



## WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

April 2014



Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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#### Weekly Economic Commentary | Week of April 21, 2014

Weather was again a key theme in the Beige Book with 103 mentions, down from 119 in March.

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Who will make critical decisions regarding your health care if you are unable to do so? This article discusses the legal mechanisms and issues that can help you answer this question.

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## Weekly Market Commentary | Week of April 21, 2014

**Highlights**

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**The Big Bang Theory: Inflating the Stock Market**

*The Big Bang Theory*, the most watched television comedy, is about a group of physicists and their aspiring actress friend from across the hall. The show often refers to theoretical physicist Sheldon Cooper's quest for a Nobel Prize in physics as he frequently derides the work of his experimental physicist roommate, Leonard Hofstadter, and puzzles his neighbor, Penny. Life imitates art: recent data suggests MIT theoretical physicist Alan Guth (think Sheldon) is likely to be awarded the Nobel Prize for his inflation theory of the origin of the universe now that an experiment by astrophysicist John Kovac (think Leonard) found evidence of the origin of the big bang in a ripple pattern of rapid acceleration outward in polarized cosmic radiation (think Penny giving a confused look).

It does not take a Ph.D. to see that we may be witnessing a big bang in inflation. The popular theory that accelerating price inflation in the U.S. would eventually be detected has gone many years with little evidence. However, signs that inflation has probably bottomed are now showing up everywhere.

- The Consumer Price Index, the most commonly cited and used measure of inflation, averaged 1.4% over the past year, but rebounded from 1.1% in February to 1.5% in March.
- The Producer Price Index, a measure of what companies are paying for inputs, increased 0.5% in March and was up even more excluding food and energy (0.6%), accelerating 1.5% year over year.
- A number of the companies that have reported first quarter earnings discussed improving pricing for their products and services. In fact, the co-CEO of a fast food chain said during the company's earnings call, "We believe we've got a lot of pricing power. We feel very comfortable that if we raise prices somewhere in that mid-single digit range, we still got room."
- After sliding for three years, commodity prices, measured by the Commodity Research Bureau Commodity Index, appear to have started to rebound [Figure 1]. Food prices are rising in part due to the extended effects of severe weather. And fuel prices have been rising—with gasoline prices at the pump jumping 45 cents over the past five months to a national average of \$3.65 per gallon.
- Average hourly earnings for American workers appear to finally be running consistently above a 2% annual growth rate.

Now that evidence has emerged that inflation has bottomed, the question is how much prices inflate. All of that quantitative easing (QE), or Federal Reserve (Fed) bond buying from the banks, is potential "energy" to fuel inflation. While thus far it has largely remained in the form of reserves on bank balance sheets, bank lending is finally beginning to reaccelerate -- a necessary driver for growth in the money supply.

This is an intended outcome for the Fed. The Fed is focused on lifting inflation and sees it as important for achieving sustainable growth. Last week Fed Chair Yellen said: "A persistent bout of very low inflation carries other risks as well. With the federal funds rate currently near its lower limit, lower inflation translates into a higher real value for the federal funds rate, limiting the capacity of monetary policy to support the economy. Further, with longer-term inflation expectations anchored near two percent in recent years, persistent inflation well below this expected value increases the real burden of debt for households and firms, which may put a drag on economic activity." Or, as Sheldon might put it: Bazinga!

The early stages of accelerating inflation have historically helped fuel economic growth as consumers begin to expect price increases and may stop delaying purchases. The early stages of inflation picking up have also been good for stocks. Examining periods since 1950, the valuation of the stock market measured by the S&P 500 trailing price-to-earnings ratio (PE) tends to be higher when the Consumer Price Index rises above the current 1.5% [Figure 2]. In fact, S&P 500 PEs tend to be a whole point higher than the current 16.8 when inflation is between 1.5 and 2.5%, a range some signs are pointing for the coming year. Only as inflation rises above 3.5% has it corresponded with lower PEs.

Could inflation quickly rise above 3.5% and act as a negative for the stock market? We see that as unlikely in 2014. CPI has not been above 3.5% in 20 years, but when it was, it was supported by much faster growth in wages (since consumers must have the money to pay the higher prices). Given the still sluggish, though improving, labor market, it is unlikely that inflation would rise that quickly over the coming year.

The big bang theory has started to emerge in the stock market with the inflation-sensitive materials and energy sectors appearing to lead the market higher. Since the 2014 low in the S&P 500 on February 5, these sectors have been outperformers. If the inflation big bang theory proves correct, these cyclical sectors may continue to help to lead the stock market higher in the months ahead.

#### **IMPORTANT DISCLOSURES**

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*The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.*

*Stock and mutual fund investing involves risk including loss of principal.*

*The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.*

*The company names mentioned herein was for educational purposes only and was not a recommendation to buy or sell that company nor an endorsement for their product or service.*

#### **INDEX DESCRIPTIONS**

*The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.*

*The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.*

*The Commodity Research Bureau (CRB) Index is an index that measures the overall direction of commodity sectors. The CRB was designed to isolate and reveal the directional movement of prices in overall commodity trades.*

*The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*

*This research material has been prepared by LPL Financial.*

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Tracking #1-265940 (Exp. 04/15)

## Weekly Economic Commentary | Week of April 21, 2014

**Highlights**

- Weather was again a key theme in the Beige Book with 103 mentions, down from 119 in March. However, the mentions in April were in a much less negative context than in March.
- Our Beige Book Barometer increased to +87 in April 2014 from +62 in March 2014, the highest reading since October 2013.
- The number of weak words in the Beige Book fell to a 10-year low in April 2014.
- The Affordable Care Act continues to be a key concern for Main Street.

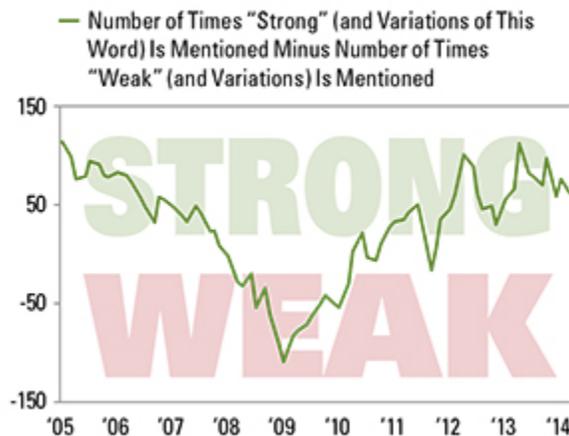
### Beige Book: Window on Main Street Weather Impact Likely to Fade as Weak Words Fall to 10-Year Low

The Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Federal Reserve (Fed) Districts. We believe the Beige Book is best interpreted quantitatively by measuring how the descriptors change over time. The latest edition of the Fed Beige Book, released last Wednesday, April 16, 2014, ahead of the April 29-30, 2014, Federal Open Market Committee (FOMC) meeting, once again described the economy as increasing at a "modest-to-moderate" pace, with price pressures described as "stable or slightly higher," and wage pressures that were "contained or minimal." The modest-to-moderate description of the overall economy has now been used in the last eight Beige Books, and in nine of the past 10 dating back to March 2013.

**Sentiment Snapshot**

To provide a snapshot of the sentiment behind the entire Beige Book collage of data, we created our proprietary Beige Book Barometer (BBB) [Figure 1]. The barometer ticked up to +87 in April 2014 from +62 in March 2014 and +76 in January 2014. At +87, the latest reading remains well below its recent peak (+112 in April 2013) but is the highest since the October 2013 Beige Book (+97), which was released just prior to the onset of the harsh winter weather that gripped much of the United States in December 2013 and most of the first quarter of 2014. The rebound in our Beige Book Barometer is consistent with the Fed's view that the slowdown in economic activity during late 2013 and early 2014 was mostly weather related. In addition, we found that the word "weak" or its variants appeared just 14 times in the April 2014 Beige Book, the lowest count since at least 2005. This suggests to us that the negative headwinds that have held the economy back over the past five years may be declining.

#### 1 Barometer Ticks Up as Number of "Weak" Words Drop to 10-Year Low



Source: LPL Financial Research, Federal Reserve 04/17/14

Weather was mentioned 103 times in the latest Beige Book, but only about 60% of the mentions were in a negative context. Forty percent of the mentions were in a positive context, in many cases describing how economic activity rebounded after poor weather held down activity in prior months. The 103 mentions of weather in the April 2014 Beige Book compared favorably to the 119 mentions in the March 2014 edition. Note that of the 119 mentions of weather in the March 2014 Beige Book, almost all were in a negative context.

To put the 119 mentions of weather in the March 2014 Beige book in historical context, weather was mentioned



### 3 Weather and Policy Drags on Economy Likely to Fade in Period Ahead

	Weather	Shutdown/Fiscal/Sequester/Debt Ceiling/Uncertainty/Confidence	Affordable Care Act/Health Care
03/2014	103	12	17
03/2014	119	18	22
01/2014	21	26	32
2013 Avg	112 (14 per Beige Book)	520 (65 per Beige Book)	178 (22 per Beige Book)
	 Weather is trending up.	 Words surrounding government policy uncertainty are trending down.	 ACA/health care remain fairly steady.

Source: LPL Financial Research, Federal Reserve 04/17/14

Good weather or bad, the Affordable Care Act (ACA), and health care in general, has remained a consistent source of concern among respondents to the Beige Book. The ACA received 17 mentions in the April 2014 Beige Book, close to the 29 mentions in the March 2014 edition. On average, the ACA/health care saw 22 mentions per Beige Book in 2013. We continue to expect this topic to appear frequently in the Beige Book in the quarters ahead as businesses and consumers adjust to the rollout of the legislation.

#### How the Barometer Works

The Beige Book Barometer is a diffusion index that measures the number of times the word "strong" or its variants appear in the Beige Book less the number of times the word "weak" or its variants appear. When the Beige Book Barometer is declining, it suggests that the economy is deteriorating. When the Beige Book Barometer is rising, it suggests that the economy is improving.

#### Beige Book: How It Works

The Beige Book compiles qualitative observations made by community bankers and business owners about economic (labor market, prices, wages, housing, nonresidential construction, tourism, manufacturing) and banking (loan demand, loan quality, lending conditions) conditions in each of the 12 Fed districts (Boston, New York, Philadelphia, Kansas City, etc.). This local color that makes up each Beige Book is compiled by one of the 12 regional Federal Reserve districts on a rotating basis - the report is much more "Main Street" than "Wall Street" focused. It provides an excellent window into economic activity around the nation using plain, everyday language. The report is prepared eight times a year ahead of each of the eight Federal Open Market Committee (FOMC) meetings. The next FOMC meeting is April 29 - 30, 2014.

The word clouds or text clouds on page 2 are a visual format useful for quickly perceiving the most important words in a speech, text, report, or other transcript. They are culled from the Fed's Beige Books published last week (April 16, 2014), the prior report (March 5, 2014), and the report from a year ago (April 17, 2013). In general, the more often a word appears in a speech, text, report or other transcript, the larger that word appears in the word cloud. The word clouds show the top 50 words for each of the two Beige Books mentioned above. Similar words are grouped together and common words like "the," "and," "a," and "is" are excluded, as are words that appear frequently in all Beige Books (federal, district, loan, level, activity, sales, conditions, firms, etc.).

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*The economic forecasts set forth in the presentation may not develop as predicted.*

*The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged*

*under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of U.S. Treasury securities).*

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Tracking #1-265868 (Exp. 04/15)



## Why You Need a Health Care Proxy

You may someday face a sudden health crisis due to an accident or serious illness that leaves you unable to make your own medical decisions. Fortunately, there is a means to address this potential future concern -- it's called a health care proxy.

A health care proxy allows you to legally designate someone -- a proxy -- to make medical decisions for you. Keep in mind that in some states you may even be able to combine a health care proxy and living will into a single document.

Hospitals and nursing homes are required to ask about the existence of any advance directive when you are admitted. In most states, a health care proxy does not take effect until you can no longer make medical decisions for yourself; until then, only you can legally consent to any treatment. In addition, you can always change or cancel the document as long as you are mentally alert. If you decide to make changes to any of these documents, be sure to do so in writing.

### Know the Potential Drawbacks

Though it is a legal document, a health care proxy cannot handle every medical situation. Here are some key points to consider before you designate a proxy.

- **Some caregivers could override your document.** Most states permit a doctor or health care facility to reject any advance directive for reasons of conscience. In these cases, the doctor or facility must tell you or your health care proxy about this when you are admitted to care and must offer to help transfer you to another party or facility that will comply with your wishes or the health care proxy.
- **The advance directive may not be followed by emergency medical services (EMS).** If EMS is summoned to treat you in case of a life-threatening situation, they are usually required to resuscitate and stabilize you until you reach the hospital, regardless of an existing advance directive.
- **Know state laws.** Though all states accept health care proxies as legal, each varies considerably in what is required of these documents. Also, if a health care proxy is written to your state's specification but you undergo medical treatment when visiting another state, the rules regulating health care proxies in the state in which treatment takes place will usually prevail.
- **Do not use a health care proxy unless you fully trust the person you have named.** If you don't have a health care proxy, many states will appoint a person to make medical decisions on your behalf. Usually, this person is your closest relative, whose values may or may not coincide with your intentions.

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**A health care proxy allows you to legally designate someone -- a proxy -- to make medical decisions for you.**

## Know Your Protections and Risks When Banking Online

As Americans increasingly migrate toward conducting banking and other financial transactions online, the threat of falling victim to ever-more sophisticated cyber-crimes continues to rise. Financial services companies are keenly aware of the potential security risks posed by online money transfer. That is why the industry as a whole has developed a series of standard security protocols designed to ensure that customers' assets and personal information is kept safe.

Following is a list of common security features offered by most banks and financial institutions. Be sure to compare these measures with what your own bank, credit card companies, and other financial vendors have in place.

**Anti-malware software.** Anti-malware is a term commonly used to describe various software products used to prevent, detect, block and remove malicious software products that are intended to damage or disable computers or computer systems. Anti-malware software may also be referred to as anti-virus or anti-spyware.

**Transaction monitoring/anomaly detection.** Network monitoring software has been in use by financial institutions for a number of years. Similar to the way in which the credit card industry detects and blocks fraudulent credit card transactions, systems are now available to monitor online banking activity for suspicious funds transfers. For instance, too many incorrect login attempts will signal the system to lock a user out of their account until positive account verification can be confirmed. Transaction amounts (specifically withdrawals) that fall outside the customer's normal or pre-established limits are also scrutinized.

**Multilayered authentication.** Many online banking/financial systems now require multiple layers of user identification, or authentication, that only those authorized can provide. For instance, some authentication protocols verify the device the customer is using to access the bank's website. If the device does not match the bank's records, additional authentication measures, such as one or more challenge questions, will be presented to the customer. Similarly, a number of institutions are requiring "out of band" authentication, which requires a transaction initiated via one delivery channel (e.g., Internet) to be re-authenticated via a different channel (e.g., telephone) in order for the transaction to be completed.

**Firewalls.** Firewalls are software- or hardware-based security systems that create a secure barrier between your bank's internal network, where your information is stored, and the unsecured Internet. The data "traffic" flowing in and out of the bank's network is monitored and analyzed to determine its legitimacy.

**Encryption.** Encryption scrambles information being transmitted between your device and the bank's network into a code that is virtually impossible to decipher, thereby protecting against unauthorized access. Many financial institutions now use 128-bit encryption, an advanced encryption technology.

### Customer Education: The Linchpin of Any Security Program

In the final analysis, even the most sophisticated security measures are no substitute for well-informed customers. Toward that end the Federal Financial Institutions Examination Council (FFIEC), a body of the federal government made up of several U.S. financial regulatory agencies, issued guidance suggesting that, at a minimum, a financial institution's customer education efforts should include:

- An explanation of protections provided, and not provided, to account holders relative to electronic funds transfers.
- An explanation of under what, if any, circumstances and through what means the institution may contact a customer on an unsolicited basis and request confidential account-related credentials.
- A list of risk-control measures that customers may consider implementing to mitigate their own risk.
- A list of appropriate contacts for customers to use if they notice suspicious account activity or experience security-related events.

<sup>1</sup>Source: *The Federal Financial Institutions Examination Council (FFIEC), "FFIEC Supplement to Authentication in an Internet Banking Environment," June 29, 2011.*

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Financial services companies are keenly aware of the potential security risks posed by online money transfer.



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