



Pence Perspectives April 2015

BOTTOM LINE UP FRONT

Aside from minor hiccups, we remain bullish on the US economy yet cautious about potential market volatility.

Consistent with our expectation in our January newsletter, the Federal Reserve has primed markets for a rate increase in the second half of this year.

Because of the Fed's move, we expect to see volatility in currency and commodity markets that will also affect equities and fixed income throughout the year. As a result, we favor a larger cash position, 5% to 15%, than a normal 2% to 5% in order to dampen portfolio volatility and to buy on dips.

We remain US-centric but we also see signs of improvements in Europe as monetary stimulus helps euro-zone countries gain traction.

US Economy

In 2013, US gross domestic product (GDP) grew **2.2%**. In 2014, the growth rate was **2.4%**. In 2015, we expect **2.5%** GDP growth, below the consensus estimate of 3%. For the past few years, unexpected factors dragged growth below America's true potential of 3%.

In 2013, it was the fiscal deficit and government spending cut. In 2014, the extraordinarily cold and snowy winter took a toll on the first quarter's growth.

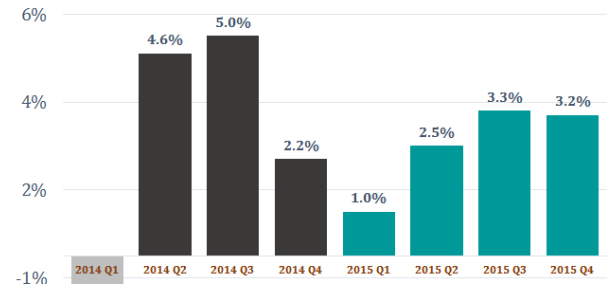
In 2015, another cold winter in the East, the now-settled labor dispute at busy West Coast ports, a stronger dollar and lower crude oil prices will likely shave *0.5 percentage point* from 2015 growth.

Our first quarter GDP forecast is in the range *between 0.5% and 1.5%* (or roughly **1%**). This is below the consensus estimate of 2%, reflecting weather- and port-related issues as well as fluctuations in currency and commodity markets (**Chart 1**).

Looking at the components of US GDP, we are taking notice of **personal consumption expenditures (PCE)**.

PCE accounts for 70% of US GDP and is running at 1.6% growth in comparison with 4.4% in the last quarter of 2014 and 3.2% in the third quarter of 2014.

2015 US Real GDP Growth Forecast



Source: BEA, Bloomberg

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In the first quarter of 2014, it was running at 1.2% when GDP contracted 2.1%.

Net exports (exports less imports) will be a drag on the economy. Net exports have been negative since the 1990s, meaning US consumers spend more on foreign goods and services than they sell abroad. Because of the surging dollar, the gap is going to be larger this year than in 2014. According to the *International Monetary Fund (IMF)*, *New York Fed*, and *Macro Advisors*, a 10% rise in the dollar reduces exports by roughly 5% while increasing imports by 5%, both annualized rates.

While exports account for only 13% of the US economy, a strong dollar may reduce growth anywhere from -1% to -1.5% from its potential rate. We think, however, some of the dollar's effect on net exports will be offset by America's declining foreign petroleum demand. For instance, in February, imports of petroleum products were the lowest since September 2004.

Overall, we remain confident about the underlying strength of the US economy and we strongly believe that America can sustain potential growth in GDP between 2.5% and 3.0% for the next decade.

US Markets

We believe 2015 will be a single-digit year for the US equity market (the S&P 500 Index).

The impacts of the strong dollar on US earnings and constrained corporate spending lead us to believe that US

corporate-profit growth will be slower throughout 2015 than the last two years.

Companies in the S&P 500 are expected to post 1.1% lower revenue during the first quarter, according to *Reuters*. First-quarter profit by S&P 500 energy companies are expected to plummet 64% (**Chart 2**). Segments expected to post positive growth during the quarter are financial, healthcare, industrial, consumer-discretionary, and technology.

S&P 500: Q1 2015 Earnings Growth Chart 2

Sector	Profit Growth
Consumer Discretionary	7.0%
Consumer Staples	-0.6%
Energy	-63.6%
Financials	10.9%
Health Care	7.2%
Industrials	7.5%
Materials	-2.7%
Technology	4.4%
Telecom	-0.9%
Utilities	-6.6%
S&P 500	-2.8%

Source: Thomson Reuters I/B/E/S Pence WM

The S&P 500 index is a measure of performance of the broad domestic economy through 500 stocks from major industries. Past performance is no guarantee of future results. All indices are unmanaged and may not be invested directly.

Overall, earnings are expected to shrink from last year over the next three quarters, according to *Bloomberg*. History shows that once earnings drop for that long, they usually take the stock market down with them.

This is why we favor a higher cash position that will allow us to take advantage of upcoming market volatility.

THE WAY WE SEE IT

The Fed's Tightening and Interest Rates

In March, the Federal Reserve opened the door for raising the federal funds rate in 2015. Fed Chairwoman Janet Yellen is cautiously optimistic the economy is getting to a point where it can still thrive without near-zero interest rates.

She said the Fed would likely end up taking a “gradualist approach” to interest rate increases in the years ahead, suggesting it would move in small steps and with much caution to avoid undermining economic expansion.

The Fed also signaled that it will probably wait at least two meetings before raising rates. The next Fed meetings are scheduled for April and June.

Hence, it is widely expected that a first rate increase of 25 basis points will be after June and more likely before October.

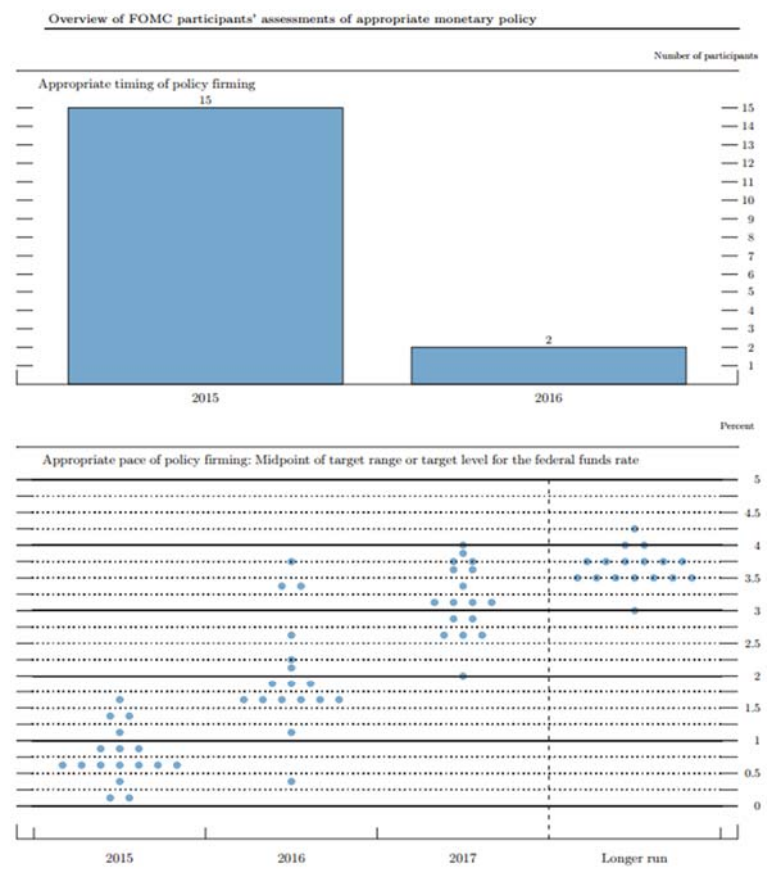
We expect the first rate hike in **September**. Depending on when and how much volatility the first move creates, the Fed could delay the second hike until the first quarter of 2016.

We mentioned in our January newsletter that Fed officials are worried about hiking rates too soon. If markets react badly, they risk losing control of the situation, possibly even being forced to reverse course.

Chart 3 depicts a dot-plot of the year-end projections of the federal funds rate by the voting members of the Federal Open Market Committee (FOMC) from the March meeting.

Chart 3

Federal Funds Rate for the end-year projections of each voting member of Federal Open Market Committee (FOMC)



NOTE: In the upper panel, the height of each bar denotes the number of FOMC participants who judge that, under appropriate monetary policy, the first increase in the target range for the federal funds rate from its current range of 0 to 1/4 percent will occur in the specified calendar year. In December 2014, the numbers of FOMC participants who judged that the first increase in the target federal funds rate would occur in 2015, and 2016 were, respectively, 15, and 2. In the lower panel, each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run.

Source: FOMC March 17-18, 2015

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For example, the median dot for fed funds at the end of 2015 rate is between **0.50%** and **0.75%**, down from 1% to 1.25% at the previous meeting. Between December 2014 to March 2015, Fed officials essentially removed two rate tightenings (50 basis points) from 2015.

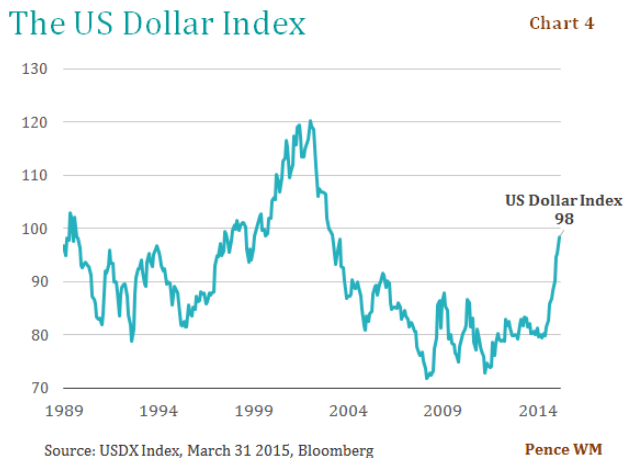
Again, this is the median expectation of each voting member of the FOMC, subject to change from one Fed

meeting to the other. The 2016 year-end target also fell to a range of 1.75% to 2.0% from 2.5%.

Although market volatility will be unavoidable while the Fed is hiking rates, we think the economic expansion will continue and positive market fundamentals should remain intact during this period.

US Dollar and Corporate Earnings

In the past 12 months, the US dollar has gained nearly 20% against a basket of major currencies primarily because of monetary policy divergence between the Fed and other major central banks (**Chart 4**).

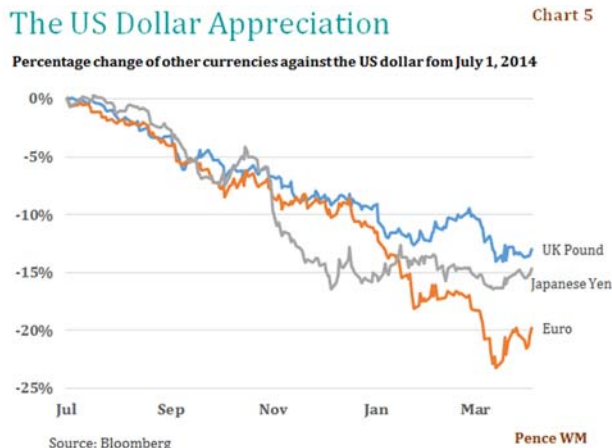


The US Dollar Index is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies.

The rising dollar will hurt US multinational corporations generating a large percentage of their revenue outside of the US during 2015. Their revenue and earnings from foreign markets will now be worth less when translated into dollars.

While the Fed is expected to begin its tightening cycle later this year, Europe has announced an extensive quantitative easing (QE) program of 60 billion euros per month expected to last until at least September 2016.

Chart 5 summarizes how the US dollar has appreciated against the British pound, the Japanese yen, and the euro in the past 12 months. The **depreciating euro** was the weakest major currency in the past 12 months as it lost 20% of its value against the dollar.



As of January 2015, the 30 companies in the Dow Jones Industrial Average derived about 45% of their sales from outside the US, according to *Bloomberg*. That compared with about 30% for those in the S&P 500 Index and 16% for those in the Russell 2000 Index.

We believe the dollar's strengthening likely isn't over. In 2015, the US will grow at a faster rate than the euro-area and Japan. We anticipate this growth differential will sustain the dollar's climb, albeit more gradually than the last six months.

During this period of dislocation, we expect small- and mid-cap US companies that have less global exposure to weather the strong-dollar storm better than US multinational companies. We also think European companies with more US exposure should do well.

US Dollar and Emerging Markets

Financing conditions in the emerging markets are at the mercy of the Federal Reserve. There will be plenty of upward pressure on the dollar in the months ahead and some economists believe that these markets are now more vulnerable than during the 2013 Taper Tantrum.

Contrary to popular belief, the world is currently more dollarized than ever before. Foreign corporations excluding banks have borrowed **\$9 trillion** in US currency outside American jurisdiction, up from \$2 trillion in 2000, according to *the Bank for International Settlements*.

Companies around the world and especially in emerging markets have been piling on dollar-denominated debt, seduced by the lower interest rates on offer compared with local-currency debt. Asian and Latin American companies have nearly doubled their borrowings since 2009. In China alone, dollar-denominated loans have vaulted from around \$200 billion in 2008 to more than \$1 trillion now, according to *The Economist*.

As the dollar rises, this debt becomes more expensive to service in local currency. Companies in emerging markets that are primarily exporters or have less dollar-denominated debt should be able to manage through this turbulence. Their revenue is in dollars, so it should keep pace with the dollar's appreciation. For companies with high dollar-denominated debt or focused domestically like real-estate developers or electric utilities, a more expensive dollar will make it more costly to service debts.

Oil

We continue to believe that it'll be a very long time before we see \$100-per-barrel oil again.

For much of the past decade, oil prices have been high — bouncing around \$100 per barrel since 2010 — because of soaring oil consumption in China and elsewhere and conflicts in key oil nations like Iraq, Libya, and Iran.

Over the last decade, oil production in the Middle East couldn't keep up with demand, causing prices to spike until advancements in technology led to the fracking boom and ignited the American Energy Revolution.

The United States is an important player in the oil world. The United States is third in production behind Russia and Saudi Arabia and perhaps will soon replace the Saudis as the only swing producer¹ in the world.

For example, more than a year ago, US oil production contributed an additional 1.2 million barrels per day to world supply, making the US the biggest contributor to growth and surpassing the next four contributors including Iraq, Canada, Brazil, and Iran **combined**.

The US shale revolution is a main reason for today's declining oil prices. Until recently, it was widely accepted that US oil production would keep rising in 1 million barrel-plus annual leaps for years to come. Also important is slowing global economic growth, primarily China.

Even with prices less than half what they were last summer and storage capacity growing scarcer, US oil output has continued to rise to **9.4 million barrels** per day as of March 27, 2015, according to the *US Energy Information Administration (EIA)*.

We see signs that US oil drillers have pulled back because of the sharp decline in oil prices.

The EIA expects crude oil production in the Permian Basin to rise through April 2015. But production in other shale regions, like the Bakken in North Dakota or Eagle Ford in east Texas, is expected to decline slightly.

As of April 10, 2015, according to data from *Baker Hughes*, there were 760 active oil drilling rigs in the United States. That's down from 1,517 rigs a year ago.

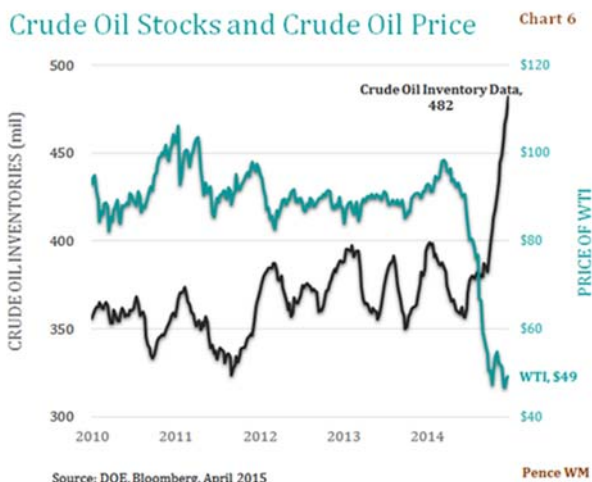
The EIA notes that the decrease in rigs hasn't translated into a decrease in oil production yet. When oil companies start idling their drilling rigs, they generally start with the older and least-efficient rigs first. That's then offset by output from the remaining rigs, which are in the most productive, oil-rich regions.

Declining oil prices also increase the need for storage to sell it later at a higher price. The US has about 550 million barrels worth of storage space, according to *Bloomberg*. As of April 3rd, nationwide oil stocks were at 482 million barrels, by far the most ever (**Chart 6**).

At the current pace—about 1 million barrels a day—the country would run out of storage space in three months.

Funding pressures are forcing countries to pump more oil despite the excess supply. Iran and Iraq need funds to rebuild their economies while Venezuela and others can't balance budgets. Because of these factors, we believe that

¹ A **swing producer** is a country or territory that has large production in relation to the total market, substantial excess capacity and the



any rebound in crude prices may be months if not years away.

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

All the best, ❖

E. Dryden Pence III, CPM®, AIF®

LPL Registered Principal – Pence Wealth Management

Ali Arik, Ph.D.

Analyst – Pence Wealth Management

LPL Registered Administrative Associate

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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 ext.: 100 or susan.a.herman@lpl.com to schedule an appointment.

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ability to turn its capacity on and off quickly in response to market conditions.