GREENWOOD REPORT

January 20, 2015

ASSESSING THE 2015 ECONOMY

March of 2015 marks the sixth year of *the most hated bull market in American history*. Our nation's media, as well as the fear-mongering market-timers who sold at inopportune 2009 levels, have chosen to repetitively focus on the *negatives*, even amongst increasingly *positive* developments. Although the crisis of 2008-2009 left a bitter taste in the mouths of us all, patience and prudent investing have rewarded those with experience and a longer-term perspective. In fact, the current bull run is the second-longest uninterrupted winning streak on record – and the longest since the nine-year stretch from 1991-1999*. A review of our Greenwood Reports of the last six years conveys our positive tone throughout. Indeed, we've moved from recovery to prosperity…*but will it continue*?

POSITIVE UNDERPINNINGS

FED MANDATE

1. **Economic Growth:** The most recent report for third quarter of 2014 indicated inflation-adjusted real growth of 5%, well above the long-term average of 2.5 - 3.5%. While surprising to some, this was a welcome sign that our nation's economic engine is resilient, flexible, and thriving.

FED MANDATE

2. **Employment:** Unemployment is at 5.6% and declining; now nearing the Federal Reserve's "full employment" target rate of 5.2%. Demographics indicate that the retirement of baby-boomers will decrease the labor force, further decreasing unemployment. At the same time, we are seeing a decrease in labor force participation which could lead to a labor shortage. The good news – 94.4% of the work force is employed.

FED MANDATE

3. **Price Stability:** Inflation remains low. The rescue policies of 2008-2009 proved *not* to be inflationary with a current GDP deflator of roughly 0% and CPI approaching negative territory due, in part, to falling gas prices (Greenwood Gearhart Q4 estimates). Deflation – not inflation – may be the issue, especially in Japan, Russia and the Eurozone economies.

4. **Deficits:** The Federal Budget Deficit continues to decline – now below 3% of GDP – a major reversal from the 10% levels of the recession. This, of course, mitigates the fear of runaway inflation.

   The U.S. Trade Deficit is also declining primarily due to lower oil prices. Lower oil imports due to decreased demand and a strong dollar supports the Export / Import equation. Exports are growing despite a stronger dollar while our consumers benefit from lower import costs.

* Sonders, Liz Ann. Levitate: "More Market Mood Swings in 2015?." Charles Schwab & Co., Inc., January 5, 2015

5. **Interest Rates:** U.S. interest rates have been low since the financial collapse in 2008 and the subsequent monetary easing policies. The 10-year treasury is below 2.0% and the 30-year is below 2.5%. This is not a bubble, rather an abundance of resource inputs. Rates could remain low for a much longer time than some expect because of the absence of inflationary pressures in the U.S. and the need to accommodate stimulative policies in Europe, Japan, China, Russia and Latin America. The low cost of capital generates positive leverage and presents an excellent opportunity for businesses and government to move forward with long-term investment plans. Individuals can benefit through the positive leverage of mortgage financing.

6. **Energy:** We have an energy surplus in the United States, as a result of the shale revolution and proliferation of new oil extraction technologies. With oil below $50 a barrel, natural gas below $3 per MCF and, importantly, gasoline near or below $2 per gallon, consumers will have additional discretionary income in their pockets to continue to drive consumer spending.

   Although the impact of cheap energy can be negative for some companies in the oil industry, we see it as a net positive for the economy as 68% of the US economy is driven by consumer spending, with only 1% coming from oil and gas capital spending.* For instance, if a car is driven 20,000 miles and it gets 20 miles per gallon, then that driver buys approximately 1,000 gallons of gasoline per year. For a couple making $35,000 each and driving two cars, a price decline from $4 to $2 per gallon of gasoline adds $4,000 to their discretionary income. This effectively acts as a 5%+ pay raise for middle-class America ($4,000/$70,000). Gas prices act as a tax when they rise, but a very real pay raise as they fall.

7. **US Dollar:** The US Dollar is strong. As we wrote in "The Future of the US Dollar" (October 2009), it should not be surprising that the long-term value of the dollar should weaken *relative* to other currencies. After all, it does not take a weakening dollar for other global currencies and economies to strengthen. However, when the US economy grows and others like Europe, Japan, and the emerging markets don't, the dollar soars. One has to look no farther than the Euro to see the impact: Price of 1 Euro (€) in USD ($) = $1.16 versus $1.60 in 2008.

8. **Manufacturing:** We continue to enjoy resurgence in US manufacturing; some have referred to this as a "renaissance". With rising Chinese labor costs, coupled with low inflation in the US and a comparatively business friendly environment, CEOs are enticed to come home.

9. **Technology:** Exponentially increasing technological change continues to drive new and exciting innovations and industries with an eye towards improving quality of life globally. The diffusion of new technology across borders, industries, and the socioeconomic strata will stimulate income and growth generating benefits for millions. We are already seeing improvement in health care, energy, infrastructure, security, and manufacturing processes, to name a few.

10. **Stock Markets:** The Dow Jones Industrial Average (Dow) has topped 18,000, S&P 500 is well above 2,000, and NASDAQ is pushing toward the all-time high of 5,000 (reached in tech bubble of 2000).

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702

So what's wrong with this picture? Very little, *in the moment*. The question is: *how long will it last?* We do expect continued growth, but the low volatility returns we've enjoyed over the past three years may come to an end. Despite the myriad of strong numbers, we have challenges in our global economy, most of which are qualitative in nature. In 2015 and beyond, the US will be required to demonstrate leadership for the global economy – especially in the monetary policy arena. It is our role and our responsibility.

SOME CHALLENGES

1. **Environment:** We have acknowledged the early warning signs of climate change. The US has begun addressing the air and water pollution, but will need to do more in the area of carbon ozone emissions. The benefit/cost relationship for emerging markets and a deeper understanding of the implications for trade and global relations is warranted.

2. **Immigration:** The U.S. has tended to open its borders during strong economic times when labor demand is strong, but restrict immigration when the economy and labor demand are weak. With a declining labor force and a decrease in labor force participation, the U.S. may be ready to open its borders again. How to address a potential labor shortage and immigration will be a challenge. It appears both sides of the political aisle accept that reform is needed; consequently, immigration is certain to be a hot-button issue in the 2016 election.

3. **Income Disparity:** Globally, the economic gap between *Haves* and *Have Nots* continues to grow. The Middle East and Africa are experiencing both social unrest and revolution. In the U.S., income disparity is a growing concern of socioeconomic analysts. A repeat of the 1960s, when our social fabric was stretched and torn, can be avoided only by increased opportunities and greater education access. Education is the key to economic success in the U.S.

4. **Education:** The cost of higher education continues to rise and those in the lower income cohorts continue to have difficulty gaining access. Primary and secondary education is at risk of cuts as state and local budgets are reprioritized. In a technology-intensive, digital economy, education is the competitive advantage that will determine the future of our children and grandchildren.

5. **Monetary Policy:** The US is the global superpower, the dollar is the reserve currency, and the Federal Reserve is the central banker to the global economy. While we co-operate with the G-8 or G-20, the U.S. is first among equals. Further, because most international financial transactions are dollar based, they must pass through the Federal Reserve System and US control (why sanctions work against obstreperous nations). As a consequence, monetary policy tools of the U.S. Federal Reserve affect both domestic and global economies – sometimes with conflicting impact. To illustrate, Federal Open Market Operations may want to sell US Treasuries to absorb excess *domestic* liquidity thereby tightening policy and raising interest rates. But this outcome may be mitigated if another nation wants to buy US Treasuries or if a "flight to safety" is present globally due to terrorism or another externality. FOMC operations have become a *global* monetary policy tool with multiple mandates. The newest Federal Reserve policy tool, the Excess Reserve Rate, may provide a domestic tool since it affects domestic banks rather than international Treasuries.

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702

6. **Health Care:** Globally, Ebola, influenza, and other viral diseases spotlight issues with clean water and health care delivery systems. With the global population reaching over seven billion, new challenges arise in hunger relief and housing.

   In the U.S., extended life expectancy is certain to require longer-term health care solutions. Because older populations utilize more health care services, costs will escalate as the population ages. Implications for the Federal Budget are certain to be a challenge. Social Security may have a fix via a higher retirement age, but with Medicare and Medicaid the solution may be more complex.

7. **Infrastructure:** Highways, bridges, tunnels, railroads, airports, high speed digital infrastructure, etc. are all capital intensive, long-term projects. The U.S. needs upgrades, replacements and new installations in many of these project areas. Unfortunately, they are difficult to get underway in a divisive political environment even though the current interest rate environment would provide low financing costs.

8. **Pension Risks:** The demographic impact of baby-boomers living longer has caused public pension plans to swell with retirees. *Pension plans* are "defined benefit" plans and have a specified benefit at retirement. Historically, these plans were invested in interest-bearing, constant-return instruments. When interest rates started falling in 1982, these plans began to accumulate unfunded liabilities. Alternatively, the private sector began shifting to so-called *profit sharing plans* with "defined contribution" or 401(k) features. These plans have unspecified benefits at retirement, putting the risk of underfunding on the individual. In the current low interest rate environment, "defined benefit" pension plans, predominately in the public sector, will have to address default or reduced benefits. This is a major challenge for plan sponsors (especially municipalities) and retirees.

The Challenges are ongoing and we can expect to address them over the next several years. However, we can celebrate the Positive Underpinnings and enjoy the benefits they provide – particularly for the investment environment. *Yes, they can continue*.

Mary Ann Greenwood, Ph.D., CFA
Chairman

G. Brock Gearhart, CFA
President

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702