Investment Tally & Perspective

2014 Half Time – Economic and Financial Market Assessment

This month marks the five year anniversary of the recession ending and the beginning of the economic recovery and expansion. In recent months, it finally appears as if the rate of growth in the U.S. economy is on an upward trajectory after several years of below average growth. During this period, consumers, businesses, and many municipal entities made significant progress in strengthening their balance sheets, unlike the federal government and our central bank (the Fed) where liabilities have grown by trillions of dollars. Liquidity from the Fed (money printing) has been the dominant driver behind upward market momentum. Though the owners of assets welcome Fed support, central bank manipulation that results in artificially low interest rates also produces serious misallocations of capital as a side effect, with negative repercussions over time.

This background, combined with several significant geopolitical issues, produce a recipe that will likely test the ability of assets to maintain their elevated price levels. The following bullet points provide a summary view of notable economic and financial market factors that will affect investment strategy and performance in the months and years ahead.

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MAJOR INDUSTRIALIZED COUNTRIES

	2014 Est. GDP	Unemployment	Consumer Prices	Budget Balance (as % of GDP)	Int. Rate 10-Yr Gov't
Britain	3.1%	6.6%	1.7%	-4.9%	2.92%
Canada	2.3%	7.0%	1.9%	-2.6%	2.32%
France	0.7%	10.1%	0.8%	**-3.9%**	**1.64%**
Germany	2.1%	6.7%	1.0%	**0.5%**	**1.29%**
Italy	0.2%	13.0%	0.5%	**-3.0%**	**2.91%**
Japan	1.5%	3.5%	2.7%	-8.0%	0.56%
Spain	1.0%	25.1%	0.1%	**-5.8%**	**2.67%**
Switzerland	2.0%	3.2%	0.2%	0.3%	0.71%
United States	2.1%	6.3%	1.9%	-2.8%	2.63%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, , 2014

MARKET INDEX RETURNS

Fixed Income	2nd Qtr. 2014	1 Year	3 Year	5 Year
Citi Treasury Bill 3 Month	0.01%	0.04%	0.05%	0.08%
Barclays US Aggregate Bond Index	2.04%	4.37%	3.66%	4.85%
Barclays Global Aggregate Bond Ex US	2.72%	9.42%	1.75%	4.37%
Stock Indices				
S&P 500	5.23%	24.61%	16.58%	18.83%
Dow Jones Industrial Average	2.83%	15.56%	13.57%	17.83%
NASDAQ Composite	5.31%	31.17%	18.18%	20.50%
MSCI EAFE Index	4.09%	23.57%	8.10%	11.77%
MSCI Emerging Markets	6.60%	14.31%	-.39%	9.24%
Other				
Bloomberg Commodity Index	.08%	8.21%	-5.17%	1.99%
S&P GSCI Precious Metal Index	3.35%	7.62%	-6.44%	6.78%

*Data obtained from Morningstar; period ending 6/30/2014

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

Lincoln Capital - Market Observations and Considerations – July 1, 2014

The Economy

- Second half growth will likely accelerate to 3% or more, which compares favorably to an average growth rate of 2.2% since the recovery began five years ago.

- Inflation – Prices throughout the petroleum complex have risen in recent months and, while nothing moves in a straight line, we expect higher energy prices as growth accelerates, and as geopolitical issues and tensions impact supplies. In the precious metals area, the price of gold and silver were up 10% and 8.7%, respectively, in the first half of 2014. We expect energy and precious metals prices to move higher as inflation pressures become a headache for the Fed.

- Income inequality is a real and concerning issue; simply stated the benefits from the economic recovery have largely accrued to the owners of assets (stocks, bonds, real estate, art), while wage increases have been minor, and those of lesser means continue to have difficulty paying the daily bills.

- The Dollar – While the U.S. currency remains in demand as international investors seek safety and higher returns compared to their own domestic bond yields, we are watching the dollar closely as it may move considerably lower, which would surprise global investors and bring significant repercussions.

Monetary Policy and Interest Rates

- The Zero Interest Rate Policy (ZIRP) adopted by central banks in the 2008-2009 financial crisis, has succeeded in lifting asset prices (bonds, stocks, real estate, art) and avoiding deflation.

- While ZIRP may have been effective during the deep recession, central bank manipulation of assets and interest rates for the past six years continues to cause market distortions and misallocation of capital, a result of asset prices and interest rates being artificial.

- Interest Rates – One major surprise in 2014 was the first half decline in interest rates with the 10 year U.S. Treasury bond rate moving from 3% at the end of 2013 to below 2.5% in recent months (presently 2.5%-2.6%).

- Outlook: For the second half 2014, we give equal odds to the 10 year bond yield reaching 2% or 3% before the end of the year. Our longer term expectation (2015+) is for higher rates (3.5%-4.5%), as inflation causes investors to demand higher returns.

- The Fed's ability to normalize monetary policy without major, unintended consequences that roil economies and financial markets remains an open question. Inflation pressures (energy, commodities, rents) may complicate their plans for continued suppression of interest rates.

Geopolitical and Washington Issues

- Turmoil and conflicts in several countries (Ukraine, Iraq, Syria, Israel, Pakistan, Turkey, Afghanistan) may grow from country/regional issues to conflicts with significant global effects.
- We may be witnessing a breakup of Iraq into three ethnic entities (Shiites, Sunnis, Kurds) with the support and involvement of Iran, al Qaeda, Syria and others whose interests often differ from the US and other Western democracies.
- With election campaigns heating up along with serious geopolitical issues around the globe, the months ahead will bring many events and changes that effect investment returns and portfolio management.
- Tensions between the Administration and Congress are rising as we move towards the November elections, with several issues worth noting, such as:
    - Legal efforts by House Republicans to restrain the Obama administration from bypassing Congress and using executive orders and regulations to achieve their objectives
    - Congressional hearings on IRS activities being directed against individuals and groups due to political orientation, as well as the missing emails (a la Watergate)

Investment Strategy

- Liquidity from the Fed (money printing) has been the dominant market driver.
- The Fed continues to buy bonds to pressure interest rates lower and they continue to publicly promise to keep short term interest rates low for an extended period of time.
- How long asset prices remain elevated remains an open question, as artificially low interest rates will lead to serious misallocations of capital in the economy.
- Following exceptionally strong returns in 2013, stock indices ended the first half of 2014 with positive returns that, while in single digits, exceeded expectations.
- As inflation pressures continue to increase, stocks provide shareholders the potential to offset rising inflation, as underlying companies can raise prices (bonds, in general, do not have the same capability).
- Today's elevated prices make stocks less attractive when compared to depressed prices five to six years ago, yet the risk/reward ratio for stocks still appears superior versus alternatives.
- While stock indices have reached new high levels, the actual number of individual stocks reaching new highs has been declining.
- In the five years since the market bottomed in 2009, stocks have experienced 12 corrections of 5% or more and, looking forward, investors are well advised to expect further periodic pullbacks; holding ample cash for buying opportunities is advisable.
- We encourage clients to reduce short term expectations and share our focus on positioning portfolios for competitive returns over a three to five year basis (2017-2019).