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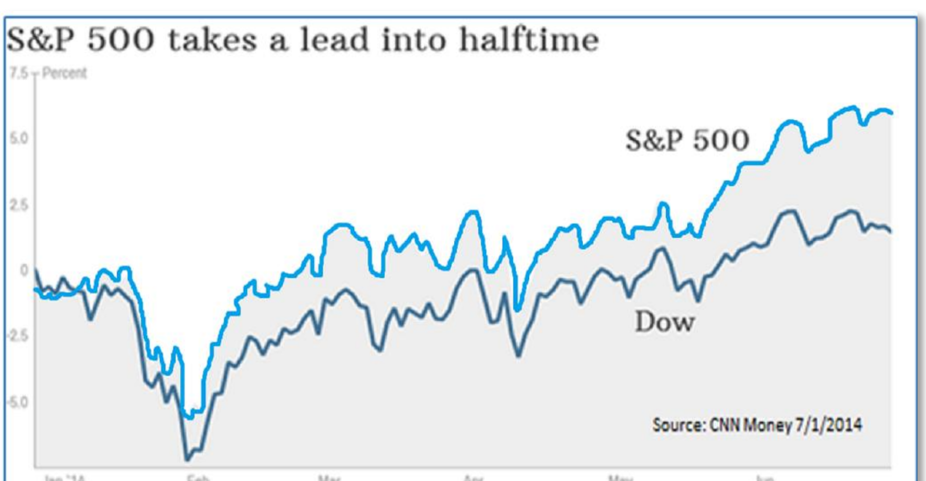
2014 2nd Quarter Economic Update

The year's first half for equities can be summed up in simple terms: confusing and unpredictable markets produced gains. As of June 30, the S&P 500 had already logged 22 record highs this year alone, ending the first half up 6% while the Dow Jones Industrial Average (DJIA) increased by 1.5%. Both of these indexes hit new highs in the 2nd quarter while the NASDAQ Composite index rose by 5.5%, reaching a 14-year highpoint. Interestingly, 2014 has produced the biggest halftime lead by the S&P 500 over the DJIA since 2009 and the seventh-biggest since 1929, according to Bespoke Investment Group.

Investors started 2014 with several serious concerns. How would the S&P 500 Index follow up 2013's 30%+ gain (including dividends)? Would the market correct, or would there be profit-taking? Would the slow economic improvement send bond prices lower, or would we see the Federal Reserve shift to higher interest rates?

So far in 2014, the bond market has also fared well—in fact, better than most had expected. The yield on the U.S. Treasury ten-year note, which moves inversely to its price, fell to 2.51% from 2.76% at the end of the first quarter.



Unfortunately, many investors are having a hard time enjoying these increases, as concerns about lofty prices make it difficult to decide whether to keep funds in cash or stay invested. The forces driving the stock market to new highs and helping parts of the bond market to remain near record low yields don't show immediate signs of changing.

What are these driving forces? Many credit the aggressive efforts by the world's major central banks to flood financial markets with new money in order to keep sluggish economies moving forward.

U.S. stocks have been supported by expectations that the still-sluggish U.S. economy will grow fast enough to keep corporate profits expanding. But many investors no longer feel comfortable with that outlook, and have begun focusing more on what can go wrong with their portfolios than on where they can make money.

The current stock market rally has outlasted the historical average of other bull markets with higher returns, but there is "still a bit of a fear-factor" among investors, said Thomas Huber, Manager of the T. Rowe Price Dividend Growth Fund. "Everyone is looking for what's going to be the big crack in the markets." ***(Source: Wall Street Journal, July 1, 2014)***

While many investors are concerned about how markets will respond when the Fed raises interest rates in the future, there are also concerns building in the opposite direction regarding the estimate in the growth of our economy. The Commerce Department's third and final estimate of the Gross Domestic Product (GDP) for the first quarter of 2014 continued the downward spiral of the first two estimates—from +0.1% to -1.0%, and now down to -2.9%. Many economists believe that the extent of the first quarter decline is so substantial that we're unlikely to reach a 2% increase, even if the next three quarters are significant. ***(Source: Bob LeClair's Finance, June 28, 2014)***

A recent GDP report offered some positive data:

- Existing-home sales climbed 4.9%, the strongest gain in three years.
- New-home sales jumped 18.6% in May (the largest gain in more than 20 years), a six-year high.
- The Conference Board's confidence index improved to 85.2 in June, its highest reading since 2008. ***(Source: Bob LeClair's Finance, June 2014)***

Will we be able to hold onto these gains and add enough through the end of the year to at least have a positive GDP for 2014? Let's hope so. Slow growth could reduce corporate profits, which would be bad news for stocks and could lead to higher-than-expected default rates on junk bonds.

PRICE–TO–EARNINGS RATIO

Price-to-earnings (P/E) ratios have risen over the last two years, as improving investor confidence helped drive market gains. Some investors are focused on the current valuations, which are slightly above the long-term average (17.1 versus 15.1). The higher the P/E, the more likely the stock market is overpriced. Although most stock indices are at an all-time high, the market valuation is nowhere near its 2001 peak. ***(Source: Fidelity.com)***

Even with a gain in the first half of 2014, bears exist. Nobel Prize-winning professor Robert Shiller notes that currently the market looks more expensive on a cyclically adjusted basis. Still, he's not telling investors to sell all of their holdings and retreat, just to be cautious and lighten up.

STOCK BUYBACKS

Companies buying back their own shares represent the single biggest category of stock buyers today, according to a study by Jeffery Kleintop, Chief Market Strategist at LPL Financial. ***(Source: Wall Street Journal, June 30)***

Some economists say buybacks allow companies to provide artificial support for stock prices by increasing demand for shares. Also, reducing the number of shares increases the earnings per share. Most professional money managers look primarily at earnings per share, so buybacks can improve a company's apparent earnings performance, even if overall earnings aren't rising at all.

GLOBAL

Financial markets worldwide are getting a boost from recent upbeat economic data out of China. China has increased its manufacturing activity and many economists believe that its appetite for raw materials will continue. While many markets were rattled earlier this year by worries that China's slowing growth would lead to a hard landing, the Chinese government took steps to build investor confidence, including credit easing, more spending on highways, and business tax breaks.

The U.K. and Germany remain the primary drivers of the European Economic Expansion, but now other European economies have also improved significantly, suggesting that Europe's cyclical upturn continues to become more broad-based.

INTEREST RATES

Central bankers around the world debate whether very low interest rates, adopted in many economies since the 2008 financial crisis to spur stronger recoveries, are actually feeding market bubbles that could burst and potentially cause new financial turmoil.

As the Fed is winding down its bond-buying program, Janet Yellen, Chairperson of The Federal Reserve, assured investors that the Fed won't raise interest rates abruptly simply because some markets may look a bit volatile. ***(Source: Wall Street Journal, July 3, 2014)***

Most Fed officials have indicated they expect to start raising interest rates gradually in 2015, but the final decision will depend on whether the economy continues to strengthen as they forecast. However, many investors think that the rise in interest rates could happen sooner and the pace of increases could be more rapid than expected.

INFLATION

Inflation finally nudged above the 2% level that the Fed says is its long-term target. Compared with a year ago, the Consumer Price Index (CPI) is up 2.1% (not including food or energy). Although that might make the Fed happy, it sent a tremor of worry through analysts, investors, and economists.

UNEMPLOYMENT

On Wednesday, July 2, a report on the U.S. labor market was better than expected in that 281,000 private-sector jobs were created in June compared with an estimated increase of 210,000. Although this is certainly good news, many investors say that stocks will need continued evidence of an improving economy to sustain the move higher. ***(Source: Wall Street Journal, July 3 2014)***

CONCLUSION

What should an investor do? Some believe that stocks will benefit from robust earnings and low interest rates, while many other financial professionals are spending sleepless nights focusing on whether the five-year-plus bull market is getting long in the tooth. Those money managers who sided with caution so far in 2014 have underperformed the indexes; however, as Confucius once said "the cautious seldom err."

Although U.S. stock indexes are pushing through fresh records and valuations have passed pre-financial crisis levels, some analysts believe markets aren't overvalued yet. Still, an examination of historical valuations points to proceeding with caution in the stock market. Normally during these times bonds would provide a safe harbor, but with interest rates still near historic lows, bonds might not provide the same portfolio protection as in years past and, potentially even worse, bond prices will decline when interest rates rise.

It's not easy to structure a portfolio in the face of these risks, but perhaps the best advice is to continue to focus on your personal situation and timelines. Consider these important questions:

- What is a realistic time horizon?
- What is a realistic return expectation for my portfolio?
- What is my risk tolerance?

Your answers to these questions will help us recommend what type of investment vehicles you should consider, which investments to avoid and how long to hold each of your investment categories before making major adjustments.

We are continually reviewing economic, tax and investment issues and drawing on that knowledge to offer direction and strategies to our clients.

We pride ourselves in offering:

- consistent and strong communication,
- a schedule of regular client meetings, and
- continuing education for every member of our team on the issues that affect our clients.

A good advisor can help make your journey easier. Our goal is to understand our clients' needs and then try to create a plan to address those needs. We continually monitor their accounts, keep a watchful eye on the markets and interest rates, and keep the lines of communication open. If you would like to discuss your specific financial situation, please call to schedule a complimentary appointment. We appreciate the opportunity to assist you in addressing your financial matters.

P.S. During this year's big Treasury rally, the question has been, "Who's buying all those bonds?" The answer is the Federal Reserve. During the six months ended in May, the Fed bought 73% of all new Treasurys, notes Strategas Research Partners' Daniel Clifton. That's the largest percentage since the start of quantitative easing.

The reason isn't greater demand, but reduced supply. With the budget deficit falling, the amount of bonds issued has declined faster than the Fed's taper, or reduction in bond buying. That leaves a limited supply of bonds for others to buy, according to Clifton. Perhaps that's why bonds have held up in the first half of 2014

Financial Literacy Facts

61% of adults admit to not having a budget, the highest percentage in six years.

35 million people admit to rolling over credit card debt of more than $2,500 a month.

29% are spending less this year than the previous year.

41% gave themselves a grade of C, D, or F on personal finance knowledge.

Source: National Foundation for Credit Counseling Survey

Complimentary Financial Check Up

If you are not currently a client of Heritage Retirement Advisors, we would like to offer you a **complimentary, one-hour, private consultation** with one of our professionals at absolutely no cost or obligation to you.

To schedule your financial check-up, please call **Raylene at Heritage Retirement Advisors, Inc. at (858) 487-1111.**

Sources: CNN Money; Shiller PE Ratio; Barron's, June 2014; Bob LeClair's Finance, June 2014; Fidelity; Bob LeClair's Finance, June 28, 2014; Wall Street Journal; CNBC.com 7/2014