Quarterly Economic & Market Update

4th Quarter 2014

Prateek Mehrotra, MBA, CFA®, CAIA

Chief Investment Officer

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

Disclaimer/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.

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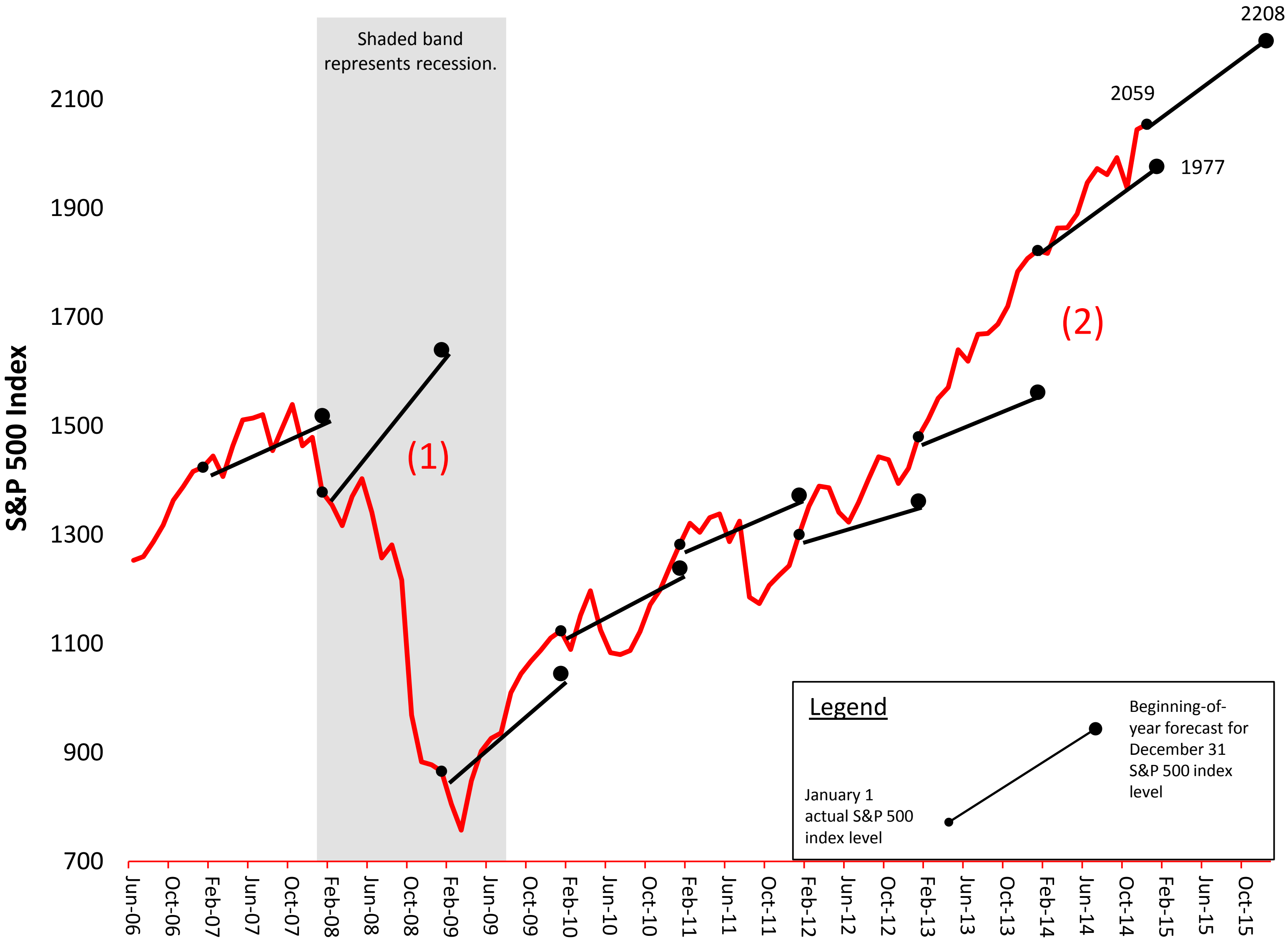
Stock Markets

S&P 500 Forecast Returns vs Actuals, Economic Drivers for Stocks, P/E Ratios vs Inflation, Earnings Forecast vs Actuals, Goldilocks, US$ and US Stocks

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



+7% gain forecast for 2015.

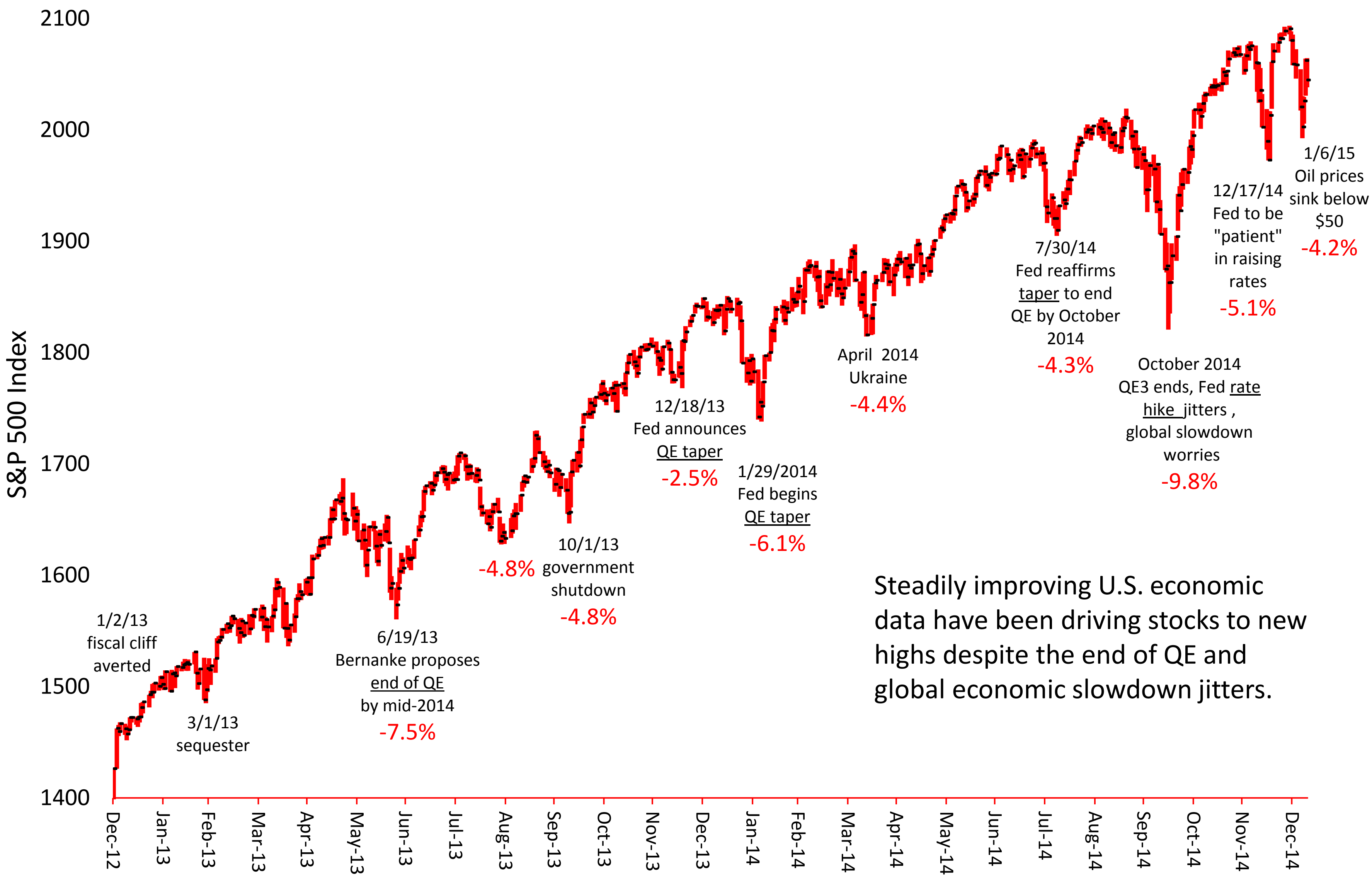
Strategists, like economists, got completely blindsided by the financial meltdown and recession of 2008. (1)

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, 2014.

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

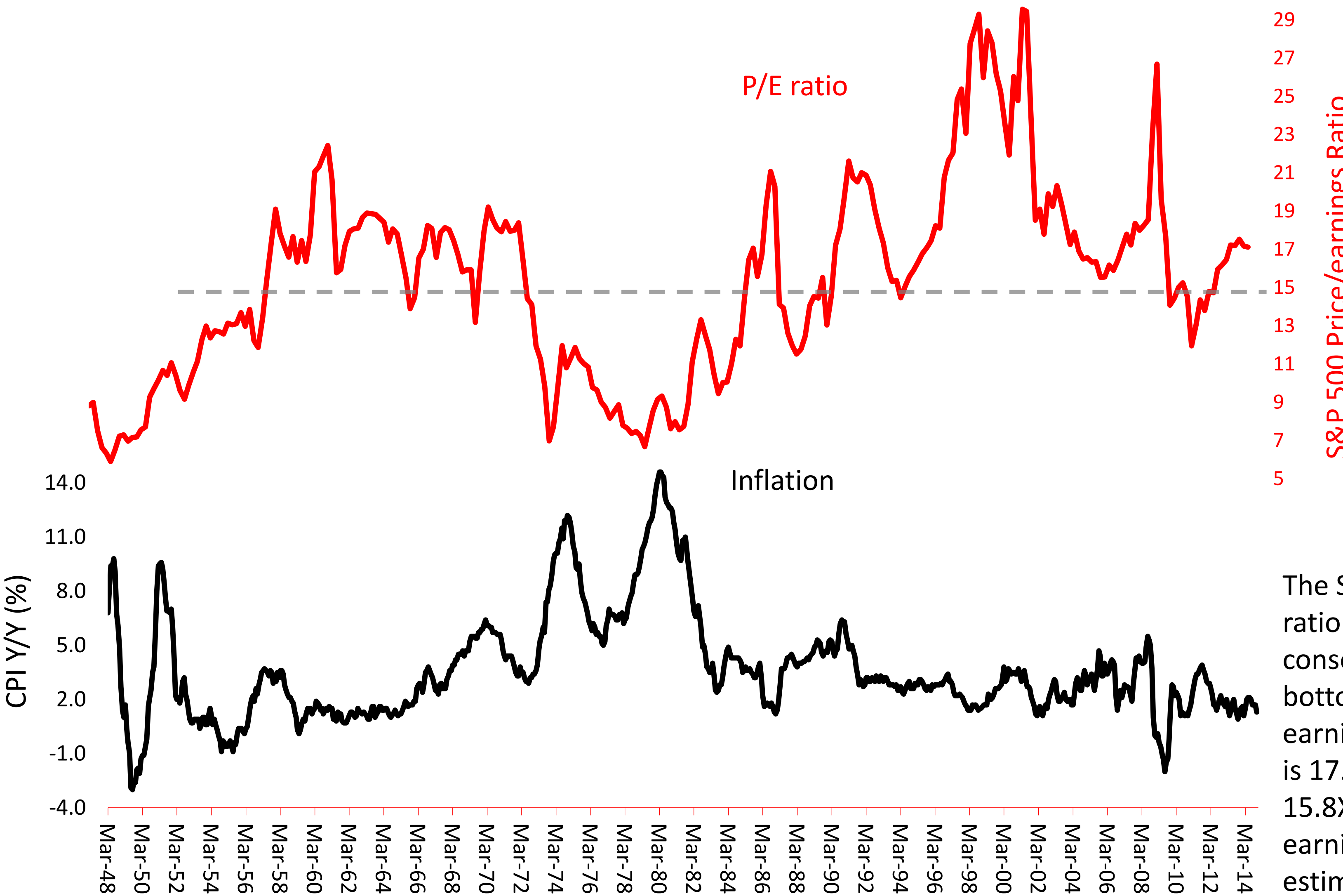
S&P 500 – economic fundamentals are in the drivers seat



Source: Standard and Poor's, data through January 9, 2015.

Overvaluation?

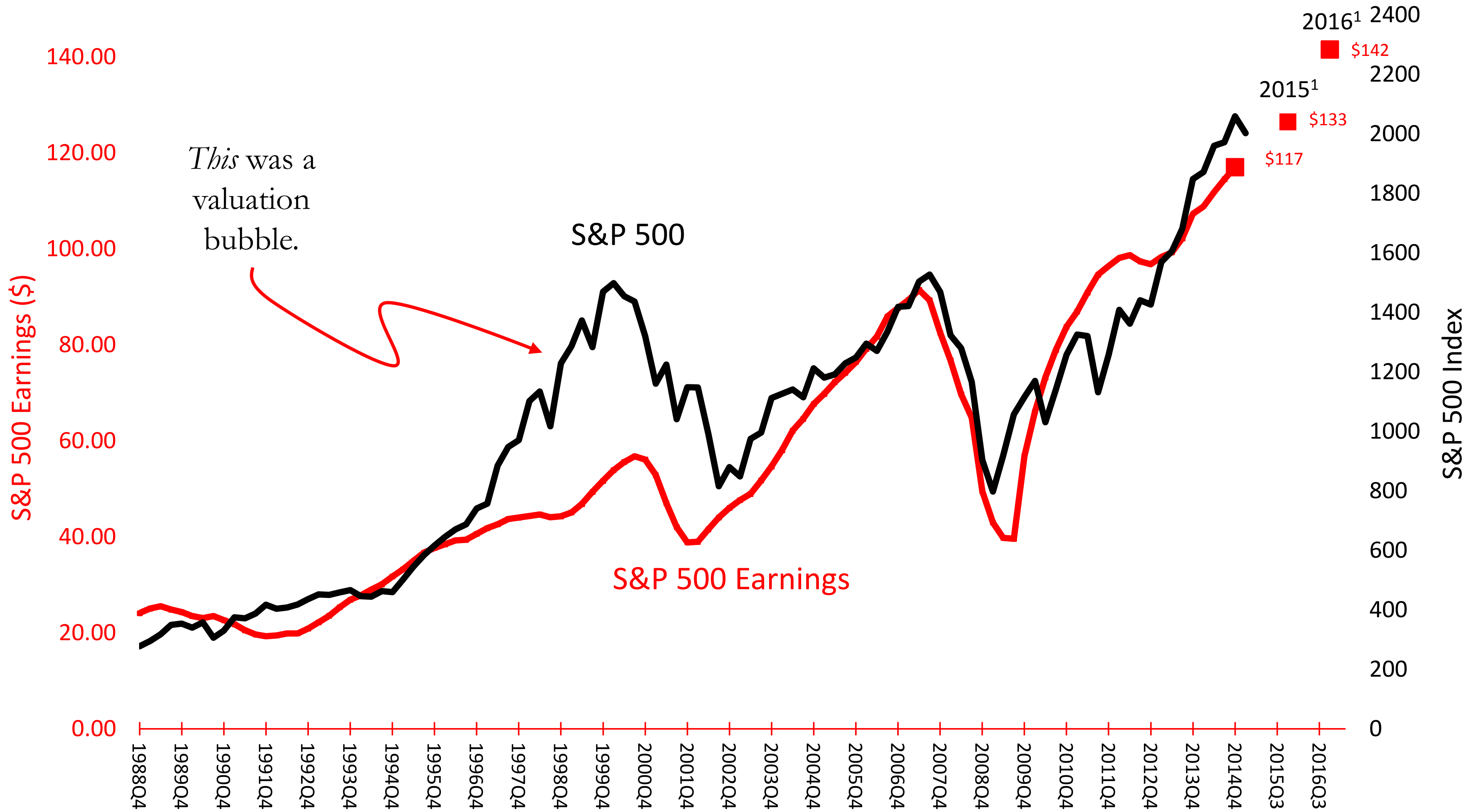
Valuation – S&P 500 P/E ratio



The S&P 500's P/E ratio (1/6/15) on consensus 2014 bottom-up earnings estimate is 17.1X[1]; and 15.8X[1] on 2015 earnings estimates.

Sources: Standard & Poor's Corporation, Thomson Reuters I/B/E/S, BLS. Stock price data through January 6, 2015; inflation data through November 2014. Top panel, latest data point: 2002 ÷ trailing earnings of $117.02 through 12/31/14 = 17.1X. [1]S&P 500 at 2002 ÷ 2014 EPS(e) $117.02; 2015 EPS(e) $126.50.

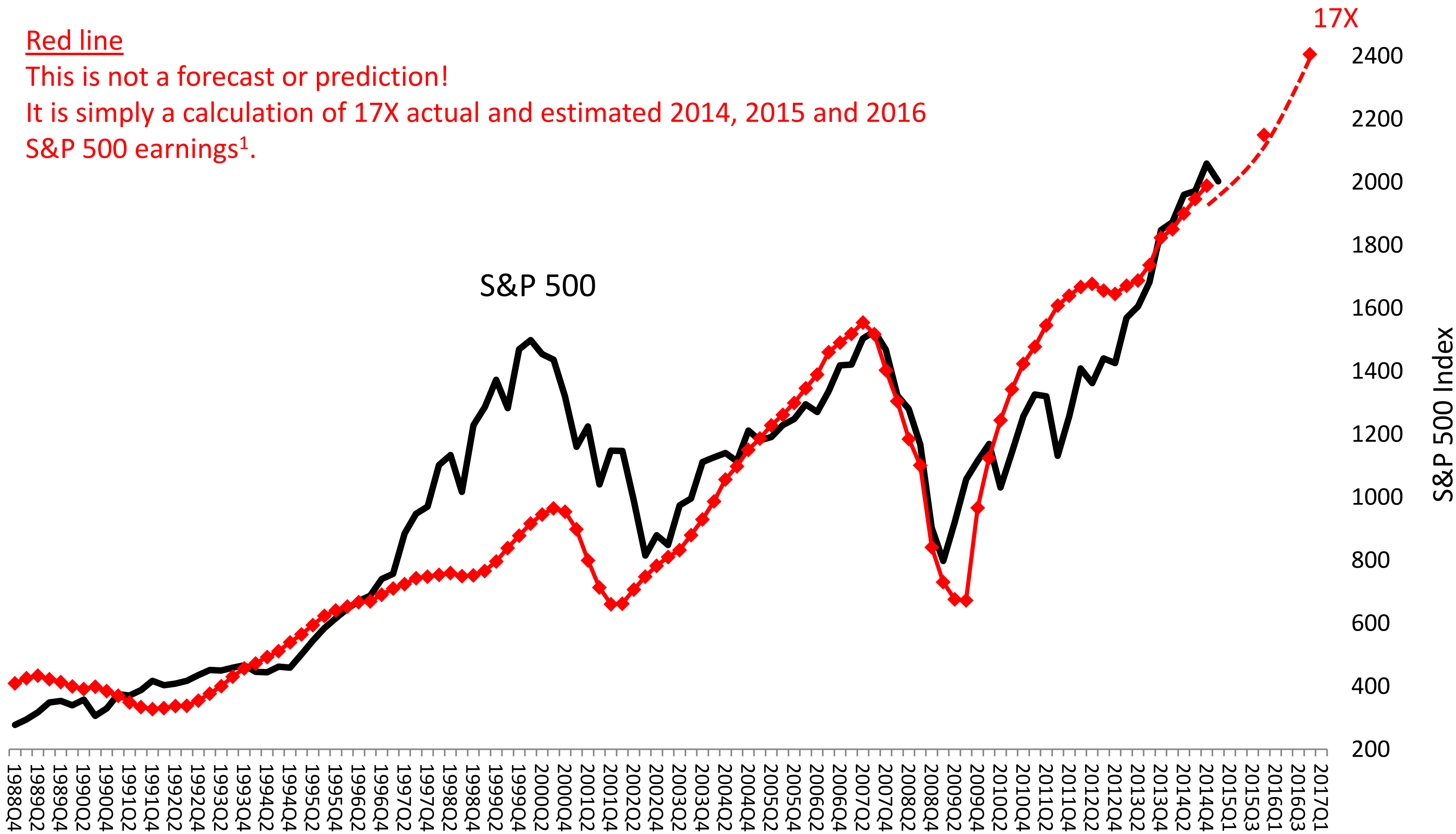
S&P 500 vs. actual and estimated earnings



[1] Estimated 2014, 2015 and 2016 bottom-up S&P 500 earnings per share (left scale) as of December 25, 2014: for 2014, $117.02; for 2015, $126.50; for 2016, $141.54. 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 6, 2015; and actual earnings data through September 2014.

Overvaluation?

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



[1] Estimated 2014, 2015 and 2016 bottom-up S&P 500 earnings per share as of December 25, 2014: for 2014, \$117.02; for 2015, \$126.50; for 2016, \$141.54.
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 6, 2015; and actual earnings data through September 2014.

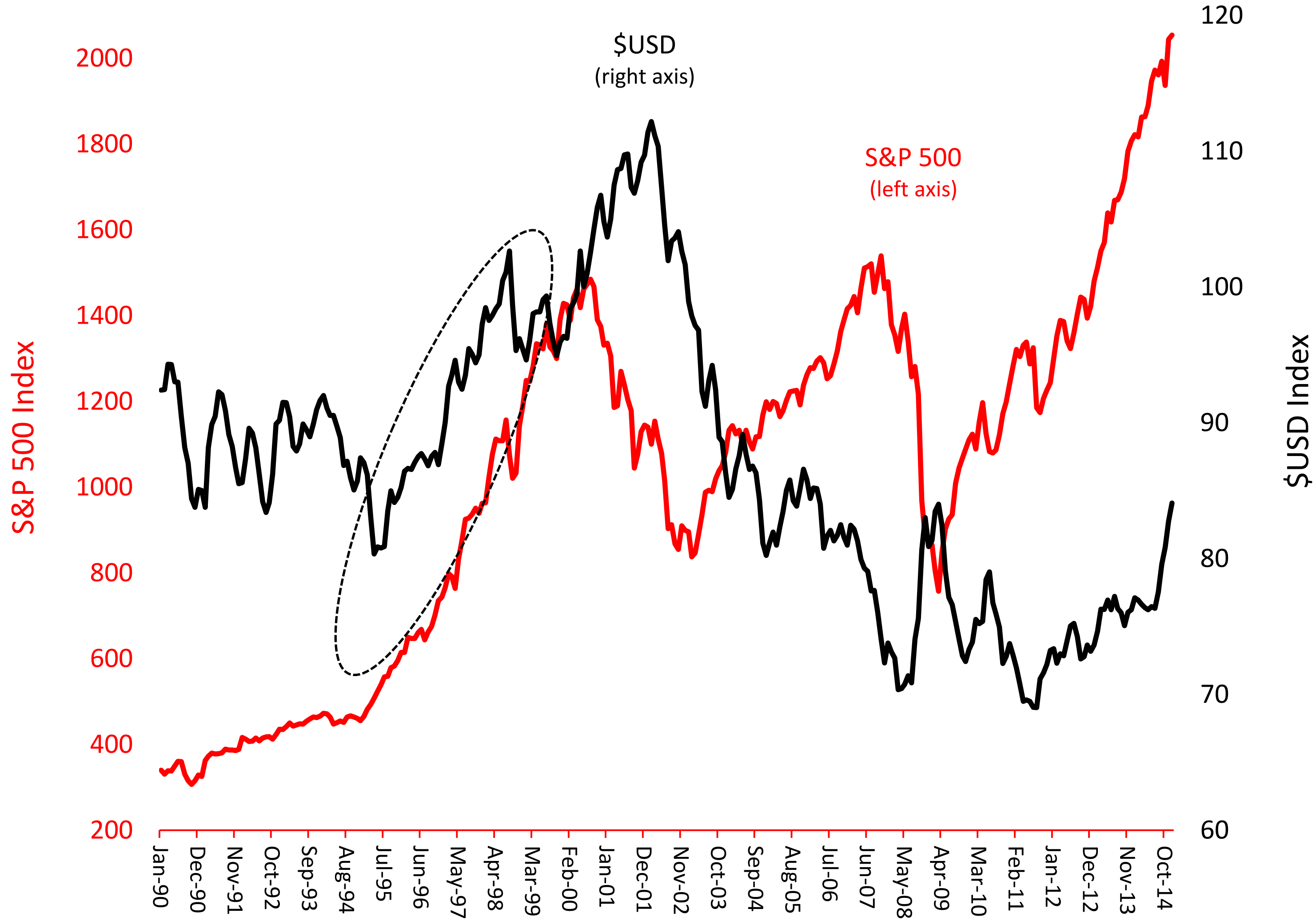
S&P 500 – economic fundamentals in the drivers seat

<u>Gold-i-locks</u> (gold'-ē-lŏks) *adj*. Not too hot, not too cold … just right for sustained economic expansion with low inflation.

PMIs car sales and housing starts unemployment claims new jobs and declining unemployment rate bank lending	signal strong current activity
earnings estimates leading economic indicators oil price cut stimulus Fed is far from hiking target funds rate yield curve compression is probably *years* away	signal strong forward activity
flat unit labor costs commodity price weakness	signal continued benign inflation

Strong dollar bad for stocks?

S&P 500 vs. $USD



Source: Standard and Poor's, Federal Reserve. Data through December 31, 2014.

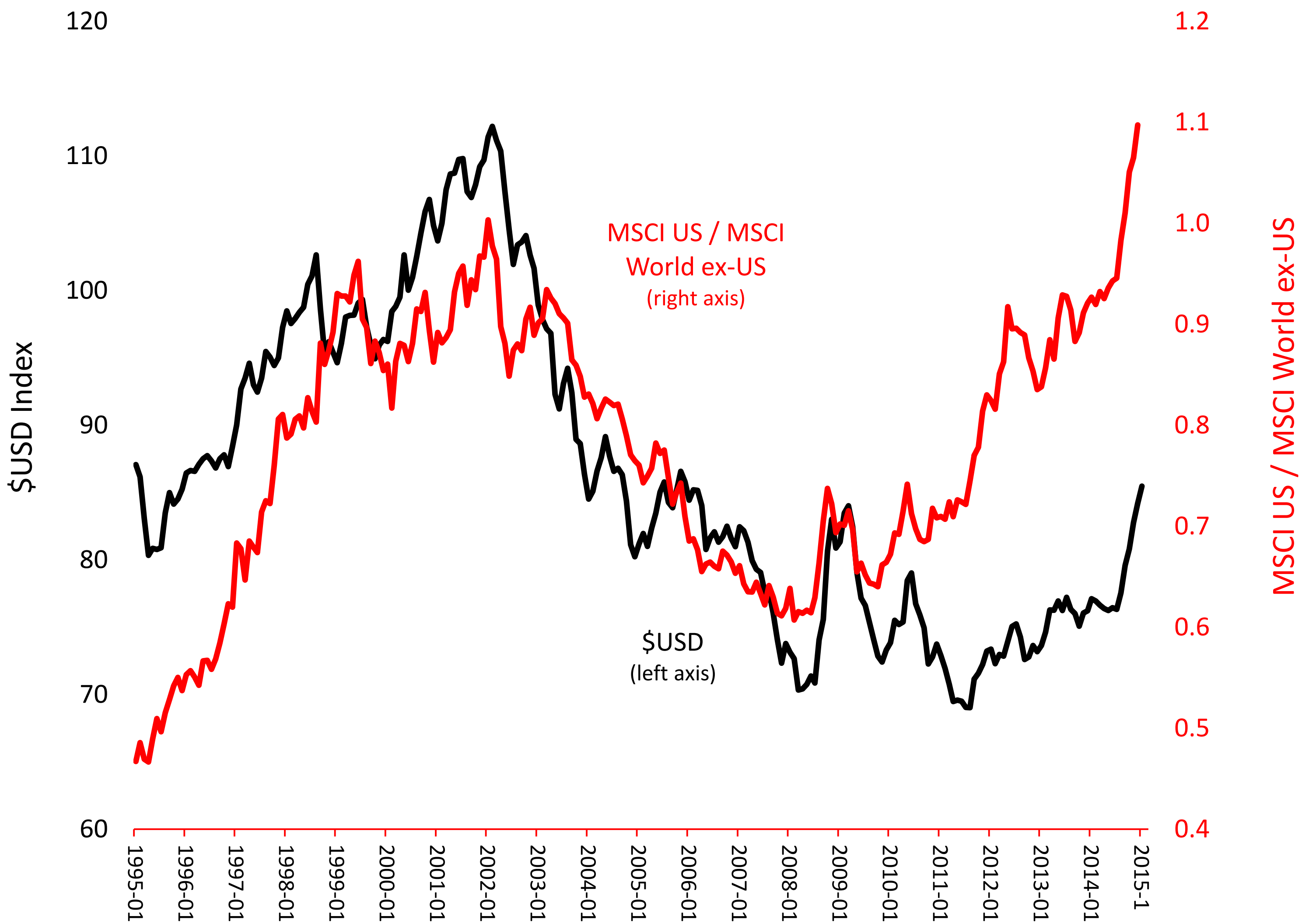
Strong dollar bad for stocks?

The argument is often made that a stronger dollar makes it tougher for exporters and foreign currency translation, hurting earnings and, thus, stock prices.

<u>The record illustrates bull markets in periods of both rising and falling $USD.</u>

Strong dollar good for U.S. stocks

U.S. stocks outperform rest-of-world on $USD strength



Dollar strength is closely correlated with U.S. stocks outperforming rest-of-world.

Source: MSCI. Data through December 2014.

U.S. Dollar index

How high could the $USD go?

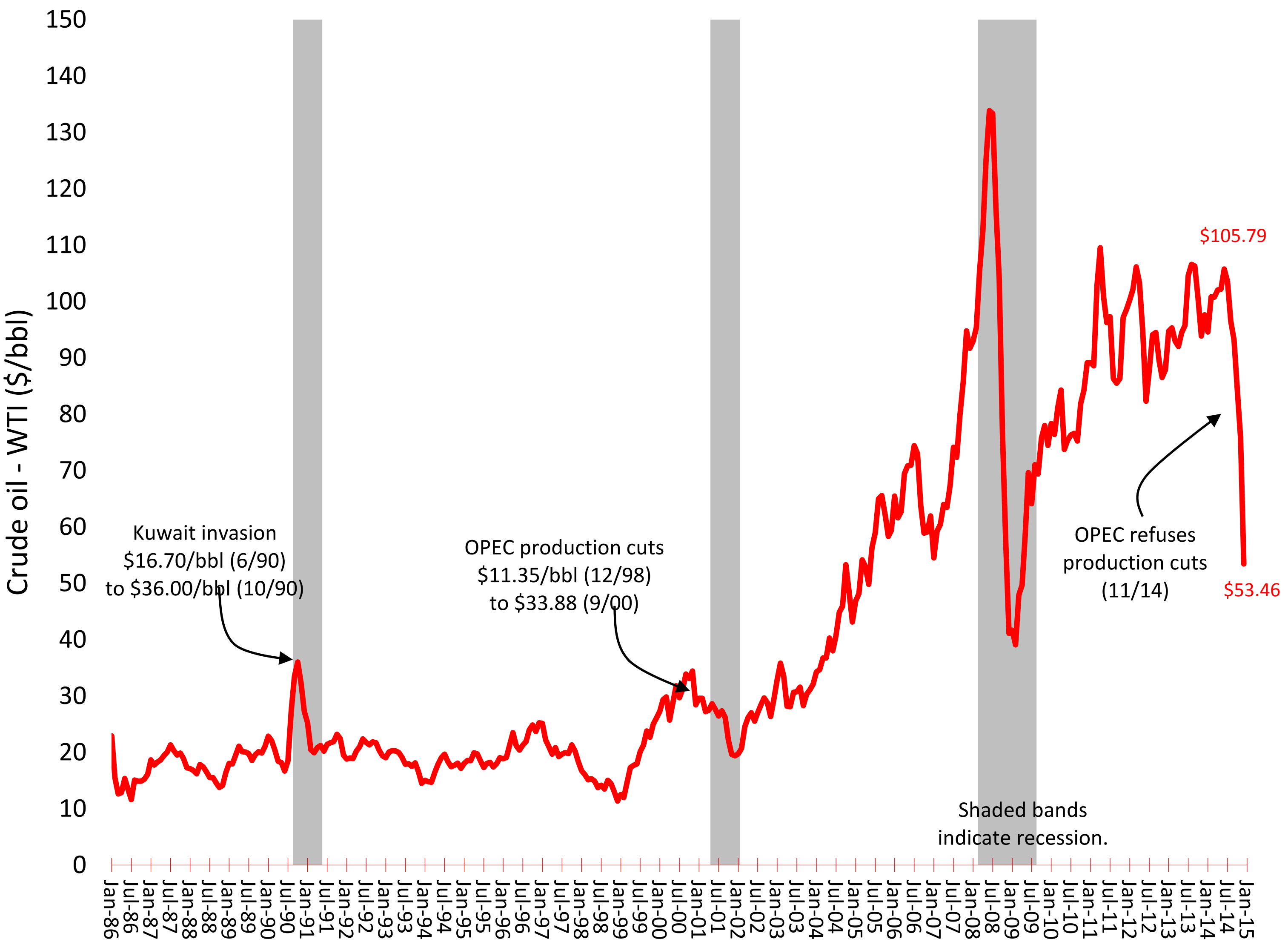
Despite its dramatic surge, it looks like the $USD could go higher.

Sources: Federal Reserve major currencies index. Monthly data through December 2014.

Crude Oil Prices

Oil Price & Recessions, World Crude Oil Supply vs Demand, Decline in Crude Prices, Decline in Crude Oil Price Stimulus, Crude Oil Price vs Inflation

WTI spot crude oil prices

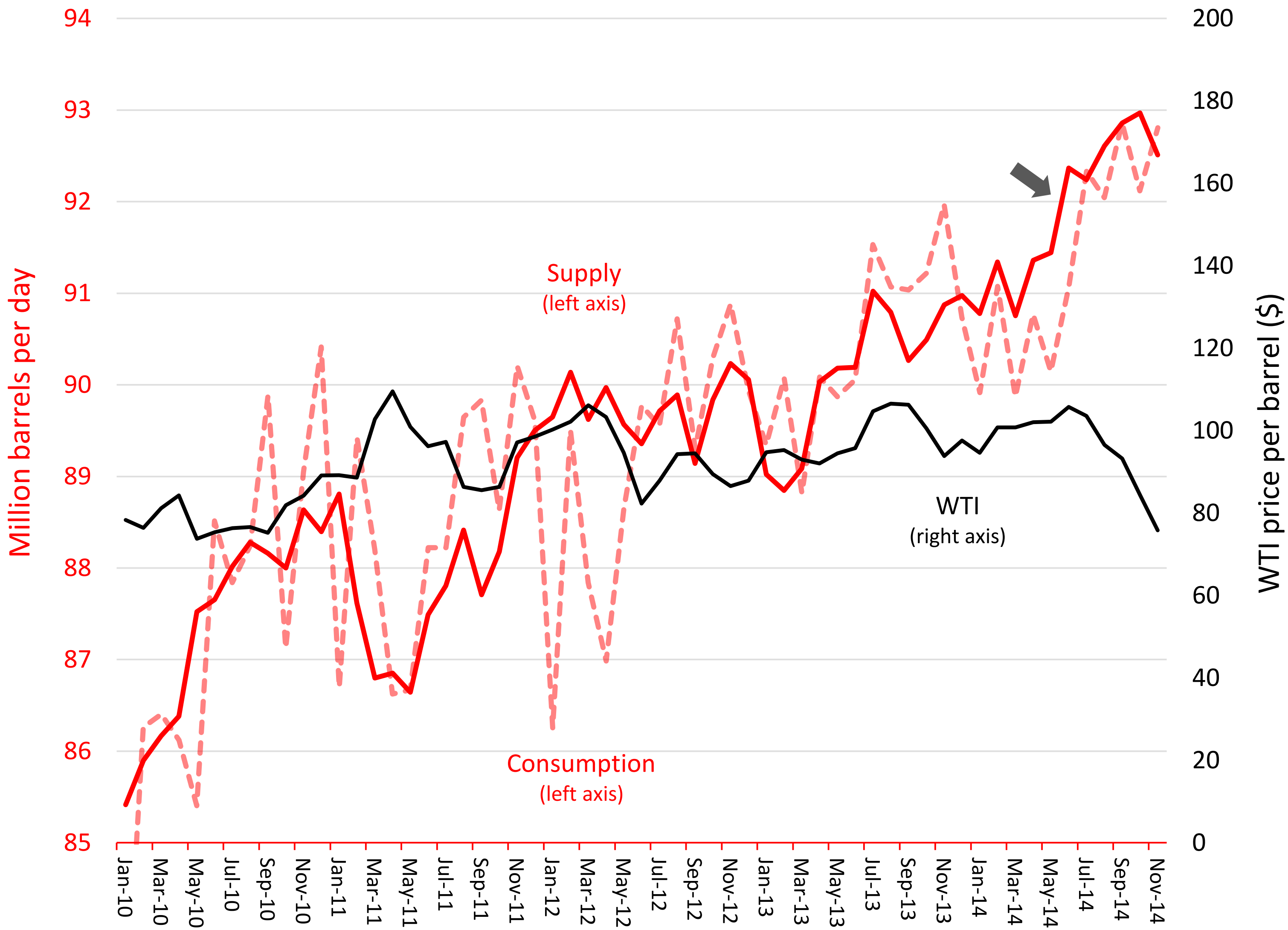


Source: U.S. Energy Information Agency. Data through December 29, 2014.

In November 2014, in the midst of increasing over-supply, OPEC refused to cut production while non-OPEC is boosting production.

WTI is down -49% from June.

World crude oil supply vs. consumption

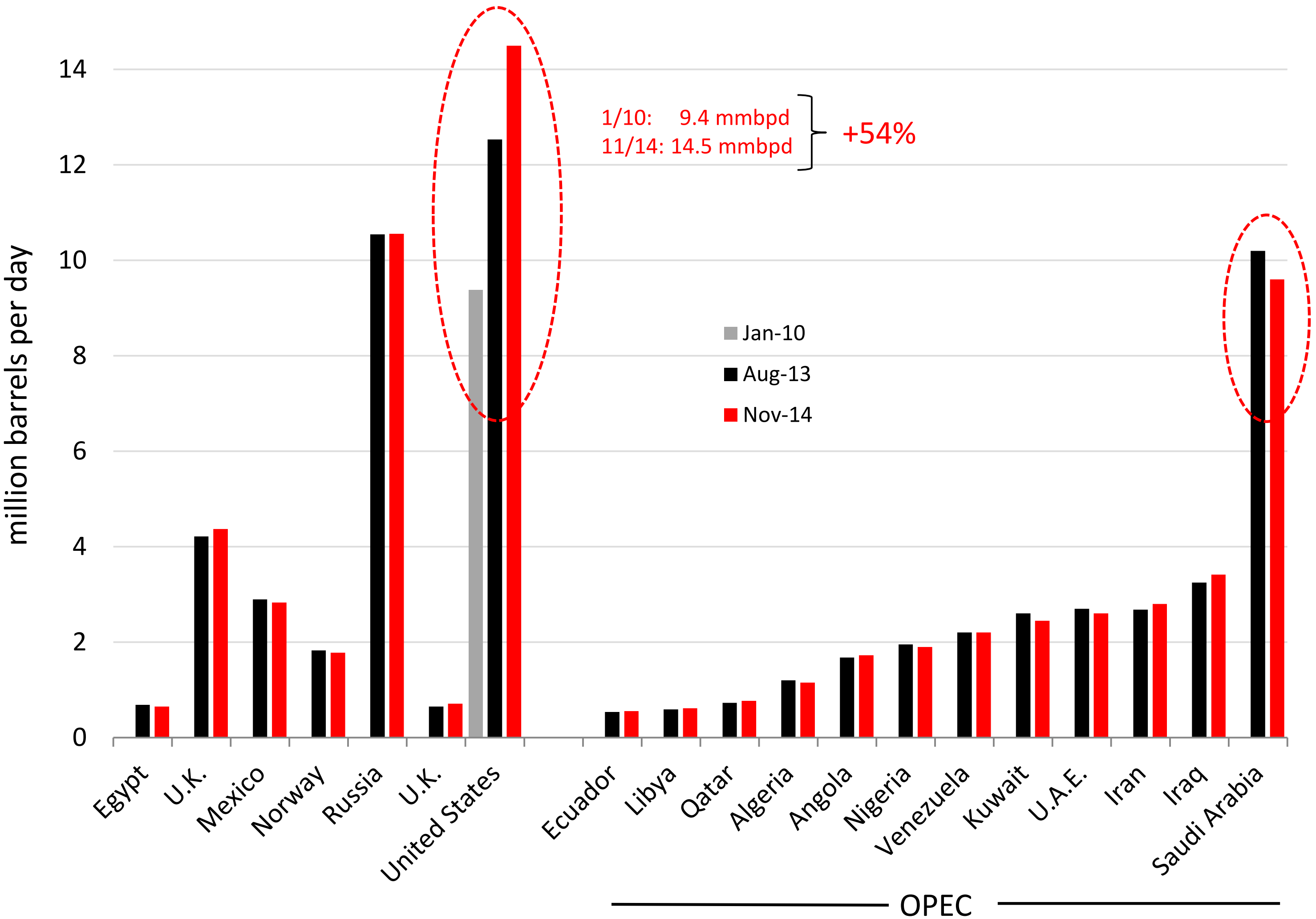


In 2014, global supply surged, outstripping demand growth, driving prices down.

But, November supply dropped and consumption popped. Stay tuned.

Source: U.S. Energy Information Agency, *Short-Term Energy Outlook*, December 2014. Includes condensate and natural gas liquids.

World crude oil production – why the price war?



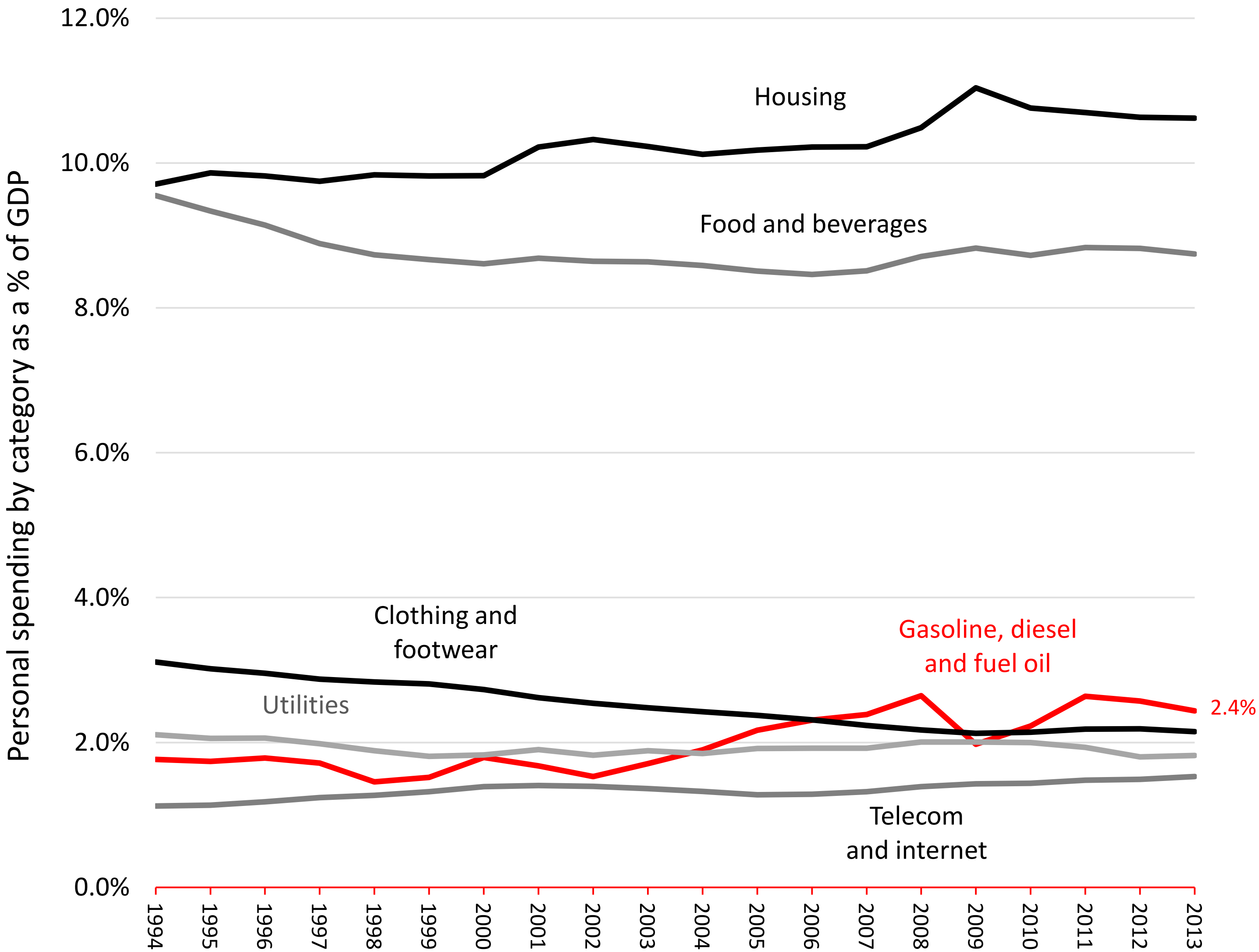
U.S. shale production has upset the global supply/demand equilibrium.

Saudi Arabia has borne the brunt of the production cuts while others in OPEC have increased.

Saudis are not going to take it any more!

Source: U.S. Energy Information Agency, *Short-Term Energy Outlook*, December 2014. For non-OPEC producers the figures include crude oil plus liquids production. For OPEC producers the figures include crude oil but exclude liquids.

Lower pump prices – how much of a stimulus?

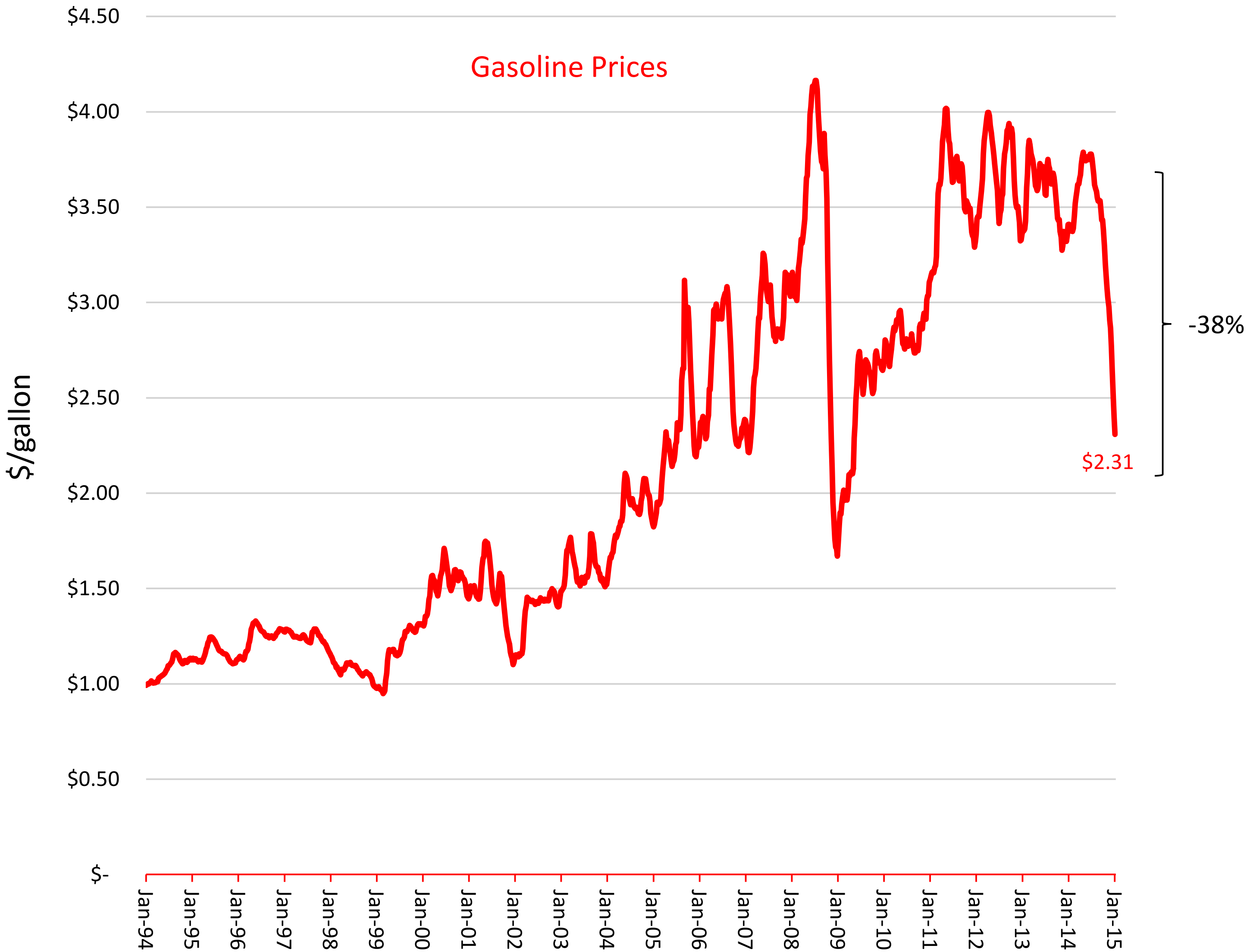


Source: BEA. Annual data through 2013.

How to quantify the stimulus from lower crude oil prices?

Gasoline, diesel and fuel oil constitute 2.4% of GDP.

Lower pump prices – how much of a stimulus?



Source: EIA, Weekly U.S. All Grades All Formulations Retail Gasoline Prices. Data through January 5, 2015.

How to quantify the stimulus from lower crude oil prices?

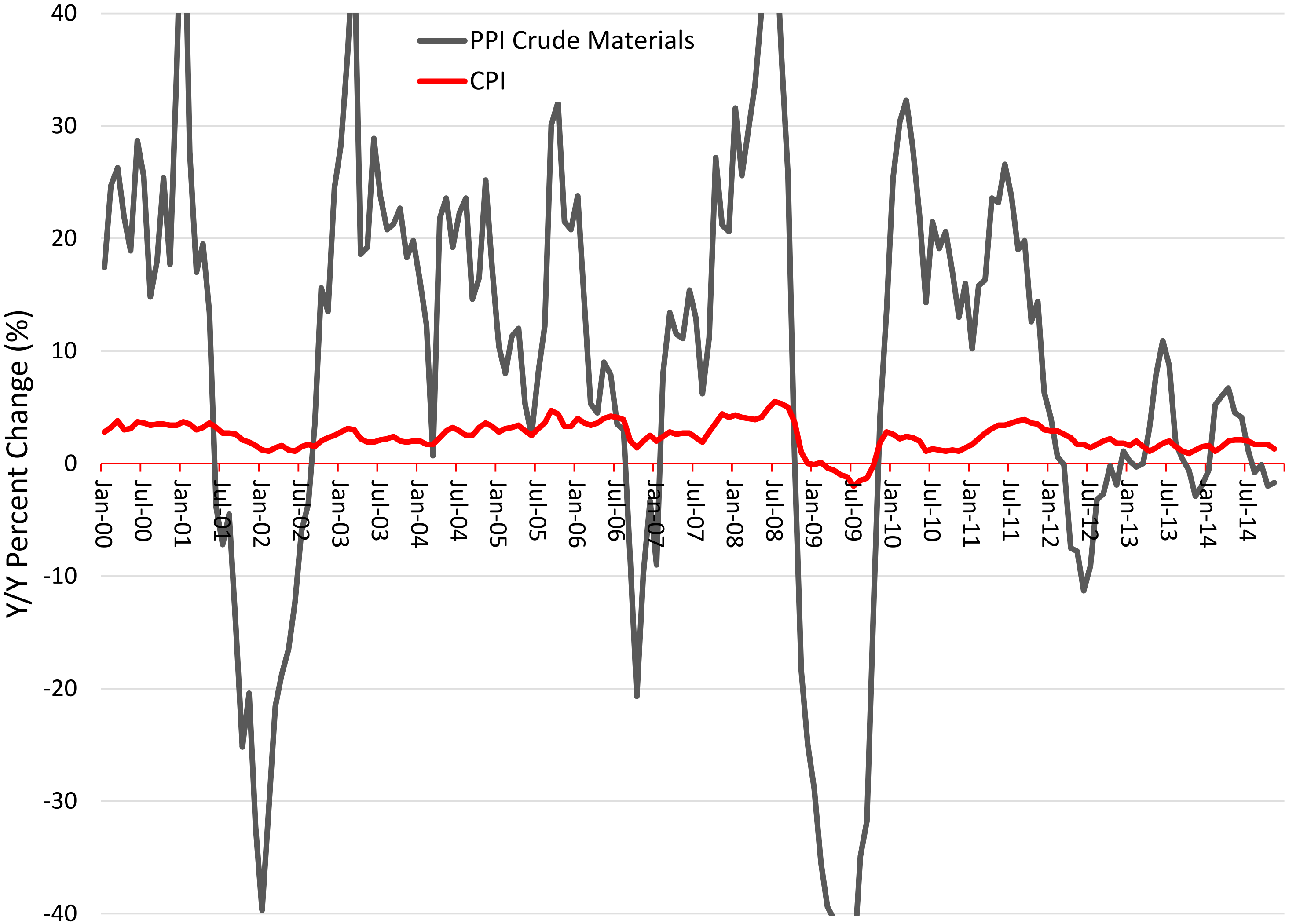
Gasoline, diesel and fuel oil purchases constitute 2.4% of GDP.

A sustained -38% drop in gas prices might give a +0.9% kick to GDP (38% of 2.4%).

This assumes that consumers spend all of their gasoline savings in other retail categories, which is probably unrealistic.

Also, there will be an offset from diminished drilling activity.

Food and energy vs. inflation



Source: Bureau of Labor Statistics, data through November 2014.

PPI Crude Materials captures commodity price inflation. This measure is comprised roughly 60% of crude foodstuffs, feedstuffs and crude oil; and roughly 40% of all other commodities used in manufacturing, including metals.

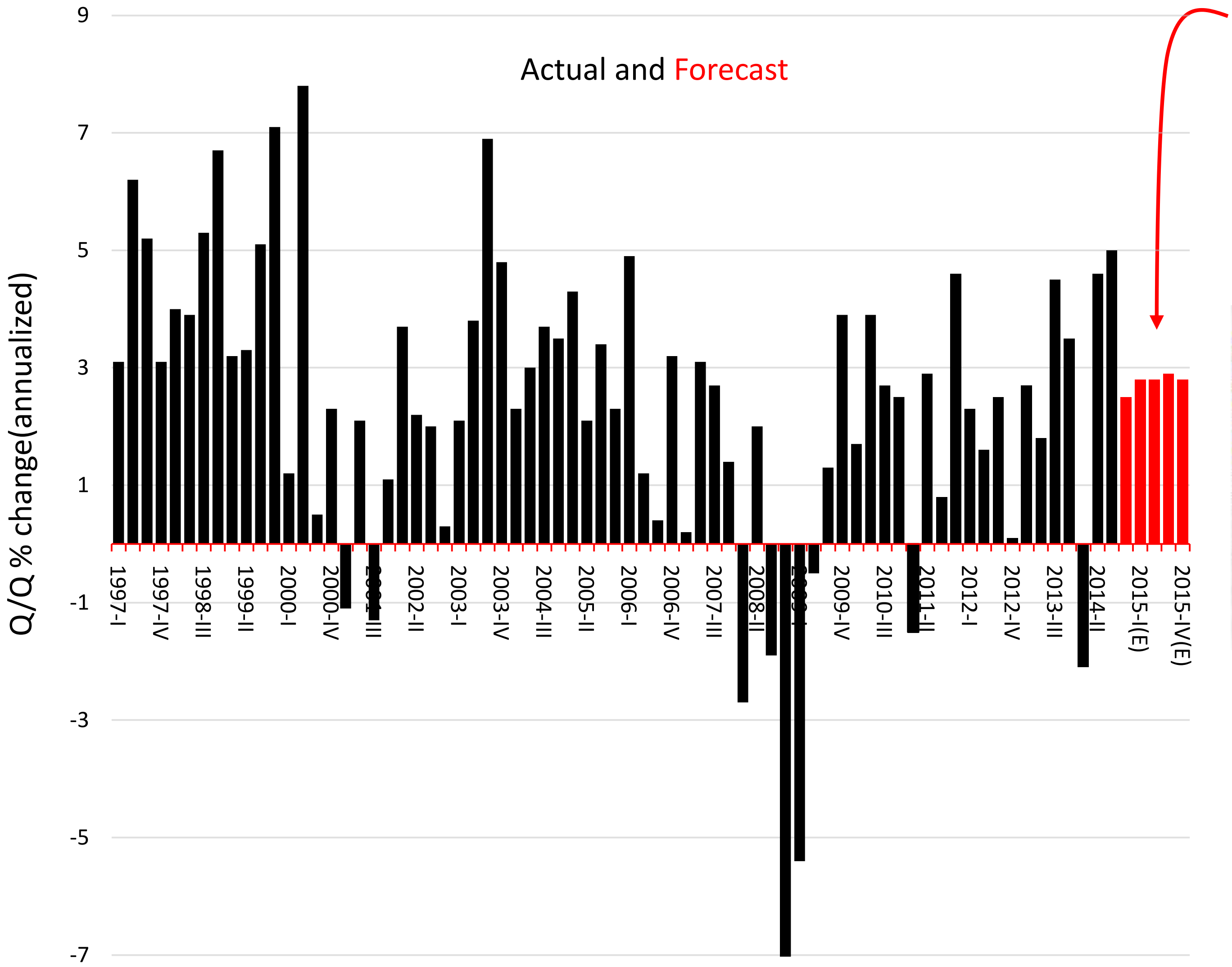
<u>The recent plunge in commodity inflation is feeding through to downward pressure on the CPI.</u>

U.S. Economy

US GDP Growth Forecast, U.S. LEI, CBO 10 Year Projected GDP Growth, Contributions to GDP Growth

Consensus U.S. economic forecast

Gross Domestic Product (GDP) Growth



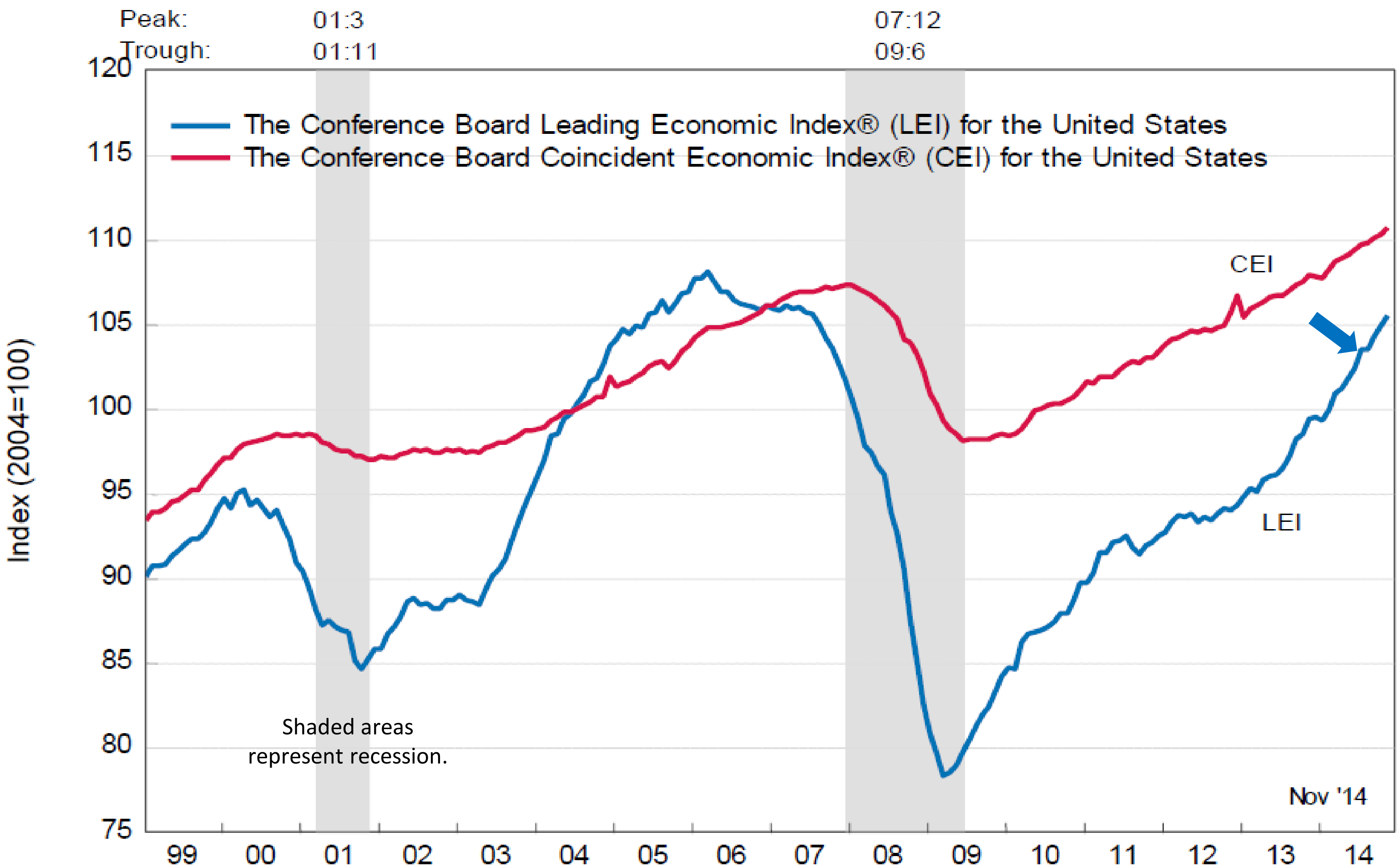
December forecast: economists see strong GDP growth in the quarters ahead.

The IMF is raising its forecast for U.S. growth next year to 3.5% from its last estimate of 3.1%, in part because of expected lower energy costs. "There will be winners and losers, but on a net-net basis, it's good news for the global economy," said IMF Managing Director Christine Lagarde at The Wall Street Journal CEO Council meeting last week.

Part of the boost comes from lower transportation and manufacturing costs, particularly for energy-intensive industries such as airlines and steelmaking. The primary benefit is more cash in consumers' wallets as they spend less of their paychecks fueling their vehicles, spurring more consumer spending.

Sources: Bureau of Economic Analysis, actual data through September 2014; *The Wall Street Journal* survey taken December 2014; article dated December 8, 2014.

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



"Widespread and persistent gains in the LEI point to strong underlying conditions in the U.S. economic expansion."

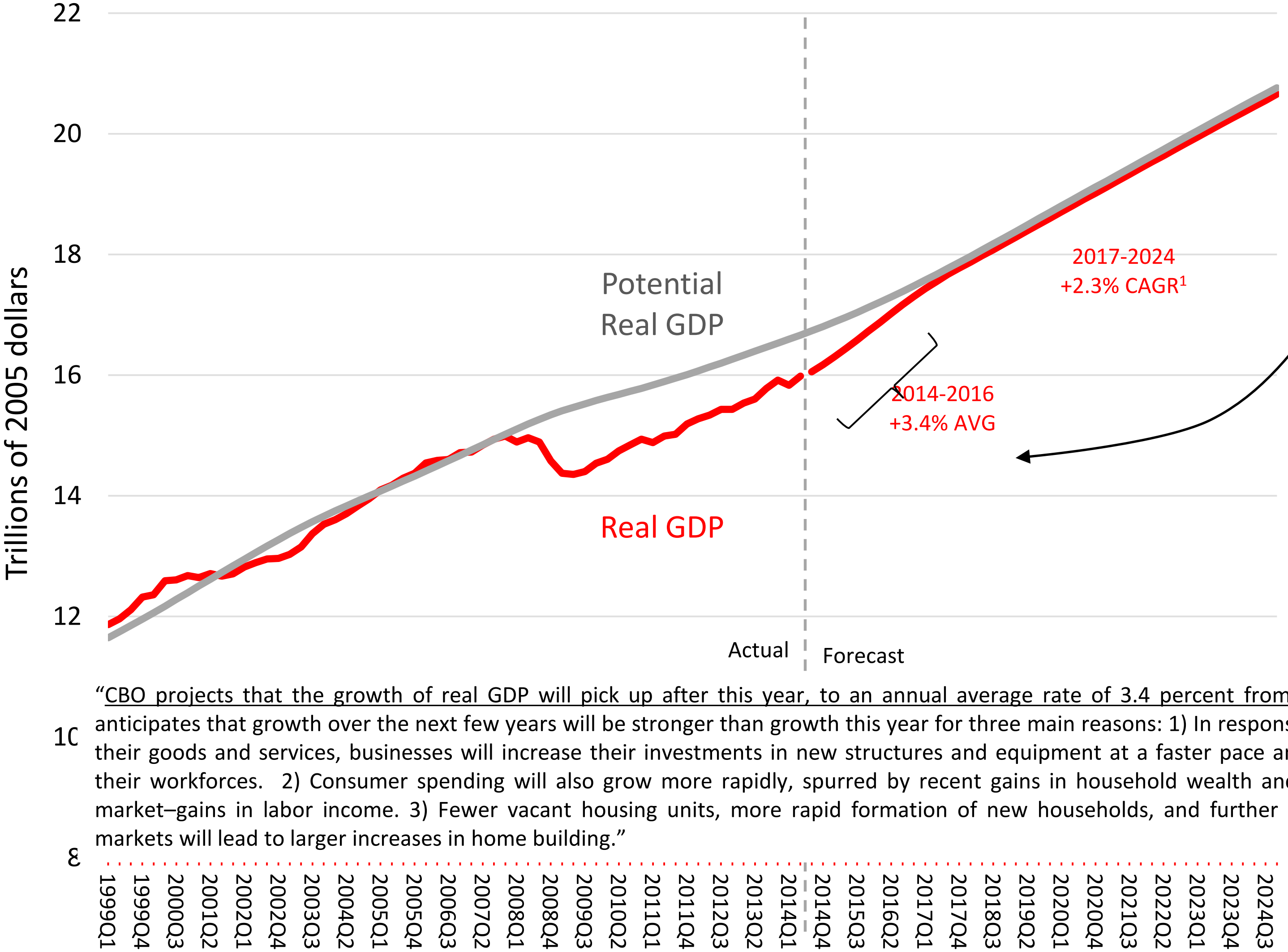
The Conference Board
December 18, 2014

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 2014, released December 18, 2014.

Secular stagnation? Not.

CBO's latest 10-year projected GDP growth



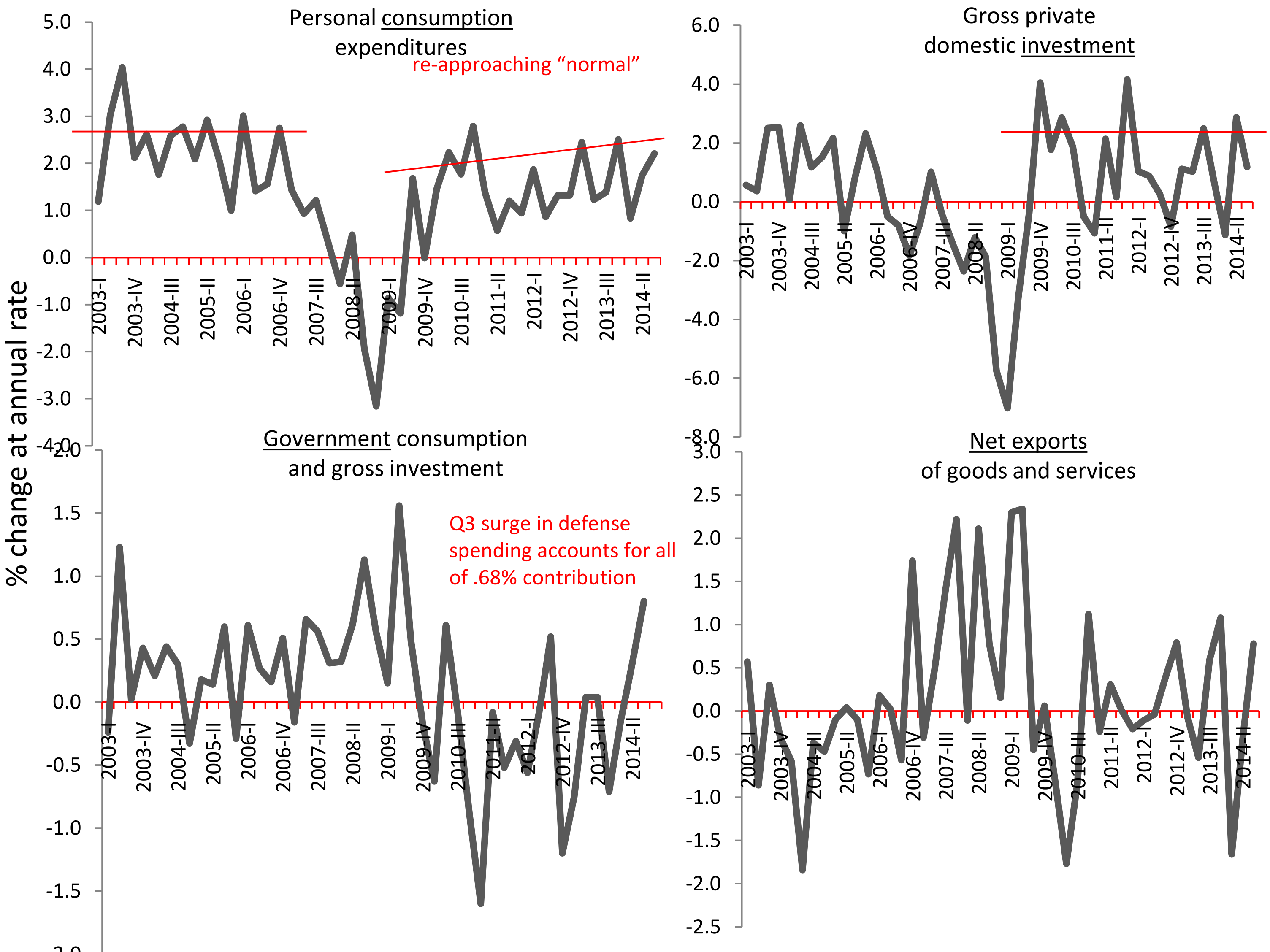
"CBO projects that the growth of real GDP will pick up after this year, to an annual average rate of 3.4 percent from 2014 through 2016. CBO anticipates that growth over the next few years will be stronger than growth this year for three main reasons: 1) In response to increased demand for their goods and services, businesses will increase their investments in new structures and equipment at a faster pace and will continue to expand their workforces. 2) Consumer spending will also grow more rapidly, spurred by recent gains in household wealth and–with an improving labor market–gains in labor income. 3) Fewer vacant housing units, more rapid formation of new households, and further improvement in mortgage markets will lead to larger increases in home building."

CBO sees a reversion to potential GDP growth looking out through 2024. This doesn't square with "secular stagnation."

If this looks anywhere close to plausible to investors it would explain why this bull market has been such an upside surprise and why it might have more room to run.

Source: Source: Congressional Budget Office (CBO), An Update to the *Budget and Economic Outlook: Fiscal Years 2014 to 2024*, August 27, 2014.
[1]Compound annual growth rate.

Contributions to GDP growth: C + I + G + Net Exports



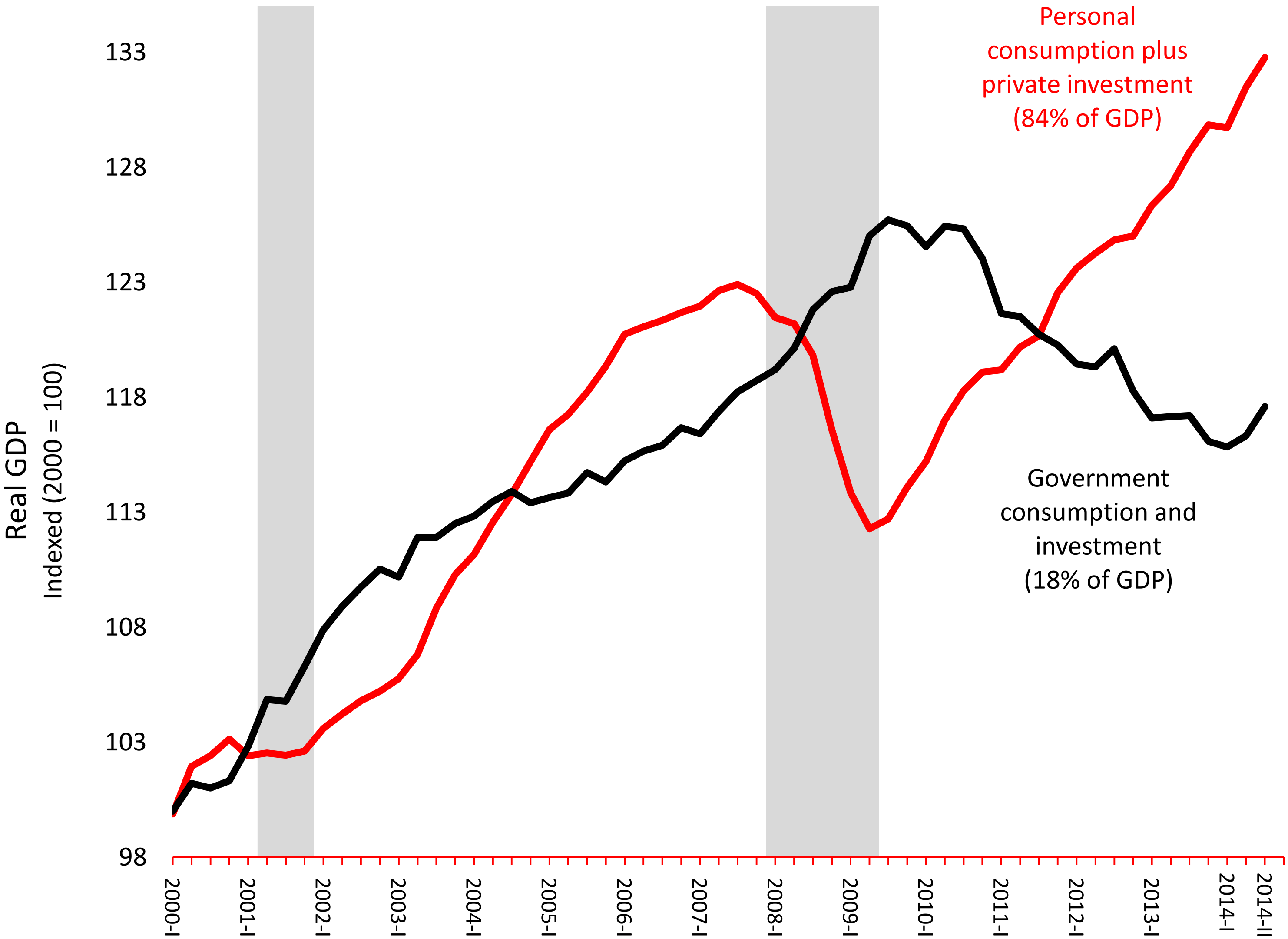
averaging "normal"

decline in oil imports is helping

Q3 ΔGDP	
Consumption	+2.2%
Investment	+1.2%
Government	+0.8%
Net Exports	+0.8%
Total	+5.0%

Source: Bureau of Economic Analysis, data through September 2014.

GDP contributors: C + I + G



<u>85% of the economy – the private sector – has been growing at a healthy clip.</u>

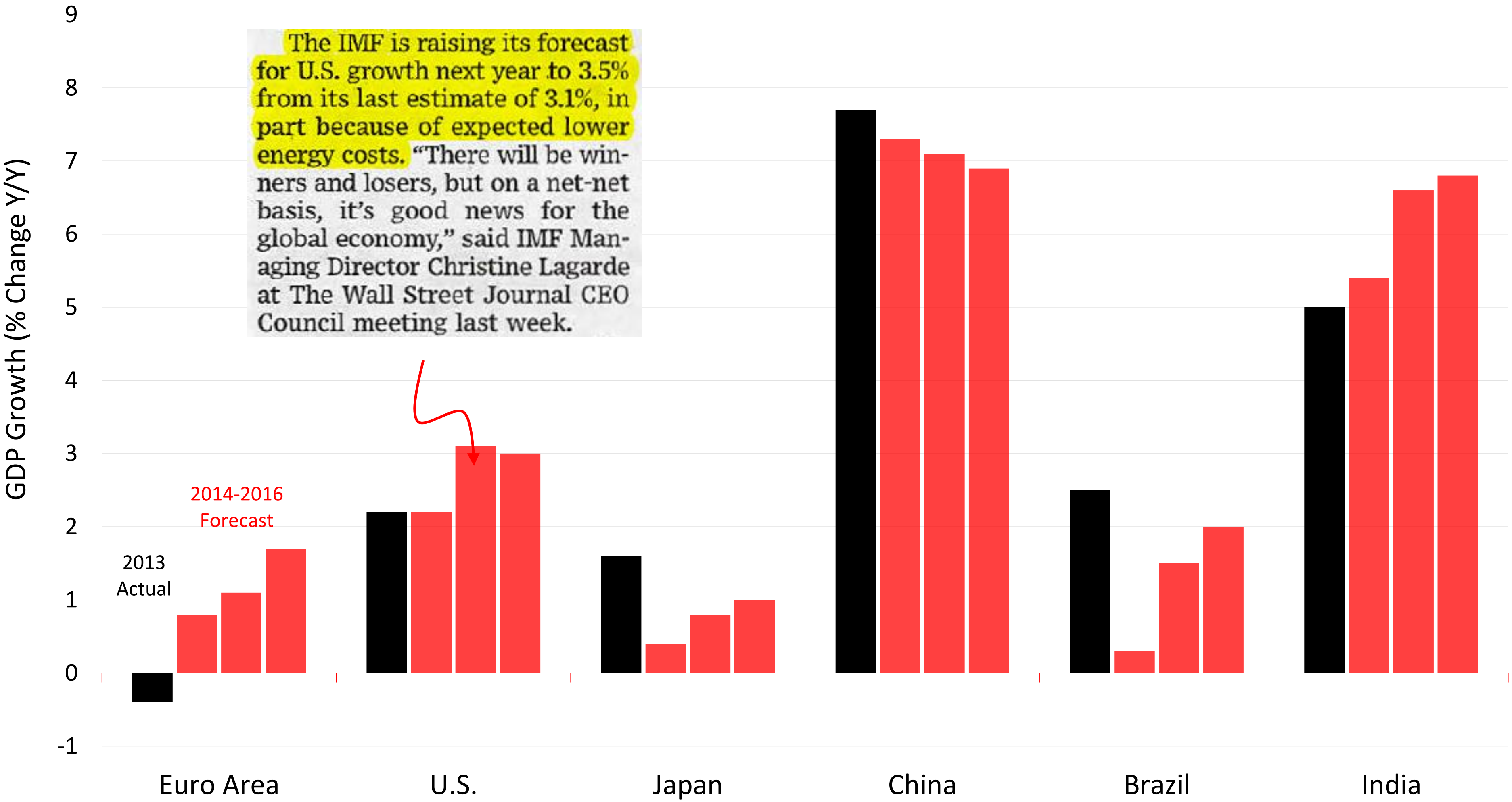
Government sector finally turning higher.

Source: Bureau of Economic Analysis, data through September 2014.

World Economy

Improving Global Growth

World GDP growth forecasts – improving growth expected

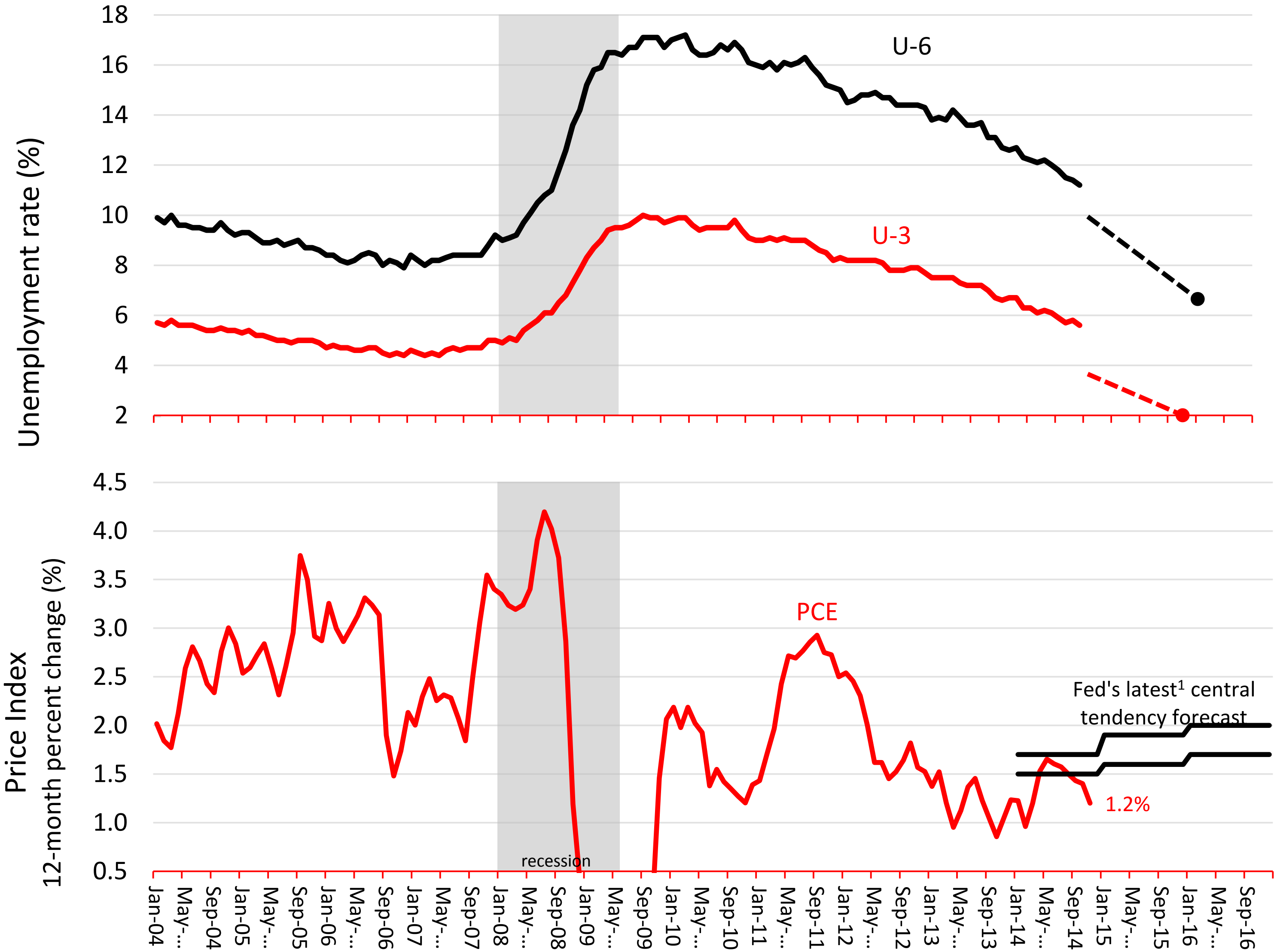


Source: OECD, *Economic Outlook* , November 2014. *The Wall Street Journal*, December 8, 2014.

U.S. Federal Reserve

Dual Mandate (dovish Fed), Yield Curve, Fed Hikes and Stock Market, Lower Than Expected Bond Yields, Comparative 10 Year Govt. Bond Yields

Dual mandate, dovish Fed



Fed's dual mandate:

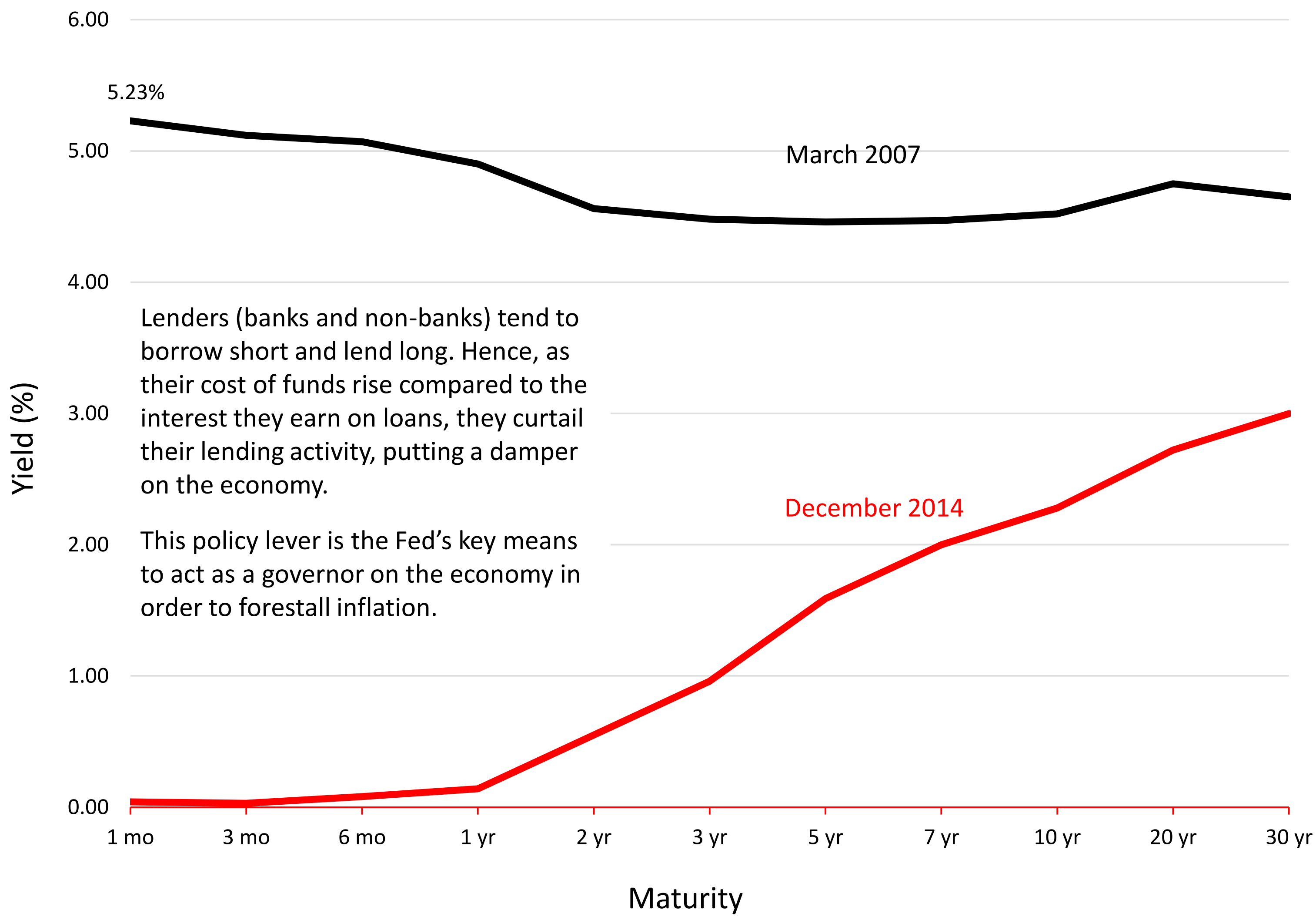
- full employment
- 2% inflation

It may take until 2016 to regain full employment.

The Fed forecasts a continuation of just 1½% to 2% inflation.

<u>Low inflation gives Fed ample room not to raise the Fed Funds target rate.</u>

Fed's key policy lever is the yield curve



Lenders (banks and non-banks) tend to borrow short and lend long. Hence, as their cost of funds rise compared to the interest they earn on loans, they curtail their lending activity, putting a damper on the economy.

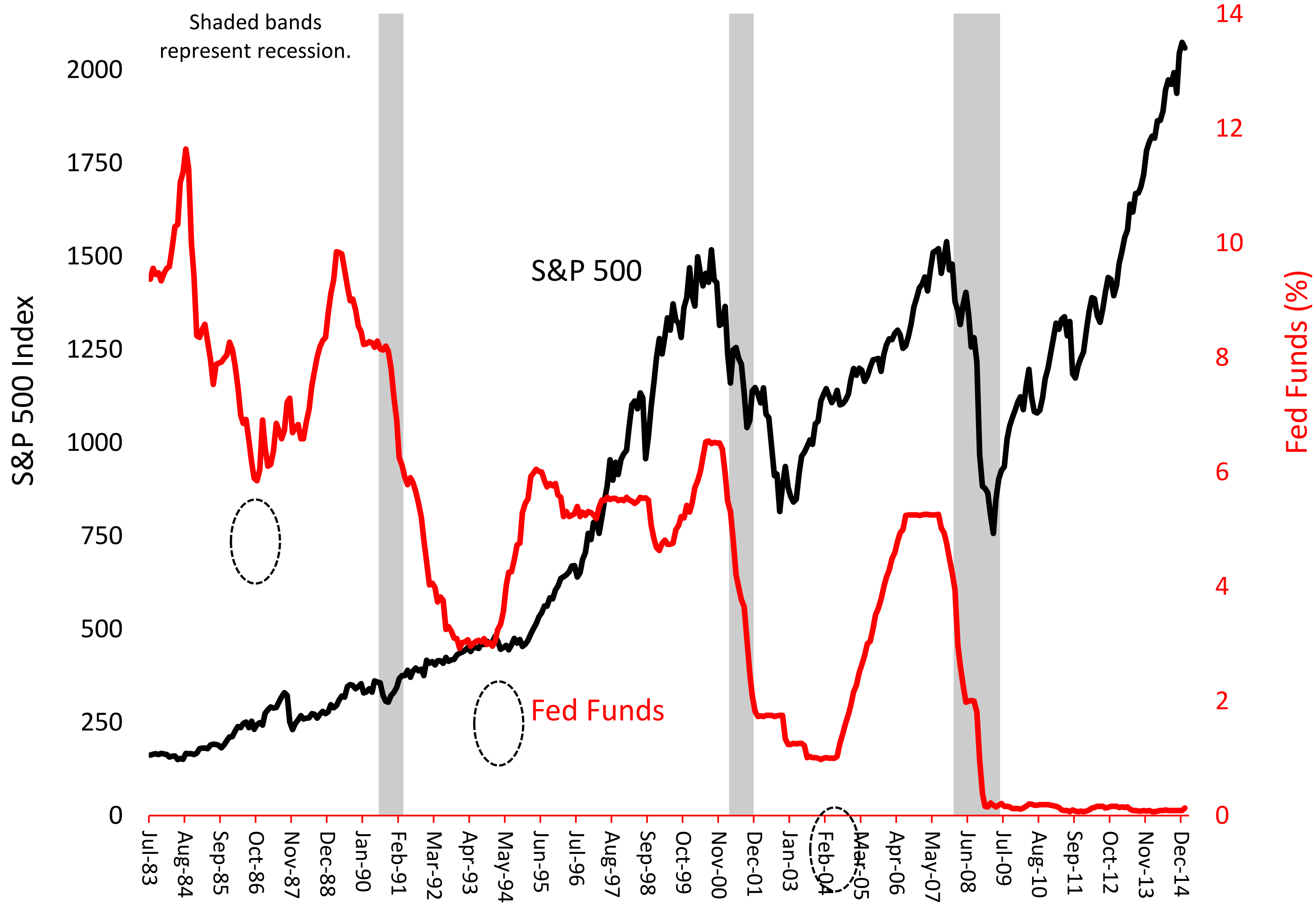
This policy lever is the Fed's key means to act as a governor on the economy in order to forestall inflation.

<u>This is an inverted (negative) yield curve</u> resulting from the Fed's raising the Fed Funds target rate (1 mo. maturity) to 5.23%.

<u>Today's is a steeply positive yield curve</u> resulting from the Fed's pushing the Fed Funds target rate (1 mo. maturity) to zero.

Source: U.S. Department of the Treasury.

Initial fed funds rate hikes and the S&P 500

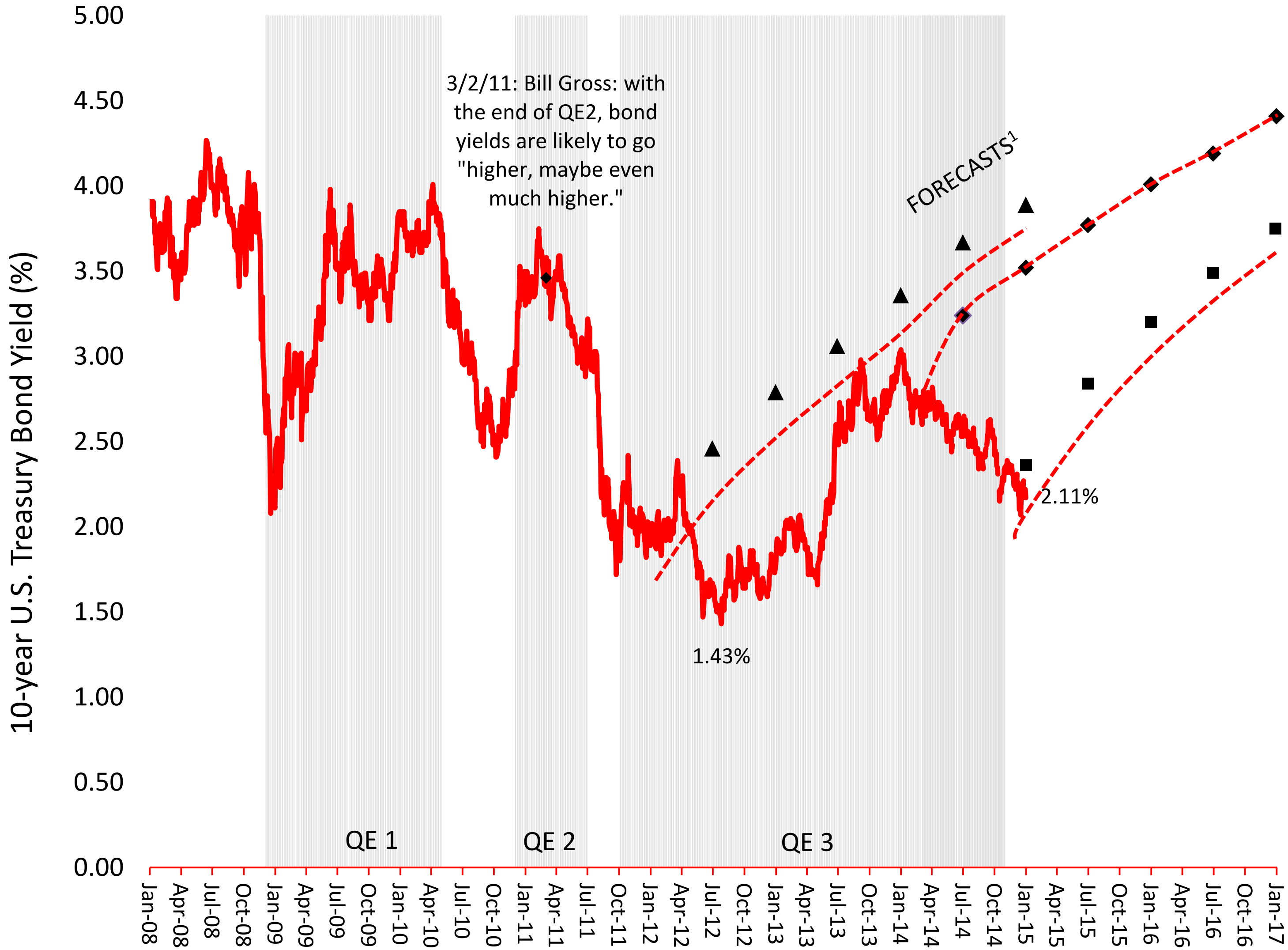


Sources: Federal Reserve, Standard & Poor's. Data through December 31, 2014.

Initial fed funds rate hikes have caused the stock market to stutter.

But, following the initial stutter stocks have continued higher even as the Fed has repeatedly hiked rates … until fed funds have approximated bond yields (flat or negative yield curve, previous chart).

Much lower than expected bond yields



Lower than expected bond yields have been the big surprise for the last three years.

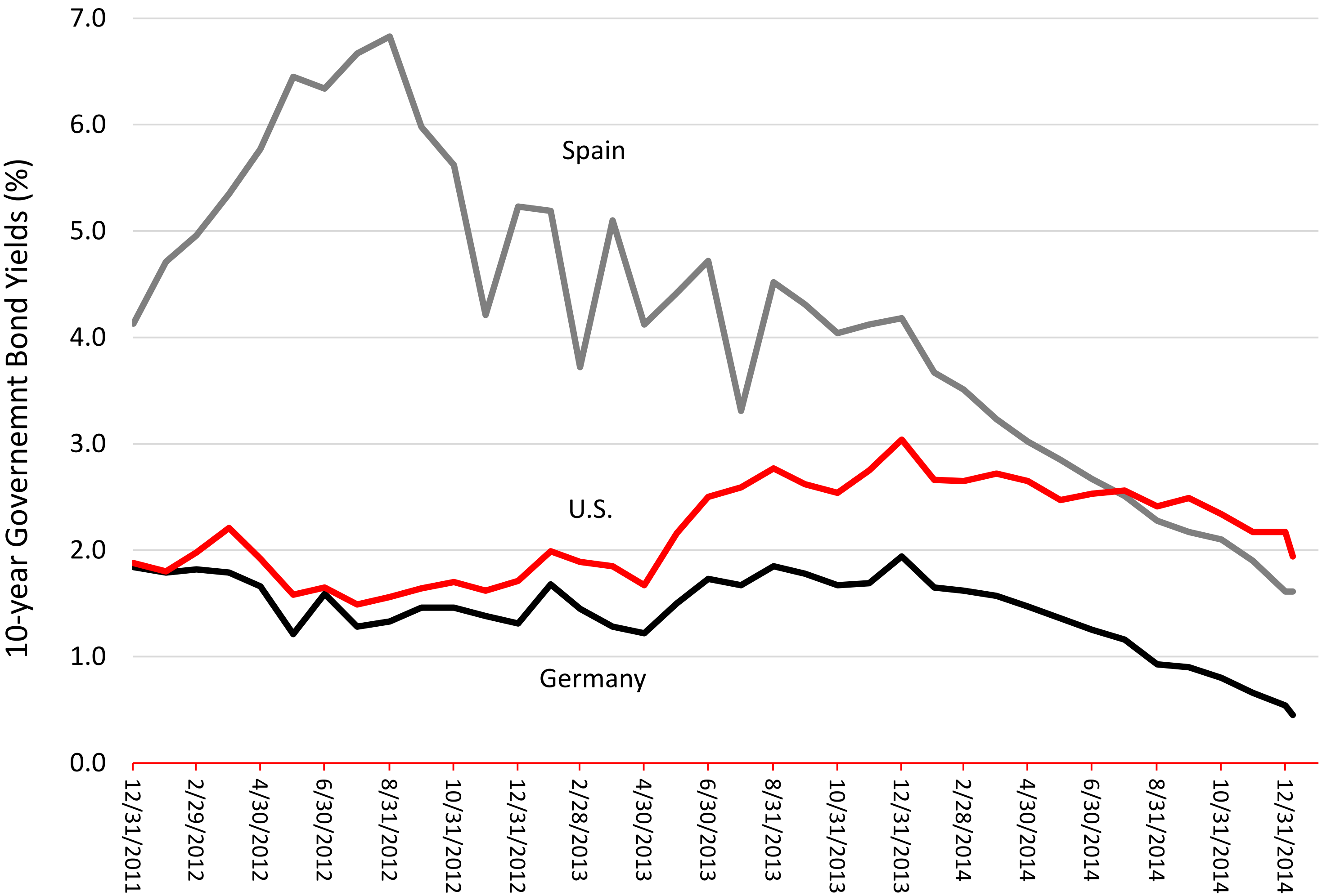
Where yields go from here depends on the inflation data and supply and demand for bonds.

<u>Inflation is very low and apt to remain so. The rate of net new supply of U.S Treasury bonds is likely to decline.</u>

Source: Federal Reserve. Data through January 3, 2014.
[1] Average of ~50 economists' forecasts from *The Wall Street Journal* 's monthly surveys taken November 2011, January 2014, and December 2014.

Bond yields – why so low?

Comparative 10-year government bond yields



Source: *The Wall Street Journal* online. Data through January 6, 2014.

Declining foreign bond yields are putting pressure on U.S. yields.

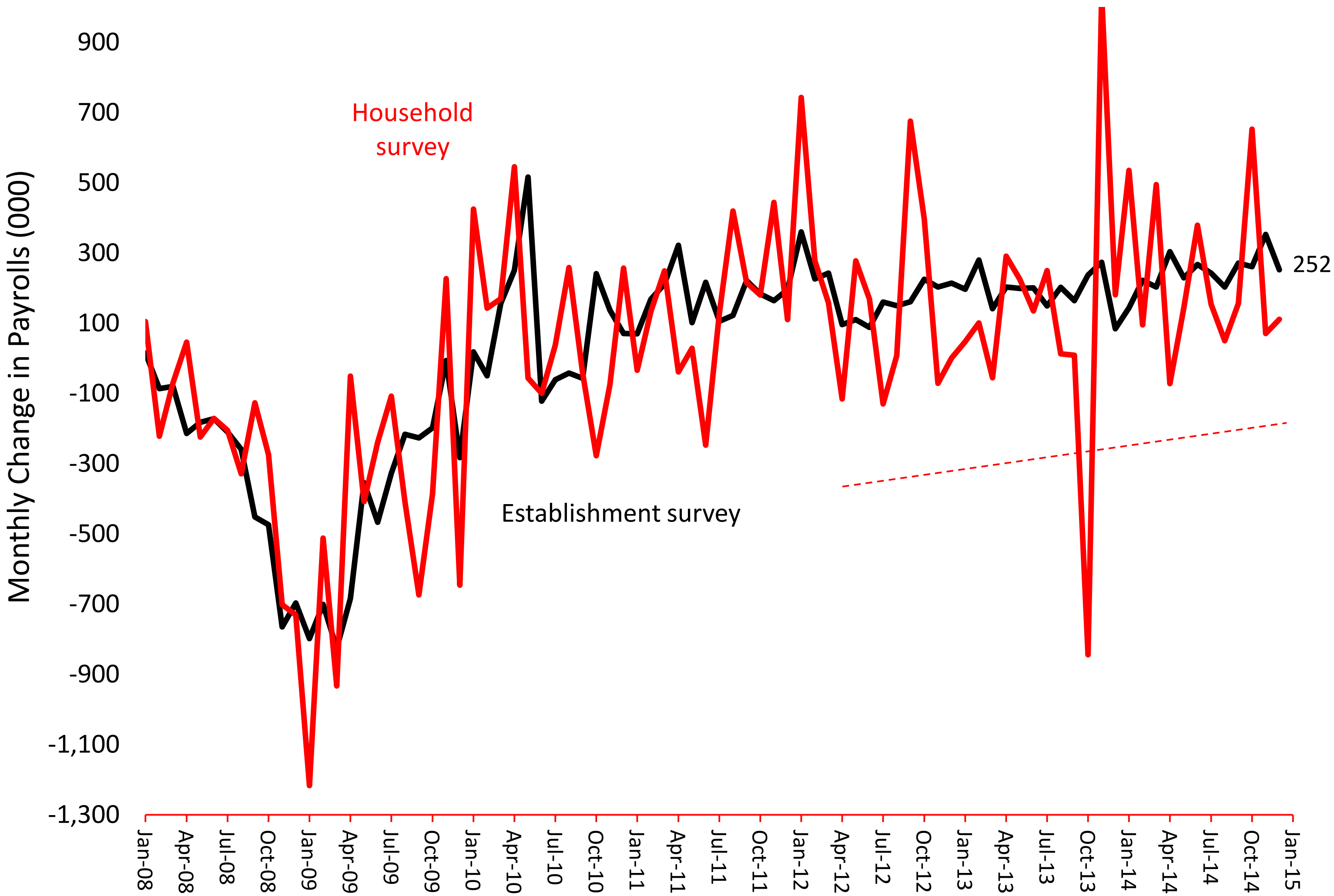
Spain yields have crossed U.S. yields!

German bund yields dropping, spread to U.S. Treasuries widening.

Unemployment

Monthly Job Formation, Private vs Govt. Jobs,

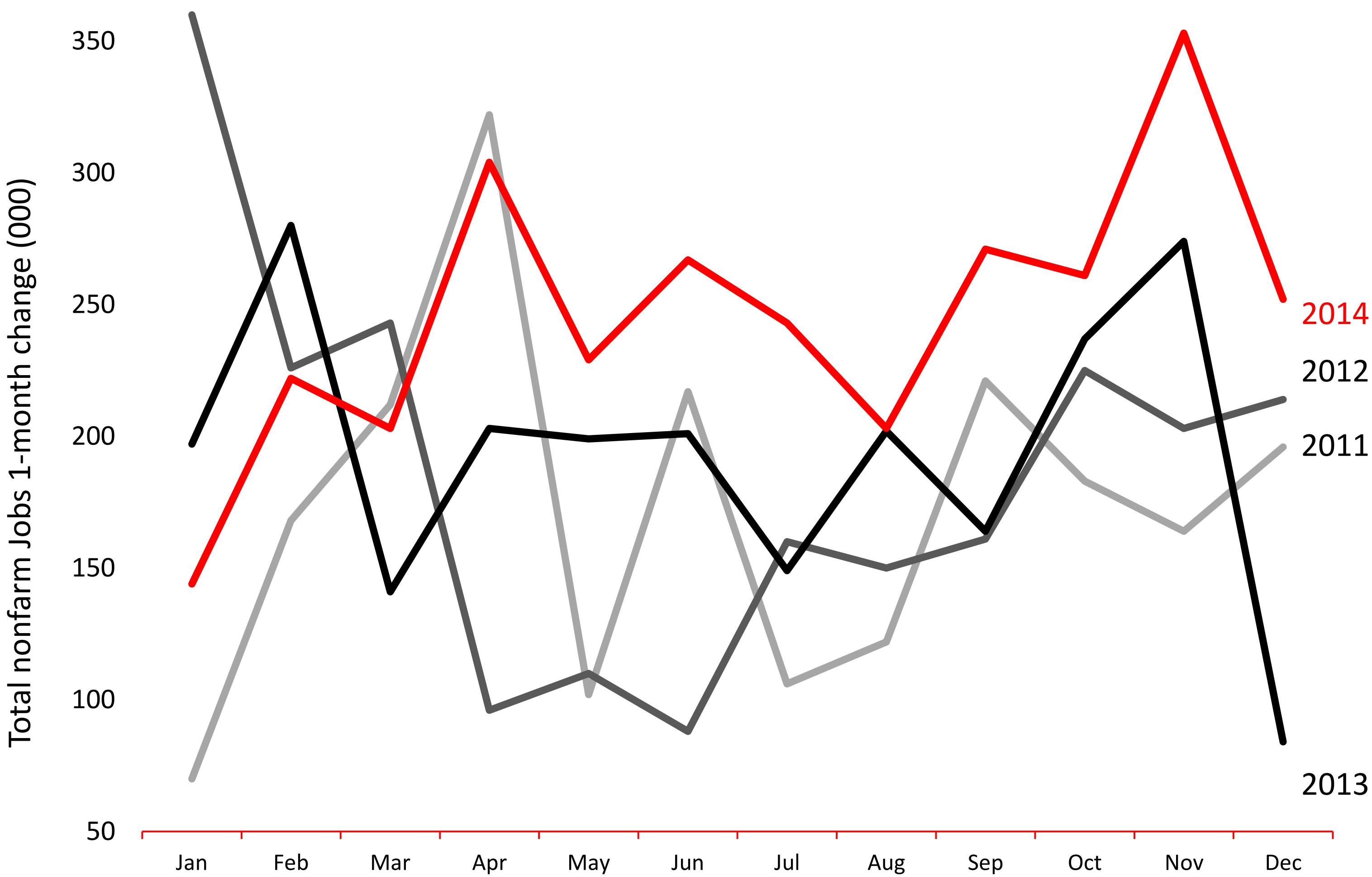
Employment – monthly job formation



<u>Both surveys trending higher.</u>

Source: Bureau of Labor Statistics. Data through December 2014.

Employment – monthly job formation

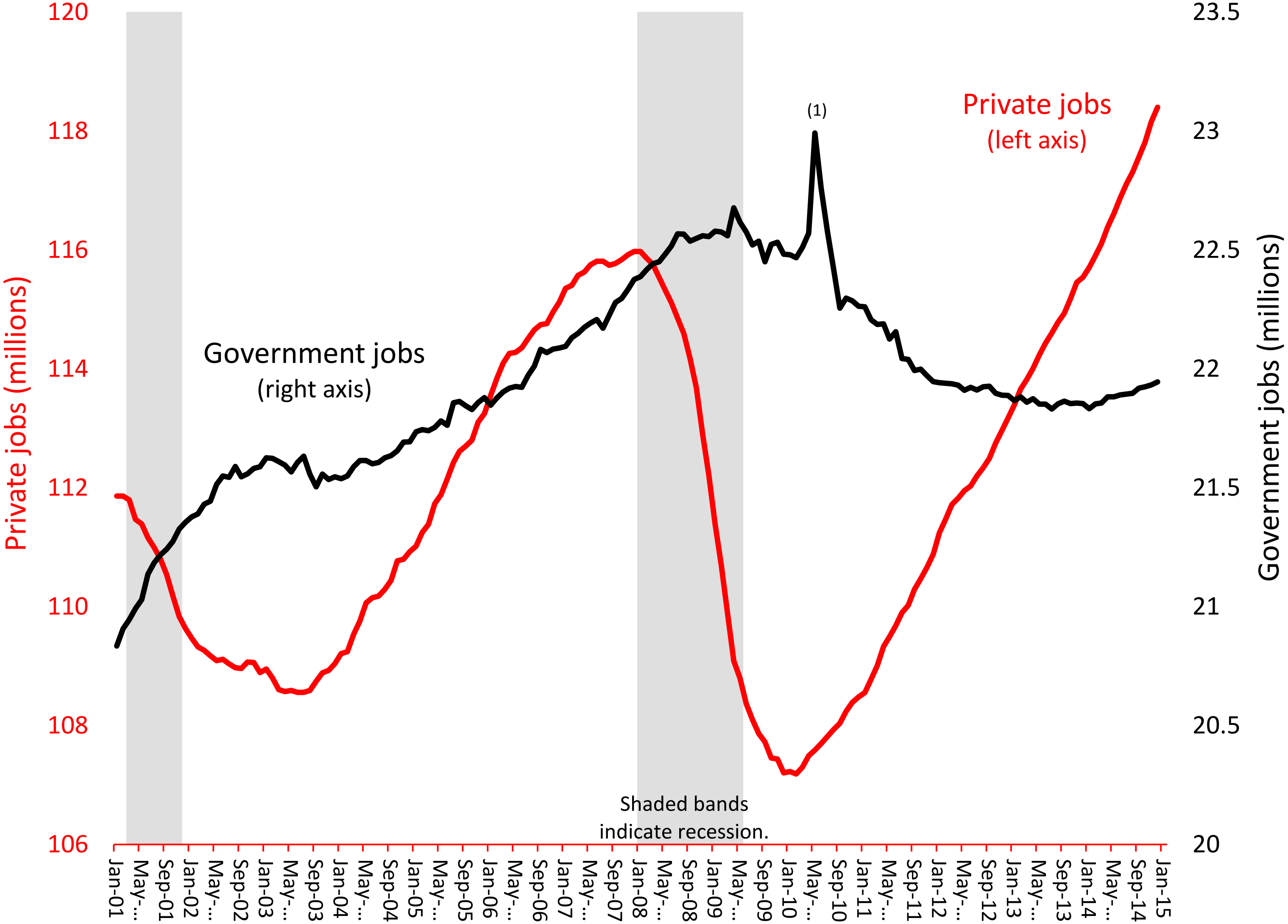


2014 broke above the seasonal pattern of the previous three years.

Summer weakness had been the norm.

Source: Bureau of Labor Statistics. Data through December 2014.

Private jobs rising, government jobs finally turning higher



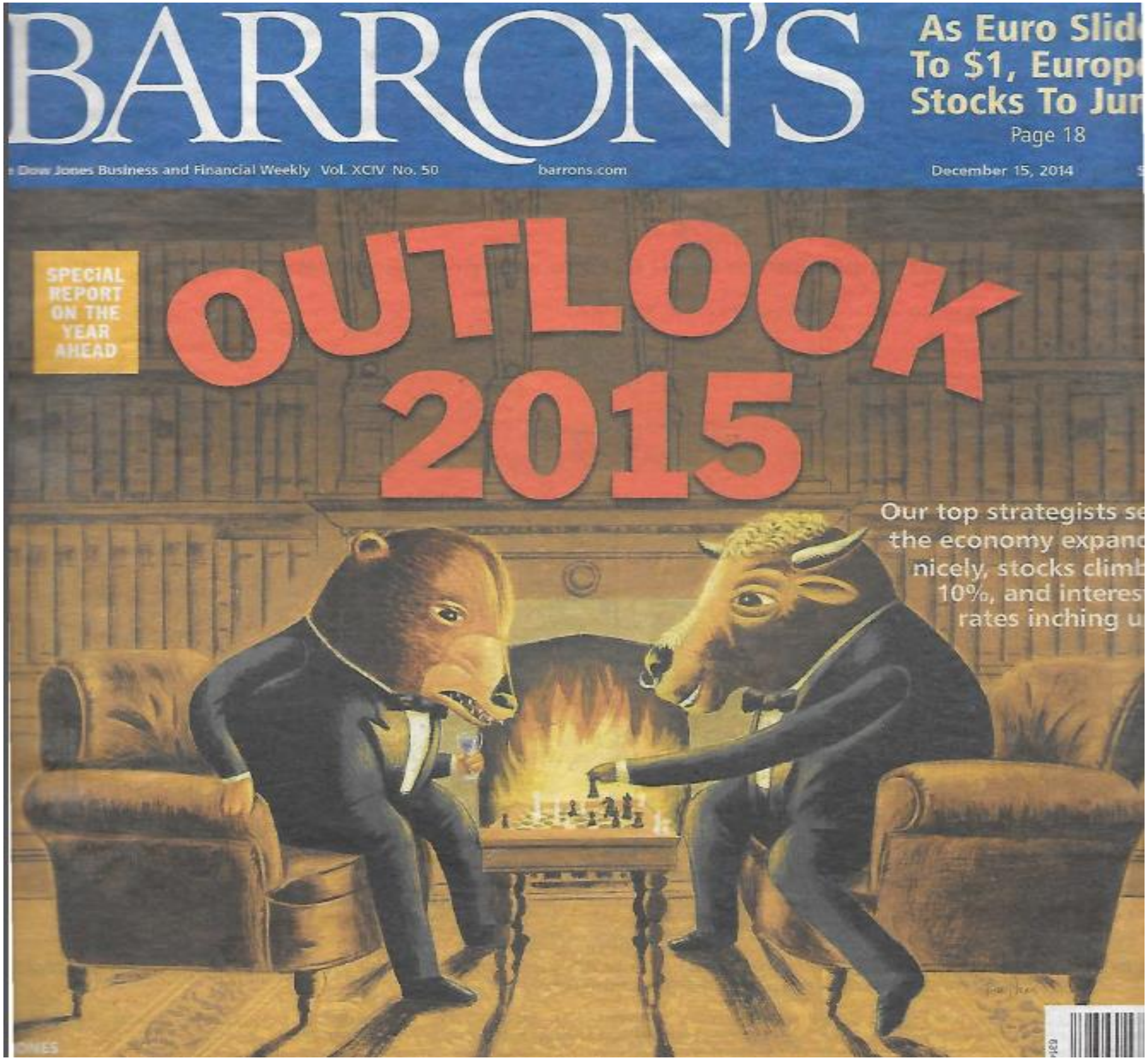
Source: Bureau of Labor Statistics; data through December 2014.
[1] 2010 census hiring spike.

Private sector jobs recovery looking good.

Government jobs finally turning higher.

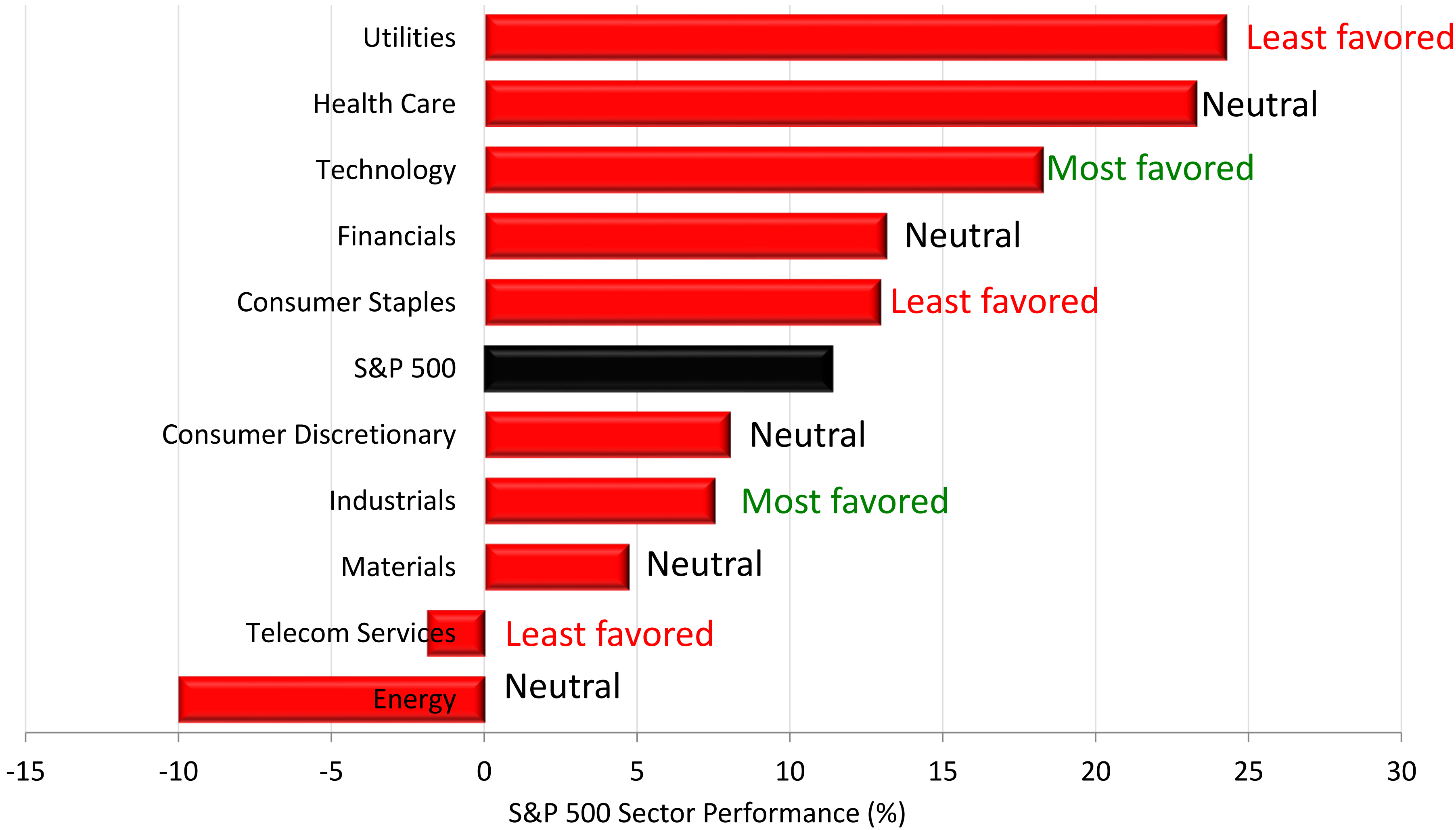
Investment Strategy

Wall Street's sector calls for 2015 – should you take their advice?



Source: *Barron's*,
December 15, 2014.

S&P 2014 sector returns – not what the strategists[1] expected



Source: Standard and Poor's. Data through December 31, *2014.*
[1] From *Barron's* survey of 12 Wall Street strategists, published December 16, 2013.

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Contact Us:

Endowment Wealth Management, Inc.
2200 N. Richmond Street, Suite 200
Appleton, WI 54911
Office: 920-785-6010   Fax: 920-277-0521

Thomas P. Remley, thomas@endowmentwm.com, (920) 785-6015

Robert L. Riedl, rob@endowmentwm.com, (920) 785-6011

Prateek Mehrotra, prateek@endowmentwm.com, (920) 785-6009

Tim Landolt, tim@endowmentwm.com, (920) 785-6012

Heidi Buhler, heidi@endowmentwm.com, (920) 785-6013