Capital & Security Management, Inc.

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

April, 2015

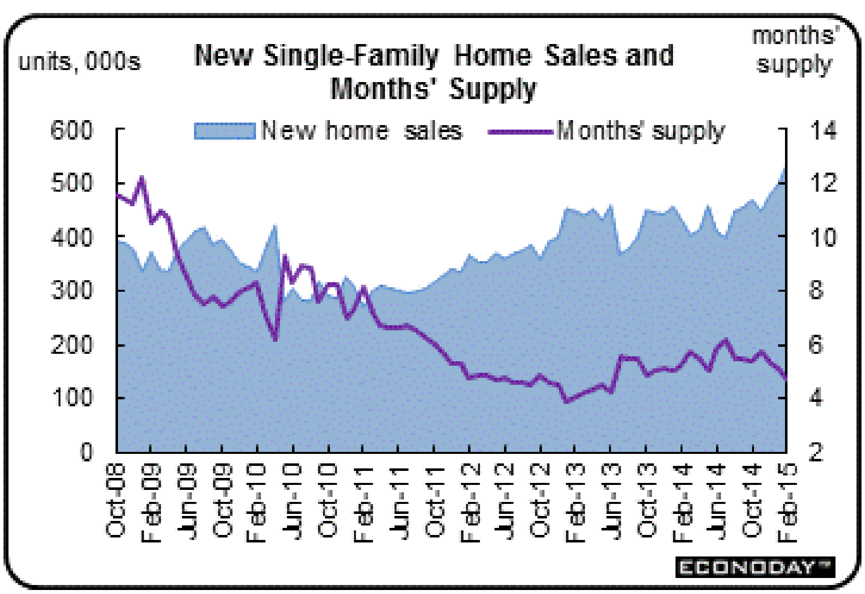
INVESTMENT COMMENTARY

THE ECONOMY

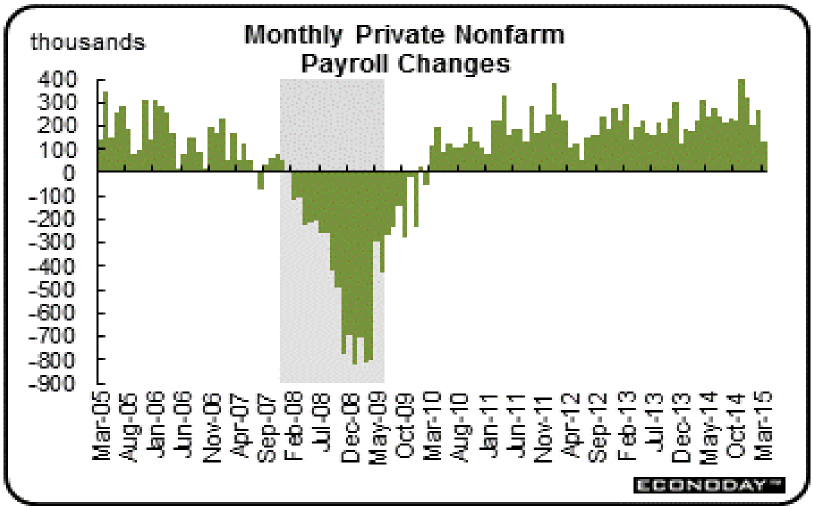
Similar to the first quarter of 2014, severe weather has negatively impacted overall economic growth. Last year, the Polar Vortex hobbled retail sales and this year "Canadian Clippers" frequently dumped heavy snow across the most populous parts of the country. Consequently, consumer spending rose only 0.1% in February as harsh weather kept us bundled up indoors. The surging dollar has negatively impacted US exports as our products have become much more expensive causing manufacturing to fall five months in a row, to the lowest level since 2013. As a result, the first quarter Gross Domestic Product growth estimates have been slashed from 3.2% to 1%. On a brighter note, pending home sales are stronger and new home sales also picked up sharply in February with the first two back-to-back monthly sales higher than 500,000 since April and May 2008. Additionally, consumer confidence jumped up in March, near its 7-1/2 year high recorded in January. Despite the disappointing March new jobs of 126,000, due to the inclement weather impact on construction and manufacturing, monthly job creation has averaged nearly 200,000 for the last three months. We are optimistic that the negatives cited above will be like the weather and prove transitory. As the warmer spring weather returns, economic indicators should snapback strongly similar to last year when second quarter GDP growth was 5%.

New home sales jump in February

"In a positive jolt out of the housing sector, new home sales picked up sharply in February to a 539,000 annual rate. Adding to the good news was a big upward revision to January, to 500,000 from 481,000. These are the first two 500,000 readings going all the way back to April and May of 2008." (*Econoday*)



Employment disappoints



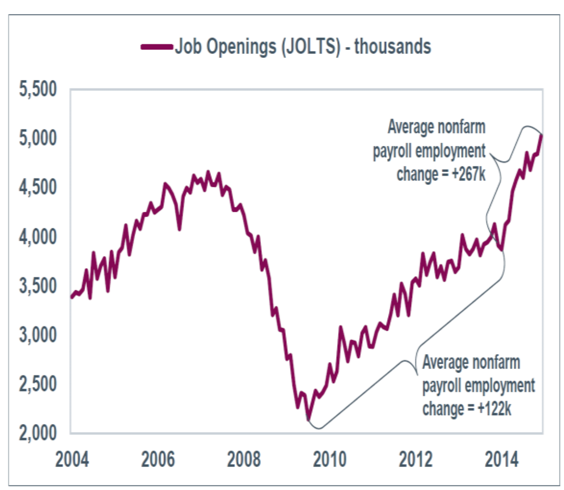
"Until the March report, the past few monthly employment reports indicated that the economy was performing better than suggested by other economic indicators. Turns out that not only was March weak with a nonfarm payroll gain of only 126,000 but January's advance was revised down by 38,000 to 201,000 and February's was lowered by 31,000 to 264,000.

Bad weather seems to have had some impact on depressing employment during the first three months of the year. But so did the strong dollar, weak oil prices, and slow economic activity abroad. The dollar may be starting to stabilize, and the price of oil may be bottoming. Economic activity seems to be improving in the Eurozone.

In any event, I expect that April's employment report should show a spring rebound. If so, then the Fed would remain on course for one-and-done for this year, if not in June then in September." (*The above excerpts from Dr. Edward Yardeni - Ed's Blog.)*

JOBS AND WAGES

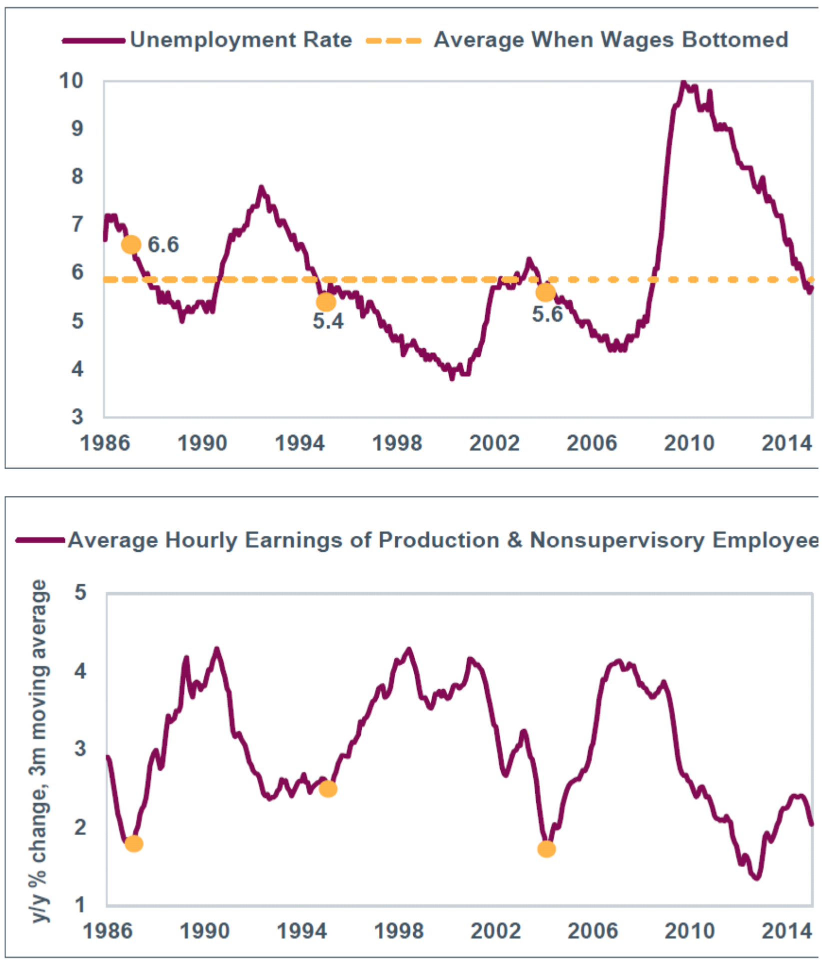
Job openings rose to a 14-year high of 5.13 million in February from January's 4.97 million. So, if the recent acceleration as shown averaging 267,000 jobs created monthly has, in fact, slowed down to the 126,000 March level, there are still plenty of jobs available and we are just back to the monthly average over the last four years. Not too hot and not too cold, could keep the Fed dovish.



Source: Schwab Snapshot

In Fed Chairwomen's Janet Yellin's most recent comments, she discussed conditions that could delay the first rate increase in nine years. "I would be uncomfortable raising the Fed funds rate if readings on wage growth, core consumer prices and other indicators of underlying inflation pressures were to weaken, if market based measures of inflations were to fall appreciatively further."

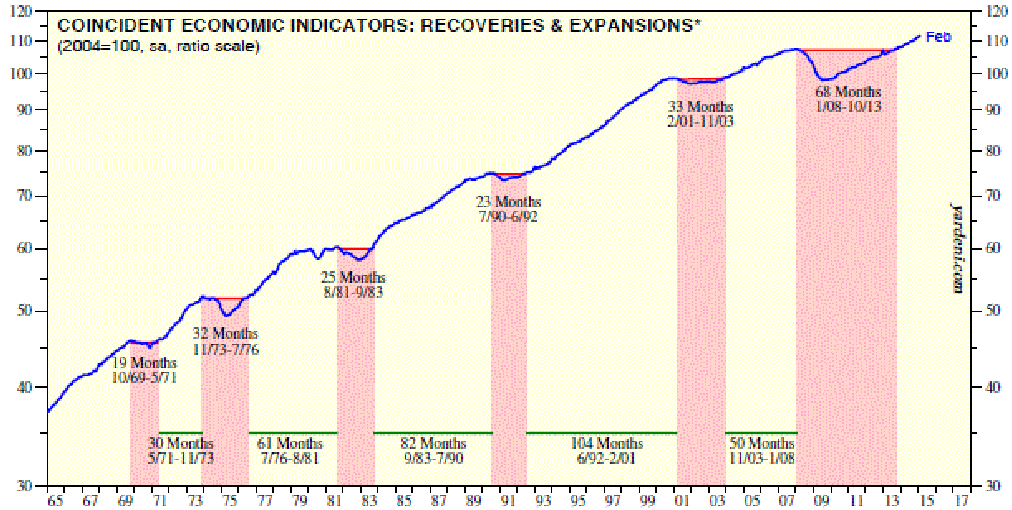
Lower US unemployment leads higher wages



Source: Schwab Snapshot

The March payroll report stated that average hourly earnings rose 0.3% versus the expected 0.2%. One of the Chairwomen's concerns is the lack of wage growth during this economic expansion. One could argue that the 5.5% unemployment rate is unrealistic because of the low labor force participation rate due to retiring boomers, but note in the above chart that these levels have historically translated into higher wage growth. Higher wages, new job creation, increasing consumer confidence all point to improving consumer spending, retail sales, autos, and housing. But, how long can this continue?

Old Age Doesn't Kill Bull Markets (excerpt from Dr. Yardeni)



* Red horizontal lines span cyclical peaks through subsequent cyclical recoveries. Green horizontal lines are expansion periods following recoveries.
Source: Conference Board, Haver Analytics, and YRI calculations.

(1) "It has taken 68 months--from January 2008 through October 2013--for the CEI to fully recover from its severe decline during 2008 and early 2009. The previous five recovery periods averaged 26 months within a range of 19-33 months.

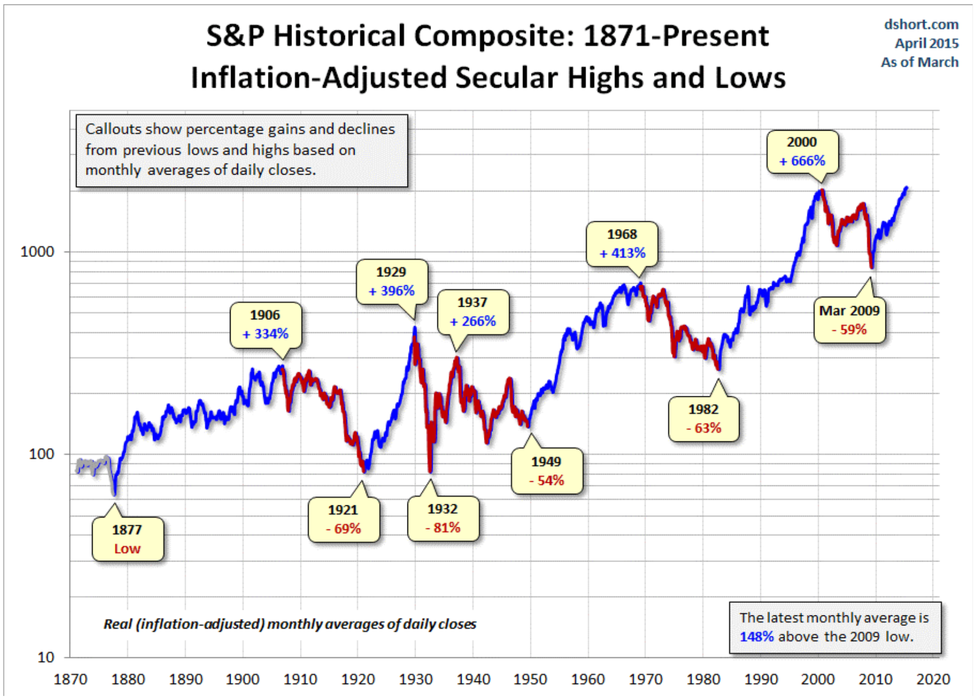
(2) The good news is that the average increase in the CEI following each of those recovery periods through the next peak was 18.6%, over an average period of 65 months within a range of 30-104 months. If we apply these averages to the current cycle, then the CEI would peak in 48 more months, during March 2019, with a substantial gain from here.

(3) For now, let's just enjoy the fact that the CEI is at a record high, and 4.1% above its previous cyclical high during January 2008. All four components of the CEI (payroll employment, real personal income less transfer payments, industrial production, and real manufacturing and trade sales) are at record highs."

LONGER TERM STOCK MARKET OUTLOOK

The historical data on the coincidental economic indicators that a much higher peak may still be four years away supports our premise that we are in the middle of a 10-year Bull Market. Many analysts contend that the pace of this economic recovery from the depths of the Great Recession in 2009 has been sub-par and anemic. Many also blame the Fed monetary policy and the level of the government's deficit spending as inhibiting the faster historical pace of economic recovery. These reasons may be valid, but if the recovery had been quicker, similar to previous cycles, it is also possible that the economy would be overheating, inflationary pressures mounting, causing imbalances and excesses that would demand that the Fed tighten monetary policy aggressively, inverting the yield curve, causing a recession and a cyclical bear market! Our belief that if the pace of economic growth which should accelerate this year, stays in the 2-3% range, then this business cycle does have greater longevity and is consistent with our secular Bull Market forecast.

As the next chart demonstrates there still is huge upside appreciation potential in the stock market if history is any guide. The S&P 500 on an inflation-adjusted basis is up nearly 150% from its March 2009 low, but the average return since 1871 is over 400%! But can we as investors relax and enjoy this possibility as Dr. Yardeni suggests with his economic outlook? Unfortunately, NO!



NEAR TERM STOCK MARKET OUTLOOK

During the first quarter, the stock market not only reflected the slowing economic impact of the severe weather, but also the angst over the timing of the Fed's first interest rate increase, the stronger dollar's impact on multi-national corporate earnings, and the profit decline in the energy related industries. For the first time since 2001, the S&P 500 traded 27 consecutive days without a back-to-back gain and ended the quarter with little change.

Here are some observations regarding the near-term outlook:

- Investors and market commentators will continue to obsess over when the Fed raises rates. Although there may be a short-term overreaction, we believe the Fed will be responding to more favorable economic growth and only gradually raise rates further.

- This quarter's earnings projections have been reduced substantially because of weather, currency translations related to the strong dollar and energy cutback. Consequently, the market's P/E based on a total earnings may appear a little high. But as the year progresses, earnings growth should return.

- The Eurozone and Japan have both embarked on their own quantitative easing and similar to the U.S., their stock markets are leading an economic recovery.

- Although confounded by the prospects of lifting the sanctions on a Iranian nuclear deal, oil is in a bottoming process. West Texas Intermediate has traded between $45 and $55. The number of oil drilling rigs has declined for 17 straight weeks and stood at 802, half of what it was six months ago. Consequently, production may be peaking soon and improve the equilibrium balance at higher prices. We continue to be optimistic that energy related bonds and stocks will recover.

S&P 500 – weekly

Source: Merrill Lynch Technical Analysis

As we have often said, history may not repeat itself, but it does often rhyme. Consumer confidence is high, jobs are being created, wage growth should improve, and warmer weather will get us back out on the road and spending more. GDP growth will turn around in the 2nd quarter and continue in the 3% range as the year progresses. Better economic data should provide the fundamental foundation for higher stock prices, but a normal correction of 10% is long overdue. This pullback may be needed to rebuild the "wall of worry" and provide a broader buying opportunity within the upward channel of the chart above and the context of a longer secular bull market. But, barring this decline, our goal is to continue to trim back issues that appear overvalued and accumulate undervalued stocks at lower levels. In either event, we also continue to believe that the next several years will be rewarding despite the challenges ahead.