MARKET AND ECONOMIC OUTLOOK

October 2015

Tax Information

Find these topics of interest at CLAconnect.com/tax:

- Estate Planning Comes Down to Tax Risk Versus Reward
- Grantor Trusts: Tax and Estate Planning with GRATs and IDGTs
- Life Insurance: A Retirement Strategy With Tax Savings for High Earners

Volatile Markets, Healthy Banks, and a Strong U.S. Economy

We currently find ourselves in a period focused on pessimism surrounding global growth prospects. It's true that declining commodity prices, primarily in energy and metals, have impacted exporters such as Russia and Brazil. And after years of extraordinary economic expansion, China is in transition to a slowing phase, but in our view, it is still producing robust growth. Despite the deflationary winds blowing from overseas, the U.S. economy is in its best shape since the Great Recession, with rising employment, rising home prices, low inflation, and improving consumer sentiment.

Some positives and negatives to the economic and investment background include:

Positives	Negatives
Improving employment	Federal Reserve stimulus/quantitative easing (QE) ending
Strong auto sales	U.S. stocks no longer cheap
Firming housing prices	Strong U.S. dollar is a negative for multi-national U.S. companies
Low inflation	Deflation risks outside the United States
Lower gasoline prices	Geo-political risks

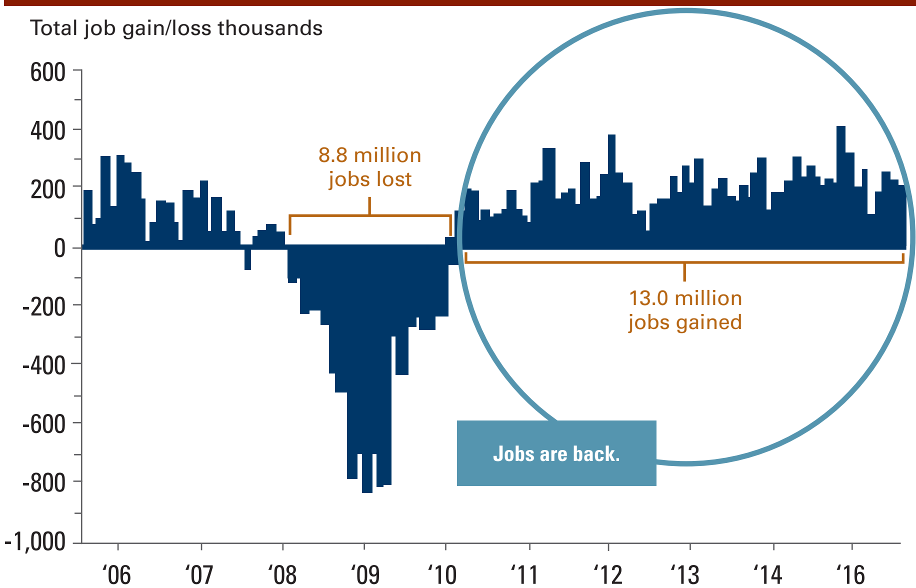
U.S. consumers are riding favorable trends

With firming employment, stable to rising home prices, and lower energy costs, it is no wonder that U.S. consumer spending is on the rise. Consumers are also enjoying multi-decade highs in the housing affordability index. Furthermore, real wage growth, conspicuously absent during most of the recovery, may be set to improve. Automobiles are flying off dealer lots at the fastest pace in 10 years, according to the *Wall Street Journal*, but auto workers are threatening walkouts looking for better pay.

Employment has recovered since the Great Recession leaving employers with fewer skilled workers to fill available jobs; this may pressure wages upward. More evidence of strong discretionary spending is found in the resurgence of cruise ship operators in tandem with lower fuel costs. While the consumer may feel dour about capital markets (see next section), we don't see a slowdown in consumer spending anytime soon.

Employment — Total Private Payroll

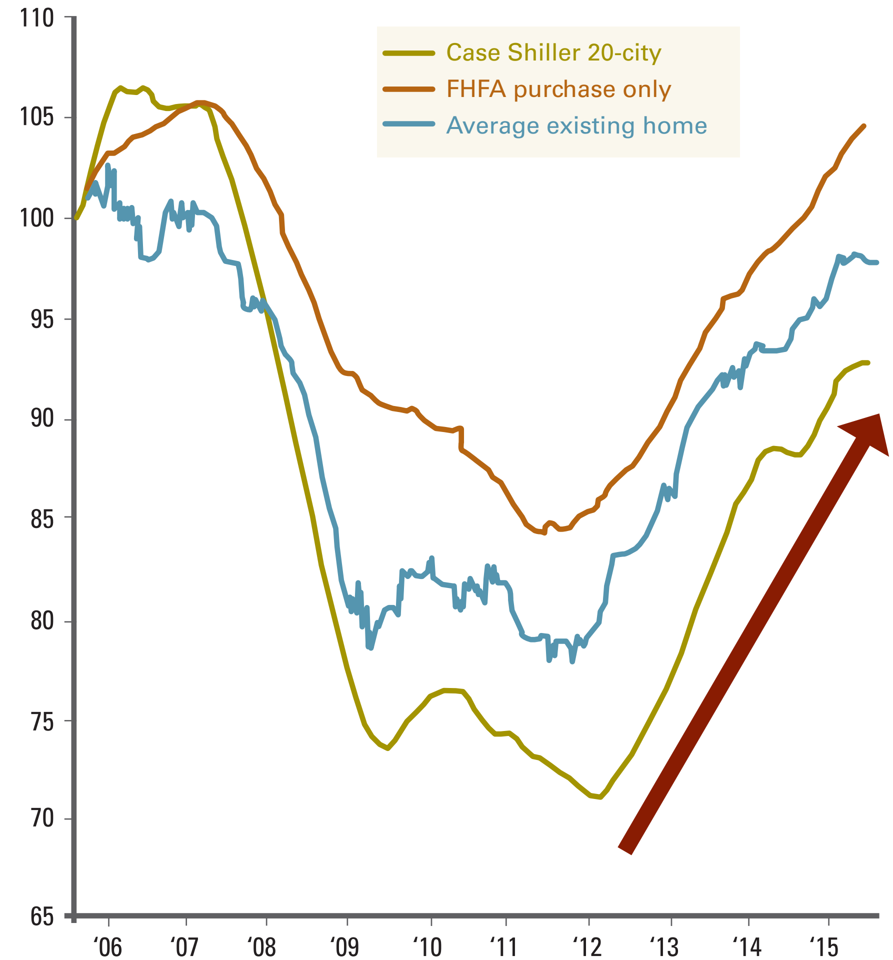
Total job gain/loss thousands



Sources: Bureau of Labor Statistics, FactSet, J.P. Morgan Asset Management Guide to the Markets — U.S. data are as of August 31, 2015

Home Prices

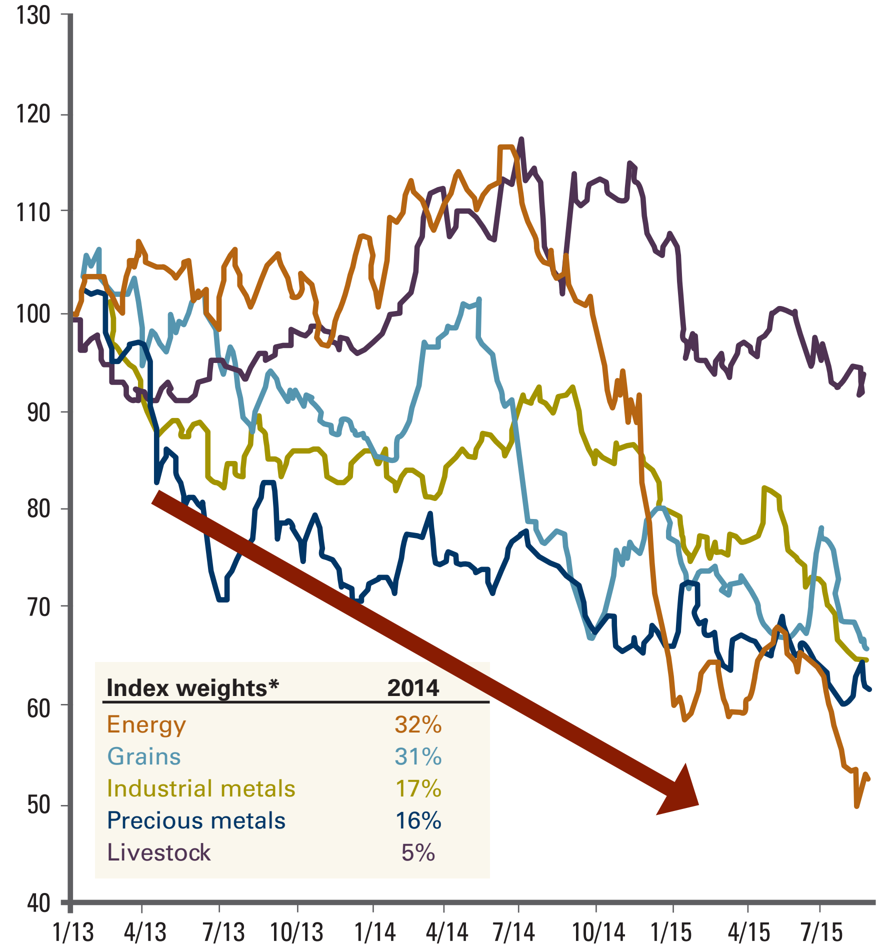
Indexed to 100, seasonally adjusted



Sources: National Association of Realtors, Standard & Poor's, Federal Housing Finance Agency, FactSet, J.P. Morgan Asset Management

Commodity Prices

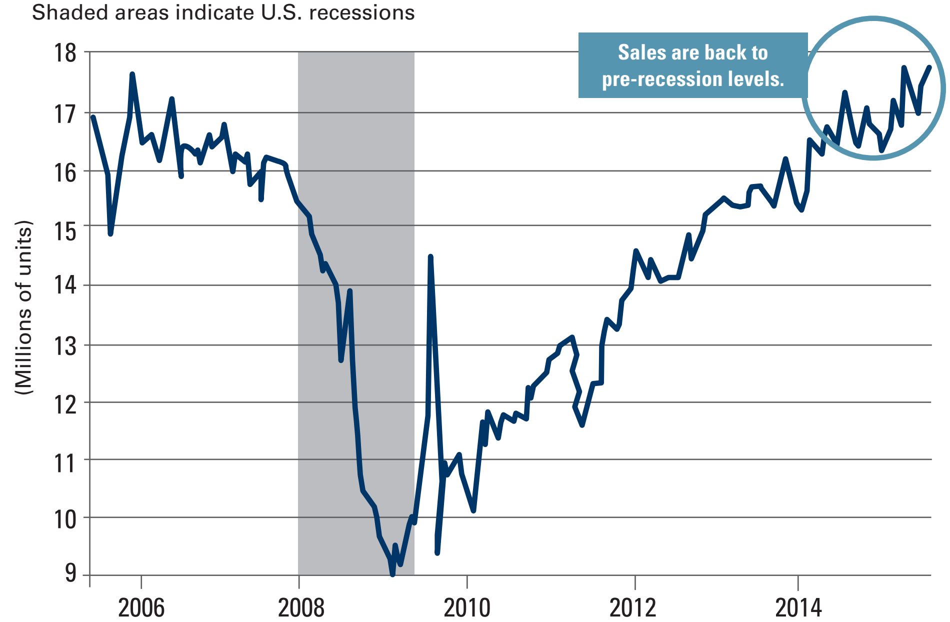
Weekly index prices rebased to 100



Sources: Bloomberg, Bureau of Labor Statistics, EcoWin, FactSet, J.P. Morgan Asset Management
**Index weights may not add up to 100% due to rounding.*

Light-Weight Vehicle Sales: Autos and Light Trucks

Shaded areas indicate U.S. recessions



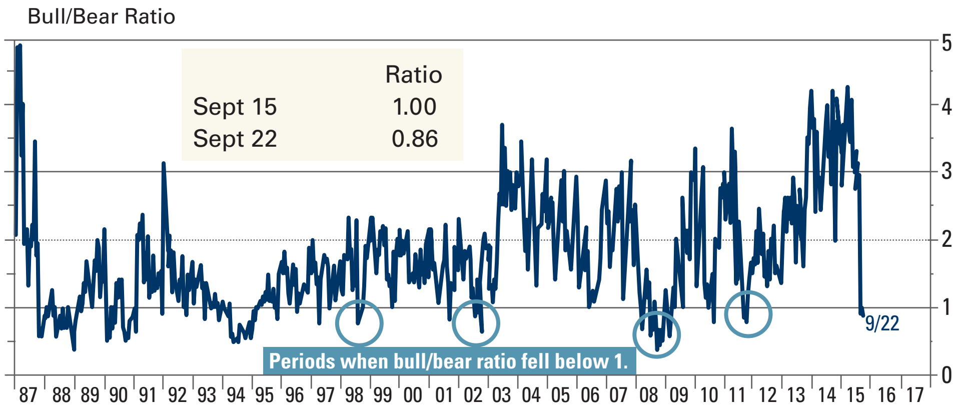
Sources: U.S. Bureau of Economic Analysis, 2015 research.stlouisfed.org

Investor sentiment low, even though correction was overdue

Various measures of investor sentiment are hitting multi-year lows, including the Investors Intelligence Bulls and Bears (next page). We have not witnessed similar levels of bearishness since the beginning of the European debt crisis in 2011. Investors tend to favor low prices for buying stocks but don't like the uncertainty that accompanies them.

Markets just emerged from one of the longest periods ever without a 10 percent correction (about three years), so we were clearly overdue. We also think investors are anchoring on the peak stock prices reached earlier this year rather than on the gains attained throughout this market cycle. Market bottoms are sometimes established during times of extreme pessimism. Check out 1998, 2002, 2008, and 2011 for other recent periods when this ratio fell below 1.

Investors Intelligence Bulls and Bears



Source: Investors Intelligence

Investor sentiment can stay depressed for a long period like 2008 – 2009, so the current market malaise may get worse before it gets better. The *Financial Times* recently reported that Saudi Arabia has withdrawn tens of billions of dollars from asset managers as it looks to cut a widening budget deficit attributable to low oil prices. Norway, with the world's largest investment portfolio or sovereign wealth fund, may not be far behind. The cascading effects from the rapid decline in commodity prices are having an impact on global capital markets.

Banks experience historic high capital levels, but earnings don't follow

Now that the Great Recession is behind them, financial institutions are experiencing historic capital levels and some of the lowest interest rates in a generation. Tim Malecha, CliftonLarsonAllen principal serving financial institutions, wonders if the lessons of the recession will have a lasting impact on the industry.

Tim Malecha
CPA, Principal, Financial Institutions

"Financial institutions are probably in the strongest capital position they have been in my lifetime," says Malecha. He cites higher capital requirements since the recession as one reason. Community banks have also had some good years recently, with some of those earnings retained as capital. An upswing in M&A activity can be attributed to higher-than-usual capital reserves, Malecha says.

But more capital hasn't necessarily translated to higher earnings. While institutions may have more capital than they've ever had, earnings haven't followed suit. Malecha says he believes this imbalance is caused by three factors:

- The cost of complying with stricter regulations
- The lowest interest rates in a generation
- Low loan demand

Most traditional banks make the vast majority of their earnings on the "spread" between their cost of funds (typically deposits) and return on funds (lending). With interest rates so low, the spread has become compressed and this has a dampening impact on earnings. Low rates are a boon for borrowers but punitive on depositors.

Due to a lack of robust loan demand, institutions have more liquidity on their balance sheets. These liquid assets are typically moved to their investment portfolio, which is very low-yielding due to interest rates. Malecha says a gradual increase in interest rates — which may now be on the horizon — would be welcomed by most financial institutions.

M&A activity among financial institutions is picking up, although Malecha says sellers are not getting the prices of 10 to 15 years ago. A decade ago it was common to see multiples of two or three times book value; now 1.5 to 1.75 times book value is more prevalent.

Bank Capital to Total Assets for United States

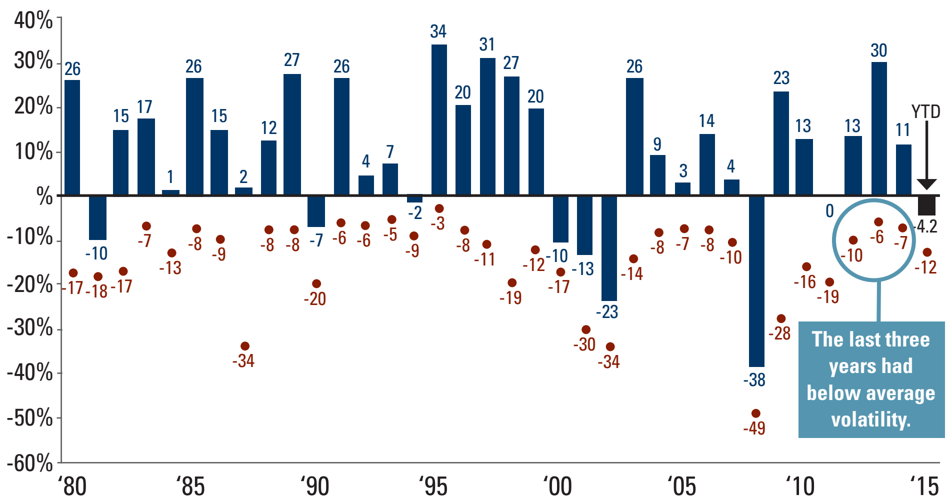
Sources: World Bank, 2015 research.stlouisfed.org

Volatility is the norm, not the exception

Since 1980, the S&P 500 has been positive in 27 of 35 years, a 77 percent win rate (bars above the line in the Intra-Year Declines chart below). However, to achieve that win rate, investors had to sustain average intra-year drops of 14 percent during that same time frame (red dots). The last three years (2012 – 2014) saw intra-year drops well below the average, which is why we believe investors are feeling more despondent than the fundamentals would support. Volatility is picking up, but we believe this is normal, especially as the Federal Reserve is on the brink of raising short-term interest rates for the first time in eight years.

S&P 500 Intra-Year Declines vs. Calendar Year Returns

Despite average intra-year drops of 14.2 percent, annual returns positive in 27 of 35 years*



Sources: FactSet, Standard & Poor's, J.P. Morgan Asset Management
Returns based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only.
**Returns shown are calendar year returns from 1980 to 2014 excluding 2015 which is year-to-date.*
Guide to the Markets — U.S. data are as of August 31, 2015

No one knows if the current drop in stock prices will lead to larger declines or if it will end soon. According to [Dimensional Fund Advisors](), a leading global investment firm that has been translating academic research into practical investment solutions since 1981, U.S. stocks historically have delivered above average returns over one, three, and five years following consecutive negative return days, which resulted in a 10 percent or more decline. It is tempting to sell after such a swift and large decline in hopes of avoiding further losses, but with millions of investors and computers sifting through information quickly, market timing is a difficult game to win. Investors who embrace dramatic stock price changes as an outcome of liquid markets are in a better position to succeed long term than those who are easily moved by declines and are inclined to act on urges.

Returns After Corrections

U.S. Large Cap: January 1926 — June 2015				Annualized Compound Return		
Cutoff for Decline	Frequency of Such Declines	Avg. Horizon for Decline (Trading Days)	Avg. Magnitude of Decline	For the Next 1 Year	For the Next 3 Years	For the Next 5 Years
5%	262	4.1	-7.55%	13.24%	9.43%	10.02%
10%	28	4.6	-14.25%	23.56%	8.89%	13.33%
Unconditional annualized compound return for full sample is 9.32%.						

Source: Dimensional Fund Advisors
Declines are defined as periods with consecutive days of negative index returns with cumulative losses at or above the cutoff. Annualized compound returns are averages across all declines. U.S. Large Cap is the S&P 500 Index, provided by Standard & Poor's Index Services Group. International Large Cap is the MSCI World ex USA Index. Emerging Markets is the MSCI Emerging Markets Index. MSCI data © MSCI 2014, all rights reserved. Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Stick to your long-term financial plan

Managing our emotions is especially crucial during market downturns. Uncertainty about the future is a given for investors, but we tend not to focus on that during market upturns. During bearish periods, our perception of uncertainty changes and we may be motivated by fear to deviate from a long-term investment strategy. A well-diversified portfolio consisting of stocks, bonds, cash, and real estate, designed with your ability and willingness to take risk, is your best defense against down periods. Based on the sentiment indicators we are witnessing, there is a lot of fear out there. But as Warren Buffett so wisely said, "Be fearful when others are greedy, and greedy when others are fearful."

CliftonLarsonAllen Wealth Advisors, LLC
Investment Committee
connect@CLAconnect.com