Fourth Quarter Outlook 2014

I|S|G
Investment Security Group, inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

"If the brain is the most important organ for successful investing, the stomach may well be the second and judgment can easily be distorted by fear and emotions."

Chris Davis - Investor

Market Recap

Global equity markets were broadly challenged last quarter, with many regions posting negative returns. In the U.S., large-cap stocks experienced small gains as a group while small-cap stocks declined sharply. Since smaller sized companies are generally more sensitive to current economic conditions, it appears that U.S. investors chose to take some risk off the table while waiting for greater conviction on economic growth and the Federal Reserve's interest rate policies. Our strategy has been for some time to tactically underweight U.S. small-cap so recent market performance has generally been beneficial to ISG clients.

With the continuing financial struggles of the Eurozone and geopolitical unrest in Russia/Ukraine, Iraq/Syria, and Israel/Palestine, international equities' markets were hard pressed for gains. On the bright side, both China and India posted advances despite continued concerns around the slowdown in Chinese growth and its impact on the Asian region plus other emerging markets whose exports are dependent on China's need for goods. Japan's struggle with economic reforms to invigorate their economy is impacting the economic performance of other Asian countries. A strengthening dollar relative to other currencies was also a contributor to declines in both the developed international and emerging markets as a stronger dollar reduces returns on foreign currency denominated investments.

Bond strategists have been proven wrong thus far in 2014 as most predicted interest rates to climb. But geopolitical tensions and uncertainty over central banks' money policies has led to declining yields for most of the year. U.S. bonds outperformed their international counterparts in the third quarter with the Vanguard Total Bond Market Index up 4% year to date. Muni bonds continue to see strong demand but High Yield bonds have experienced some selling pressure as investors anticipate higher rates down the road.

Returns for most alternative asset categories were negative. Master-limited-partnerships (MLP's) performed well despite the decline in energy prices and have been the top performer in the alternative space year to date. REIT's were down about 3% but continue to be double digit positive for the year.

U.S. Outlook

After more than 5 years of GDP growth since the end of the Great Recession, conditions appear to be returning to something closer to norm. This is reflected in the Federal Reserve's recent announcement that it would end the bond-buying program, Quantitative Easing, in October. Under the plan, the Fed will purchase $15 billion of mortgage and Treasury bonds this month and then stop the purchases. Guidance from the Fed continues to indicate that short-term interest rates will remain near zero for a "considerable time" after the program is discontinued. Projections from Fed officials indicate they expect the federal funds rate, their benchmark short-term rate, to move from its current rate of 0.25% to between 1.25% and 1.50% in late 2015.

The average age of private-sector plants and equipment is pushing 22 years – the oldest since 1958. At some point, companies need to replace these aging assets and it appears that process has started. Business fixed investment spending looks strong going into fourth quarter. Combine that with the increase seen in energy production and we should experience a big lift to the overall economy.

On balance, housing data has been disappointing. Existing home sales have stalled in recent months and the months' supply of new homes has returned to its historical norm. Multi-family housing continues to be the primary growth driver. This may be attributed to the

News Notes

260 clients attended the ISG annual event and dinner held on September 20th at the Inverness Hotel and Conference Center. Our guest speaker, Kelly J. Brough, President and CEO of the Denver Metro Chamber of Commerce, spoke about issues affecting Denver and surrounding areas. Partner Mitch Powers shared ISG's views on the economy and investment outlook moving forward.

Thank you to all who joined us.
Copies of the slides are available upon request.

higher student debt burdens of hope-to-be home buyers and still tight mortgage conditions. In addition, a lack of overall real wage growth isn't helping housing momentum.

The outlook for increased inflation has turned benign given the accelerated decline in oil prices thru October. Although energy prices have played a key role in moderating headline inflation, the absence of any significant wage growth is a fundamental factor in stabilizing inflation. The increase in hourly wages since 2007 is negligible and median household income is still well below where it was in 2007. In this environment, we can expect the Fed to remain dovish and core bond interest rates are unlikely to move up sharply.

The job picture remains cloudy. Payroll jobs were up in September and have averaged over 224,000 per month for the past 3 months. The unemployment rate has fallen to 5.9%. However, the labor force participation rate has now fallen to 62.7%, the lowest it's been since the mid 1970s. If only 63% of our workforce is employed, then 37% is not working. It's a good assumption that the 37% not working are also not purchasing homes, cars, vacations or making other major expenditures that contribute to the growth of our economy. Almost 70% of our economy is derived from consumer spending so many economists think that, without a significant increase in the labor participation rate, the U.S. economy will continue to struggle to get back to pre-Great Recession growth rates.

The make-up of our work force is also changing dramatically due to technology advancements in such areas as process automation, advance robots, drones, artificial intelligence and other technologies that are replacing humans in the work place. A recent study by the Federal Reserve Bank of Dallas found that middle-skill level jobs have been in decline for 20 years. This decline has intensified in the last 10 years to the point that many analysts are concerned about the long term prosperity of the middle class. Meanwhile, highly-skilled labor shortages exist in such areas as manufacturing, transportation services, and technology. Unemployment among college graduates has hovered around 3% and 23% of small businesses have at least one position they cannot fill. We've not included the demographic or "grey hairs" challenge facing most economies going forward. We'll save that for another time.

Despite these and other challenges the U.S. economy continues to gain strength. Both the manufacturing and service sectors remain in substantial expansion modes; consumers are showing signs of life heading into the holiday shopping season with more money in their pockets from falling energy prices; and there are increased signs of corporate confidence as companies shift their spending from stock buybacks to capital expenditures. Relative change continues to be positive and that should be reflected in the markets going forward.

Navigating thru Choppy Waters

Over the past couple of weeks, stock market volatility has been well above what many investors have grown accustomed to. This volatility has coincided with a "flight to safety" to US Treasuries. Many factors contributed to this volatility to include: weaker economic growth in Europe; fears of an Ebola outbreak on U.S. land; and war in Iraq and Syria. In addition, many investors have been anticipating a correction (10% or greater) in the U.S. stock market since it has not experienced one in 3 years. These are all valid areas of concern but do not warrant reason to abandon the market. The factors that have supported the run-up over the current 5 year period remain in place. All indications are that the U.S. economy will continue to expand at a slow pace and provide good opportunity for domestic based companies. This translates into strong earnings and favorable stock prices.

As Liz Ann Sonders, Schwab's chief investment officer, frequently reminds us, investing should be a process over time – never about a moment in time. Markets react daily to uncertainties like geopolitical tensions and economic struggles. Pullbacks are a natural condition of the markets. Diversification through allocation of assets to various categories, with an eye on risk relative to reward scenarios, allows us to navigate thru these uncertainties. We will continue to stay focused and disciplined in our stewardship of your assets. And as always, we appreciate the trust you place in us.

Social Security Changes coming in 2015

1) Bigger payments – Recipients will receive a 1.7% cost-of – living adjustment in January 2015. Payments are adjusted each year to keep up with inflation as measured by the Consumer Price Index.

2) Increased earnings limits – Beneficiaries that are under age 66 can earn as much as $15,720 in 2015 before $1 in benefits will be withheld for every $2 earned above the limit. Retirees turning 66 in 2015 can earn up to $41,880 before every $3 earned above the limit will result in $1 being withheld. There is no earnings limit once a retiree turns age 66.

3) Maximum benefit increases – For a worker signing up at full retirement age, the maximum monthly benefit will increase to $2,663 monthly.

4) Increase in maximum taxable earnings – Maximum taxable earnings will increase to $118,500.

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