for the S&P 500 are $118 and the index trades at 1967. Dividing $118 by 1967, I get 6%. From this metric, it appears that stocks are still relatively cheap. In addition, with money market funds yielding next to nothing, and bond yields so low, stocks offer investors a more attractive option.

Adding it all up, economies around the world are improving — they're not great but getting better — and central banks are stimulating with additional liquidity. As the saying goes on Wall Street, "Don't fight the Fed" – or the central bank. I guess I'll hang on to my stocks a while longer.

Market Indexes
Second Quarter, 2014

INDEX	Q2'14	YTD	12 MONTHS	10 YEARS
S&P 500	5.23%	7.14%	24.61%	7.78%
Russell 2000	2.05%	3.19%	23.64%	8.70%
Europe, Aust., Far East	4.09%	4.78%	23.57%	6.93%
Barclays Agg. Bond	2.04%	3.93%	4.37%	4.93%
Dow Jones REIT Index	7.15%	18.24%	13.27%	9.41%
Treasury Bills	0.01%	0.02%	0.05%	1.63%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- The Dow Jones REIT Index is an index of commercial real estate properties
- Treasury Bills are 3-month securities issued by the U.S.Treasury