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Planning for Your Dreams

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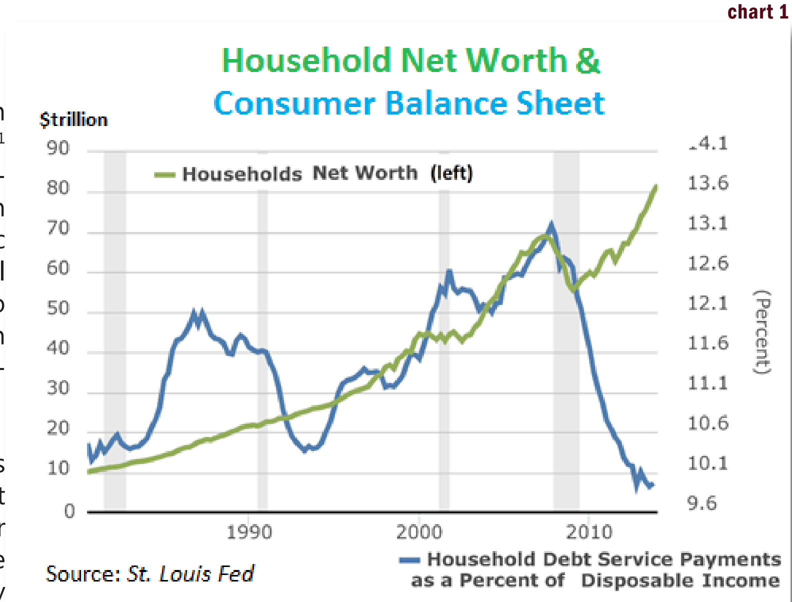
PENCE PERSPECTIVES

JUNE 2014

BOTTOM LINE UP FRONT

chart 1



We are half way through 2014 and the S&P 500 Index[1] is about half way to our year-end expectation. Based on our analysis of gross domestic product (GDP) growth, we still expect the S&P 500 index to finish the year with between high-single- and low-double-digit gains.

The US economy continues to be a slow-moving freight train that is getting harder and harder to derail. The jobs report in June was very encouraging. The economy added 288,000 jobs, the fifth straight monthly gain above 200,000. More importantly, the private sector has recouped all the 8.7 million jobs lost during the recession. It has created over 9 million jobs since then.

In our February 2014 Newsletter, we estimated the US economy would grow around 3% this year. The US economy unexpectedly contracted at an annual rate of 2.9% in the first quarter due to extreme winter weather, which drew down inventories, reduced exports, slowed the pace in the housing market, and lowered consumption spending. Because of this, we have adjusted our 2014 US GDP growth estimate to between 1.8% and 2.4% for the full year. We believe this year's GDP growth will be back-loaded, expanding at an annual rate of between 3% and 4% over the next three quarters. We have not changed our 2015 GDP outlook of between 3% and 4%. The key reason is that many forces that had been holding back the recovery—so-called compression—have receded.

THE WAY WE SEE IT

US GDP is heavily a function of disposable income. While **government consumption** and **private investment** together account for 1/3 of the US GDP (19% and 14%, respectively), **private consumption** carries the most weight, more than 2/3 of US GDP. The higher the disposable income, the higher the consumption spending; and therefore, the higher the growth in GDP.

We think the US economy has what it takes to grow **at a minimum** of at least 2% for the next several years, a slow-moving freight train. Two things have driven the US economic recovery up to now: (1) balance sheet repair and (2) the decline in the unemployment rate. Households have strengthened their finances by reducing debt and debt service. Their net worth has increased since the recession due to the recovery of home values and the rise in equity prices (**chart 1**).

To achieve longer term sustainable GDP growth above 3%, however, requires a bit more work. Namely, an increase in corporate capital spending and real wage growth. We continue to expect higher labor productivity and steady

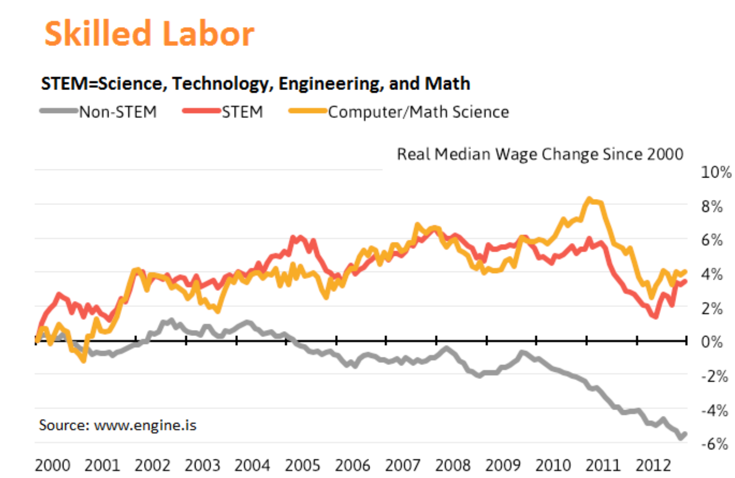
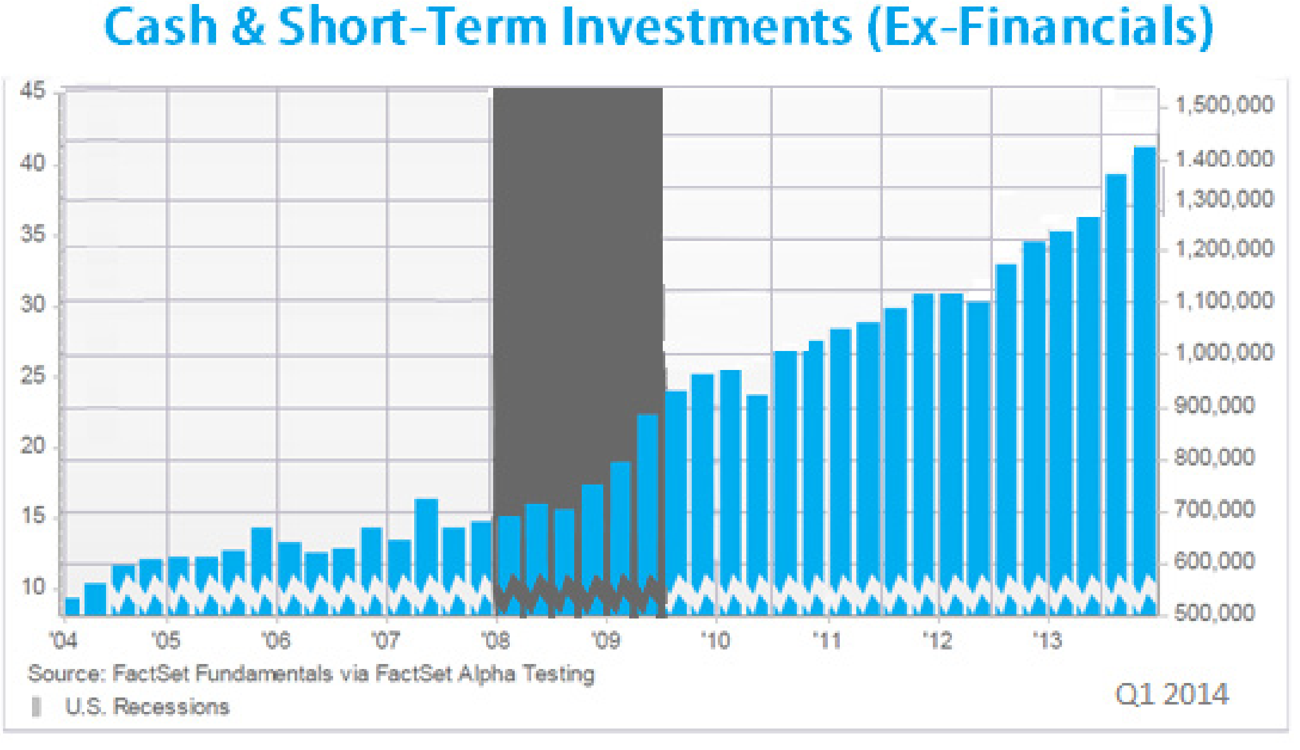


chart 2

chart 3



wage increases for skilled labor while real wage growth for unskilled labor will continue to lag. **Chart 2** clearly shows that wage growth of skilled labor exceeds that of unskilled labor.

After the financial crisis, cash holdings of nonfinancial US companies have reached a staggering $1.4 trillion dollars (**chart 3**). One reason is lower business investments. Many corporations do not want to take on long-term risk. They are still nervous and cautious or just reluctant to spend their

chart 4

Source: JPMorgan Asset Management

cash on organic growth and capital expenditures. **Chart 4** demonstrates that post-recovery capital expenditures have lagged. Corporations have enough cash to internally finance the majority of their capital expenditures without taking on additional debt.

Instead, firms have chosen to use their cash in two of the least risky methods: share buybacks and mergers and acquisitions (M&A). Share buybacks and dividend payments among members of the S&P 500 climbed to a record $241 billion in the first quarter of 2014[2] (**chart 5**), while total M&A deals have amounted to $2.5 trillion so far in 2014[3].

We are confident that some of these massive cash holdings will be deployed towards organic expansion and will help sustain the continuing economic growth.

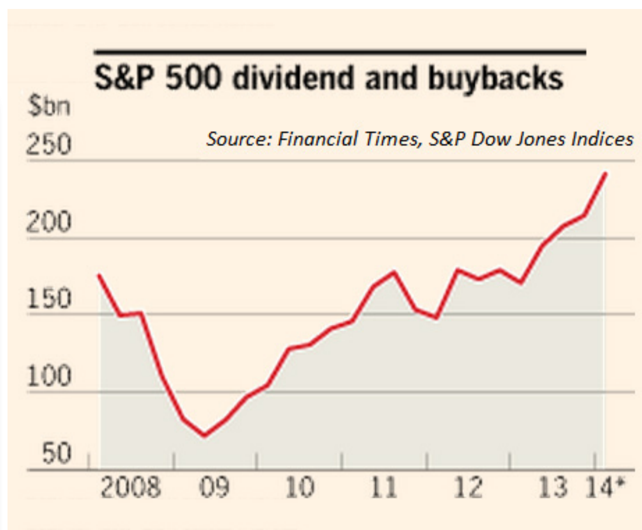


chart 5

For all the reasons above, we continue to believe the economy is in the early stage of a very long expansion and will finally transition into a higher, internal, and sustainable growth that will produce an average 3% GDP growth for 2015 and the next several years.

THE BIG KNOWABLE THEMES

At our luncheon in May, we talked about persistent regional conflicts and the end of the Treaty of Versailles. What is happening in various parts of the world today is the erasure of artificial borders drawn by French and British diplomats almost a century ago.

Today, this is clearly what we see in Syria and Iraq. The Islamic State of Iraq and Syria (ISIS) with the ambition to create a modern-day caliphate has taken control of a great stretch of territory in western Iraq and eastern Syria. This has provoked fears in surrounding countries such as Jordan, Saudi Arabia and Turkey. Oil prices hit a nine-month high on June 20 after ISIS militants seized the Iraqi city of Mosul.

The World Bank has cut its 2014 global economic growth forecast to 2.8% from 3.2% due to the impact of the Ukraine crisis and a harsh US winter. After Ukraine failed to pay its debt by the deadline of June 16, Russia's Gazprom said the country would now have to pay up front for deliveries.

These events continue to create uncertainty outside the US and our markets are not immune to such geopolitical events.

On June 18, Janet Yellen gave the green light for further stock gains. She said US economic growth is expected at around 3% for the next two years, above the long-term trend. This rate is consistent with the view we expressed at our luncheon.

The Fed also seems committed to keeping long-term interest rates below 4% so that mortgage rates can remain accommodative to help the housing-market recovery.

Fed officials predict that the federal funds rate will be 1.125% at the end of 2015 and 2.5% at the end of 2016.
As widely expected, the Fed is reducing its monthly asset purchases by $10 billion. At this pace, the Fed will be done with its purchases in October. However, the Fed said in its policy statement that it would continue reinvesting the proceeds of its holdings as they mature, meaning the central bank's $4.3 trillion balance sheet will for now remain intact.

We believe the Fed will stop re-investing its maturing holdings when/if inflation rises significantly above the Fed's long-term target. Until then, we expect the Fed to maintain an accommodative monetary policy.

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 or opportunity to increase yield.

Investing involves risk including potential loss of principal and no strategy ensures success or protects against a loss. 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, Administrative Associate, at (949) 660-8777 ext. 100 or susan.a.herman@lpl.com to schedule an appointment.

We strongly encourage you to attend our annual client luncheon next year on May 2, 2015. It is at this annual event where we 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, Director of Marketing & Projects at anne.godfrey@lpl.com or (949) 660-8777 ext 116.
We appreciate your trust and the opportunity to be of service.

All the best,

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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.

[1] The S&P 500 index is a measure of performance of the broad domestic economy through 500 stocks from major industries
[2] Financial Times, June 18, 2014 "US share buybacks and dividends hit record".
[3] As of July 22, 2014