FirstPoint Financial

WEEKLY MARKET THOUGHTS

October 27, 2014

Growth on Track

Investors are faced with a rising level of asset price volatility. Stock and other risk-based asset prices are rising and falling rapidly. This is indicative that investors are unsettled and worried about various factors. Additionally, investors are aware that U.S. stocks aren't cheap (we believe foreign stock markets are cheaper) and the Federal Reserve is ending Quantitative Easing (QE) activities. Risk-based asset prices have struggled and volatility has risen during past periods when the Fed is moving away from QE activities. ***Concerns regarding the onset of an economic contraction (recession) have risen***. ***We believe these fears to be misguided as our outlook for 2.5% - 3.0% GDP growth in 2015 stands.***

Various Current Factors Which May Impact Economic Growth

At times, the nation's economy is faced with non-normal factors, which either raise or lower overall economic growth. Today's economy is no different. The non-normal factors are present, the only difference is what the variables are, not if they exist. At the end of the day, what normally drives sustained higher prices in risk-based (stock) assets is corporate earnings. This is why investors are currently nervous about economic growth – they are worried about the sustainability of corporate profit growth rates.

Recent Questions – Growth Sustainability

While visiting with clients and wealth advisors, many of the questions I'm asked have to do with these non-normal economic factors, which have the capacity of augmenting reported corporate profit growth rates. These factors are touched on in most business publications on a regular basis. Some of the factors have the capacity of raising economic growth, while others may hamper overall growth. The table above appeared recently in the *Wall Street Journal.* ***With our weaker than normal overall economic environment, are these factors strong enough to meaningfully impact overall future economic growth and push our economy into recession?***

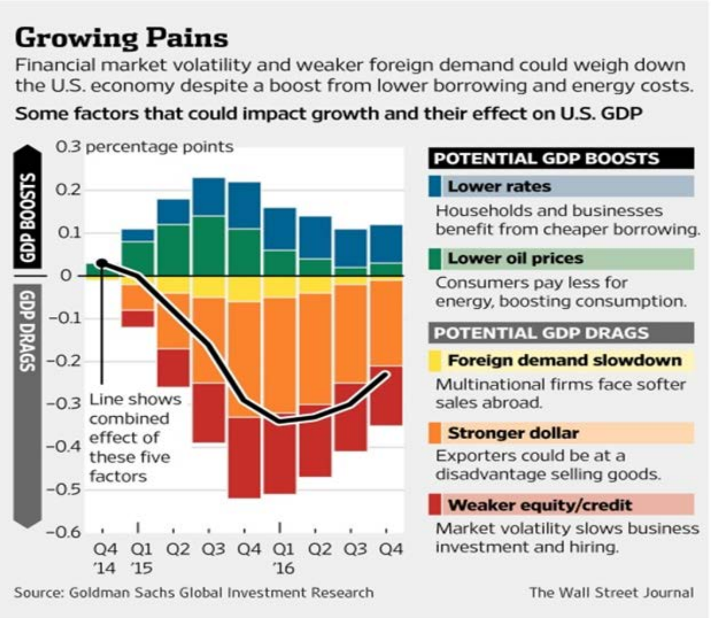
We think not.

The Five Factors

The swing factors are:

- Lower Interest Rates
- Lower Oil Prices
- Foreign Demand Slowdown
- Stronger Dollar

- Weaker Equity Markets

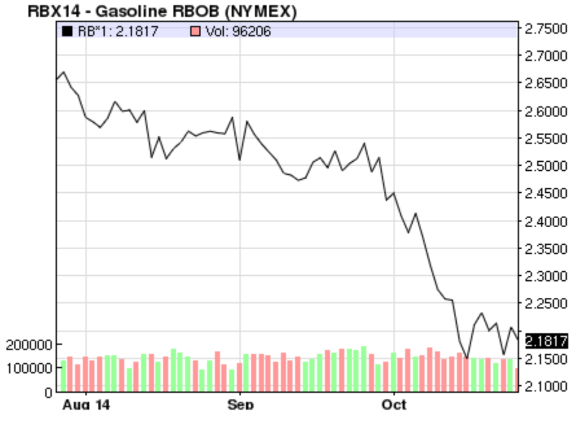


Two of these factors have the capacity of raising end-demand (and economic growth), while the other three may weaken overall short-term economic activity.

Recently, the *Wall Street Journal* published an article featuring information from Goldman Sachs' economic research department. The article outlined these five factors, which have the capacity of raising or lowering overall economic activity. A graphic from this article is included above. Two of the factors have the capacity of raising overall economic activity, while three have the potential of lowering economic growth. The heavy black line is Goldman Sachs' estimate of the net economic impact of these five factors. Below, we go into some detail as to our views of these five factors.

The Positive Factors – Additives to Growth

- **Lower interest rates.** As many are aware, interest rates (10-year Treasury bond yields) bottomed in 2012 at 1.6%. Last year, rates rose to 3.2%. Since then, due to weakening growth in Europe and other factors, interest rates have fallen back to 2.2%. 30-year mortgage rates are closely tied to 10-year Treasury rates. Of course, housing demand is closely tied to mortgage rates, which have declined by .35% this year, from 4.5% to 4.15% for 30-year mortgage financing. While this doesn't seem significant, this level of interest rate decrease would lower the monthly payment on a $300,000 mortgage by more than $1,000, an amount that is very meaningful for the average family.
- **Lower oil prices.** Oil prices have declined from a high of $104 per barrel to $81, a decline of 22%. Gasoline prices are correlated with oil prices – as oil prices rise/fall, so do gasoline prices, in a rough fashion. Gasoline prices have declined by 18% since August (see chart). According to the Washington Post, the average family spends 4% of their annual budget on gasoline. The decline in gasoline prices adds about 1% to discretionary spending power for the average U.S. family. When considering that the growth rate in discretionary spending has risen by 5.5% over



to overall economic activity.

Taken together, these two positive developments have the capacity to add nicely to overall consumer spending activity and add upwards of 0.1% to 0.2% to GDP growth over the next 12 months, per the Goldman Sachs analysis.

Economic Drags – Detriments to Growth

- **Foreign Demand Slowdown -**
  The U.S. exports $327 billion of goods to Europe and $122 billion of products to China. These two areas, as mentioned above, are the prime focus of investors' anxiety about slowing overall economic growth. If a cataclysmic economic slowdown were to occur, the U.S. may lose exports to these parts of the world. However, frankly, the numbers are so small, representing less than 0.1% of overall economic activity in the U.S.
- **Stronger Dollar -**
  The U.S. dollar has been very strong in relation to most foreign currencies over the last 6-9 months. As the dollar strengthens, it makes our exports less competitive to like-products from foreign manufacturers. This may represent a large drag on economic activity, as estimates suggest that this may cost the country between 0.2% and 0.3% in overall economic growth over the next 12-months.
- **Weaker Stock Markets** -
  Why would weaker stock markets have some type of impact on overall economic activity? Well, for a number of reasons – among which the "wealth effect" may be the most important. As people's wealth rises and falls with stock prices, eventually a significant trend in stock values (be it up or down) tends to have an impact on consumption patterns. While the folks at Goldman Sachs believe the stock markets have declined enough to risk some type of pullback in consumption patterns, I believe those numbers to be far too pessimistic at this stage.

Putting it in Perspective

Looking at these five factors leads me to the conclusion that these factors may, indeed, affect the level of demand, and, more importantly, corporate profit growth rates, which could slow real GDP growth by between -0.1% and -0.3%. Real GDP growth rates in the U.S. have been +2.7%, even including the odd -2.0% growth in the first quarter of this year.

If the factors mentioned above affect GDP growth by the suggested -0.1% and -0.3%, GDP growth should still register in the +2.5% range – a level that would normally support higher earnings growth.

In other words, I believe U.S. investors are focusing on a potential economic growth slowdown that may not actually take place. Of course, if I am correct, reported earnings would be positive. Currently, my guess is that U.S. corporate profit growth should be in the 6% - 9% range for the next 12 months, a range that has normally supported higher stock prices. ***Even with the factors mentioned above, both positive and negative, I believe that the U.S. economy is on track to grow in the 2.5% to 3.0% range for 2015.***

Regardless of corporate profits, it appears stock price volatility is going to be higher for a period than has been the case over the last couple of years.

We'll be back next week.

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