Investment Commentary

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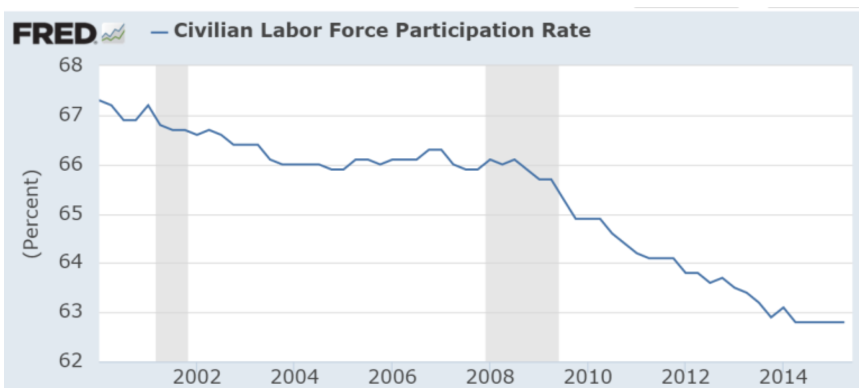
Solid Economic Growth Positions Business Growth to Continue

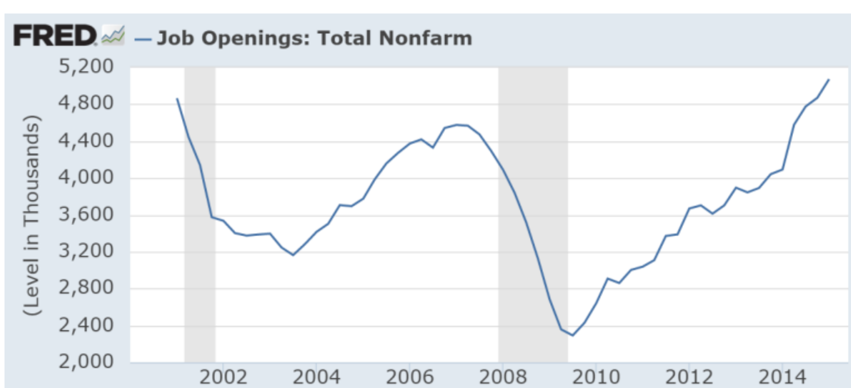
When the Federal Reserve finally begins to increase the target for overnight bank-to-bank loans (aka Fed Funds Rates), it will be a clear sign that monetary policy will begin to reflect an economy that has been growing steadily for six years. Federal Reserve Chairman, Janet Yellen, has been telegraphing that higher interest rate targeting will begin by the end of 2015.

The first increase from essentially 0% to anything is important for at least two reasons: 1) the Fed Funds Rate sets the tone for all interest rates, and 2) in this very low interest rate environment, lenders have little incentive to lend. As such, when rates increase from low levels to normal levels, there will likely be some positive effects to the economy since a pick-up in lending activity tends to stimulate growth.

Ms. Yellen's primary hesitation is that some slack remains in the economy. Specifically, she ponders if too many workers have been discouraged from looking for full-time employment as illustrated by the shrinking pool of potential workers participating in the workforce.

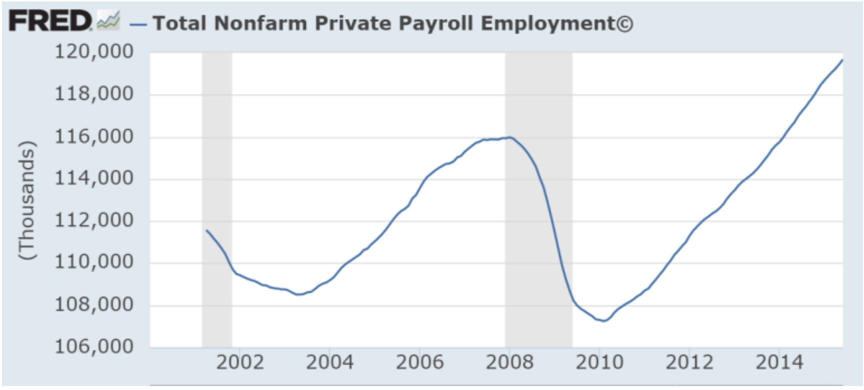


We part company with Ms. Yellen at this point. Despite having a lower workforce participation rate, there has been an accelerating flurry of job openings and hiring since 2009.

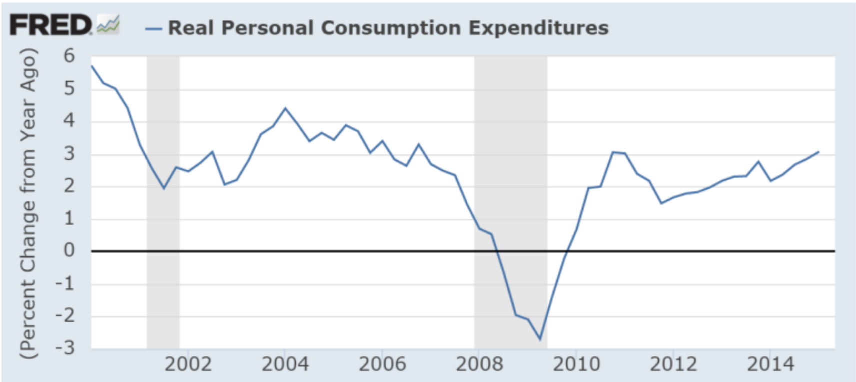


The result has been lower unemployment,

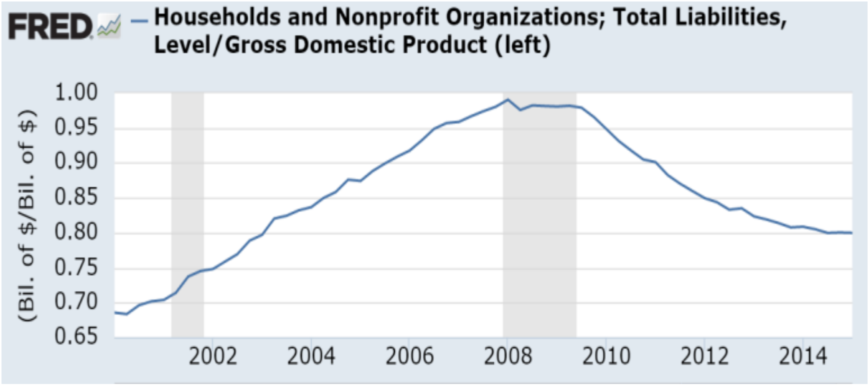
and more income to consumers as a group.



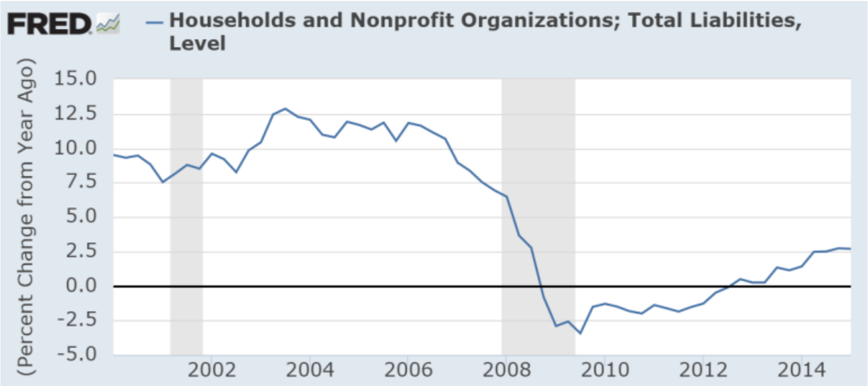
With more money, consumer spending growth continues, albeit at a level lower than what is desired. On the next chart, spending growth has been close to, but generally less than, a solid 3% after inflation.



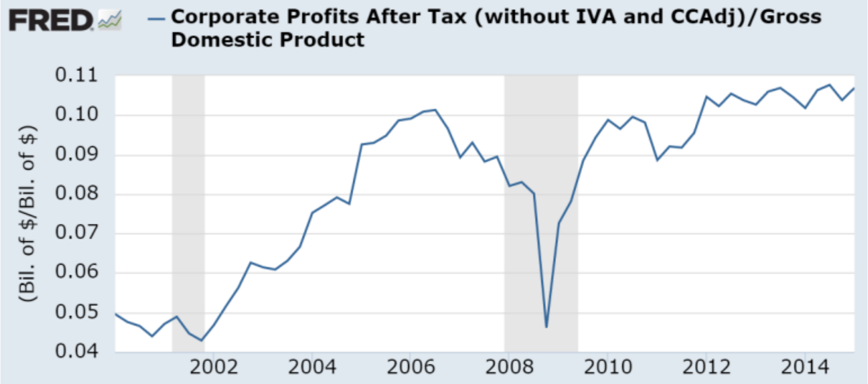
Consumers have instead chosen to reduce debt (not counted as consumer spending) which is a double-edged sword because consumer spending is the largest component of economic growth. However, lowering debt means households are becoming financially stronger.



It also means consumer lending activity has been mild but is steadily growing. In the chart below, we see that the yearly growth in household borrowing continues.



On the business side, despite a pickup in hiring, businesses have done an excellent job reducing expenses since the recession resulting in historically high profit margins as evidenced in the following chart.

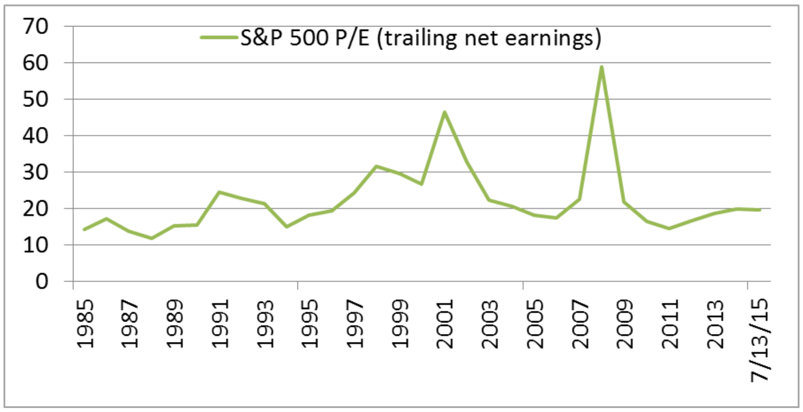


With businesses earning more money, the future of the second largest component of economic activity, private investment, looks bright in our view.

The net result is that at least 80% of the economy is more employed, has more money to spend, and is reducing debt to healthier levels. *Given these factors, we feel the economic growth will continue and perhaps accelerate - which ultimately bodes well for U.S. business.*

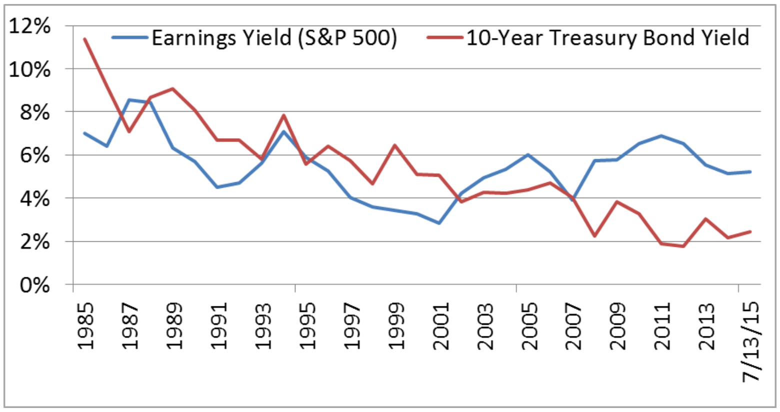
Stocks on Average are Fairly Valued

Of the several ways to study the stock market's valuation, a simple price-to-earnings ratio over history is informative. In the next chart, we look at the market's 500 largest U.S. companies (via the S&P 500) – specifically comparing the trailing 12-month's net income vs. price as a group – over the past 30 years. While levels of 20 times sounds high, we are taking a conservative approach of using trailing and net earnings. When using forward and/or operating earnings, the ratio tends to be lower.



Finding Sources of Income Still Favors Equity-Related Investments

The chart below compares the yield on treasury bonds versus the earnings yield (earnings-to-price ratio) for the stock market. The comparison suggests the asset class with the higher yield is relatively more attractive. Today, companies earn approximately $5.3 for every $100 invested which translates into a 5.3% earnings yield for stocks; much higher than treasury yields. In this light, stocks are appealing. For the average company, paying out a competitive dividend (versus the bond market) is quite achievable. In turn, investors have more equities with higher yields than many bonds.



Overall, the Stock Market is Positioned to Provide Competitive Returns

The net result for stocks is positive since: 1) business growth looks promising, 2) valuations are robust but fair, and 3) income from equity investments are readily available.

Risks in the Stock Market

Consistent with history, stocks remain risky in the short-term. As events around the world such as the Greek crisis or the China slowdown occupy headlines, the "risk off" trade will always be around the corner. A 10% decline in any given month is possible regardless of a favorable backdrop. In the longer run, equities are positioned to do well. For us, what would likely trigger a more cautious view of equities would relate to (among other things) overvaluation, relatively high interest rates, the threat of recession, or outsized risks to the financial system – none of which we see as a near-term risk.

Conservative Investing in a Low Yielding Environment

While fruitful in the long-run, investing in a number of asset classes can be an exercise in patience and frustration. Regardless of one's ability to appreciate this, there are those who cannot accept temporary declines in portfolio values. These conservative investors seek to preserve capital in the short-run (and long run).

In today's very low interest rate environment, the least volatile and liquid market remains in short-to-mid-term bonds (and related investments). For conservative investors, the challenge is that yields are historically low. Many conservative investors do not have a level of wealth necessary to live on a stream of income provided by a low-volatility portfolio yielding 2% to 3%. As such, today's biggest challenge for these investors is solving the difficult trade-off between income and risk.

In our view, an appreciation of risk is the primary guideline for asset allocation decisions since the biggest mistakes often happen when portfolio values decline. Having a thorough plan in place that fully addresses these challenges can help provide the solutions necessary to succeed in today's landscape. We encourage all investors, and particularly conservative investors, to review their asset allocation, cash flow needs, and risk-levels with us.

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