OVERVIEW

Economic Analysis and Market Review — Q2—2015

BRIEFLY...

- US economy grinds on
- Good news on job front

A view of the US economy thus far looks like déjà vu all over again. The first quarter of 2014 had a sluggish start with growth finalized at -0.2% and finished on a strong note with upward revisions for the last three months of the year. The payroll data for March of this year came in at just 126,000, and with revisions the quarter created 591,000 jobs compared to more than a million in the previous quarter. Sound familiar? A green shoot in the labor data is that first-time applicants for unemployment fell to the lowest level in 15 years and jobless claims fell to 279,500, also the lowest in 15 years. This is solid evidence that layoffs remain at unusually low levels and the job market is moving closer to full health. Most major segments of the economy except for the energy industry added workers. This suggests the second quarter is off to a good start. Stronger job gains also brought the unemployment rate down to 5.3% from 5.5%; this in spite of the fact that more people entered the labor force in search of work. This is the lowest level in seven years and earns the Obama administration a gold star. In the last election, Romney promised to bring down unemployment to 6% in 2016. Of course gold stars could also be handed out for 12 million new jobs, a stock market that has more than doubled, deficits that have been cut by two-thirds, health care inflation at the lowest rate in nearly 50 years, manufacturing coming back, auto industry coming back and clean energy has doubled. Bravo!

The good news on the job front came as the economy fought off two longer term headwinds – lower oil prices and a stronger dollar. US oil companies are slashing hiring plans and exploration budgets in light of continued weak prices. Currently, the Saudis are continuing to pump at a high rate even as the world is producing 2 million barrels per day in excess of what is needed. Their intent is to maintain their market share. With oil prices hovering around $50–$60/ barrel, the Saudis can still make a profit whereas the newer wells in the Bakken, Eagle Ford and Marcellus shale in the US have a much higher cost to extract their oil. The domestic rig count is down by half and over 6000 workers have been laid off. As for the dollar, with geopolitical turmoil in the Ukraine, sanctions in Russia and a debt crisis in Greece, the dollar has become the world's safe haven causing its value to rise significantly.

BRIEFLY...

- Wage growth not keeping up
- Eurozone picking up

There's no doubt that the economy continues to grind higher with each new data point providing more evidence. If there are negatives to the economic news, and I can think of two, it's the lack of wage growth and the housing and construction sector. Wage growth hasn't kept up with the economy. According to the U.S. Bureau of Labor Statistics, private sector wages have only grown by about 2% a year since the financial crisis, compared with nearly 3% for the economy. If there's a silver lining to this statistic it's that inflation has remained extremely low. Over the last few years, inflation has hovered around 2% and rather than increasing with a growing economy, it's actually been falling. It's near 0% for most of this year. As for housing and construction, it still needs to catch up. Building houses used to be about 4.5% of the economy. Now it's just 2%. Anyone in the industry can tell you that they haven't been busy but things are picking up. Just over the last year, construction spending has picked up almost 8% and the stocks of home builders have risen.

Across "the pond", economic growth in the Eurozone advanced at its fastest pace in nearly 2 years as the economy got a boost from the central bank's stimulus plan. This could be the only piece of good news to come from Europe for a while. The Greek issue is being poorly handled on both sides and the current resolution is just a way of "kicking the can down the road". Greece should never have been allowed into the Eurozone in the beginning. They have a long history of profligate spending, huge budget deficits, serial debt defaults and tax evasion is a way of life. The numbers they produced to show that they were adhering to the guidelines of the Maastricht Treaty were pure fabrication. But at this writing, they have settled on an agreement that guarantees that they'll be back to the tables again in the future. None of Greece's debts have been reduced or written off so the Greek populace will have to endure decades of harsh restrictions. I find it ironic that Germany has held so tightly to Greece's repayment of all their debts. Germany has a long history of not repaying their debts ever. What wasn't forgiven was never repaid.

More concerning to the global economy is the financial crisis in China, the world's number two economy. Chinese stocks lost 30% of their value in the last three weeks of the quarter. A dizzying three-week plunge in their stock market has wiped out $3.2 Trillion in market value. That's equal to more than 10 times Greece's gross domestic product in 2014. The Shanghai Composite has risen approximately 150% over the last 12 months and in the last three weeks of the quarter lost nearly 30%. Several desperate measures have been taken to stem this slide but like many other attempts to prop up a bubble, they probably will suffer the same fate. Already economists are changing their forecasts for growth in the Chinese economy from roughly 6%, down to around 3–4%. With an economy of this size, this will certainly have an impact on our markets.

BRIEFLY...

- Greece & China concerns
- Stock market muddles along

Our stock market has been mired in doubts about the strength of the recovery, distracted by the sideshow in Greece and preoccupied with parsing Janet Yellen's statements to determine when the Fed will begin raising interest rates. The Dow Jones began the year at 17833 and ended the second quarter at 17620, a decline of 1.19%. With dividends, the actual return was 1.2%. If there's a word for the market this year it's volatility. The market has oscillated in a 1000 point range from 18300 to 17300 over the last 6 months. The high points were hit in March and May. Although the economy seems to be doing much better, earnings forecasts have been falling for all S&P 500 Index sectors. At the beginning of the year, analysts expected second quarter S&P 500 earnings would increase 4.2% from the prior year. However, driven in part by weakness in the energy sector, the forecast is now for a 4.2% decrease as of June 23.

Forecasts are just that – forecasts and how one believes the year will turn out for the markets depends on if you're an optimist or a pessimist. The optimist will point to the Presidential Cycle where the third year has historically been a good year for the markets. The pessimist will point to the January Effect which says that how goes the month of January, so goes the year. The Dow Jones Average closed down for the month of January this year and the theory states what follows is the continuation of a bear market, a 10% correction or a flat year. According to the Stock Trader's Almanac, since 1950, this indicator has been accurate almost 90% of the time with just seven major errors in 64 years.

Market Indexes
Second Quarter, 2015

INDEX	Q2'15	YTD	3 YEARS	5 YEARS	10 YEARS
S&P 500	.28%	1.2%	17.3%	17.3%	7.9%
Russell 2000	.42%	4.8%	17.8%	17.1%	8.4%
EAFE	.62%	5.5%	11.9%	9.5%	5.1%
Aggregate Bond	-1.7%	-0.1%	1.8%	3.4%	4.4%
Treasury Bills	0.01%	0.01%	0.06%	0.08%	1.4%
REIT Index	-10%	-5.8%	8.7%	14.4%	6.8%

1. S&P 500 is an index of 500 large capitalization stocks
2. Russell 2000 is an index of 2000 small capitalization companies
3. EAFE (Eur. Australia Far East) is an index of developed international markets
4. Aggregate Bond is an index of investment grade corporate bonds
5. Treasury bills are short term (3 mo.) US debt obligations
6. REIT Index is an index of public commercial properties