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Planning for Your Dreams

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Pence Perspectives October 2015

BOTTOM LINE UP FRONT

Consistent with our view in July, the Federal Reserve (**Fed**) chose not to raise the benchmark short-term interest rate, the federal funds rate, in September. Despite the strengthening United States economy, the Fed cited weakening conditions elsewhere in the world, low inflation in the U.S., and volatile stock markets globally, especially in China. We assign a 75% probability that the Fed will raise rates in 2015. Only if market volatility persists or any sign of weakening in the U.S. occurs will the Fed delay the rate hike into next year.

The **long-term outlook** for the U.S. economy is less controversial and more compelling compared to the rest of the world. We expect the U.S. economy to grow around 2.5% per annum for the next three years. Central to our view is that the American consumer, having paid down debt and increased savings, is now in much better shape than at any time since the Great Recession. Moreover, for the first time in five years, government (federal, state, and local combined) will no longer be a drag on economic growth.

As we said in July, the second half of the year has been more volatile than the first half. We continue to expect **market volatility** throughout the year. In order to dampen portfolio volatility and to buy on dips, we continue to favor relatively larger cash positions of 5% to 15%, compared to a normal 2% to 5%. We believe S&P 500 Index earnings (excluding the energy sector) will continue to grow at a modest but fairly secure trend over the next 12 months. We still like US-centric companies and view technical pullbacks as long-term buying opportunities.

THE WAY WE SEE IT

The Fed (Janet Yellen's Challenge)

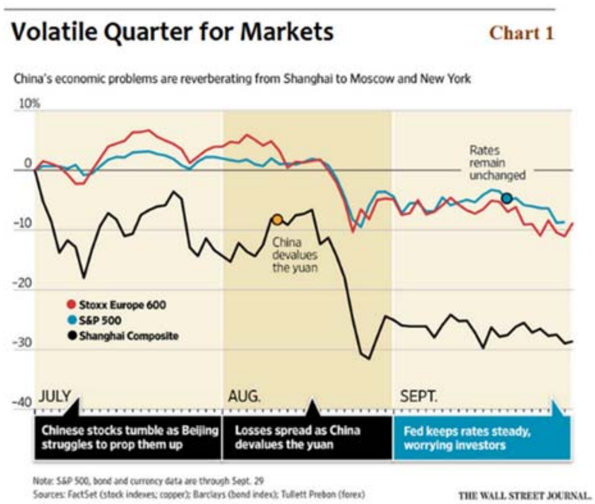
In late October and mid-December, Fed officials will meet again to evaluate economic conditions and decide whether to raise rates. From a fundamental viewpoint, an increase in the federal funds rate of up to a quarter percentage point is insignificant but the event will be in the news headlines until it finally happens. The market remains hypersensitive to the act itself because it will begin the tightening cycle after seven years of near-zero short-term rates during which the Fed expanded its balance sheet by $3.6 trillion, a five-fold increase.

To us, more important than the start of the cycle is its pace as well as its length and the resulting interest-rate peak. We are calm since the Fed has clearly signaled that rate hikes will be small and gradual and that the ultimate peak may settle at a level lower than in past tightening cycles. The Fed's actions from the start of the Great Recession have always been consistent with its prior guidance: the Fed does what it says it will do. We are confident Fed Chairwoman Janet Yellen won't raise rates until she's convinced the economy is healed. She will want to be absolutely sure that the economy is on track with growth above 2%, inflation around 2%, and a healthy labor market headed toward full employment. A rate hike should be interpreted as a positive sign of the Fed's confidence in the economy's prospects. And while rates will rise, we believe the Fed will ensure that credit remains available to and affordable for small businesses and consumers.

Financial Markets (Expect Volatility)

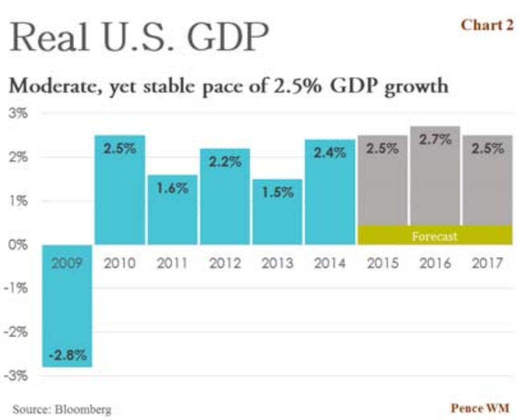
We live in a world where financial linkages among countries are deeper than ever before. These linkages make global financial markets competitive, helping companies reduce their capital costs, improve access to financing, invest more, and grow more rapidly. But at the same time, they increase **systematic** risk[1] and **contagion** risk, where the need for liquidity in one market creates selling pressure in another.

Over the summer, the Chinese stock market plunged from its April peak and dragged stock markets worldwide down with it. Both the U.S. and European markets declined but their selloffs were much smaller than China's (**Chart 1**). We think 2015 will be a single-digit year for the U.S. equity market (S&P 500 Index), with market volatility lingering. During periods of high volatility, we rely on **fundamentals** while managing **technicals**.

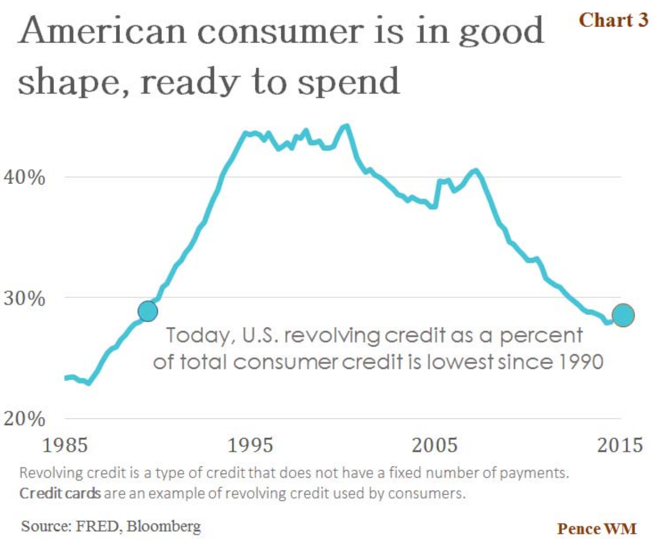


US Economy (The American Consumer is Back)

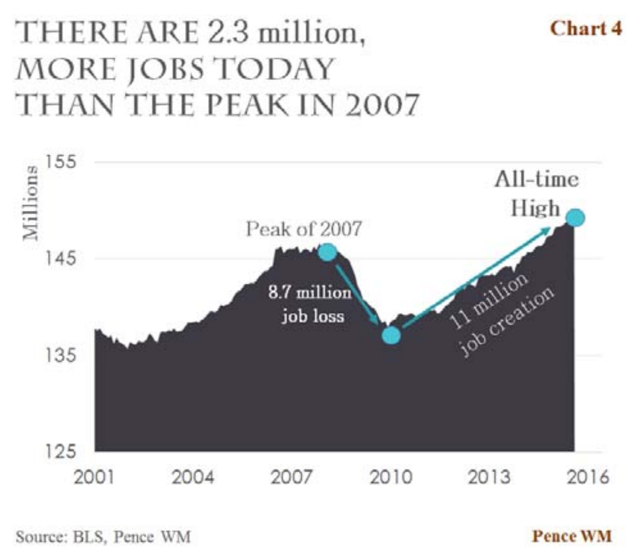
As illustrated in **Chart 2**, we continue to expect a moderate **2.5%** rate of growth for gross domestic product (**GDP**) in the U.S. for the next three years.



GDP growth fuels income gains, supporting increased spending. Today, consumers account for more than 2/3 of the U.S. economy. They have more income and less debt than a decade ago. U.S. revolving credit (such as credit card debt) as a percent of total consumer credit is at its lowest level since 1990 (**Chart 3**).



The U.S. economy provides 2.3 million more jobs today than before the Great Recession (**Chart 4**).



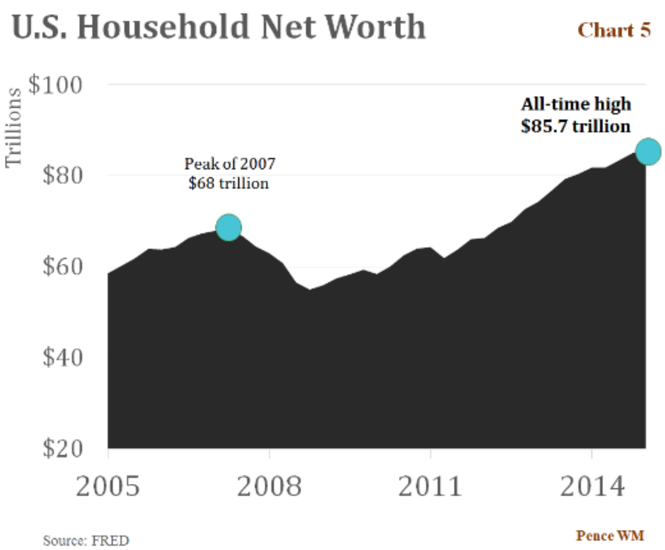
The gains in income and jobs are finally fueling an acceleration in **household formation.** Why does that matter? Traditionally, household formation and a wide range of related purchases – including homes, building products, and furnishings – serve as an important catalyst for transitioning an economic recovery into a self-sustaining expansion. An important demographic contributor to household formation is the 25-34 cohort. We believe many in this age group dropped out of the

[1] **Systematic risk**, also known as "market risk," affects the overall market, not just a particular stock or industry. This type of risk is both unpredictable and impossible to completely avoid. It cannot be mitigated through diversification.

labor force during the Great Recession, returning to school or moving back with parents. Today, they are returning to work, forming new households and often making their first home purchase.

Still on the horizon is a likely increase in consumer spending once the drop in oil prices is accepted as more than temporary. It's been almost a year since oil fell to $50 per barrel, down from $100 at the start of 2014. We expect consumers to spend a meaningful portion of that oil-related savings starting the middle of next year.

Another important support for our economy: the aggregate net worth of U.S. households, now $85.7 trillion, has hit new highs each of the last three years, thanks primarily to higher values for housing and stocks (**Chart 5**). The improving finances of households



strengthen their spending capacity, a possible additional source for ongoing economic growth.

(Note: U.S. household wealth has grown by $17.7 trillion since 2007. That new wealth is like adding another UK or another France and Spain combined to U.S. households' net worth.)

Tightening US Labor Market

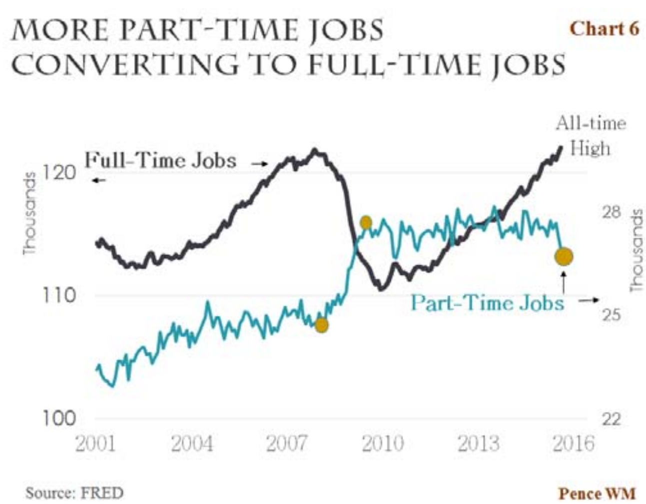
We believe the U.S. economy has fully recovered from the Great Recession and is in the midst of a sustained period of growth.

The unemployment rate stands at 5.1%, nearly half the peak of 10.0% reached in October 2009. Despite this low level, only 1.3 percentage points above the 20-year low of 3.8% back in 2000, we believe that the 5% rate will prove to be a stubborn barrier. Our reasoning: the **participation rate**[2] of the labor force will increase and part-time job-holders will **transition to full-time jobs**.

The labor force participation rate has declined since 2000 from 67.3% to September's 62.4%, its lowest level since 1977. With jobs plentiful, we expect people on the sidelines will re-enter the labor force, and the participation rate will improve to 63% or 64%. A percentage-point increase in the participation rate will bring an additional 2.6 million new entrants into the labor force, about a year's worth of new jobs at the present monthly rate without lowering unemployment.

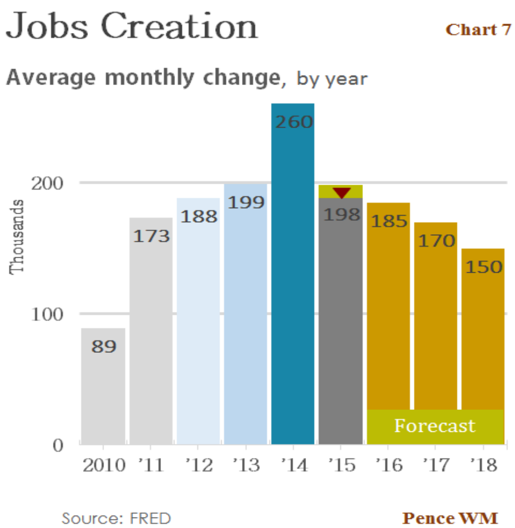
The sustained health of the U.S. economy is generating more full-time positions. Many of today's part-timers were forced to accept their jobs after the Great Recession cost them their full-time ones. In the 15 months from February 2008 to July 2009, part-time positions spiked nearly 15% (**Chart 6**).

Part-timers will transition to full-time employment as the growing economy brightens their prospects. This trend has already reduced the number of part-time jobs today below their level in July 2009 (**Chart 6**).



We forecast the average monthly change in new jobs will gradually decline to 150,000 over the next years (**Chart 7**).

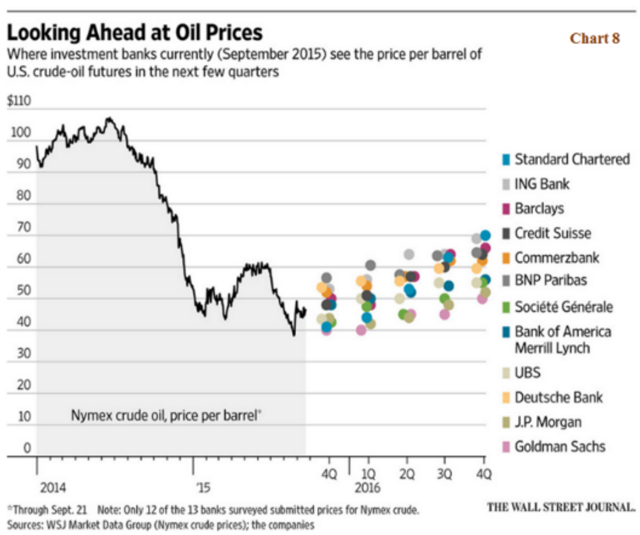
[2] **Participation Rate:** A measure of the active portion of an economy's labor force. The participation rate refers to the number of people who are either employed or are actively looking for work. The number of people who are no longer actively searching for work would not be included in the participation rate. During an economic recession, many workers often get discouraged and stop looking for employment, decreasing the participation rate.



Wage growth has been the missing element so far in this recovery, growing only about with inflation. During and after a recession, slack in the labor market from job cuts constrains wage increases. As the economy recovers, new jobs take up this slack until at some point wage increases are needed for employers to attract workers. We are not yet there, but we expect we are close. Higher real (adjusted for inflation) wages will be an indication that the economy is healthy enough to provide advances in workers' living standards. Higher living standards mean more aggregate income, healthy household spending, sustainable economic growth, and wider prosperity.

Energy (Low Oil Prices Are Here to Stay)

Oil's price has fallen to $40 to $50 per barrel (West Texas Intermediate Grade), down by half since the beginning of last year. We think, as many observers do (**Chart 8**), that oil prices will stabilize between $50 and $60 a barrel next year.



Why did oil drop so far in just several months? We believe it is **too much supply** rather than slowing global demand.

Oil demand continues to grow, even though the growth rate has fallen. A slowing China, accounting for just 12% of global oil consumption, is unlikely to cause consumption to fall.

United States domestic oil production has nearly doubled over the last six years. Canadian and Iraqi oil production has also grown year after year recently. Even the Russians, with all their economic problems, are managing to keep pumping. And additional Iranian oil will come to market once sanctions are lifted. Despite these supply additions, Saudi Arabia has continued to maintain its output while prices fell, declining its prior consistent role as a swing producer set on stabilizing prices.

In our opinion, the oversupply condition reflects both geopolitical tensions and competitive strategies of the principal Middle East players, Saudi Arabia and Iran. On the geopolitical front, the decline in oil prices reflects a prolonged **political conflict** between Saudi Arabia (Sunnis) and Iran (Shia). The Saudis have kept prices low to weaken Iran, already forced to cut production while faced with international sanctions.

On the competitive front, we believe the Saudis have maintained production to pressure U.S. shale producers. Shale production has made the U.S. the largest oil producer, ahead of even Saudi Arabia. But with oil below $50 per barrel, most shale reserves would be unprofitable so they are unlikely to be developed. No doubt the Saudis want to protect their market share, but more important to them, we believe, is the threat that U.S. energy independence may lead to a reduction in U.S. strategic support to Saudi Arabia and the region as a whole.

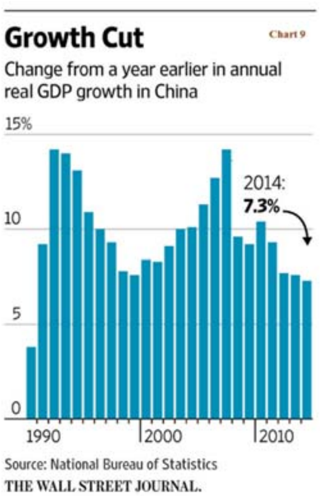
The Saudis have enough cash reserves to burn, roughly $650 billion (although they drained it down from $746 billion a year ago). However, they are in trouble if lower oil prices persist. The oil sector accounts for roughly 80% of Saudi Arabia's budget revenues and 45% of its GDP. So despite the low cost of production, the Saudis still need oil between $90 and $100 to balance their budget.

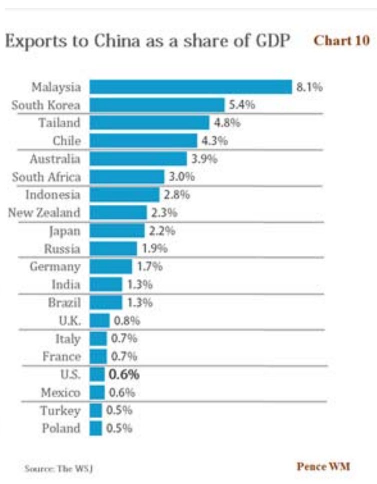
We believe that today's turmoil in the oil market will evolve to either one of two outcomes. If Saudi Arabia becomes convinced that they are not under threat from

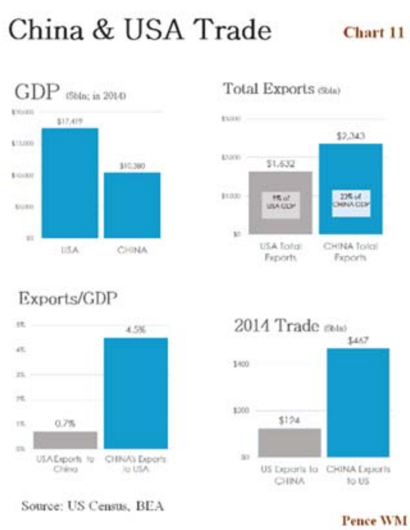
Iran and that U.S. shale producers pose no meaningful threat of regaining lost market share, it will cut its own production and let prices rise. On the other hand, if these conditions are not met, Saudi Arabia is likely to maintain its production (if not increase it) to keep prices low. We believe these potential outcomes should lead to prices between $50 and $80 for the foreseeable future.

Growth in China and Beyond (Different Speeds around the Globe)

China's growth, while lower than over the last decade, is still projected near 7% (**Chart 9**). So why worry? It's been the main driver of resource-dependent economies like Australia, Brazil and Malaysia and an important customer for South Korea, Japan and Germany (**Chart 10**). As China slows, these countries will also be affected. The U.S. is much less dependent on exports to China than any of these countries (**Chart 11**).



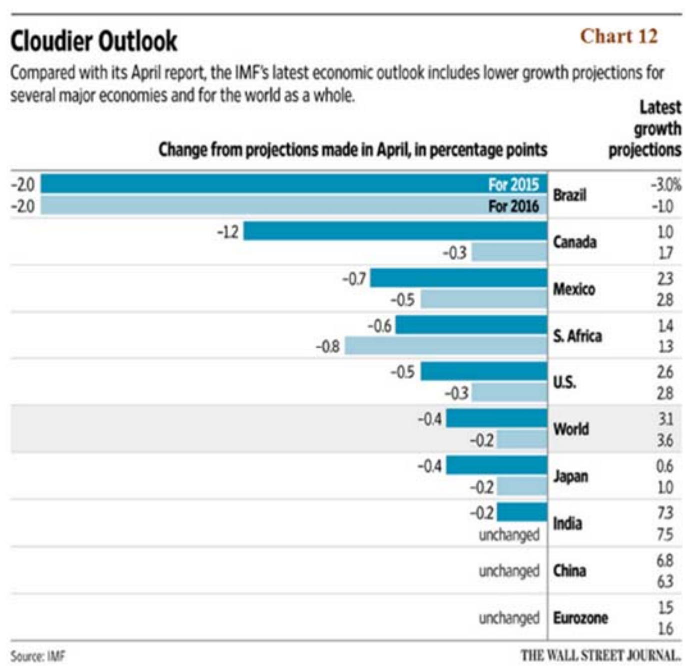




We believe if China can manage to slowly and smoothly transition its investment-based economy to a consumption-driven growth model (China's soft-landing hypothesis), its economy will benefit in the long term. A smooth transition will mean lower investment and GDP growth slower than today's 7% rate.

Another concern is China's excess capacity. They built too much, too fast. Put aside the building of (still empty) housing blocks and office towers: the Chinese built too many factories that now threaten to overwhelm global demand. With more supply than demand, product prices will fall so China will export deflation as well as their products. Protecting against deflation has been an important, possibly the top priority for the Fed since the Great Recession, and the risk that a slowdown in China may trigger the process has markets on edge.

China's shift from investment (factories, housing blocks, office towers, and trains) to consumption to grow its economy has drastically reshaped demand for the commodities on which many developing economies rely. In numbers: China consumes 54% of the world's aluminum, 50% of its nickel, 48% of its copper, 46% of its zinc, 45% of its steel, 40% of its lead, 31% of its cotton, 30% of its rice, 22% of its corn, and 17% of its wheat[3]. Top commodity exporters such as Brazil and Russia are facing serious economic difficulties as they adapt to falling commodity volumes and prices. The IMF cut its forecast for growth in emerging markets to 4% this year. That marks the fifth consecutive year of declining growth (**Chart 12**).



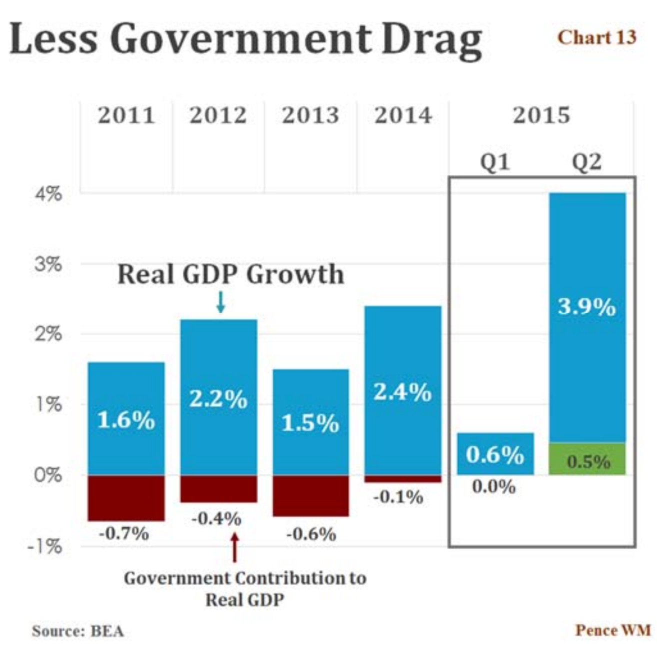
[3] Source: The Wall Street Journal

We believe emerging markets will face headwinds from declining commodity exports, higher U.S. interest rates and the risk of more dollar appreciation. While the world goes through this turbulence, we believe U.S. markets for stocks and bonds will continue to attract investor capital (**the US Stability Premium**). That is why we continue to favor US-centric companies as we believe the fundamentals underlying the strength of the U.S. economy are strong compared to the rest of the world.

Washington (A Long Agenda with No Consensus)

A partisan Congress with an eye on next year's presidential election faces important deadlines over the next three months. It will need to make decisions on raising the debt limit, extending expiring tax breaks, funding a new highway bill, and passing a spending bill to keep the federal government operating past December 11. The risk of an unforeseen (and probably avoidable) misstep is high. The good news is, for the first time in five years, government (federal, state and local combined) is no longer a drag on the U.S. economy but instead a contributor to GDP growth (**Chart 13**).

Local governments are hiring again, 127,000 new jobs as policemen, fire fighters, school teachers and more in the first nine months of 2015. That compares to 48,000 in 2014 and *minus* 20,000 jobs in 2013.



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

All the best, ❖

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For our clients with Strategic Asset Management (SAM) accounts where we manage with full discretion, depending on your individual situation and account, we expect to 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 remain tactical in a market we expect to be volatile.

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.