Economic Updates and Outlook



"Cup of Joe"

Reasons for Optimism

Over the past 6 to 8 months, the market has been historically flat, with a substantial correction occurring within the last couple of weeks. Although we feel this was very healthy and positive for the market, volatility is high and many investors have a lot of questions regarding interest rates, China, slowing global growth, deflation, oil, and the fundamental question: "are we heading higher or into a recession?". In this market update, our goal is to paint a picture for our clients that showcases our bullish case for what the future holds and why we feel the bull market is not over.

CHINA

One thing is for sure - China has had problems of late, picking up most of the blame for the last correction and the decline in global growth. But let's play devil's advocate for a minute. Nothing changed in China that made the market sell off. A slight devaluation took place, and then - whammy! - the market went off a cliff. Was this due to slowing growth? I would say that some of the volatility was linked to this, but remember, it's not a new issue. President Xi has been talking about reform and moving China to a more consumer-based economy for a couple years now. This was baked in to the markets already. The Chinese can't just keep building and building to prop up their economy. This is unsustainable. To be more realistic, President Xi is normalizing China's economy and we feel this is a good thing. The consumer is China's biggest economic weapon and utilizing it takes time, with occasional speed bumps along the way. Ten percent of the population was invested when the Chinese market crashed. That leaves roughly a billion people that haven't invested yet. That's a lot of future growth potential. We like China for the long term, while understanding that bouts of extreme volatility will remain in the short to medium term.

EUROPE AND JAPAN

Europe and Japan are in the early stages of boosting their economies (they started in March of this year), having implemented tremendous amounts of monetary stimulus. I'd say Europe is in the first inning of this with Japan slightly ahead in terms of timing. Remember, using history as a reference, this worked very well for the U.S. markets over the last 6 years (think 800 billion of printed money that we injected into our economy...and it worked!). Europe is poised to benefit from cheap energy, a cheaper Euro that will help boost exports, negative interest rates, and a growing U.S. economy. Japan has experienced an increase in wages that are outpacing inflation for the first time in two years. All good news.

UNITED STATES

Finally, the juggernaut in this whole optimistic thesis. Why invest in the U.S. after bull market conditions have lasted 6 years already?

- Unemployment at 5.1%
- Zero Interest Rates
- Historically cheap energy prices
- Wage growth is increasing
- Energy Renaissance (our backyard)
- Dovish FED

These bullet points are the backdrop; now let's get into the nitty gritty. We are virtually at full employment. Borrowing costs are historically low. The current year is setting up to be one of the most successful automobile cycles in history along with a resurgence in housing. Wages are rising and the consumer is coming back with more money in their pocket from cheap gas prices (Target just blew out their numbers last quarter and Best Buy is on a roll). All of this is great news, with the caveat being that we are growing too slowly. I think this is a blessing in disguise. Slow growth provides conditions where the economy doesn't overheat, giving the FED more time to ease into raising rates. Inflation is moving higher as well, but slowly. This enables the FED to take it's time and dovishly raise rates. I'll also blame the slow economic growth on the fact that our government has been at a stalemate for 8 years. which has limited our ability to fiscally stimulate the economy. An example of fiscal stimulus would be an infrastructure bill that is long overdue. With the possibility for tax reform, immigration policy, infrastructure bills, and the economy now cranking at full employment, I'd refer to our economy as a sleeping giant. So why aren't people spending like crazy if all of this positivity is on the radar? My guess is that the overall population has deep scars from 2008. That was a scary time - a lot of people lost a lot of money (we pulled your money out!). And psychologically, it's been proven that it takes people decades to mentally get over such a crisis. Look at the people who experienced the Great Depression. They still would be considered "conservative, save first" thinkers. I feel that the residual effect of the Great Recession is providing the ground work for a very long and sustainable secular bull market.

So, why should we invest now? I'll ask simple questions and everyone play along and think about what they would do from a common sense standpoint. Right now, our stock market is considered to be fairly valued or slightly over-valued. But, let's now introduce something called the Fed Model. The Fed Model is a theory that states that "cash flows from fixed-income investments (bonds) can be compared with profits generated by companies to arrive at a relative value for each". Okay, so that sounds kind of

confusing. Let's put numbers in there to make it easier to understand. If the S&P 500's (largest 500 companies in the country) earnings yield is currently at 5.8% and the 10-year treasury (a government bond that pays interest to you over a 10-year period) is at 2.1%, the difference would be 3.7%. This number is staggering. The average difference over a very long period of time (53 years of data!) has been 0.32%. So, in relation to historical valuations, one could point to our current market valuation as high. But, you have to take into account the extremely low interest rates. When rates come into play, stocks look cheap. And with the savings rate for people coming into retirement going up due to the fact that people are living much longer, where else are you going to get the yield necessary to maintain a healthy retirement? Nobody wants to run out of money in retirement. If you sit in bonds or cash for twenty to thirty years in retirement, you will spend all your money. If you want to look at just valuations, the S&P after the correction last week was trading at 16.5. This is right around the historical average. In 2013, it was 17.9 and in 2014, it was 17.7. So, with continued gains in employment, cheap gas prices, a booming housing industry, etc., as well as a valuation far below the last two years, this market looks attractive.

APPLE

One final comment on our biggest position: Apple. We've had several clients ask us in the last couple of months why we like Apple moving forward after such a great year of gains. There are a number of reasons:

1. Apple has $212 BILLION in cash. If Apple were to just take that money and buy back their own stock, the price of Apple would be at $200/share. It's currently at $116/share.
2. Apple, in terms of valuation alone, is cheap. It actually should be considered a value play. In relation to a company like Google, Apple trades at 12 times earnings and Google trades at 28 times earnings. When looking at the valuation metrics linked to growth such as the PEG ratio, Apple is undervalued. That makes no sense. Apple is famous for not talking about their innovation and future plans whereas Google constantly blabs about such things as Google Glass, robots, Artificial Intelligence, etc. I believe if Apple was more forthcoming with their future plans (we don't want this), it would trade way higher than it does now. Remember, analysts don't like to be wrong.
3. Apple pays a great dividend. It currently yields 1.9%.
4. Apple is the leader in market share for phones and this number keeps growing.
5. The Chinese consumer loves Apple and has just started to see the momentous growth potential moving forward over the next 5 years.
6. Apple has the ability to buy growth. Let's use one of my picks for acquisitions. Let's say Apple buys Disney, which they could easily do. Apple could make an iPad for kids that is Disney specific. If you are a parent or have watched kids nowadays, they are glued to these devices. It's the modern day babysitter. With Disney, they would also get ridiculous amounts of content, such as ESPN and, in this day and age, we can all look at Netflix's success and realize that CONTENT IS KING.
7. Apple's interest in cars. Apple has the ability to change the entire way we interact in our vehicles. If over 100 million people use iPhones, I think there would be tremendous demand for a car dashboard display that mirrors the Apple interface, let alone dabble in the up-and-coming driverless car market.
8. Apple's new phone-leasing program which will lock in customers to buy new phones every year. GENIUS!

The bottom line is that we feel the future is bright for the economy and markets moving forward. The aforementioned are just a couple of the positives that we see on the horizon. If we are looking short term, yes, we would agree that things are bouncing around right now. We are always monitoring global economic storylines with the notion that things can change on a dime. But, with a long term perspective and a patient, well-diversified approach, we feel that this secular bull market will continue. Our investment thesis generally takes a look at a 2-5 year window (think about when we originally bought Apple). Right now, for example, China is struggling, along with emerging markets. Long term, we see this as one of the biggest areas for growth. Sometimes, you just have to look at the bigger picture and not focus on the day-to-day storylines. In summary, we feel the FED will raise rates later this year/early 2016, providing confidence that the economy is on a stronger footing that will drive the bull market higher throughout the end of 2015 and into 2016. We also feel that a round of stimulus to boost the consumer will be coming from China in the near future. This should suppress the global growth fears and allow Janet Yellen to start her long climb back to monetary normalcy.

Thank you to all of our clients for your feedback, as well as your referrals, and remember to keep funding those retirement accounts!

- Joe and Ryan

CONTACT US

jsc@chapelhillinvestment.com
rmc@chapelhillinvestment.com

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Chapel Hill Investment Analysts, Inc.
126 Mathews Street, Suite 1600 | Greensburg, PA 15601
P: 724.830.2600 | F: 724.830.2795
www.chapelhillinvestment.com

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