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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

January 1, 2015

Outlook & Trends

Economic and financial market conditions have shown modest improvement over the last quarter, but there are diverging influences across the globe and for the future. This issue of *Outlook & Trends* reviews the basis of today's growing complacency and several issues that could end it.

The Economy

Domestic conditions continue to remain stable or improve. GDP grew 5% in the third quarter, the best quarterly number since 2003, but full year growth remains below the 3% rate usually found during strong expansions. The recent performance is particularly welcome, since the Federal Reserve stopped its money-printing, Quantitative Easing policy. Employment continues to grow at a 2% annual rate, while unemployment dropped below 6% for the first time in over six years. The Federal Reserve reports, "contacts remained optimistic about the outlook for future economic activity" in their most recent survey of economic conditions. Increasing economic activity and slower increases in government spending (remember the "sequester"?) have kept the US budget deficit to "only" $514 billion in 2014. Annual profits increased for S&P 500 companies by 12% over the prior year. Paradoxically though, the US Bureau of Economic Analysis, the organization that computes GDP, reported that US corporate profits increased only 1.4% during the same period.

The big change during the last quarter was the price of oil. It has been cut in half since July. In sympathy, regular grade gasoline now averages $2.20 per gallon across the US and less than $2.00 in some states. This price cut is expected to help the economy even further, for it acts like a tax cut, giving consumers more money to spend on other goods. What happened? There are several factors involved in the drop. First, worldwide oil production continues to grow. Led by the new hydraulic fracturing ("fracking") technology, the US expects to produce 60% more oil today than in 2011. Secondly, the OPEC countries did not agree to cut their production at their last meeting, which accelerated the price drop. It is believed that the Saudis are defending their market share by putting pressure on marginal, higher-cost producers.

The third largest producer, after Saudi Arabia and the US, is Russia. Russia, like Venezuela and Iran, has an energy-based economy and cannot afford to cut back their production. In fact, the reduction in oil revenues has put financial stress on the Russians. CNBC reports that the ruble has lost 76% of its value since the beginning of the year. The Russians are propping up their banking system and the ruble, raising central bank interest rates to 17%, as their economy slipped into recession in November. These events remind us of the Russian financial crisis in 1998 that devalued the ruble and resulted in a Russian debt default. The default helped to bring down Long Term Capital Management, a US hedge fund, and precipitated a 20% drop in the US stock market. While history may not repeat itself, the prior incident shows how interrelated global trade and financing is, and how an unpredictable string of events can occur from a seemingly unrelated source.

The Markets

Large cap stocks continued to gain during the quarter, shaking off two sharp declines. The broader market was not as fortunate, scoring successively lower rally peaks since July. Perhaps this difference is due to the contrast in corporate profitability mentioned earlier, reflecting the "Wall Street / Main Street" divide. Nor were foreign stocks or commodities successful, both of which are clearly trending down. Additionally, investment grade bonds have out-performed lower quality bonds. Taking these together suggests the markets are losing their appetite for riskier returns and have been focusing more on quality, as we leave the effects of QE behind us.

Going forward, a case can be made for reasonable stock market performance: (1) the economy is growing, albeit still not with sustained vigor, (2) analysts believe S&P earnings will continue to rise next year, (3) Washington budget battles appear to be behind us, and corporate tax reform may be on the horizon, (4) we are entering the third year of the Presidential Cycle, which is historically the strongest year of the four, and (5) the next four months finish up the November-April period, which is typically the strongest time of the year.

As always though, the fly in the ointment continues to be valuation. Low interest rates suggest continued low returns for bonds during the next decade. Long-term stock valuations continue to be some 73% above average. Even short-term cyclical valuations, at 16 times analysts' year-ahead estimated earnings, are now above the 2007 peak, and are about 23% above average. The way we reconcile these conflicting observations is to suggest that you enjoy the trend while it lasts, but be careful to know how you will protect your investment wealth in the face of a possibly significant decline.

Be Prepared!

Speaking of knowing what to do, "Be Prepared" may be the motto of scouting, but it is also essential for success in many other aspects of life, including financial well-being. Being prepared implies taking the time to think in advance about the future, identifying how to act to promote your goals, or how to react to mitigate problems and minimize loss.

Financial planning is the process that is used to be prepared financially. It is based on identifying what you want your future to be and what you need to do. How much do you need to earn? How can you earn it? It is preparing for retirement. It is preparing to educate your children or grand children. It is understanding and executing both short and long-term actions to minimize taxes. It is preparing to effectively distribute a legacy. These are essential questions that most people would like to answer. No matter where you are in life, you will be most successful if you start now. The longer you wait, the less flexibility you will have. Your ability to take advantage of important options continually decreases with time. Many people are hesitant to prepare simply because they are not comfortable with their mastery of these topics. The good news is that you do not need to know everything about everything. You only need to know about how these issues effect you, and what plans you should put into place to be successful. Check with a fee-only financial planner like *LFM&P,* if you need help getting started or need help with a significant challenge like retirement. Be prepared!

The essence of being prepared is to increase the likelihood of realizing your desired outcome and to reduce the risk of an unfavorable result. Being prepared from an investment viewpoint is knowing what you need your investments to accomplish for you. It is knowing what approach is appropriate for your stage of life. It is knowing how much risk you can successfully carry as well as how much risk you can comfortably live with. It is being aware of the valuation risk embedded in the markets. Strong emotions usually lead investors to the wrong decisions at the wrong time. Being prepared is knowing ahead of time what actions you will take when investment markets are rising and when they are falling too. Being prepared requires frequently matching your plans against reality. Yes, it does take time, perhaps more than you would like to spend yourself. This too is where *LFM&P* can help. Be prepared!

To learn more about our client goal-centered financial planning and investment management services, please call or e-mail. We invite you to visit www.linnardfinancial.com.

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