OPTIVEST
WEALTH MANAGEMENT

Turning Success into Peace of Mind.

FOURTH QUARTER 2014

October 28, 2014

To Our Investors:

By: Mark Van Mourick, CEO
Leslie Calhoun, COO

US Economy

With residential home prices at multi-year highs and the US stock market near all-time highs, you would think that inflation has picked up. However, it has not. A stronger dollar, lower energy costs, weak wage growth and 1% - 2% inflation worldwide has led to a stubbornly low 1.7% - 1.9% US inflation. Our dollar has strengthened despite our low interest rates (US 10-Year Bond yield is < 2.4%) because our interest rates are higher than in Europe and Asia and the US is a better credit risk. The Fed's tapering of its bond buying program will end next month with very little of the "taper tantrum" that was feared.

Weak Wages

It is good that we have weak inflation because since the 2008 Recession (adjusted for inflation), median household incomes have fallen by 2.9% and are now 9% lower than in 1999 – about even with 1989 (Wall Street Journal). Minorities and unmarried men suffered the worst, and the decline has also been felt across every education bracket. With this in mind, it is clear why the White House's solution is to raise the minimum wage by 40% to $10.10.

However, it is not that easy. Only 15% of minimum wage earners are household breadwinners, a mere 0.3% of the total workforce (Andy Puzder, CEO of CKE Restaurants). The rest are under 24 years old and/or entry level jobs. The Congressional budget office has warned this could lead to a loss of 500,000 jobs; a high minimum wage will simply accelerate the replacement of workers by machines (example: gas station attendants).

Strong Dollar & Interest Rates

Fortunately, our currency is strong for several reasons: 1) the US and other foreign central banks and sovereign wealth funds are long-term buyers and holders of about 50% of our Treasury debt; 2) our fiscal deficit has been shrinking so we are issuing fewer bonds; 3) we are in a technical multi-year Dollar bull market; 4) inflation is weak here, but in comparison Europe and Japan are bordering on deflation with interest rates 50% - 75% lower than ours; 5) global growth is weakening just as the US is starting to strengthen; 6) the US is seen as a safe place during Middle-Eastern unrest.

The stronger dollar helps keep commodity prices down and import goods become cheaper (it does make our exports more expensive, however). This strong dollar, low nominal inflation, weak organic wage pressure and the labor participation rate at a new 36-year low of only 62.7% will allow the Fed to delay raising short-term interest rates until next summer, and then raise the rates more slowly than in past recoveries. While very short and long-term rates look to remain low, technical factors lead us to believe that 1 - 3-year short/mid-term bond yields might rise, hurting prices on those bonds.

US Stock Markets

While the S&P 500 advanced a modest 1.1% in Q3, the average US diversified stock fund fell 2.9% in the 3rd quarter of 2014. Further, international funds fell 5.7% and are now down 1.8% for 2014 (Lipper). In our mid-quarter stock market update on August 1, 2014, we explained that the equity markets are due for a 10%+ correction and that in the August – October timeframe it may happen. The good news is that we see no US recession on the horizon and believe that a short stock market pull back would be a healthy step on the way to higher prices by next year. We have had an economy that has felt shaky and a stock market that has improved quickly; that trend may reverse in the quarter ahead.

Portfolio Management by Leslie Calhoun

Since July, we’ve seen increased volatility and this has caused us to get stopped out of some of our high yield bond funds late in July and our gold miners’ index in early September. Fortunately, we sold before both continued downward. The recent market volatility is not completely unexpected. This year started with negative GDP in Q114 and then we saw a large quarter over quarter rebound in Q2 of +6.7%, the sharpest rebound since Q282. These types of swings tend to create a lot of headlines and a lot of reactions. Consumer confidence quickly rose, ISM manufacturing remains in expansionary territory, unemployment showed significant improvement and the divergence between the US recovery and Europe’s recovery became more apparent. Whether Europe moves further into “à l'Américaine” QE program probably lies in the success of our Fed to balance letting rates rise without stagnating our recovery. We are under the microscope, so to speak.

Our move to be less reliant on US Equity performance earlier in the year has helped our portfolios as we see risk and volatility being balanced well with fixed income exposure in US and foreign currency bonds, alternative and inflation sensitive allocations pulling their weight while the S&P has returned only 1.1% in Q314.

Year-to-date, on the fixed income end of portfolios, we've moved upstream for lower default risk by blending in high-yield municipal short duration debt, taking some exposure out of taxable high-yield. Our inflation sensitive sectors have seen mixed returns with straight commodity exposure down as a result of struggling world growth and rising US dollar while REITs and MLPs that are more confined to within the US have seen better performance. Tactical allocations are doing their job of providing return while protecting capital, being our third best performer year-to-date.

Mortgage Credit too Tight?

As reported by the LA Times this month, former Federal Reserve Chairman Ben Bernanke told the audience at a Chicago conference that, "I recently tried to refinance my mortgage and was unsuccessful in doing so". The audience laughed and he said, "I'm not making that up". Ouch… I guess lending is still very tight.

Summary

The year is unfolding close to our beginning of the year forecast - weak stock advances coupled with mid-single digit returns from a broadly diversified portfolio. Our cautiousness against higher interest rates has so far been unwarranted, but we locked in gains in gold and high-yield bonds before the declines. While we operate in this low-return environment, we will strive for capital preservation over chasing risky returns.

Until next time,

Mark Van Mourick

Leslie Calhoun

Optivest Inc. | 24901 Dana Point Harbor Drive, Suite 230 | Dana Point, CA 92629 | 949-363-8686 | www.optivestinc.com