July 9, 2015

CAUTIOUS CONSUMERS

Dear Investor:

Since my last letter, stocks and bonds have both declined modestly. Investors have seen a lot of movement in the first half of 2015, but we have made little forward progress. There are several reasons for the current situation.

In the stock market we have a valuation issue. Speaking in general terms, the market is fully valued. According to JP Morgan Asset Management, the forward P/E ratio of the SP500 is 16.4. This is above the average of the last 25 years. What this means to us is that earnings need to advance meaningfully for stocks to advance. While it is possible that we could have more multiple expansion, I don't view this as desirable. It simply means that the big investors who drive the market are willing to pay more for the same expected stream of earnings. We prefer real growth over multiple expansion. Very high P/E ratios may signal a bubble. We don't want to go in that direction.

As I discussed last time, energy earnings are having a major impact on the rest of the SP500. In the first quarter of this year, the decline in energy earnings negated the gains in all other sectors of the SP500. All the other sectors were up, with the exception of materials, and showed a gain of 8.5% over the first quarter of 2014. This clearly shows us that the rest of the economy seems to be doing reasonably well. There's no way to know when things will improve in the oil patch. If sanctions are lifted in Iran over their nuclear program, they may put as much as another million barrels per day of oil on a market that already has too much supply. Boone Pickens disputes that number and says he believes it's much closer to 200,000 barrels a day. He also believes worldwide supply and demand will tighten the market soon and bring prices into the $70 a barrel range by the end of this year.

The bond market has been moving on interest rate expectations and overseas developments. In the US we are edging ever closer to the beginning of rate increases. This had led to some selling and slightly higher interest rates. Then, uncertainty over the situation in Greece and also the bursting of the Chinese stock market bubble, led to safe haven buying of US Treasuries. This has helped the investment grade bonds represented in the Barclay's US Agg Index to edge back into the black at this point in time. When things settle down overseas, the focus will return to Fed interest rate policy and the probability of an increase later this year. The safe haven money will likely move back out of bonds.

Consumer spending is 70% of GDP. One of the key ingredients for most companies to increase earnings is strong consumer spending. That hasn't happened in this recovery. The recovery has been characterized by slower spending, much less use of credit, and more savings. It's amazing to read that some economists don't understand this and find it puzzling. The crisis was caused by way too much easy credit, particularly in real estate. You may also remember that your dog could get a credit card if he wanted one. Low interest rates and the massive credit expansion caused the greatest crash we've seen

Lyndon Office Park|7000 East Genesee St. Bldg D| Fayetteville, NY 13066-1139
315-701-5750|Fax 315-701-5751|dkeim@keimassetmanagement.com
www.keimassetmanagement.com
Securities and Advisory services offered through Commonwealth Financial Network, Member FINRA/SIPC, a Registered Investment Adviser.

since the great depression. Unemployment shot up to 10% plus, and the U6 real unemployment rate was much higher. Turns out, consumers are real people and this scared them. No one likes to lose money or their job. Since then, many people have worked hard to reduce their debts and save more money. Naturally, this has to include less spending. Although measures of consumer confidence are high, most people are being a lot more careful with their money. This makes obvious sense after everything that has happened. The good news is that unemployment has come down a lot, and this has put more "wallets" back into the economy. Most businesses are doing reasonably well. If you look at the last six years, I think you can see the recovery has been slow and steady. This reflects the caution of real people who realize that the basic laws of economics and spending sensibly were never suspended.

There's a range of forecasts for the second quarter GDP, as there always is. The Federal Reserve Bank of Atlanta is currently at 2.3%, and I'm comfortable with that. Most of the private economists are somewhat higher. The important point is that we are recovering from the terrible first quarter caused by the winter weather, as we did last year. If things stay on track, most market participants are expecting the second half of the year to be stronger. Hopefully, earnings will be able to increase enough to overcome the problems in the energy sector, and the market will be able to advance again.

Please feel free to contact me anytime to discuss your portfolio.

Best Regards,

David Keim

DEK/jg

Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. All indices are unmanaged and are not available for direct investment by the public. Past performance is not indicative of future results.

Lyndon Office Park|7000 East Genesee St. Bldg D| Fayetteville, NY 13066-1139
315-701-5750|Fax 315-701-5751|dkeim@keimassetmanagement.com
www.keimassetmanagement.com
Securities and Advisory services offered through Commonwealth Financial Network, Member FINRA/SIPC, a Registered Investment Adviser.