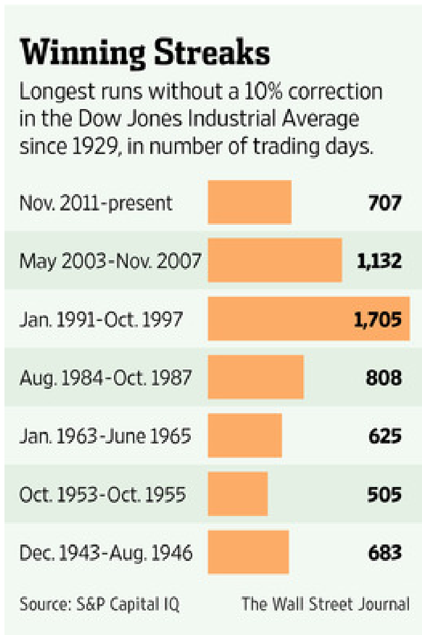
Challenging, But It Could Be Worse
Third Quarter 2014 Commentary

The investing climate has not gotten any clearer or easier since our last commentary.



Stock Market: Although the stock market continues to march higher, we don't believe it is for fundamentally sound reasons.

With interest rates incredibly low, more and more investors are turning to the stock market in an attempt to maintain their purchasing power.

Furthermore, in assessing the quality of "earnings" there is an important observation to be made: ***earnings are going up but revenues are not***. Earnings are increasing due to cut backs in personnel, inventory and physical plant. Earnings per share are increasing due to ***stock buybacks*** which can be good or bad, depending upon how disciplined management is. This is not a good long term situation as over long market cycles, earnings and revenue growth should be similar.

Interest Rates: After falling as low as 2.3% the yield on the ***10 Year US Treasury Bond has rebounded to 2.55%***. Although some are predicting that the Federal Reserve may increase interest rates in 2015, we are not holding our breath. For a variety of reasons listed below, we believe the economy is simply too weak to warrant an increase in interest rates.

A continued low interest rate environment will most likely continue to be good for the stock market and leveraged investments. However, it will continue to punish the average family and fixed income savers/investors.

ECB's Draghi Attempts Quantitative Easing: While the U.S. is talking about exiting our quantitative easing program and increasing interest rates, the EU is doing the opposite. As such, Mario Draghi is attempting to boost the Eurozone economy by purchasing Eurobonds in the open market. http://online.wsj.com/articles/ecbs-draghi-takes-a-gamble-on-qe-lite-1410121204

Labor Force Statistics from the Current Population Survey: The ***labor force participation rate declined to 62.8%, the lowest reading since 1978.***

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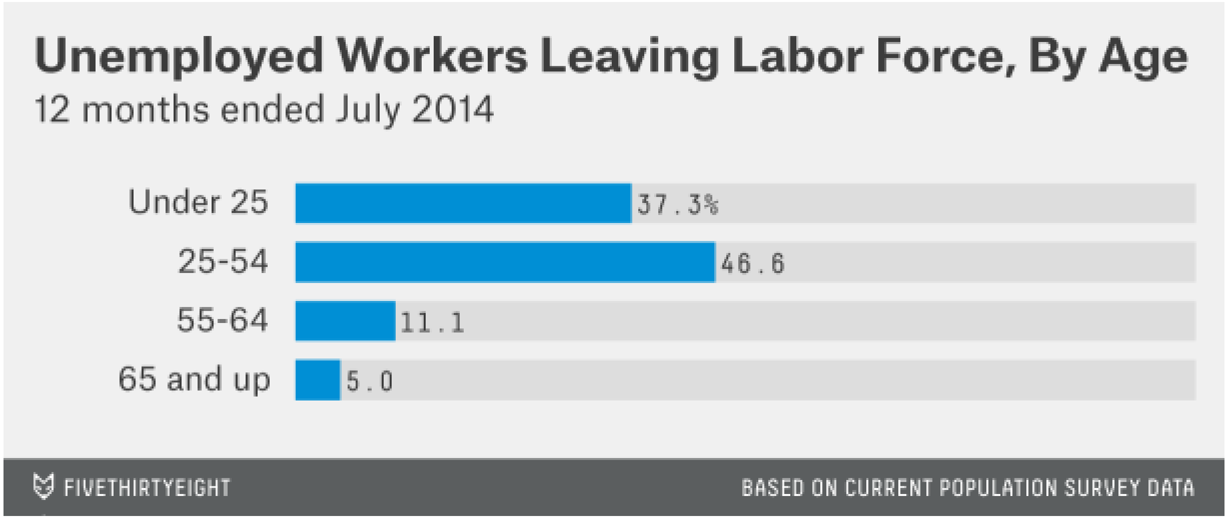
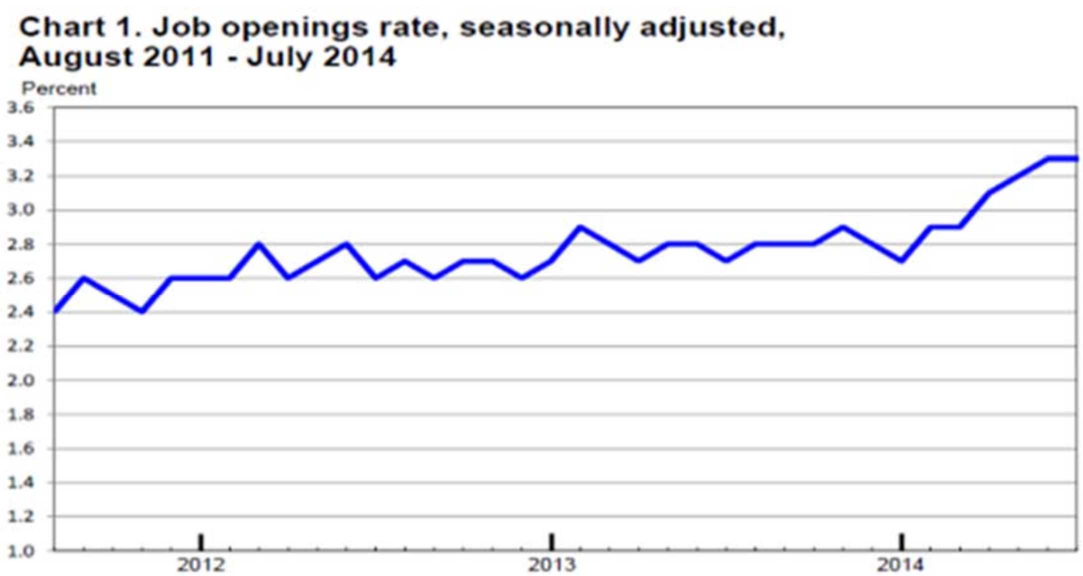
Exiting Baby Boomers Not To Blame: A breakdown by age shows most unemployed workers leaving the labor force aren't boomers. In fact, only 5 percent are of retirement age (65 or older) and most aren't even close.



http://fivethirtyeight.com/datalab/dont-blame-boomers-for-unemployed-workers-leaving-the-labor-force/

Bureau of Labor Statistics Job Openings and Labor Turnover July 2014: There were ***4.7 million job openings [13-year high]*** on the last business day of July, little changed from June, the U.S. Bureau of Labor Statistics reported. The hires rate (3.5 percent) and the separations rate (3.3 percent) were unchanged in July. Within separations, the quits rate (1.8 percent) and the layoffs and discharges rate (1.2 percent) were unchanged.

The number of total nonfarm job openings is little changed since July However, ***there were 799,000 more job openings in July than in Jan 2014***. The largest increases since January were in retail trade, professional and business services health care, and social assistance. http://www.bls.gov/news.release/pdf/jolts.pdf

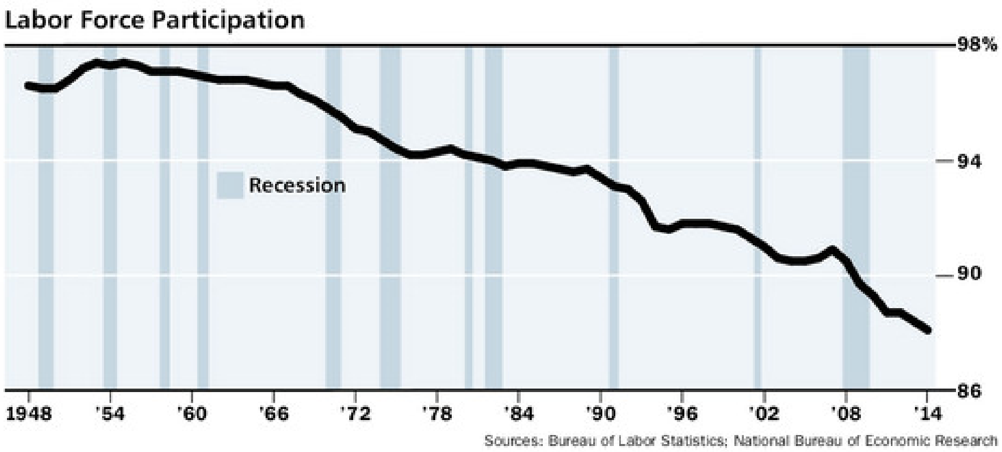


Bureau of Labor Statistics: Average expenditures per consumer unit in 2013 were $51,100, little changed from 2012 levels. **In 2013 spending decreased 0.7 percent** during the same period that the Consumer Price Index (CPI-U) increased 1.5 percent. In 2012 spending had increased 3.5 percent, outpacing the increase in prices. In 2013 average income per consumer unit edged down from 2012. The biggest increases were healthcare, insurance and autos.
http://www.bls.gov/news.release/pdf/cesan.pdf

We question this data. If consumer spending declined 0.7% in 2013 while the Consumer Price Index increased 1.5%, how accurate was GDP in 2013?

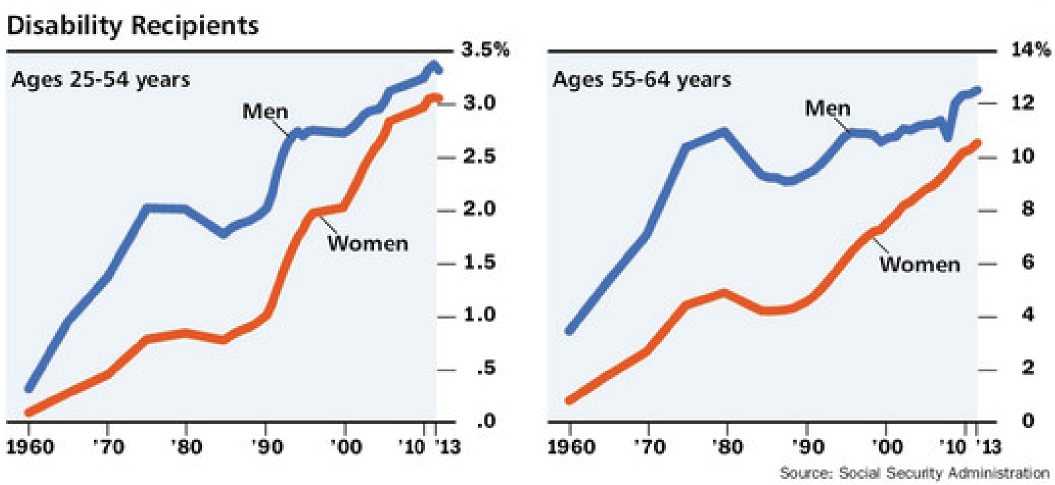
Losing Ground

The labor-force participation rate of prime-age men was about 97% from the late 1940s to the late 1960s. It has fallen every decade since, though it often regained some lost ground during expansion periods. The decline has persisted through the recent expansion, however, to 66-year lows of 88%. Currently, nearly one of every eight prime-age men is not in the labor force.



Disability Explosion

The share of men and women ages 25-54 and 55-64 receiving disability payments from the Social Security Administration has soared over the past few decades, hurting the workforce-participation rate.



http://online.barrons.com/news/articles/SB50001424127887323949604580113811574041250?mod=BOL_archive_twm_ls

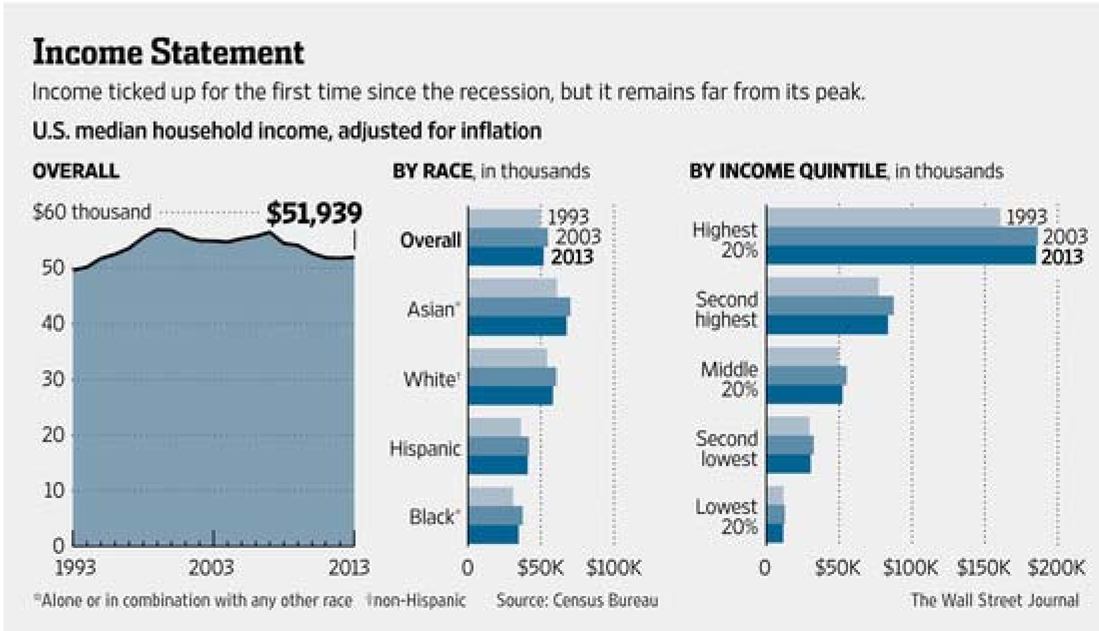
The Barron's article linked above states that ***normal working age people are intentionally staying out of the workforce***. They are doing so since they are ***collecting disability benefits and collecting cash for jobs "under the table."***

The article also points out that the implementation of the ***Affordable Care Act will also serve as a dis-incentive*** for people to enter the normal workforce. If they have no (or low) reportable earnings, they will get healthcare for free or with a significant subsidy.

This reinforces the understanding that if you want to see how people are motivated you should follow the cash.

Federal Reserve Bulletin Survey of Consumer Finances Changes in U.S. Family Finances from 2010 to 2013:

Between 2010 and 2013, mean (overall average) family income rose 4% in real terms, but **median income fell 5%**, consistent with increasing income concentration to the high end during this period.



Families at the bottom of the income distribution saw continued substantial declines in average real incomes between 2010 and 2013, continuing the trend observed between 2007 and 2010.

Ownership rates of housing and businesses fell substantially between 2010 and 2013.

Retirement plan participation in 2013 continued on the downward trajectory observed between the 2007 and 2010 surveys for families in the bottom half of the income distribution.

Participation rebounded slightly for upper-middle income families, but did not move back to the levels observed in 2007. The fraction of families that owned a privately held business fell 1.6 percentage points between 2010 and 2013, to 11.7 percent. ***This level is the lowest ever recorded*** in the Survey of Consumer Finances, dating back to the 1989 survey. Obviously, this is not a good sign. http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf

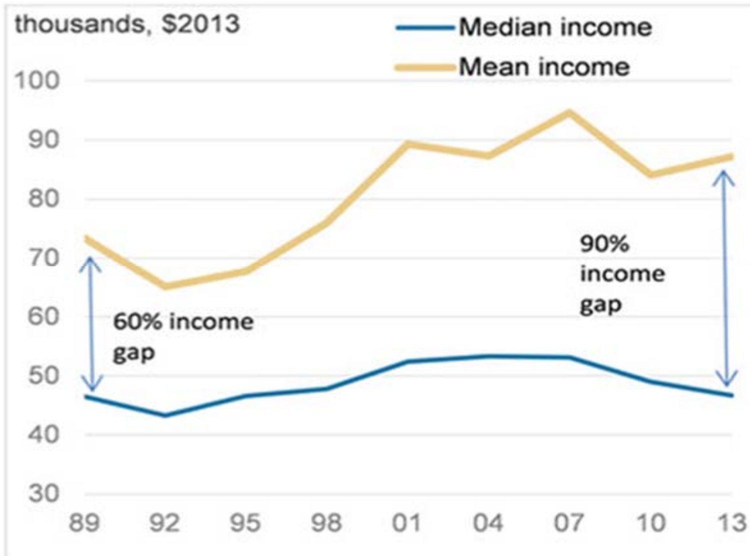
Wealth Gap Unsustainable: The widening gap between America's wealthiest and its middle and lower classes is "unsustainable," but is unlikely to improve any time soon, according to a Harvard Business School study.

The study, titled "An Economy Doing Half its Job," said American companies—particularly big ones—were showing some signs of recovering their competitive edge on the world stage since the financial crisis, but that workers would likely keep struggling to demand better pay and benefits. http://www.cnbc.com/id/101980156

American stock holdings at 18-year low: According to recent data from the Federal Reserve, America has the lowest level of stock ownership in 18 years. Yet ***stock ownership for the wealthy is at a new high—and that has accounted for most of their good fortune*** compared to the rest of America.

The Federal Reserve Survey of Consumer Finance found that only 48.8% of Americans held stock either directly or indirectly in 2012, the latest period measured. That's the lowest level since 1995, when 40.5% of Americans held some form of stock. Indirect ownership is stock held in mutual funds, 401-K plans, and other investment vehicles.

Exhibit 6: Growth in Mean and Median Family Income Reveal Widening Gap



Note: Mean income is the average income across all families regardless of how that income is distributed. Median income is the level at which 50% of families have lower income and 50% have higher incomes.
Source: Federal Reserve. Morgan Stanley Research.

This emphasizes the understanding that ***the average family has not participated in the recovery since 2009. In fact, the purchasing power of the average family has been in decline since 1998***.

Unless you held significant financial assets, you have most likely not recovered financially. http://www.cnbc.com/id/101980294

Summary:

1. Interest rates continue to be manipulated at a low level in an effort to stimulate demand.
2. GDP growth is very lethargic.
3. Although the official unemployment rate has dropped, the labor participation rate continues to get worse.
4. Workers are leaving the workforce—many are collecting financial benefits to remain out of the workforce.
5. The longer that workers stay out of the workforce, the more likely it will be that they will become permanently unemployed as technology passes them by.
6. Workers with technical skills (college or trade) continue to have high levels of employment.
7. The average family continues to have lower “spending money”.
8. The surge in the stock market has primarily benefitted those in the top 5% of American households.
9. As challenging as matters are in the U.S., things are far worse elsewhere in the world.

As always, thank you for the opportunity to work for you and your family--it is truly appreciated.

Sincerely yours,

Dave   Warren

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