HBK Wealth Management
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WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

October 2014

"Making a positive impact on as many lives as I can." Please contact me if you have friends and family who would enjoy receiving this newsletter!

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Client Letter: "PIMCO Update"

LPL Financial research provides an update regarding PIMCO.

Highlights

- Earnings season is here and may counteract the negative headlines with another dose of positive fundamental news.
- We expect the third quarter of 2014 could produce another good earnings season, which we believe may positively impact stocks.
- While there are some headwinds, Europe in particular, the U.S. economic backdrop is supportive and profit margins should remain high, given the few signs of cost pressures.

Earnings Preview: Welcomed Opportunity to Focus on the Micro

The global headlines are certainly not uplifting these days: Russia-Ukraine, Iraq, Syria, Hong Kong, Ebola, etc. All of these challenges are sources of investor anxiety that have led to bouts of selling pressure on the U.S. stock market in recent weeks. The good news is that even with the sell-off in September through early October 2014, the S&P 500 has not experienced a drawdown of more than 4% since spring 2014, thanks to positive underlying fundamentals.

Earnings season is here and may counteract the negative headlines with another dose of positive fundamental news. Four times a year, financial markets focus on what matters most to stocks: earnings. Over the last four years, nearly 90% of S&P 500 returns have come in or around earnings season, as measured by the pre-announcement season--two weeks before Alcoa reports--through the first four weeks of results. (Alcoa marks the unofficial start of earnings season each quarter because the company is typically the first high-profile firm to report after calendar quarter end.) We expect the third quarter of 2014 could produce another good earnings season, which we believe may positively impact stocks.

The Old Adage Has Proven True:
Earnings Have Driven Stock Prices

Why place so much emphasis on earnings? Because historically, earnings have driven stock prices. This has proven to be the case this year with S&P 500 returns (8%) matching Thomson-tracked consensus forecasts for S&P 500 earnings growth in 2014 (also 8%). Looking further back, stocks and earnings have generally been well aligned during the entire current economic expansion [Figure 1]. Our expectation coming into this year was that earnings and stock prices would reconnect after diverging (in a good way) during 2013, and that has indeed been the case. Last year was all about expanding price-to-earnings ratios (PE) and clarifying policy uncertainty in Washington. In 2014, with policy uncertainty fading and valuations higher, it is all about earnings.

1 Earnings Have Been Aligned with Stock Prices During Economic Expansion

Source: LPL Financial Research, Thomson Reuters, FactSet 10/06/14

The S&P 500 is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

Third Quarter Earnings Season Potentially Another Good One

We expect this earnings season to be another good one for several reasons:

- **U.S. economic growth has picked up.** Revenue growth has historically tracked nominal U.S. gross domestic product (GDP) growth (GDP growth plus inflation). Nominal GDP is tracking toward a 5%

annualized growth rate during the third quarter of 2014 and has exceeded 5% in three of the past four quarters (the exception being the weather-depressed first quarter of 2014). The consensus expectation for revenue growth for Q3 2014 is 3.7% year over year, while revenues have exceeded consensus by 0.9% and 1.4% during the past two quarters.
- **Upside earnings surprises are typical.** The Thomson-tracked consensus for S&P 500 year-over-year earnings per share (EPS) growth for the third quarter of 2014 is 6.6%. If companies deliver the same upside as in the second quarter (3.5%), then earnings growth may exceed 10%. This percentage upside is similar to the long-term historical average of 3% (again, according to Thomson). Earnings have beaten targets every quarter since the Great Recession ended on June 30, 2009.
- **Our favorite earnings indicator is still very positive.** The Institute for Supply Management (ISM) Manufacturing Index, which has a strong track record of predicting earnings growth six months ahead, may be signaling continued 5-10% earnings growth. The index has exceeded 56 during the past three reported months (through September 2014) and averaged 56 over the past six months, solidly in expansion territory.
- **Few signs of cost pressures.** Wage growth reported in the latest (September 2014) monthly Employment Situation report from the Bureau of Labor Statistics was 2% year over year. Labor represents the majority of costs for corporations. The most recent reading on manufacturing unit labor costs for the second quarter of 2014 rose just 0.8% year over year. Another component, raw material costs, is getting cheaper based on the 6.6% drop over the past year for the Bloomberg Commodity Index. (The offset here is the pressure on revenues for energy and materials companies, as discussed below.)

What Might Limit the Upside?

Although these big picture items all suggest corporate America may deliver good earnings results, several factors could limit the upside or result in companies lowering future earnings guidance:

- **Sluggish growth in Europe.** With only marginal economic growth near 1% (based on latest GDP data) and marginal inflation (which means less pricing power for businesses operating there), Europe could be a drag for the many multinational corporations that compose the S&P 500 and may lead companies to provide cautious guidance. S&P 500 companies generate an estimated 15-20% of their revenues from Europe, including Russia. During the last week of September 2014, automaker Ford cited weakness in Europe while both Ford and Nike cited a drag from Russia. Conditions in China are better; however, growth there has levelled off and may not help the overall profit growth picture very much.
- **U.S. dollar strength.** The average price of the U.S. dollar was about 0.5% higher during the third quarter of 2014 than it was during the year-ago quarter. A strong dollar negatively impacts foreign profits of U.S.-based companies when those profits are translated back into U.S. dollars. With roughly 40% of S&P 500 profits generated internationally, currency will be a slight drag on third quarter 2014 earnings growth versus the year-ago quarter. The bigger concern is the trajectory of the U.S. dollar, which moved sharply higher during August and September. If U.S. dollar strength continues, this could potentially bring bigger negative currency translation effects in the coming quarters.
- **Commodity price weakness.** Lower costs for raw materials are generally good for company profit margins, but they are not good for the revenues of commodity producers. During the past three months, the Bloomberg Commodity Index plummeted more than 11%, increasing the risk that energy and materials companies miss earnings estimates or lower guidance. These companies are among the most global, with meaningful European and Russian exposure, which carries risk despite recent losses for both sectors.

Conclusion

We welcome the opportunity to focus on the micro amid all of the unsettling macro headlines overseas. We expect another solid earnings season for the third quarter that should have a positive effect on stock prices. While there are some headwinds, Europe in particular, the U.S. economic backdrop is supportive and profit margins should remain high, given the few signs of cost pressures. And that could mean higher earnings and higher stock prices.

Price-to-earnings ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

INDEX DESCRIPTIONS

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 # 1-315113 (Exp. 10/15)

Inflation Happens: Don't Let It Derail Your Long-Term Plans

A penny saved is a penny earned, right? Not necessarily. Thanks to inflation, over time that penny could be worth less than when it was first dropped into the piggy bank. That's why if you're investing-especially for major goals years away, such as retirement-you can't afford to ignore the corrosive effect rising prices can have on the value of your assets.

Inflation Under the Microscope

Just what is inflation, this ravenous beast that eats away at the value of every dollar you earn? It is essentially the increase in the price of goods or services. The most commonly referenced measure of that increase is the Consumer Price Index (CPI), which is based on a monthly survey by the U.S. Bureau of Labor Statistics. The CPI compares current and past prices of a sample "market basket" of goods from a variety of categories including housing, food, transportation and apparel. The CPI does have shortcomings, according to economists: It does not take taxes into account or consider that as the price of one product rises, consumers may react by purchasing a cheaper substitute (name brand vs. generic, for example). Nonetheless, it is widely considered a useful way to measure prices over time.

Inflation has been a very consistent fact of life in the U.S. economy. Dating back to 1945, the purchasing power of the dollar has declined in value every year but two-1949 and 1954. Still, inflation rates were generally considered moderate until the 1970s. The average annual rate from 1900 to 1970 was approximately 2.5%. From 1970 to 1990, however, the average rate increased to around 6.0%, hitting a high of 13.3% in 1979.[1] Recently, rates have been closer to the 1% to 3% range; the inflation rate has been 2.06% thus far in 2014.

What It Means to Your Wallet

In today's economy, it is easy to overlook inflation when preparing for your financial future. An inflation rate of 4%, for instance, might not seem to be worth a second thought-until you consider the impact it can have on the purchasing power of your money over the long term. For example, in just 20 years, 4% inflation annually would drive the value of a dollar down to $0.44.

Or look at it another way: If the price of a $1,000 refrigerator rises by 4% over 20 years, it will more than double to almost $2,200. A larger-ticket item, such as a $23,000 automobile, would soar to more than $50,000 given the same inflation rate and time period.

Inflation also works against your investments. When you calculate the return on an investment, you need to consider not just the interest rate you receive but also the real rate of return, which is determined by factoring in the effects of inflation. Your financial advisor can help you calculate your real rate of return.

Clearly, if you plan to achieve long-term financial goals-from college savings for your children to your own retirement-you will need to create a portfolio of investments that will provide sufficient "inflation-adjusted" returns.

Investing to Beat Inflation

Insulating your portfolio against the threat of inflation might begin with a review of the investments most likely to provide returns that outpace inflation.

Over the long run-10, 20, 30 years, or more-stocks may provide the best potential for returns that exceed inflation.[2] While past performance is no guarantee of future results, stocks have historically provided higher returns than other asset classes.

Consider these findings from a study of Standard & Poor's data: An analysis of holding periods between 1926 and December 31, 2013, found that the annualized return for a portfolio composed exclusively of stocks in the Standard & Poor's Composite Index of 500 Stocks was 10.14%-well above the average inflation rate of 2.96% for the same period. The annualized return for long-term government bonds, on the other hand, was only 5.52%.[3] In addition, the study found that the stock portfolio did not suffer a loss in 817 separate 20-year holding periods. In every period, the annual rate of return for the stock portfolio was greater than the inflation rate. The bond portfolio outpaced inflation in only 447 of the 817 20-year holding periods-by a much lower margin.[4]

A Balancing Act

Keep in mind that stocks do involve greater risk of short-term fluctuations than other asset classes. Unlike a bond, which offers a fixed return if you hold it until maturity, a stock can rise or fall in value based on daily events in the stock market, trends in the economy or problems at the issuing company. But if you have a long investment time frame and are willing to hold your ground during short-term ups and downs, you may find that stocks offer greater potential to beat inflation.

The key is to consider your time frame, your anticipated income needs and how much volatility you are willing to accept, and then construct a portfolio with the mix of stocks and other investments with which you are comfortable. For instance, if you have just embarked on your career and have 30 or 40 years until you plan to retire, a mix of 70% stocks and 30% bonds might be suitable.[5] But even if you are approaching retirement, you may still need to maintain some growth-oriented investments as a hedge against inflation. After all, your retirement assets may need to last for 30 years or more, and inflation will continue to work against you throughout.

Take Steps to Tame Inflation

Whatever your investor profile-from first-time investor to experienced retiree-you need to keep inflation in your sights. Stocks may be your best weapon, and there are many ways to include them. Consult your financial planner to discuss your specific needs and options.

[1]Source: U.S. Bureau of Labor Statistics.

[2]Source: Investing in stocks involves risks, including loss of principal.

[3]Source: Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value.

[4]Source: Standard & Poor's. Stocks are represented by the S&P 500, an unmanaged index that is generally considered representative of the U.S. stock market. It is not possible to invest directly in an index. Bonds are represented by a composite of returns derived from yields on long-term government bonds, published by the Federal Reserve, and the Barclays Long-Term Government Bond index. Inflation is represented by the change in the Consumer Price Index. Past performance is not a guarantee of future results.
[5]These allocations are presented only as examples and are not intended as investment advice. Please consult a financial advisor if you have questions about these examples and how they relate to your own financial situation. The investor profile is hypothetical.

Tracking #1-311192

Client Letter: "PIMCO Update"

Dear Valued Investor,

Last Friday, LPL Financial Research was made aware that Bill Gross, Pacific Investment Management Co. (PIMCO) Chief Investment Officer (CIO) and lead portfolio manager on several funds, would be leaving PIMCO. After the market close on Friday, PIMCO provided us the details of its new investment management structure, including its new Chief Investment Officers and portfolio managers.

Earlier this year, LPL Financial Research met with PIMCO management to discuss the situation within the ranks at PIMCO and the management of the portfolios. During those conversations, it became clear that PIMCO executives and Bill Gross did not agree on the future direction of the firm and that Bill Gross, as CIO, was using a heavy hand in the management of all of the portfolios at the firm. At the time, it was implied to us that a detailed succession plan would be established.

Soon thereafter, we saw an appointment of six deputy CIOs under Bill Gross. On Friday, the new structure was unveiled, with one of those six named as Group CIO (Dan Ivascyn), while the other five are now CIOs. This structure of collaboration is different from that which existed under Bill Gross. We believe Bill Gross is a strong investor. However, leading investors and negotiating the politics of being a CIO at a very large investment firm is not as easy. Given these changes, we expect a more effective management process at PIMCO, allowing us to fully see the portfolio management skills of the individuals now managing the PIMCO portfolios.

Given that we believe there is a deep and talented team managing the assets at PIMCO, we are maintaining our Watch List status, meaning PIMCO funds remain on heightened oversight and review, but we are not recommending a sale of these funds at this time. We will closely monitor the performance of the funds, assets in the funds, and any other potential changes at the firm to determine what future action, if any, we would recommend.

LPL Financial Research will update your Financial Advisor with more information and perspectives as the implications of these changes continue to unfold. Please contact your Financial Advisor to discuss any concerns or questions regarding your investments.