Capital & Security Management, Inc.

34 West Miner Street
West Chester, PA 19382
Telephone: 610-692-4794
Fax: 610-692-0118

INVESTMENT COMMENTARY

January 2015

The Stock Market

Despite the initial selloff in early January, as investors have temporarily emphasized the negatives of lower energy costs versus the long-term benefits, we expect 2015 to be a very rewarding year for investors. Although the bull market is now entering its seventh year and by some measurements is becoming *long in the tooth*, we believe we are still in the middle of a longer-term secular bull market rather than in the final stages of a cyclical bull market. Some of the reasons are as follows:

A) Economic growth since the Great Recession ended has been erratic and anemic, dependent upon massive monetary stimulation better known as quantitative easing. Our analysis indicates the economy is on the brink of *"lift-off"* ... i.e. entering "escape velocity," which should be the beginning of a self-sustaining economic advance. Last year witnessed job growth of over 200,000 a month. Job creation could accelerate in 2015 fueling higher household income, higher consumer spending, generate growing corporate sales, revenues, and profits, which in turn will stimulate job creation and faster wage growth.

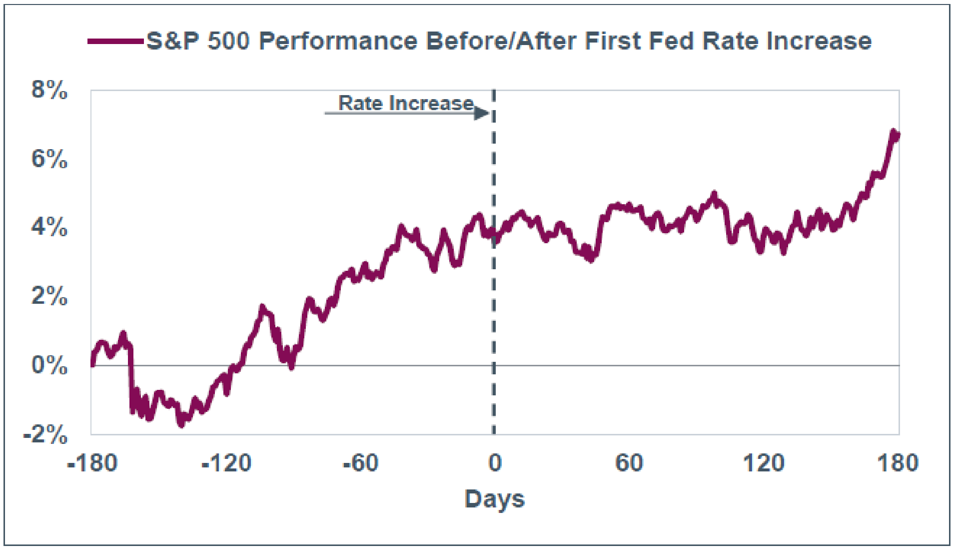
Closer to "escape velocity" than recession

Indicator	"Escape Velocity" level	Key recession level	Current level
NDR Recession Probability Model	5	50	0.4
Breadth of Philly Fed State Leading Indexes	95	52	92
NDR Economic Timing Model	17	0	19
NDR Composite Leading Model	3.4%	-2.6%	2.9%
National Financial Conditions Index	-0.7	0.9	-0.9
Initial unemployment claims	350,000	500,000	294,000
Conference Board's Consumer Confidence Index	98.2	63.2	88.7
Conference Board's Business Confidence Index	61	43	59
ISM Manufacturing Index	55.0	48.0	59.0
ISM Non-Manufacturing Index	55.2	51.4	57.1

Escape velocity refers to economic growth returning to potential after a recession, and activity is self-sustaining, i.e., it no longer needs the support of fiscal/monetary accommodation

B) Since the economic patient will soon be off monetary life-support (the last quantitative easing finally "tapered off" last Fall) the Federal Reserve Board will begin increasing interest rates in the expectation of stronger economic data later this year. Our best guess at this point is around midyear, but the recent reporting of lower inflation due to falling energy prices and weaker wage growth in December payroll report, may postpone this decision. Indeed, some economists predict that there will be no increase this year. In any event, historically, the time-period six months prior to the Fed's first interest rate increase and six months afterward have been rewarding.

Stocks tend to rally into/after initial rate hike

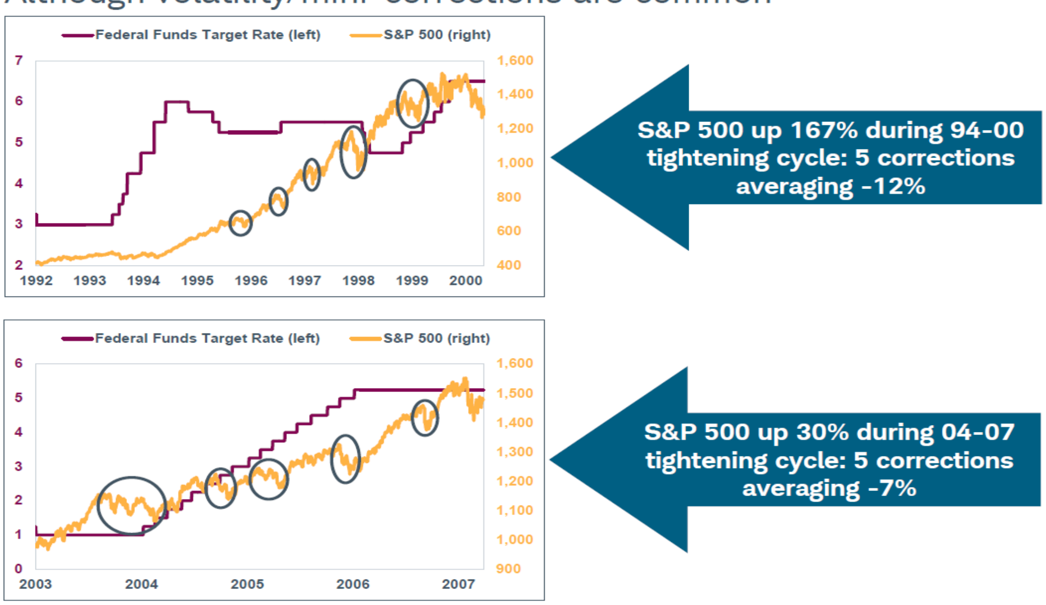


Source: Birinyi Associates, Inc.

C) The next chart is a repeat from the last quarterly commentary, which summarizes that rate increases can create higher volatility and short-term corrections while the stock market can continue its bull market advance for several years.

Fed tightenings not necessarily bad for stocks

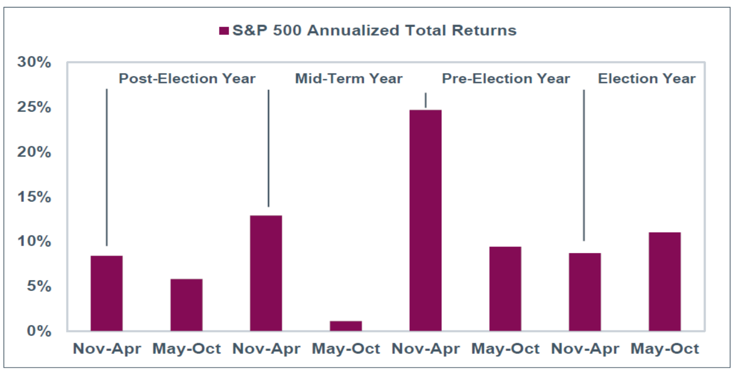
Although volatility/mini-corrections are common



Top chart as of 9/30/92-1/2/01. Bottom chart as of 6/24/03-9/17/07. Source: FactSet, Federal Reserve, ISI Group LLC.

D) While seasonal and historical tendencies are not as important in determining the direction and performance of the stock market, the prospect for improving growth in the underlying economy particularly now that lower energy costs will act as a stimulative tax break to the consumer, increases the possibility that 2015 could provide a very pleasant surprise. As stated in our cover letter, the third year of the four-year presidential cycle is usually the best, averaging 13.4%. The years ending in five have been very lucky indeed, averaging over 32%! Additionally, the consequence of the November election also bodes well as the combination of a Republican Congress and Democratic president suggest nearly 10% historical returns. Please refer to the following four charts:

Now in favorable seasonal/election cycle phase



Presidential cycle points to further strength

Period after mid-term elections (since 1942)	S&P 500 average price return	% positive
3 months later	8.5%	94
6 months later	15.0%	94
12 months later	15.6%	100
Presidential term (since 1928)	**S&P 500 average price return**	**% positive**
1st year	5.2%	55
2nd year	4.5%	62
3rd year	13.4%	86
4th year	5.5%	76

"5" has been the market's lucky number

Year	S&P 500 price change
1905*	38%
1915*	82%
1925*	30%
1935	41%
1945	31%
1955	26%
1965	9%
1975	32%
1985	26%
1995	34%
2005	3%
Average	32%
Median	31%

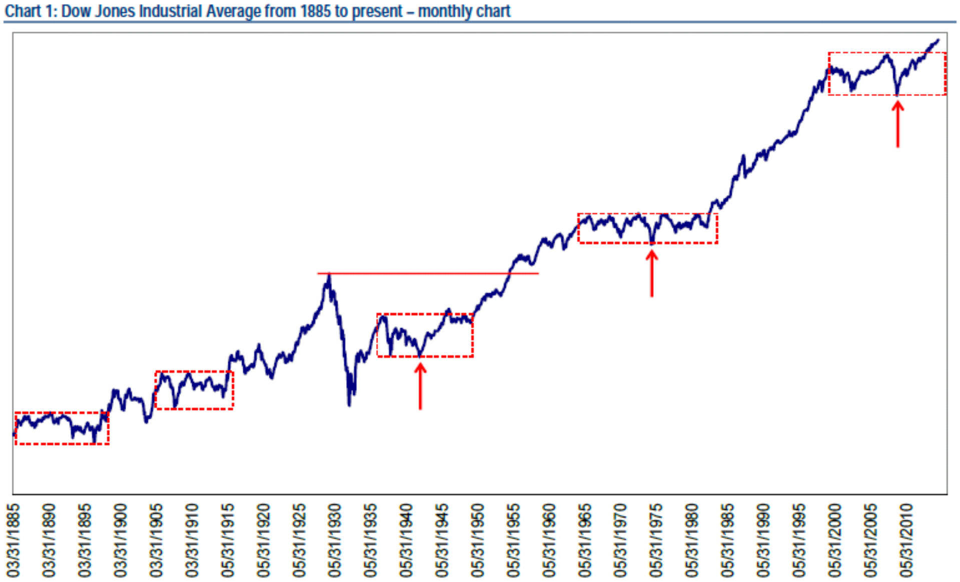
Market loves the current make-up of DC

Political power lies with:	DJIA gain/annum (since 1901)	% of time
Democratic president	8.0%	47.2
Republican president	3.0%	52.8
Democratic congress	5.5%	54.4
Republican congress	7.8%	31.7
Congress split	-0.6%	14.0
Democratic president/democratic congress	7.3%	35.0
Democratic president/congress split	11.2%	3.4
Democratic president/republican congress	9.6%	8.8
Republican president/republican congress	7.0%	22.9
Republican president/congress split	-4.2%	10.6
Republican president/democratic congress	2.2%	19.3

We are sure that we all would be happy with the 9.6% performance based on previous political Presidential and Congress relationship for the seventh year of this bull market, but don't count out the higher rewarding historical patterns.

HOW MUCH FURTHER CAN THIS BULL MARKET RUN?

Chart 1: Dow Jones Industrial Average from 1885 to present – monthly chart



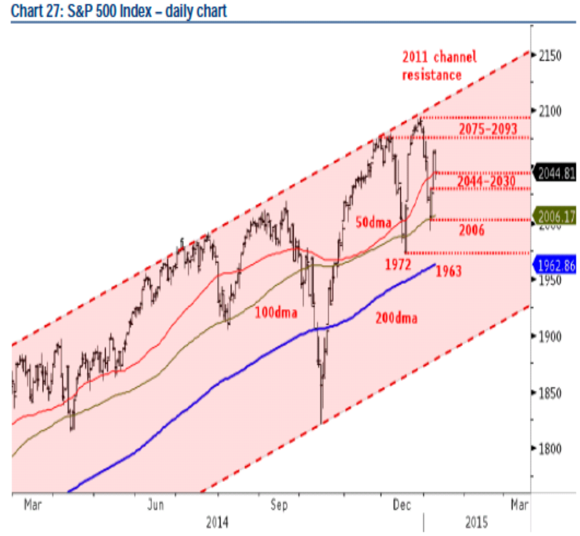
Source: BofA Merrill Lynch Global Research, Global Financial Data

"We believe the S&P 500 entered a new secular bull market on the April 2013 breakout above 1775. The average intra year pullback for the secular bull market years spanning 1950-1965 and 1980-1999 is only 11.5% ---still more than investors have seen over the last couple of years." (*Merrill Lynch Technical Analysis Source*) ***We agree with this conclusion***.

Chart 26: S&P 500 Index – weekly candle chart

Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 27: S&P 500 Index – daily chart



Source: BofA Merrill Lynch Global Research, Bloomberg

Within the context of this rising channel over the last several years, as shown in the chart on the left, and increasing market volatility, we could expect a pull back to the lower support level of 1900 to 1925 or around 10%. The early January weakness in stock prices may be pushing the market lower to that range now, but we feel it is likely that over the next six to nine months the S&P 500 will be at the top end of that channel once again between 2150 and 2250. Please note the chart above on the right. At that point, investor sentiment could become overly optimistic again, valuations more extended and suggest a more defensive portfolio posture would be warranted once more.

"*IT AIN'T OVER UNTIL THE FAT LADY SING*S"

In our previous commentary, we used the following graph to demonstrate the relationship between the inverted yield and recession (*Bear Market*). Forecasts may be frequently wrong, but most long-term economic predictions do not have short-term interest rates higher than long-term interest rates (*Inversion)*) for many years. This prediction reinforces the likelihood that a recession and bear market is still several years down the road. Also, the slow pace of economic growth during this business cycle extends the time-period before excesses and imbalances cause the Federal Reserve Board to adopt a more restrictive monetary policy and an interest rate inversion.

1 Yield Curve Inversions Mark Stock Market Peaks

Source: LPL Financial Research, Bloomberg data 05/12/14

Red bars indicate when yield curve began to invert.

Shaded areas indicate recession.

Past performance is no guarantee of future results.

Lastly, our investment strategy over this time-period embraces the probability shown in previous charts that demonstrated historical corrections within the context of a secular bull market would be in the 7% to 12% range. We anticipate periodically becoming more defensive to protect principal, reducing equity exposure during periods of overvaluation and reinvesting during weakness when stocks appear more attractively valued. These modest asset allocation shifts from time to time should enhance our long-term performance. So, buckle up, but stay optimistic. This will be a challenging, but rewarding year.