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Planning for Your Dreams

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Pence Perspectives July 2015

BOTTOM LINE UP FRONT

The Federal Reserve still signals a rate hike in 2015 but at a gradual pace. We are maintaining our opinion in our April newsletter. The first rate hike will be between **September** and **December**. There is a 50% chance for **one** rate hike and another 50% for **two** rate hikes before the year end. The outcome will depend on economic activities in the second and third quarters.

Due to transitory factors in the first quarter, we now expect the US economy to grow slightly below 2% in 2015. But the fundamentals underlying the strength of household spending appear favorable and we expect economic growth to pick up in the second half of the year.

Looking ahead, we continue to remain US-centric and favor US-based companies.

In addition, we see opportunities on the other side of the Atlantic Ocean as the cheaper euro and a pick-up in economic growth help Europe's biggest multinational corporations export and sell more.

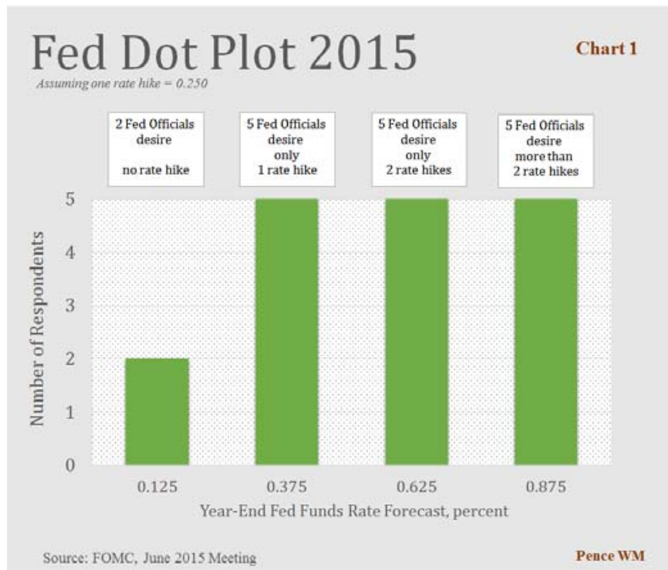
With regards to Grexit – Greece defaulting on its debt payments, and subsequently being pushed out of the euro currency union, we say, "Who cares!" The US grows the equivalent of a new Greece in every 8 months.

We believe Greece's exit from the euro, if it happens, will not be a major blow to global financial markets. This is because there is little or no fear of a domino effect. Spain, Italy, and Portugal are doing much better now. Also, the Greek debt held by foreign banks is well spread out and the debt amount is much smaller than it was in 2010. In the event, a last minute deal is reached and Germany decides to save Greece, then so much the better.

THE WAY WE SEE IT

The Fed Rates Hike

Depicted in **Chart 1**, and consistent with the March Fed meeting, 15 of 17 Fed officials said they expected to start raising the federal funds rate before the end of 2015.



Currently, the effective funds rate is at 0.125 percent. The general consensus is that one rate hike is equivalent to 0.25 percentage point.

Seven out of 17 want one or no rate hike in 2015, whereas ten want two or more rate hikes.

We believe five Fed participants with 0.625 percent year-end forecast will be the swing voters in determining whether we'll see one or two hikes by the end of this year.

Chairwoman Janet Yellen said the importance of the **initial rate increase** "should not be overstated." What should matter is the entire expected trajectory of policy, which is likely to shift as the economic data evolves. She emphasized that even after the first move higher, the Fed's policy will still be **broadly accommodative**.

In Yellen's view, economic conditions are currently anticipated to evolve in a manner that will warrant only **gradual** increases.

Nonetheless, the chairwoman has no plan to follow any type of mechanical approach to raising the rates. In the past, the Fed increased funds rate at a quarter percentage point.

It is our opinion that the Fed officials will evaluate incoming conditions and move in the manner that they regard as appropriate. This means smaller 0.10 or 0.15 percentage point incremental increases are on the table as well.

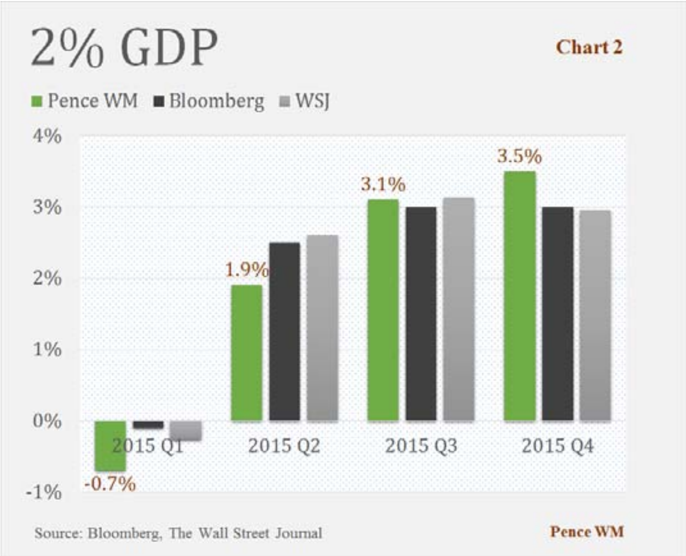
US Economy & US Markets

Consistent with our view in April, we continue to believe 2015 will be a single-digit year for the US equity market (S&P 500 Index).

We still believe the second half of the year will be more volatile than the first half as we get closer to the Fed rate hike. For this reason, we continue to favor relatively larger cash positions, 5% to 15%, than a normal 2% to 5% in order to dampen portfolio volatility and to buy on dips.

In the disappointing first quarter, net exports were a substantial drag on the US economy because of the surging dollar and West Coast port issues.

In line with the soft data for the first quarter, we reduced US gross domestic product (GDP) growth projections for this year. But we expect a stronger growth in the second half of the year. Our forecast for 2015 is now 1.5 to 2%, down 0.5% point from our April projection (**Chart 2**).



We continue to believe the fundamentals underlying household spending accounting for 70% of US GDP because they appear strong. Both consumer and business sentiment remain solid.

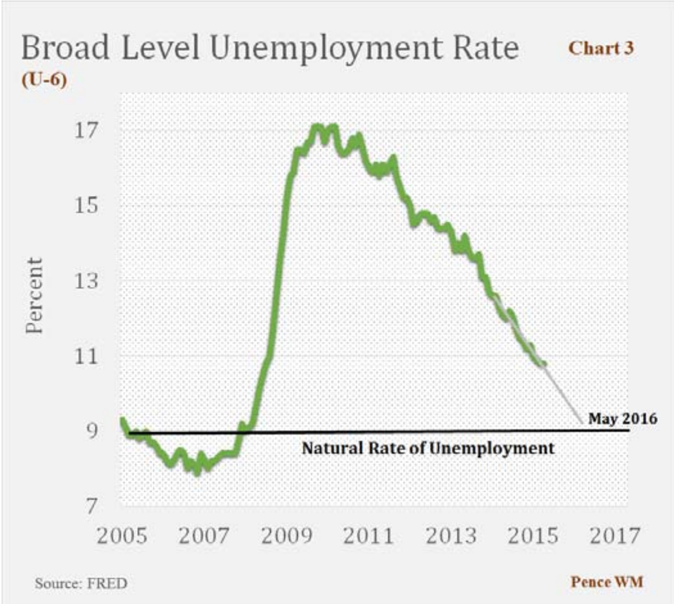
Looking ahead, we still expect a moderate pace of GDP growth (around 2.5%) with strengthening labor market and lower energy prices that are supporting consumer spending.

The labor market data so far this year shows further progress toward a maximum level of full employment.

The US **jobless rate** (U-3) stood at 5.5% in May, down from 6.3% a year earlier. We've seen 63 consecutive months of private job creation and the economy has created an average of 217,000 jobs per month so far this year.

Looking at a broader measure of unemployment (U-6) that *includes individuals who want and are available to work but have not actively searched recently and people who are working part time but would rather work full time*, we see improvements as well.

In **Chart 3,** we forecast that the broad level unemployment rate should be normalizing around 9% in mid-2016 from the current level of 10.8%.



We still believe the dollar's strengthening isn't over. Energy prices appear to have stabilized recently. In general however, a stronger dollar puts price pressure on commodities. Therefore, we continue to be cautious on oil.

US Energy Information Administration (EIA) data published this month also shows that global petroleum oversupply, or production versus consumption, has more than doubled to 2.6 million barrels per day (bpd) since the end of the second quarter last year. With the possibility of a return of Iranian crude exports, more oil may yet come to the market and further price turbulence looks almost certain.

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.