DIVIDEND ASSETS CAPITAL, LLC

DIVIDEND ASSETS CAPITAL – INVESTMENT STRATEGIES FOR RISING INCOME & GROWTH

QUARTERLY COMMENTARY — Q2

NEWSLETTER — **JULY 10, 2015**

HALF FULL OR HALF EMPTY

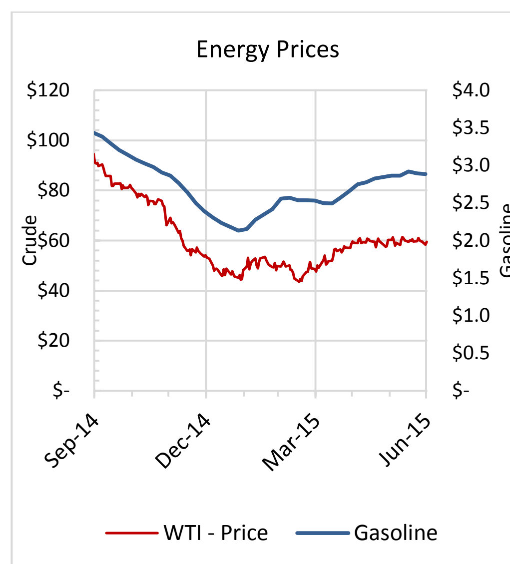
Now that the year is half over, an appropriate question to ask would be, “Is the glass half full or half empty?” As equity investors, we might logically look at the S&P 500 Index as a proxy for the performance. On that basis, the Index is up 1.23% total return for the first half of the year and up 0.28% for the second period. Positive numbers are better than negative, of course, but neither number suggests a robust investment climate. As we progress through our commentary for the quarter, we will make the case for the economy to be back-end loaded with the expectation that the full year total return for the S&P 500 will be in the 6% to 8% range as the economy recovers from a slow start. That is certainly better than inflation and better than the ten-year US Treasury, but less than recent years.

While the Federal Open Market Committee (FOMC) may not be right all the time, they do have considerable influence on the direction of the economy, so paying attention to their policy guidance is useful. The press release of their June meeting suggests there is uncertainty as the words *moderately*, *somewhat*, *gradually*, and *reasonably* were used to describe the progress of the economy. The FOMC has a policy mandate to maximize employment while holding inflation to a manageable level. The economic indicators that the Fed watches most closely are unemployment and inflation. Both have made progress in returning the economy to fuller use of assets but at an uneven pace. Investors have concerns about when the Fed will begin to raise interest rates and the pace of the increase. Since the recession of 2008-2009, the economy has been pushed along by low interest rates. Our expectation is that economic growth will be strong enough to absorb the higher costs of capital that rising interest rates would impose.

The voting members of the FOMC believe that the rate of economic growth, as measured by Gross Domestic Product (GDP), will be in the range of 1.8% to 2.0% for 2015 and 2.4% to 2.7% for 2016. This is a slower rate of growth than prior recoveries and therefore continues to need stimulus in the form of low interest rates. The unemployment rate expectations for the Fed are 5.2% to 5.3% for 2015 and 4.9% to 5.1% for 2016. The rate of growth of wages continues to be low, which in turn has pressured consumer spending and remains a concern. These two economic measures and the recent FOMC press release suggest that the Fed will be careful about when and how much it will raise interest rates.

This gradualist approach, we believe, will help to keep the equity markets on reasonable footings.

The *Energy Prices* graph (below) shows the sharp decline in crude oil prices and effect on gasoline prices. The red line shows the price of a barrel of West Texas Intermediate (WTI) crude from the end of September 2014 to the end of June 2015. As the second quarter 2015 progressed, the magnitude of price changes has diminished as the crude price leveled out in the $60 range. This is well below the high $90s we saw in early October and well up from the low $40s reached in early December. Lower prices for crude have caused producers to reduce their drilling activity, thereby gradually reducing supply. Over time, this will bring supply and demand into closer balance. The lower prices have enabled gasoline prices to be reduced, which in turn have helped energy consumers and stimulated demand.



Source: Bloomberg

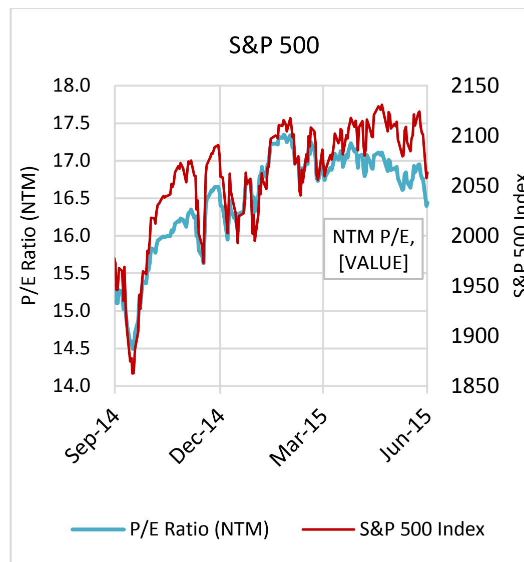
Inflation has been held in check at least in some part by the decline in the cost of gasoline. The May release of the Consumer Price Index (CPI) shows interesting contrasts. The headline number for May had the index increasing 0.4% month over month, up from 0.1% for April. The core CPI number for May was only 0.1%, which excludes energy and food. Food was flat month-over-month but total energy prices increased 4.3% and

gasoline increased 10.4%. Gasoline prices year-over-year are down 25.0%. As the Energy Prices chart shows, the steep decline in gasoline prices will run its course and is likely to be a significant factor in putting upward pressure on inflation as we progress through the fall and winter. With the Fed watching this progression they will have more reasons to want to begin increasing interest rates. On the other hand, the Greek financial crisis and the modest growth of GDP in the Eurozone put some pressure on the Fed to overstimulate the domestic economy. It is a delicate balancing act.

We have exposure in many portfolios to companies and energy Master Limited Partnerships (MLPs). Insofar as MLPs are concerned, there is little exposure to commodity price risk. The partnerships collect fees for the transport, storage and in some cases the processing of the commodity being shipped. Investors, however, have been more negative than we believe is warranted given the fundamental stability of midstream business models.

The June non-farm payroll numbers reported by the Bureau of Labor Statistics showed an addition of 223,000 workers to the workforce. While this was down from the May increase of 254,000, it was enough to reduce the unemployment rate to 5.3%, a new low for this recovery cycle. There is some concern that average hourly earnings did not increase from May and wages are only 2% over the year. This level of employment increase should not cause any consternation at the Fed or the equity markets.

We are of the opinion that the economy and the equity market will have noticeable improvements in the second half of the year. There are numerous global issues that may cause momentary upsets, but the efforts of central banks around the world to stimulate their economies appear to be working. The *S&P 500* graph (right) shows the price progress of the index on the red line and the blue line shows the Price/Earnings ratio of the index with the earnings being the consensus estimate for the next twelve months. While 15.61 times is above where the index was at the start of the recovery, we believe that it is not stretched at this point, particularly with economic growth projected to be back-end loaded for 2015.



Source: Bloomberg

On an organizational note, DAC welcomes Deborah A. Lamb, CSCP, and Hayes C. Lanford to the family. Deborah joined us in early May as Chief Compliance Officer with more than 25 years of industry experience with both institutional and individual investment advisers. Hayes joined us in mid-June as Portfolio & Systems Analyst having recently graduated from Wofford College with a BS in Mathematics and a minor in Economics.

As always, we appreciate the opportunity to be of service to you. Please let your portfolio manager know if you have any special concerns. If there are changes in your financial situation that affect your investment objectives, please let us know.

Have a great summer!

Additional Sources: Bloomberg, Federal Reserve, EIA, Briefing.com

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