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OCTOBER 2014

Pence Perspectives

BOTTOM LINE UP FRONT

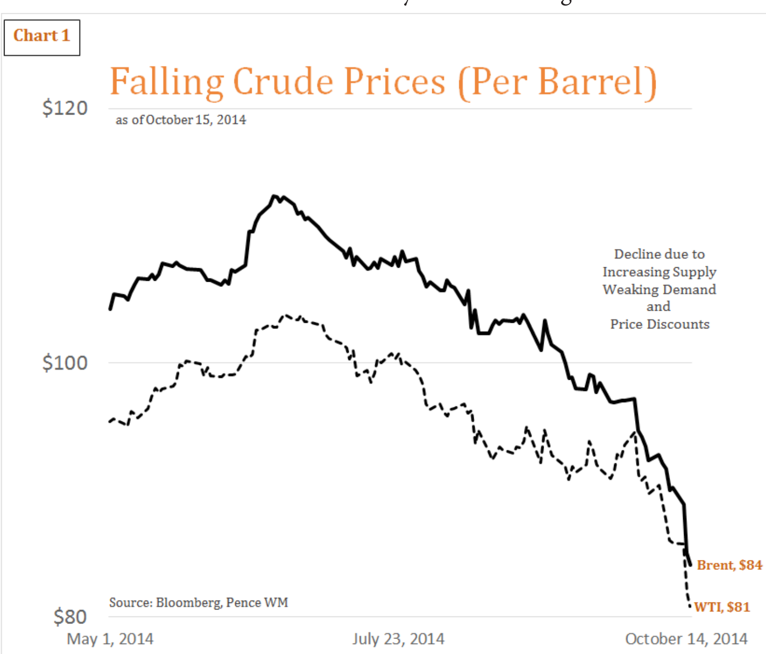
The US economy continues to expand at a slow and deliberate pace. However, market volatility has increased significantly in October. The Federal Reserve is cautiously anticipating increasing interest rates. Abroad, less effective monetary policy and geopolitical disturbances are muting potential growth. The US looks like the safest bet and best place for global capital. While we expect the US economy to continue its expansion at ***around 3%*** gross domestic product (GDP) growth for the ***next several years,*** we think that continued anemic global growth will have a limiting effect. Regardless of Fed action, interest rates will stay low as money moves to the US as a safe haven.

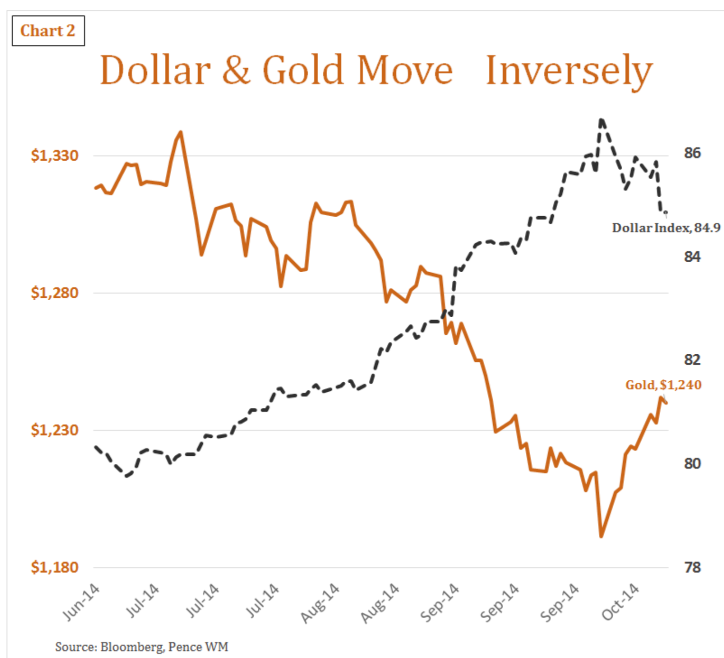
MARKETS: The first two weeks of October have been highly volatile for the markets. The S&P 500 Index erased most of the year's gains. On a total-return basis, including dividends, the S&P 500 Index is up 3% year-to-date (YTD) as of October 15. Despite the current market volatility, we expect the market to finish the year in positive territory. This is consistent with our February 2014 and June 2014 letters.

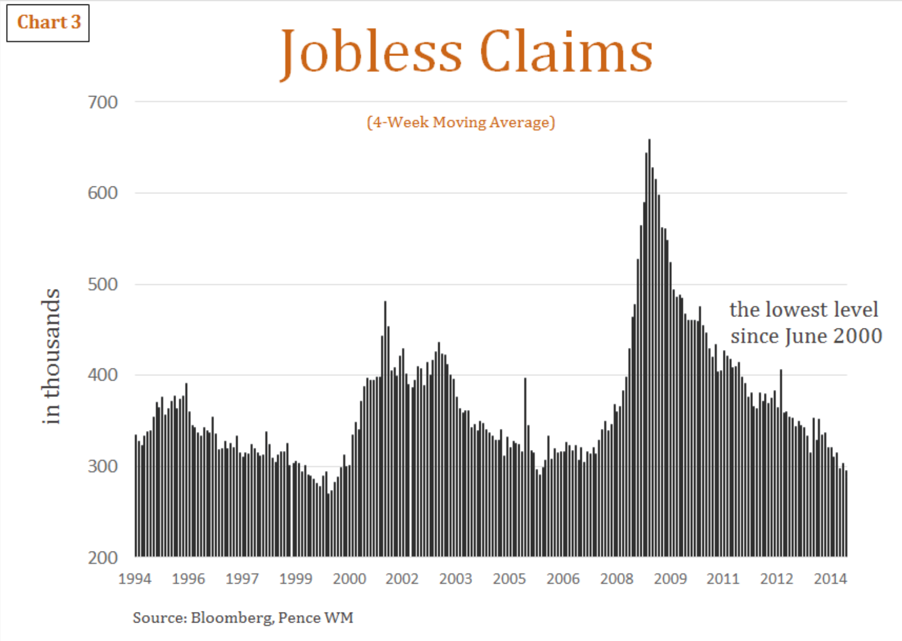
The recent high market volatility has mainly escalated from worries about global growth, geopolitical tensions, and the end of Quantitative Easing (known as QE). Regardless, we continue to believe that the fundamentals in the US economy remain strong relative to other countries and the long-term fundamentals for US equities remain sound.

Brent crude oil is down 24% YTD (chart 1). On October 15, it fell below $85 per barrel for the first time in years after Iraq followed Saudi Arabia and Iran in cutting prices. Ample oil supply, helped by OPEC and Russia as well as increased US production from hydraulic fracturing and horizontal drilling, and less global demand due to slower growth are contributing to large declines in crude oil prices. The fall in oil prices also reflects the recent strength of the dollar. Since July, the dollar has been on a steady climb as gold fell until the end of September (chart 2). This strengthening may pose a risk to growth in the US if it results in export weakness. On the other hand, gold shows no signs of stabilizing as money flows out of gold and other commodities into US dollars.

US ECONOMY: According to the IMF, the US is a bright spot compared with the rest of the world. The world's largest economy is predicted to grow ***2.2%*** this year, in line with our estimate, compared with a 1.7% projection the IMF made in July. We now estimate the US GDP to grow between ***2.0%*** and ***2.4%*** in 2014, compared to the 1.8% and 2.4% estimate we made in June.







The September employment report confirms that the US labor market is still improving at a steady pace. On average, the US economy created 227,000 new nonfarm jobs each month during the first nine months of 2014. Jobless claims continue at cyclical lows: the four-week average of new claims for unemployment benefits fell to 283,500 as of October 4. It was the lowest level since June 2000 (chart 3).

GLOBAL WORLD: Because of concerns about global economic growth and geopolitical tensions, investors are piling into the US dollar and US government bonds, which they perceive as safer. The dollar has gained more than 10% against the euro since early May. On October 15, the 10-year Treasury yield broke below 2% for the first time since May of 2013.

On October 8, the IMF lowered its outlook for global growth in 2015 (chart 4). It warned about the risks of rising geopolitical tensions as global recovery remains fragile and uneven. The world economy is expected to grow 3.8% next year after a 3.3% expansion this year.

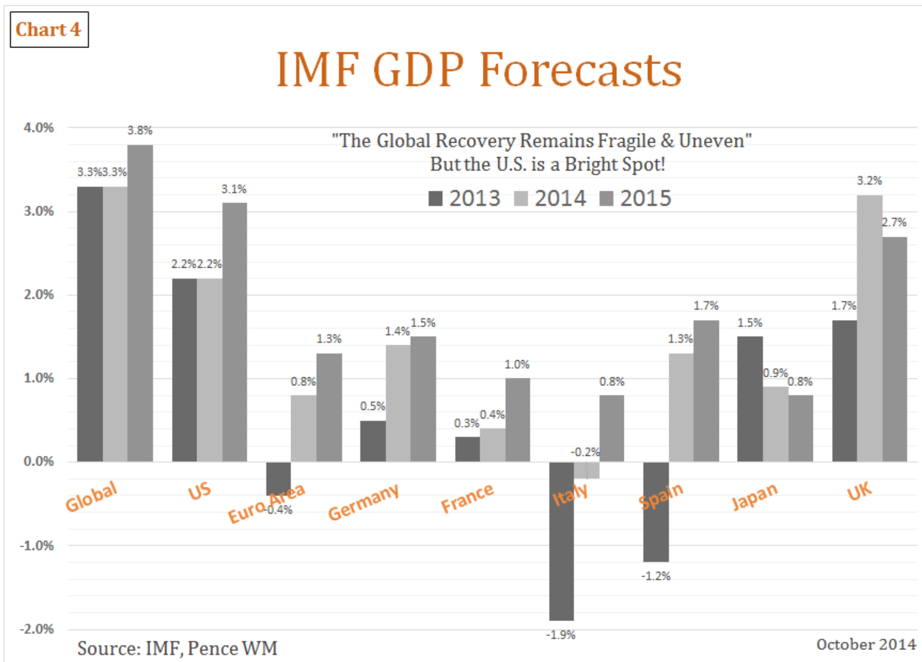
THE WAY WE SEE IT

This month, the Fed is ending its bond-purchasing program known as Quantitative Easing (QE). We expect the Fed funds rate to rise gradually from the zero lower bound to as high as 3.75% (although lower is possible) by the end of 2017. This should amount to a 1.25% per annum pace of rate increases over the next three years.

We believe the first rate hike will not take place until the third quarter of 2015 (although the second quarter is possible). The latest minutes from the Fed's September meeting expressed concerns that a slowdown in global growth and the stronger dollar may hurt the US economy. Fed officials seem to be struggling with how to come to grips with the ***dual challenges*** of a stronger dollar and a global slowdown.

We still continue to believe the US economy is in the early stage of a very long expansion period. As we stated in our February 2014 and June 2014 letters, we expect the US economy to grow ***around a 3% rate*** for the next several years. We think 3% US GDP growth is sustainable. This will however depend on how well the rest of the world does. We are likely to see above 3% US GDP growth if there is overall global economic strength and a little less than 3% GDP growth in the face of broad global economic weakness. The lower end of the range band for this estimate focuses on the fact that about 46% of revenues for companies in the S&P 500 Index in 2013 came from foreign sales and US exports composed about 13.5% of the economy.

European markets have declined in the face of poor economic data especially in Germany, Europe's largest economy. Germany's stock index (DAX) declined to its lowest level for the year on October 9 after German factory orders dropped sharply in August, led by a big drop in demand from abroad. A closely watched survey of German business confidence (IFO) fell in September to its lowest level in more than one year amid fears caused by the persistent turmoil in Ukraine and sluggish growth in Europe

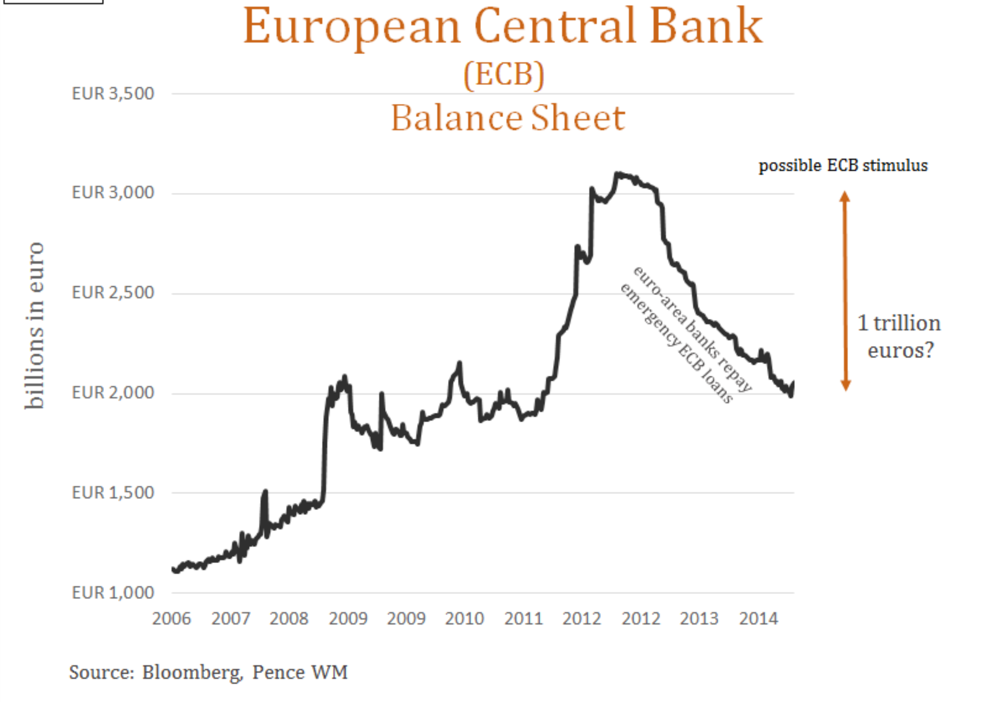


and China. The latest data also showed that German exports dropped the most since 2009. The outlook for the Japanese and Chinese economies is also less than optimistic.

US corporations and the US economy are not immune to developments outside of the US. As always, we are carefully monitoring the situation in the rest of the world including Ukraine, the Middle East, and Asia. We believe however the US economy is at a better position compared to the rest of the developed economies, which is why the US is receiving higher demand for its currency and government bonds. We call this the ***stability premium***.

The European Central Bank (ECB) balance sheet has shrunk since 2012 after euro-area banks started to repay emergency

Chart 5



ECB loans (chart 5). The ECB President Mario Draghi (who is equivalent of the Fed chair Janet Yellen), however, wants to steer the central bank's balance sheet back to the levels seen at the start of 2012. In our view, they took the foot off the gas too soon.

According to Draghi, the ECB would begin to buy covered bonds (CB) from banks in mid-October and purchase asset-backed securities (ABS) at some point in the fourth quarter of 2014. Although Draghi did not specify what the scope of this program would be, market analysts estimate that as much as 1 trillion euros ($1.3 trillion) in assets could be added to the ECB's balance sheet. Nevertheless, there are rising concerns regarding whether the proposed ECB stimulus will have its intended effect of stimulating the euro-area economies.

THE BIG KNOWABLE THEMES

In our June 2014 letter, we talked about staggering cash holdings of US nonfinancial companies. One reason for high cash holdings is lower business investments. According to a Bloomberg study[1], US corporations are the healthiest in decades. They have the lowest net debt to earnings ratio in at least 24 years, accumulated $3.59 trillion in cash and marketable securities, and posted record earnings.

The reluctance to raise capital investment has left companies with the oldest plants and equipment in almost 60 years.[2] The average age of fixed assets reached 22 years in 2013, the highest level since 1956.

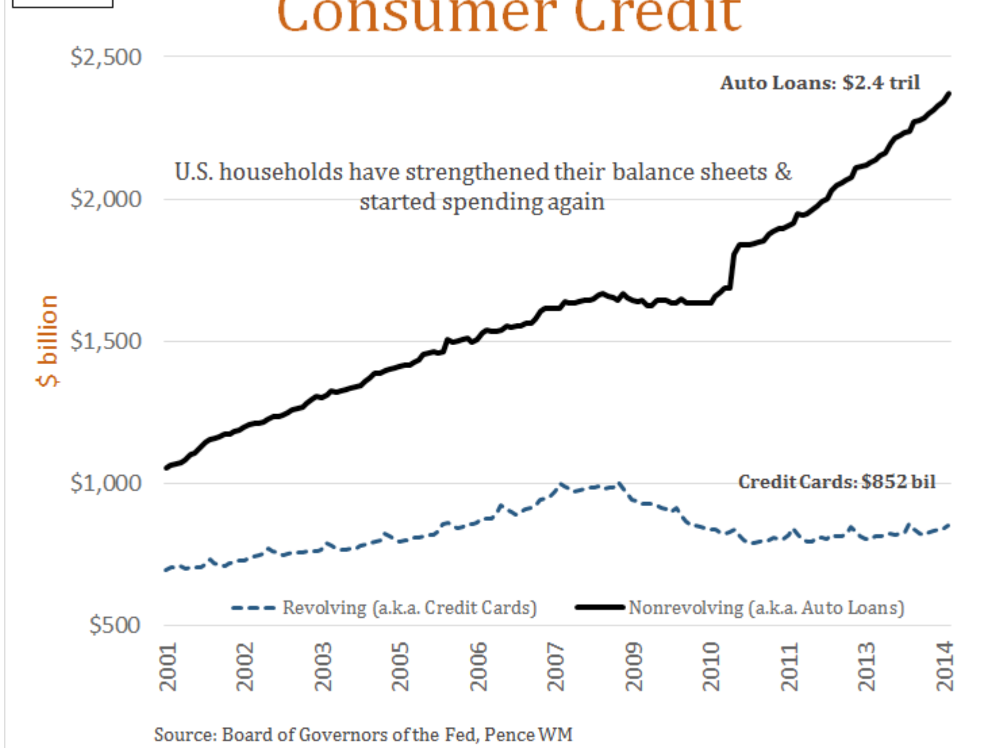
Corporate investment and capital expenditure account for 14% of the US GDP. We are still confident that some of these massive cash holdings will be deployed towards business spending and will help sustain continuing economic growth.

In fact, the latest labor market and other economic data suggest that the US economy continues to grow well above the recovery's trend.[3] This month, the US unemployment rate fell to 5.9%, its lowest level in six years. After a 2.1% decline in the first quarter, the US GDP grew at an annual rate of 4.6% in the second quarter, the best performance since the fourth quarter of 2011. The growth reflected a faster pace of business spending and sturdier export growth than previously estimated.

In the last quarter, businesses invested more in nonresidential structures as companies built more factories and purchased more equipment. Business spending increased at a 9.7% annualized rate and corporate spending on equipment was raised to an 11.2% pace, both of which were higher than previously estimated.

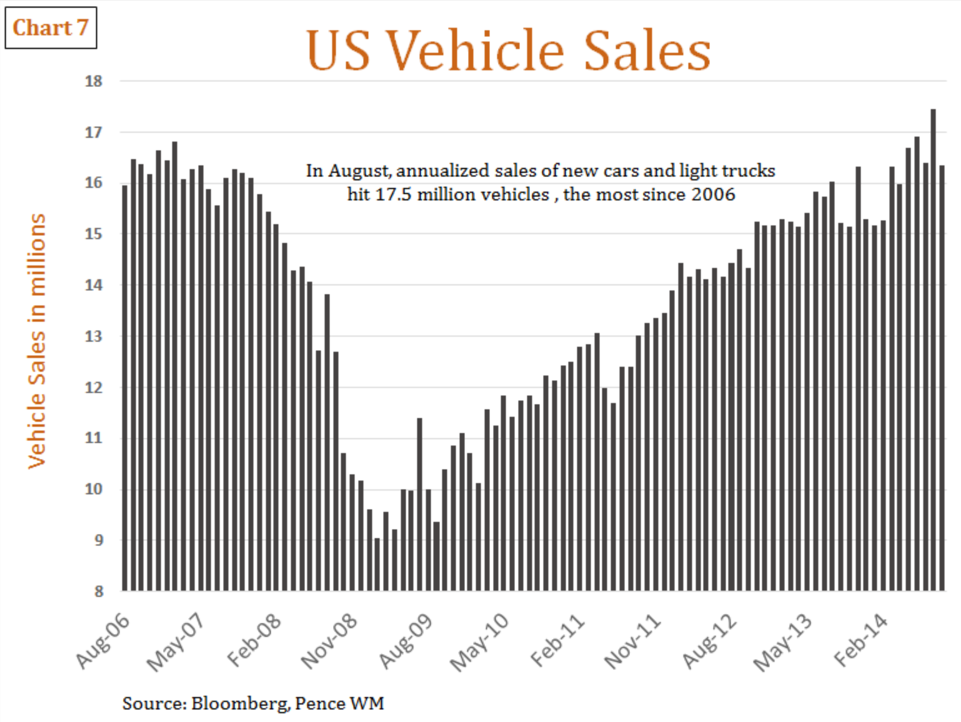
The GDP report also suggested that US companies were a bit more upbeat about the prospects for demand. Given the fact that private consumption accounts for more than 2/3 of the US GDP, strong consumer spending and higher GDP growth go hand in hand.

Chart 6



After the 2008 Financial Crisis, US households have strengthened their balance sheets by saving more and paying down debt, so much so that consumer credit card debt has declined by $150 billion from

[1] http://www.bloomberg.com/news/2014-10-02/corporate-u-s-healthiest-in-decades-under-obama-with-lower-debt.html
[2] http://www.bloomberg.com/news/2014-10-06/s-p-500-companies-spend-almost-all-profits-on-buybacks-payouts.html
[3] The Goldman Sachs Analyst Index (GSAI) was at the fifth straight month above 60 (index above 50 suggests growth)



its $1 trillion peak over the course of the recovery since 2009 (chart 6). As consumers become more confident about their income and future wealth, they purchase durable goods such as cars, refrigerators, and washer/dryers. These purchases have gone up as people bought things they had delayed during the recession.

Chart 7 highlights that the consumer confidence on purchasing household durable goods is back. Vehicle sales in August were at 17.5 million, highest since 2006.

So far this year, we have seen that most of the economic indicators got back to their pre-crisis levels. The question remains whether they can hold these levels and continue to grow as the economy moves forward. We at Pence Wealth Management think so. As we stated in our earlier letters, the US economy continues to be a slow-moving freight train that is getting harder and harder to derail.

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 they may be reinvested to take advantage of any potential growth or opportunity to increase yield.

Investing involves risk including potential loss of principal and the economic forecasts set forth in the publication may not develop as predicted and there can be no guarantee that stratagies promoted will be successful. 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 Sue 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, in 2014 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, 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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LPL Registered Principal

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