HBK Wealth Management
Haire · Bohmer · Kilcoyne

WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

May 2014

Making a positive impact on as many lives as I can.

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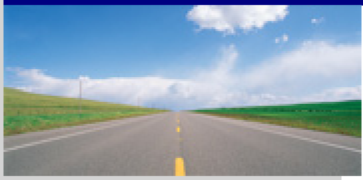


Weekly Market Commentary | Week of May 27, 2014

Highlights

- Why -- if the United States is producing more oil and consuming less than it was a decade ago -- is the price of oil going up, and what does it mean for investors?

Oil, Oil Everywhere

For the third year in a row, the summer driving season kicked off with national gasoline prices at $3.67 per gallon, according to data from the U.S. Department of Energy. Prices at the pump are below the $3.80 - $4.00 danger zone where they contributed to economic soft spots in 2011 and 2012. But they may head higher with crude oil prices rising over $104 last week -- well above the levels seen around Memorial Day weekend during the past couple of years. While the conflict in Ukraine may be fueling some of the price gain, this is nothing new -- a year ago the world was focused on the conflict in Egypt, and in 2011, the civil war in Libya was the source of geopolitical risk to oil prices. So why -- if the United States is producing more oil and consuming less than it was a decade ago -- is the price of oil going up, and what does it mean for investors?

Leaking Oil

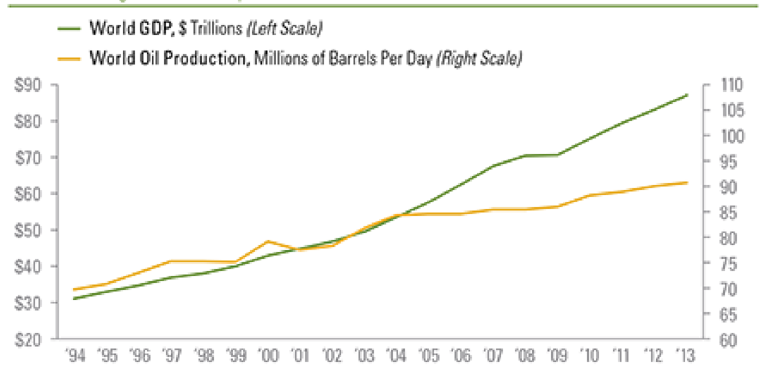
The United States is the largest producer of petroleum products in the world, exceeding even Saudi Arabia. Output has been soaring. In fact, U.S. production is up over 50% since 2007. Rising production and relatively flat consumption -- the United States uses about 10% less petroleum than in the middle of the last decade -- has led to rising inventories. U.S. inventories recently hit the highest level since government records have been kept back to 1920.

But this is not all destined for use in the United States. In fact, crude inventories at the United States' main oil hub in Cushing, OK have declined sharply -- falling by over 50% from a year ago -- to levels not seen since 2008. Instead of being routed to other destinations across the country, oil supplies have been diverted through the southern portion of the Keystone XL pipeline from the Midwest to the Gulf Coast refineries for export overseas. The United States has rapidly become the largest exporter of petroleum products in the world (the United States does not export crude oil by law, but instead exports refined petroleum products).

Global Gap

Petroleum prices in the United States are being boosted by the gap between global supply and demand [Figure 1]. Relatively weak supply growth is the result of declines in oil production and exports in countries such as Libya and Iran that can be tied to geopolitical tensions and in others like Venezuela and Mexico stemming from poor reinvestment. At the same time, global demand has been growing as the world economy expands. It is true that developed market countries like the United States are much more energy efficient than they were 30 years ago -- the United States uses 45% less energy per dollar of gross domestic product (GDP) than in 1980. However, emerging market countries are less efficient and use more energy per dollar of GDP as the manufacturing portion of their economies grow. For example, Thailand and Vietnam both use about twice as much energy per unit of GDP as they did in 1980. As a result, there has been no change in the ratio of world energy consumption per unit of world GDP for decades, according to data from the U.S. Energy Information Agency. The world demand for energy rises in lock step with global GDP, putting pressure on prices.

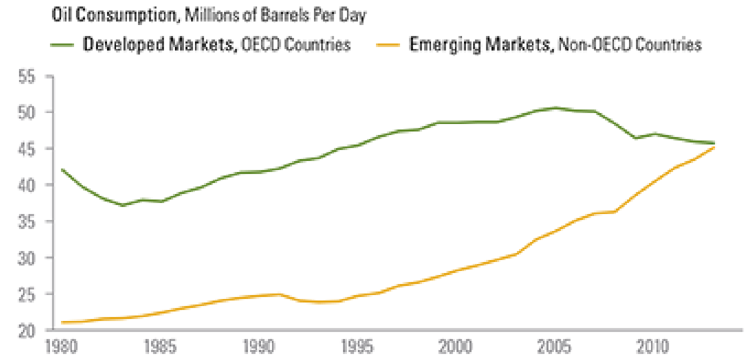
1 Widening Global Oil Gap



Source: LPL Financial Research, Energy Information Agency 05/27/14

Growth in global demand is coming from emerging markets like China and even Saudi Arabia. Saudi Arabia is now among the top-five largest oil consumers in the world as its youthful population grows, leaving less available for export. In fact, in 2014 it is likely that emerging markets may -- for the first time -- account for more world oil consumption than developed countries [Figure 2].

2 Emerging Markets Becoming World's Biggest Energy Consumers



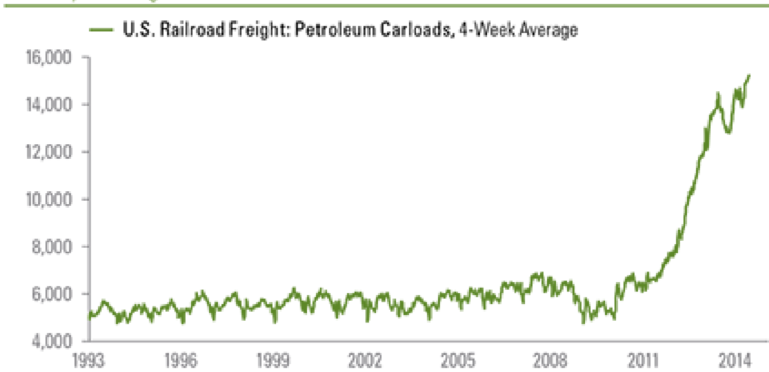
Source: LPL Financial Research, Energy Information Agency 05/27/14

Transportation

As energy production continues to increase in the United States, oil supply from Iran and Libya resumes flowing to world markets, consumers react to higher prices, and emerging markets adopt more energy-efficient practices, the gap between demand and supply growth may narrow and ease the pressure on oil and gasoline prices. We will be watching the movements in energy prices carefully to judge their impact on the economy, but at a little over $104 prices may already be near their peak for the year -- crude oil peaked at $110 in each of the past two years before dropping back into the $90s.

The primary focus for investors may be on transportation -- not what they pay to drive their cars, but the increasing amount of oil being moved around the United States. Three-quarters of U.S. refining capacity is located on or near the coasts. These refineries have traditionally tended to use imported crude oil delivered by tanker because it was cheaper than getting U.S.-sourced crude to their operations over land. But the growing supply and a pipeline capacity shortage have led to more crude oil moving around the United States on trucks, barges, and trains than at any point since the government began keeping records in 1981. In fact, rail shipments of oil have more than tripled since the beginning of 2010 [Figure 3].

3 Skyrocketing Petroleum Rail Traffic



Source: LPL Financial Research, American Association of Railroads 05/27/14

Strong demand for transport of U.S.-sourced petroleum combined with tight pipeline capacity may continue to support stocks in the railroad and trucking industries along with the pipeline operators. We continue to favor these industry groups in the industrials and energy sectors as part of a broader theme of improved business spending.

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.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.This research material has been prepared by LPL Financial.

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Tracking #1-276083 (Exp. 05/15)

Weekly Economic Commentary | Week of May 27, 2014

Highlights

- We don't think the economic weakness in Q1 is the start of another recession, and, indeed, we continue to expect that real GDP will expand 3.0% in all of 2014.
- We believe the conditions are in place for a pickup in business spending and we expect the pace of business capital spending to accelerate over the next several years.

Capital Spending Check-up

This week, financial markets will digest a series of key reports on the health of the United States' economy in the second quarter, with reports due out on:

- **Business capital spending:** Durable goods orders and shipments for April, the Richmond and Dallas Federal Reserve (Fed) Manufacturing Indices for May, and the Chicago Area Purchasing Managers' Index for May.
- **Housing:** Pending home sales for April and the S&P/Case-Shiller Home Price Index for March; and
- **Consumer spending:** May consumer confidence measures from the Conference Board and the University of Michigan and personal income and spending for April.

The data released thus far for April and May all suggest that real gross domestic product (GDP) growth will accelerate to between 4% and 5% in the second quarter of 2014, after a weather-induced slowdown in growth in the first quarter of 2014. The data include:

- Employment;
- Vehicle sales;
- Initial claims for unemployment insurance;
- Institute for Supply Management (ISM) Indices;
- Philadelphia and New York Fed Manufacturing Indices;
- Retail sales; and
- New and existing home sales.

Investors will get a look at the revised figures for first quarter GDP this week as well. The data released for February and March 2014 since the first quarter GDP data were first reported in late April 2014 suggest that, upon revision, first quarter GDP could turn negative. As we noted in last week's *Weekly Economic Commentary: Snapback*, we do not think the economic weakness in the first quarter is the start of another recession, and, indeed, we continue to expect real GDP will expand 3.0% in all of 2014.*

Why So Slow?

The pace of business capital spending in this cycle has been unusually slow. Uncertainty around the durability of the expansion itself, lack of clarity on fiscal and in some cases monetary policy, and the unwillingness by businesses to spend cash due to fears that the next downturn will be just like the last one are among the contributing factors. In addition, corporate managements have seen stock prices respond better to using corporate cash for share buybacks and dividend increases.

We continue to see conditions that, in the past, have been conducive to a solid pace of capital spending. Low interest rates for corporate borrowers, shrinking spare capacity, aging industrial equipment, the ongoing secular trend to replace labor with capital, the energy renaissance and related spending, a steady stream of Good Old American Know-How, and faster economic growth here and abroad could generate more capital spending in the coming quarters and years.

The Details

Business capital spending -- business spending on equipment like computers, medical equipment, vehicles, copiers, furniture, construction and mining equipment, and on intellectual property, research and development (R&D), entertainment, literary and artistic patents, and other items -- decreased between the fourth quarter of 2013 and the first quarter of 2014, and the revised data (due out later this week along with the revised first quarter 2014 GDP data) will likely show an even bigger decline. It was just the second time since the start of the current economic expansion, which began in mid-2009, that business capital spending contracted in a quarter.

As noted in Figure 1, the overall pace of inflation-adjusted (or real) GDP growth in this expansion has been below average. Real GDP has grown by just 11% since the end of the last recession. The average increase at our current point into a recovery has been 19%. Although it is true that the slow pace of consumption, housing, and, in particular, government spending are the main culprits behind the sluggish rebound in the economy since mid-2009, none of the main sectors of GDP have kept pace with gains seen during the last three economic recoveries -- those that began in 1982, 1991, and 2001. The U.S. economy has changed significantly since the end of the inflationary 1970s. The last 30-plus years have seen the transformation of the U.S. economy from a domestically focused manufacturing economy to a more export-heavy, service-based economy. In general, this economic structure is less prone to inventory swings that drove the shorter boom-bust cycles of the past, and has led to longer expansions. We use these three cycles as comparisons in most of our analysis in this commentary.

1 The First Five Years of the Current Economic Recovery Have Been Tepid at Best, With Little or No Imbalances Building Up

	Current Recovey	All Post WWII Recoveries	Average of Last Three Relavent Recoveries
GDP	111	122	119
Consumption	111	122	119
Capital Expenditures	134	147	139
Housing	128	145	147
Structures	96	115	97
Exports	132	138	139
Government	93	112	110

Source: LPL Financial Research, Bureau of Economic Analysis 05/23/14

Start of Recovery = 100

For example, business capital spending has increased by just 34% since the end of the Great Recession, below the average gain of 39% through the first 19 quarters of the prior three cycles -- those commencing in 1982, 1991, and 2012. Business spending on structures (office buildings, malls, shopping centers, etc.) has almost kept up with the average of the past three cycles, seeing a 4% drop over the past five years versus the average of a 3% drop, as have exports, which have risen by 32% versus the average gain of 39%.

On balance, the sluggish nature of the recovery thus far -- as well as the fact that none of the major economic sectors have grown faster than average -- strongly suggests that the tepid pace of the expansion thus far has not allowed imbalances to build up in the economy. These imbalances (overbuilding, overinvesting, or overspending) are typically what brings premature ends to economic recoveries. Our view remains that the odds of recession in the next several years are low (between 10% and 15%) and that we are somewhere in the "middle innings" of the recovery that will turn five this summer.

Capital Spending Trends in the Current Recovery

A closer look at the capital spending trends during the economic recovery [Figure 2]reveals that business spending on "traditional" capital spending areas like industrial equipment, and especially transportation equipment -- business purchases of autos, trucks, railcars, shipping containers, aircraft, ships, and boats -- have soared during the recovery. In fact, each of these key subcomponents of transportation equipment has seen well above-average gains in this business cycle relative to the prior three cycles. This reflects the impact of the energy renaissance and, in part, the snapback in U.S. manufacturing jobs as companies reconsider the offshoring and outsourcing that dominated the economy since the early 1980s. The surge in transportation capital spending also reflects the near collapse of the U.S. auto industry in late 2008/early 2009.

Please click here for Figure 2: Business Spending on Industrial Equipment and Transportation Has Boomed in This Cycle

Similarly, business spending on industrial equipment (which accounts for 13% of overall business capital spending and includes items like construction machinery and mining equipment) has surged during this recovery, partially reflecting the ongoing energy renaissance and the solid performance of both commercial construction and residential construction -- since late 2011 -- in this cycle.

Remarkably, business capital spending on information processing equipment -- the bellwether for business capital spending in the 1990s and 2000s -- has lagged far behind the spending seen in previous cycles. Spending on computers and peripheral equipment has increased by just 10% since the end of the recession, the slowest pace of advance in this category in any recovery in the past 55 years. One area within this broad category that has bucked the trend is photocopy and related equipment, where spending is up 60% since the end of the recession, far exceeding the gains seen at this point in any recovery in the past 55 years.

Corporate spending in the intellectual property categories of capital spending in this cycle has also lagged behind the pace seen in prior cycles, and this is concerning given the U.S. reliance on "Good Old American

Know-How" (see the 8/19/13 *Weekly Economic Commentary: Exporting Good Old American Know-How*) for exports and jobs. The longer-term health and competiveness would benefit greatly from resurgence in this area of capital spending in the period ahead.

On balance, the pace of business capital spending -- along with most other categories of GDP -- has fallen short of the pace seen in prior recoveries. This suggests that the overspending, overbuilding, or overinvesting in one or more sectors that ultimately lead to imbalances in the economy and, inevitably, recessions, are not present today. Rather, the conditions are in place for a pickup in business spending in the latter half of the business cycle, and we continue to expect the pace of business capital spending to accelerate over the next several years. A pickup in business capital spending over the next several years is vital for the long-term health and viability of the U.S. economy in the years and decades to come.

IMPORTANT DISCLOSURES

*As noted in our *Outlook 2014: The Investor's Almanac*, our GDP forecast is based upon many of the drags of 2013 fading, including U.S. tax increases and spending cuts, the European recession, and accelerating growth from additional hiring and capital spending by businesses

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Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Chicago Area Purchasing Manager Index that is read on a monthly basis to gauge how manufacturing activity is performing. This index is a true snapshot of how manufacturing and corresponding businesses are performing for a given month. A reading of 50 or above is considered a positive reading. Anything below 50 is considered to indicate a decline in activity. Readings of the index have the ability to shift the day's trading session one way or another based on the results.

The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. The S&P/Case-Shiller U.S. National Home Price Index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arm's-length transactions. The index is named for its creators, Karl Case and Robert Shiller.

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