CitizensTrust™ A Division of Citizens Business Bank

Investment Outlook

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The Fed and the Moving Goalposts

It's fall so the football analogies will run rampant in this quarter's note, with the Fed acting like Lucy in the famous Charlie Brown comic strip, pulling the proverbial football out from under the market (a.k.a. Charlie Brown). After proclaiming during 2014 and 2015 that they would be raising rates multiple times in 2015, the Fed pulled the ball out from under the market and punted on raising rates yet again. As we'll discuss later in the note, the goalposts for the Fed have been constantly shifting, and their yanking of the ball is just one more hesitation by the once revered central bank.

Equity Markets

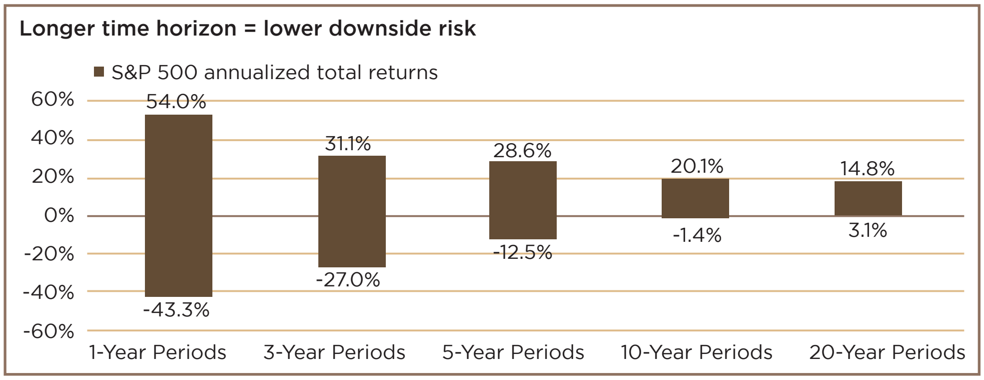
After six-plus years of steadily rising markets with relatively low volatility, we finally experienced a true correction this quarter with the S&P 500 falling 10% from its all-time high set on May 20 falling to 1920, and it is now down 5.3% for the year. That low remains 5.5% above last fall's correction low of 1820 set in October 2014, but still was enough to create significant angst among investors as volatility spiked to levels not seen in four years.

What caused the correction? Well, one factor might just have been time. Typically we would anticipate at least a 5% correction to occur roughly every three months and a 20% correction every three to four years. We haven't had a 20% correction since this bull market started in early 2009, making the bull a bit long in the tooth and contributing to investor complacency.

We have discussed many potential warning signs in our prior notes, many of which contributed to the recent market weakness. We feel that extended valuations, declining earnings expectations, widening credit spreads, economic weakness in China, the Fed, and continued uncertainty from Washington all have contributed to the market correction.

One item that deserves commentary is earnings growth, which we expect to be flat to slightly down for member companies of the S&P 500 index during 2015. Most of the weakness in earnings can be attributed to declines in energy company earnings stemming from collapsing oil prices combined with weaker exports to emerging markets as those economies sour. The strength of the dollar exacerbates this weakness from emerging markets as US exports become more expensive for foreign consumers as the dollar strengthens and their currencies weaken.

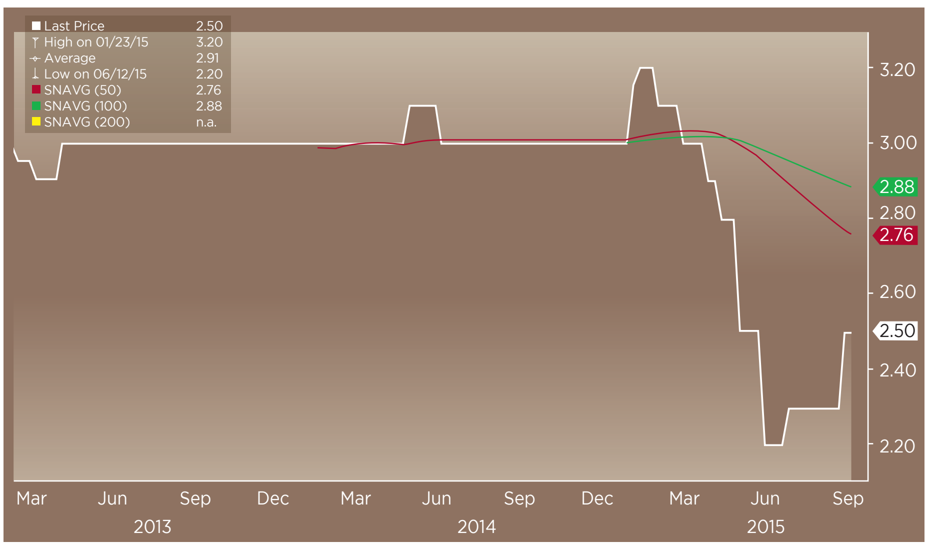
We eschew market timing and believe that time is the factor that we must use to our advantage. While equity returns for 2013 and 2014 were above average and we anticipated low or even negative returns for 2015, it still takes discipline to stay the course and buy into the market weakness when warranted. The chart to the right shows annualized return ranges for the S&P 500 over various time frames, demonstrating historically that patience has paid off for investors, dampening both volatility and the probability of negative returns over longer holding periods.



Source: the Big Picture

The Economy

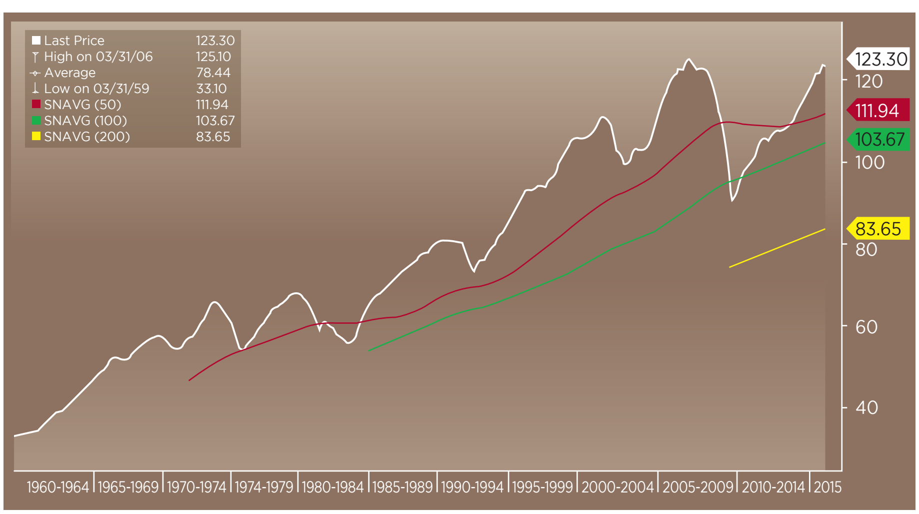
In the past we have discussed the importance of credit creation in the growth of the economy. Over the past seven years credit in the US hasn't been growing as the country de-levers after a multi-decade cycle of credit expansion.



Source: Bloomberg Finance L. P.

In periods of slow or declining credit creation, economic growth is driven by productivity gains, which are dependent upon population growth and education. Given low US population growth and, therefore, low productivity growth, combined with credit creation limitations as banks grapple with new regulatory limitations resulting from Dodd Frank legislation, the US economy is growing slowly and may continue to do so for many years. Estimates of GDP growth for this year are 2.5% (see chart to the left), but we anticipate even slower growth in the second half of 2015.

All is not horrible in the economy as the Conference Board's index of Leading Economic Indicators (LEI) has increased over the past six years. While the indicator is designed to forecast future economic activity, it also has the dubious distinction of peaking right before recessions. As can be seen in the chart to the left, the indicator is near all-time peak levels once again, and comparable to levels observed in March 2000 and March 2006.

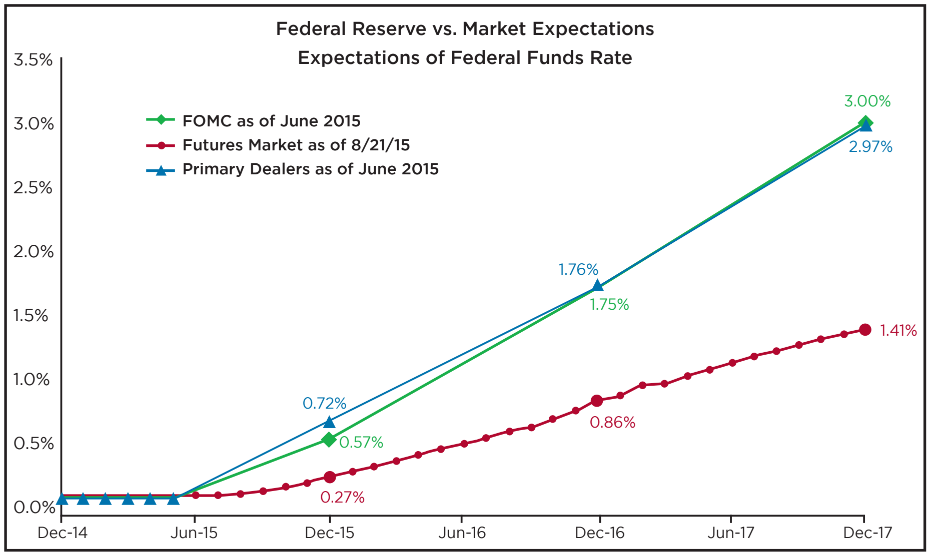


Source: Bloomberg Finance L. P.

Other areas of economic strength include housing, which is being driven by stubbornly low interest rates, and auto sales, which are also benefitting from low rates and somewhat easier credit terms for sub-prime borrowers.

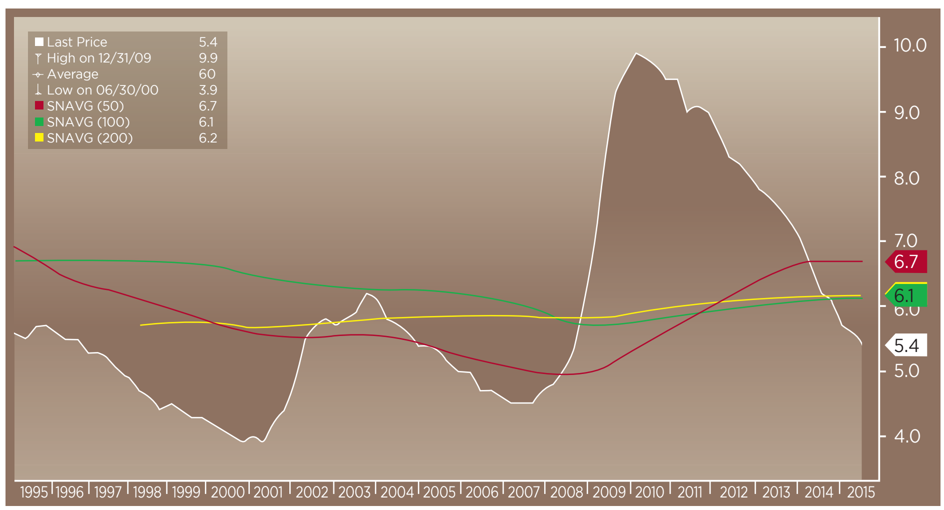
The Fed and Fixed Income

In spite of economic weakness, the Fed has been talking tough for the past two years. Signaling from the Fed is as important as their actions, and the signals from the Janet Yellen-led Fed have been hawkish while the actions have remained dovish. After making unusually direct comments about raising rates, including Chairwoman Yellen specifically stating they would raise rates, the Fed confused and scared the markets by not taking any action at the September meeting. Some in the market took this as a sign the economy is weaker than expected.



Source: Bloomberg Finance L.P.

Others were concerned about the dollar becoming too strong in the face of weaker global economies. We fall into a third camp, which is that the Fed is petrified to make a move because of uncertainty about the impact. While we didn't anticipate any major impact on the economy because of a Fed increase, we don't believe an increase is justified at this point in the cycle. The chart (above) shows the difference in rate expectations between the Fed and the market, with the Fed's expectations in green and the market expectations in red. The market doesn't anticipate rates to move much over the next two years, whereas the Fed continues to talk up their game, but until they figure out how to get the ball over the goal line, we'll keep our views closer to those in the market.



Source: Bloomberg Finance L. P.

While the Fed has two official mandates, to control inflation and maintain full employment, they obviously have assumed a larger mandate given their statements in September. Unemployment remains low enough at 5.1% to justify higher rates (see Bloomberg chart above), but inflation remains weak. Typically the Fed's goal is to keep inflation low, but in this environment they are pushing for higher inflation in an effort to stimulate the economy. Raising rates would strengthen the dollar, which would put more downward pressure on inflation.

Straying a bit from their mandate, the Fed commented about their concerns regarding the weakness in China. Many observers felt that the Fed was concerned about weaker demand by China for US goods; however, given the extremely small contribution of Chinese exports to US GDP, we viewed it as a concern that weakness in China would cause the country to sell US treasuries. Recall that China holds roughly $1.7 trillion in US treasury bonds and, were they to sell it, could cause unwelcome rate increases along the yield curve that would have a braking effect on the US economy. The Fed primarily controls the short-term rates, which have some impact on longer term rates but it is not significant. If rates along the curve were to rise, whether from selling pressure from China or another cause, it would have a much more immediate impact on those areas of the economy we cited as being strong: autos and housing. That logic is what we call second derivative thinking and we may be too generous in thinking the Fed thinks that broadly.

Politics as Usual?

While we periodically comment on political activity when it is relevant to the economy or our investment outlook, we typically attempt to avoid this third rail of America. Given the recent development in Washington that saw Speaker of the House John Boehner resign both his Speaker position and also announce he was leaving Congress before his term expired, we felt it necessary to provide our two cents. First, Mr. Boehner was thrust into a difficult position between two extreme groups: the very conservative Tea Party members of Congress and the very liberal White House. The Speaker has been heavily criticized by both sides and, while we won't be able to judge how effective he was in the role until time passes and we can view his leadership in a historical context, it was certainly an unenviable position. Without taking a position in the political debate, it is our view that the Tea Party is trying to win the battle but, in the process, could lose the war for the Republicans if they are successful. Their efforts to shut down the government, defund HCA, etc., are certainly the mandates they were sent to Washington to achieve by their constituents; however, just prior to a close election we feel the negative branding of the party will create pressure on the eventual Republican nominee for the Presidency, an anchor which may be difficult to overcome.

Either way the election turns out, a government shutdown would be psychologically damaging to the markets, especially given the loss of confidence in the Fed.

Oil is Good for the Environment?

How about this for a controversial statement. Oil is good for the environment, could solve world hunger, and will save the global fish population.

Researchers at the Societe Francaise des Petroles have been testing a method of growing high grade protein produced by microorganisms that feed on petroleum hydrocarbons. How significant is this? Consider they estimate a yield of 20 million tons of pure protein from 40 million tons of petroleum, roughly 2% of current production. Is this relevant? The global fishing catch is 20 million tons annually yet only yields 6 million tons of pure protein. These numbers suggest that the petroleum-derived protein could dwarf that derived from seafood and possibly provide protein-based diets to a much larger percentage of the global population.

In other words, we can find a use for all the excess oil being drilled right now, solve world hunger, and save the fish. Sounds like a win-win to us.

CitizensTrust Focus

2015 is proving to be a volatile year and, as we discussed in our Q4 2014 Outlook, more than likely a year of subpar returns. We continue to focus on the longer term outlook, adjusting our game plan slightly as market conditions warrant. While some of our competitors start their analysis with a return target, we begin ours with a risk focus, attempting to structure portfolios that have acceptable levels of risk for our clients. You will notice modest recent adjustments in portfolios to take advantage of mispricing in assets we feel have long-term value as well as tax-advantaged adjustments for those clients with tax sensitivity. Our job is not to change the game plan, just make adjustments as opportunities arise.

As always, we thank you for your confidence in CitizensTrust, value our relationship with you, and look forward to speaking with you in the near future. Please feel free to contact us with any questions or concerns.

"You've got to be very careful if you don't know where you are going because you might not get there."

-Yogi Berra

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