Quarterly Economic & Market Update

1st Quarter 2015

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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.

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.

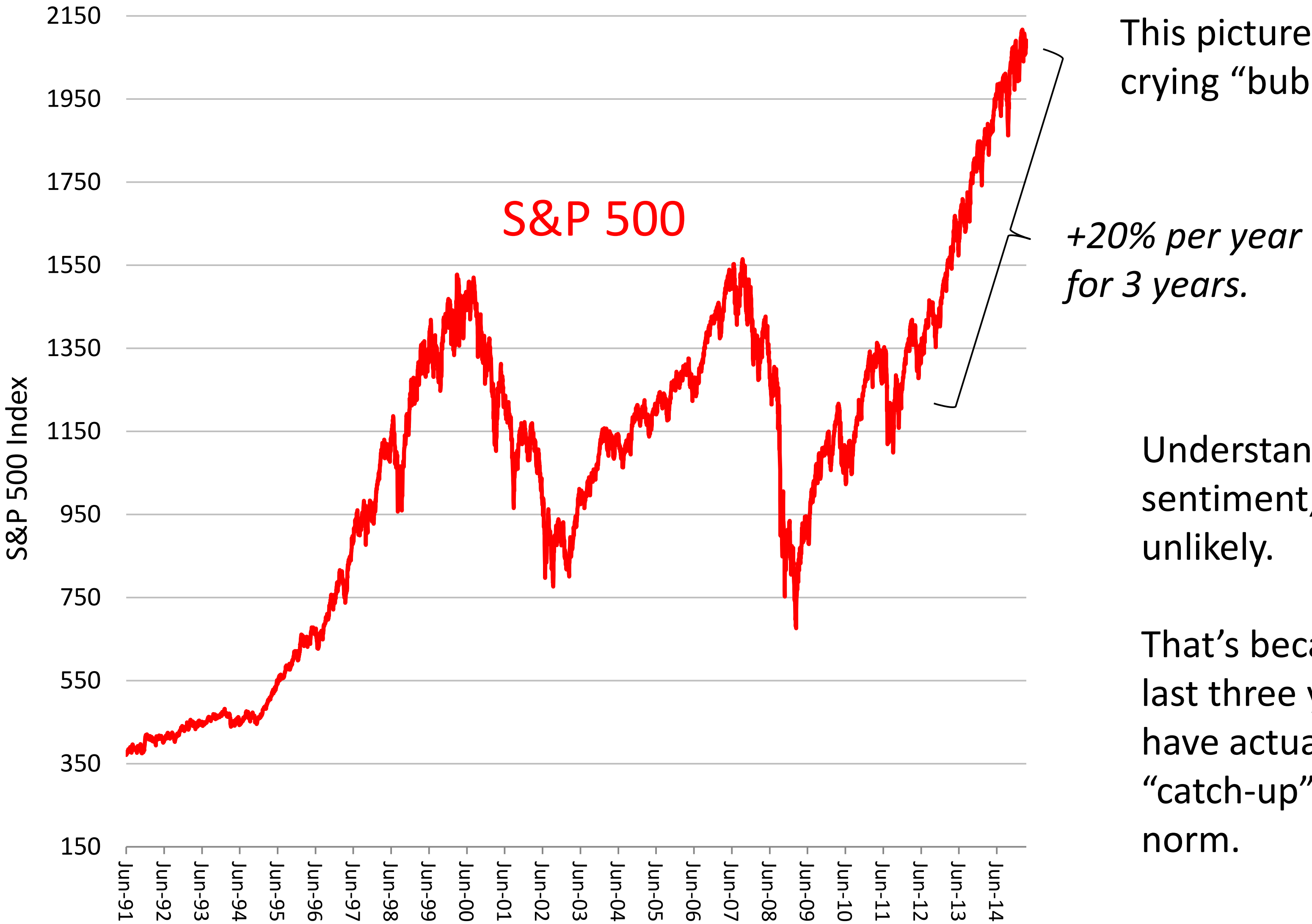
The views and opinions expressed are those of Endowment Wealth Management and are subject to change based on factors such as market and economic conditions. These views and opinions are not an offer to buy a particular security and should not be relied upon as investment advice. Past performance cannot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

Stock Markets

Stock Market Bubble, Stock Market Arithmetic, Overvaluation, Sector P/Es, Shiller CAPE, Economic Fundamentals, Fed Rate Hike

Stock market bubble?

Bubble baloney



Source: Standard & Poor's. Data through April 9, 2015..

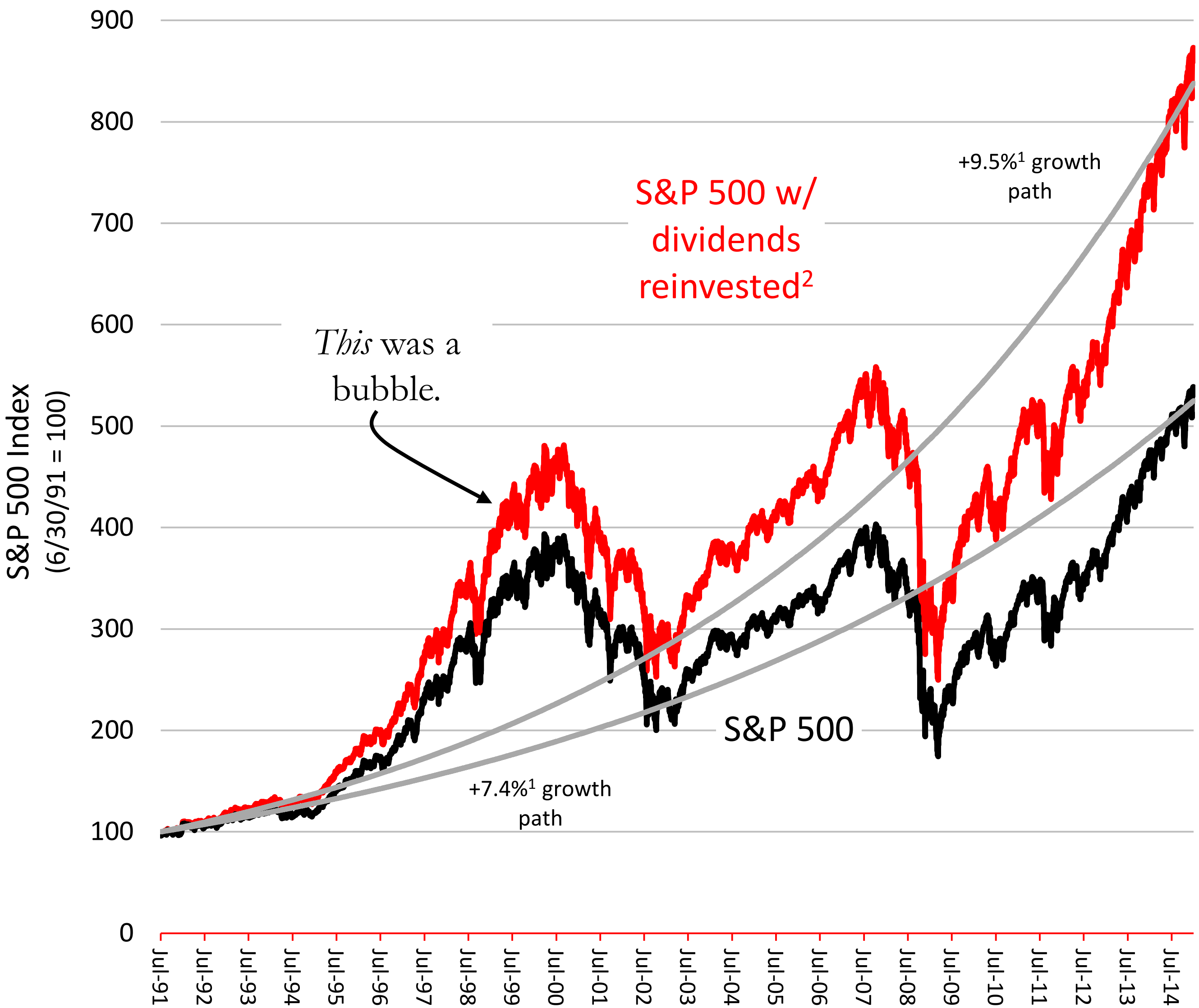
This picture has some crying "bubble."

Understandable sentiment, but unlikely.

That's because the last three years have actually been "catch-up" to the norm.

Stock market arithmetic

Total return = 7.4% earnings-driven price + 2.1% dividends reinvested



The S&P 500 price index has trended higher at approximately +7.4% CAGR[1] for the last 25 years, in line with earnings growth (previous chart).

The S&P 500 total return index, which includes reinvested dividends, has trended higher at approximately +9.5% CAGR[1] for the last 25 years.

<u>Neither of these indexes presently look like bubble territory. They are right in line with their long-term trend rates of appreciation</u>.

Source: Standard and Poor's. Data through December 2014.[1] Compound annual growth rate. [2] S&P 500 total return index.

Recovery to +9.5% long-term trend … not a bubble

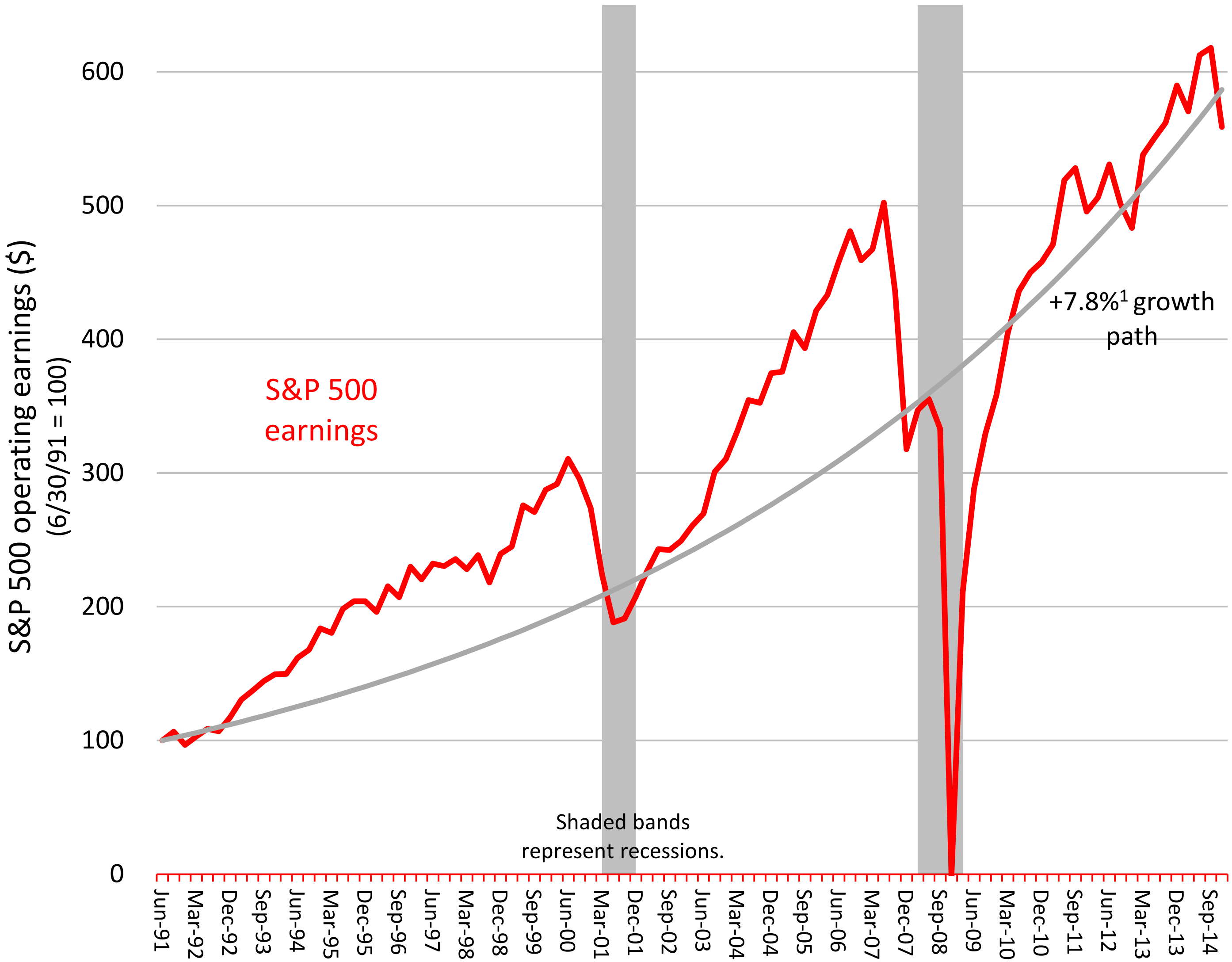
+20% per year for 3 years = recovery to trend

This logarithmic scale shows the +9.5% per year trend rate of total return as a straight line.

<u>+9.5% per year over the last 25 years is right in line with the stock market's *long-term* returns going back to 1926, or back even further to 1871.</u>[3]

Source: Standard and Poor's. Data through December 2014.[1] Compound annual growth rate. [2] S&P 500 total return index.
[3] per Professor Jeremy Siegel's seminal *Stocks for the Long Run*, first published in 1994.

S&P 500 earnings growth



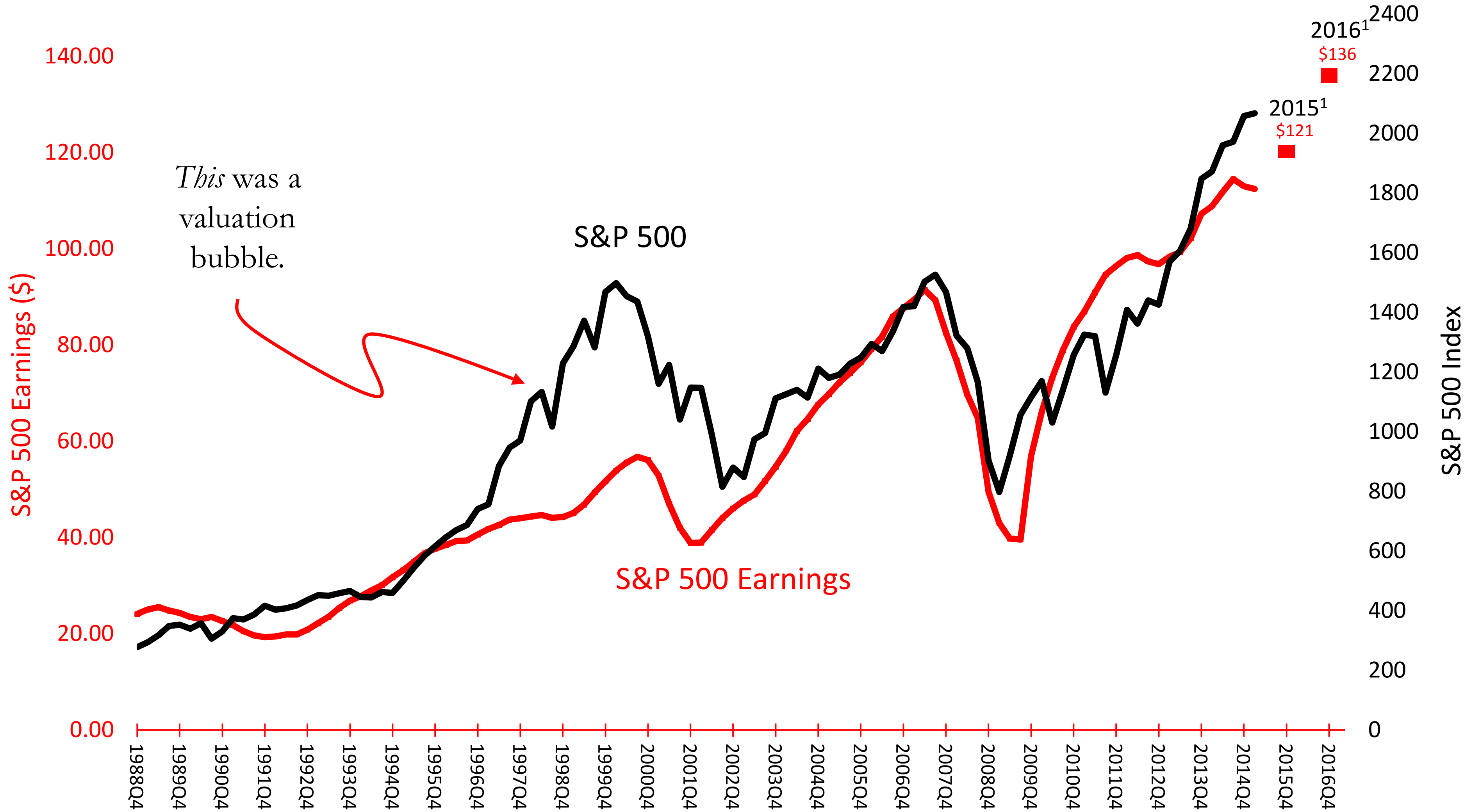
Source: Standard and Poor's. Data through December 2014. [1] Compound annual growth rate.

S&P 500 earnings have trended higher at approximately +7.8% CAGR[1] for the last 25 years.

Earnings growth over the past five years has been right in line with the long-term average, not creating unreasonable expectations going forward as happened leading up to the last two stock market bubbles.

Overvaluation?

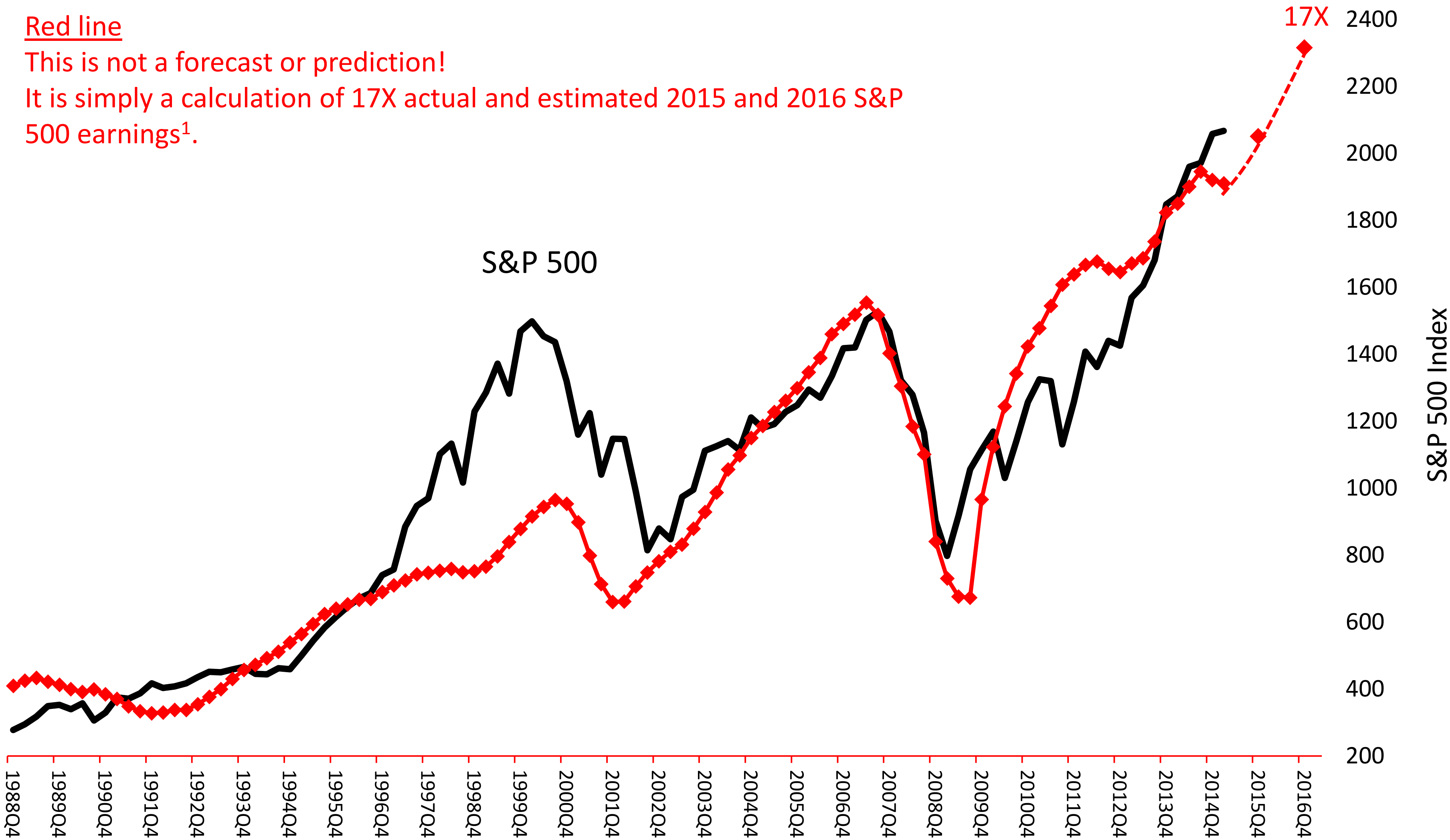
S&P 500 vs. actual and estimated earnings



[1] Estimated 2015 and 2016 bottom-up S&P 500 earnings per share (left scale) as of April 2, 2015: for 2015, $120.66; for 2016, $136.24. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through April 6, 2015; and actual and estimated earnings data through March 2015.

Overvaluation?

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



[1] Estimated 2015 and 2016 bottom-up S&P 500 earnings per share as of April 2, 2015: for 2015, $120.66; for 2016, $136.24. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through April 6, 2015; and actual and estimated earnings data through March 2015.

Stock market bubble?

Bubble baloney

The New Era of Lower Stock Returns

THE INTELLIGENT INVESTOR

JASON ZWEIG

After more than six years of a bull market, investors should stare a cold, hard truth straight in the face: Future returns on stocks are likely to be far slimmer than the fat gains of the past few years.

Leading investment analysts think you will be lucky to squeeze out an average return of 2% annually, after inflation and fees, from a typical portfolio of stocks and bonds over the coming decade or so.

Investment expenses will loom much larger in a world of smaller expected returns. So will avoiding big mistakes.

The Dow Jones Industrial Average fell 2.7% from its Monday high to its close on Friday as economic growth seemed to falter. But that wasn't nearly enough to make stocks cheap.

One measure of valuation, based on data compiled by Yale University economist Robert Shiller, shows that the market price of the S&P 500 is about 27 times its average earnings over the past 10 years, adjusted for inflation. The long-term average, based on data going back to 1871, is about 16 times adjusted earnings.

So how have U.S. stocks performed in the past when valued around 27 times average earnings? Over the following 10 years, they generated total returns, counting dividends and adjusting for inflation, averaging about 2.5% annually, Prof. Shiller told me earlier this month.

Another method of estimating future stock returns yields a higher expectation—by a hair.

Over time, the return on stocks after inflation has tended to come very close to the sum of two numbers: dividend yield—total dividends over the past year divided by the current share price—plus the inflation-adjusted growth rate in dividends. The yield on the S&P 500 is 2%. For more than a century, the growth rate has averaged about 1.5% after inflation. Add those two numbers and you get 3.5%.

Now consider that the yield—interest income divided by price—on 10-year U.S. Treasury notes is 2% and that the government's core measure of inflation is running at about 1.7% annually.

If you have half your portfolio in stocks that return 3.5% and half in bonds that return 0.3%, you will earn about 1.9% after inflation. If stocks average the 2.5% return from Prof. Shiller's data, then a balanced portfolio will return only 1.4% after inflation. (These numbers assume no fees, taxes or trading costs.)

Either way, "it's pretty awful by historical standards."

Please see STOCK page B9

+2.5% real returns going forward?

The S&P 500 total return index has risen at a +20% CAGR[1] over the last three years. So, no, stocks likely won't continue higher at that pace.

However, an after-inflation +2.5% going forward is too pessimistic.

See following slides.

What does make sense? My opinion:

The most likely path forward for stocks is a rate of appreciation equal to S&P 500 earnings growth plus 2% in dividends.

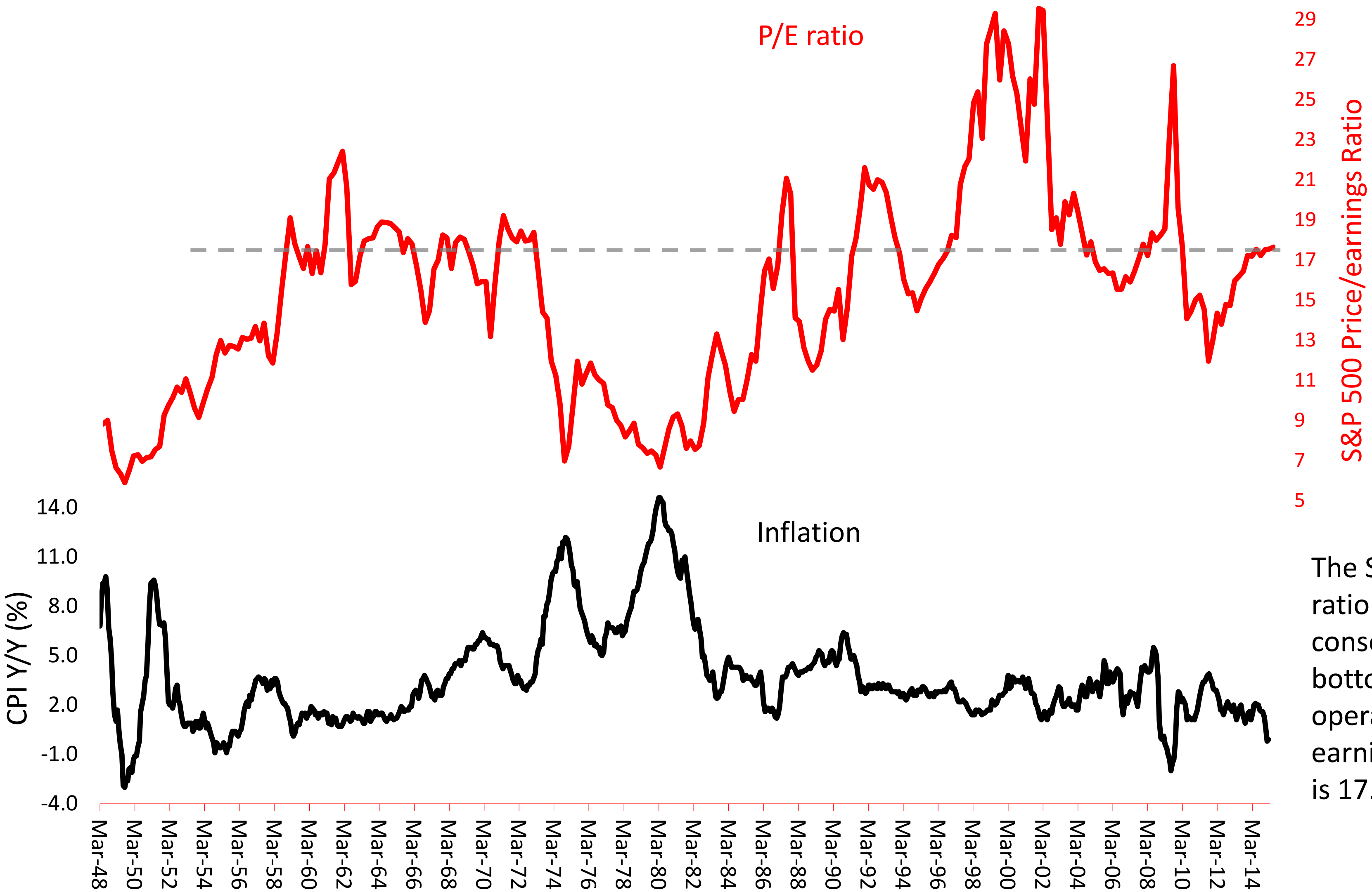
This assumes that stocks are reasonably valued (the market's fair P/E ratio) at present. So, no P/E expansion or contraction is, I think, the logical assumption.

Say +7% earnings growth plus 2% dividends, less 2% inflation, equals 7% real (after inflation) expected return.

That's a far cry from +2.5%.

Source: The Wall Street Journal, March 28-29, 2015. [1] Compound annual growth rate.

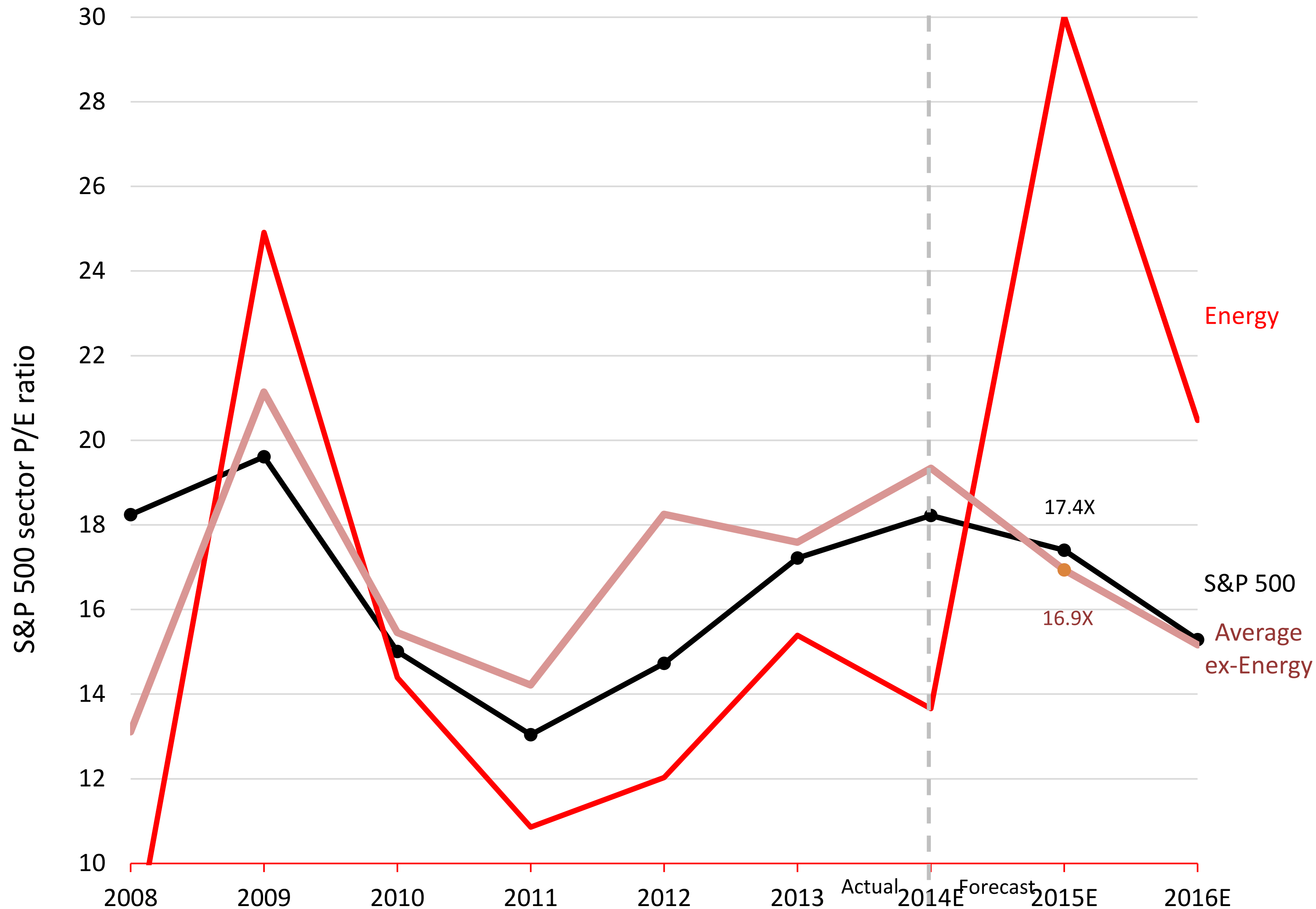
Valuation – S&P 500 P/E ratio



The S&P 500's P/E ratio (4/6/15) on consensus 2015 bottom-up operating earnings estimate is 17.3X[1].

Sources: Standard & Poor's Corporation, Thomson Reuters I/B/E/S, BLS. Stock price data through April 6, 2015; inflation data through February 2015. Top panel, latest data point: 2081 ÷ trailing earnings of $117.86(e) through 12/31/14 = 17.65X. [1]S&P 500 at 2081 ÷ 2015 EPS(e) $120.66.

S&P 500 sector P/E ratios



The collapse of 2015 energy sector earnings estimates has bumped up the S&P 500 's forward P/E ratio by a half point.

<u>Ex-energy, the other nine S&P 500 sectors are trading at an average 2015 P/E ratio of 16.9X.</u>

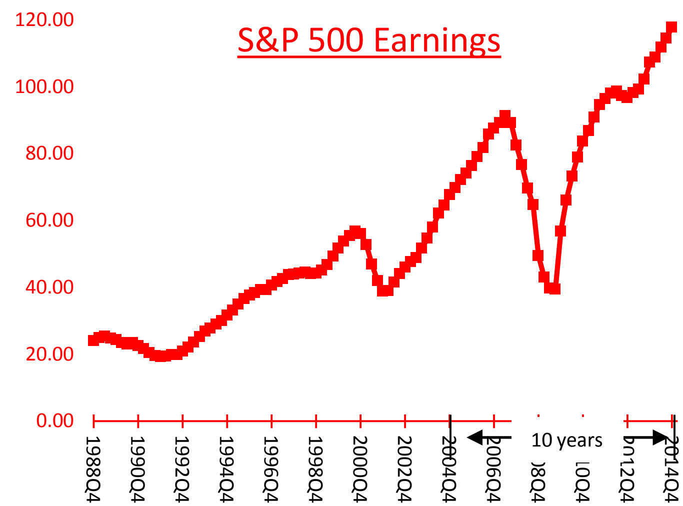
Source: Standard & Poor's. Actual S&P 500 sector index operating earnings and prices as of December 31 of each year indicated. For estimated P/E ratios, sector operating earnings estimates and prices as of April 1, 2015. Earnings estimates are based on the Capital IQ consensus forecast.

Valuation – Robert Shiller's Cyclically Adjusted P/E Ratio[1]

Shiller's CAPE is frequently cited as evidence of overvaluation.

While Shiller's CAPE[1] might be a reasonable concept in "normal" times, at present it is averaging into the denominator the most extraordinary earnings meltdown in modern history.

I think it's giving a distorted reading.

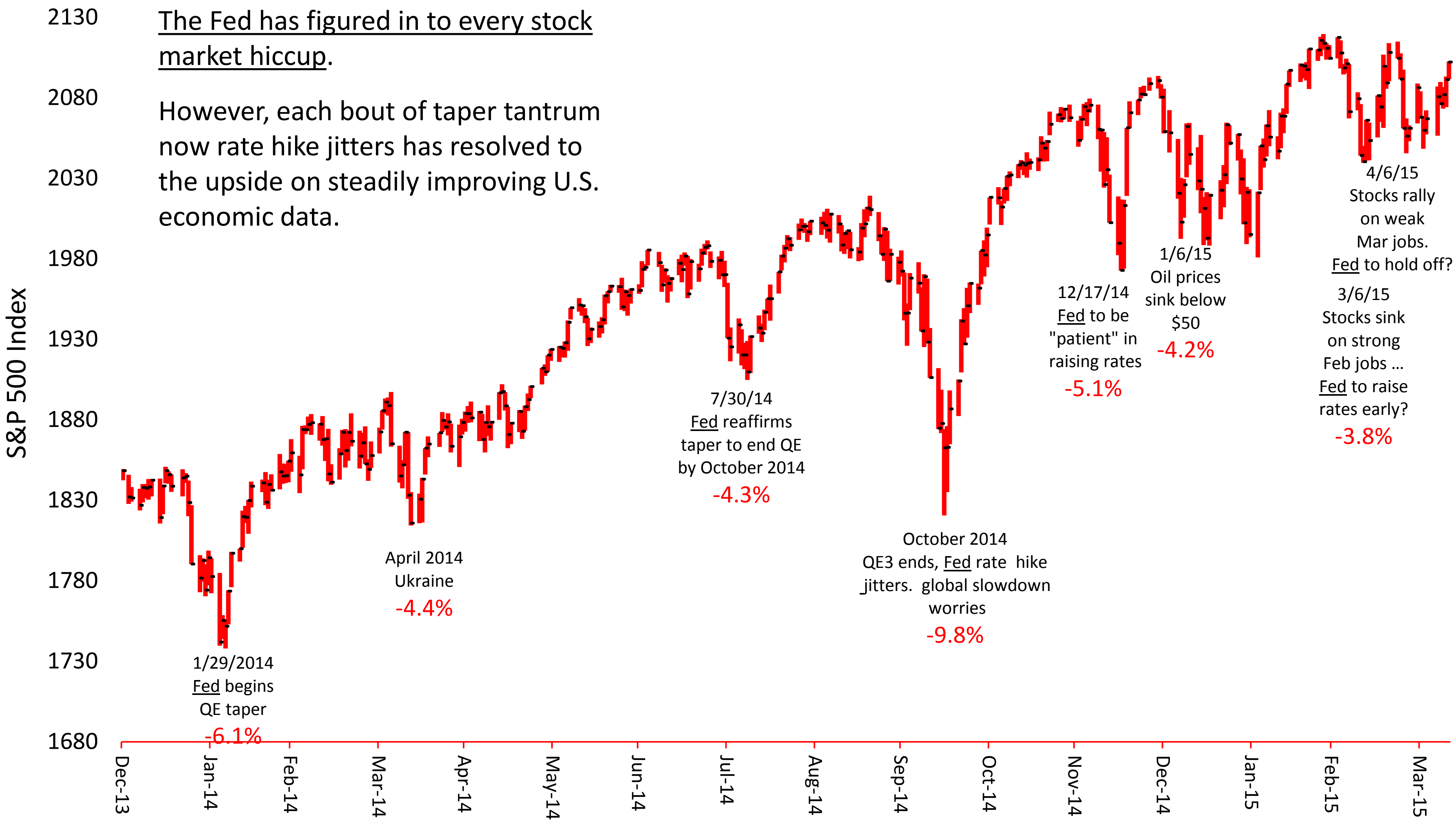


Source: Robert Shiller online data. Data dated April 2015.

[1] Cyclically adjusted P/E ratio: stock prices divided by their average earnings over the past 10 years, adjusted for inflation.

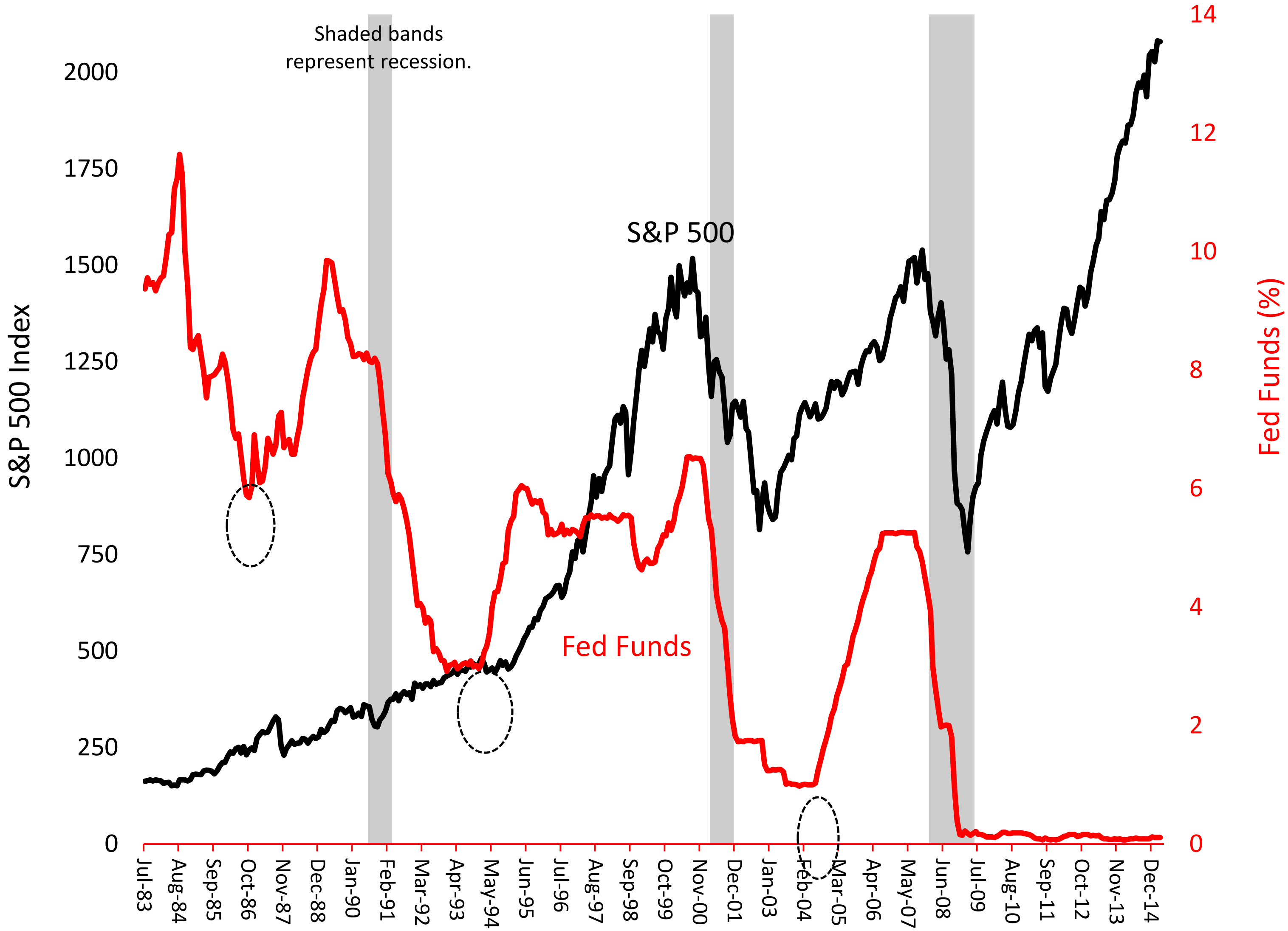
[2] Adjusting for the 9/07-2/11 earnings collapse gives a reading of 23.1.

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



Source: Standard and Poor's, data through April 10, 2015.

Initial fed funds rate hikes and the S&P 500



Sources: NBER, Federal Reserve and Standard & Poor's. Data through March 2015.

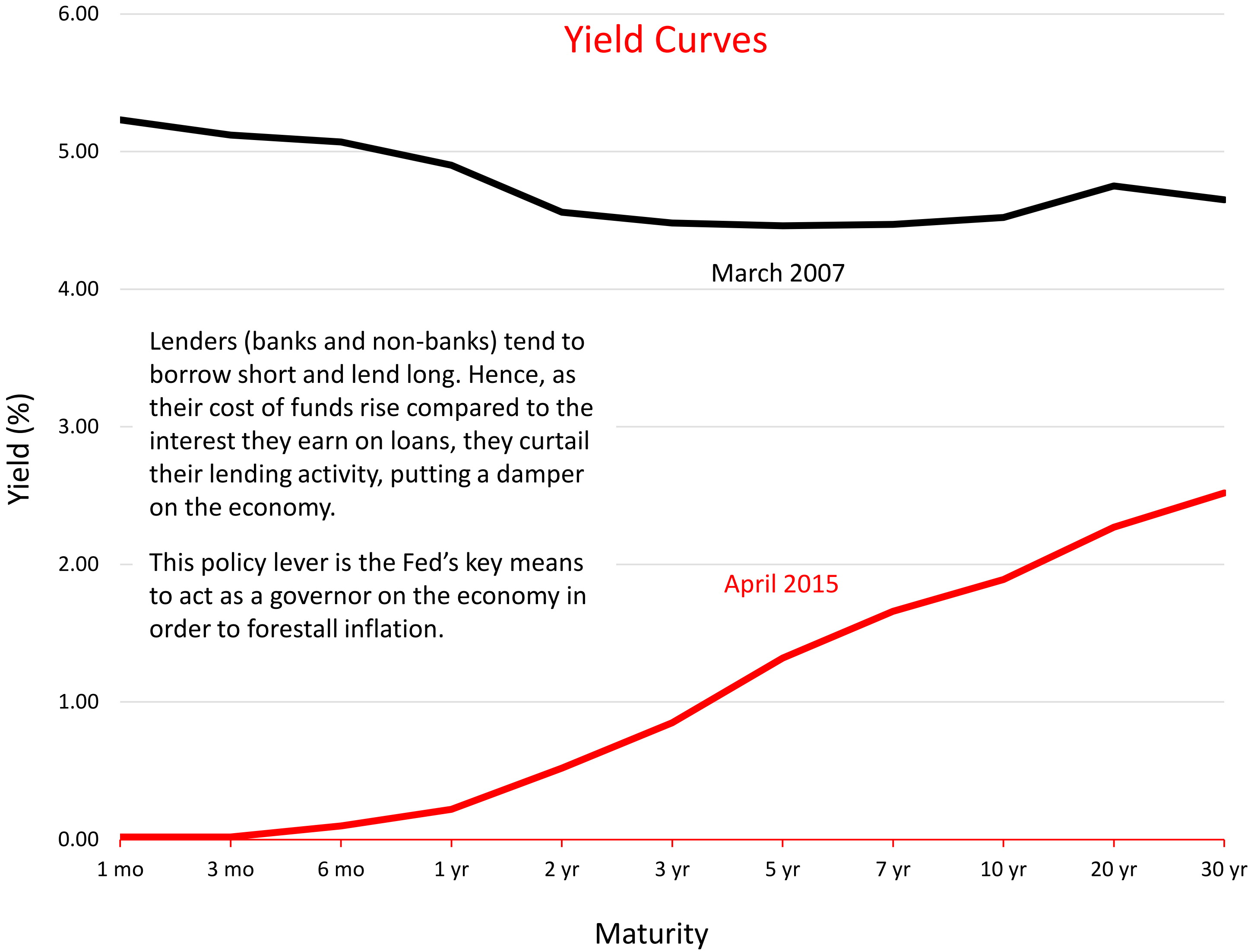
Initial fed funds rate hikes have caused the stock market to stutter.

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

U.S. Federal Reserve

Yield Curve, Dual Mandate
(dovish Fed)

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.

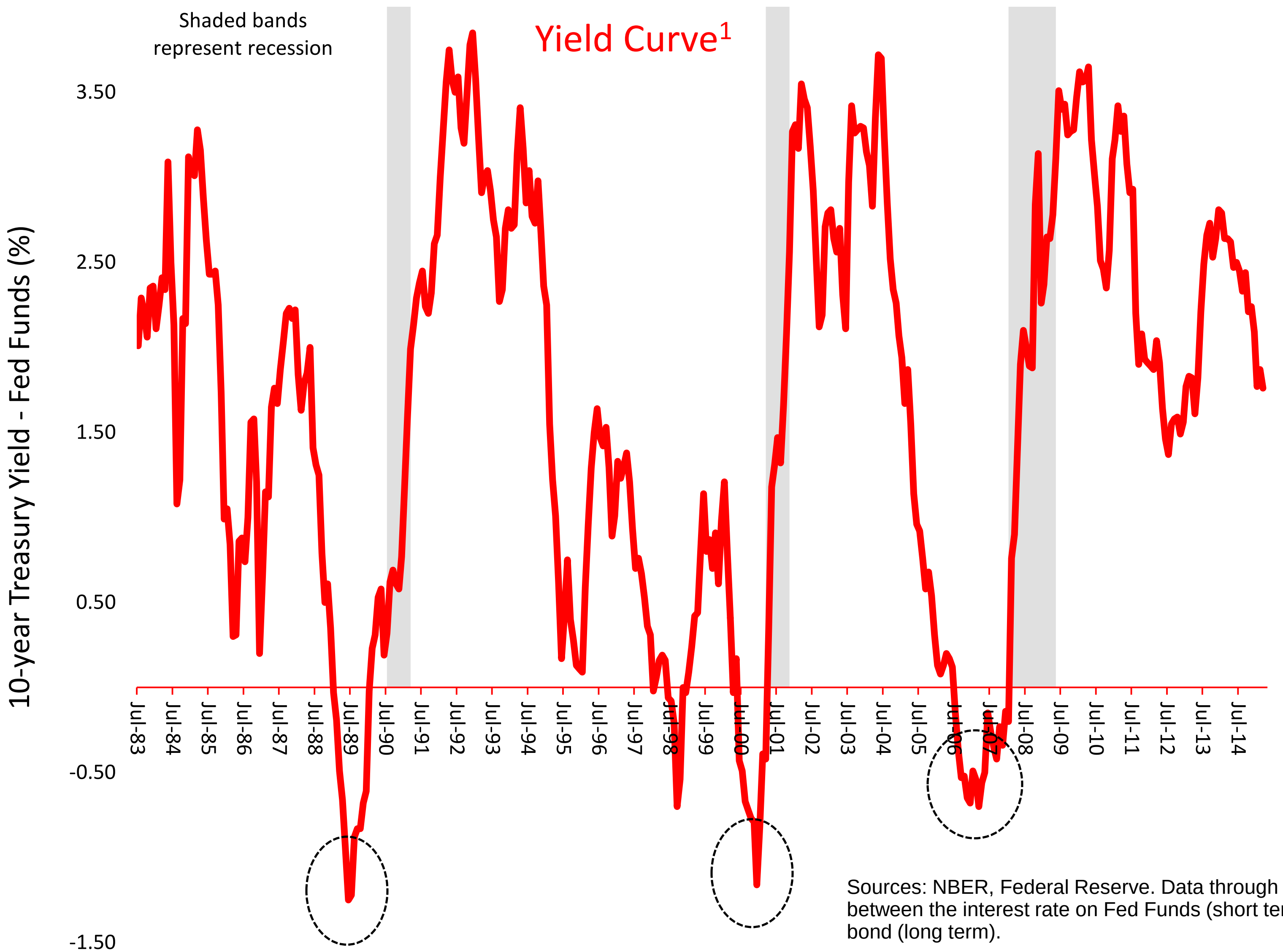
This policy lever is the Fed's key means to act as a governor on the economy in order to forestall inflation.

Source: U.S. Department of the Treasury.

<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.

Fed's key policy lever is the yield curve



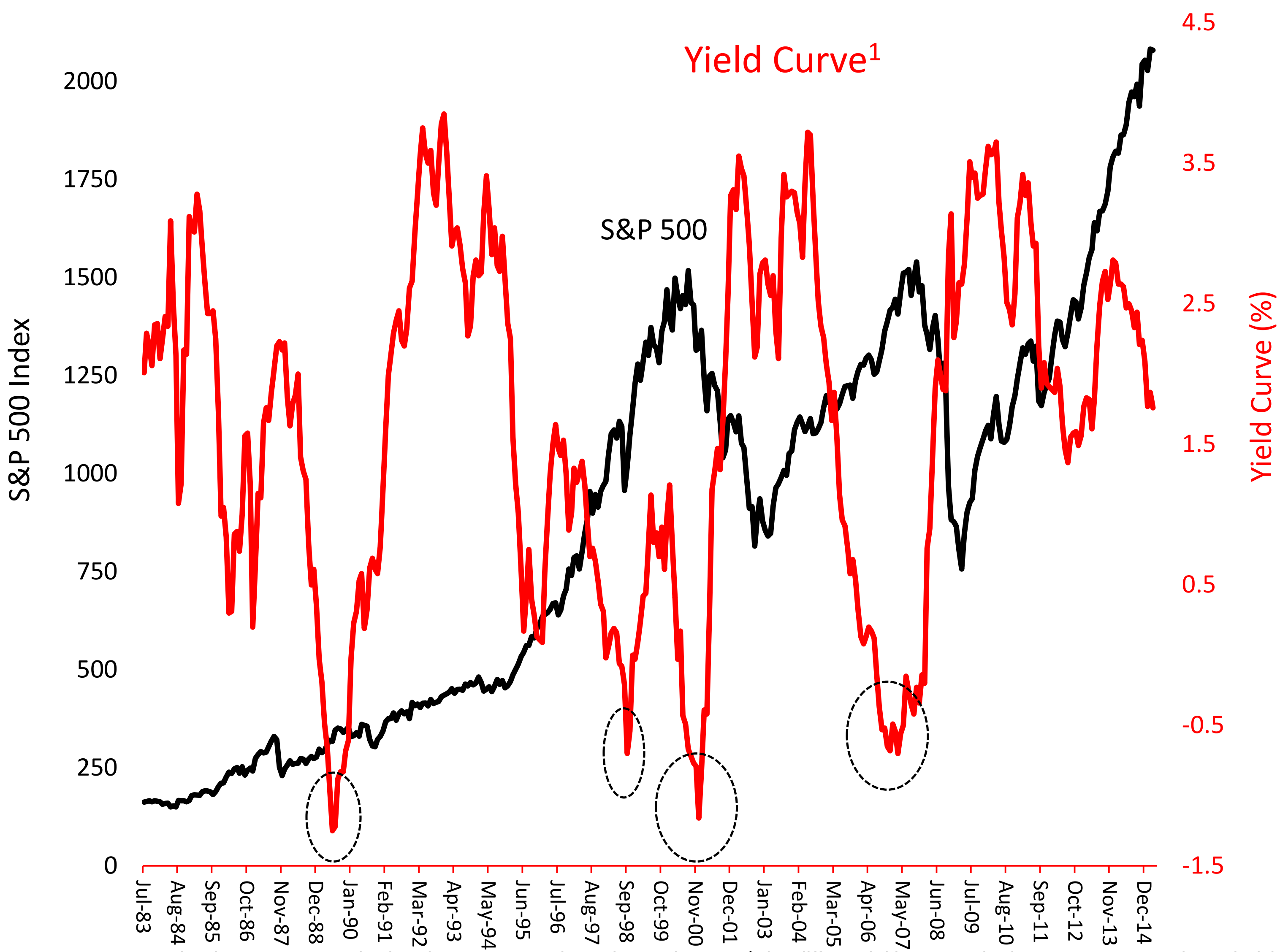
Steep yield curves – high bond yields compared to Fed Funds rates – are consistent with strong GDP growth.

Flat or negative yield curves have preceded recessions.

<u>Today the yield curve is steep and apt to remain steep inasmuch as the Fed has made it clear that rate hikes are likely to be very gradual.</u>

Sources: NBER, Federal Reserve. Data through March 2015. [1]The differential between the interest rate on Fed Funds (short term) and the 10-year Treasury bond (long term).

Yield curve has been key to the stock market



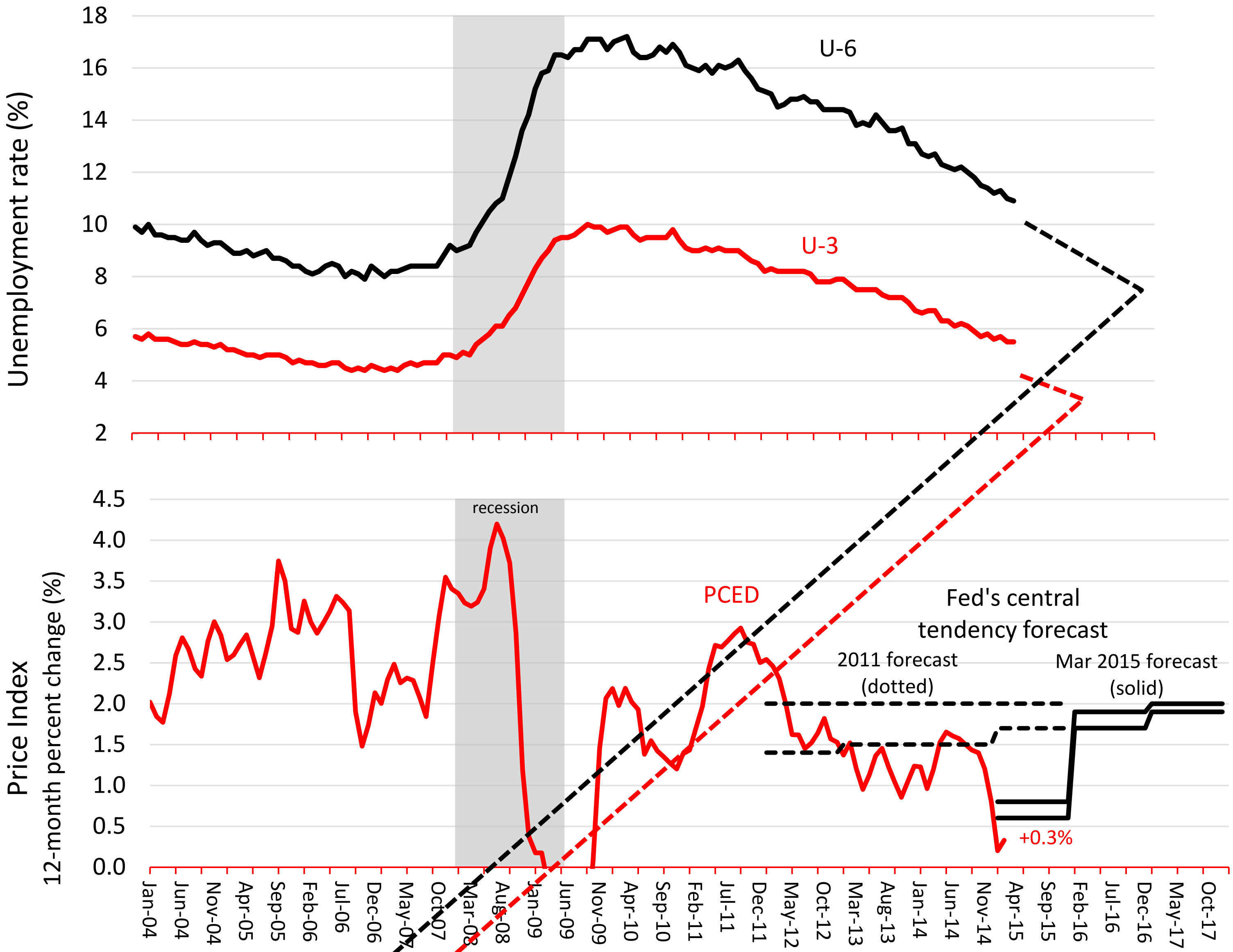
Steep yield curves – high bond yields compared to Fed Funds rates – are consistent with strong GDP growth.

Flat or negative yield curves have preceded recessions.

<u>Flat or negative yield curves have signaled bear markets in stocks</u>.

Sources: Federal Reserve, Standard and Poor's. Data through March 2015. [1]The differential between the interest rate on Fed Funds (short term) and the 10-year Treasury bond (long term).

Dual mandate, dovish Fed



Fed's dual mandate:

- full employment
- 2% inflation

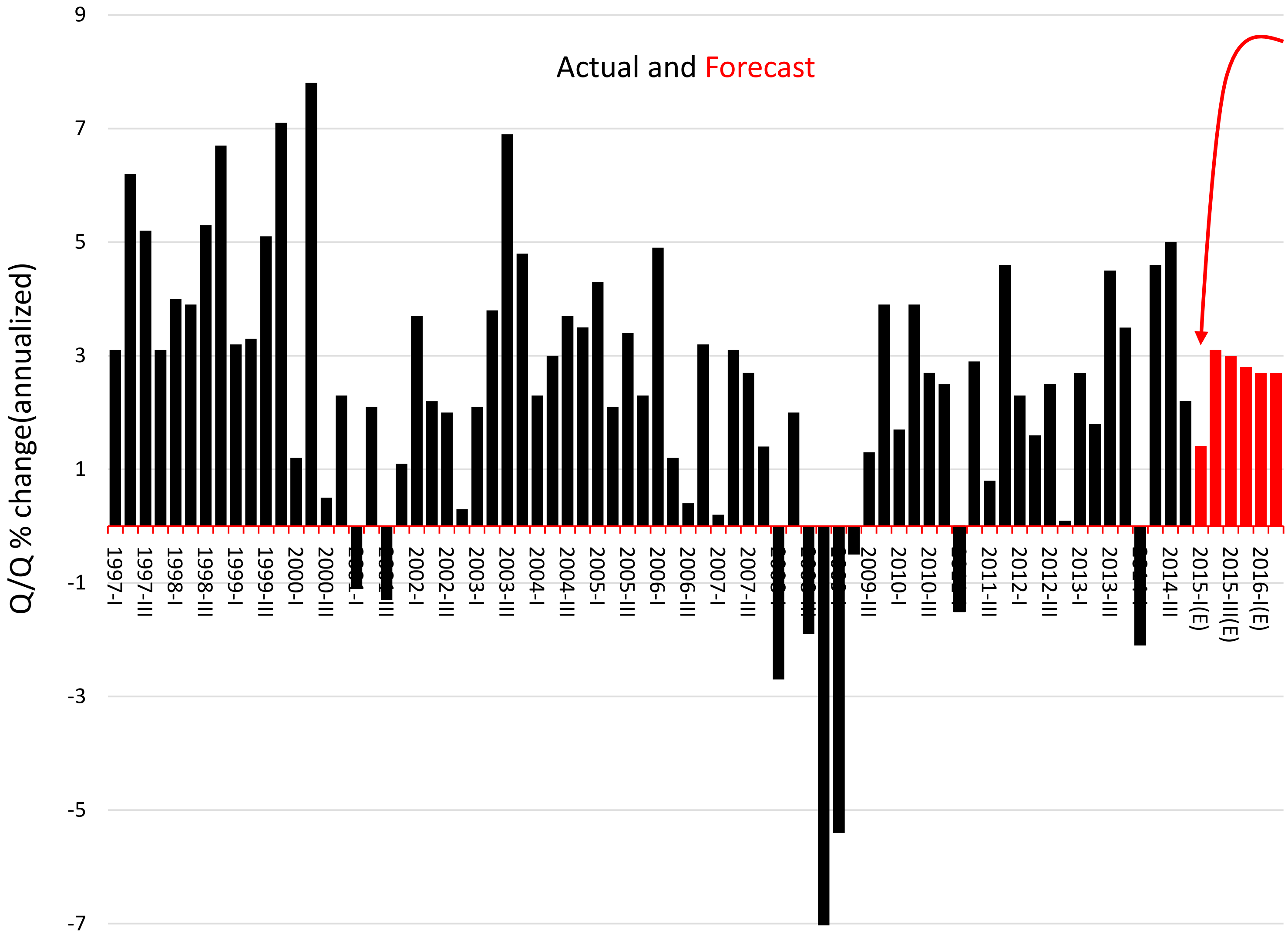
It may take until well into 2016 to regain full employment (dotted lines).

The Fed forecasts a return to 1½% to 2% inflation even though their forecasts have been consistently too high. <u>Low inflation gives the Fed ample room not to raise the Fed Funds target rate.</u>

U.S. Economy

Weak Q1-2015 U.S. GDP, World GDP Forecast Improving, U.S. LEI, US$ & Stocks, U.S. Household Networth, CBO 10 Yr GDP Growth Forecast

Weak Q1 GDP to be followed by snap-back



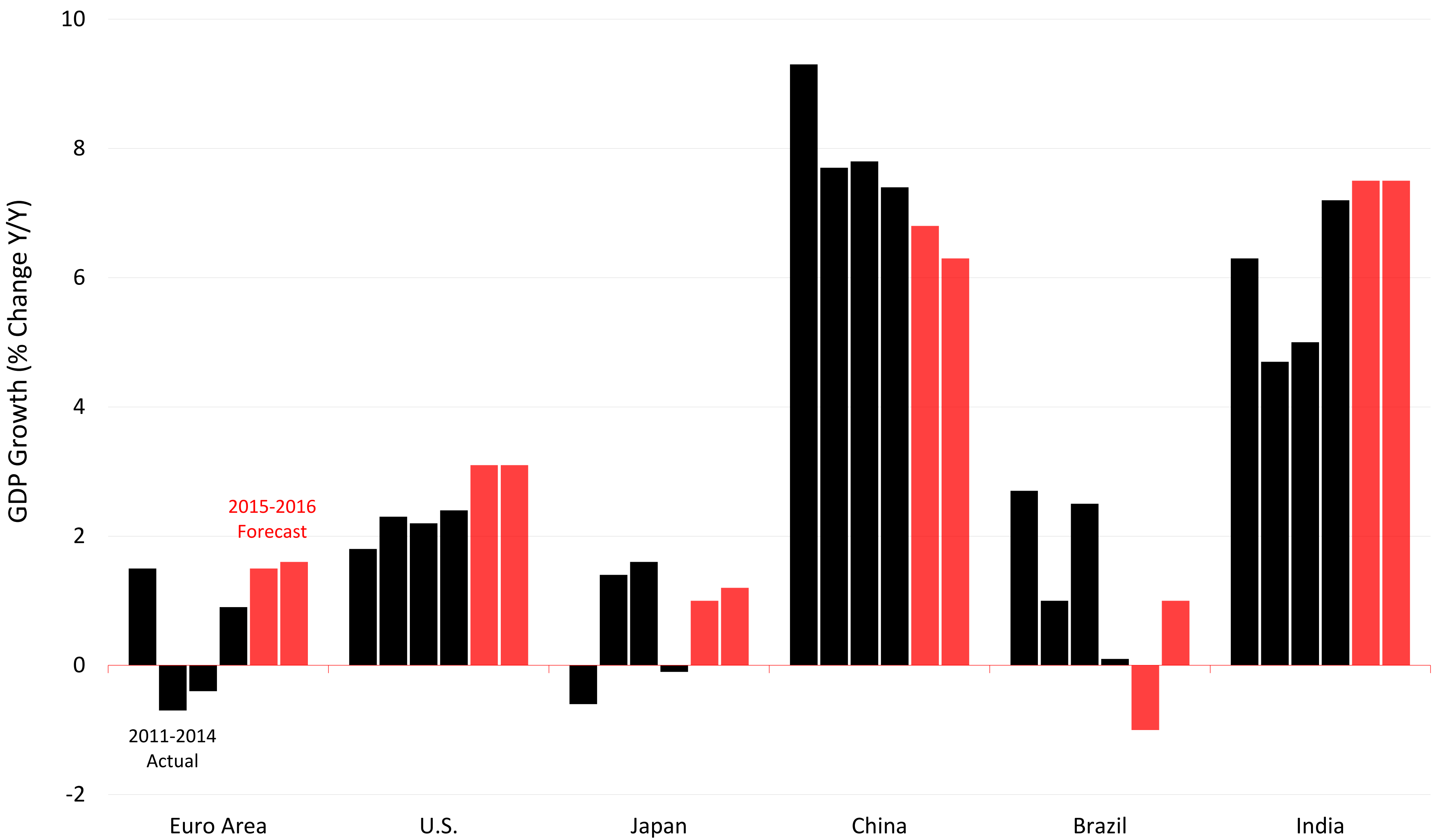
<u>Weak Q1 but it's still Goldilocks</u> … healthy economic growth with benign inflation.

The 70 economists surveyed by *The Wall Street Journal* in early March on average see approximately +3% GDP growth following weaker Q1.

Sources: Bureau of Economic Analysis, actual data through December 2014; *The Wall Street Journal* survey taken April 2015.

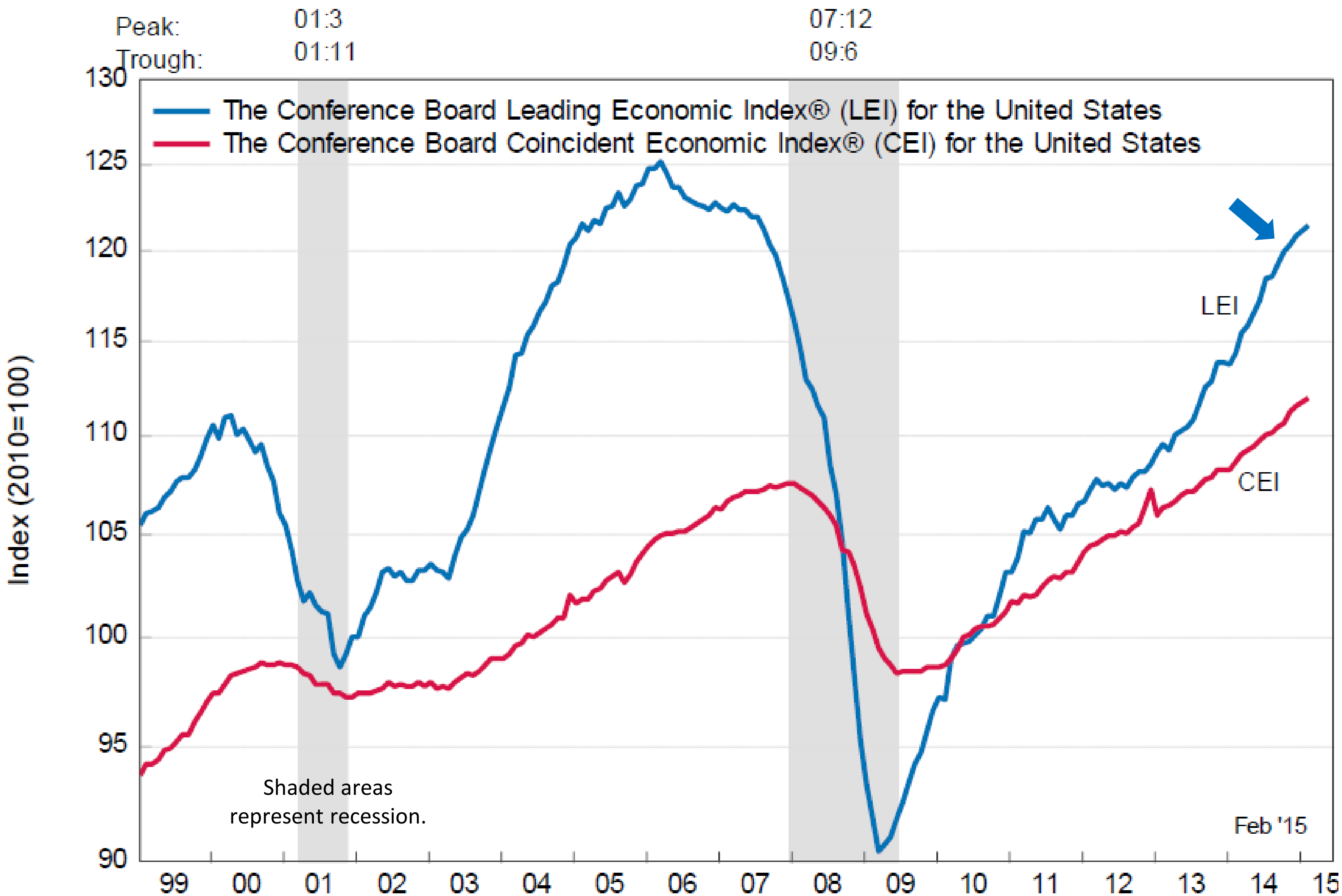
Economic Data rest-of-world

World GDP growth forecasts – improving growth expected



Source: IMF, *World Economic Outlook,* April 2015.

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



"Widespread gains among the leading indicators <u>continue to point to short-term growth</u>. However, easing in the LEI's six-month change suggests that we may be entering a period of more moderate expansion. With the February increase, the LEI remains in growth territory, but <u>weakness in the industrial sector and business investment is holding economic growth back</u>, despite improvements in labor markets and consumer confidence."

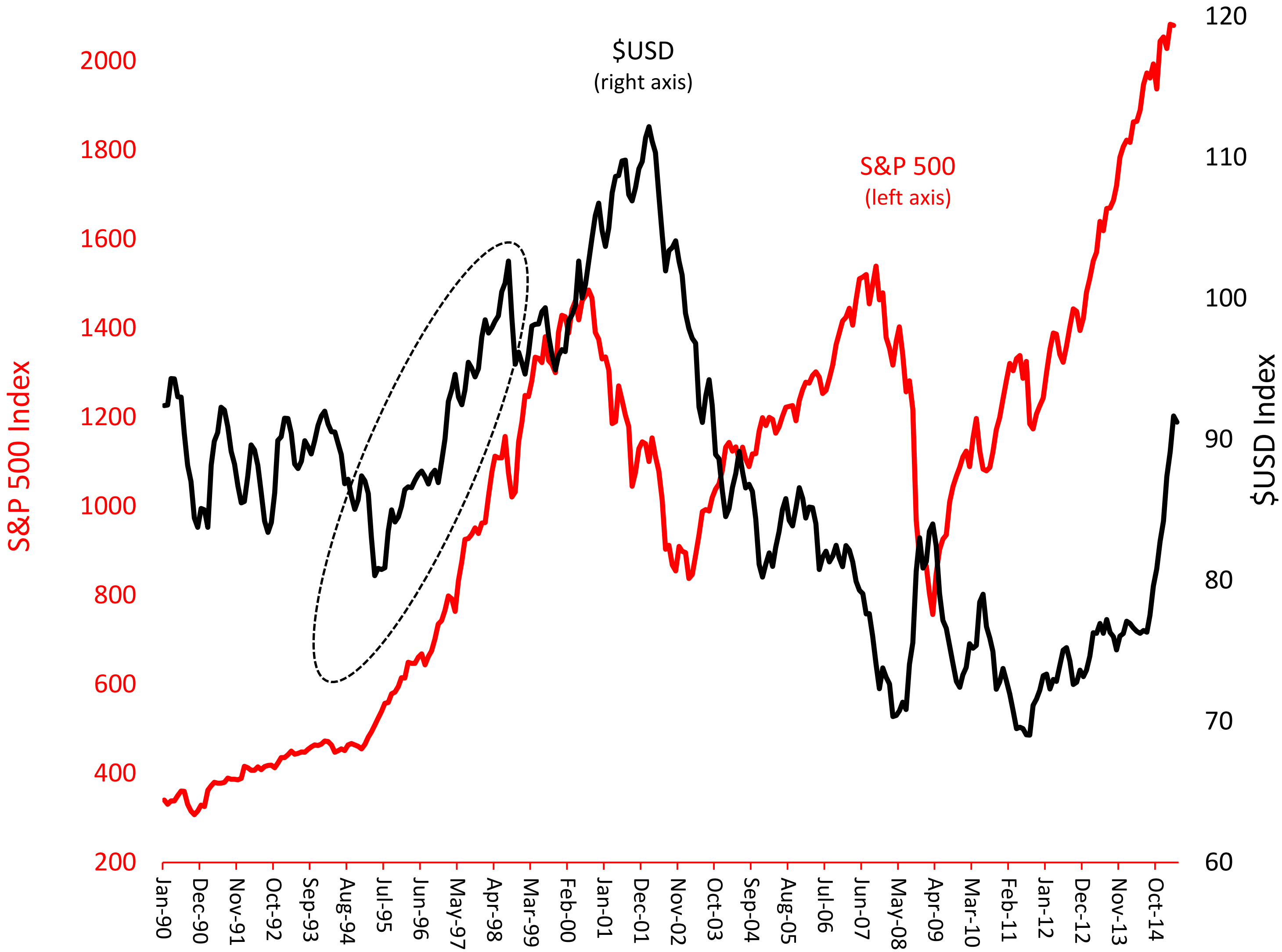
The Conference Board
March 19, 2015

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 February 2015, released March 19, 2015.

Strong dollar bad for stocks?

S&P 500 vs. $USD



Source: Standard and Poor's, Federal Reserve. Monthly data through March 2015.

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>

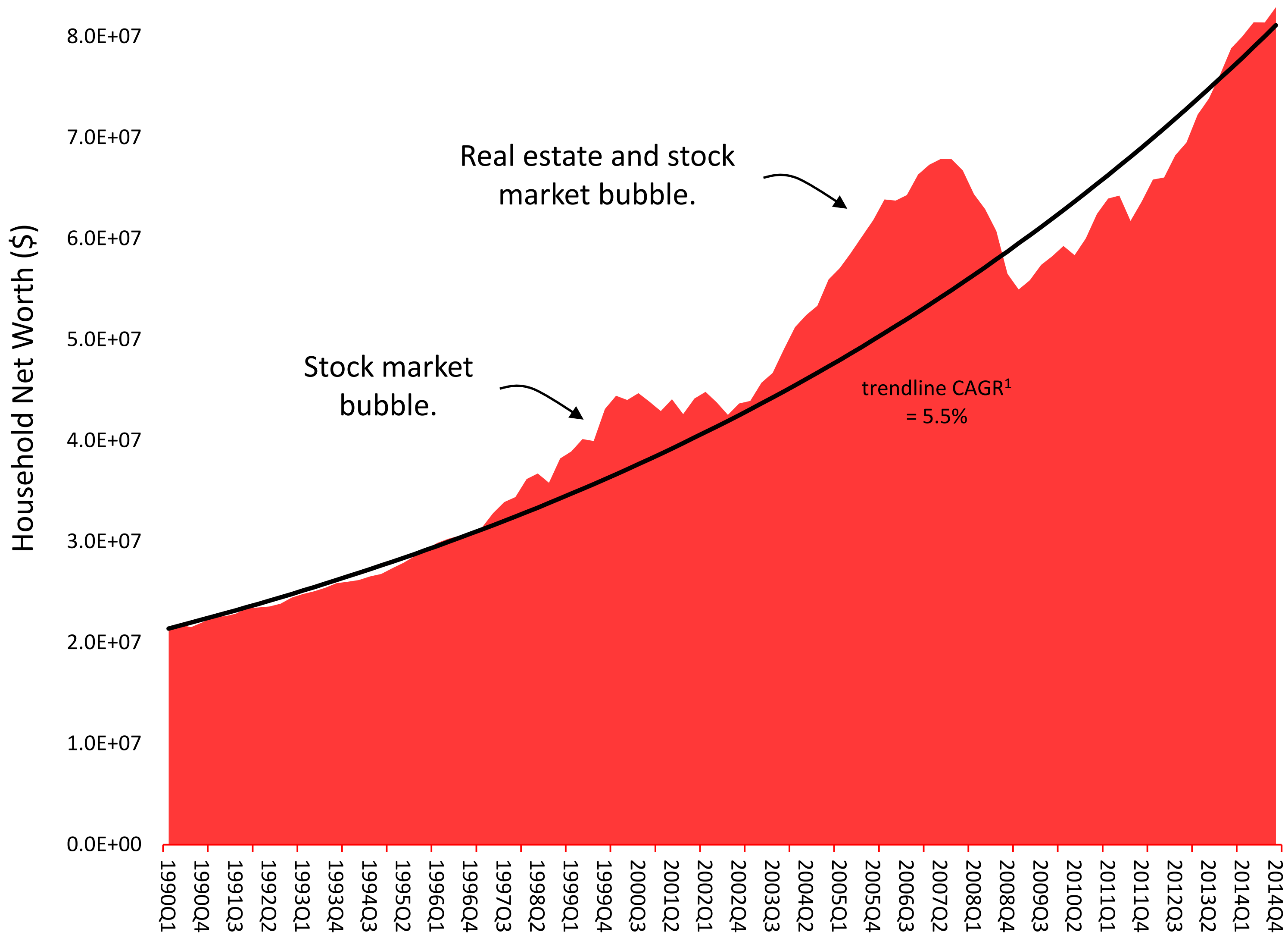
U.S. Dollar index

How high could the $USD go?

Despite its dramatic surge, it could go higher.

Sources: Federal Reserve major currencies index. Data through April 3, 2015.

Household net worth



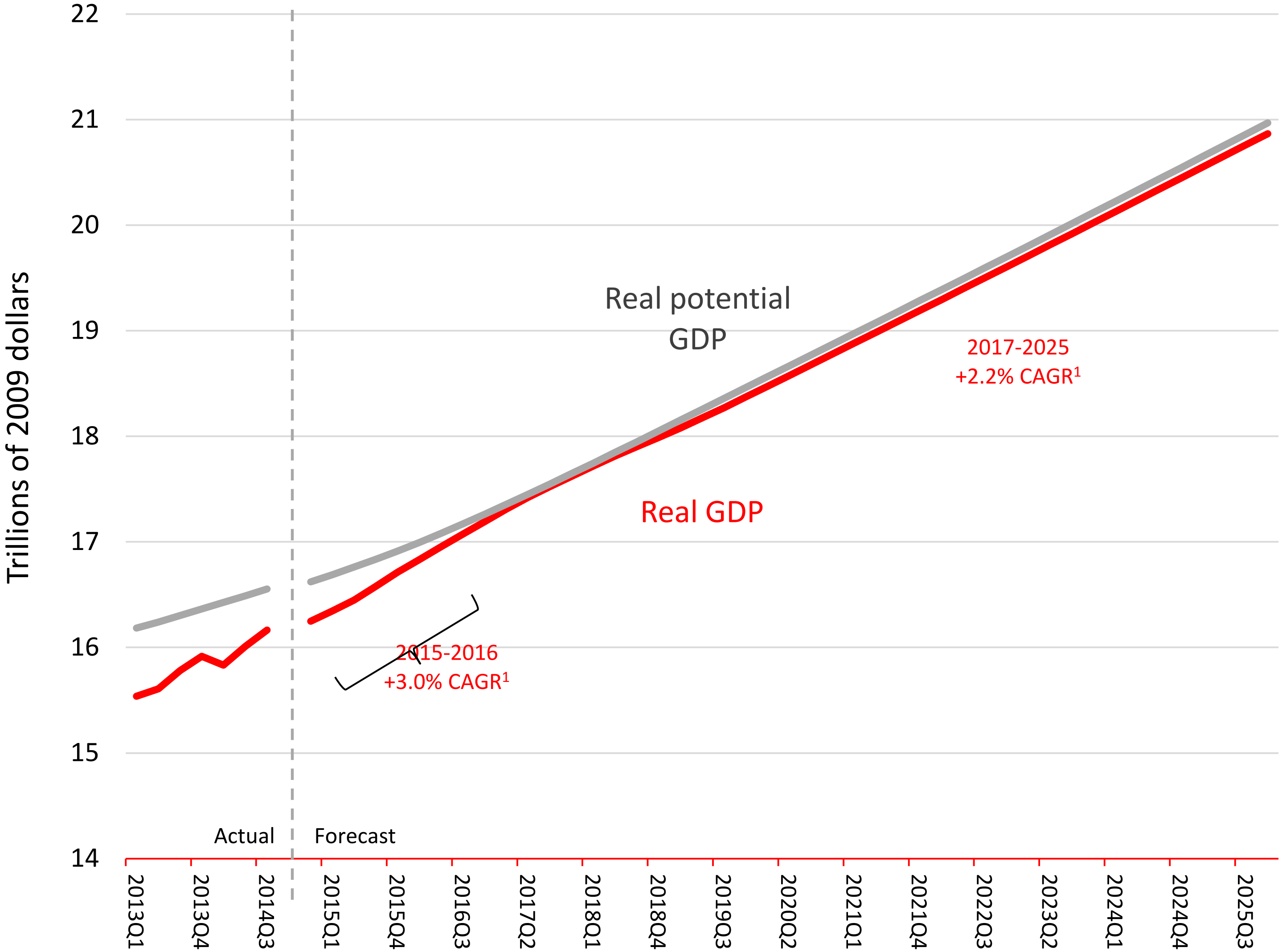
Household net worth has fully recovered.

Good for consumer spending.

Source: Federal Reserve. Data through December 2014, released March 12, 2015. [1]Compound annual growth rate. $8.0E+07 = $80 trillion.

Secular stagnation? Not.

CBO's 2015 10-year projected GDP growth



CBO sees a reversion to potential GDP growth looking out through 2025.

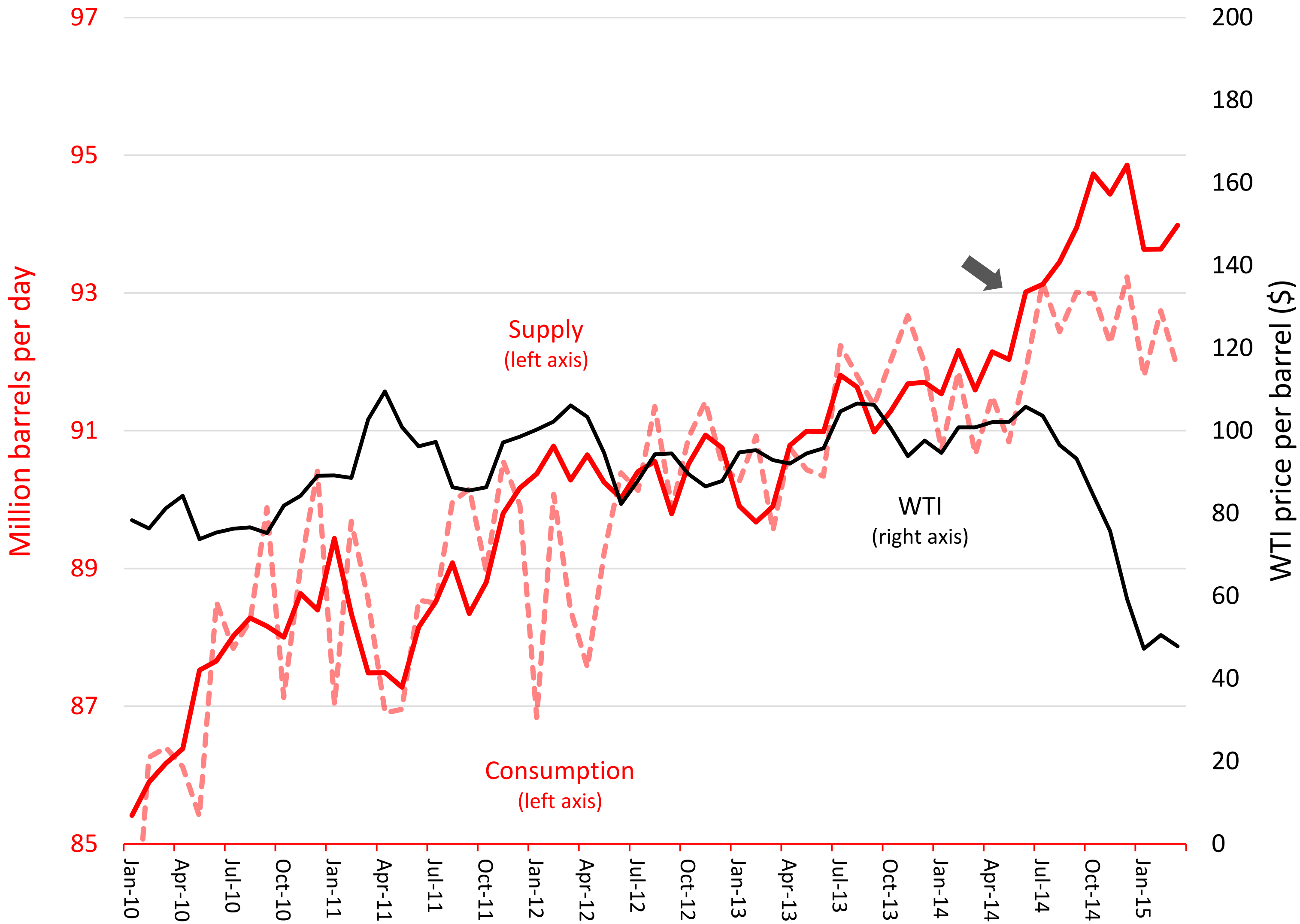
+3% GDP growth forecast for 2015 and 2016.

Source: Source: Congressional Budget Office (CBO), *The Budget and Economic Outlook: Fiscal Years 2015 to 2025*, January 2015.
[1]Compound annual growth rate.

Crude Oil

- Global supply still outstripping demand
- U.S. rig count plummets
- Oil is hitting inflation hard

World crude oil supply vs. consumption

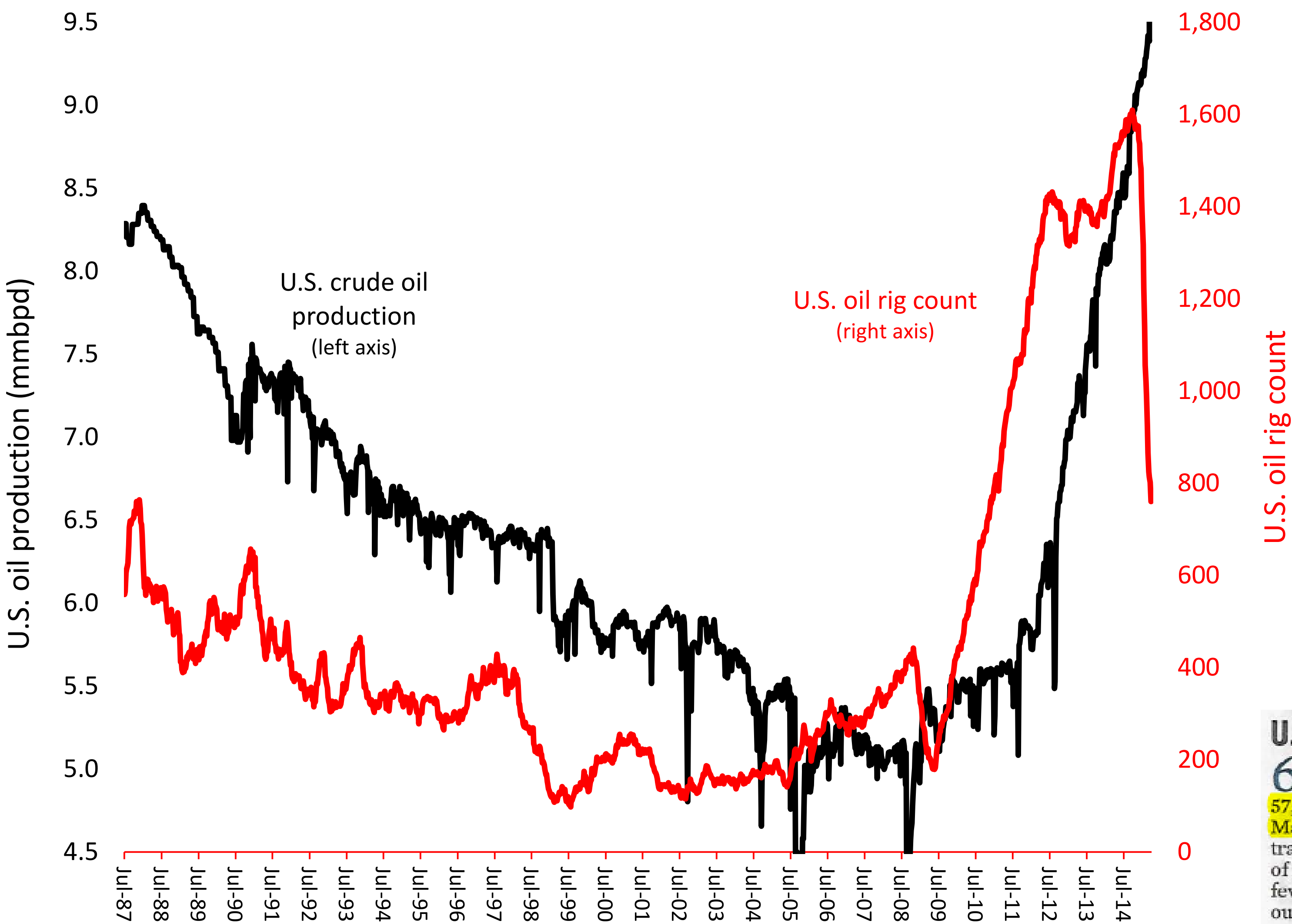


In 2014 and so far in 2015, global supply surged, outstripping demand growth, driving prices down.

Supply has now outstripped demand for 15 consecutive months.

Source: U.S. Energy Information Agency, *Short-Term Energy Outlook, April* 2015, data through March 2015. Includes condensate and natural gas liquids.

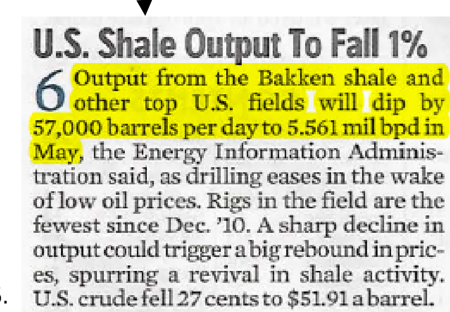
U.S. drilling plunge



The oil rig count has plunged -53% with probably more to come.

How long before crude production follows suit?

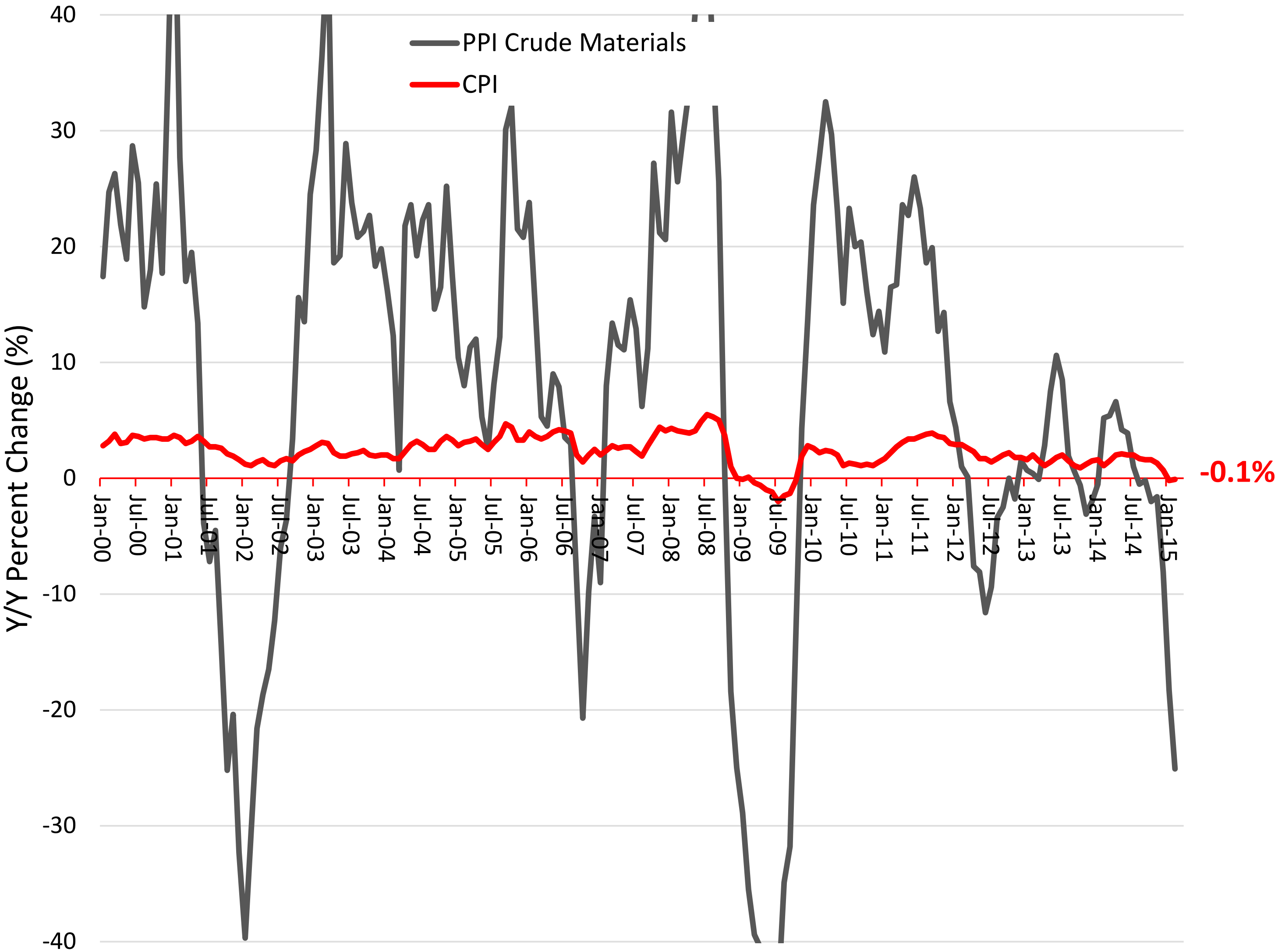
Today's paper:


U.S. Shale Output To Fall 1%

6 Output from the Bakken shale and other top U.S. fields will dip by 57,000 barrels per day to 5.561 mil bpd in May, the Energy Information Administration said, as drilling eases in the wake of low oil prices. Rigs in the field are the fewest since Dec. '10. A sharp decline in output could trigger a big rebound in prices, spurring a revival in shale activity. U.S. crude fell 27 cents to $51.91 a barrel.

Source: U.S. Energy Information Agency, Baker Hughes. Rig count through April 10, 2015. Crude oil production through April 3, 2015.
Investor's Business Daily, April 14, 2015.

Food and energy vs. inflation



Source: Bureau of Labor Statistics, data through February 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.

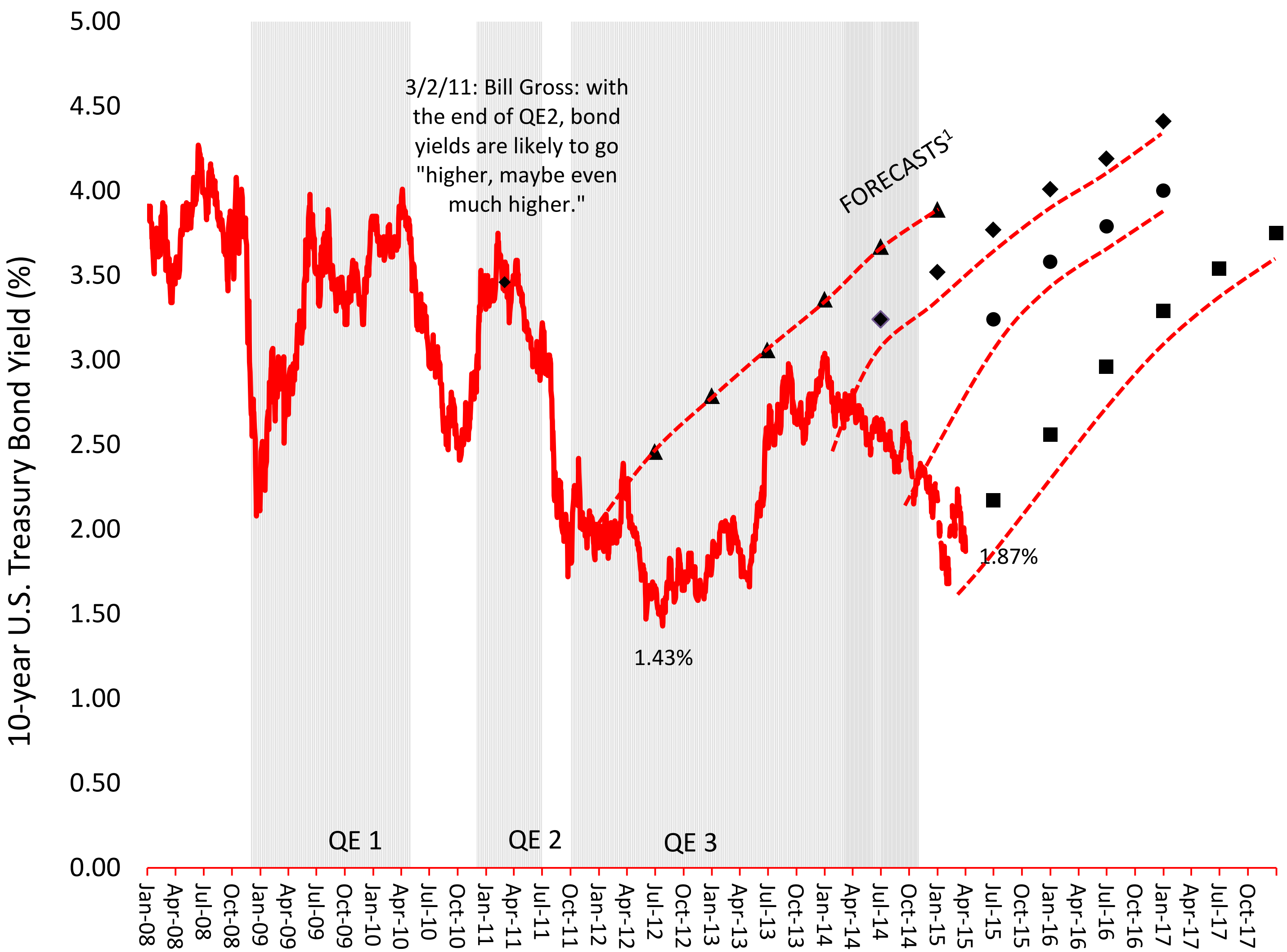
<u>The plunge in commodity inflation has pushed the CPI into deflation.</u>

Bond Yields

- forecasts have been way off
- almost-flat 5-10 year maturities forecast
- ECB driving euro yields towards zero

- Hard to see much upward pressure on bond yields in this environment.

Much lower than expected bond yields



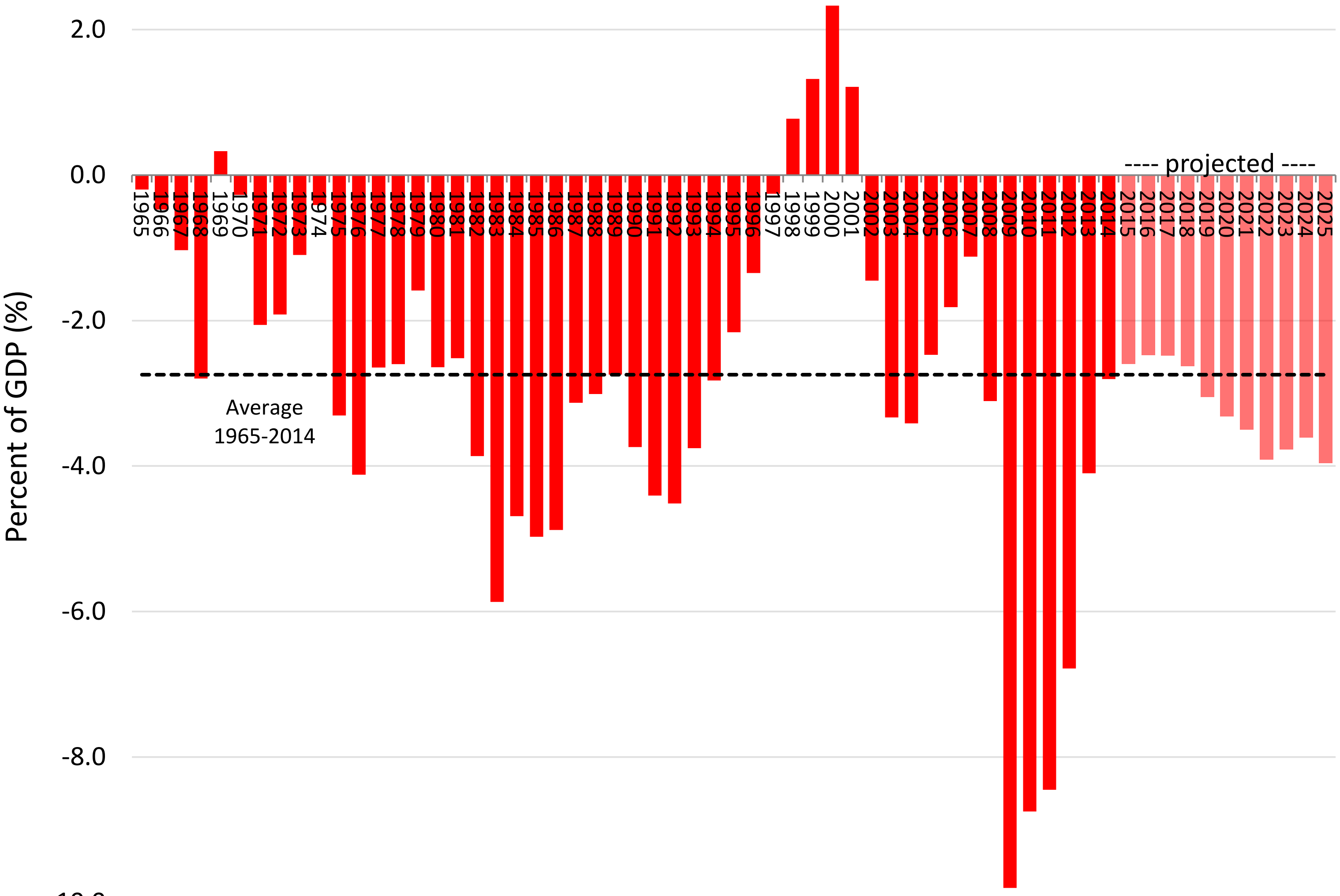
Lower than expected bond yields have been the big surprise for the last four years.

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

Inflation is very low and apt to remain so. The rate of net new supply of U.S Treasury bonds will be close to flat.

Source: Federal Reserve. Data through April 1, 2015.
[1] Average of economists' forecasts from *The Wall Street Journal* 's monthly surveys taken November 2011, January 2014, September 2014 and April 2015.

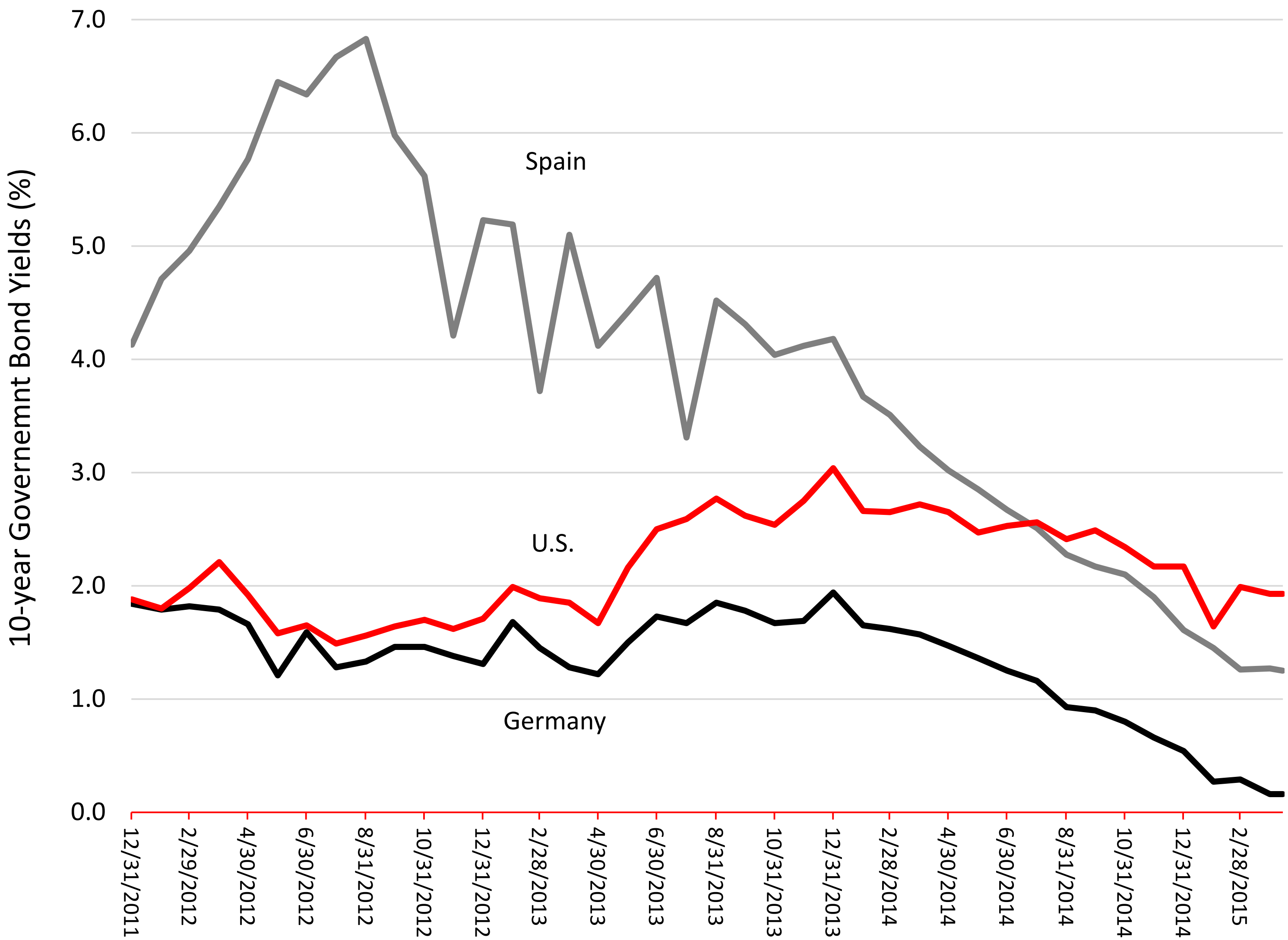
Federal deficits – declining



CBO is projecting diminished federal borrowing requirements through 2018.

Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2015 to 2025*, dated January 2015.

Comparative 10-year government bond yields



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

Spain yields have crossed U.S. yields!

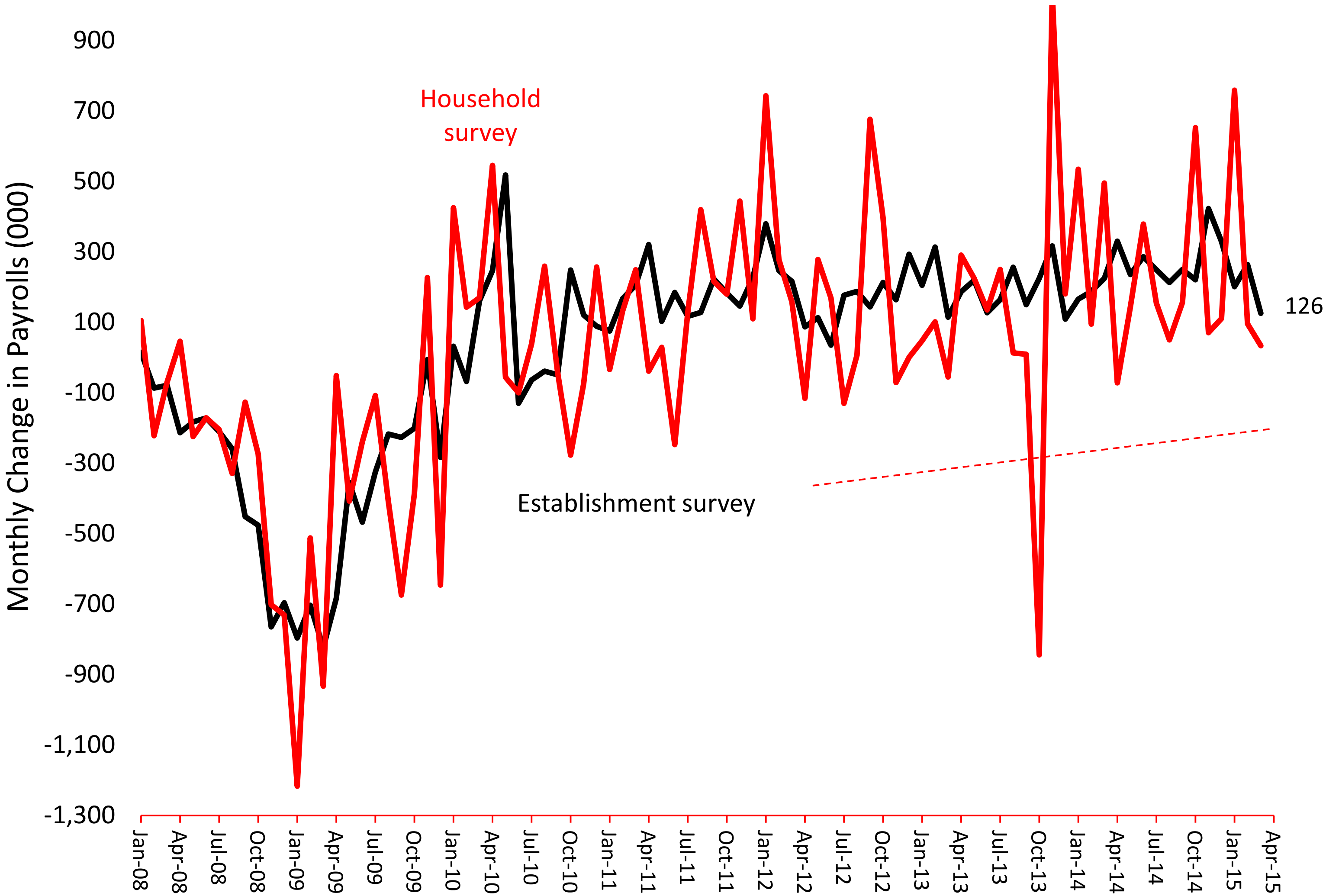
German bund yields approaching zero, spread to U.S. Treasuries widening.

Source: *The Wall Street Journal* online. Data through April 13, 2015.

Unemployment

- weak March jobs report
- likely temporary
- strong private sector, public sector drag
- strong relative U.S. job formation long-term
- middle class "wage stagnation"
- "… but we're not creating good jobs"

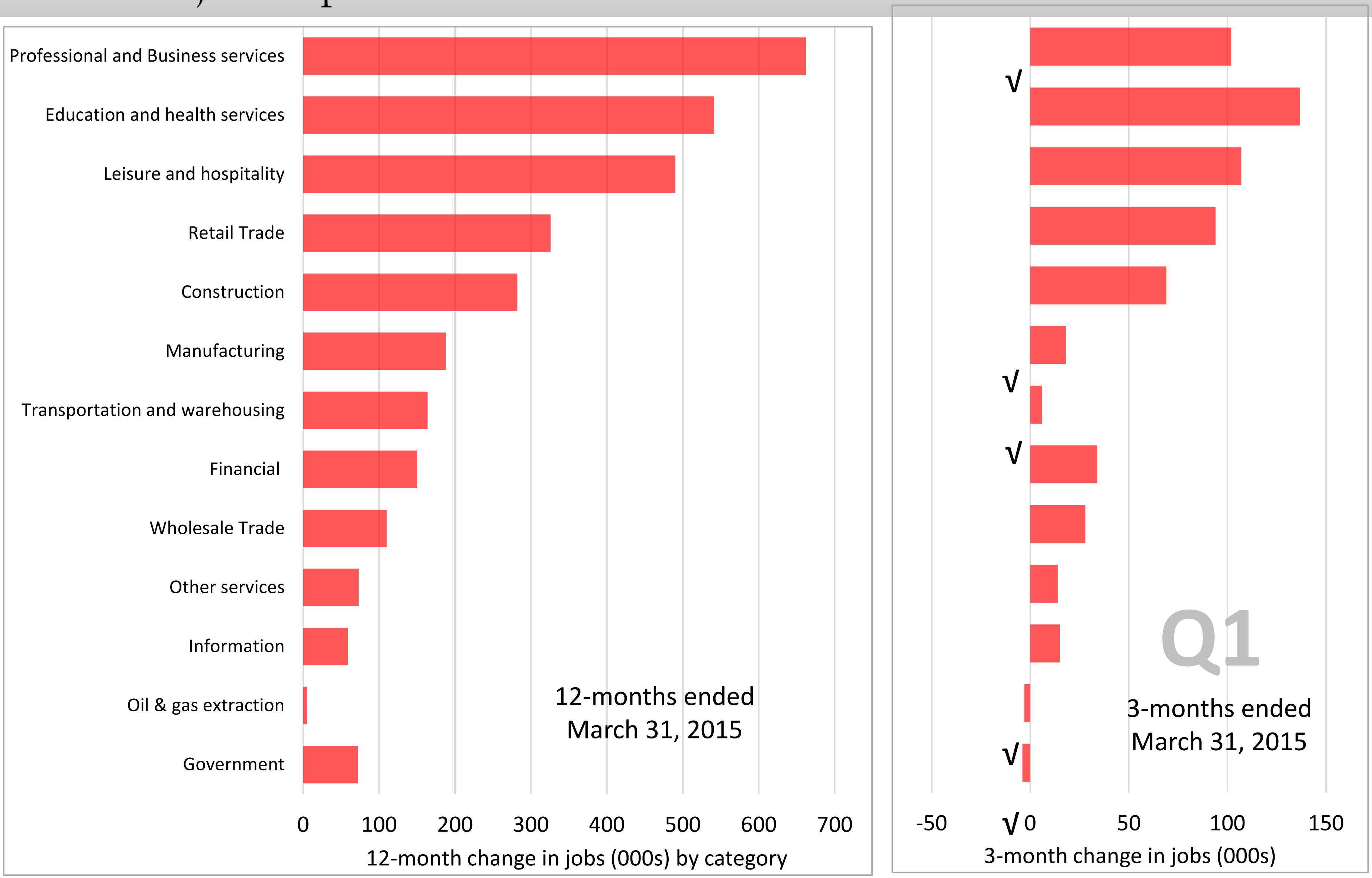
Employment – disappointing March new jobs



Disappointing March but both surveys have been trending higher.

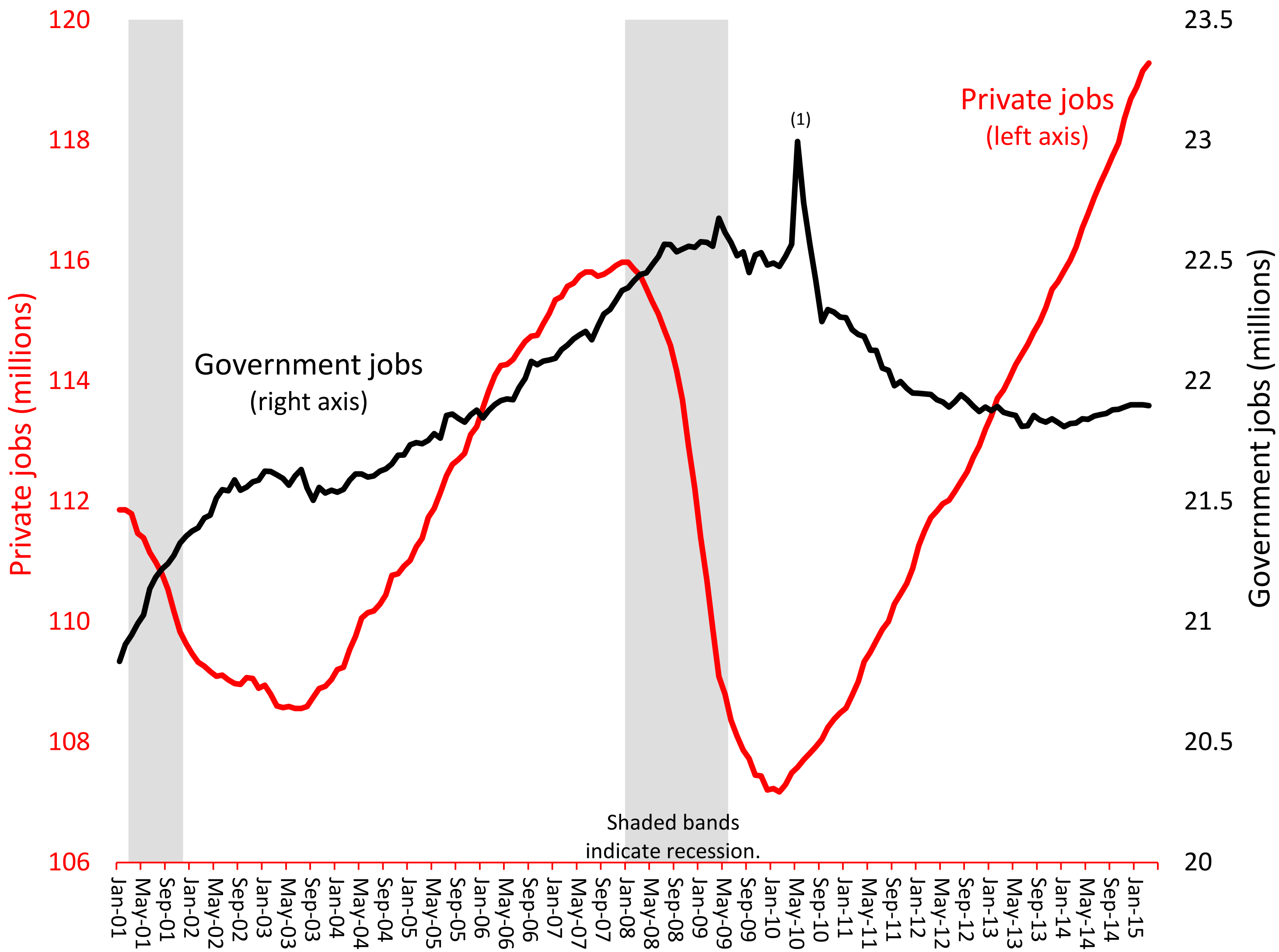
Source: Bureau of Labor Statistics. Data through March 2015.

March jobs report – where is the weakness?



Source: Bureau of Labor Statistics; data through March 2014.

Private jobs rising, government jobs finally turning higher



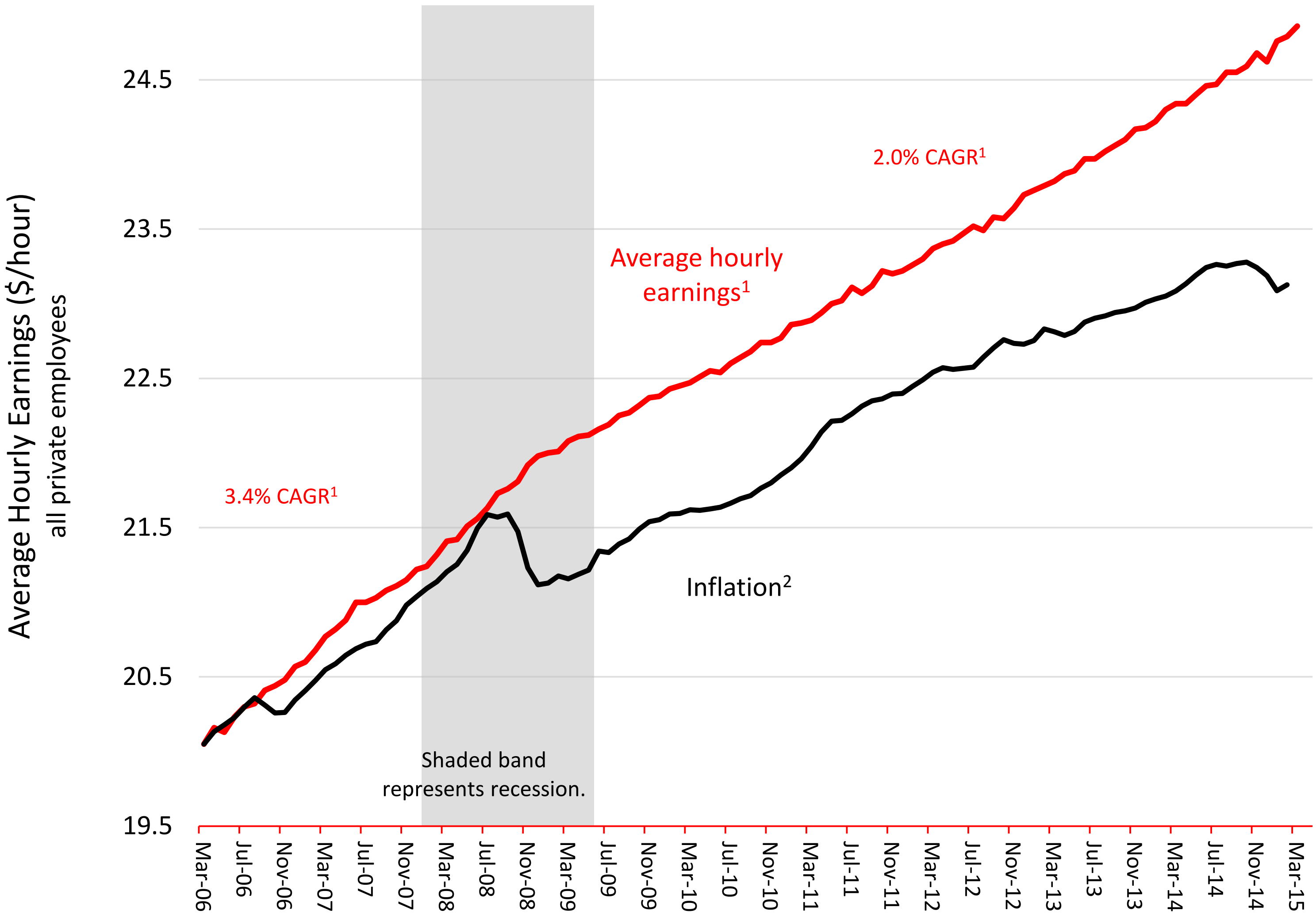
Private sector jobs recovery looking good.

Government job formation turned higher … but faltered in February and March.

Source: Bureau of Labor Statistics; data through March 2015.
[1] 2010 census hiring spike.

Wages – middle class wage stagnation?

Average hourly earnings vs. inflation

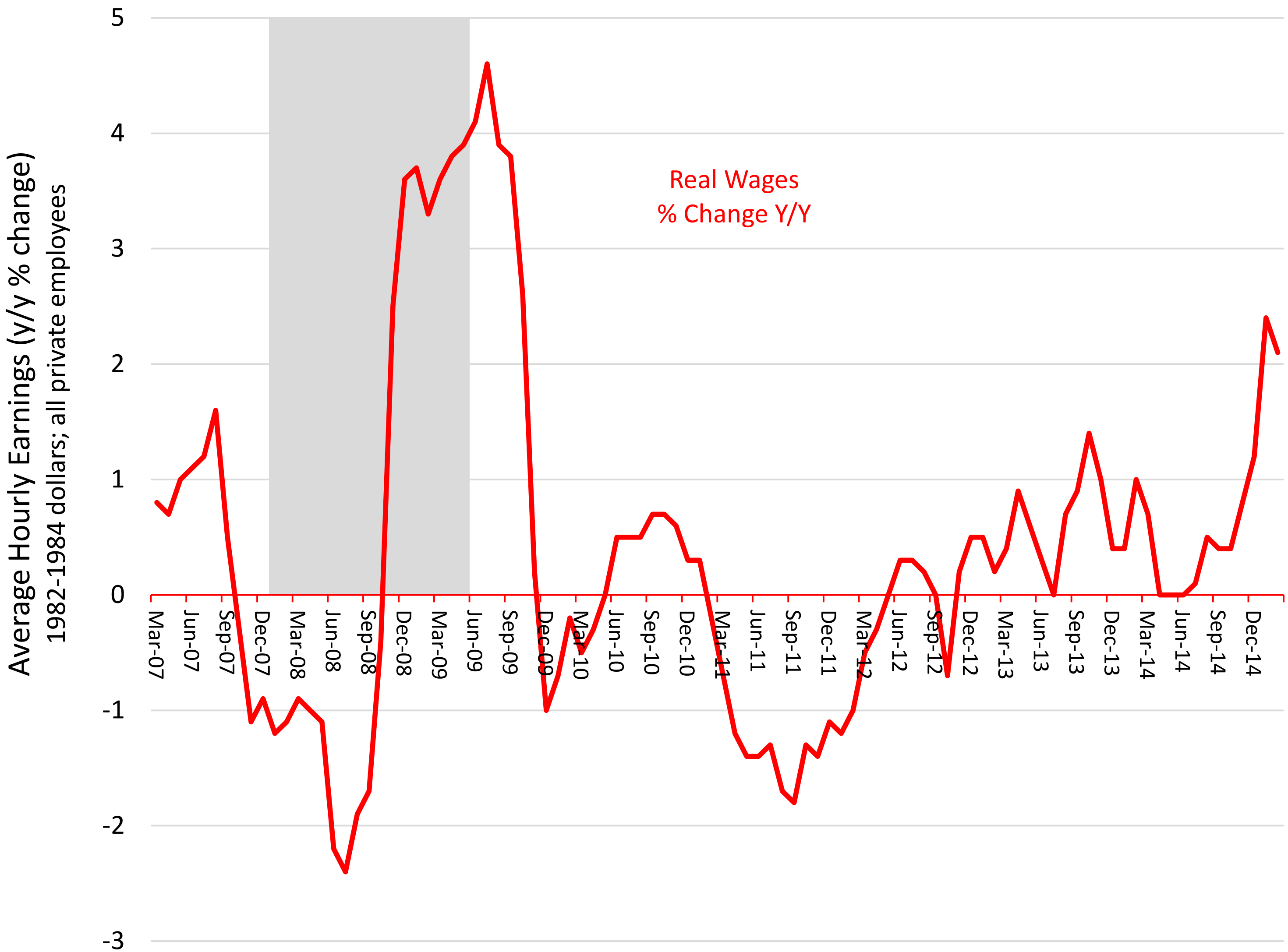


The trend in AHE remains steady at +2.0% y/y growth – down from the pre-recession rate of +3.4%.

AHE growth has outstripped inflation. Real wages have grown … actually at a better clip than pre-recession because inflation has been declining.

Source: BLS, BEA. Wage data through March 2015. Inflation data through February 2015.
[1] Compound annual growth rate March 2006 through December 2008 = 3.4%; CAGR December 2008 through March 2015 = 2.0%.
[2] March 2006 average hourly earnings of $20.05 inflated by the personal consumption expenditures deflator (PCED).

Real wages surge



Source: BLS. Data through February 2015.

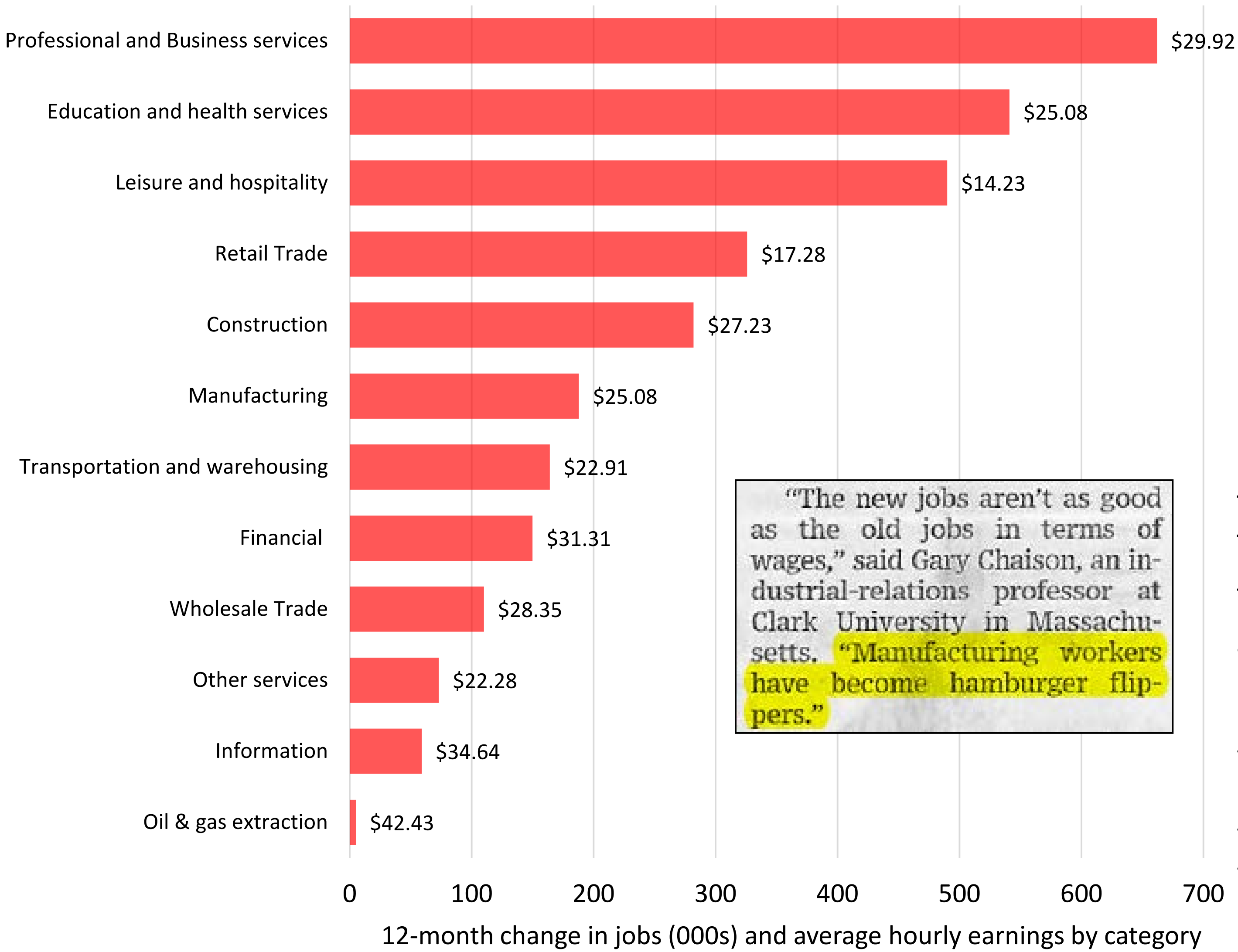
This is another look at the data presented in the previous chart.

Real wages are computed by subtracting inflation from nominal wages.

Over the past two years, with inflation having dropped so low, real wage gains have surged.

Jobs … "but the jobs we're creating aren't 'good' jobs."

y/y job growth and average hourly earnings by category



"The new jobs aren't as good as the old jobs in terms of wages," said Gary Chaison, an industrial-relations professor at Clark University in Massachusetts. "Manufacturing workers have become hamburger flippers."

Average hourly earnings for all total private payrolls = $24.86.

<u>Good sound bite but stupid observation.</u>

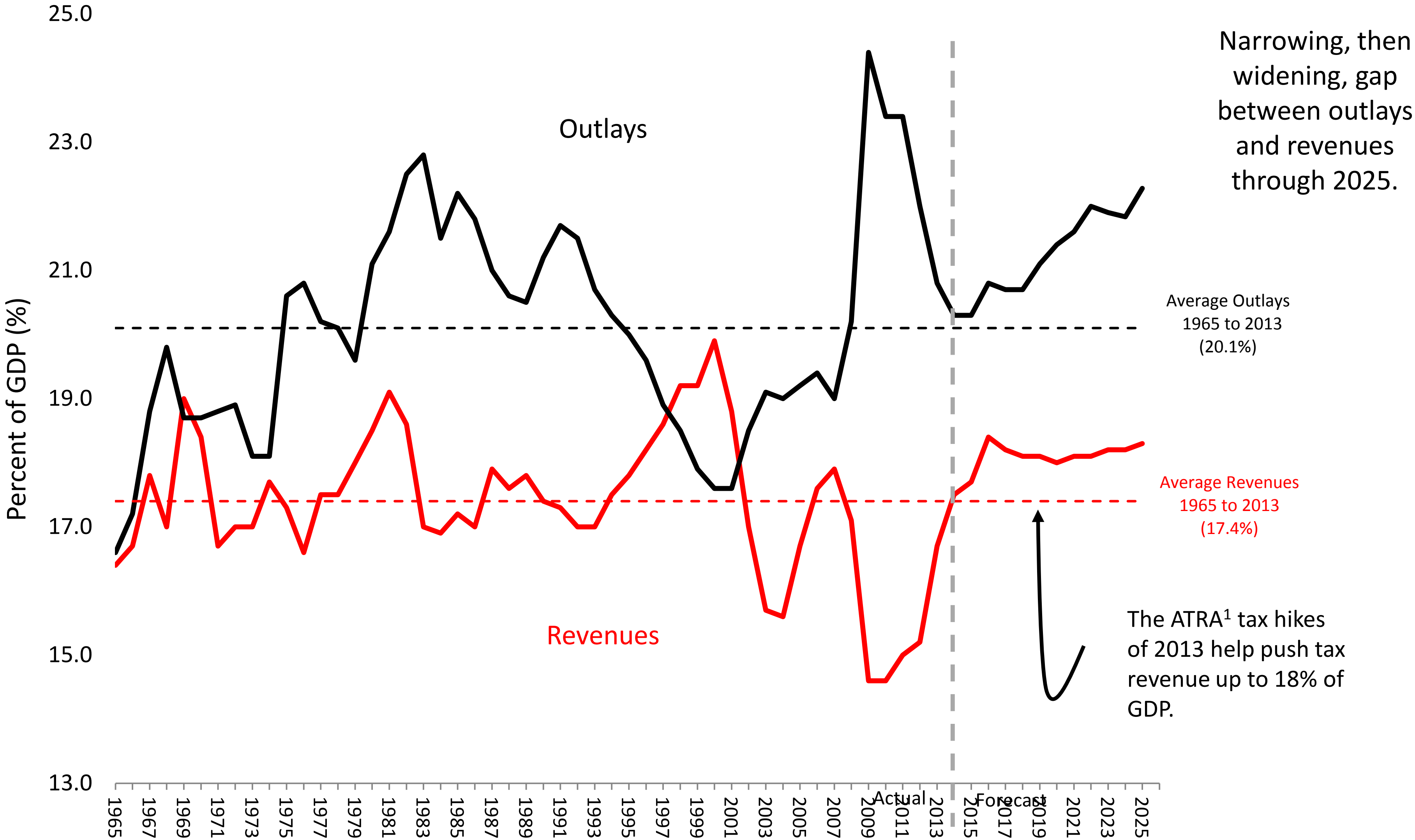
The largest and fastest growing jobs categories (top two in the chart) pay equal to or better than manufacturing, and pay more than twice what "hamburger flipping" (leisure and hospitality) pays.

Source: Bureau of Labor Statistics; data through March 2014. *Investor's Business Daily*, March 9, 2015.

Federal budget

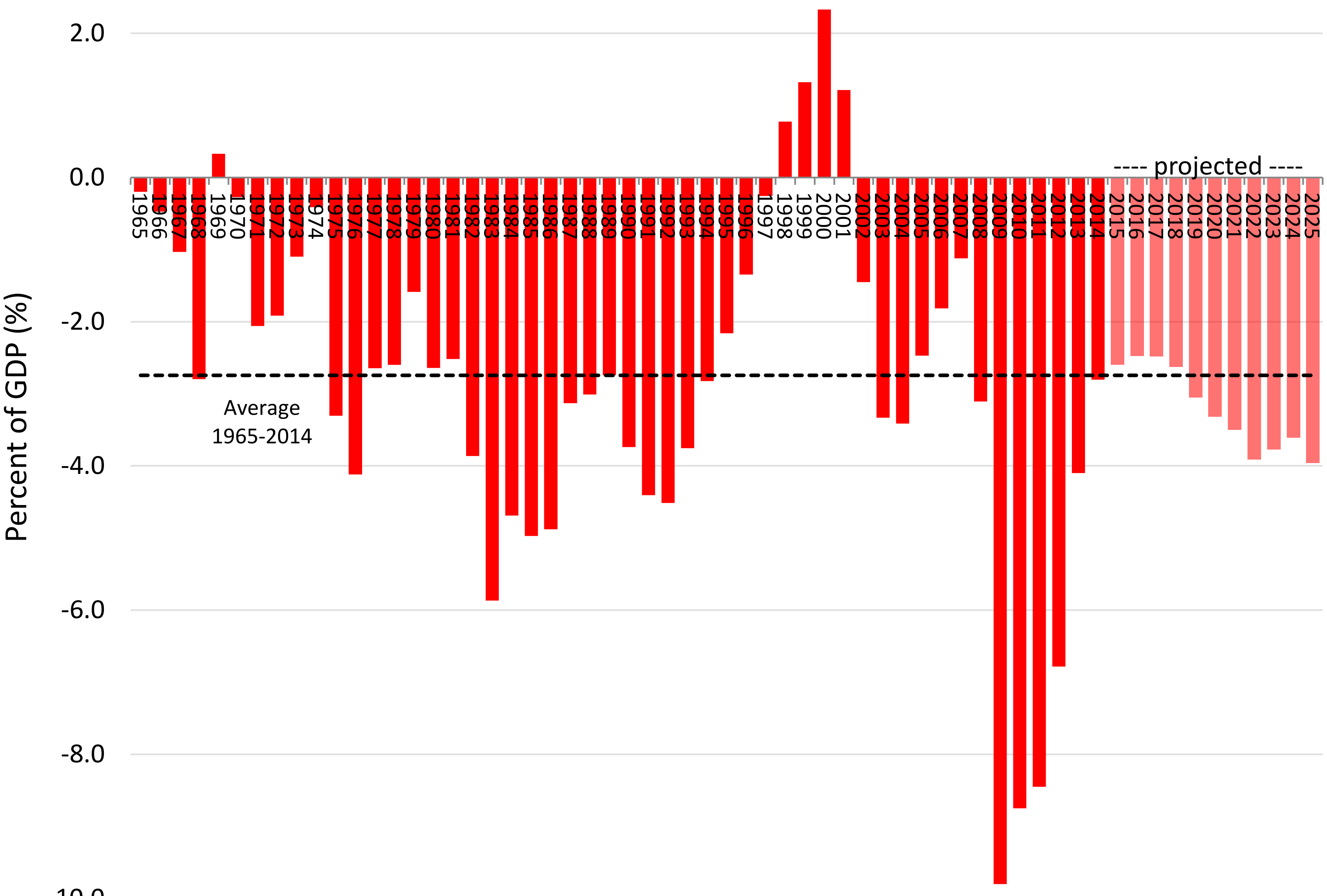
- CBO’s January 2015 forecast
- looks good for a few years …
- … but the entitlements problem hasn’t gone away

Federal revenues and outlays – a rising spending problem



Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2015 to 2025*, dated January 2015.
[1] American Taxpayer Relief Act.

Federal deficits – declining

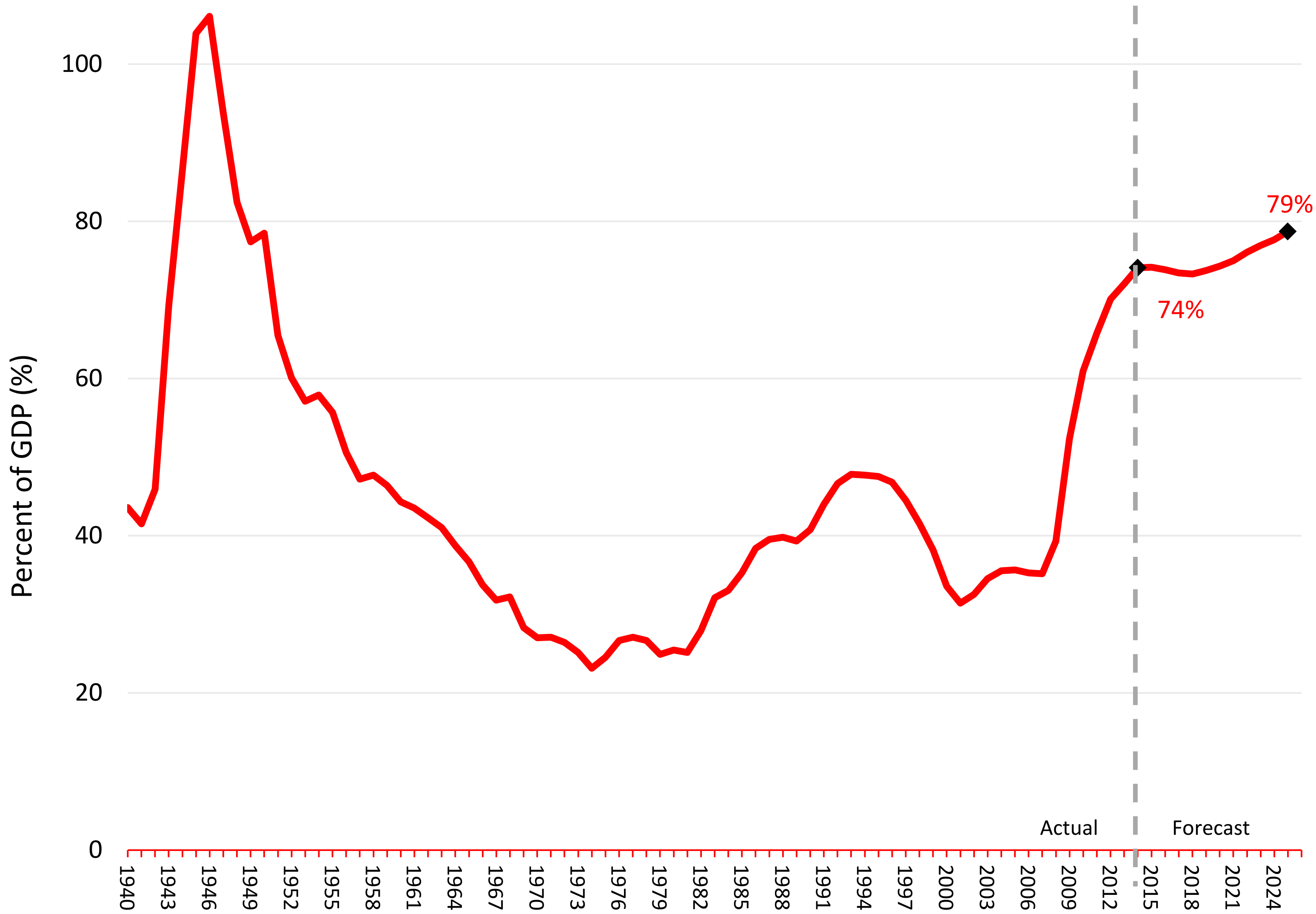


CBO is projecting diminished federal borrowing requirements through 2018.

Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2015 to 2025*, dated January 2015.

What happened to the debt crisis?

Federal debt % of GDP

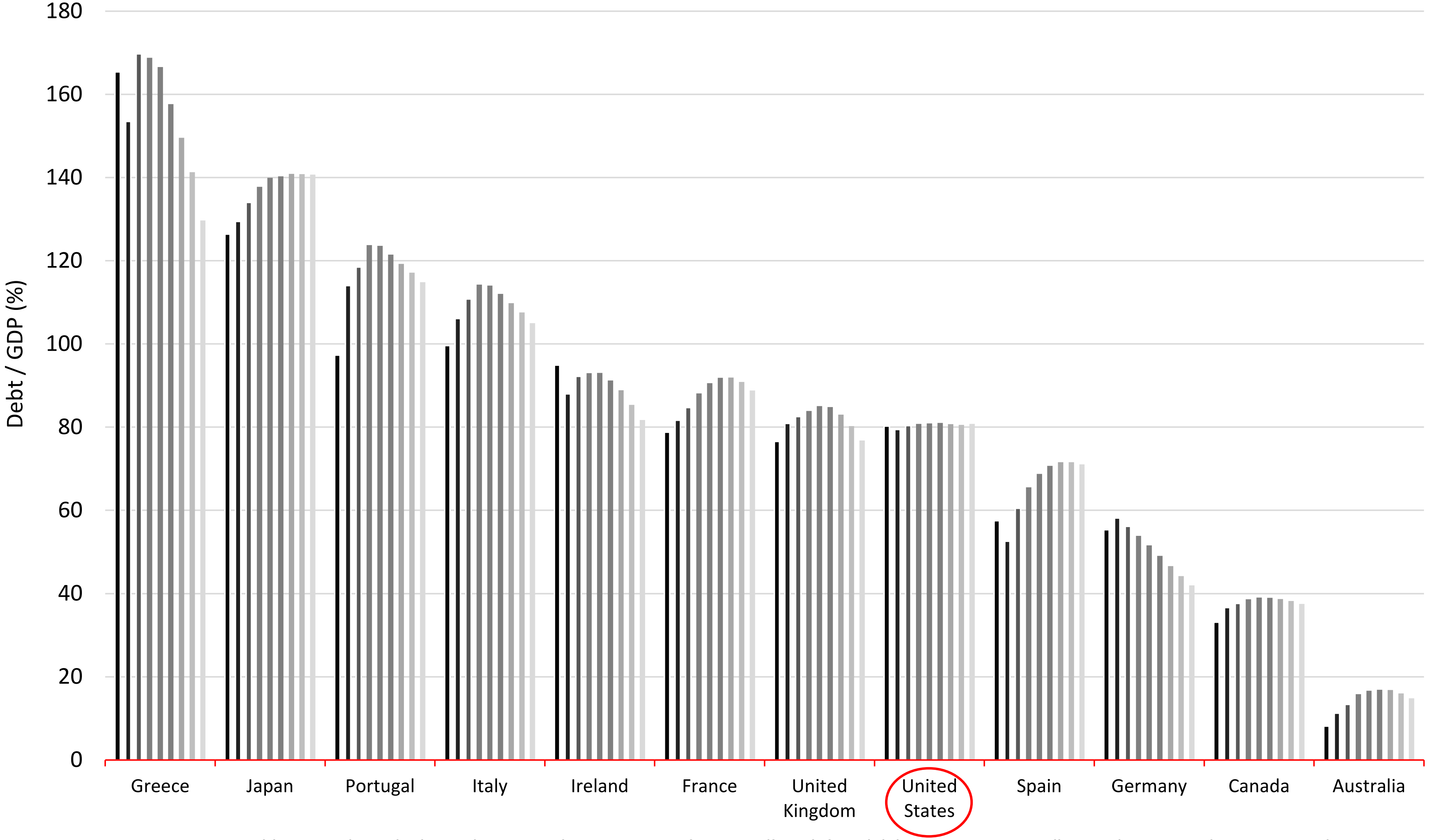


Debt % of GDP improves through 2018, then increases.

Source: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2015 to 2025*, dated January 2015.

Deficit spending

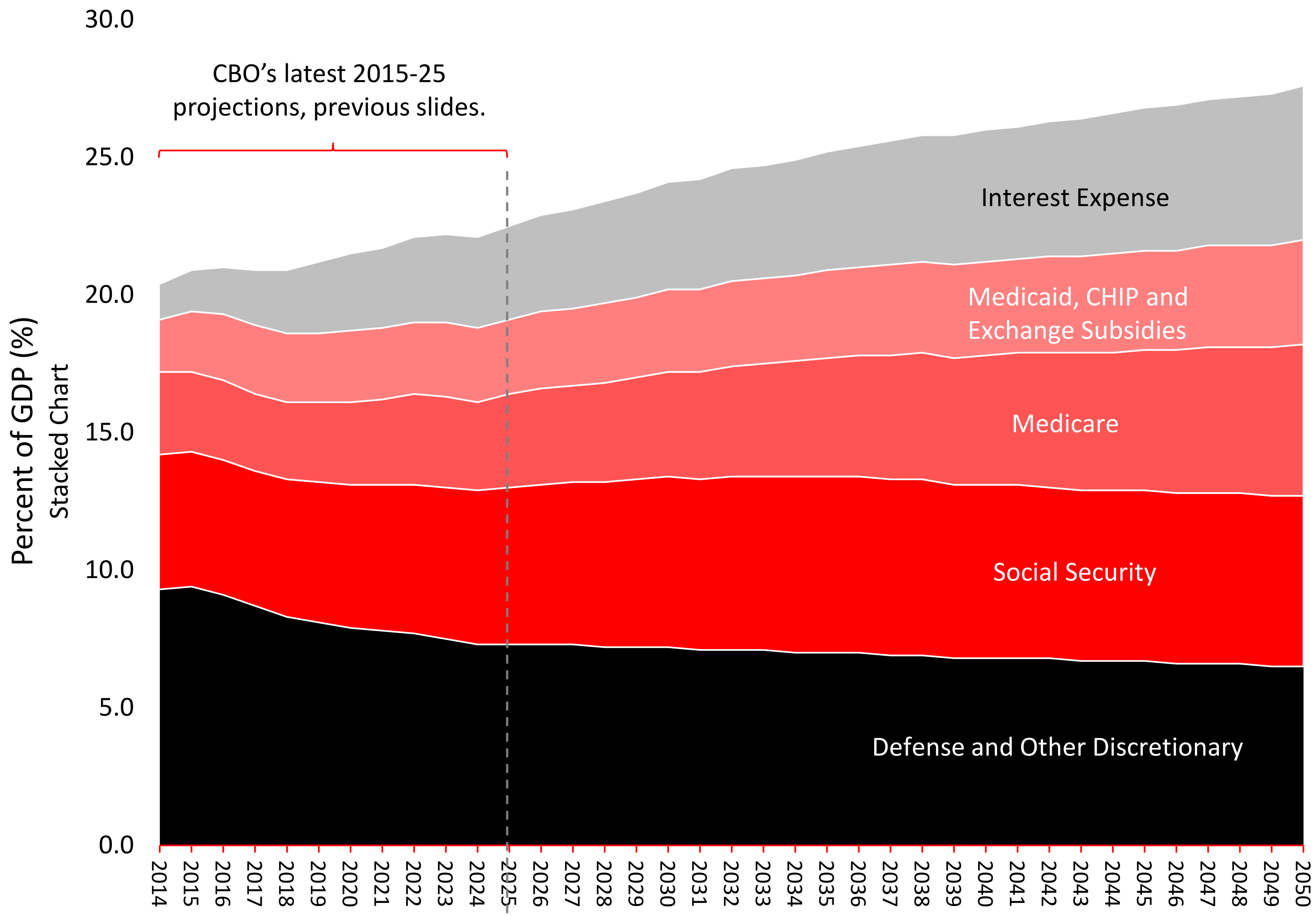
Government debt-to-GDP ratios (2011-2019)



Source: IMF, World Economic Outlook Database, October 2014. Data for years (from left to right) 2011-2019. For all countries except the U.S.: actual data for 2011-2013, estimates for 2014-2019. For the U.S.: actual data for 2011-2012, estimates for 2013-2019

What happened to the debt crisis?

Projected federal spending[1]

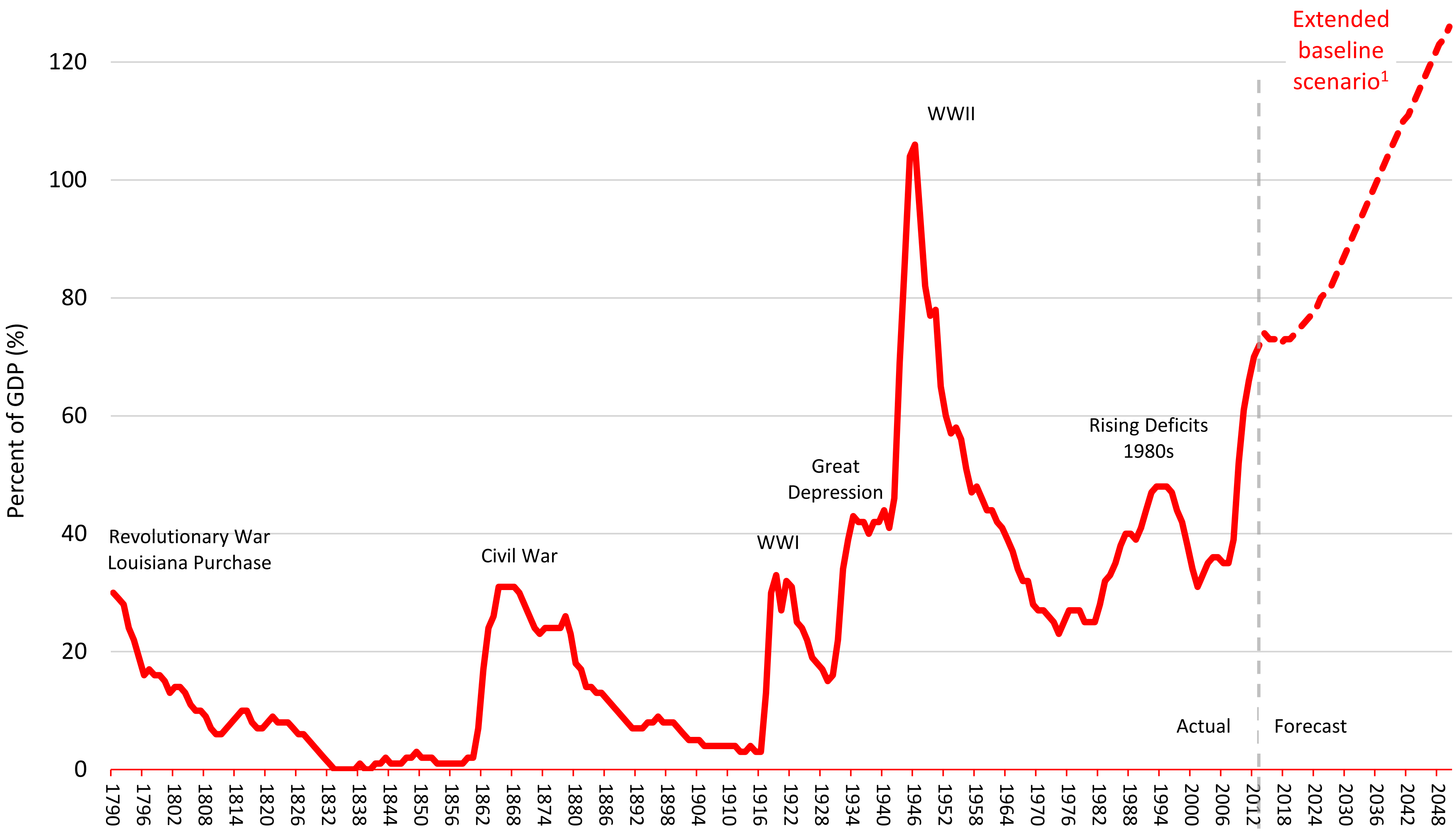


Entitlements are on autopilot and interest expense keeps growing as a share of total spending as the debt accumulates.

Source: Congressional Budget Office (CBO), *The 2014 Long-Term Budget Outlook*, July 2014. [1]CBO's 10-year and extended baselines are meant to serve as benchmarks for measuring the budgetary effects of proposed changes in federal revenues or spending. They are not meant to be predictions of future budgetary outcomes; rather, they represent CBO's best assessment of how the economy and other factors would affect revenues and spending if current law generally remained unchanged.

What happened to the debt crisis?

Federal debt % of GDP through 2050



Source: Congressional Budget Office (CBO), *The 2014 Long-Term Budget Outlook*, July 2014. [1]CBO's 10-year and extended baselines are meant to serve as benchmarks for measuring the budgetary effects of proposed changes in federal revenues or spending. They are not meant to be predictions of future budgetary outcomes; rather, they represent CBO's best assessment of how the economy and other factors would affect revenues and spending if current law generally remained unchanged.

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."

Disclaimer/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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