THE WEALTH STRATEGIES GROUP
Independent Unbiased Financial Advice

The Seven Signs of a Changing Economy™

"What to look for, where to find it and what to do when you see trends changing!"
As of January 2016

Summary

In January 2000, the "dot com" sector of the market was positioned for a correction. It seemed to me at the time this was pretty apparent, as the prices investors were paying for what some of the dot com companies earned was, in my opinion, somewhere between ridiculous and stupid.

It was for that reason we didn't own any of these or if we did, it was in a broad based technology type fund. So it was surprising to see that some large, well established companies that we owned incurred large drops in the price of their shares. It turns out many large, well established technology companies had accepted "dot com" company stock as payment for services, in lieu of cash.

When all the dust settled the sector had gone through a really unpleasant backing and filling process and it took many of the companies who survived a decade to recover. Not only that, this was the catalyst that caused the entire market go through nearly a 50% drop in prices, as measured by the S&P 500 between January 2000 and October 2002.

Interestingly, the economy during that same period was doing pretty well. Consumers were spending, jobs were being created, inflation was in check, etc.

Flash forward to the summer of 2006 when I wrote Surviving the Storm – Investment Strategies That Help You Maximize Profit and Control Risk During the Coming Economic Winter, McGraw-Hill, 2007. That August it was pretty apparent that lending standards for home buyers were, in my opinion, ridiculous. Stock valuations were once again high and stock prices appeared to be in a position to drop significantly if the economy slowed just a little.

In this forecast I was correct and we once again saw the S&P 500 drop in value over 50% between October 2007 and March of 2009. The economy not only slowed down, it just about stopped. Some would argue that our economic system came as close as you can get to a complete systematic failure, as

Lehman Brothers, AIG Insurance, FNMA, FMAC and others went bankrupt. Other financial services firms were forced by government to merge with stronger partners to avoid bankruptcy. It was chaos, to say the least.

So, in one period, 2000-2002, the economy was pretty darn good and the S&P 500 dropped approximately 50%. In another period, 2007-2009 there was a complete financial crisis and the S&P 500 dropped approximately 50%.

This sounds like the old "heads you lose, tails you lose!"

But…there was a constant in both! The constant was the value being paid for the earnings of the companies in Corporate America!

In late 1999-2000 the prices being paid for the companies of Corporate America, as measured by the S&P 500 was 24 times! The outlook was good, but that's a high valuation, so it better be really good.

In late 2007, the prices being paid were a more reasonable 16 times. However, the outlook, as noted in Surviving the Storm, was pretty scary at best.

Using these two historical points to gain clarity, it seems that in 1999 investors were overly optimistic and in 2007 investors were also overly optimistic, based on the outlook. Certainly, investors were paying more reasonable prices than 2000, but not really when you compare the outlook with the bottom soon to fall out of our economy.

I observe 1999 to be "too hot" and 2007 to be "too cold".

What about now in 2016? The valuations being paid, as detailed below in Sign #6 are under Fair Market Value (FMV) and all Seven Signs of a Changing Economy™ are positive. I would have to conclude not too hot, not too cold, perhaps just right.

But Jim, the S&P 500 has just dropped 9% in just a few weeks, are you crazy?

Please remember, an upward market trend can "back and fill", "go down", "drop", etc. as much as 20% and by historic norms, still be in an upward trend.

In other words, this is very unpleasant, but normal. If this version of normal makes you queasy, then it is very important to review my "Rules of Clarity™":

1. Eliminate outstanding debt and have plenty of cash on hand to reduce worries during volatile economic times. This can include paying off your mortgage(s) for those inclined to think in terms of philosophy versus quantification.

2. Have a list of your monthly costs. Yes, a budget.

3. Know your sources of income, i.e. your earned income, retirement income, social security, etc.

4. You should consider allocating and diversifying your investments to reflect your constraints for time, risk and volatility. Once that is done, ALWAYS set aside a predetermined dollar amount to invest each month. At The WSG we refer to this as **"Systematic Investing"** or **"Dollar Cost Averaging"** and it is a strategy that seeks to help grow your assets in periods of economic volatility. If you don't understand what this is, call and we'll have a class!

*Dollar cost average involves continuous investment in securities regardless of fluctuation in price levels of such securities. An investor should consider their ability to continue purchasing through fluctuating price levels. Such a plan does not assure a profit and does not protect against a loss in declining markets.

If you still feel queasy, then you might consider two additional adjustments:

1. Reduce the percentage of your portfolio allocated toward conservative growth. Consider moving a portion to a two-year A-rated or better bond ladder. In a bond ladder, the bonds' maturity dates are evenly spaced across several months or several years so that the bonds are maturing at regular intervals. The more liquidity an investor needs, the closer together his bond maturities should be.

2. Accept the fact that you may not have the temperament needed to be an investor, unwind your investments in a prudent way over a reasonable period of time, like one to six months, and promise yourself you will never invest for a larger future again.

In the client relationships that I personally oversee at The Wealth Strategies Group, I have planned a reasonable investment portfolio customized around each client's constraint for time, risk and volatility. I believe each of these currently remains intact based on historical perspective and the economic outlook noted below in this month's issue of The Seven Signs of a Changing Economy™.

This month's Seven Signs are updated below. As always, I have added some unique insight with my comments. Just scroll down to view these now.

Your thoughts, comments and discussion are welcome. Please call me at 303-933-2107 or e-mail me at Jlunney@wealthstratgroup.com.

Respectfully,

James O. Lunney, CFP®, CEP
CERTIFIED FINANCIAL PLANNER Professional

Certified Estate Planner

The Wealth Strategies Group was founded by James O. Lunney under the guiding principle that comprehensive wealth counseling combined with independent investment advice will provide high net worth clients with complete trust in our competence, execution and integrity.

P.S. Please join me for our monthly conference call on The Seven Signs of a Changing Economy. You have the option of calling in or listening live for free from your computer. To call in, simply dial **347-826-7481**. There is no access code needed. To listen live from your computer, go to our website, www.wealthstratgroup.com, and click on the **"LISTEN LIVE"** button on the home page. You will be sent directly to our page on the Blog Talk Radio website and you can click on the link there. Instead of having a live Q & A session at the end of the call, you can now e-mail your question to me prior to the call at JLunney@wealthstratgroup.com and I will address them after my commentary on The Seven Signs of Economic Change.

The call is always on the first Thursday of each month at 1:00 p.m. MST/3:00 p.m. EST, unless otherwise noted. Please mark your calendar to join me for the next call on Thursday, February 11,2016.

We encourage you to invite people from your family, work and social circle to join in the call. Just forward my e-mail notification to your e-mail list. It is very timely information and in the volatile investment environment a second opinion may be greatly appreciated in these uncertain times.

1)	**Indicator:**	*Personal Consumption Expenditure (PCE)*
	Where to find it:	*www.bea.gov*
	What to look for:	*Consumer spending increases or decreases for three consecutive months*

(Positive)
In The Weekly Update posted on the WSG website on 12/4/2015 (read it here), I wrote: "My prediction is that not only will this holiday season be the largest this planet has ever experienced, I am guessing it will be 12% larger than last year."

A quick look back reveals:

- ✓ Amazon had its best holiday shopping weekend…ever! (Source: Market Watch 12/2/2015)
- ✓ Cyber Monday was the largest one day of shopping on the internet…ever! (Source: Market Watch 12/2/2015)
- ✓ Online orders via mobile phones accounts for nearly half of all online shopping. The most…ever! (Source: Market Watch 12/2/2015)
- ✓ Light vehicles sold over 18,000,000 units a month for three months in a row…first time ever! (Source: WardsAuto's Forecast)

Those are some rather impressive first ever stats!

As of January 8, 2016 MasterCard reports the holiday season retail sales were up 8% versus the prior year.

Conclusion: I was correct on the prediction of higher holiday season retail sales ever on the planet, but off a few percentage points on the amount. Part of the "off" on the percentage was gasoline sales. As prices dropped, it pulled down the retail sales number too. In this data, that is actually a good thing as it frees up money in our wallets to buy other "stuff" with our increased disposable income.

Consumer Spending is the main ingredient needed to get, and keep, the U.S. economy spiraling up. This data lags one month, but through November 2015, and without the December holiday sales surge, Personal Consumption Expenditure (PCE) are annualizing at a +2.51% growth rate. This is solid growth in the U.S. economy and Sign #1 remains positive.

2)	**Indicator:**	*Institutional Money Flow*
	Where to find it:	*www.wordenbrothers.com or www.barrons.com/convictionoftraders*
	What to look for:	*Increasing or decreasing prices on high volume of large block trades*

(Positive)
Due to the holiday data flow, this month's edition of The Seven Signs of a Changing Economy™ is a week later than normal. The good news is this delay in the update allowed for an additional week to observe the money flow, which we track here in Sign #2.

The money flow has been negative with net equity fund outflows of $22.8 billion. This is serious selling pressure and appears to be fear-based selling. At this point this appears to be similar to the prior fear-based sell offs like we have seen before, i.e. July 2014, October 2014, December 2014, August 2015, September 2015 and now January 2016.

As I write this update on January 11, 2016, we have only five business days of money flow to look at. The talking heads on TV suggest this is a trend and I would argue there is not much in the world where five tracking days represents a trend.

Again, outside news events and happenings do impact the valuations of Corporate America for short periods of time. Trends, on the other hand, are based on quantifiable valuations of Corporate America. As detailed below in Sign #6, the current Fair Market Valuation (FMV) of Corporate America is attractive based on both the earnings outlook and historic prices to earnings averages.

The recent mini-crash, like the others before this one, appears to be emotionally driven and not based on value erosion or outlook erosion. Sign #2 remains positive, but clearly if this trend continues, it could turn neutral or perhaps negative in just a few months. We will be watching closely.

3)	**Indicator:**	*Leading Economic Indicators (LEI)*
	Where to find it:	*www.businesscycle.com or www.newyorkfed.org/research/global-economy/globalindicators.html*
	What to look for:	*Trends up or down for three to four months*

(Positive)
The Conference Board Leading Economic Index (LEI) was released on December 17, 2015 at +.4%. This follows last month's +.6%, which is a great number. On the flip side, the year of 2015 was volatile the first three months, each posting a relatively flat +.2% each. July and September actually reported -.2% each.

Through this most recent data, the LEI is annualizing at +3.38%. This is not bad, but it is only about half of where it was at this time one year ago.

If we look at the ten components that make up the LEI, only one of my three super indicators of LEI is positive, manufacturers' new orders for consumer goods and materials. Of the ten input components, five were positive and five were negative contributors.

The LEI trend remains positive and it will be most interesting to see if December reports positive, and by how much, when it is released mid-January 2016. December is not generally a big positive contributing month to LEI, as the holiday slowdown plays into the data flow. For that reason, it is likely full-year 2015 will report a lower LEI than the prior years, but after six years of economic expansion it seems reasonable to expect a leveling off.

Sign #3 remains positive and indicates solid economic growth six to nine months into the future.

4)	**Indicator:**	*Employment rate and after-tax personal income*
	Where to find it:	*www.bls.gov*
	What to look for:	*A flattening, then downward trend in non-farm employment with a flattening to decreasing after-tax income would be a negative indicator. The appropriate trend would, of course, be a positive trend indication*

(Positive)
If you have been reading these reports for a few years, you will recall my notes on how the U.S. economy lost 8.8 million jobs during the great recession. In addition to creating new jobs to get these lay-offs back to work, we needed to

create 100,000 new jobs per month to absorb the young people entering the workforce.

Doing the math at 200,000 new jobs per month, 100,000 for new entrants to the work force and 100,000 to get laid off workers back on the job, this suggested seven years of 200,000 new jobs per month to get back where we were.

So where are we? Per the Bureau of Labor Statistics (BLS) and FactSet the U.S. economy has created 13.7 million new jobs in the last six years. Based on this data we are back! 8.8 million jobs lost and 13.7 million created. So far, so good!

And, the trend continues! In December 2015, 292,000 jobs were created and that is after the usually questionable adjustment for the birth/death model, which actually took away 23,000 jobs in December. If those 23,000 jobs were not taken away the new jobs creation would have been 313,000 for the month.

In addition, layoffs are at a nine-month low and the four-week moving average of initial claims for unemployment remain under the magic 300,000 at 275,750, a 50-year low. (Source: The Complete Investor, December 2015) The percentage of people participating in the workforce also increased to 62.6, but remains down from pre-recession peak in 2008 of 66%.

I still hear a great deal about part-time workers versus the better paying full-time positions. However, per the Labor Department, the number of part timers who want a full time job has dropped from 9 million to 6.1 million. Part timers are now 4.1% of the workforce versus 6.6% during the recession.

Those more desirable full-time positions have increased by 9.3 million jobs to a total of 122 million. The fact is more people are working at full-time jobs than before the recession.

The 13.7 million jobs created reflect the reality that Corporate America, large and small, is doing quite well. You don't hire new people if this were not the case. These people are also earning more and saving more at the gas pump. It is these dollars combined with our growing population that will likely cause the valuations of Corporate America to grow and trend higher. There will be mini-corrections to scare us all along the way, yet the trend is the key and it remains positive.

5)	**Indicator:**	*Durable goods spending*
	Where to find it:	*www.census.gov/indicator/www/m3*
	What to look for:	*An increasing or decreasing trend, especially a trend of four to five months out of six would be a positive or negative sign*

(Positive)
These long shelf-life items like non-perishable, non-fashion items are usually the first to show signs of a slowing economy. Remember, these are items we can do

without, if need be. New orders were up slightly, but not enough to move the needle. So neutral, 0%. Shipments increased +.90%. Unfilled orders, up the last two months, were +.2%. Inventories dropped .3%.

This is good data! Like most of the government reported data, there is a lag time between collection and reporting, so this detail is for November 2015. Holiday orders are in by November so usually November is flat and December is negative. We will see if that is true again this year. So, normal.

To see shipments and unfilled orders up and inventories selling down suggests the goods are moving. Normally we would expect to see a nice bounce up in January (reported February 2016) as the shelves get re-stocked. As noted above, these are items we can do without, if need be. To see strong product flow is a very good sign.

As noted above in Sign #4 (jobs creation) data is great and people are spending. This causes more hiring and spending, driving the economic spiral up, as measured in Sign #1 (Personal Consumption Expenditures). On that note, I will add that "on shoring" continues to create jobs, i.e. U.S. companies bring manufacturing back home to lower costs. Costs like cheap natural gas, gasoline and labor!

Manufacturing construction is up +40.5% in the last 12 months. This is solid, dependable job growth and should keep people spending on durable goods. Thus, Sign #5 remains positive.

6)	**Indicator:**	*S&P 500 Earnings per Share growth*
	Where to find it:	*www.standardandpoors.com*
	What to look for:	*Two quarters of S&P 500 earnings per-share growth, up being a positive trend and down being a negative trend*

(Positive)
2016 earnings per share for the S&P 500 are projected to be $127.11 by the research firm FactSet. The energy sector pulled the overall earnings down in 2015 and as that sector bottoms out, it should reduce or stop the pull down and perhaps even add to the positive side.

For 2016 overall, FactSet analysts are projecting an earnings increase of +7.4%. This suggests the current price reduction noted in Sign #1 above should be fairly short lived.

To peek around the corner and estimate what may be in store for Fair Market Value (FMV), let's plug the numbers into our rule of thumb, the Rule of 20.

To use the "Rule of 20" you subtract the inflation rate from 20. I will use the same inflation rate the BEA used in calculating the U.S. Gross Domestic Product in their "final" estimate released on December 27, 2015, which was +1.3%. The

result becomes your multiplier and is multiplied by the respective year's earnings per share to calculate the estimate of Fair Market Value.

- 2016 S&P 500 earnings estimate = $127.11
- $127.11 x 18.70 = 2,376.95 (FMV)

As of 1/11/2016 the S&P 500 trades at 1,923.67 (a 19.07% discount to FMV).

For a moment let's pretend we are still in 2015. S&P 500 earnings are expected to settle at $117.26. Let's run the "Rule of 20" for this too.

2015 S&P 500 earnings per share = $117.26
$117.26 x 18.70 = 2,192.76

As of 1/11/2016 the S&P 500 trades at 1,923.67, a 12.27 discount to FMV.

The 20-year average price to earnings on the S&P 500 is 16.70x.

2015 EPS = $117.26 x 16.70 = 1,958.24 (+1.80% premium to FMV)

2016 EPS (est.) = 127.11 x 16.70 = 2,122.73 (-10.35% discount to FMV)

Looking at 2016 we appear to be 10.35% below FMV even using the 20 year average price to earnings.

I would also add that low interest rates play into this valuation. When interest rates are low, there are fewer fixed income alternatives that are investment attractive.

Another rule of thumb to determine over or under valuation is to add the current price to earnings number (P/E) to the 90-day treasury yield. A number above 20-22 is overvalued with 20 or below undervalued. (Source: S&A Research)

Today the S&P is	1,923.67
divided by 2015 EPS	117.26
	16.40x
+ 90 day T-bill rate	.25
	16.65

An approximate FMV discount to the historical norm of 20.71%.

Valuations remain favorable based on 2015 actual earnings and more so based on 2016 earnings estimates.

As stated, these are "Rule of 20" estimates of Fair Market Value. No one knows the future and that is why prudent investors build a plan around this type of outlook. A plan that takes into account each person's constraints for time, risk and volatility.

Creating and implementing these plans happens to be our specialty. If you would like to have a discussion on how we could create a customized plan for you, just call me at 1-800-800-6364.

Sign #6 remains positive.

7)	**Indicator:**	*Inflation/deflation numbers*
	Where to find it:	*www.bls.gov/ppi/ or www.bls.gov/cpi/*
	What to look for:	*An interruption to the consistent but modest increase in the cost we all pay for goods and services*

Inflation and deflation make a big difference in our economy. As noted above, in Sign #6, low interest rates have a large impact on the valuations of companies as well as the cost of living at each of our households.

The inflation related to input costs, as measured by The Producer Price Index (PPI) is actually in the deflation area at a -1.1%. This would be a large concern if it weren't known that the cause is energy related. This should help keep costs down leaving each of us a few extra disposable dollars to spend elsewhere.

At the household level a normal measure of inflation is calculated via the Consumer Price Index (CPI). The CPI is annualizing at +.5%, which is quite low. Again, energy prices are having the effect of making the inflation very low, by historical comparisons.

Where inflation really has an effect is in calculating the growth of our economy, as measured by Gross Domestic Product (GDP), which is all the goods and services we produce and deliver. In the "final" estimate of GDP for 3Q2015 released on 12/22/2015 the growth rate was +2.0%.

The growth rate, as measured by GDP is inflation adjusted. To reach the +2% rate the Bureau of Economic Analysis (BEA) deflated the growth rate, i.e. used an inflation rate of 1.30%. Meanwhile over at another government agency, the Bureau of Labor Statistics (BLS) the inflation rate was calculated at a -.37%, i.e. deflation.

When the BEA used a higher inflation rate to calculate the growth of the economy it results in a lower growth rate. If instead the BEA used the BLS inflation rate, the U.S. 3Q 2015 GDP would have been +3.68% versus the reported +2%.

Pick whatever deflator you like, as both are from the same government and our economy is growing between +2% and +3.68%. My guess is that the actual growth rate of our economy is somewhere in the middle, likely closer to the rate of Personal Consumption Expenditures (PCE) noted above in Sign #1 at +2.51%.

Sign #7 will continue to indicate slow to low inflation as long as energy is dropping in cost, as energy is approximately 20% of the inflation rate calculation. It is likely we stay in this low inflation, slow growth, environment for most of 2016.

Sign #7 remains positive.

*The Rule of 20 is in this calculation implying, and using, a price/earnings ratio, which is the valuation ratio of a company's current share price compared to its per-share earnings. Thus, 18x the expected Earnings per Share. Both EPS and the multiple of 18 could drop. The earnings could be reduced due to the consumers spending less. The multiplier of 18 could drop to, say 8 for example, if investors were to get scared and become risk adverse. All of a sudden 8 x $117.26 turns the 2,192.76 2015 FMV into 938.08and even worse if earnings were to drop below the example of $117.26.00/share! This is the multiplier risk and earnings risk I personally worry about. It may never occur, but what an unfortunate event it would be if it did and we had not prepared for it as a possibility. Thus, I am glad we have!

The opinions voiced in this material are for general information only and are not intended to provide specific advice for every client.

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