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Memorandum

To: Clients, Friends, Family & Associates of ProActive Advisory
From: Mark Wyssbrod, Managing Member
Date: January 27, 2015
Re: 2015 predictions and interest rates effect everything!

In this memorandum you will receive information about the following:

- 2014 in hindsight
- 2015 predictions
- Review of 2014 predictions
- Higher interest rates effects everything!

Please contact me should you have any questions. Look for new opportunities in the New Year!

2014 in hindsight

2014 was a better year than most expected. Business owners will take their rebounding optimism and expectations into 2015. Confidence has already returned to many sectors of the economy. One of these sectors with increased confidence is residential construction. Last year my interactions with home builders and their representative lead me to believe there is no more negotiations. In fact, many came off very arrogant! You may try to negotiate with a home build for a new house or a seller of an existing one, but the response will most likely be a standardize price sheet or see the listing price.

There is a lot of debate about the timing of interest rates increasing. Haven't we heard this one before? The Fed threatens to raise interest rates for the past 18 months; the market responds; then interest rates stay the same or move lower! What is keeping interest rates from moving up? I believe it is more complex than I can represent. However, I have showed some of the effects of rising interest rates below and potential offsets to cure the negative effects.

The low interest rates have allowed companies to cheaply increase supply. However, supply wasn't the problem; demand was! Demand is still not showing up in the market place. Lack of demand indicators are all around us: low interest rates, a glut of oil reducing oil prices, lower home prices (compared to inflation) and lower consumer prices.

Cutting to the chase, my 2015 predictions are below (including my reasons):

- Oil prices to remain below $60 per barrel. Increase in volatility in pricing; potentially showing super spikes to the low 30s and perhaps (very low probability) up to the upper $70s within 12 months of reaching a low
    - The world is supplied in oil! There are 4 countries which describe themselves as the Saudi Arabia of oil: Saudi Arabia, the United States of America, Russia and Venezuela.
    - This list doesn't include major oil finds which have not been widely circulated such as the Bahamas.
- Interest rate will remain low for longer than most believe
    - See below for reasons
- Unemployment stabilizes and stays in a 5 – 6% range for the U-3
    - The U-6 will stay above 11% and continue its divergence from January 2014
    - Jobs available will be low skilled service jobs resulting in low wages
    - Higher skilled jobs will be in demand and have an unemployment of under 3%
        - This individuals will also receive signing bonuses and raises
- The economic growth will stabilize around 3%
    - Most likely economic growth will be under 3%, however any growth is good growth right?
        - Be careful for what you wish for! The jobs being created are not the jobs you would want per se; the jobs in high demand require decades of experience, which the economy is not producing the experience or leadership it will require during the next decade. We may be importing experienced leaders from overseas
- The stock market will be more volatile than the economy
    - The Dow Industrial moved from over 18,000 to about 17,000 back to 18,000 from last week in December 22, 2014 to January 9, 2015 (and once since then)
- Lack of demand will continue to be the problem, a continued increase in supply will pressure prices down
    - We have built out supply capabilities, but haven't increased demand
        - If anything, we are fighting falling prices, deflation, which postpones demand (consumers wait for lower prices)

<u>2014 Predictions: How did we do?</u>

- Removal of GA 400 tollbooths will be replaced my multiple tolls on GA 400
    - There is talk of added a toll lane, but no new toll at this time
- The 2014 will stabilize and provide opportunity to those who seek it
    - Correct call!
- Oil will drop below $80 per barrel
    - This was a gusher of a correct call!
- Business owners will continue to select low bid

    - From my observation this was correct!
- The Fed continues with quantitative easing for the next decade
    - Too soon to tell! The Fed stopped purchasing bonds, but has kept interest rates lower for longer than they have communicated even
- Interest rates remain low
    - Got it!
- Inflation will begin to statistically show up between 2016 and 2018
    - Too soon to tell! If the Fed wants to increase inflation to 2% they will need to do something to help this one!

<u>Higher interest rates:</u>

- Increase the value of the U.S. dollar
    - Increase value of U.S. dollar allows us to purchase items from other countries at lower prices
        - U.S. consumers purchase more from overseas and less from the U.S. because it is lower in price
            - The U.S. ends up owing other countries money due to our trading deficit (i.e. we are buying more from them than they are buying from us)
    - Increase value of the U.S. dollar makes U.S. products more expensive to other countries
        - U.S. companies have to sell at lower prices reducing their profitability or lose to foreign competitors
        - U.S. companies face pricing pressure in the U.S. from foreign competition since their products costs less to import (see above)
            - Other countries are reducing interest rates resulting in the U.S. dollar strengthening
            - Other countries are effectively exporting lower prices (deflation) to the U.S. (i.e. we are importing deflation)
    - Foreign investor send monies to U.S. due to the higher interest rates and better return on investments
        - Resulting in the U.S. getting more foreign investors who profit off of U.S. companies and U.S. ends up purchasing more overseas items which increases the U.S. debts to foreigners
- Reduce the purchasing power for home buyers
    - For example to purchase a $200,000 house using a 30 year mortgage
        - 1/9/2015 rate is 3.92% per Yahoo!Finance
            - The monthly payment is $945.63
        - At 4.5% the monthly payment is $1,013.37
        - At 5% (a prediction by Forbes Magazine) the monthly payment is $1,073.64

- This payment is $128.01 higher; a 13.5% increase
  - To afford this difference (without considering income tax effect, etc.) a household of $50,000 would require a 3.4% raise (including Social Security and Medicare)
    - I have not seen the average worker have significant compensation power, so I deem this unlike they can afford higher interest rates
- At 5.4% (a prediction by The Street) the monthly payment is $1,123.06
  - This payment is $177.43 higher; a 18.8% increase
    - To afford this difference (without considering income tax effect, etc.) a household of $50,000 would require a 4.6% raise (including Social Security and Medicare)
- Assuming the average person cannot afford a higher mortgage payment, let's look at this example in reverse
  - A monthly payment of $945.63 at a 5% mortgage allows the purchaser to qualify for a $176,153.49 home
    - This is a $23,846.51 reduction!
      - A 11.9% decline in purchasing power
  - A monthly payment of $945.63 at 5.4% mortgage allows the purchaser to qualify for a $168,402.16
    - This is a $31,597.84
      - A 15.8% decline in purchasing power
- This example does not include the reality of increases insurance costs and real estate taxes over the long-term of home ownership
- Conclusion:
  - Home prices will be ranged bound for the next several years, especially compared to inflation and as interest rates rise. To have increasing home valuations in an era of increasing interest rates compensation will have to increase at a faster pace than the increase of mortgage cost

- Market valuations
  - The economy should be stable and expanding; however the S&P is valued at a Price to Earnings (P/E) of 19.83 (1/9/2015 per http://www.multpl.com/)
    - The average or mean is 15.53
      - Why is there a 4.3 higher P/E valuation (a 27.7% premium) on today's average P/E than the average?
        - Theories include:
          - Lower interest rates lead to P/E expansions
          - Increase in earnings growth expand P/E ratios
  - Higher interest rates in the market
    - Bond market

        - Higher interest rate reduce the value of bonds which have been issued at lower prices
            - This creates a bear market for bonds
        - zzHigher interest rates increase interest expense for borrowers
        - Higher interest rates increase interest income for lenders
    - Stock market
        - Higher interest rates reduce the P/E aforementioned low rate expansion of the P/E
        - Higher interest rates increase interest expense, lowering earnings
        - Higher interest rates increase the value of the U.S. dollar which reduce the value of the overseas earning
- Demographic influence the markets as well
    - How Markets Could Doom The Bull Market is an interesting read
        - Demographics can strongly influence the market
        - As aging baby boomers transfer monies from more risky stocks to less risky bonds may impact valuations by more selling than purchasing
    - Conclusion
        - Increases in interest rates will have to be offset by significant earnings surprises in order to maintain the same market valuation

I hope this information enlightens your 2015!