Humming Along

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If asked to name the appliances that are the largest energy users in your home, many people could come up with the air conditioner as the number one, but number two is often surprising. According to a recent article in the Los Angeles Times, the satellite/cable tv box has become the second largest consumer of electricity in most people’s homes. These little devices are constantly working because even when the tv is off, their spinning hard drives are updating program guides and downloading the latest software, causing them to keep humming along day after day. (LATimes)

During the second quarter of 2014, the U.S. economy and the stock market have both continued this theme of humming along day after day. While not as robust as 2013, most equity indexes produced respectable gains led by the utility and energy sectors, with volatility remaining very low. Both the S&P 500 and the Dow Jones Industrial Average reached all-time highs during the quarter. This was the first time in more than 20 years that the first half of the year saw gains in stocks, bonds, and commodities.

<table>
<thead>
<tr>
<th>Index</th>
<th>2nd Qtr 2014 Return</th>
<th>1 Year Return</th>
<th>3 Year Annualized Return</th>
<th>5 Year Annualized Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>5.2%</td>
<td>24.6%</td>
<td>16.6%</td>
<td>18.8%</td>
</tr>
<tr>
<td>Dow Jones Industrial Average</td>
<td>2.8%</td>
<td>15.6%</td>
<td>13.6%</td>
<td>17.8%</td>
</tr>
<tr>
<td>Nasdaq Composite</td>
<td>5.3%</td>
<td>31.2%</td>
<td>18.2%</td>
<td>20.5%</td>
</tr>
<tr>
<td>Russell 2000 – Smaller Companies</td>
<td>2.1%</td>
<td>23.6%</td>
<td>14.6%</td>
<td>20.2%</td>
</tr>
<tr>
<td>MSCI EAFE – International</td>
<td>4.1%</td>
<td>23.6%</td>
<td>8.1%</td>
<td>11.8%</td>
</tr>
<tr>
<td>Barclays US Aggregate Bond</td>
<td>2%</td>
<td>4.4%</td>
<td>3.7%</td>
<td>4.9%</td>
</tr>
</tbody>
</table>

While 1st quarter GDP growth was actually revised even lower to show a decline of 2.9%, as the year goes on, it does appear that this was indeed caused by the harshest winter in decades and does not seem to be indicative of an economic slowdown. In fact there seems to be a pent up demand that looks poised to propel growth through the rest of the year, as we are seeing an increase in business spending, consumer confidence, as well as a reacceleration of house sales.
The biggest surprise during the quarter was that interest rates have declined – this in spite of the Fed continuing to reduce the pace of its bond buying program. The 10 year Treasury bond was yielding 2.53% at the year’s midpoint compared with 3.02% at the end of 2013.

The Fed seems to be on a pace that would end the stimulating purchases by November; and though at their most recent meeting their assessment of the economy was mostly positive, they did seem content to leave rates low for a considerable time.

Earlier we mentioned the improving consumer confidence. What follows is a chart that illustrates the impact various economic points have on consumer sentiment as well as the returns you would have received in the past when investing at the various inflection points of consumer confidence.

Inflation seems to have reversed its downward trend having ticked higher in each of the past 3 months and currently stands at 1.9%.

Gold prices have risen about 10% this year while oil is up 9.1% from this same time last year helping raise the average price of gas by an average of $.20 per gallon.

On the jobs front, the unemployment rate has continued to steadily fall and now stands at 6.1%. While this strong number does come with the caveat of lower participation and slower wage growth, the improving jobs numbers give more credence to the idea of an economy that continues to strengthen, humming along shall we say.
As you can see by the previous chart, P/E ratios have climbed in conjunction with the rise in the stock market. This chart shows a forward looking P/E, one that compares the ratio of the current price of the S&P 500 with its projected combined earnings for the next 12 months. Valuations seem to be in line with their long term averages, not yet expensive, but not necessarily cheap either. We would expect further gains for the rest of the year to be driven primarily by increased earnings rather than by seeing price multiples rise.

While the markets are achieving record high levels, quarterly profits are also hitting record levels. Even in the 1st quarter, when economic growth slowed, corporate profits continued to post solid growth. Companies today are as lean as they have ever been and though profit margins are likely to come under pressure in the coming quarters, they currently remain elevated.

Looking forward we are not currently afraid of the stock market as it is supported by reasonable valuations, strong company profits, and improving economic conditions. At the same time, very few would be surprised by a correction of some significance after the run-up of the past few years.

We remain advocates of balanced, diversified portfolios that take advantage of the indications of worldwide economic growth and low interest rates that appear to be persistent, while utilizing a defensive posture.

On the heels of soccer’s World Cup (congratulations to all of our German readers), the value of this defensive posture is summed up in an expression that I’m told is popular in Italy: “He does not win who scores one more goal, but who concedes one less.”

Thank you to our clients and best wishes for a terrific summer to all.

Sincerely,

The Castle Investment Advisors, LLC Investment Team

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