Wimmer Associates

Quarterly Report

Volume 13, Issue 3 November 2015

A Letter from Kathy

Dear Friends,

Although the third quarter of the calendar year 2015 was rather dismal for equity investors, we are happy to report that the month of October showed the strongest equity performance since 2007. As is our consistent practice with our newsletters, we shall endeavor to explain the economic, market and policy factors that weighed down the overall stock market. Ironically, the most likely factor that lowered third quarter results is also the primary factor that drove October's recovery in stock prices, namely, China. The Middle Kingdom's economic slowdown and bursting equity bubble spooked investors worldwide, as Chinese officials offered seemingly unworkable policy prescriptions to stem the tide of losses in Chinese equities. Throughout the third quarter, Chinese officials ordered state run banks and brokerages to buy up equities in a futile effort to reverse broad price declines, as retail investors rushed to exit from their Chinese-based holdings. What a difference a month can make in market sentiment. It appears that China's equity markets have now entered into a new "bull market" as the Shanghai Composite Index climbed back more than 20 percent since its August 20th low. Recent policy moves by the Chinese Central Bank to lower interest rates, devalue the Yuan currency and prohibit short selling proved more salutary for Chinese equities than the previous policy of state-ordered purchases of falling stocks.

The other driving force behind the third quarter's market decline was the dithering of the US Federal Reserve Bank over monetary policy. Fed Chair, Janet Yellen, has been "telegraphing" for some time now that the Fed wants to return to "normal" monetary policy after driving short term interest rates down to practically zero for the past six years. But it seems that every recent Fed meeting develops a new rationale for keeping interest rates near zero. The justifications for zero interest rate policy (ZIRP) include concern for a slowing Europe, low inflation in the US and the fear of a tightening policy while Europe, Japan and China are all loosening monetary conditions. Some argue that the Fed should not raise interest rates any time soon because it would lead to a strengthening of the dollar, which would serve as a drag on domestic manufacturing and ultimately curtail US exports. The Fed's inability to make up its mind on raising interest rates signals to investors that the central bank does not have enough confidence in the US economy's ability to withstand normalized interest rates. We believe that the Fed should have raised short term interest rates at its September 2015 meeting, rather than adding to market uncertainty with another delay in rate hikes.

Below we will review key developments in the markets and the economy. Later, we will relay our thoughts and expectations for the fourth quarter amidst equivocating monetary policy from the Federal Reserve and muted GDP forecasts by the International Monetary Fund (IMF) for the US and Europe.~

Cordially,

Kathy Wimmer, CFA, CIC
President

Key Facts for 2015

- *Annual gift exclusion $14,000*
- *Estate, gift and generation-skipping tax exemption $5,430,000*
- *Highest marginal estate tax rate 39.6%*
- *IRA contribution limits $5,500, plus another $1,000 for those over fifty*
- *SIMPLE IRA and 401(k) contribution limits $12,500, plus another $3,000 for those over fifty*
- *401(k) contribution limits $18,000, plus another $6,000 for those over fifty*
- *SEP IRA contribution limits 25% of compensation, max of $53,000*
- *Top Federal tax rate is 39.6% on income over $413,201 (single filers)*

Inside This Issue:

Third Quarter 2015

The broad based S&P 500 index declined 6.9% during the third quarter as investors became unnerved with the meltdown of China's equity markets, coupled with sharp declines in energy and materials as the world stands awash in a glut of oil, copper and steel. Investors feared that a premature rate hike by the Fed could lead to a market decline and economic pullback as a result of tighter monetary policy. Bloomberg reporter Blaise Robinson reports that energy earnings for the third quarter are running 54 percent below last year's quarterly results and the materials sector's earnings per share are projected to be 15 percent lower this quarter versus last year's quarterly results. The best performing industry sectors during the third quarter of 2015 were footwear, tobacco, defense and airlines, while the worst performing sectors were led by oil services, alternative fuels (especially ethanol), pipelines, iron and steel. The price of West Texas Intermediate crude oil fell by over 24% from $59.48 to $45.06 during the third quarter as record production from Saudi Arabia, Iraq and Russia flooded the market with excess supplies. The Saudis are trying to drive out marginal oil producers who have piloted the "fracking revolution" and Canadian tar sands companies who now face unfavorable economics with oil priced below$50 per barrel. We have already seen a nine week sequential decline in new well production in the United States and oil production has now started to fall from record highs set back in June of this year. Manufacturers fared poorly in the third quarter of 2015, as the strong US dollar made domestic exports more expensive and tepid demand in Europe and Asia led to disappointing sales of machinery.

The technology and biotech-laden Nasdaq Composite Index declined 7.4% in the third quarter as Apple, the world's most valuable company; saw its share price down 12% for the quarter, despite the successful introduction of the new iPhone 6s. Biotech shares, as measured by the iShares Nasdaq Biotechnology Index (IBB), fell nearly 18% during the third quarter, as some particularly egregious drug pricing came under fire from both Congress and various presidential contenders. It is one thing to buy up a lifesaving drug that is 62 years old and ratchet up the price by 5000% overnight and another matter to charge $50,000 a year for a cure for hepatitis C, a condition that previously required hundreds of thousands of dollars to treat patients saddled with cirrhosis of the liver and who ultimately would need organ transplants for survival. It should be noted that Gilead Sciences' cure for hepatitis C cost the company in excess of $13 billion to develop and bring to market. Nevertheless, we can expect drug pricing to remain under pressure on multiple fronts, including insurers, patients, Medicare and Medicaid, as well as from politicians looking to score points against "greedy" pharmaceutical companies.

According to S&P Capital IQ, "Aggregate Q3 2015 S&P 500 earnings are expected to decline 1.68% year-over-year. Excluding the energy drag, growth would be +6.4%. Of the 446 companies that have reported, 291 of those companies have beat analysts' estimates, 92 missed and 63 met." We do not see a turnaround in the energy space anytime soon as there is simply too much supply and too little demand. However, lower gasoline prices are leading to increased gas consumption in the US on the order of a 4-5% year over year gain. There is an industry saying that the cure for "low oil prices is low oil prices" The opposite is true as well: high oil prices lead to conservation, technical innovation and higher levels of exploration which ultimately drives down the cost of oil.

The Federal Reserve September decision to postpone a hike in the Federal Funds rate until at least its December meeting appears to be a case of "cold feet" as the Fed has been "telegraphing" for some time that it wants to normalize monetary policy after driving short term interest rates down to practically zero for the past six years. Through the release of its Open Market Committee Minutes and in congressional committee testimony, the Fed has been signaling that it intends to raise short term interest rates in the near term. In late October, the Committee stated that it "anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." Since then, the U.S. Bureau of Labor Statistics October released blockbuster unemployment data showing 271,000 individuals added to Non Farm Payrolls (NFR) and the unemployment rolls declining to 5.0%, down from 5.1% in September. To put this in perspective, the unemployment rate has now been halved from its peak during the Great Recession. Moreover, the consensus expectation had been for the economy to have added 182,000 jobs in October.

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Diving deeper into the latest unemployment numbers, one finds that the labor-force participation rate of 62.4% remained flat at a historically low level not seen since the 1970s. The low participation rate is a result of baby boomers retiring, higher claims of disability and hapless individuals who have simply given up extended job searches out of frustration. On a more positive note, wages climbed 2.5% on an annual basis to $25.20 per hour. Although not reflected in the data as of yet, the big three auto manufacturers have all recently concluded wage and benefit negotiations with the United Auto Worker union with generous new packages to match recent record sales of American made vehicles. This bodes well for meeting the Fed's stated annual target rate of 2.0% for inflation as higher wages and thus, higher costs of production, meet the definition of "cost-push inflation" in classic economics.

Yet it appears to some that the Fed should not raise interest rates any time soon out of a fear of a strengthening dollar, which would serve as a drag on domestic manufacturers whose products would become more expensive to export. Also, foreign manufacturers would benefit selling to the US as imports to the United States would become cheaper to American consumers. This would also make it more difficult for US inflation to meet the Fed's stated inflation target of 2% per year. Heretofore, the Fed's inability to make up its mind on raising interest rates indicates a lack of confidence in the US economy to withstand normalized interest rates. With the recent data showing stellar gains in employment and strong wage growth, we believe that a small rise in short term interest rates will have minor effects on currency exchanges, interest rates and equity valuations. In fact, markets may have already "baked in" a December rate hike by the Federal Reserve.

While the US stock market lagged in the third quarter, the economy at large saw a modest annual increase in the Gross Domestic Product of 1.5%, which mainly reflected increases in consumer spending, services (especially healthcare), nondurable and durable goods, according to the U.S. Bureau of Economic Analysis (BEA). On a more positive note, real disposable personal income (DPI) rose a healthy 3.5% during the third quarter after rising only 1.2% in the second quarter.

One of the biggest criticisms of US monetary policy has been its effect on "inequality". Zero bound interest rates and quantitative easing have the effect of easing liquidity for the creditworthy and creates asset appreciation in housing, commercial real estate and equities, while the average American worker has little savings or assets and falls further behind those in the upper echelon, who inordinately benefit from the Federal Reserve's monetary policies. The *Telegraph's* Ambrose Evans-Prichard credits Bank America/Merrill Lynch's take on the Fed's contribution to income inequality as follows: "Never in the field of monetary policy was so much gained by so few at the expense of so many" The Fed has clearly steered policy towards asset appreciation by creating a "wealth effect" that ultimately leads consumers to increase consumption and thus stimulate the economy. The law of unintended consequences unfortunately traps the Fed's monetary policy with a byproduct of greater wealth inequality in society. Once the Fed begins to retreat from its accommodative stance, Main Street should benefit from greater returns on savings while asset appreciation moderates and normalizes. The wage increases cited previously should dampen the phenomenon of growing disparity between the "haves and have nots". ~

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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

LOOKING FORWARD

The most recent World Economic Outlook from the IMF sees global economic growth moderating to 3.1% in 2015, down 0.3 % from its July outlook, as developed countries' prospects appear a bit brighter versus commodity-dependent developing countries. US Gross Domestic Product is projected to grow at 2.6% in 2015 and 2.8% in 2016, while Europe struggles along with 1.5% growth in 2015 and 1.6% in 2016. The UK is projected to grow at 2.6% in 2015 and 2.2% in 2016. Both the US and UK are well ahead of Europe and Japan in recovering from the recession, having implemented accommodative monetary policy more rapidly. China's rate of economic growth has been declining for a number of years but still should rise at an annual rate of 6.3% in 2016. China's slowdown has had major repercussions on natural resource dependent exporters, but should benefit energy and mining importers with lower commodity prices. The economy, equity and bond markets remain dynamic and liquid in the US and UK, while Europe and Japan recovery remains muted. Therefore, we favor an emphasis on US-based investments. Already we are seeing US stock prices rebound, having recorded their largest monthly gains since October of 2008. China's ability to stem further market declines, Europe's hint of further monetary easing and the US investors seeming indifference to a possible Fed Funds rate hike in December augurs well for further asset appreciation in the US. We see no evidence of a recession in the US on the horizon.~