PENCE WEALTH MANAGEMENT
Planning for Your Dreams

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PENCE PERSPECTIVES

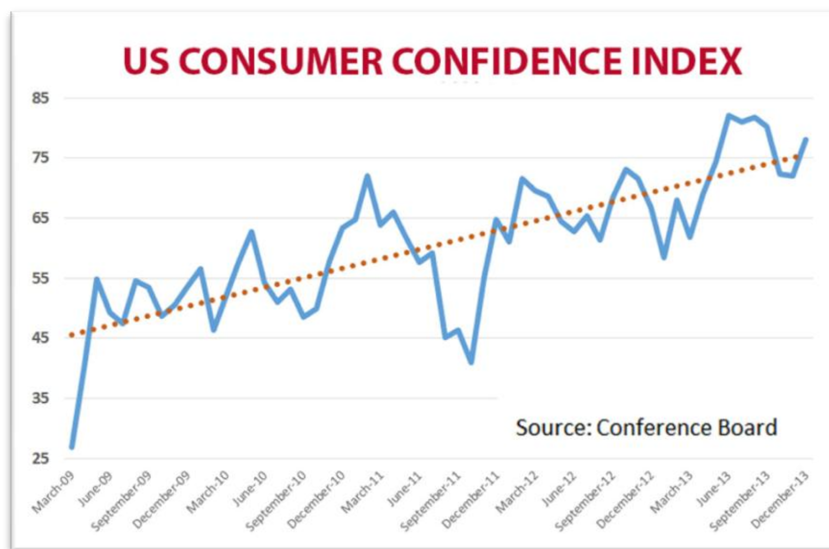
February 2014

Bottom Line Up Front:

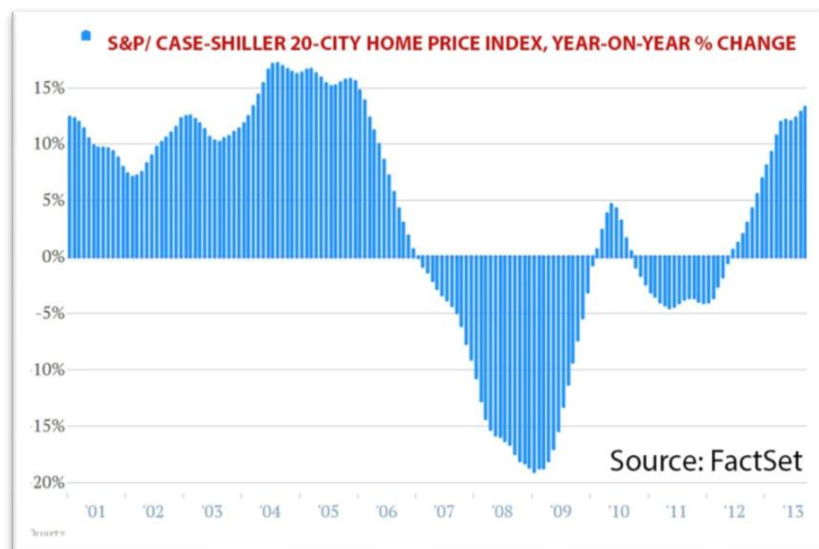
We are positive for 2014. We think the economy will continue to improve consistently. We believe the market is a forward predictor of the economy and last year's market gains were uncharacteristically larger than expected. So in the first quarter, we will have to digest some of last quarter's gains. Thus, we expect some choppiness. Overall, we expect the market to continue with an upward trend in a volatile environment with gains that are slightly greater than dips, translating to high-single or low-double-digit gains for the year.

In our September 2012 Newsletter, we spelled out the external events holding back the underlying strength of US economic growth, what we called "**compression**". Efforts to shrink government deficits and debts have been painful for some sectors and may have resulted in slower US economic growth throughout the recovery (so-called **fiscal drag**). In addition, Washington's inability to pass a budget deal that would end the cycle of fiscal cliffs, government shutdowns, and unpopular spending has contributed to the slower recovery process.

This month, the US Congress reached a massive $1.1 trillion spending bill[1] that would keep the government running through September 30, 2014. We see consumers regaining confidence **(Chart 1)**. Recovery of the housing market is spreading to the rest of the economy. Housing prices, up 14% in the first ten months of 2013 **(Chart 2),** have increased household wealth and strengthened consumer confidence, which in turn, is helping to stimulate the economy **(Chart 3)**



(Chart One)

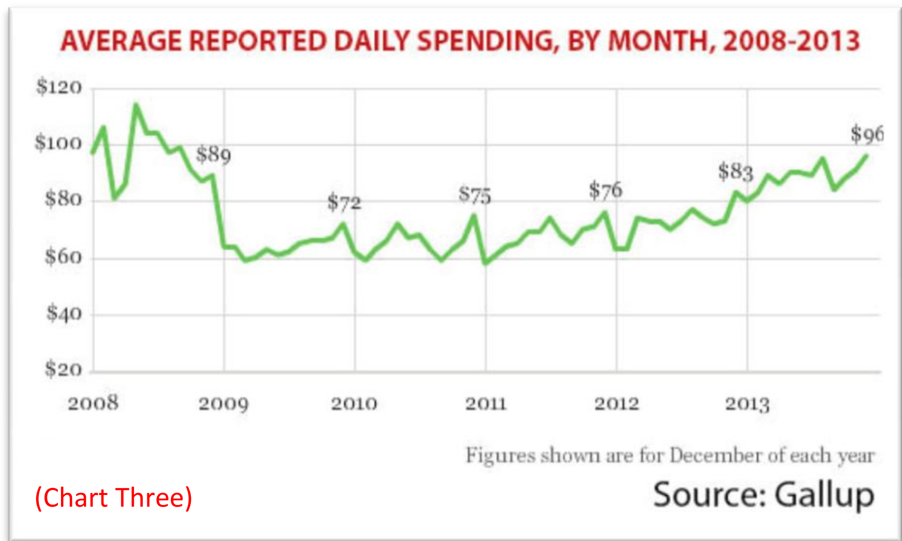


(Chart Two)

1 http://appropriations.house.gov/news/documentsingle.aspx?DocumentID=366721

Securities and fee-based advisory services offered through LPL Financial, Member FINRA/SIPC

In order to keep up with increasing consumer spending and higher demand, corporations need to increase their capital investment and inventories, both of which also directly go to the calculation of GDP growth. Altogether, we expect businesses will start picking up and banks will become more confident about lending money to businesses across the country. This is a growth story, not just a recovery



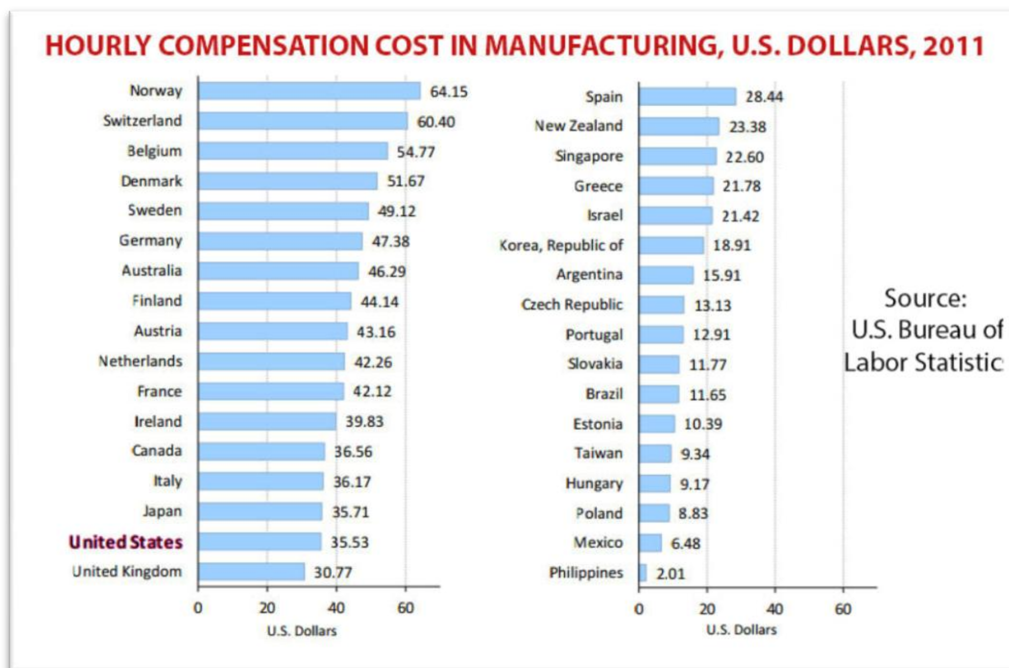
(Chart Three)

The Way We See It:

The S&P 500 Index rose 30% in 2013, its largest annual jump in 16 years. The Dow rallied 27%, its best performance since 1995[2]. The Fed's easy monetary policy has ignited market optimism and business confidence and driven economic growth. Three rounds of Fed stimulus (**QE**s) have sent the S&P 500 up 173% from a 12-year low in March 2009. Last month, the Fed announced that it would start to taper its bond-buying program by $10 billion to $75 billion a month beginning in January 2014[3]. The Fed Chairman Bernanke said that the recovery remains "far from complete," but if job market gains continue as expected, the bond purchases would likely continue to be cut at a "measured" pace throughout next year. Investor reaction was positive. US stock markets were up after the announcement as they saw tapering as a positive sign for the economy. We understand that the Fed will keep the rates low until the recovery fully manifests itself, at least until the late part of 2015, and we plan to be in front of that trend.

We believe the US economy is slowly lifting off as we enter 2014. We continue to believe that underlying fundamentals of the economy are strengthening like a slowly accelerating freight train that is getting harder and harder to derail. We see lower fiscal drag, higher capital expenditure, and improving housing investment. **We are more bullish than consensus estimates**. We expect the US economy to grow around a little over 3% in 2014 and 3.5% to 4% in 2015. The United States is experiencing a manufacturing renaissance as wages remain lower than other developed countries and the energy revolution continues **(Chart 4)**. We think US output productivity will continue to improve in the next decade as it did in the last one **(Chart 5)**.

The Big Knowable Themes:



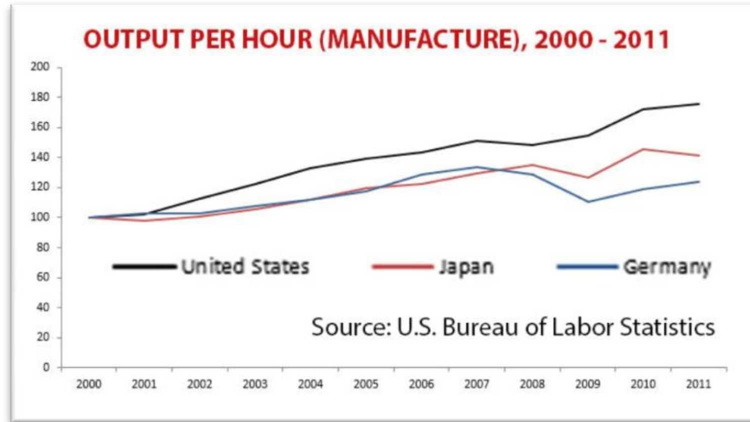
(Chart Four)

For the next several months, we expect market volatility will be closely tied to **economic** headlines rather than **political** headlines. After that, we might see political headlines weighing in again as we approach the November election. We are confident in US manufacturing because it utilizes higher labor productivity and cheaper energy than the rest of the developed world. The sectors that we favor are US industrials (particularly railroads and aerospace), technology, and growing e-commerce retail along with consumer discretionary.

During recovery, we have seen that US household balance sheets have become stronger as households managed to lower their debt obligations. This has a positive effect on consumer spending. We also believe that we have not seen the full benefit of

[2] Source: Bloomberg
[3] Source: Board of Governors of the Federal Reserve System

housing "**wealth effect**" in US GDP growth[4]. Housing affects many parts of the economy (so-called **multiplier effect** in economics). This is why everyone was hit hard by the housing collapse in 2007 and 2008. In fact, because housing is such a large expense, its ripple effect throughout the economy is larger per dollar spent than for most other spending categories[5]. As home values continue to recover and balance sheets continue to strengthen, homeowners tend to feel more secure about their wealth and are inclined to spend more, leading to higher GDP growth. We believe **housing formation**, which has been well below trend, will also push the housing recovery further. Both housing starts and housing permits are already up 18% in 2013[6]. Overall, we are optimistic about ongoing recovery in housing.



(Chart Five)

Actions:

For our clients with *Strategic Asset Management* (SAM) accounts where we manage with full discretion, depending on your individual situation and account, we will continue to tactically reduce bond positions and increase equity positions. We will continue to buy shares of companies that we believe are undervalued as the opportunity arises. We will continue to focus on portfolios that generate positive cash flow so that it may be reinvested to take advantage of any potential growth.

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 (949) 660-8777 ext. 100 or** susan.a.herman@lpl.com **to schedule an appointment.**

I strongly encourage you to attend our annual client luncheon next year on **May 3, 2014**. It is at this annual event where I lay out our key thoughts for the entire year and those clients and potential clients who attend always find it rewarding and informative. If you would like to receive an invitation please email anne.godfrey@lpl.com.

As Pence Wealth Management embraces the digital age, we encourage you to like us on Facebook, follow us on Twitter and check our daily blog on our website www.PenceWealthManagement.com/blog.

For our clients, friends and prospective clients we wish to remind you that, once again, we have been recognized by Barron's Magazine as one of the top Financial Advisors in the Nation (Barron's criteria: based on assets under management, revenues generated by the advisor and quality of their practices).

We are accepting new clients, and the greatest compliment or gratitude that you can show us is the referral of a friend or family member. If you would like a hard copy version of this newsletter to pass on, please contact Anne Godfrey anne.godfrey@lpl.com or (949) 660-8777 ext 116.

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

To receive email communication from Pence Wealth Management:
Please make sure to add no-reply@salesforce.com and anne.godfrey@lpl.com in your email address book.

[4] "US Economics Digest", February 2013, Neal Soss and Henry Mo found, Credit Suisse
[5] Case, Quigley, Shiller 2011 "Wealth Effects Revisited 1975-2012", Cowles Foundation Discussion Paper No. 1884
[6] US Census Bureau and US Department of Housing and Urban Development, January 17 2014