PENCE WEALTH
MANAGEMENT
Planning for Your Dreams

www.PenceWealthManagement.com
PHONE 800.731.3623

NEWPORT BEACH OFFICE (OSJ)
5000 Birch Street, Suite 8000
Newport Beach, CA 92660
PHONE 949.660.8777
FAX 949.660.8778

TORRANCE OFFICE
990 W. 190th Street, Suite 500
Torrance, CA 90502
PHONE 310.329.3545
FAX 310.329.3504

MICHIGAN OFFICE
39209 W. Six Mile, Suite 201
Livonia, MI 48152
PHONE 734.432.1966
FAX 734.432.1977

THOUSAND OAKS OFFICE
468 Pennsfield Place, Suite 201
Thousand Oaks, CA 91360
PHONE 805.496.2348
FAX 805.207.2351

Pence Perspectives June 2016

Bottom Line Up Front:

Given recent market volatility and the present level of uncertainty among investors, we believe it is prudent to maintain a somewhat larger position than normal in cash or short-duration bonds. Cash continues to be attractive for three reasons. First, with yields on the usual fixed-income options near historic lows, the opportunity cost of holding cash is lower today than before the Great Recession. Second, markets are exhibiting unusual patterns of volatility driven primarily by sentiment: market moves are highly susceptible to each news headline. Given high valuations and profit headwinds in certain sectors, we believe the market is likely to go down 5% before it goes up 10%. Thus, it seems sensible to us to have extra dry powder to dampen volatility and to try to buy on dips. Third, even in a challenging environment, companies can still potentially gain market share, grow their earnings, and increase dividends over time. Identifying and buying them at potential bargain prices is an important tactical advantage.

The Way We See It:

The US economy is still expanding at a slow-but-steady pace of around 2%, and the labor market continues to strengthen. The recent recovery in commodities has pushed inflation closer to the Fed's target rate of 2%. Continuing growth and reduced concerns over too-low inflation may give the Fed room to raise rates for the second time fairly soon, if not before the election, then soon after.

That said, we remain concerned the Federal Reserve's second and further moves may trigger another run-up in the dollar like the one we saw in the second half of 2014. That episode caused pain for emerging markets in particular, but it also meant stronger headwinds for earnings at US companies with large non-US operations.

What's going on with oil? Prices nearly doubled from the low of $26 to $50 in three months. US crude production has stopped growing and is expected to decline by 1.6 million barrels per day, roughly 10%, by the third quarter of 2017 from its peak in April 2015 according to the US Energy Information Administration1. Short-term supply disruptions in Nigeria, Canada, Libya, and Venezuela pushed global oil production below consumption this month for the first time in at least two years. Despite these developments, we believe oil prices will stay below the $60 level for at least several years for three reasons. First, excess global supply will continue beyond 2017. Second, the new economics of US shale production will limit future prices. US shale producers don't need $80-to-$100 oil to operate profitably any longer. New drilling and fracking techniques unleashed drastic improvements in efficiencies: today, the cost structure for new shale production is significantly lower as the required capital expenditure per barrel of production has fallen. Third, major OPEC members and Russia will continue competing on price to maintain their share of global markets.

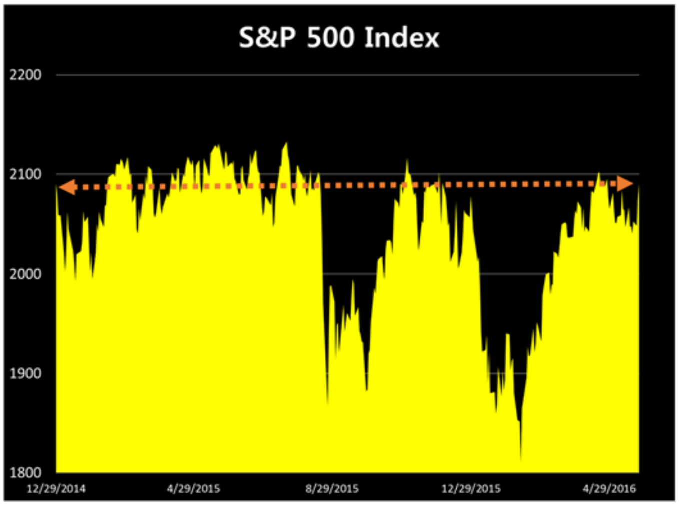
Investing In The Current Environment:

We are cautious yet tactical in this environment when identifying opportunities and exercising our buy-sell discipline. Since the end of 2014, the market has been nearly flat [See Chart]. But it doesn't feel that way. It's because we've witnessed a pattern of volatility with two major check-downs each over 10%. And over the same period, moves in the major stock indices between each day's high and low exceeded 1% over 30% of the time. We expect these unusual, sentiment-driven market conditions will stay with us for a while because of what's ahead:

- Brexit, Britain's June 23 referendum to decide whether to stay in the European Union or not
- The US presidential election in November
- The uncertain path of Fed rate hikes and its potential consequences on the dollar, earnings, and the global economy

In times when the market is driven mostly by sentiment with changes in P/E multiples rather than by changes in earnings, it tends to overreact to uncertainty as well as unexpected events. We believe having more-than-usual cash in this type of market is not a luxury but the necessity. We believe it is prudent and conservative to hold extra cash not only to dampen volatility but also to be able to act when opportunity strikes by purchasing great companies at bargain prices. At this moment, we prefer to err on the side of caution.

[1] https://www.eia.gov/forecasts/steo/report/global_oil.cfm



Source Bloomberg

In identifying sectors and companies with potential earnings growth, we continue to favor technology, especially newer industries such as e-commerce, web search, and cloud computing. These industries are growing quickly; they are dominated by only a few companies that are consolidating their competitive positions and will be hard to displace. We also believe consumer-discretionary companies will benefit from the strengthening US economy and continuing global growth. Healthcare companies will also likely to benefit from the aging of the US population.

As we get closer to the US election we'll hear more about the fiscal policies of the candidates. One thing is certain: today, we spend significantly less on infrastructure as a percentage of the economy than we did sixty years ago when infrastructure was once at the heart of American public policy. (The American Society of Civil Engineers suggests more than $3.6 trillion is needed by 2020 to upgrade our infrastructure to acceptable levels!) We also expect US defense budgets to increase in 2017 now that the automatic sequestration limits on expenditures have ended. Major industrials and defense contractors may benefit from these themes going forward.

Balanced with the need for higher cash to reduce risk, we will be making purchases over the next eighteen months on a security-by-security basis where we see value, favorable dividend situations where we get paid to wait, or growth potential.

We appreciate your trust and the opportunity to be of service.

All the best, ❖

E. Dryden Pence III, CPM®, AIF®
Chief Investment Officer, Pence Wealth Management
LPL Financial Registered Principal

Ali Arik, Ph.D.
Senior Analyst, Pence Wealth Management
LPL Financial Registered Administrative Associate

David J. Karachuk, CFA
LPL Financial Advisor

For our clients with Strategic Asset Management (SAM) accounts where we manage with full discretion, depending on your individual situation, objectives and type of accounts, we expect to hold slightly higher cash positions. We will deploy excess cash positions opportunistically as we evaluate both volatility and value. In short, we will remain tactical in a market we expect to be volatile.

For our clients who hold brokerage accounts, if you are interested in a similar fee-based strategy, please contact your advisor.

If you are not yet a client and are interested in learning more about our services, please contact Susan Herman, our receptionist, at 949.660.8777, extension 100, or susan.a.herman@lpl.com to schedule an appointment.