Investment Tally & Perspective

2015 Second Quarter Investment Strategy & Outlook

Economy – After a strong finish in 2014, economic activity slowed in the first three months of the New Year, with brutally cold weather and a West Coast dock strike being negative factors. We expect a pickup in activity in the current quarter and second half of the year, and see muted inflation pressures giving the Fed needed running room to be patient.

Financial Markets – With dollar strength proving to be a drag on first quarter earnings for many multinational companies, and with expectations for the Fed to begin raising interest rates, is the next 10% to 20% move in stocks up or down? How should portfolios be positioned when higher interest rates are likely, yet not certain? While two primary drivers of stock price movements are earnings and interest rates, a fuller assessment of stock valuations and prospects includes many factors for consideration. In the following, we briefly look at two interrelated factors of importance - negative interest rates and the all-important central character, the Fed.

A Strange, Strange World

History was made last week by two new bond issues as Switzerland became the first country to sell a 10 year government bond at a negative interest rate (this means that the buyers of these bonds are, in essence, paying the sellers a fee, or an agreement that they will receive less capital upon maturity than when they started). Other countries with bonds trading at negative rate levels include Denmark, Germany, the Netherlands, Austria, Ireland, and Belgium. Separately, though just as remarkable, Mexico issued a 100-year Euro bond that yields just 4.2%. Financial history attests to other times with negative interest rates, though it has been quite rare in modern times and one natural question is "What does this imply about the outlook for inflation or deflation"?

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MAJOR INDUSTRIALIZED COUNTRIES

	2015 Est. GDP	Unemployment	Consumer Prices	Budget Balance (as % of GDP)	Int. Rate 10-Yr Gov't
Britain	2.6%	5.7%	0.5%	-4.4%	1.61%
Canada	2.1%	6.8%	1.1%	-1.7%	1.37%
France	0.9%	10.6%	0.1%	**-4.2%**	**0.51%**
Germany	1.6%	6.4%	0.2%	**0.7%**	**0.21%**
Italy	0.5%	12.7%	mil	**-3.0%**	**1.31%**
Japan	1.1%	3.5%	1.0%	-7.0%	0.37%
Spain	2.0%	23.2%	-0.7%	**-4.5%**	**1.27%**
Switzerland	1.0%	3.2%	-0.7%	0.3%	mil
United States	3.2%	5.5%	0.3%	-2.5%	1.96%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, April 4, 2015

MARKET INDEX RETURNS

Fixed Income	1st Qtr. 2015	1 Year	3 Year	5 Year
Citi Treasury Bill 3 Month	0.01%	0.03%	0.05%	0.07%
Barclays US Aggregate Bond Index	1.61%	5.72%	3.10%	4.41%
Barclays Global Aggregate Bond Ex US	-4.63%	-10.08%	-2.68%	0.76%
Stock Indices				
S&P 500	0.95%	12.73%	16.11%	14.47%
Dow Jones Industrial Average	0.33%	10.57%	13.18%	13.23%
NASDAQ Composite	3.79%	18.12%	18.11%	16.72%
MSCI EAFE Index	4.88%	-0.92%	9.02%	6.16%
MSCI Emerging Markets	2.24%	0.44%	0.31%	1.75%
Russell 2000	4.32%	8.21%	16.27%	14.57%
Other				
Bloomberg Commodity Index	-5.94%	-27.04%	-11.52%	-5.71%
S&P GSCI Precious Metal Index	0.44%	-9.22%	-12.61%	0.26%

*Data obtained from Morningstar; period ending 03/31/15

*All figures are stated as trailing total returns, and returns over 1 year are annualized

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Banking 101 - Given the importance of interest rates and the Fed, a brief primer follows: The primary, traditional business of a bank is to make a profit on the "spread" - the difference between the amount banks earn on loans and investments after paying for the cost of their capital (such as interest paid to depositors). If the spread is positive, then banks can further increase shareholder profits by using leverage (borrowed funds) – for example, the bank may loan nine dollars for every dollar of shareholder capital. Despite the best screening efforts of banks, some borrowers will default and fail to repay their obligations, so banks are required to set aside funds to cover potential losses in reserve accounts. When banks have more funds available then necessary, they are able to deposit "excess reserves" with the Fed for a modest return. The Fed is the primary bank regulator and serves as the "Bank of Last Resort" given its ability to create money and credit.

The Fed's Quagmire – The Path to Normalization

From Rescue to Control – Throughout 2007, the banking system had operated with less than $5 billion is reserves. Then, during the fourth quarter of 2008, while in the process of rescuing a few large financial firms following the Lehman Brothers bankruptcy, the Federal Reserve added about $600 billion in excess reserves to the banking system. This action drove the primary interest rate on bank reserves, the Federal Funds or Policy Rate, near zero and in December 2008, the Fed set the official federal funds rate target at a range of 0 to 0.25 percent, where it remains to this day. With the objective of avoiding deflation and to further support the recovery from deep recession, the Fed took further actions in subsequent years with large-scale bond purchases to exert downward pressure on long-term interest rates. As of June 2014, this latter policy had increased the total of excess reserves to $2.6 trillion, and they currently stand around $2.3 trillion (a far cry from $5 billion in 2007).

Investment Outlook – Cloudy Near Term, Clearing on the Horizon

By opening the monetary spigots, the Fed and other central banks have succeeded in inflating asset prices. In the process, they have forced savers to move funds from risk-free savings to investments that provide some manner of income or growth, with commensurate risk. Further, with fears of deflation and with the objective of avoiding another recession, the Fed has come to the rescue of investors each time the markets get the jitters, taking actions that have not allowed stocks to decline more than 10%. These historically abnormal actions, which investors may now perceive as "the new normal", may have inadvertently made investors complacent, which is negative from the perspective of investor sentiment and market psychology.

While there are no shortage of risks, one of our primary market concerns is the lack of liquidity in both the bond and stock markets (liquidity is the ability to buy or sell assets without moving prices). As stock indices have risen to record levels in the past six years, they have done so with the volume of shares traded being below historical averages. Of more concern is the bond market, where regulatory changes (Dodd-Frank) have resulted in less capital being allocated to bank and institutional trading desks, to the detriment of the markets ability to handle trading in larger amounts without prices being moved by sizable buyers or sellers. The bottom line – We can easily visualize a scenario where interest rates begin to rise and bond prices weaken and, as investors react by putting more bonds for sale, values nosedive due to the lack of bond liquidity, and the selling then cascades to stocks (not unlike 1987 when stocks rose sharply for eight months, then declined in massive selling, even though the economy was doing fine, or 1994 when the Fed raised rates even more than they expected).

In sum, while we continue to view stocks as attractive long term investments, with valuations on the high end and investor sentiment quite complacent, markets are quite likely to experience episodes with air pockets in the weeks and months ahead, with investor fortitude being tested as asset prices get reset to more historical norms.

Lincoln Capital - Our Investment Philosophy and Strategy

As a wealth management firm, we work with clients from a personal planning perspective, and we utilize the spectrum of marketable securities for portfolio management, including individual bonds and stocks, mutual and exchange traded funds (both active and passive), as well as specialized securities such as REITs. High quality, personalized service in a cost efficient manner is an integral part of our value proposition.

Common Stock Portfolio Management – A Distinctive Approach for Income and Growth

Our portfolio management strategies are based on fundamental research with a focus on four related areas - monetary policy, economic activity, security valuation, and investor sentiment or psychology. While we diversify assets into various classes of investments (bonds, real estate, stocks), we view the ownership of well managed and leading businesses (common stocks) as the best asset class for income, growth of income, and capital appreciation. Our stock selections are made from the perspective of a long term investor in operating businesses, which is quite different than a speculator's view of stocks as short term vehicles for trading.

While we invest in stocks with an extended time horizon, we make appropriate changes where warranted. Importantly, we do not believe that markets are truly efficient as human emotions, primarily greed and fear, periodically present both opportunities and traps that are often difficult to identify. In this regard, research processes that focus on trading data of markets, sectors, and individual securities (technical analysis) complement their fundamental counterparts, and are useful tools and inputs. The summation of our research efforts result in portfolio strategies that consider general economic and financial market factors, and weigh the risk and reward factors of each individual security.