Monthly Economic & Market Update

January 2014

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Chief Investment Officer

Our mission is to provide professional wealth management services that will sustain Multi-Generational Family Wealth, Unity and Legacy.

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Important Information

Performance quoted is past performance and cannot guarantee comparable future results; current performance may be higher or lower.

Results shown assume the reinvestment of dividends.

An investment cannot be made directly in an index.

Investments with higher return potential carry greater risk for loss.

Investing in small companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Foreign securities have additional risks, including exchange rate changes, political and economic upheaval, the relative lack of information about these companies, relatively low market liquidity and the potential lack of strict financial and accounting controls and standards.

Investing in emerging markets involves greater risk than investing in more established markets such as risks relating to the relatively smaller size and lesser liquidity of these markets, high inflation rates, adverse political developments and lack of timely information.

Fluctuations in the price of gold and precious metals often dramatically affect the profitability of the companies in the gold and precious metals sector. Changes in political or economic climate for the two largest gold producers, South Africa and the former Soviet Union, may have a direct effect on the price of gold worldwide.

The views and opinions expressed are those of Endowment Wealth Management and are subject to change based on factors such as market and economic conditions. These views and opinions are not an offer to buy a particular security and should not be relied upon as investment advice. Past performance cannot guarantee comparable future results.

**"It's just a correction.
The fundamentals are still good."**

Economic data:

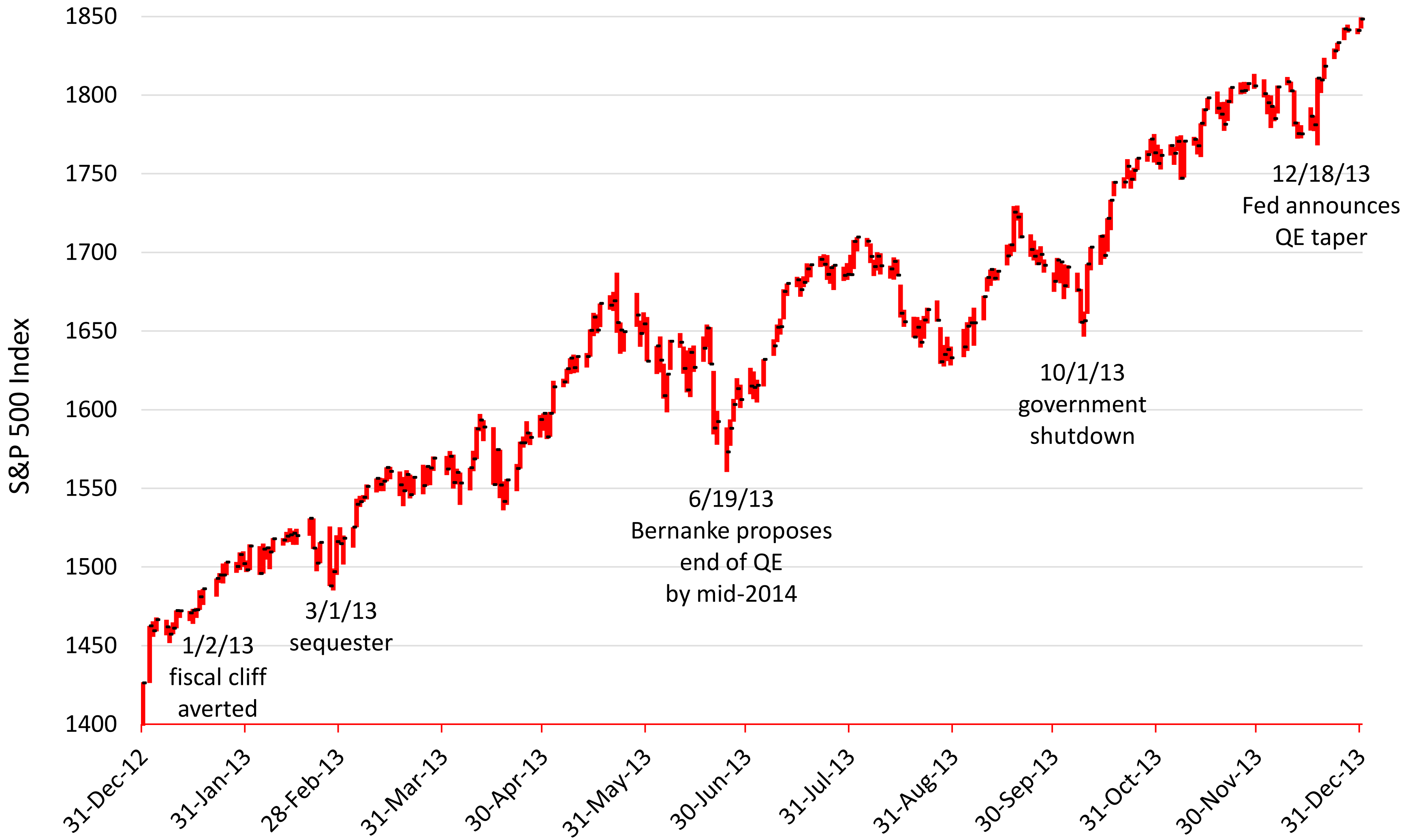
- Economists see continued economic expansion.
- Slow but steady progress on new job formation.
- Consumers' savings and liquidity have risen substantially.
- Household net worth has recovered – deleveraging is done.
- Significant skew in income, spending is relevant to economic recovery. Retail sales have come roaring back.
- The U.S. economy is positioned to continue a +2 to +2½% long-term trend rate of growth.
- Positive changes in manufacturing.
- Inflation is subdued and will probably remain so until there are signs of wage inflation – which may be a ways off.
- The CBO projects massive budget deficits if current revenue and spending policies continue.

Market data:

- Better, and better-than expected, U.S. economic news has been a catalyst for stocks.
- Stocks climbed the Wall of Worry to new highs even as consumer sentiment has remained depressed.
- Stocks are still reasonably valued on estimated earnings.
- Fed is poised to ratchet down QE.
- Total return on bonds cannot continue recent years' returns.
- Municipal bonds are attractive.

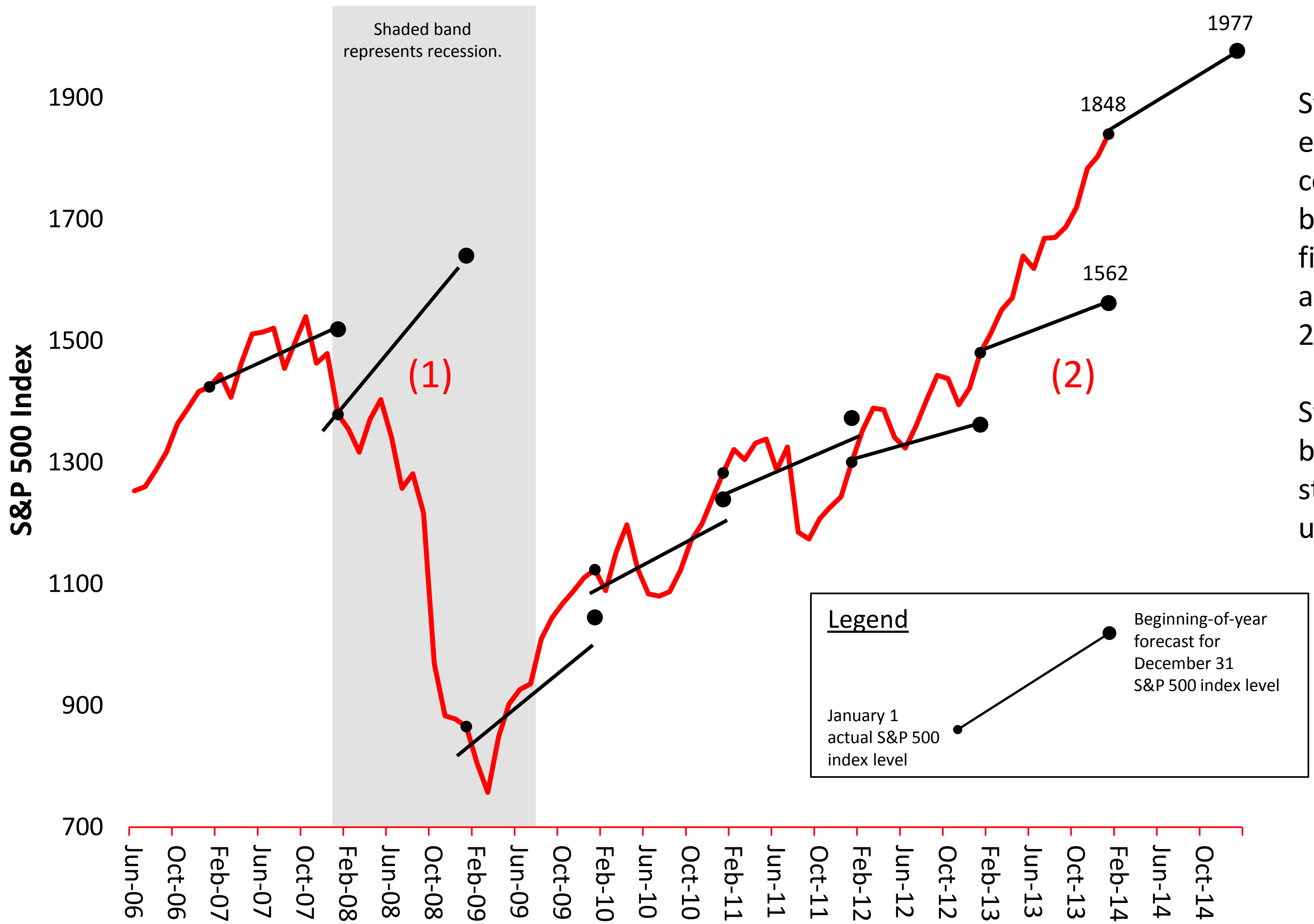
Stock Market Bubble?

2013—S&P 500 climbed the Wall of Worry to new highs



Source: Standard and Poor's. Data through December 31, 2013.

S&P 500 beginning-of-year forecasts[1] – two big misses in 8 years



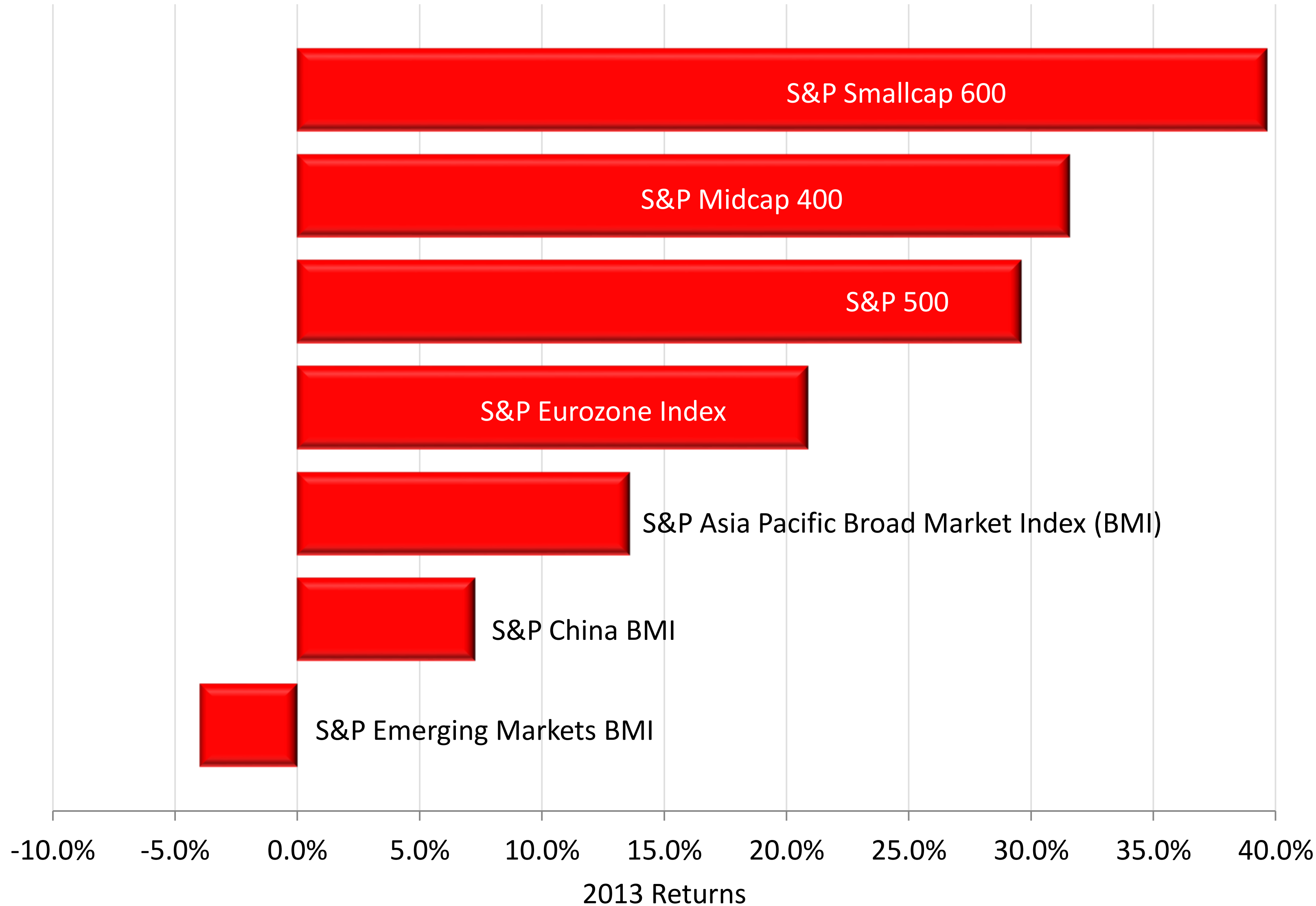
Strategists, like economists, got completely blindsided by the financial meltdown and recession of 2008. (1)

Strategists got blindsided by the stock market's melt-up in 2013. (2)

Source: S&P 500 Index data from Standard and Poor's, data through December 31, 2013.

[1] *Barron's* annual surveys of Wall Street strategists' beginning-of-year forecasts.

2013 Returns



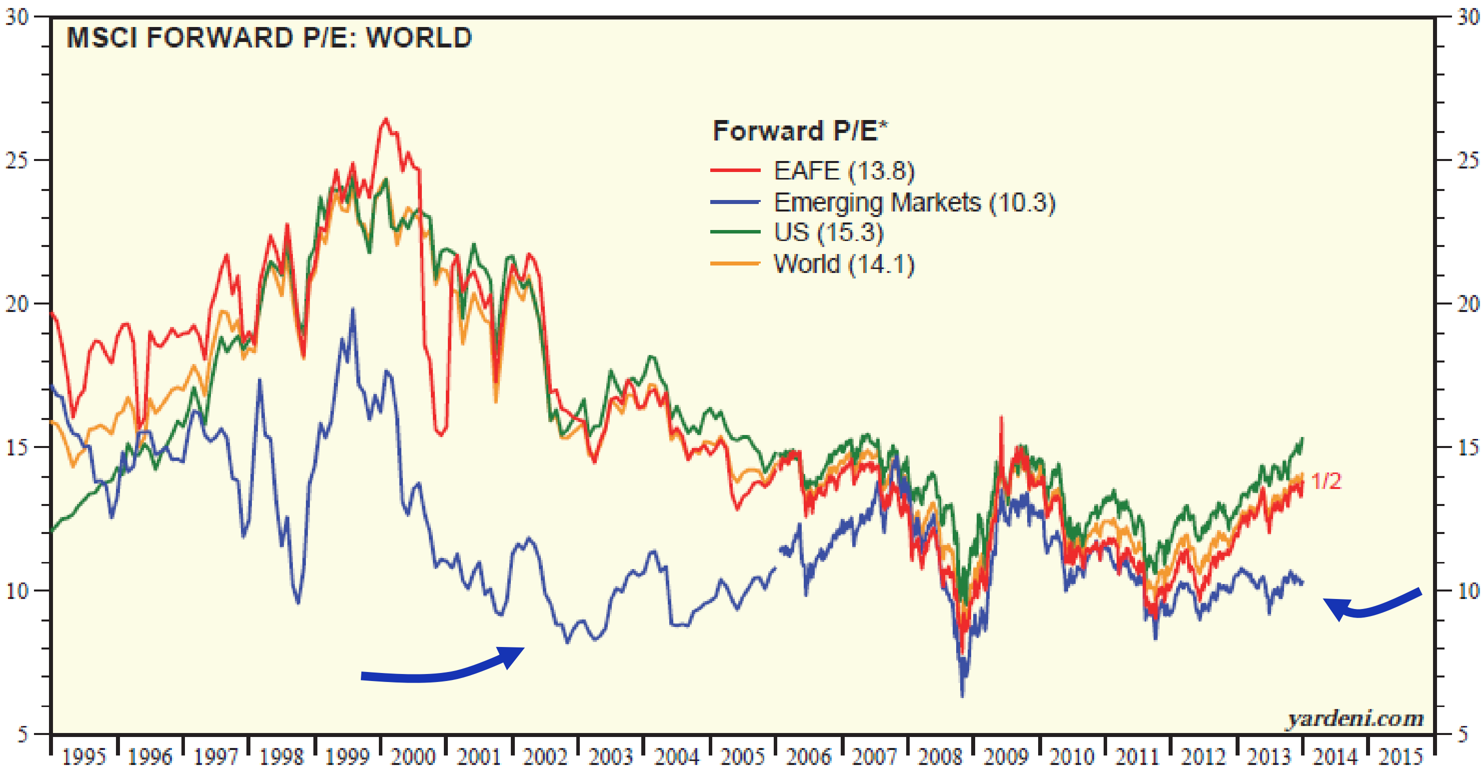
Source: Standard and Poor's. Data through December 31, 2013. Index returns do not include dividends.

Modern Portfolio Theory

Wall Street strategists' dismal track record with their S&P 500 sector recommendations illustrates how extremely difficult it is to systematically add α with tactical asset allocation – ie. trying to guess which sectors, styles, markets (foreign vs. domestic) or asset classes (eg. stocks, bonds, commodities, gold, etc.) are going to outperform and which are going to lag. In my opinion, MPT is still the best investing mousetrap yet devised.

"Your mother called to remind you to diversify."

World P/E Ratios



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly thereafter.
Source: Thomson Reuters I/B/E/S.

The valuation relationship of EAFE[2] to U.S. looks pretty typical at present – the U.S. has, historically, often carried a slight valuation premium to EAFE.

Emerging markets look cheap relative to developed markets – however, history shows they can stay cheap.

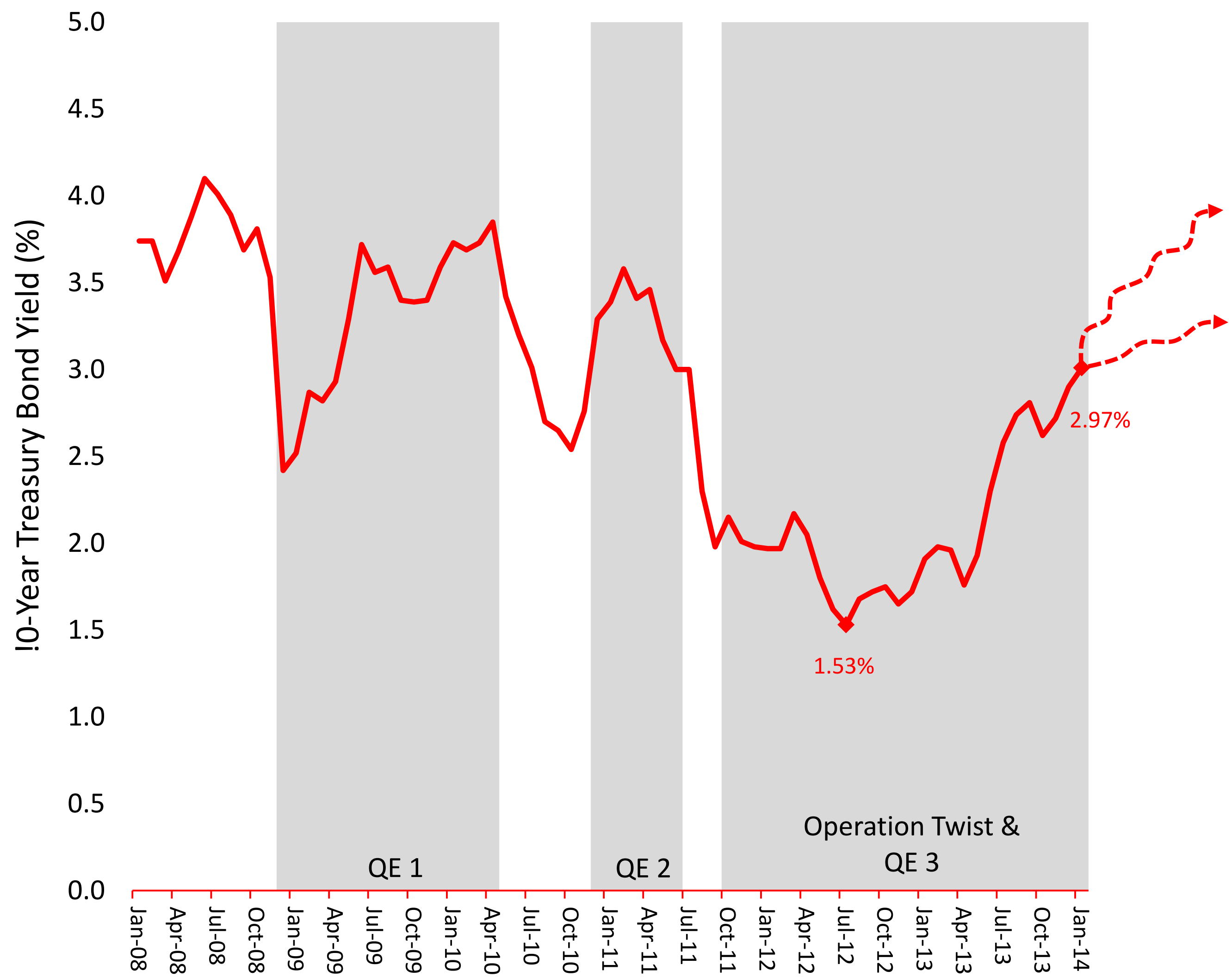
Emerging Markets Bottom-Line[1]

Liquidity withdrawals and portfolio rebalancing contributed to the EM underperformance in 2013, and currency depreciation had a significant effect on the dollar returns of EM equities. Going into 2014, we don't foresee a significant rebound of currencies, as the countries that suffered the most have weaker financial fundamentals. Additionally, 2014 could be marked by significant political risks, as nine countries are holding general elections, and most of them are deemed politically unstable.

However, relative valuations bode well for the Emerging Markets in general when compared to the U.S. Within the EM space, European countries compare favorably from a valuation standpoint, and investors may want to overweight them and the larger Asian countries including China, Taiwan and South Korea. Conversely, we see Indonesia, Turkey, India, South Africa, Thailand and Chile having more downside risks in 2014.

Source: Yardeni Research, Inc., with permission. Global Index Briefing, January 8, 2014.
[1] The Leuthold Group—January 2014, with permission. [2] Europe, Australia, Far East. (EAFE).

10-Year U.S. Treasury bond yield and QE



Source: Federal Reserve. Data through January 9, 2013.

In anticipation of the QE taper, bond yields have already retraced most of their decline.

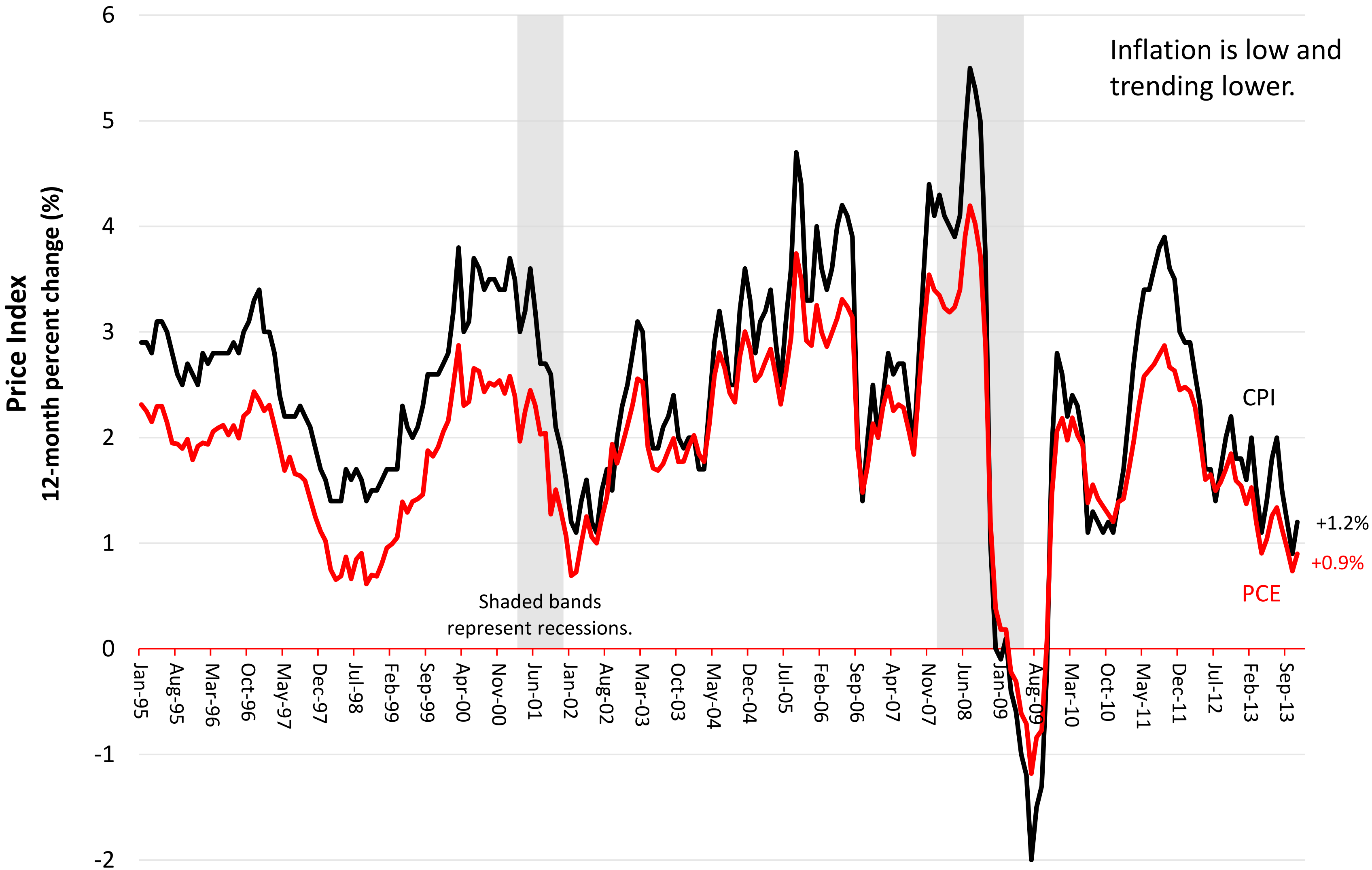
I'm hearing a lot of 3¾% to 4% forecasts by year-end 2014.

I think that where yields go from here depends on the inflation data more than anything.

Inflation is very low and apt to remain so. (see next slides)

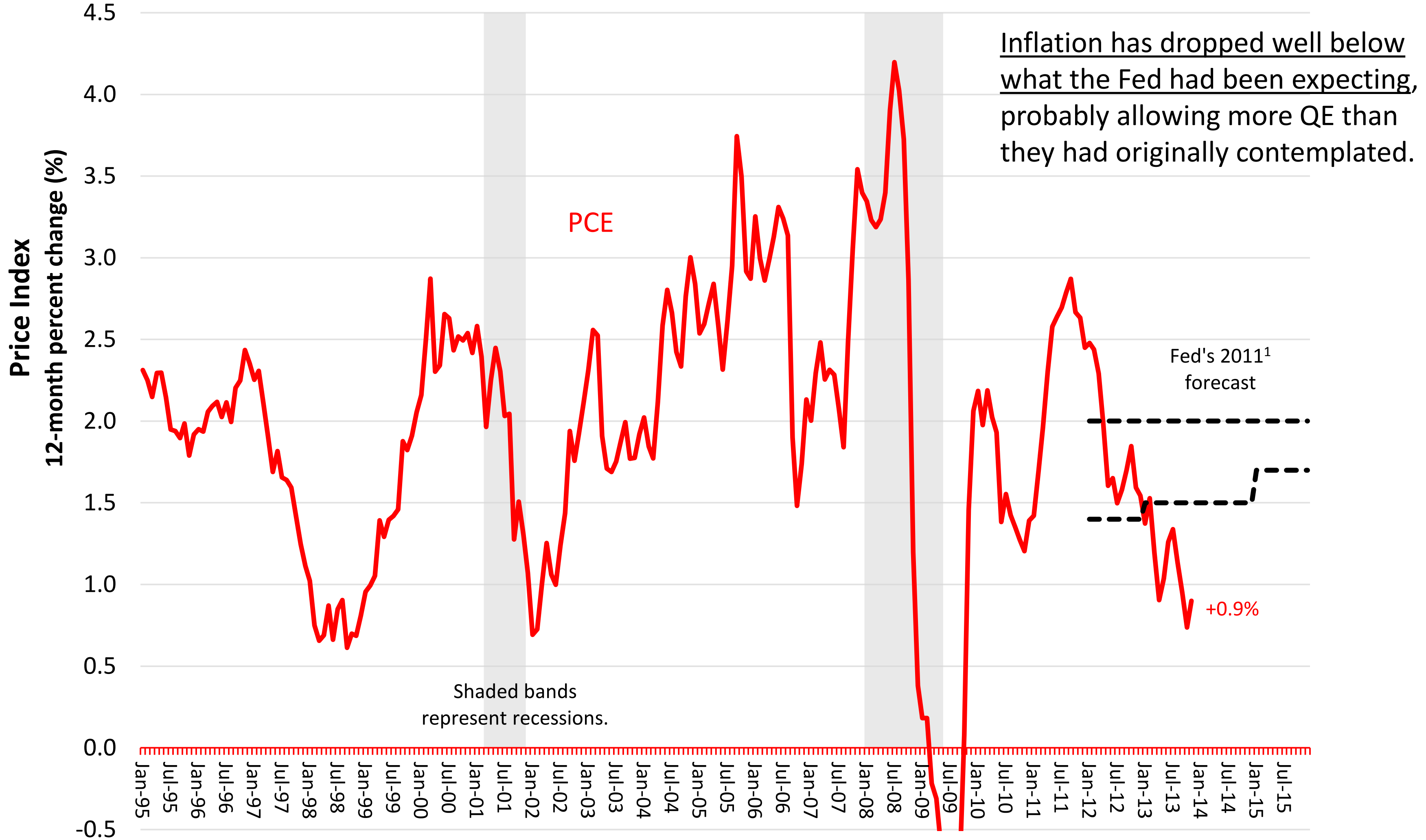
<u>So, maybe the surprise will be how *measured* the rise in bond yields ends up being.</u>

Inflation is low and trending down



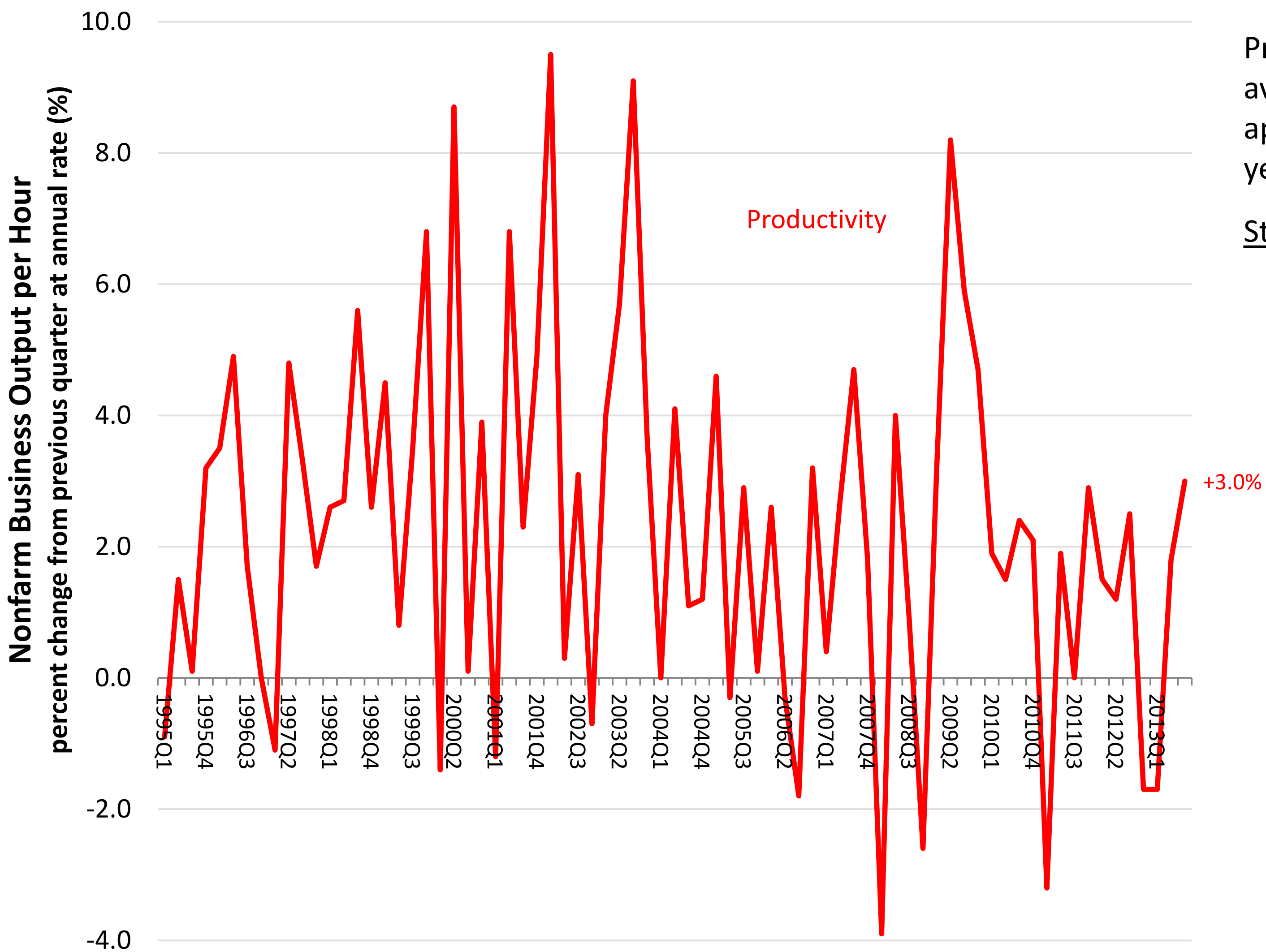
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics. Data through November 2013.

Inflation is way below Fed's forecast



[1] FOMC's November 2, 2011 central tendency forecast.
Source: Bureau of Economic Analysis, data through November 2013.

Productivity

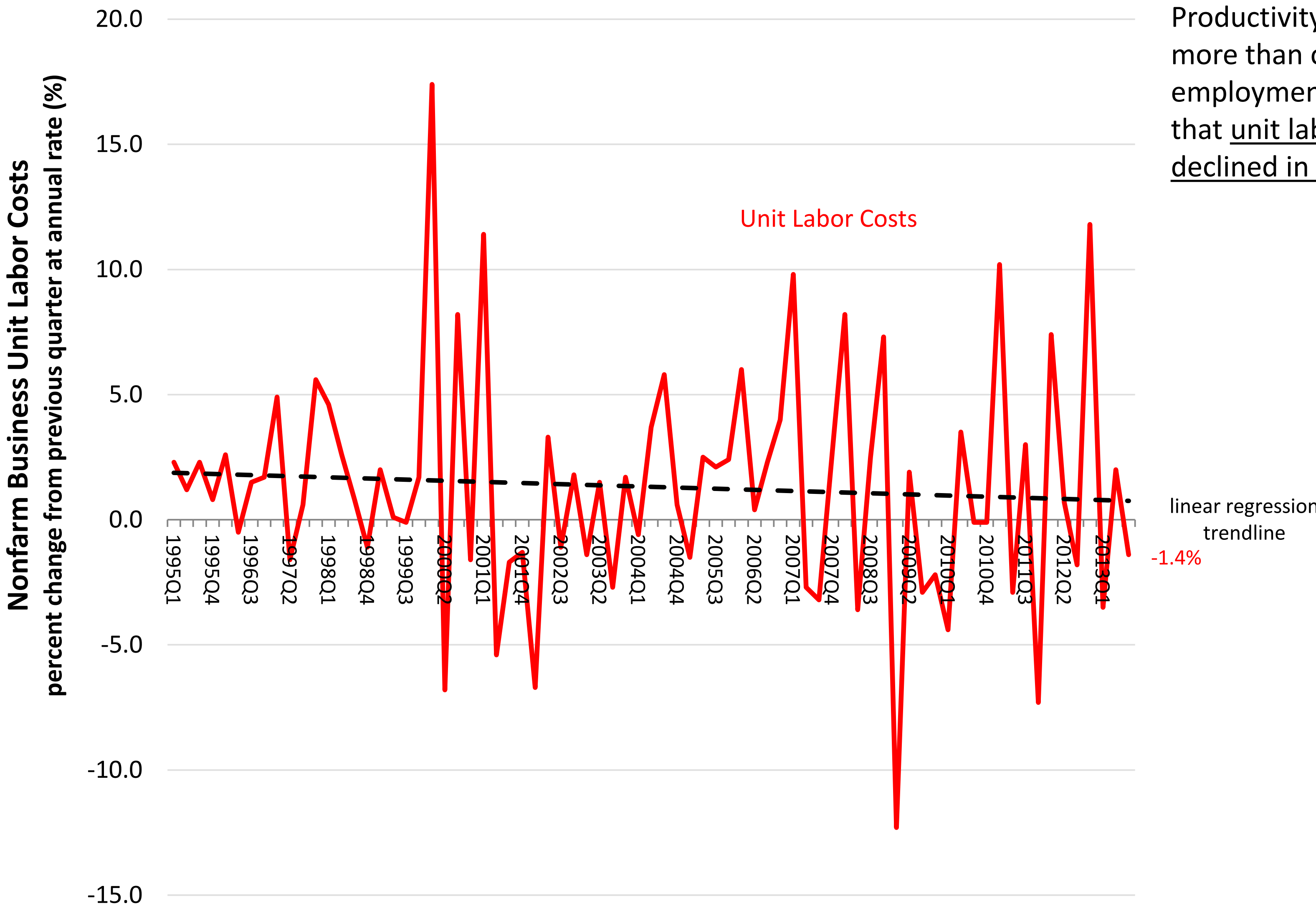


Productivity gains have averaged approximately 2% per year.

Strong +3.0% in Q3.

Source: Bureau of Labor Statistics, data through September 2013.

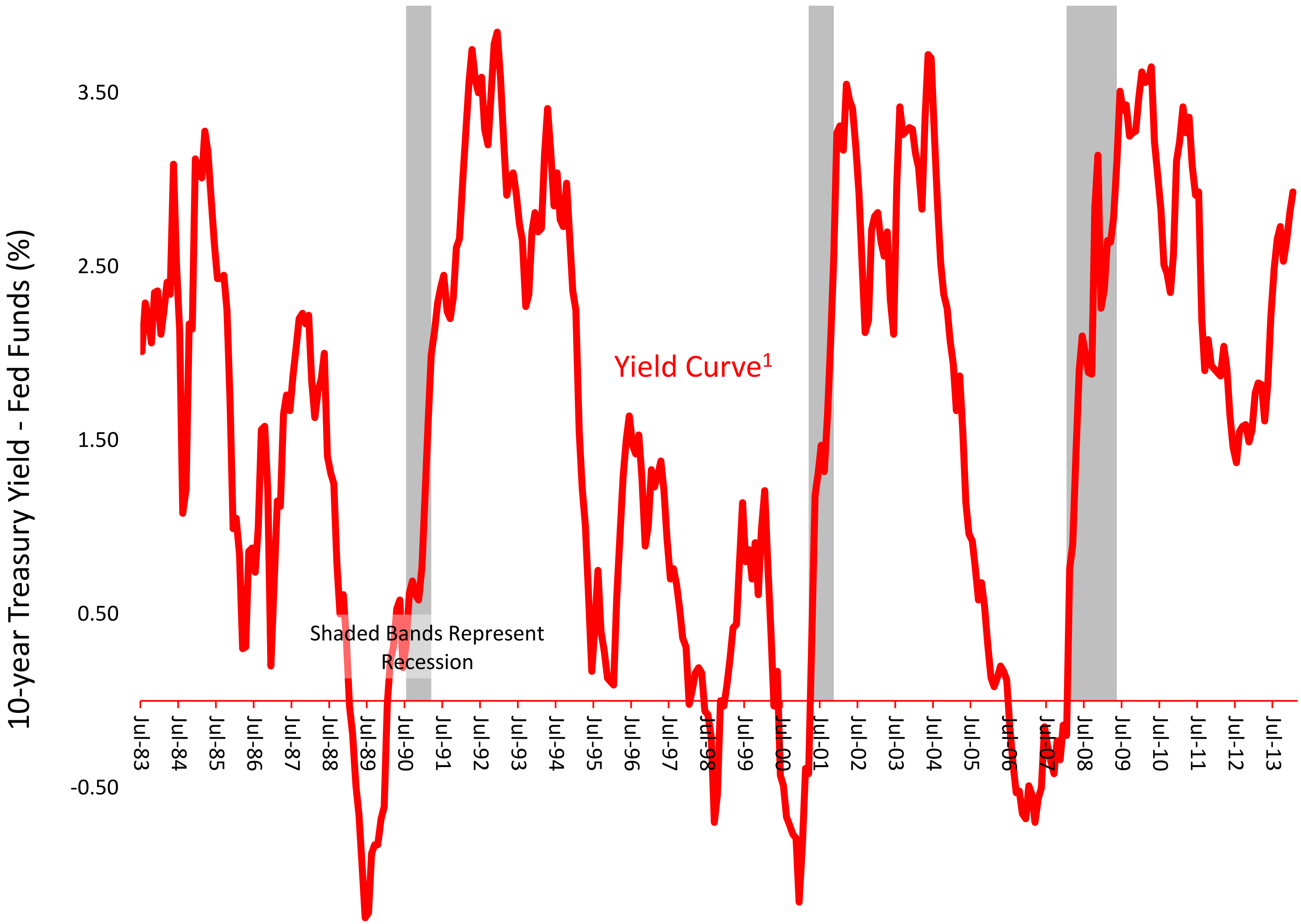
Unit Labor Costs



Productivity gains have more than offset higher employment costs such that <u>unit labor costs declined in Q3</u>.

Source: Bureau of Labor Statistics, data through September 2013.

Yield curve vs. recessions



"Higher bond yields will choke off the recovery."

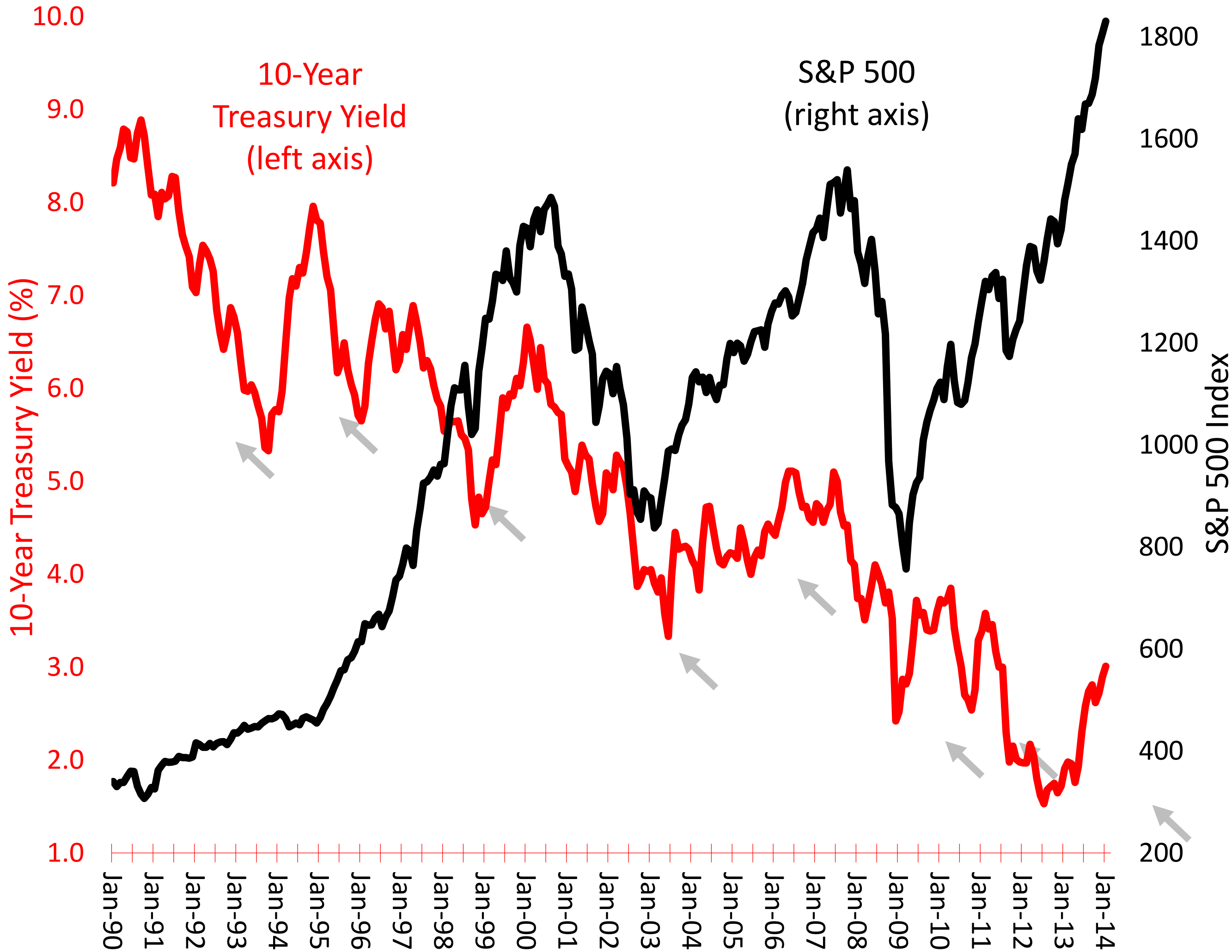
It's not so. Steep yield curves – high bond yields compared to Fed Funds rates – are consistent with strong GDP growth.

Flat or negative yield curves have preceded recessions.

This history suggests that if bond yields do march higher as the Fed tapers QE it would be consistent with robust GDP growth.

Sources: NBER; Federal Reserve Data through January 3, 2014. [1]The differential between the interest rate on Fed Funds (short term) and the 10-year Treasury bond (long term).

Rising bond yields have been good for stocks



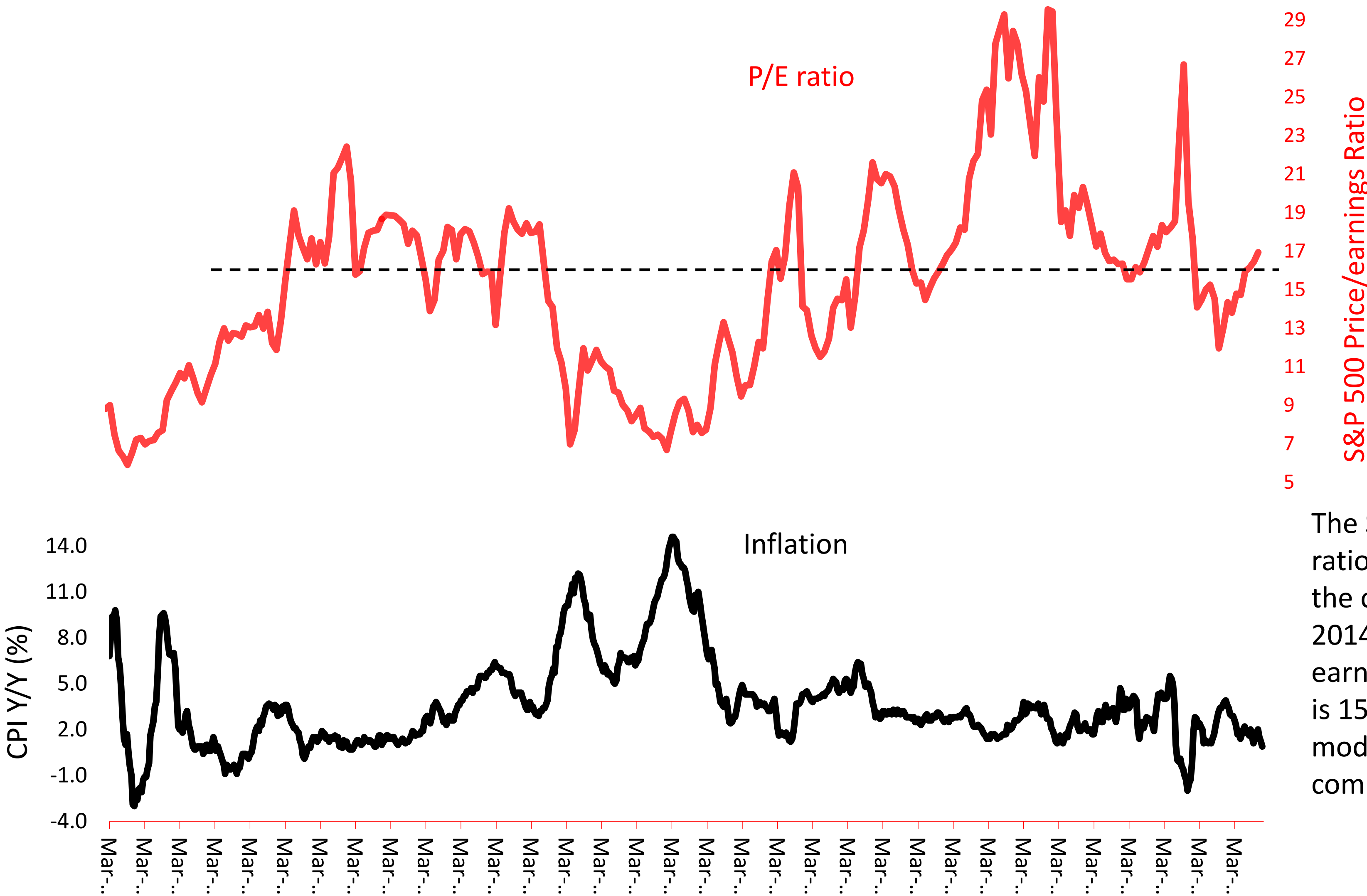
"Higher bond yields are bad for stocks."

It's not so. Bull markets have often been accompanied by rising bond yields.

Sources: Standard and Poor's; Federal Reserve Bank of St. Louis. Data through January 3, 2013. [1] The usual reasons cited are a) higher bond yields provide competition to dividend yields, making stocks less attractive; b) higher bond yields drive down the market's P/E ratio; and, c) higher bond yields will choke off the economic recovery, taking stocks down.

Stock Market Bubble?

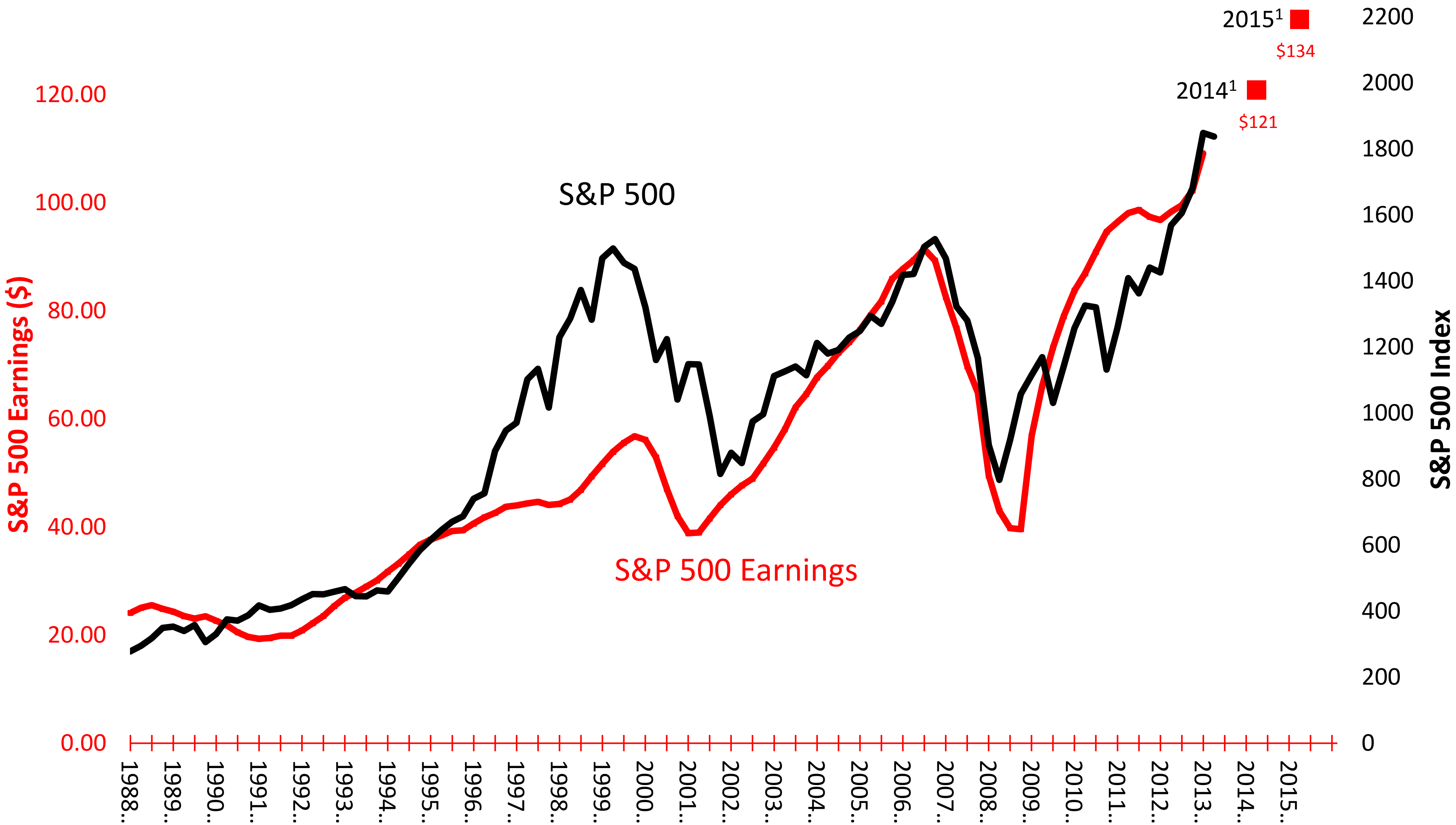
S&P 500 P/E ratio – reversion to the mean for a benign-inflation environment



The S&P 500's P/E ratio (1/7/14) on the consensus 2014 bottom-up earnings estimate is 15.2X[1] – still modest by historic comparison.

Sources: Standard & Poor's Corporation, Thomson Reuters I/B/E/S, BLS. Stock price data through December 6, 2013; inflation data through October 2013. Top panel, latest data point: 1848 ÷ trailing earnings of $109.13 through 12/31/13 = 16.94X. [1]S&P 500 at 1837.88÷ 2014 EPS(e) $120.83.

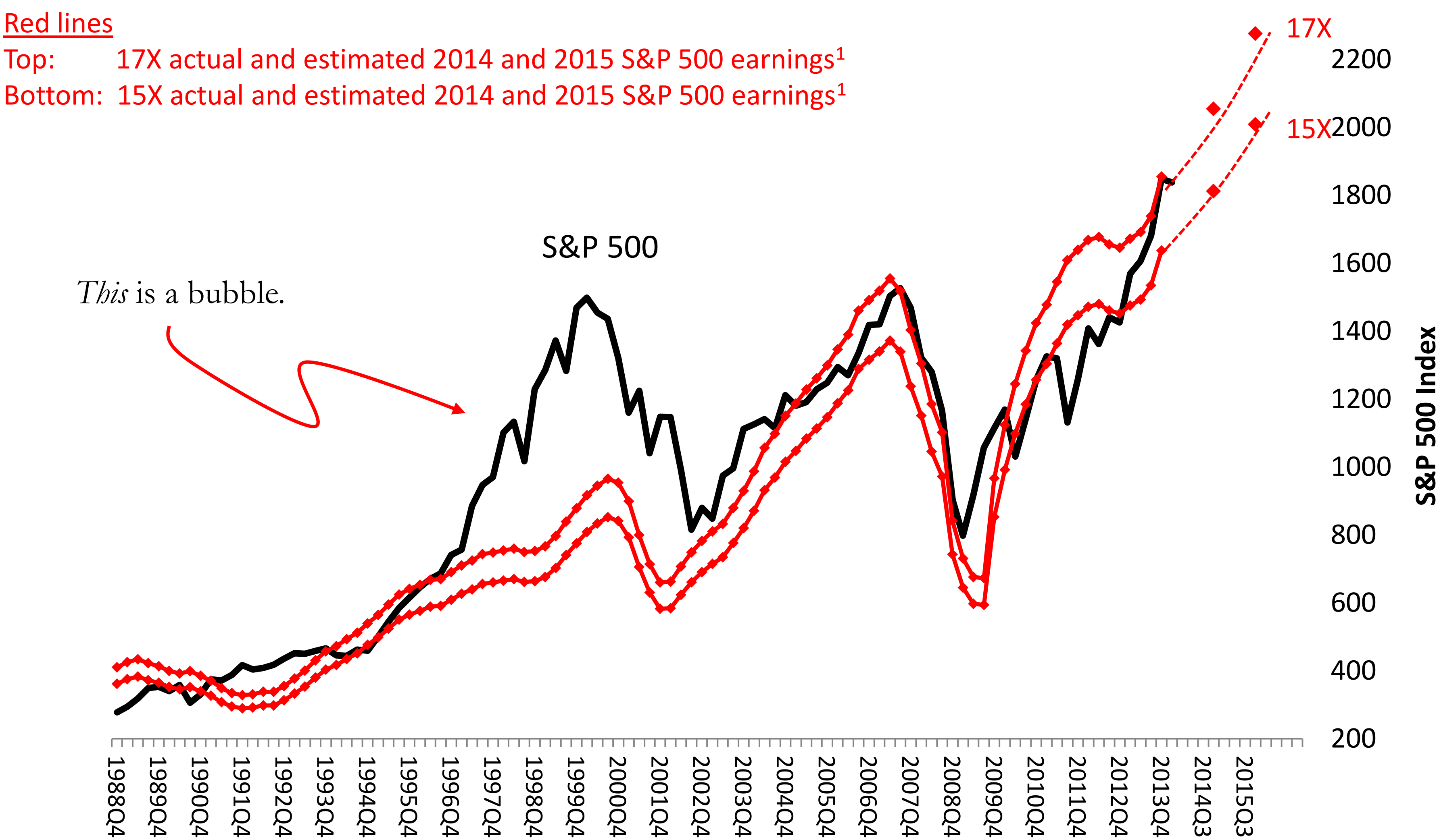
S&P 500 vs. actual and estimated earnings



[1] Estimated 2013, 2014 and 2015 bottom-up S&P 500 earnings per share (left scale) as of January 6, 2013: for 2013, $109.13; for 2014, $120.83; for 2015, $133.91. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through January 7, 2014; and actual earnings data through September, 2013.

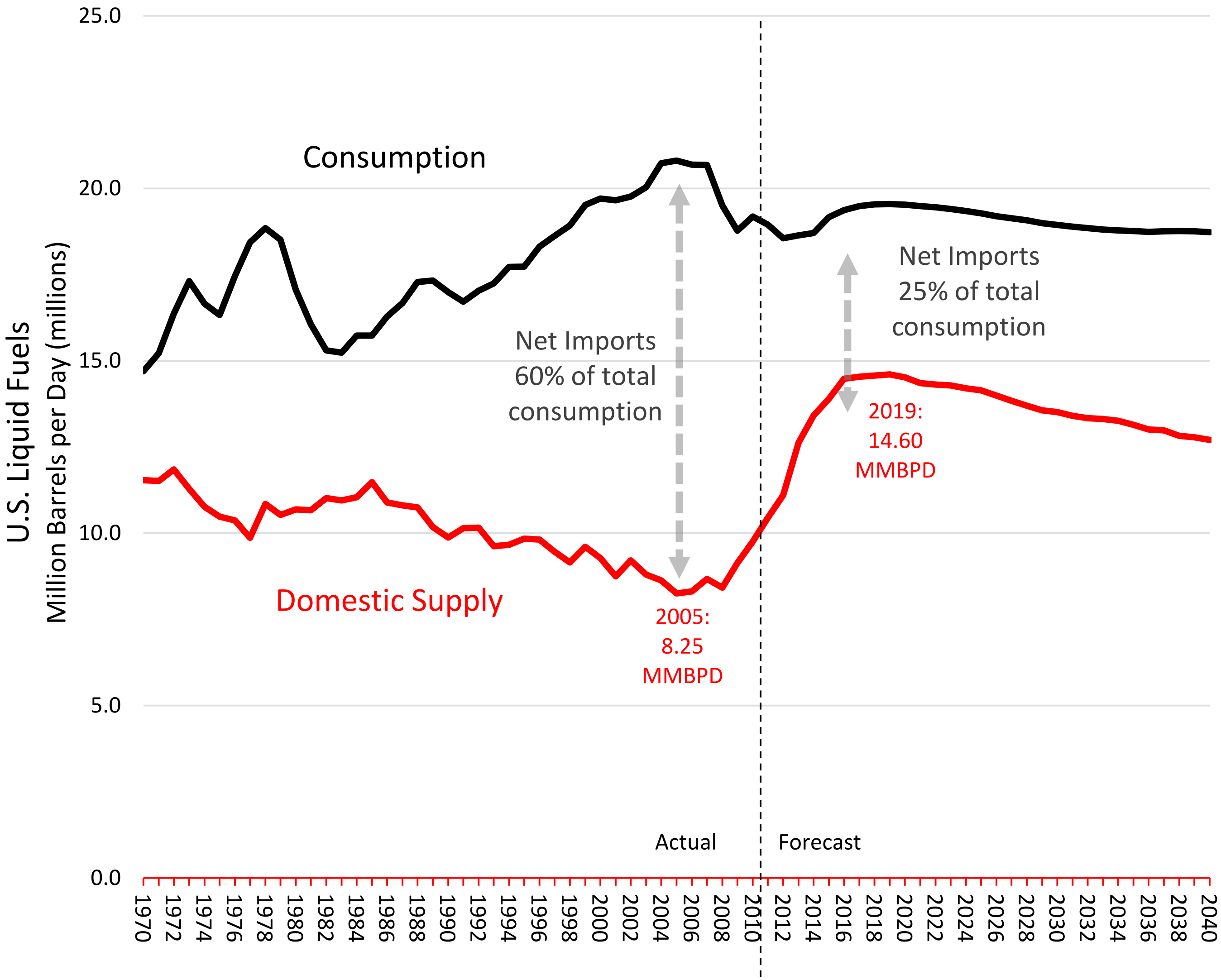
Stock Market Bubble?

S&P 500 vs. 15X-17X actual and estimated earnings



[1] Estimated 2013, 2014 and 2015 bottom-up S&P 500 earnings per share (left scale) as of January 6, 2013: for 2013, $109.13; for 2014, $120.83; for 2015, $133.91. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through January 7, 2014; and actual earnings data through September, 2013.

The fracking dividend – U.S. liquid fuels supply and consumption

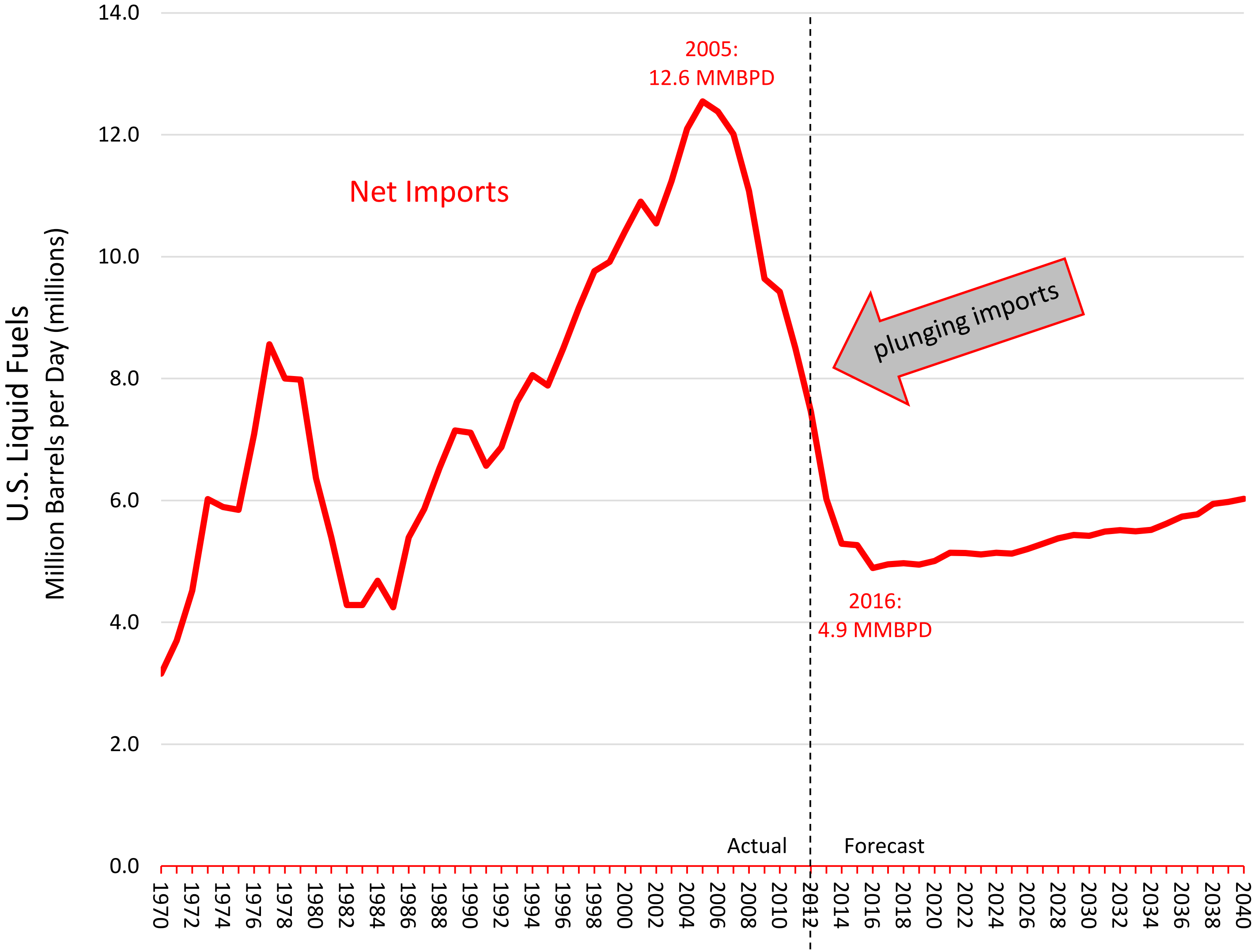


In the next five years, U.S. crude oil plus liquids production is forecast to surge by +80% from 2005's low of 8.25 MMBPD, taking imports' share of total consumption down to 25%, from 60%.

<u>This is a big plus for the U.S. economic outlook: jobs, energy prices, balance of payments.</u>

Source: U.S. Energy Information Agency, *Annual Energy Outlook 2014 Early Release*, December 16, 2013.

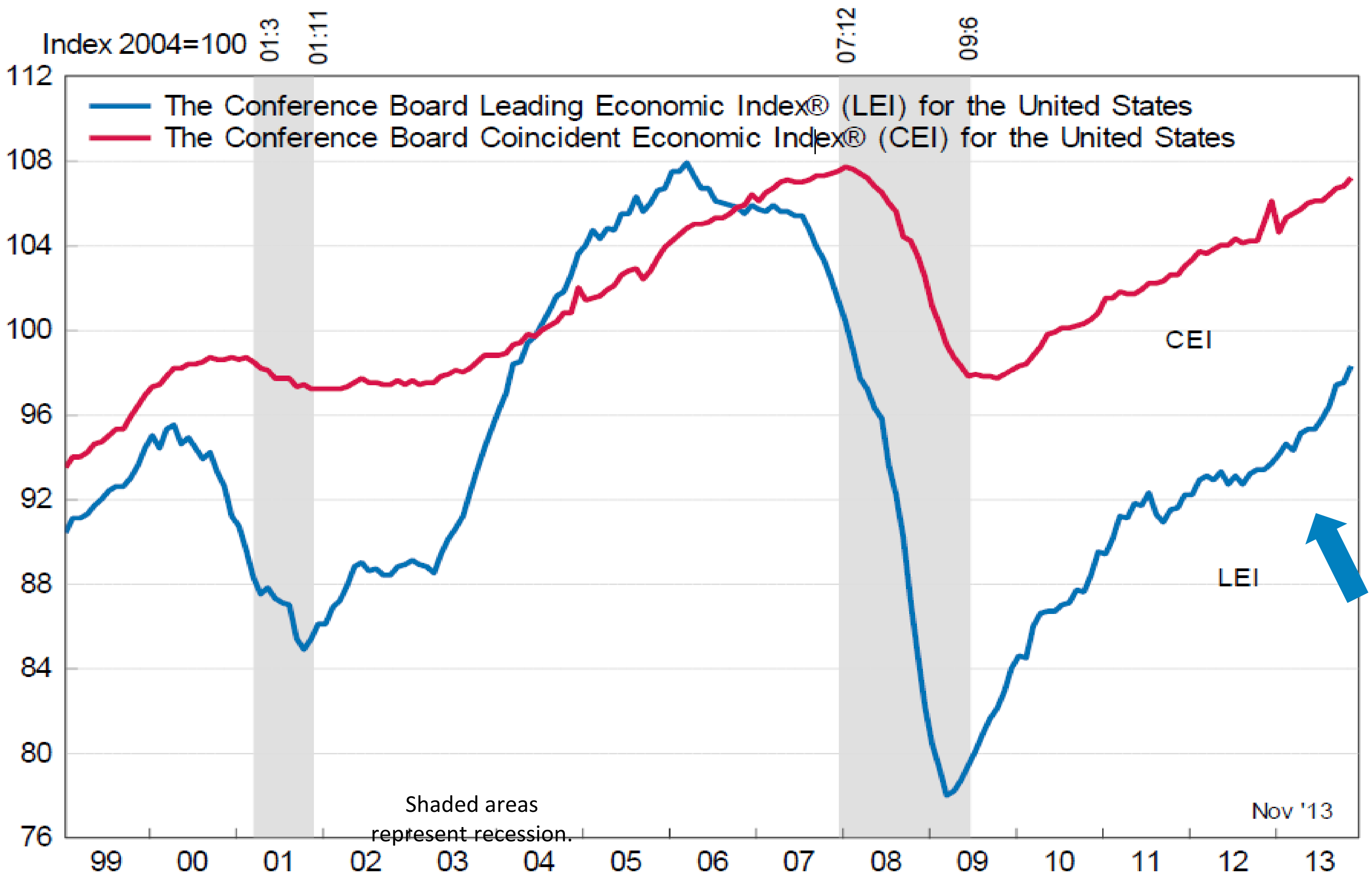
The fracking dividend – U.S. liquid fuels imports



U.S. crude oil plus liquids net imports are forecast to drop further from 6.0 MMBPD estimated in 2013 to 4.9 MMBPD, further reducing the U.S. trade deficit.

Source: U.S. Energy Information Agency, *Annual Energy Outlook 2014 Early Release*, December 16, 2013.

U.S. Index of Leading Economic Indicators (monthly)



"The LEI continues on a broad-based upward trend, suggesting gradually strengthening economic conditions through early 2014. Improving labor markets and new orders in manufacturing, combined with strong financial indicators, drove November's gain."

The Conference Board
December 19, 2013

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers' new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers' new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.

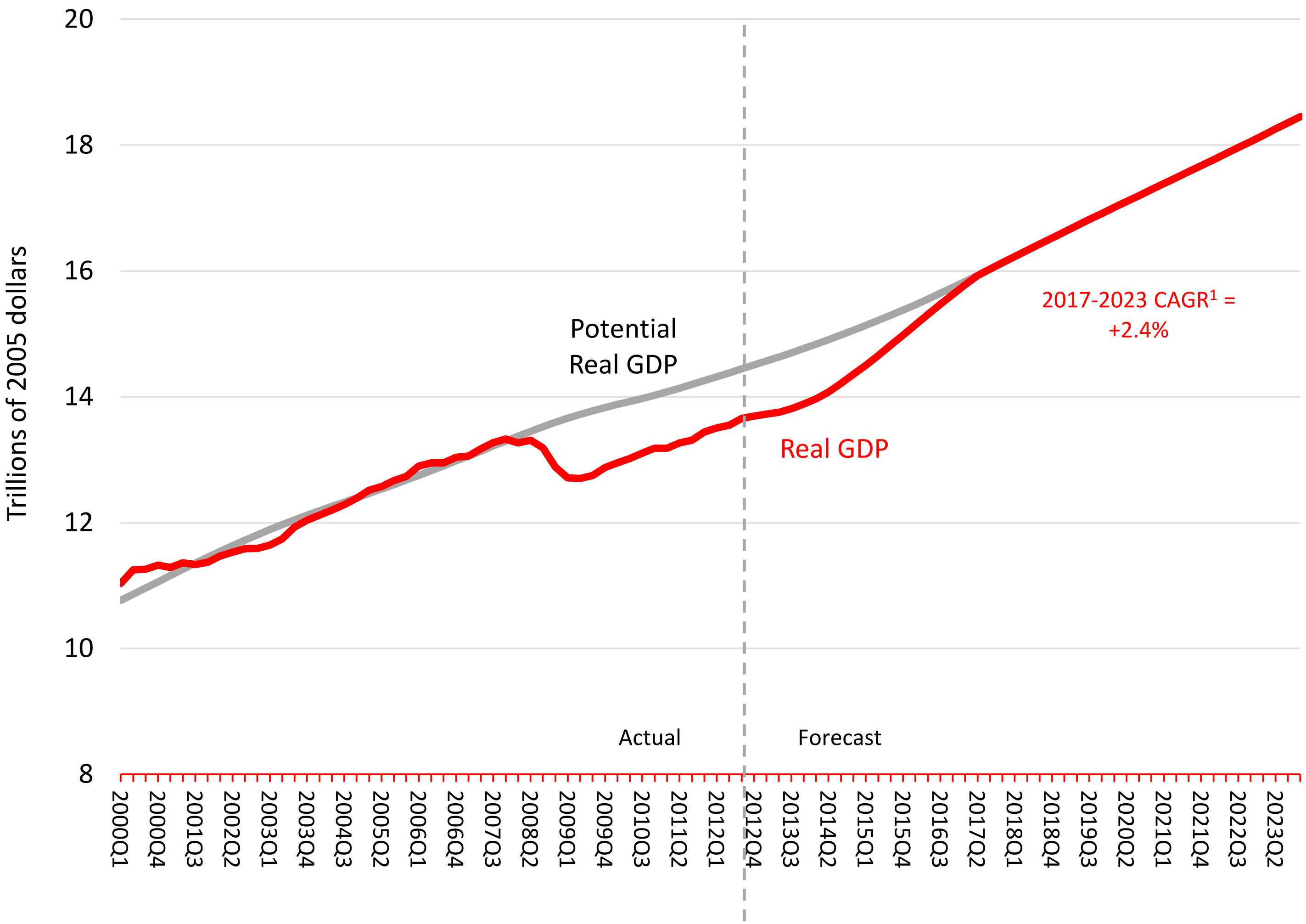
Source: ©The Conference Board. Data through November 2013, released December 19, 2013.

ECRI's Weekly Leading Index

Hit a 3½-year high.

Source: Copyright 2013, Economic Cycle Research Institute. Data through January 3, 2013.
ECRI: "The components of ECRI's composite indexes are proprietary. More importantly, our ability to forecast turning points is not predicated on some "special" ingredient that we use, but rather it's the co-movement of our indicators that is most revealing."

Real GDP actual and forecast vs. potential



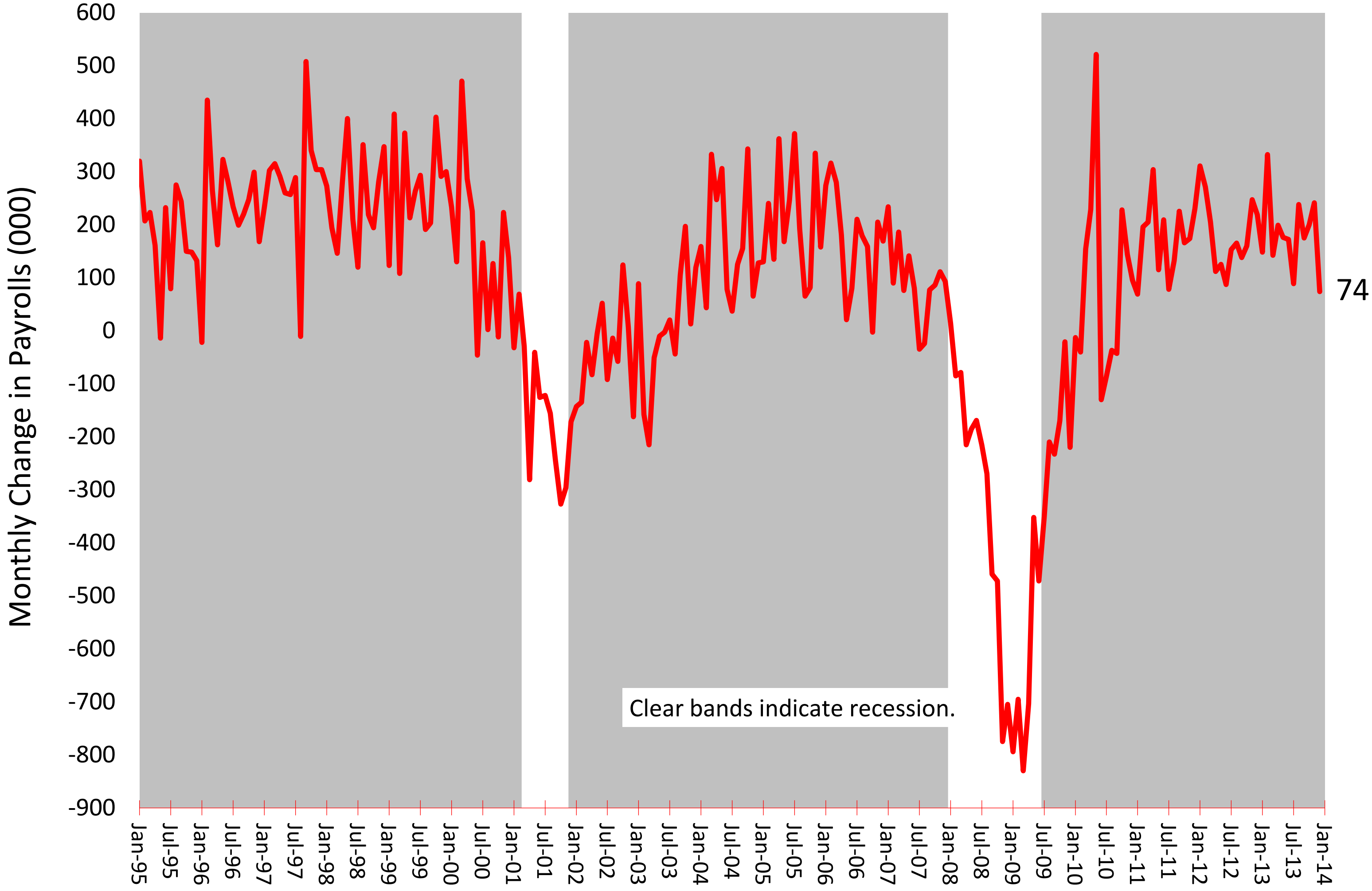
<u>Can real GDP growth continue along its historic growth path?</u>

<u>Can stocks continue to deliver their historic real rates of return?</u>

Here's an illustration of how the CRB's economists see the U.S.'s 10-year economic growth prospects based on the fundamental drivers of economic growth.

Source: Congressional Budget Office (CBO), *The Budget and Economic Outlook, Fiscal Years 2013 to 2023*, released February 5, 2013.
[1]Compound annual growth rate.

Employment – monthly job formation

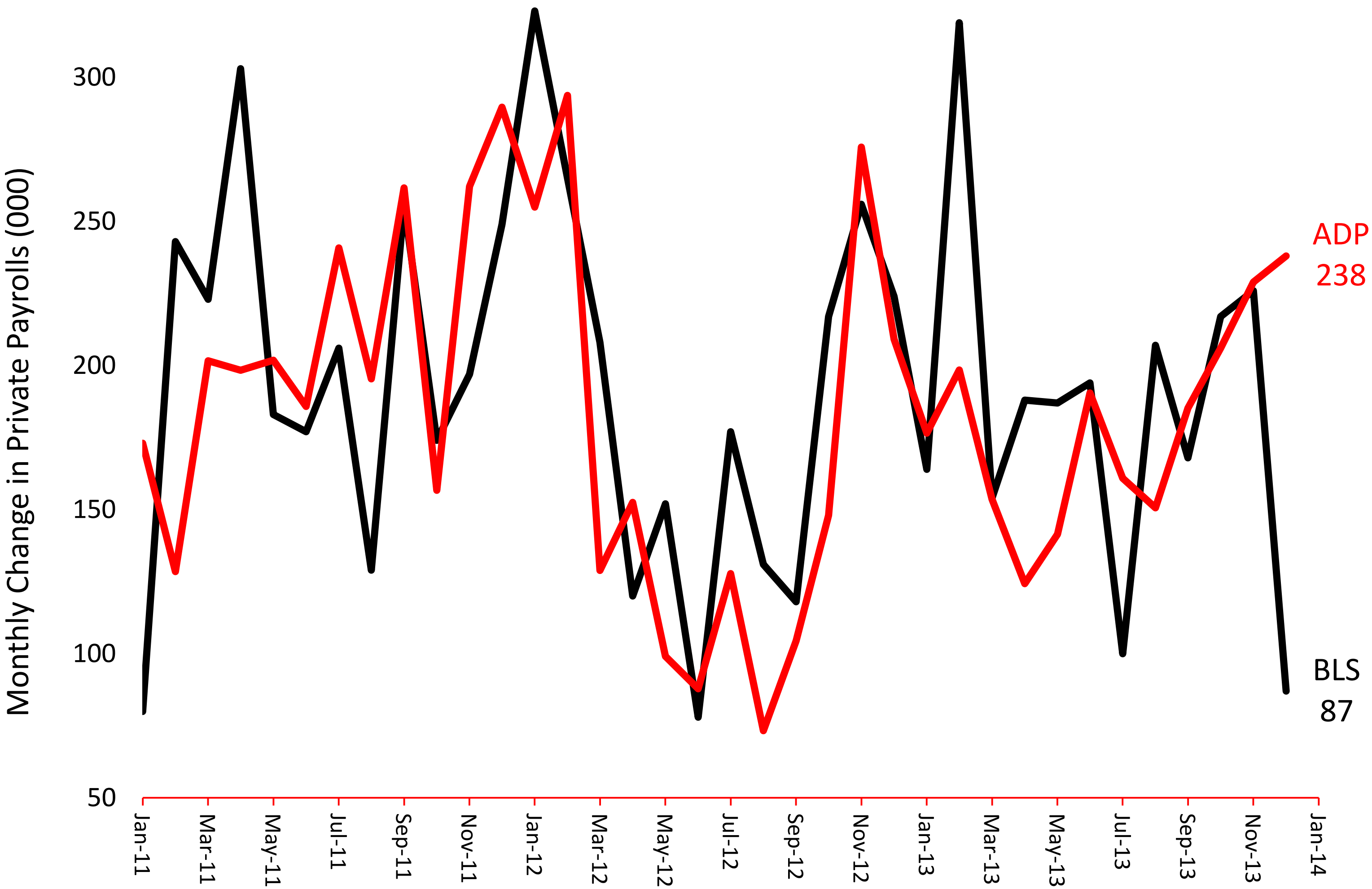


While termed "sluggish" and "sub-par" the recovery in job formation has actually been pretty typical.

Note the month-to-month volatility.

Source: Bureau of Labor Statistics. Data through December 2013.

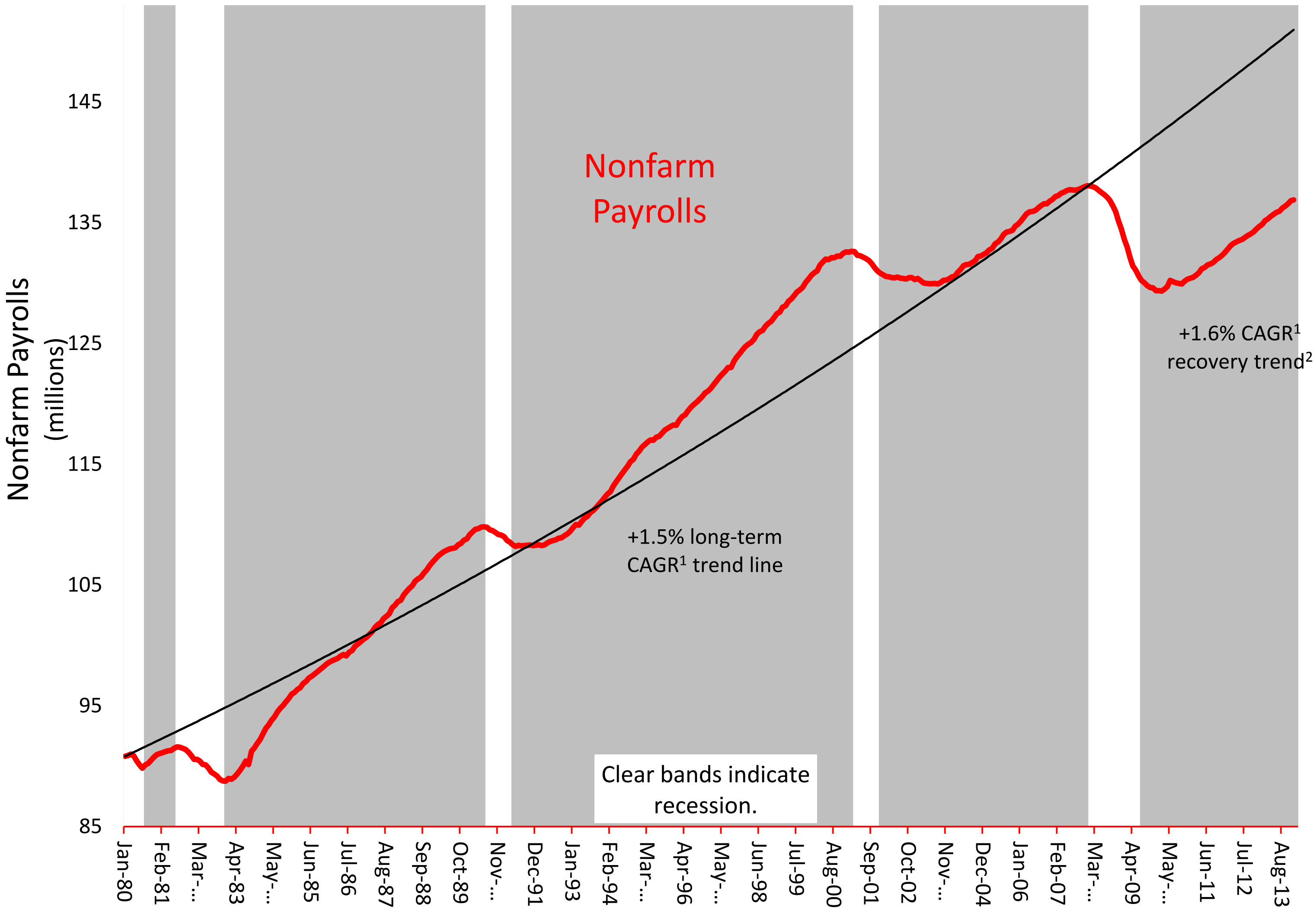
Employment – monthly private sector job formation



Strong correlation but <u>occasionally the BLS data spikes unusually</u> – both up and down

Source: ADP and Bureau of Labor Statistics. Data through December 2013.

Employment

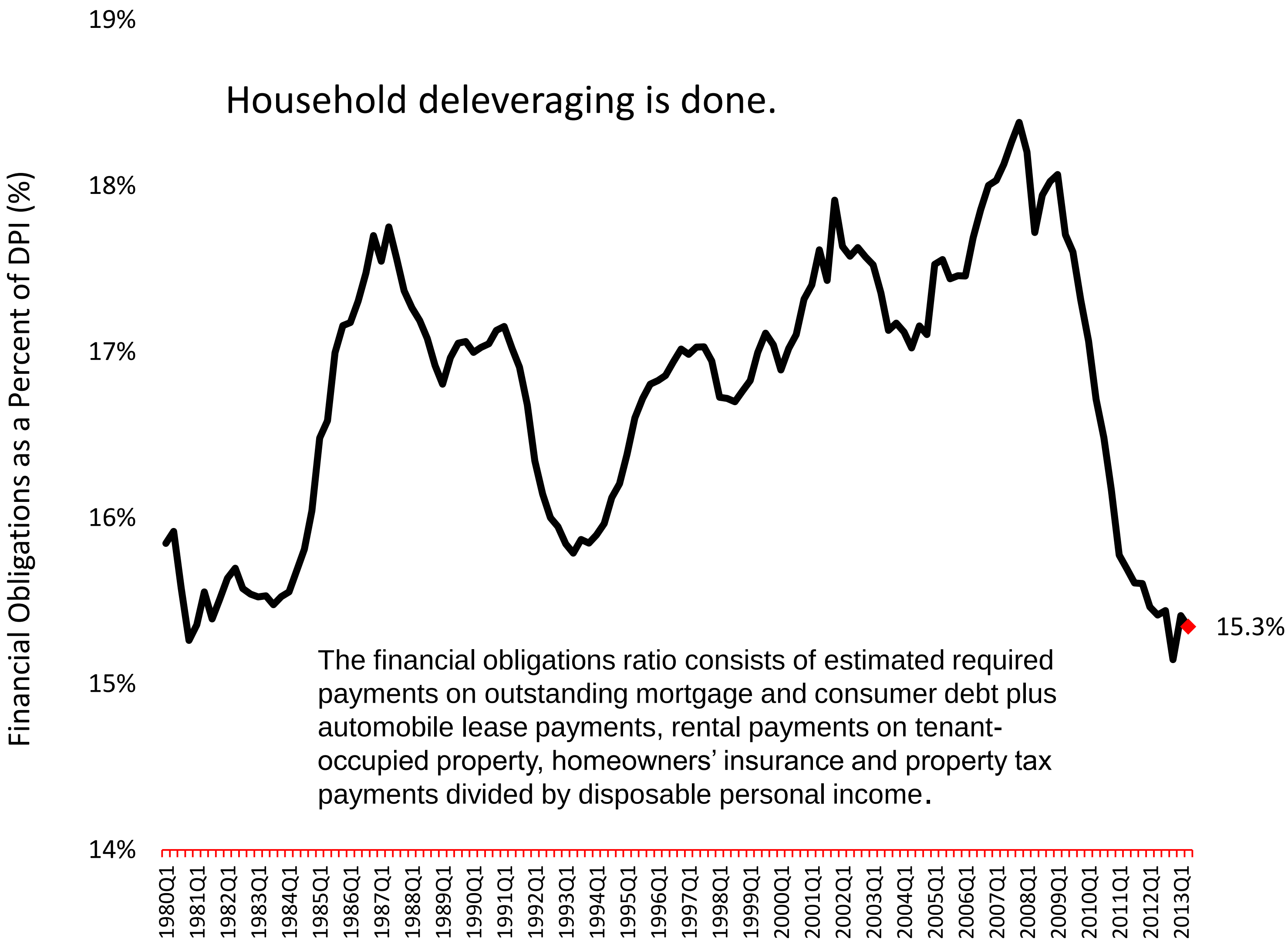


December's total nonfarm employment at 137 million is still short of the 2008 peak of 138 million.

<u>Below trend but growing steadily – sufficient to drive a healthy consumer spending recovery</u>.

Source: Bureau Labor Statistics, data through November 2013. [1]Compound annual growth rate. [2] 3-years ending November 2013.

Financial obligations ratio – record low

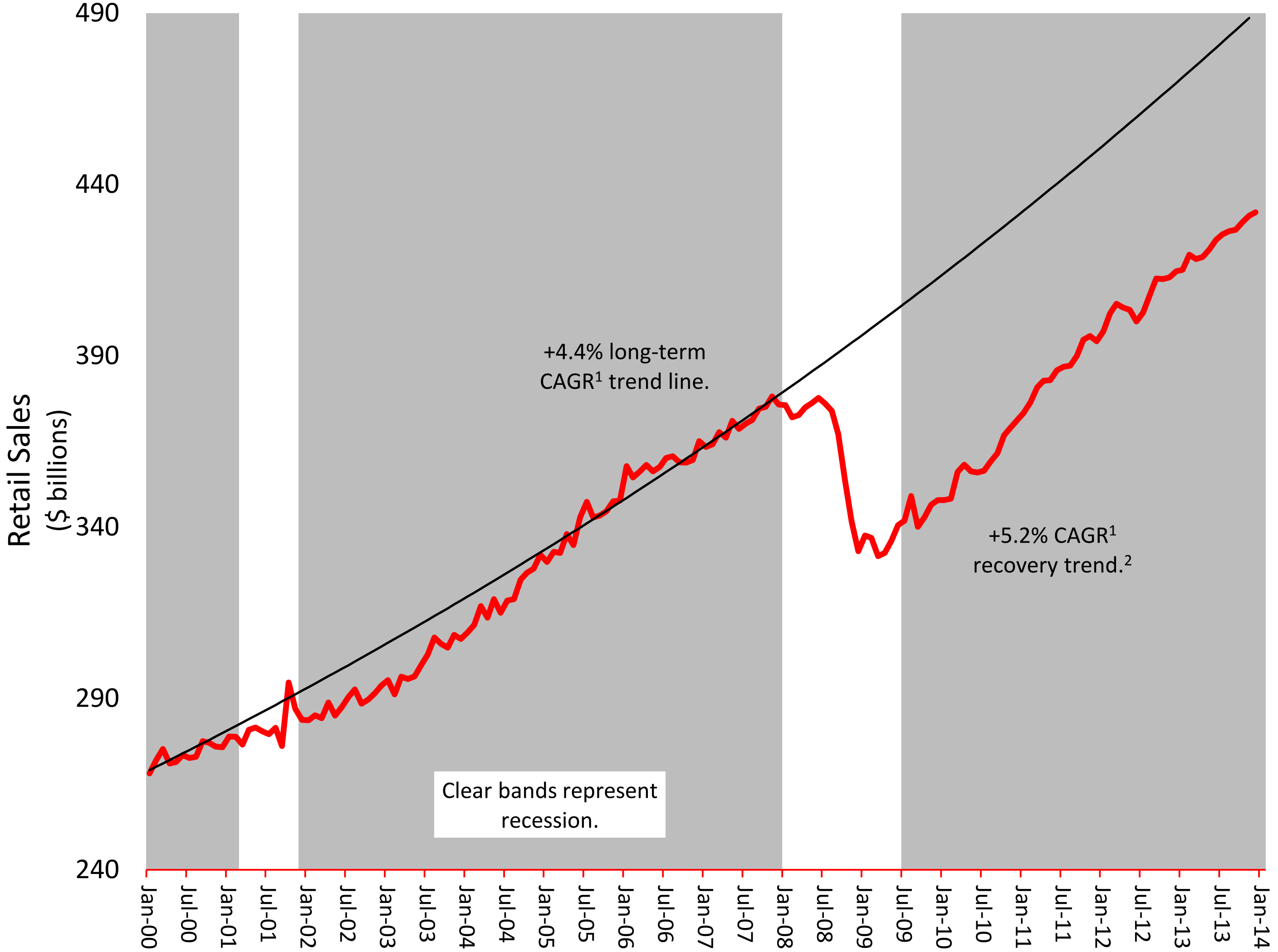


Source: Federal Reserve, data through June 2013; released October 29, 2013.

Comparing consumers' monthly flow of income to their fixed recurring monthly expenses, including debt service, gives a more accurate measure of consumers' financial health.

Here's the stunner: consumers' ability to cover the monthly "nut" has seldom been better as incomes have recovered, household debt has been reduced and interest rates remain low.

Retail sales – strong recovery from 2008-09 recession

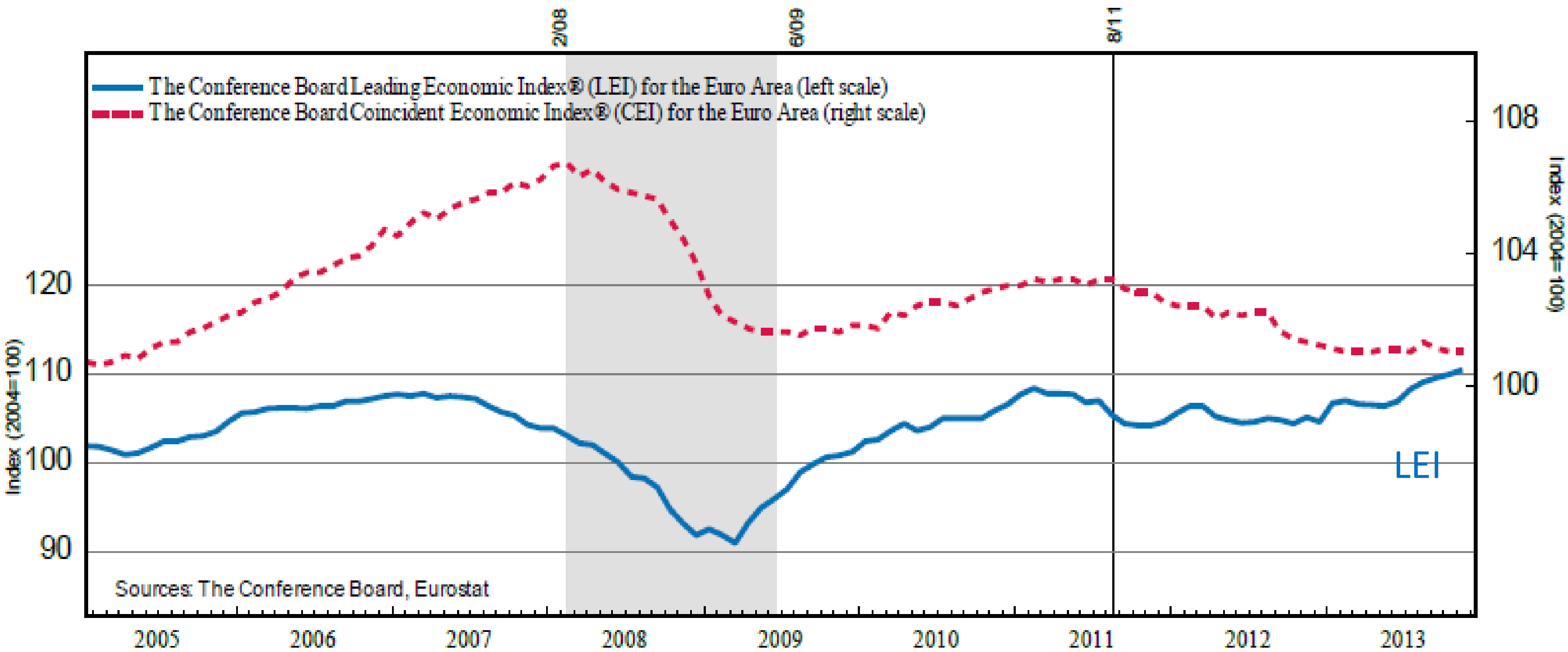


The robust recovery in retail sales conflicted with the widely accepted new normal hypothesis that consumer spending would be substantially constrained.

Source: U.S. Census Bureau; data through November 2013. [1] Compound annual growth rate. [2] 3-years ending November 2013.

Europe's leading economic indicators – turning higher

"The LEI increased for the sixth month in a row, indicating that the outlook for the Euro Area economy continues to improve. The gains in the LEI were widespread with only business expectations in the service sector holding the index back. The banking union agreement which is intended to contribute to the stability of Europe's financial system should also have a positive effect on the short-term outlook."



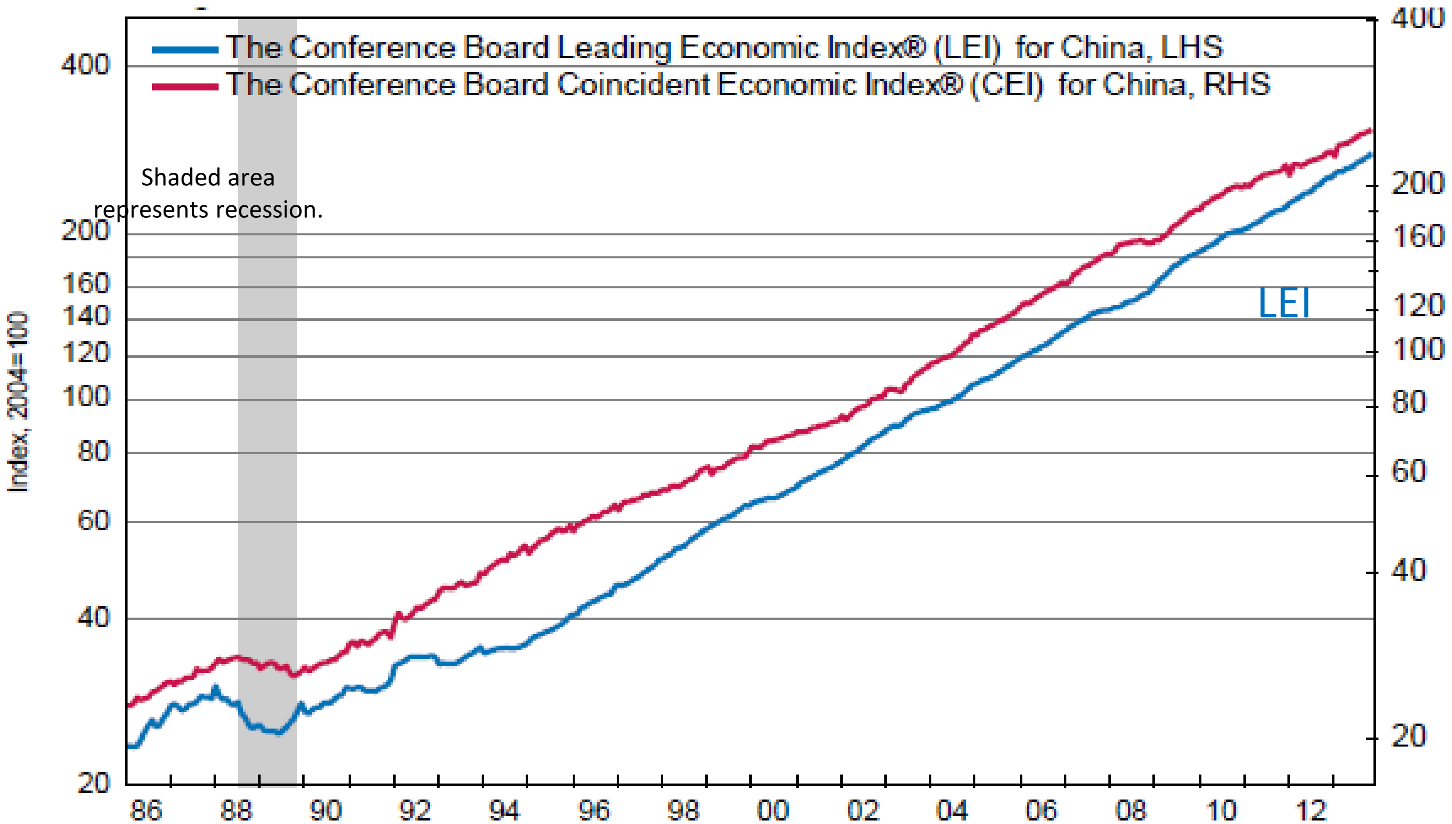
Note: The shaded area represents a business cycle recession in the Euro Area as determined by The Conference Board

The seven components of The Conference Board Leading Economic Index® for the Euro Area:
1) Economic Sentiment Index (source: European Commission DG-ECFIN) ; 2) Index of Residential Building Permits Granted (source: Eurostat); 3) EURO STOXX® Index (source: STOXX Limited); 4) Money Supply (M2) (source: European Central Bank); 5)Interest Rate Spread (source: European Central Bank); 6) Eurozone Manufacturing Purchasing Managers' Index (source: Markit Economics); 7) Eurozone Service Sector Future Business Activity Expectations Index (source: Markit Economics).

Source: ©The Conference Board. Data through November 2013, released December 24th.

China's leading economic indicators

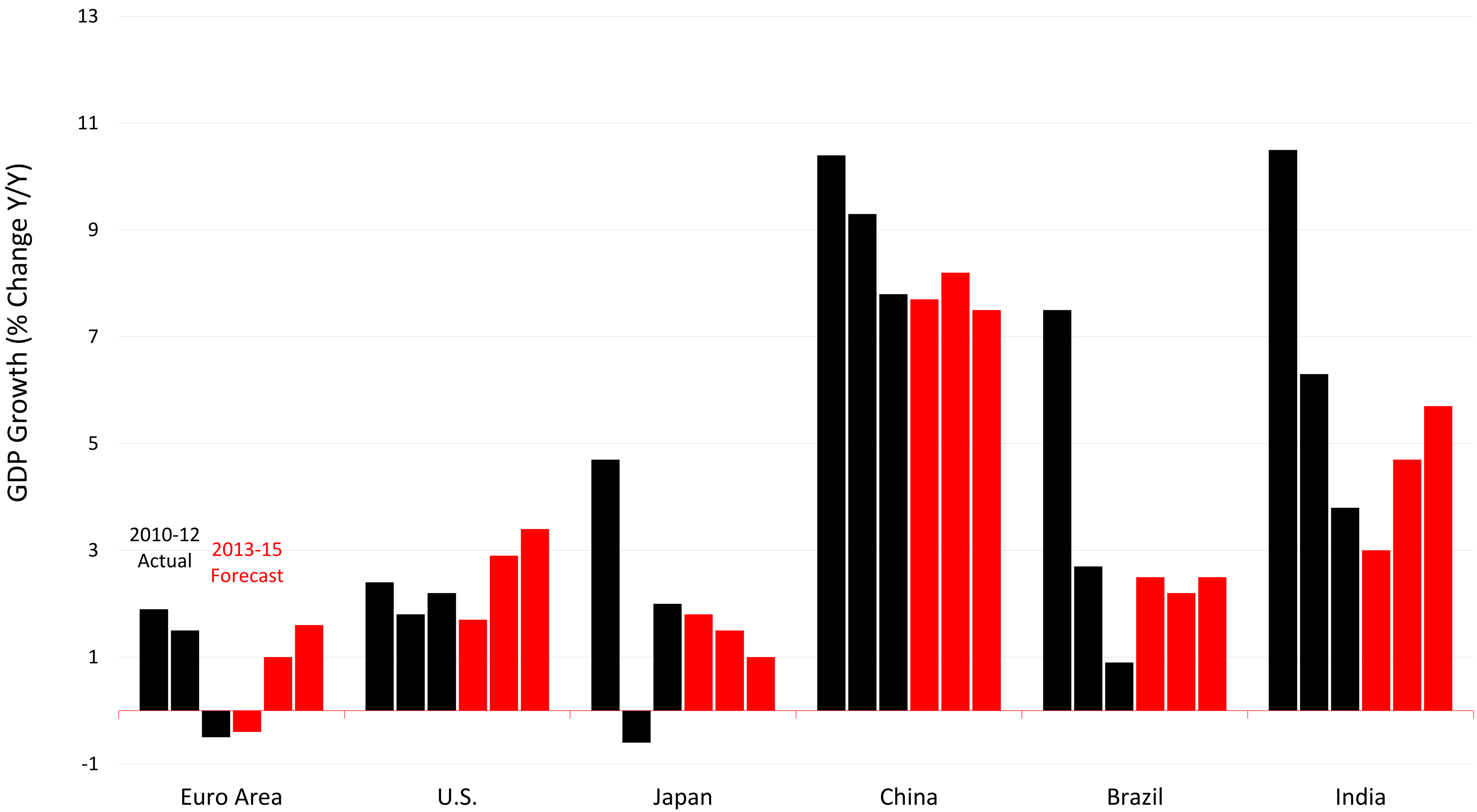
China's LEI rose +1.4% in November, following a +0.6% increase in October and a +1.1% increase in September.



The six components of The Conference Board Leading Economic Index® for China:
1) Total Loans Issued by Financial Institutions (source: People's Bank of China); 2) 5000 Industry Enterprises Diffusion Index: Raw Materials Supply Index (source: People's Bank of China) ; 3) NBS Manufacturing PMI Sub-Indices: PMI Supplier Deliveries (source: National Bureau of Statistics) ; 4) Consumer Expectations Index (source: National Bureau of Statistics); 5) Total Floor Space Started (source: National Bureau of Statistics); 6) NBS Manufacturing PMI Sub-Indices: Export Orders (source: National Bureau of Statistics).

Source: ©The Conference Board. Data through November 2013, released December 18th.

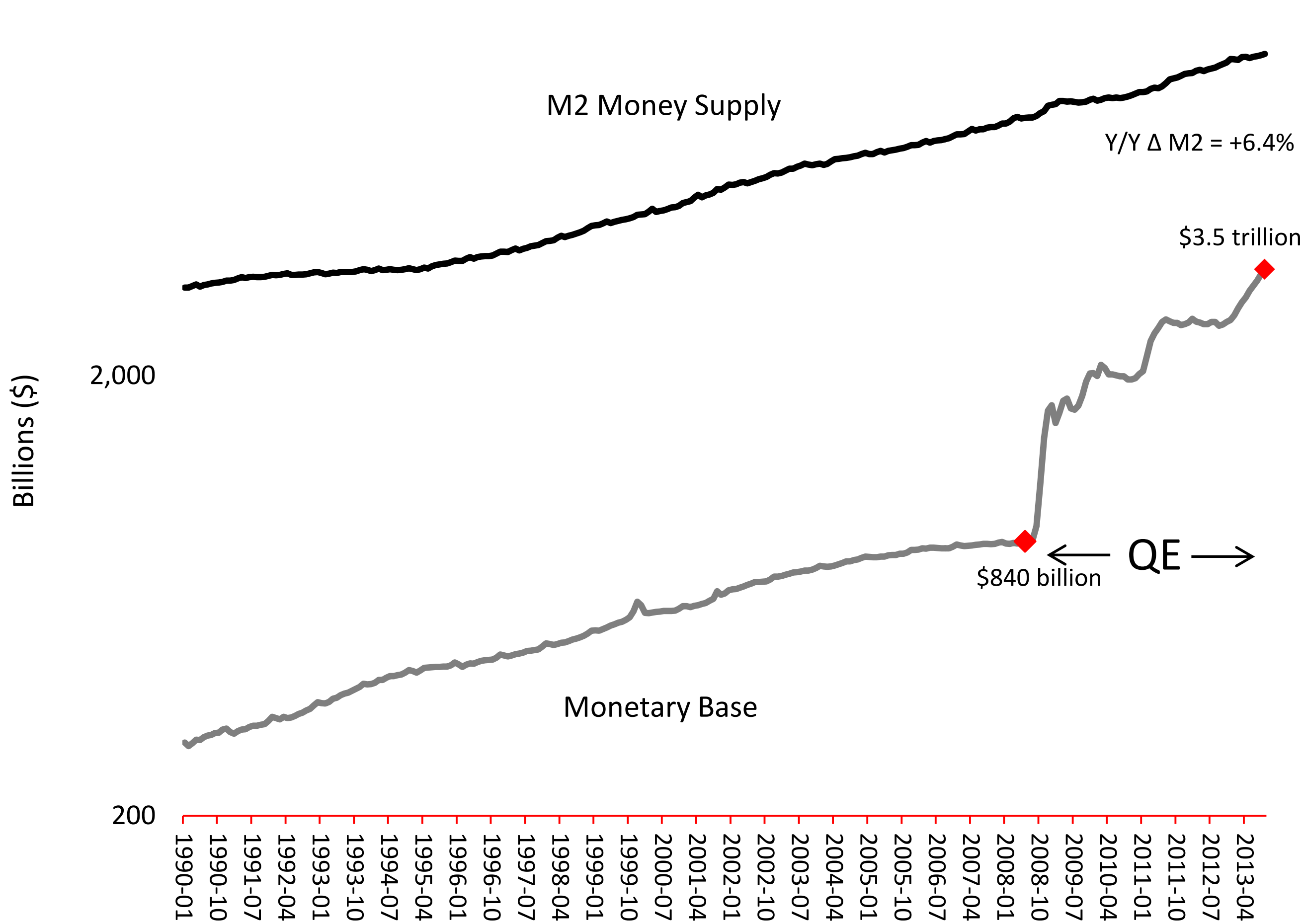
World GDP growth forecasts – better growth expected in 2014



Source: OECD *Economic Outlook Update*, November 19, 2013.

"The Fed is printing money." Key distinction between money supply and monetary base.

The Federal Reserve has engineered an explosion in the Monetary Base — reserves that commercial banks keep on deposit at the Fed — in an effort to restore confidence in banks and stimulate the economy. M2 — which is a function of both supply *and* demand for funds — is responding sluggishly.



The Fed's money-printing has increased the money supply. Banks have parked at the Fed about $1.5 trillion more than their required reserves. Inflation-phobes predict those reserves will someday turn into loans, flooding the economy with credit and triggering inflation.

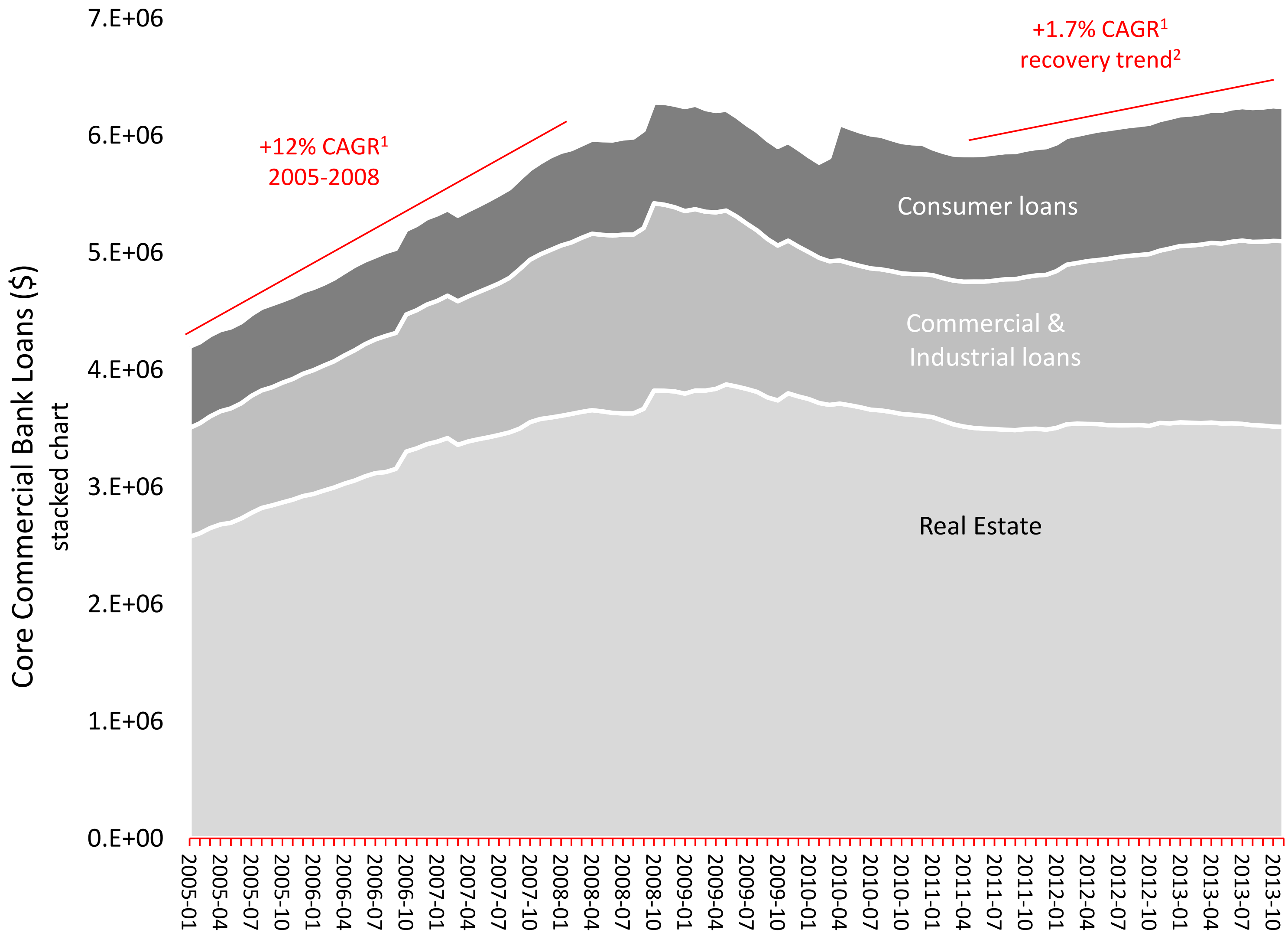
Mr. Bernanke says that won't happen because, unlike his predecessors, he has the legal authority to boost the interest rate (now 0.25%) the Fed pays banks on those reserves. Raising that rate would encourage banks to leave money at the Fed instead of lending it. It also would lead banks to charge higher rates on loans, discouraging borrowing. "We have all the tools we need to undo our monetary-policy stimulus and to take that away before inflation becomes our problem," Mr. Bernanke insists.

That is plausible, though untested.

Source: Federal Reserve. Data through September 2013, released November 7, 2013. *The Wall Street Journal,* January 16, 2013.

Economic Data – credit

Core Commercial Bank Loans

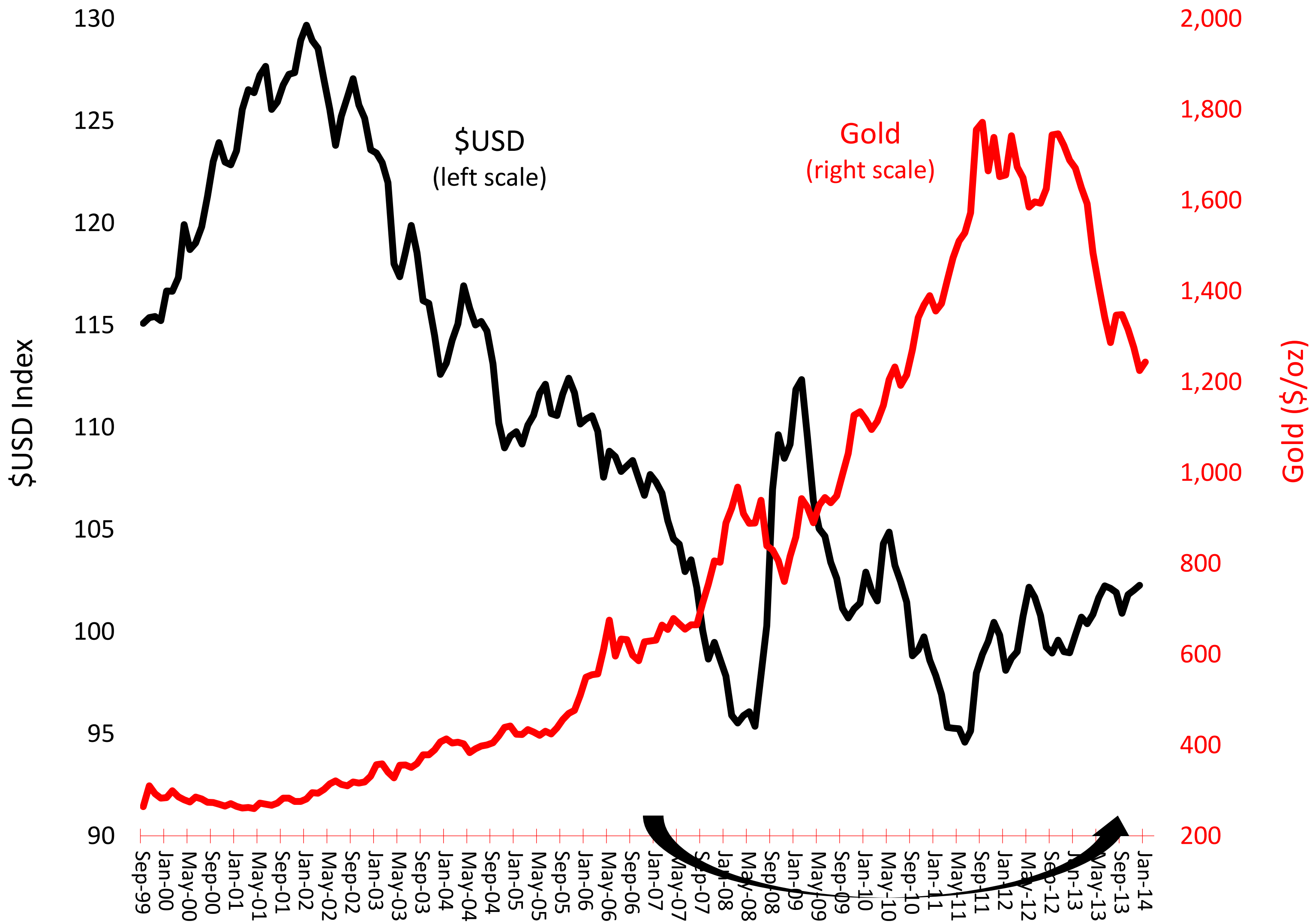


Total core commercial bank lending has been growing at a sluggish rate principally because real estate bank lending is still contracting slightly.

This explains why money supply growth has remained so constrained despite the Fed’s efforts to make abundant funds available for lending.

Source: Federal Reserve, data through November. 6.E+06 = $6 trillion.
[1] Compound annual growth rate. [2] 3-years ended November 2013.

Gold



Sources: Federal Reserve broad dollar index and London spot prices. Data through January 10, 2014.

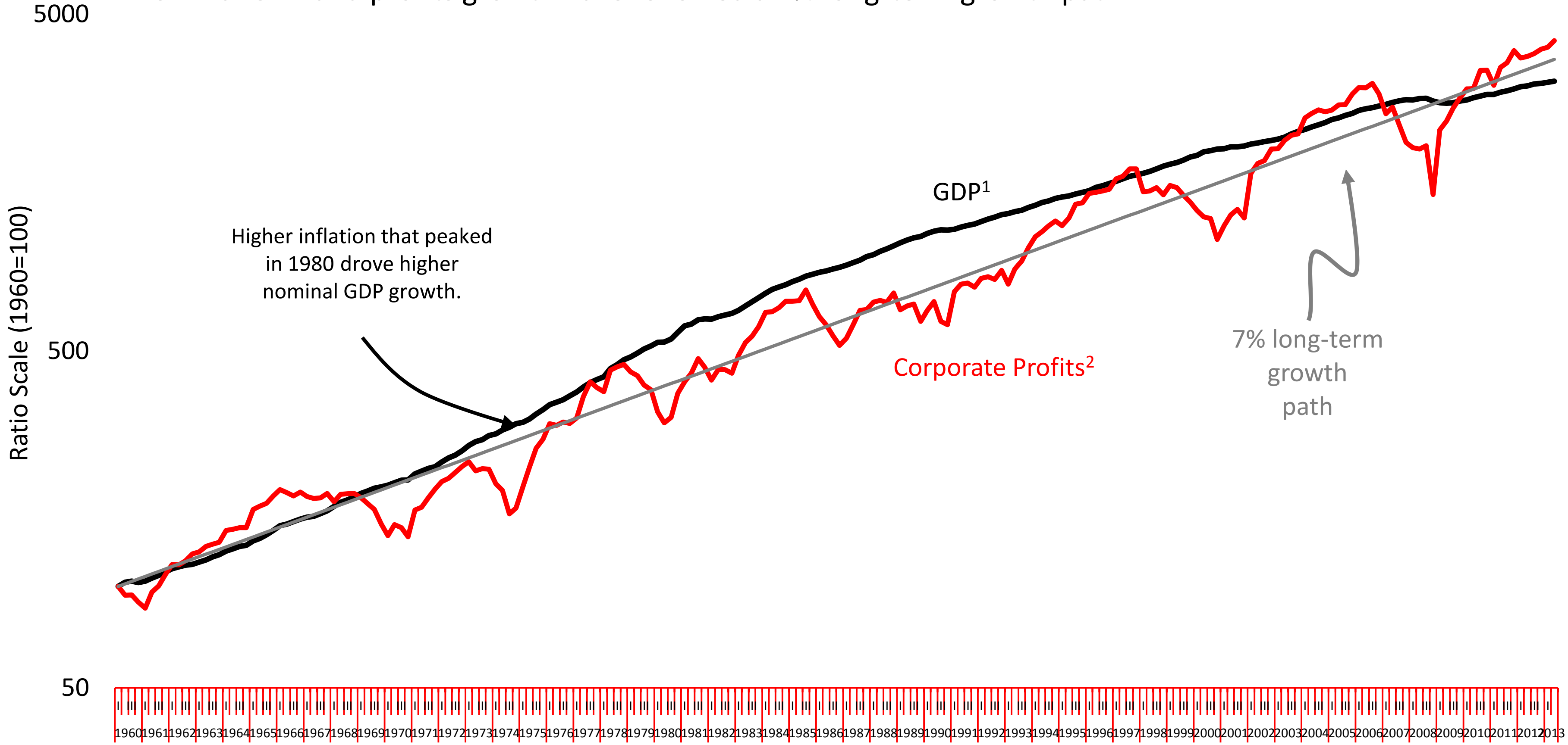
Gold has generally trended inversely to the dollar.

Until 2011, gold trended relentlessly higher as investors sought a safe haven from paper currency debasement and geopolitical risks.

The perception has changed. The $USD appears to be putting in a big, saucer-shaped bottom.

GDP growth and earnings

What drives stock prices? Corporate profits.
What drives corporate profits growth? GDP growth.
Nominal GDP and profits growth have followed a 7% long-term growth path.



[1] Nominal GDP.
[2] Corporate profits after tax with inventory valuation and capital consumption adjustments.
Source: U.S. Department of Commerce, Bureau of Economic Analysis. Data through June 2013.

Important Information

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment making decision. As with all investments there are associated inherent risks. Please obtain and review all financial material carefully before investing.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice.

These materials may contain statements that are not purely historical in nature but are "forward-looking statements." These include, among other things, projections, forecasts, estimates of income, yield or return or future performance targets. These forward-looking statements are based upon certain assumptions, some of which are described herein. Actual events are difficult to predict and may substantially differ from those assumed. All forward-looking statements included herein are based on information available on the date hereof and Endowment Wealth Management, Inc. assumes no duty to update any forward-looking statement. Accordingly, there can be no assurance that estimated returns or projections can be realized, that forward-looking statements will materialize or that actual returns or results will not be materially lower than those presented.

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