SEBOLD CAPITAL
WEALTH MANAGEMENT

March 2015

Market Update

February Benchmark Returns		
Domestic Benchmarks	**Feb**	**YTD**
Large Cap: S&P 500	5.8%	2.6%
Small Cap: Russell 2000	5.9%	2.5%
International Equity Benchmarks		
Developed: MSCI EAFE	5.8%	6.3%
Emerging: MSCI EM	3.1%	3.7%
Fixed Income Benchmarks		
Domestic: Barclays Aggregate	-0.9%	1.1%
Foreign: Barclays Global Aggregate	-0.9%	0.4%
Other Benchmarks		
Municipal: Barclays Municipal Bond	-1.0%	0.7%
High Yield: ML High Yield Bond	2.7%	3.2%
Commmodity: Dow Jones UBS Commodity	2.6%	-0.9%
Real Estate: FTSE NAREIT All REITS	-3.0%	2.9%
Risk Free: US Treasury CD 3 Month	0.0%	0.0%

The US stock market rebounded from January to post a gain of 5.8% in February. This brings large cap stocks to a 2.6% gain on the year. Small cap stocks also rebounded with an impressive 5.9% return on the month, also bringing the year to date numbers to 2.5%. The big news on the month was Federal Reserve Chairwomen Janet Yellen's testimony to Congress indicating that the Fed is on track to raise the Federal Funds rate later this year. The economic indicators that she cited were predominantly jobs related. New jobs for January (released in February) came in at a healthy 227,000 and wages rose slightly after their decline in January. Inflation maintains its status as non-existent. While this can partially be blamed on the fall of oil prices, Yellen indicated that she views this as transitory and believes that inflation should be rising in the future. There were some indicators that continued to be lackluster; consumer confidence, manufacturing, housing, and spending numbers did not impress. Valuations on the domestic market continue to be high from historical standards; adjusting for interest rates, the argument goes, that domestically we still may have some room for upward expansion.
International markets, on the other hand, added to their gains in January for a solid performance in February, the MSCI EAFE gained 5.8% on the month bringing the year to date number to 6.3%. The news for the international markets continues to be centered on Greece and the EU bailout. While nothing has been settled, the IMF, ECB and European Commission have courageously decided to kick the can down the road. The parties agreed to a four month extension of the current aid program, along with other details to be laid out later on the repayment of Greek debt.

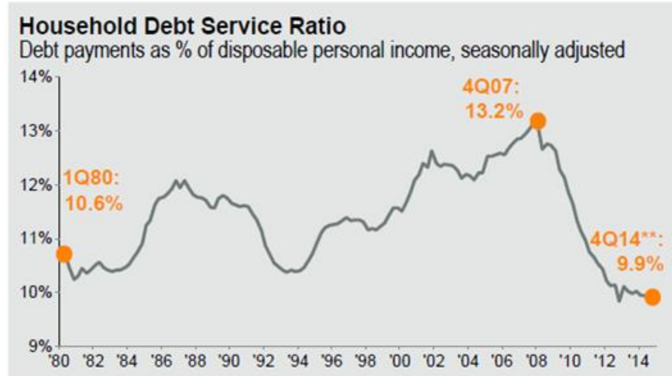
While Greece grabbed the headline news, the economic data being released out of the Eurozone came in much more optimistic than anticipated. GDP for the fourth quarter exceeded estimates, bank lending grew for the first time in three years, and consumer confidence grew.

Japan also seemed to crawl out of the recession that has gripped the country. Their fourth quarter GDP numbers showed a moderate positive growth. While it was a bit short of expectations, the country's export numbers continues to add to the economy with the help of the weaker yen.

Interest rates jumped higher during the month of February. Starting the month at a 1.64% rate, the 10 year treasury ended the month almost at a 2.00% handle, over a 20% increase from a very low starting point.

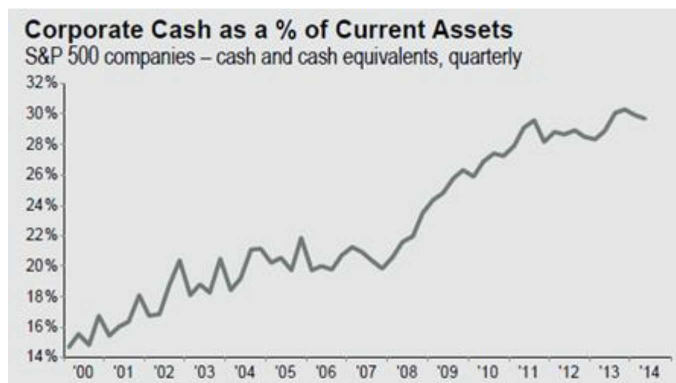
Market Valuation—Due for a Crash?
We seem to be getting this question quite a lot lately. We have seen the current bull market run for six years from March 9, 2009. The average bull market run is around 4 years without a 20% correction. Could this mean we are due? The answer is a definite maybe. Do we think a downturn the size and scope of 2000-2002 or 2008-9 is in the cards? The answer on that is definitively no. Both of these past recessions were precipitated by economic conditions that currently do not exist. The internet fall from grace was brought about by grossly overvalued equity positions that were eventually seen. The 2008-9 recession was brought about by lenient lending standards combined with a poor regulatory decisions, by both the Federal Reserve and the Financial Accounting Standards Board.

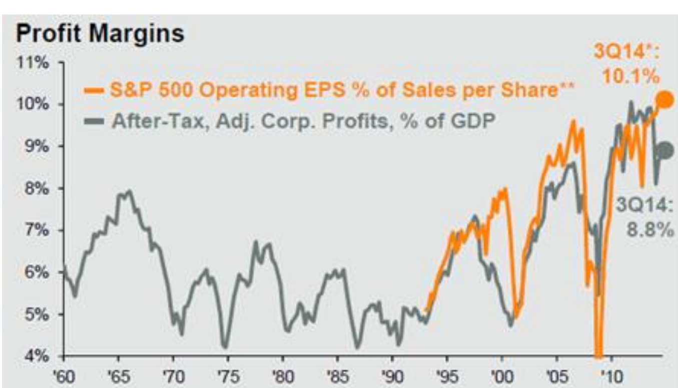
Today's environment is quite different. It seems as though we are still living in the shadow of the recession of 6 years ago. Time and time again we hear business owners and individual investors commenting that they do not want to live through that again and will do everything in their power to avoid it. The challenge is, of course, that by definition a crash is not foreseen. As a result, we have had self-imposed limiters put on the economy for the past 6 years. It appears as though we are a victim of our own learning. For example, the household debt service ratio, at a 20 year high in 2008 of 13.2% has dropped to a 30 year low in 2014, of 9.9%. This measures debt payments as a percentage of disposable personal income. No longer are consumers leveraging up because they can afford it.

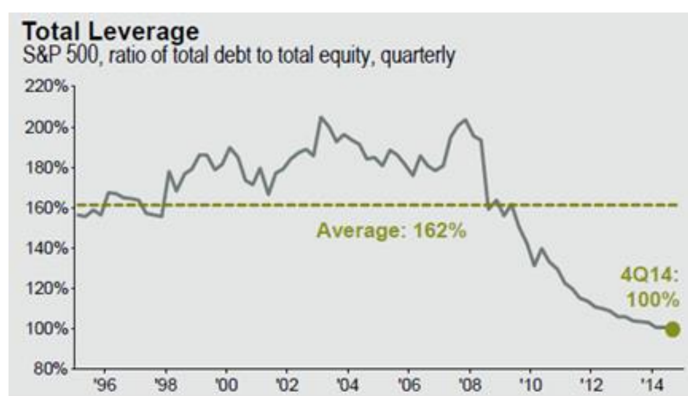


Consumers are also being cautious to make those big purchases. Prior to 2008, cars were being sold at a rate of around 16mm per year. It has also taken us a full 6 years to get back to that type of sales number. While this bodes well for car manufacturers, housing sales have yet to get to their pre-recession levels of over 7mm per year. In January we hit 4.82mm, a fall of 4.9% from December. While there might be some desire to buy homes, the credit market still has not loosened its noose on borrowers trying to get a mortgage. Lending standards continue to get tighter, not looser over the past couple of years.

Consumers are not the only part of the market that has been cautious. Companies have been hesitant to invest the cash that they have been generating. Corporate cash as a percentage of current assets is at an all-time high of over 30%. This building of cash has been a result of profit margins that we have never seen so high. S&P 500 earnings per share has ballooned to 10.1%, a number that has not been seen in 50 years. All this is being done without the use of leverage. Total debt to equity has been cut in half from the 2008 mark of over 200% down to 100%.







So if consumer balance sheets are strong, and corporate balance sheets are strong, where can the concern come from? The biggest source of concern that we are looking at is valuations. The S&P 500 has now surpassed its 25 year average multiple. While certainly not at the record highs that we saw in the internet bubble, higher multiples generally come at a price of greater volatility, and lower long term returns. Consider the chart to the right, the highest P/E's give us the lowest returns… in order. While just using a P/E ratio to determine future returns is a bit short of the analytical mark, it certainly has the ability to give us pause if we have the expectations that US Large Cap stocks will give us historically average returns going forward.

S&P 500 Returns From Different Starting Shiller P/E Deciles

	Median Returns	
P/E Decile	**5-Year**	**10-Year**
1 (Lowest P/Es)	17.5%	16.2%
2	15.3%	15.4%
3	13.8%	15.3%
4	13.2%	13.4%
5	10.4%	12.6%
6	9.5%	9.5%
7	10.1%	8.7%
8	7.9%	7.7%
9	4.0%	4.2%
10 (Highest P/Es)	-0.2%	2.9%

Source: Robert J. Shiller and Litman Gregory Analytics.

If we are to be intellectually honest, we have to look at how lower returns could manifest themselves in a market that appears to be humming along quite nicely. There are several items on our concern list. While profit margins are at historical high levels, is it safer to assume they will stay there or they will begin to revert to their long term mean? There are three reasons that we are leaning toward the latter.

First, employment numbers are picking up. This suggests that companies are now willing to invest in new employees. This will come at a cost to profits. Employee return on investment can be upward of 3 years. Second, US employers will begin to fight price battles with foreign companies with a lower cost structure. This comes as a result of the currency wars that are raging from central banks around the world. Third, while corporations have been harvesting cash from their earnings, capital expenditures have not kept up. Corporations must ratchet up their capex to stay competitive in this environment. While this will make great sense, it will provide an immediate hit to current earnings. In the next 3 years, there would appear to be headwinds facing corporations that they haven't seen in the past 5 years; which should bring profit margins closer to historic means.

With expected lower profit margins in the future, we will either see expanding multiples from an already high level or market stagnation. It appears that current market participants have very little tolerance for expanding multiples and higher valuations with the 2008 market performance emblazoned in their memories. However, the market is not long for an average that does not have some volatility in it. We could be in for a domestic market that moves a lot, but doesn't go anywhere.

As always, thank you for your continued support.

Firms plan to increase capital spending by 5.2% over the next 12 months, down from 5.9% expected in the previous quarter.

Technology spending is projected to increase 3.8%, the least since Q4 2012. But R&D spending is projected to increase 3.6%, the second best in four years.

Hiring plans moderated slightly, with full-time employees expected to increase 2.4% in 12 months, down from 2.9% in the previous quarter. Similarly, wages and salaries are projected to increase 2.7%, down from 3.4% previously.

Nevertheless, 70% of firms expect to raise remuneration by at least 3.0%, led by tech, services and consulting, manufacturing, and health care. Industries with sub-2.0% projected wage growth included retail/wholesale, energy, and communications/media.

Source: Duke University/CFO Business Outlook Survey

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