401KVentures

OVERVIEW

Economic Analysis and Market Review

Q3—2014

BRIEFLY...

- US economy rolls on
- Quantitative easing: What's next?
- Resurging oil production

If it's not one thing, it's another. The third quarter provided a plethora of market rattling news from around the globe: military conflict in Ukraine with Russian supported separatists, riots in Hong Kong for universal suffrage, a vote for Scotland independence from the U.K. , Middle East conflict involving ISIS's establishment of an Islamic state and the spread of the deadly virus EBOLA. Did I miss anything?

In spite of all of these potential disturbances to our economy, we continued on our way to GDP growth in the quarter of 3.2%, around our trend level for the past 60 years. Now the question is when will the Federal Reserve begin to raise interest rates. The Fed's program of "Quantitative Easing"will end in October. That has helped keep bond yields low and the stock market rising. There is strong evidence to support the "tapering" of the program as the jobs data continues to show robust growth. Our economy has produced over 200,000 jobs per month this year on average and job openings data climbed to 4.6 million, the most since 2001. The number of people getting jobs rose to a six-year high. The strength in jobs data is only adding to Fed Chairwoman, Janet Yellen's concerns as a growing number of economists say the Fed risks overshooting its inflation target or creating a bubble in risky assets by holding to an easy monetary policy too long. The Fed has held its benchmark interest rate near zero since December, 2008.

The Fed's two charges are to promote full employment and maintain moderate inflation. On the inflation front, there's little concern at the moment. The most recent data showed domestic inflation around 1.6% well below their target of 2.5%.

After expending a great deal of political, economic and monetary capital in its attempts to avoid a depression, the Fed is certainly unwilling to do anything that might jeopardize that objective like raising interest rates before the economy is on solid footing. Janet Yellen said in her testimony to Congress that there is no "mechanical answer" for when to raise rates and, while her overall view of the economy is positive, she said there are still "mixed signals" and "we have in the past seen sort of false dawns". With limited tools to work with to combat another recession, I think the risks of raising interest rates too early outweigh those of tightening too late.

BRIEFLY...

- Eurozone in a funk
- QE for Europe
- Markets slump in Q3

Although the lack of any rise in inflation is worrisome to many economists believing that deflation is just around the corner. A major contributor to our growth with low inflation is the resurging oil industry. With the latest technology in oil production, fracking and horizontal drilling, the U.S. is on the cusp of becoming the biggest oil producer in the world surpassing Saudi Arabia (9.7 million barrels per day) and Russia (10.1 million bpd). Our imports of foreign oil have declined from 60% in 2005 to just 21% ten years later. OPEC, as a whole, is producing about 1 million barrels more per day than it says the world needs from it. On the demand side, with growth in Europe and China slowing and oil production continuing at current levels, the price of a barrel of oil has declined from over $100 earlier this year to $87. And this in spite of the turmoil in Iran, Iraq, Syria, Nigeria and Crimea, events that normally would cause oil prices to spike.

A sidebar to the cheap energy story is the resurgence of American manufacturing. The price of natural gas in the U.S. is roughly $4/mbtu and there is plenty of it. The price in Japan and Europe is three times that amount. With such a disparity in pricing, many companies are considering moving their production to the U.S. to reduce their manufacturing costs. Oil and natural gas are the main feedstock for many manufacturing companies and the U.S. has an abundance of both. That coupled with the fact that the U.S. has one of the greatest transportation infrastructures of any country and you have the ingredients for a budding manufacturing boomlet.

While the U.S. economy continues on an upward trajectory, the rest of the world is not so fortunate. Europe embarked on their version of “quantitative easing” late and is currently working on their recovery. Mario Draghi, the President of the European Central Bank (ECB), recently cut the bank’s refinancing rate to a record low of 0.05% from 0.15%. At the same time, he raised the bank deposit rate to -0.2% from -0.1% as a further incentive for banks to lend. Now banks are not only not earning interest on their deposits, they’re being charged for holding deposits at the central bank. And the charge just doubled! The ECB also plans to start buying up to 700 billion euros worth of asset backed securities and bonds in October. Economic signals from Europe are not good. Eurozone factories reduced prices by the most in more than a year and Germany, the engine of Europe, saw their manufacturing shrink, perhaps because of the heavy sanctions imposed on Russia for their illegal actions in Crimea and Ukraine. (The sanctions hit Europe the hardest as Germany, France and Italy all have significant assets and trade in Russia. The U.S.’s trade with Russia accounts for about 4% of our total.)

One would think with all the positive notes being played in our economy, our markets would sound like a symphony but that was not the case. With the exception of the S&P 500 Index and short-term bonds, the markets struggled during the quarter. Especially the small and mid-cap stocks. The Russell 2000, an index of small companies, declined 7.4% and the S&P mid-cap 400 Index slumped 4%.

Diversifying a portfolio into other asset classes like real estate and international securities offered little support as the Dow Jones Real Estate Index dropped 3% in the third quarter and the index for international developed stock markets, EAFE, declined almost 6%. Even the geopolitical excitement in Europe and the Middle East couldn't arouse the commodity that's supposed to be owned during financial and political crises – gold - continued on its declining trajectory. No port in a storm.

Looking ahead, I believe the markets will respond to our growing economy, low interest rates, declining unemployment and a history of innovation with the S&P 500 reaching 2500 next year.

Market Indexes
Third Quarter, 2014

INDEX	Q2'14	YTD	3 YEARS	10 YEARS
S&P 500	1.13%	8.3%	22.9%	8.1%
Russell 2000	-7.4%	-4.4%	21.3%	8.2%
Europe, Aust., Far East	-5.9%	-1.4%	13.7%	6.3%
Barclays Agg. Bond	0.2%	4.1%	2.4%	4.6%
Dow Jones Real Estate	-3.0%	14.7%	16.2%	8.2%
Treasury Bills	0.01%	0.03%	0.07%	1.6%

- 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
- Dow Jones Real Estate Index is an index of commercial real estate properties
- Treasury Bills are 3-month securities issued by the U.S.Treasury