The FAI
1Q 2015
Investment Outlook

Investment disciplines have a lot in common with weather forecasting. Both are a mixture of art and science. Both try to anticipate future developments completely beyond their control. And professionals in both fields are closely observed by millions of people who make plans based on their prognostications.

But somehow we humans tend to cope better with surprise storms than with investment disappointments! Maybe that's because we've learned to keep a spare umbrella in our cars and be sure our tires are good. Hmmm. It's probably a good idea to take analogous precautions in our portfolios. As a matter of fact, that pretty much describes our investment responsibilities at FAI… *to anticipate developments as well as possible but be sure our clients' portfolios can handle the unexpected.*

Many clients are avid consumers of data and opinions from Wall Street, Washington and foreign Capitals. Recent news flows are causing them some concern. So, beginning with this inaugural issue, we plan to provide periodic *Investment Outlook* reports to summarize our take on changes in the investment climate and how we are adapting your portfolio to the current realities… even as we make provisions for the unexpected.

Questions We're Hearing

Here are a dozen of the headline issues on our clients' minds as 2015 begins. • Is the sudden decline in the price of oil a blessing or a curse? • Can the U.S. prosper while Europe and Japan are struggling? • Can interest rates stay low when the Federal Reserve has created so much money out of thin air? • If rates rise, will stocks fall like they did when the Fed first hinted at an increase? • Is China really growing at 7%; and is their debt getting out of control?• Housing construction is a big employer. What's the outlook for single-family home starts? • Inflation is below the Fed's target… is that good or bad for stocks? Bonds? • Our Utility stocks had a great year in 2014… is that over? • U.S. Jobs have been growing nicely… but wages are sluggish. What are long-term consequences? • Does the strong U.S. Dollar mean we don't need gold anymore? • Why are stock valuations so high? • And the real biggie… what can-or-should investors do about the rise in terrorism and global conflicts?

Plenty of challenges

It is obvious from people's questions that there's plenty to worry about if you're so inclined; wars and rumors of wars, soaring government debts, stagnant wages, plunging commodity prices, weak consumer spending… a *shrinking* European economy, government defaults in South America, boomers are retiring while 30-somethings cannot afford houses, blah, blah, blah. Not to mention that both stock and bond valuations seem oblivious to the risks!

All these are real, and how they evolve will influence 2015's market developments. But, hey, it's not like these are brand new problems. Fortunately, nations, companies and financial markets, like individuals, have a survival instinct that eventually leads them to some way of coping with all the turmoil.

It's often messy and progress can be slow. But there will be corporate champions as well as casualties. In the 60 years since the end of WWII, the world has managed to work through some serious international stresses, businesses have produced amazing, life-changing technologies, and backward parts of the globe have earned the title of "Emerging Economies" by adopting aspects of free-market democracy. Oh, and stocks have rung up double digit annual returns!

The Debt Reality

Besides the problems of terrorism and international sword rattling, the one modern challenge most threatening to the global economy (and therefore to investment prospects) is the over-indebtedness of the whole world… governments, companies and individuals. So far, governments have kept papering over the problem with more debt. After 230 years, America's federal debt stood at $8.6 trillion in 2006. Then, in just the next 8 years the debt more than doubled to $17.8 trillion, while the economy that must support it grew only ¼ as fast!

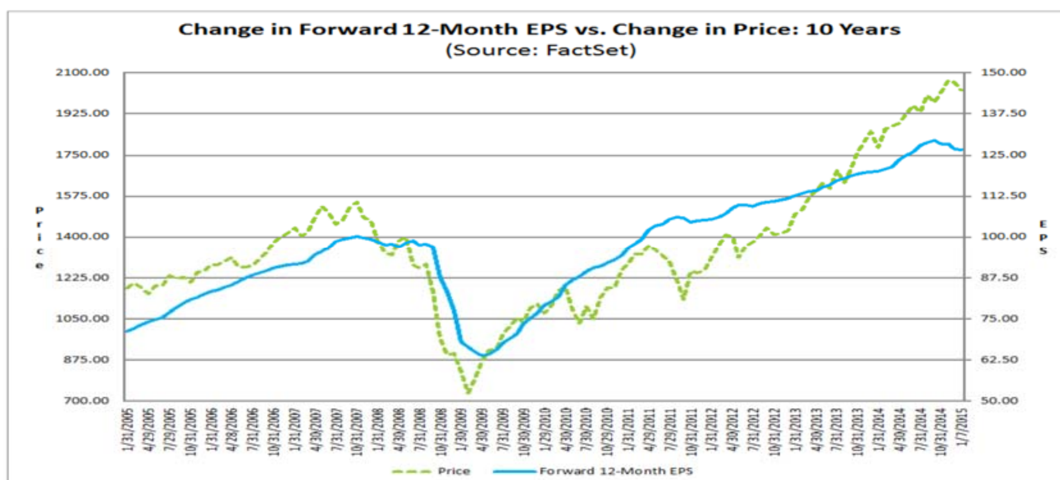
Compounding the problem is the unprecedented experimentation with loose-money policies by the world's central banks… literally creating money out of thin air in an attempt to make private borrowing cheaper and thereby raise spending. Lurking in the weeds is the risk that the world will lose the stability of having the Dollar as the one currency accepted everywhere… opening the Pandora's Box of beggar-thy-neighbor currency wars and economic chaos.

Ultimately, more debt cannot be the solution to a problem of too much debt! That's the bad news. The good news, if we can call it that, is that there is so far no indication that the debt has reached a crisis point. Can deficits and money printing go on another year, five years, or a generation? No one knows. We've not been here before! But if debt cannot be right-sized via government policy decisions, then it will eventually happen by a global financial crisis of epic proportions. Let's hope for sensible government policy… but be wary.

Pulling it all together

With these uncertainties in mind, here are the components of FAI's 2015 investment outlook:

- World governments will keep trying (with limited success) to stimulate economic activity with cheap credit; so, rising interest rates are low on our worry list.
- Inflation seems well-contained for the moment since capacity exceeds effective demand in most businesses. Our best estimate for CPI this year is a historically-low +1% or so.
- U.S. and global GDP growth will remain sluggish, with risks on the side of more disappointment. Our best guess for the U.S is +3% before inflation, +4% *nominal* growth.
- The key variable in global growth prospects is the U.S. consumer; we're watching U.S. jobs, wages and homebuilding. World Bank sees emerging economies growing about 4.5% real. We think that could be a bit optimistic unless U.S. real wages start to grow along with our GDP.
- Analysts' 2015 earnings estimate for the S&P 500 this year have slipped to only +6%. That could support a 6% gain in stock prices… if current rich valuations hold up. The following chart shows how much stock prices have outpaced earnings forecasts since the lows of 2009. Look a little bit like the '07 market peak?



- Stock exposure in our portfolios is hugging the midpoint of our equity-range discipline. But for the strong foreign demand for U.S. securities, we might be inclined to trim equity exposure a bit. We do expect opportunities to add to some favorite long-term stock holdings at lower prices during market corrections this year. That's the good side of volatility!

- Prospective returns on bonds… the traditional portfolio stabilizer… have been neutered by historically-low interest rates. The 5-year Treasury has a whopping 1.37% interest yield. While that's better than zero in a traditional money market fund, it is actually less than inflation! AND, when interest rates eventually rise, the market value will decline! A higher yield can be found in longer maturities (you get 1.8% on a 10-year, big deal!). Or you can take more credit risk… tricky territory this late in a debt-driven recovery. We lean toward munis and corporates.
- The U.S. Dollar has appreciated against a basket of other currencies all year, rising +8% vs the Euro and +14% vs the Yen! We currently expect further Dollar strength in 2015. Overseas investors who see a strong dollar may gladly choose to buy a 10-year U.S. Treasury (at 1.8%) rather than a 0.5% 10-yr German Bund, and collect a currency gain on top of the interest advantage. But a strong dollar would also penalize foreign earnings translations for U.S. multi-nationals and make foreign manufacturers more competitive here.
- Precious Metals: We agree with those who see gold as an "insurance policy" against the destruction of paper currencies by the governments that sponsor them. The world's transactions are denominated in Dollars, Yen, Euros etc. All are being seriously abused by their makers. Gold is the only "medium of exchange and store of value" that cannot be reproduced without cost! Over the last ten years gold has been very good to us. Bullion's dollar price fell by a third between 2012 and 2013, but it has stabilized the last 18 months. We tend to have a 5% gold position in most portfolios, but could go as high as 10% in some circumstances.

FAI Equity Strategies

In the long run, stocks will always be the highest-return asset class. The short-run is much less dependable! When economic growth is slow, currencies suspect, P/E's high and yields in the basement, long term investors need a fresh approach to stock selection. We want to draw your attention to the upcoming issue of **the Blue Sheets** which describe our five equity selection strategies designed specifically for these challenging times.

We hope you found this at least a little helpful. See you again in April 2015.

For the Investment Team,

J. Michael Martin

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