SOUNDVIEW FINANCIAL

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Looking Back

The U.S. economy continued to improve in 2014.

The value of all the goods and services produced in the U.S. adjusted for inflation (real GDP) increased by 5%.[1] More of our neighbors found jobs lowering the unemployment rate a full percentage point to 5.6%.[2]

Corporate profits[3] increased 9% to $109.21 per share partly because hard working employees increased their productivity a solid 2.3%.

Existing homes stopped their late 2013 decline in February then increased 9% through years-end. Construction of new homes grew 20% from 775,000 to 927,000 houses.[3a]

Overseas the story was gloomier as many countries neared recession levels. The 19 country European Union (Euro Area) grew only 0.2% with unemployment averaging 11.5%.

Japan had negative growth of -0.5%. China's growth slowed to 1.5%. [4]

In the U.S. the combination of more people working, low inflation and very low interest rates propelled stocks[5] up 13.7% to a second year of double-digit gains. Small company stocks[6] did less well but gained 4.9%.

Confounding most economists, rather than rising interest rates fell pushing U.S. bonds[7] up 6% and tax-free municipal bonds[8] up 8.9%.

Overseas financial markets reacted to poor conditions there with declines. Developed-market international stocks[9] dropped -4.9% while emerging-market stocks[10] fell -4.6%.

Surprisingly negative real interest rates didn't help gold as the precious metal's price fell -4.3%. Collapsing oil prices dropped commodities[11] -32% and insured low inflation which increased only 1.3%.

Looking Ahead

The late Stephen R. Covey popularized the analogy of organizing priorities by putting "the big rocks in the jar first" thereby ensuring first things were done first. Our investment selection also begins with putting the "big rocks" of the macro environment in place first. We do this with our quadrant decision table which sets probabilities for four possible economic scenarios*: Inflationary Bust (Stagflation), Inflationary Boom, Deflationary Bust and Deflationary Boom.*

It is not possible to know with 100% certainty which macro environment will actually occur. If it were investment decisions would be easy as we know which investments do well within each scenario.

"Boom" signifies a growing economy. The U.S. is experiencing reasonable growth yet real GDP growth for this expansion which began in 2009 is only 2.3%, well below the average growth of past expansions[12].

Globally many countries are at or near economic contraction. Europe and Japan are pumping money into their financial systems in hopes of forestalling recession and reviving growth. Yet, we've seen the limits of monetary and fiscal policy makers in this regard.

In recent months the housing market has lost some momentum with permits for new homes declining 1.9%. Still, entry-level houses are affordable and one index[13] which measures financing for non-luxury homes has been rising recently. Housing's missing ingredient has been first-time home buyers. The Millennials, now in their 20's and early 30's, have not had an easy time in the job market but if this 80-million strong demographic group can obtain job security and wage growth they may tire of paying high rents and finally buy houses. Though not large itself, the tentacles of the housing market encompass and help many sectors of the economy from home goods and electronics retailers to carpenters, plumbers, and electricians.

Key to the housing market is the job market. Here, the good news is that jobless claims have been falling for several years. More people finding work means more potential home buyers. Slightly concerning is the recent change in the trend of new unemployment claims which have increased on average since October.

Increasing corporate profits continue to come largely from cost cutting, especially labor, resulting in flat real wages and incomes. Corporate earnings generally expand for 2-5 years then contract for 1-2 years. Profit growth in 2015 would be the 7th consecutive year and put actual earnings well over the historical trend line which revolves around GDP growth over time. Given that fact plus the lack of quality earnings growth (i.e. cost cutting vs. price and volume expansion) gives us concern because either scenario can mask an overpriced stock market which by some measures is significantly overvalued already at 27 times earnings.[14]

Absolute values only tell part of the story though because investors compare asset classes relative to one another in making decisions. For example, the stock market's current earnings yield[15] of 5.3% vs. 1.8% for a 10-year U.S. treasury bond suggests stocks are a better value than bonds.

Adding it up, our highest probability scenario for 2015 is *Deflationary Boom.* In this scenario inflation (prices) are stable or falling while the economy is growing.

The *Deflationary Boom* scenario favors equities especially companies with price elasticity (i.e. lower prices increase demand), platform companies (i.e. in-house design & sell, out-source production), financial services, Real Estate, oil importers (e.g. Japan) and the U.S. dollar. This overarching theme will guide our security selection until and unless it changes or is proved incorrect.

We were overly cautious with fixed-income (bonds) last year expecting interest rates to rise. We still believe we are near the end of the long-term decline in interest rates. Yet, the net effect of low energy prices may be negative to the overall economy as we lose jobs in that well-paid sector further cooling already tepid global growth and raising the specter of potential deflation (*Deflationary Bust* is our 2nd most probable scenario).

With real cash yields negative (interest rate minus inflation) we dug deeply into this conundrum. In a nutshell our research indicates that a 7-year Bond Ladder is our best option now. Splitting your bond allocation over 7 years (i.e. 1/7th matures each year) gives us a good balance between earning current income while taking advantage of higher future interest rates, should they occur. We will implement this strategy throughout the year as opportunities arise.

We look forward to a profitable 2015 and to seeing you. Thank you for your continued confidence and trust.

Sincerely,

Robert J. Boronski, MBA, CFP®

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[1] National Bureau Economic Analysis YOY Q3-2013-Q3-2014, [2] Bureau of Labor Statistics, [3] S&P 500 EPS, 3a Census Bureau d [4] Trading Economics, [5] S&P 500 total return, [6] Russell 2000, [7] Barclays Capital US Aggregate Bonds [8] AMT-Free Municipal Bond index [9] MSCI EAFE, [10] MSCI Emerging Markets, [11] I Shares S&P GSCI Commodity Index Source [12] NBER, , [13] FHFA House Price index +0.8% Nov. 2014 [14] Cresmont Research P/E Report 12/31/[15] 12-months earnings per share divided by the current market price per share

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