Second Quarter Outlook 2014

I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

"It's always wise to look ahead, but difficult to look further than you can see."

Winston Churchill

In the Rearview Mirror

Global markets experienced a volatile first quarter amidst continued slow economic growth in the United States and Europe, a change of leadership at the Federal Reserve, slowing growth in China as their government manages a credit bubble, and Russia's annexation of Crimea.

Severe winter weather depressed some of the short-term indicators of U.S. economic health but the overall picture remains one of modest but steady growth. The U.S. stock markets cooled from last year's blistering pace with large-cap stocks up 1.8% for the quarter and small-caps rising about 1%. Core bonds were among the stronger performers with the Vanguard Total Bond Market Index gaining 1.9%. Yields on the 10-year Treasury declined from 3% at the end of 2013 to 2.73% at the end of the first quarter. Even as the Fed continued its tapering, bonds benefitted from their safe-haven status in the midst of geopolitical tensions in Ukraine as well as concerns over economic slowdown in many emerging market countries.

Stocks in developed international markets were flat for the quarter, primarily due to a significant decline in Japanese equities, where a new sales tax is creating more uncertainty in a country trying to achieve healthy inflation and sustainable growth. European markets were up against a backdrop of slow growth but still dealing with high unemployment and low inflation bordering on deflation. Emerging markets have experienced ongoing concerns about economic growth fueled by China's slowdown and the U.S. Fed's tapering. These issues led to a small first quarter loss and will continue to be a headwind going forward.

U.S. Outlook

Recent indicators on the U.S. economy are weaker than can be explained solely by our severe winter and may imply that real GDP growth for 2014 will be closer to 2% versus the 3% expected at the beginning of the year. Housing starts, auto sales, industrial production, and payroll job growth are all relatively weak for a recovering economy. And job creation continues to be a major concern.

In housing, the affects of the financial crisis and historically low long-term mortgage rates have made banks raise the bar on credit quality. The average FICO score on approved loans in 2013 was considerably higher than levels prior to the great recession. Growing income inequality and a falling birth rate may be limiting the growth in the number of new homebuyers. Demographic forces should provide a boost to housing demand beyond current supply levels but a return to a long-term historical level of housing starts may be years away.

News Notes

Please Save the Date!

Our annual client appreciation event will be held at Inverness Hotel & Conference Center on Saturday, September 20th. Please note, it will be an evening affair this year. Details will be forthcoming.

Vehicle sales tell a similar story. Though recently reaching average sales levels, there is little evidence to support sales exceeding current levels as pent-up demand doesn't exist. Cars have simply become more reliable. Vehicles are remaining in service reliably for 10 to 15 years which is suppressing the chain of events triggering new car purchases.

This economic recovery also appears to be benefiting wealthier households more than the general population. According to Census Bureau data, the real income of the average household rose by just 0.4% between 2010 and 2012. The real income of the top 5% climbed by 5.2% during this same period. From a demand perspective, this disparity does pose economic risk since upper income households have a smaller average propensity to consume than the general population. Growing inequality in an economy trying to expand may be stifling demand.

Manufacturing production has improved but is still weak relative to "normal". Inventory build up over the last couple quarters has resulted in $52 billion in

manufacturing and trade stockpiles, well above trend. It's estimated that getting inventory accumulation back to normal pace across the economy will cost U.S. real GDP growth 0.6%. Over the past three years, productivity in the non-farm business sector has risen an anemic 1% per year.

Jobs continue to be a primary focus for the Fed and labor markets continue to improve with the unemployment rate hovering at 6.7%. But the Fed is concerned about elevated longer-term unemployment. The labor participation rate continues to be under 63% which means that 37% of those available for work are not working. This factor has a direct bearing on lack of consumer spending which drives 70% of our economy. A wave of retirements in recent years among baby boomers has been the biggest contributor to the labor force participation rate fall off. Finding solutions to this problem will continue to be challenging without significant game changers that alter the economic equation.

On the positive side, there are several reasons to feel that stronger growth lies ahead. Substantial gains in net worth over the past couple of years should continue to bolster consumer spending. And pent-up demand for both consumer and capital goods, a modest acceleration in global growth, continued easy monetary policies, and less government austerity or intervention should boost GDP growth for the balance of 2014.

Across the Ponds

European leadership continues to" talk the talk" but has yet to fully "walk the walk". Growth in the eurozone is still not strong enough to generate inflation and, in fact, a prolonged period of low inflation is predicted by the European Central Bank (ECB). Some experts are concerned that the eurozone will enter a Japan like period of deflation. So far, inflation is still in positive territory, and inflation expectations have recently rebounded. But the ECB forecasts thru 2016 are for inflation targets under 1.8%. It is highly likely that the ECB will initiate a program similar to the QE (quantitative easing) program in the U.S. but multi-country laws and logistics will create some difficulties in executing such an initiative. The eurozone's recovery should continue at a sluggish pace despite economic challenges and geopolitical risks. Remember, as investors we are buying stocks in companies not countries. Prospects for improved corporate profit margins are good so we remain positive on European stocks.

China's slowdown from a 10% GDP to a 6-7% GDP economy has been felt worldwide. However, concerns about the potential of China having a "Lehman moment" need to be put into proper perspective. China's current situation is in no way similar to that of the U.S. in the pre-Lehman days. One major difference is that China is an over-saver, with domestic savings of approximately 50% of GDP. This translates into $4.5 trillion annually of new savings. Since China's equity markets are relatively immature, this savings pool gets put to work thru issuance of debt instruments. China is also in a current account surplus position (net exporter) and not reliant on foreign capital for growth, much unlike our reliance on foreign creditors to help meet financial obligations. In China, a majority of bank assets are government controlled; money in and out of the country is restricted thru closed capital accounts; and China has over $3.8 trillion and growing in foreign exchange reserves to fight any liquidity crisis that may arise. The level of household debt is very low which also adds to their resiliency in a liquidity crisis. Imbalances in China's economy do exist, been built in large part by heavy governmental influence. Therefore, it will take structural reforms and slower growth to repair. And their recent property market slowdown deserves close monitoring as it could have repercussions for their overall economy. Bottom line is that China's economy will continue to decelerate as their property market cools and credit growth declines. Their economy, and banks in particular, can withstand this downturn so no hard landing is anticipated. The question to investors is whether markets have overreacted to these near-term slow growth concerns. With Chinese stocks down more than 50% from their 2007 highs and trading at 6.8 times forward earnings, chances are the answer is yes.

Emerging market economies tend to be negatively affected by any China slowdown because of their dependence on China for commodity and consumer good demand. However, while China's industrial commodities demand is expected to grow at a slower rate, not all emerging markets will be affected to the same extent. For example, China's agricultural products and consumer goods imports could still increase at higher levels as rising personal income continues to create more demand for grains and soybeans. This demand could benefit selected Latin American countries with surging exports to China. A rise in middle class China would also generate a demand for consumer electronics and other discretionary items. Scenarios like these lead us to active management of emerging markets as investors must be selective in their emerging market positions.

Investment Initiatives

As we've discussed before, the markets react to uncertainty and relative change. For example, relative to the U.S. economy, the question isn't whether growth is as strong as we'd like or expected, but is it strong enough to move the unemployment rate lower, push wage inflation up, and sustain growth in earnings. When looked at in that context, a 2% growth scenario should help earnings continue to rise, reduce wage pressures, and lower unemployment. U.S. equities are trading close to 25 year earnings averages. They are not cheap in absolute terms but remain attractive relative to cash and fixed income alternatives. Europe continues to have de-leveraging issues but substantial progress has been made. European equities continue to be undervalued and provide solid long-term opportunities. China and other emerging markets are currently facing some headwinds so we have recently reduced our direct exposure to emerging markets' equities. Long term, emerging markets should provide value so we've stayed involved by repositioning assets to global funds.

Our core strategy for defensive assets continues to be one of capital preservation first, income second, and growth of principal third. We continue to anticipate a rising interest rate environment and will continue to do due diligence on asset categories that provide performance similar to or better than bonds with comparable risk characteristics. For many of you, our search has resulted in investments in non-traded REITS, a Business Development Company specializing in loans to private mid-America companies, and event related bonds thru the reinsurance marketplace. Each of these positions was selected for their lack of correlation to stocks and bonds, relatively low risk/volatility characteristics, and stable performance. Efforts to find additional asset categories that fit our criteria will continue.

It's been five years of recovery from the worst financial crisis since the Great Depression. Most of you weathered the storm with us, and for that, you have our deep appreciation. For all of our clients, we take stewardship of your assets very seriously and thank you for the trust you have placed in us.

Client Spending Regimes: A Time to Re-examine?

For years, it has been standard operating procedure for practitioners to build annual spending increases into their long range estimates of client spending requirements during retirement. Typically, planners have applied an annual cost of living adjustment(2%-3%) to an initial target spending level which at first glance seems benign but over an extended projection period results in large spending increases. For example, a 65 year old starting out with a $50,000 spending target who increases that spending at 3 percent a year will be theoretically spending slightly over double that amount ($104,688) by age 90. Whether or not these spending increases fit with reality is an important issue for planners and clients to tackle as it has major ramifications on the investment strategy and associated "hurdle rate" needed to meet the estimated spending regime.

Planners today find themselves in a potential quandary. On the one hand, they don't want to short change their clients' lifestyles in the first half of retirement due to heavy spending projected in the second half. Yet, they also don't want to see their clients outliving their assets and typically default to a more conservative route, citing the uncertainties of future health care expenses and the "funny money" syndrome of steady, long-term inflation (" I paid as much for my car yesterday as my mom and dad paid for their first house!).

Fortunately, as better data on "lifecycle spending" is gathered, better strategies can be developed. In a study done by J.P. Morgan which tracked long term spending data from 1.5 million households, spending increased 15% instead of doubling over the 25 year period from age 65 to 90. As predicted, health care spending went up over time, but spending on most all other categories declined enough to restrain overall spending increases over time.

The bottom line is that spending in retirement isn't constant- the mix of categories will shift over time and overall spending will likely decline in most categories except health care. As the financial planning industry continues to mature, more realistic assumptions about spending and inflation along with careful monitoring will lead to even better plans and more successful outcomes.