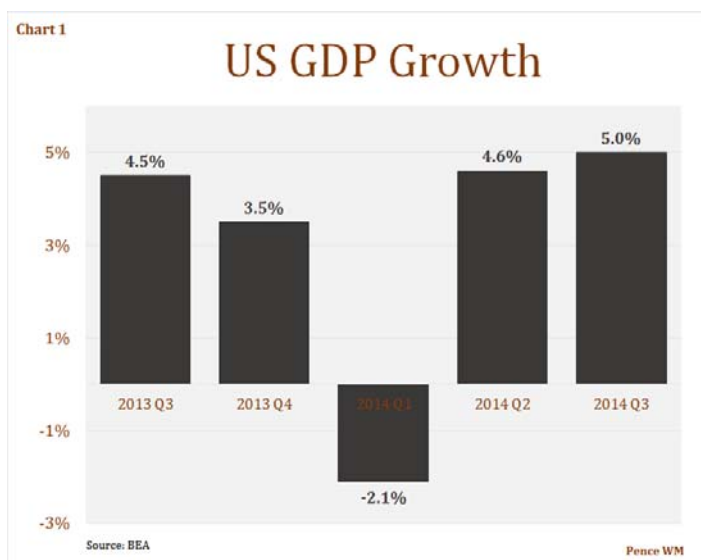




Pence Perspectives January 2015

BOTTOM LINE UP FRONT

At some point in the future interest rates may rise due to an improving US economy. An interest rate hike will be negative for bonds and create some volatility for stocks. We believe that a cash position slightly larger than a normal, 2% to 5%, is warranted during this period of transition for two reasons. First, we can use cash in lieu of bonds as a volatility dampener. Second, we hold cash opportunistically to take advantage of equity volatility and buy on dips. In accounts where bonds must be held, we prefer municipals because the improving economy will translate into improving credit quality for municipalities which at worst is neutral and at best a positive in this market. Outside of the United States, the world will continue to struggle for most of the year. We will continue to be US-centric for at least the first half of the year.



US GDP

Despite increasing global uncertainty, the US economy continues to expand at a steady pace and will shine as a bright spot compared with the rest of the world. We remain bullish on the United States of America!

Confirming our view in our earlier newsletters, US gross domestic product (GDP) grew at a 5.0% annual rate in the third quarter of 2014 as consumer spending and business investment fueled the biggest expansion in more than a decade.

On average, the US economy has now grown at 4.4% for four of the past five quarters, if we don't count the first quarter of 2014, which was negatively affected by the harsh winter (**chart 1**). By the time we get to the final revision, we expect 2014 GDP growth to be between 2.2% and 2.4%.

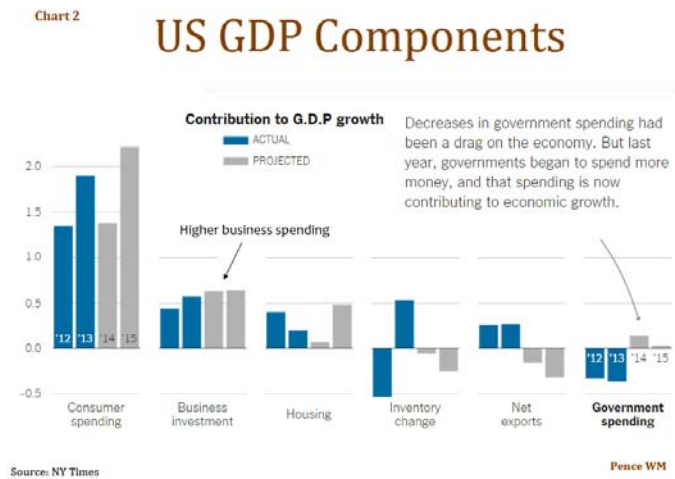
The US represents less than 5% of world's population while accounting for roughly 25% of world's \$75 trillion GDP. We remain confident that the US, the world's largest economy, will deliver **around a 3% GDP growth rate** for the next several years.

On the whole, consumers have strengthened their balance sheets since the Great Recession. So with balance sheets now in better shape, people are going to spend the extra cash they receive due to improving labor market conditions and cheaper gasoline prices.

US consumer spending and business investment are the main reasons behind a sustainable 3% GDP growth. Together, they account for more than 80% of the US GDP. In fact, at \$12 trillion dollars, just the personal consumption expenditure component of the US economy is bigger than the total of the world's second largest economy, China. Business spending is picking up as aging equipment is being replaced. Nonresidential corporate fixed investment has represented almost 25%

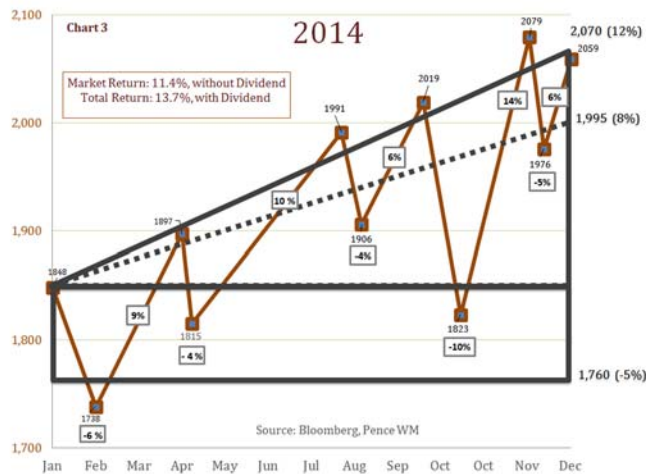
of the US GDP growth in the last two quarters. That's compared with 16.8% in 2013.

Additionally, government spending is no longer a drag to the economy but providing a small but significant increase to US GDP (**chart 2**).



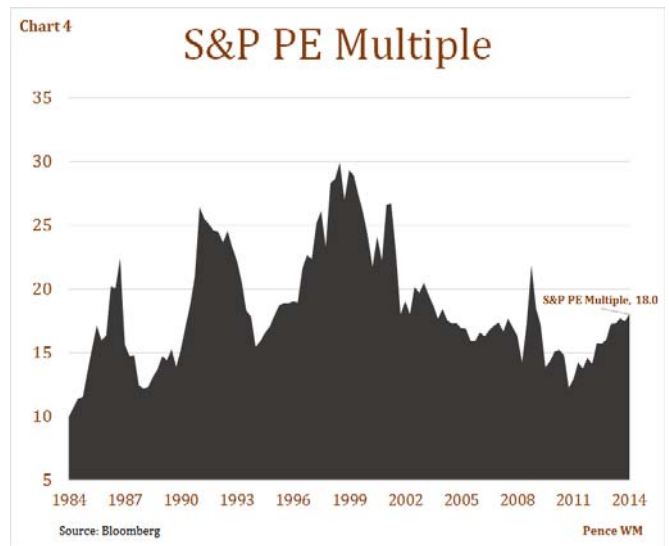
Markets

2014 was a good year for the US equity market. The S&P 500 Total Return Index finished the year with a 13.7% gain, which is consistent with our range fan of high single- and low double-digit gains in the beginning of 2014 (**chart 3**).



For 2015, we expect the US equity market to finish the year with similar gains while observing higher volatility.

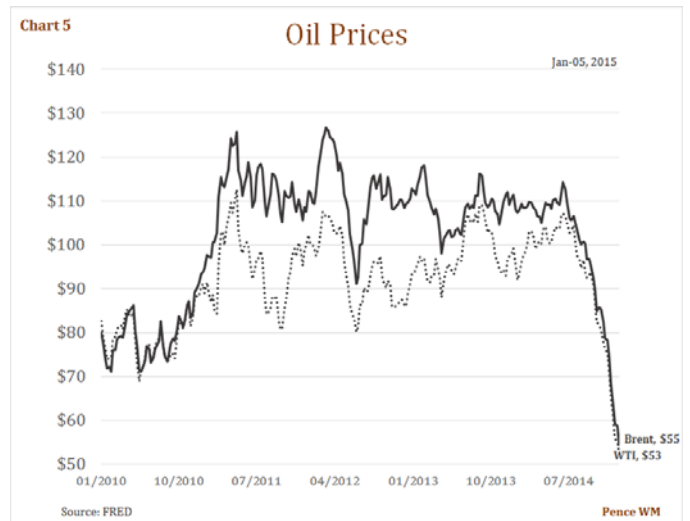
Currently, the market is trading at 18 times trailing earnings (known as price-to-earnings (PE) multiple) (**chart 4**). We think this level is sustainable if not going higher due to higher global demand for US equities.



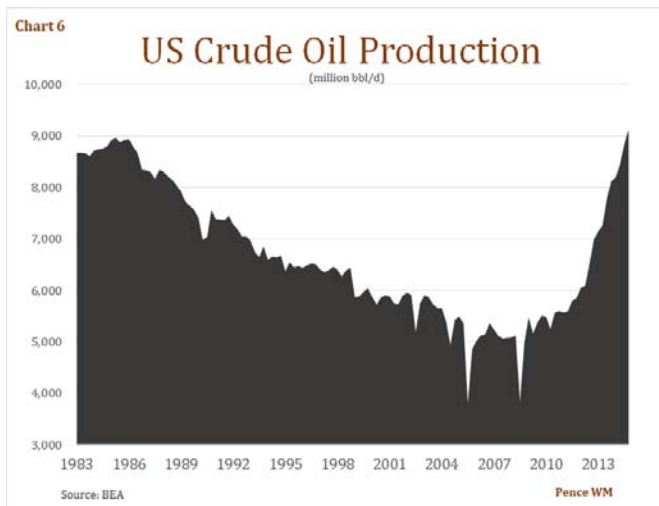
THE WAY WE SEE IT

Oil

In our October newsletter, we discussed falling crude prices, which have plummeted 60% from their June 2014 peak (**chart 5**).



Most of the drop in oil is being driven by upside supply development (led by the US shale boom and non-OPEC production) and a switch in strategy by OPEC's decision not to cut output. For example, US oil production has surged from around 5 million barrels per day (bpd) to reach a near 30-year record of more than 9 million bpd over the past six years (**chart 6**). The rest is driven by slowing global oil demand.



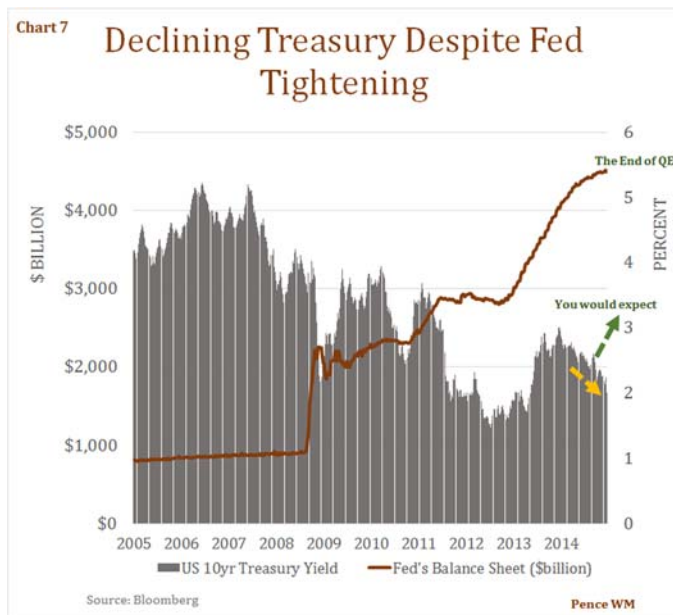
Between 2010 and 2014, the price of oil stayed within \$80 to \$100 per barrel. We think oil prices will bounce back from their current lows later in 2015 and should stabilize between the \$60-to-\$80 range for the next several years.

Overall, the net effect of falling oil prices to the US economy is positive. The clear winners are consumers.¹ That is one reason why we remain bullish on the USA.

US Stability Premium in 2015 and Beyond

While the rest of the world muddles, the US has shaken off its worst recession and is gradually getting back on its feet. Geo-political tensions and sudden moves in currency and commodity markets make global investors nervous. Investors who are more concerned with the market fundamentals and economic growth tend to favor stable countries over unstable ones. This is exactly why the US is attracting more investors to invest in US securities. We call this the “US Stability Premium”.

This “Stability Premium” is one reason we have a stronger US dollar, higher market PE multiple, and lower Treasury yields (despite tightening Fed policy) (**chart 7**).



We believe this theme will continue in 2015. Turmoil in Japan and Europe and negative trends in emerging markets along with plunging world oil prices will not undo the underlying strength of the US economy: in fact, it will drive more investors to hold US assets.

Fed Fear Factor

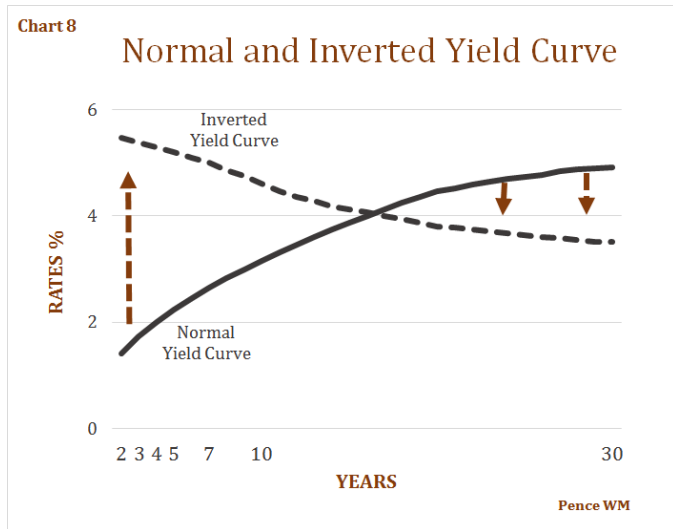
Since the Great Recession, the Fed has been masterful in engineering the recovery of the US banking system and our economy. Controversial yet decisive action has helped us recover. You can contrast our recovery to the lack of one in Europe to clearly see the difference. But the Fed has to be cautious. Over the coming years, there will be a major shift in global markets. It is a multi-speed world and policies are no longer acting in unison. On one hand, the Fed announced the end of its multi-year asset purchasing program, known as Quantitative Easing (QE). On the other hand, the European Central Bank (ECB) and the Bank of Japan (BOJ) are expected to further loosen monetary conditions.

Fears around the Fed concern the Fed losing its credibility if it miscalculates the timing (and magnitude) of the first two rate hikes.

We believe the current expected inflation rate below 2% is the most important reassurance that the Fed can afford to be patient raising the Federal Funds rate. The Fed doesn't want to increase short-term rates too soon, while long-term rates remain the same or even fall.

¹ Roughly, \$40 drop in oil reduces gasoline prices by \$1, which generates about \$10 billion monthly disposable income (Bloomberg Study).

These are benefits of the “Stability Premium” mentioned above. The Fed no longer has to work so hard to artificially keep interest rates low because the rest of the world is doing it for them. Here is the problem. A normal yield curve has a positive slope, lower interest rates for short-term and higher for longer-term (**chart 8**). The Fed can control short-term rates easily, but mid-term and longer-term rates are more difficult.



In the past when the Fed wanted to fight inflation and slow down the economy, they raised short-term rates, thus flattening or inverting the yield curve². This was “usually” a signal for the next recession. However, this time, the Fed does not want a recession, and therefore cannot risk a flat or inverted curve, which is why they have to be very careful. If they blow it and rates rise too soon, they risk losing control of the situation and having to reverse course. For the bond market the stakes are high.

Therefore, we expect relatively higher market volatility in 2015 especially around the time of the Fed’s first move to raise interest rates. We currently believe that won’t take place until the later part of the second half of the year. Given the extremely low interest and inflation rates, we believe short-term rates will increase gradually and slowly. The Fed does not want to create a recession in the US in order to bailout Europe and Asia, just like Germans don’t want to work longer so the French can retire early.

For our clients with *Strategic Asset Management (SAM)* accounts where we manage with full discretion,

² During “normal” times the yield curve is positively sloped with the duration farther out in time yielding more than bonds with shorter durations. An abnormal, or inverted yield curve, occurs when longer

depending on your individual situation and account, we will hold slightly higher cash positions as opposed to bonds, as they may become more volatile. We will deploy excess cash positions opportunistically as we evaluate both volatility and value. In short we will keep calm and somewhat tactical around a market that we expect to be volatile but overall upward trending due to the strength of earnings of US companies in a steadily growing economy. We expect the ride in 2015 to be a little rougher than 2014 but end up in almost the same place with a high single- or low double-digit market. 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.**

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

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

All investing involves risk including potential loss of principal.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise.

Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply.

term rates fall below short term rates. This is typically caused by a falling long term yield as investors demand the safety of the longer term bonds driving their prices higher and rates down.