Robshaw & Julian Associates, Inc.
Trusted Investment Advice Since 1979

Investment Matters

For the quarter ended September 30, 2014

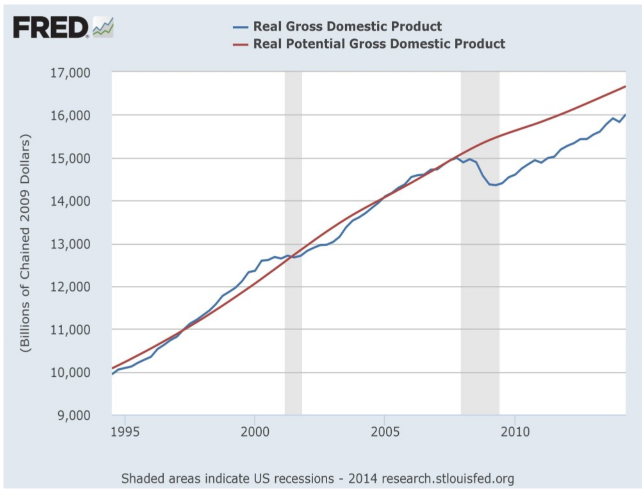
Output Gap Suggests Recession is Years Away

Like a student with a high I.Q. but poor grades, our economy is not performing up to its potential.

Based on the number of people who want to work and the number of facilities available for their employment, the U.S. economy should be producing more goods and services than it actually is. This difference between potential production of goods and services and actual production is called the output gap.

Historically, the output gap has fluctuated between negative (underperforming) and positive (outperforming) over the course of a business cycle. During a recession when consumer demand is low, not all willing workers can find jobs, few factories are running at full capacity and less efficient facilities are being shuttered. When consumer demand returns to normal, jobs are plentiful, factories are running at full tilt and businesses are adding productive capacity.

The best economic situation is when the economy is producing right at its potential. When it overheats (positive gap) it leads to shortages of both workers and productive facilities; this creates a general inflation in prices. When it is underperforming (negative gap) it is characterized by high unemployment.



THE GAP BEWTEEN POTENTIAL AND ACTUAL GDP IS WIDE

The job of the Federal Reserve is to manage the money supply and interest rates to nudge actual economic output toward potential output. In doing so it attempts to prevent overheating with inflation or underperformance with high unemployment.

Since late 2008 the Fed has been struggling to close the negative output gap. While some progress has been made it is clear from the chart that today's economic situation is different from the past. The gap is far larger and far more persistent than in past economic cycles.

The gap will eventually close, most likely by actual output accelerating until it reaches the growing trend of potential output. This will take time and thus a recession is many years away. Under this scenario stock prices should continue to rise for a number of years.

But there is an alternative. Some people believe that the productive potential of the American economy has been permanently reduced. If so, current actual economic output may already be closer to potential than shown on the graph. If this is true the economy may soon experience a tight labor market, capacity constraints and rising inflation, eventually leading to a recession. While this idea has its share of adherents there is little evidence that this is happening.

For a complementary review of how this may impact your portfolio, please call our office at (716) 633-6555 to schedule an appointment at your convenience.

Energy Stocks Are Weak

From 1999 until 2008, as oil went from $12 to $145 per barrel, energy stock prices went up 30% per year, far better than the S&P 500 Index. Since then, as oil fell from $145 to $82 per barrel, energy stocks have been the worst performing stock group.

So what are the factors which drive oil stock prices and is now a good time to buy?

First, oil is priced in dollars on the global market. When the dollar strengthens over other currencies, the price of oil declines. That is part of what has happened since 2008 as the dollar rose 18% in value vs. other currencies. The dollar is up 6% this year alone.

Variations in supply and demand are very important. The supply of oil grows at a fairly steady 2-3% per year but strong production growth in the U.S. as a result of fracking and weakness in OPEC has helped keep world supply growth strong. Analysts estimate that oil production is profitable as long as the price stays above $50 per barrel.

Demand fluctuates considerably from year to year depending on the rate of world economic growth. In 2008 world economic growth was high and rising. China's economy was growing at 14% per year and they were the leading importer of oil in the world. Many people worried we would soon run out of oil. Since then world economic

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Energy: continued

growth has slowed considerably. China is now growing at a mid-single digit rate. The U.S. is at 2%. Much of the world is growing at less than 1%. Recent economic signals point to a further slowing for much of the world next year. The risk of a glut has further depressed oil prices.

Another important factor is general price inflation. In mid-2008 it was over 5% in the U.S. and expected to rise. Today it is less than 2% and continues to fall.

Lastly, oil is often affected by the "terror premium", the fear that oil production may fall as a result of terrorist activity. This is probably low right now.

While production is strong and demand weak, oil prices are likely to remain low, possibly falling below $70 per barrel. Inflation is not likely to influence prices any time soon. Currency movements and terror are nearly impossible to predict. Owning high quality dividend paying oil stocks at this point makes good long term sense, but expectations of outsized returns in the near future are probably unwarranted.

Not Well Known

Today there are only 61 companies in the Fortune 500 which were on that list in 1955.

Every day, Americans buy 365 million gallons of gasoline or about three gallons per household. The $0.42 per gallon drop in the price of gasoline since April will save each American household more than $450 in a full year.

Personal computer sales were up 7% in the U.S. for the last quarter, reversing a multi-year decline. Tablet sales, which have been trending up for years declined during the quarter.

In 2013 there were 365 violet crimes in the U.S. for every 100,000 people, a 40 year low.

The average person on planet earth earns roughly three times as much as he or she did 50 years ago, corrected for inflation. We also eat more food, live about one third longer and have higher I.Q scores.

During our recent economic recovery the gain in manufacturing jobs was greatest in states with the lowest electricity prices. States with the highest electricity prices actually lost manufacturing jobs.

Walmart, Kmart and Target all opened their first stores in the same year, 1962.

An NBER working paper estimates that the government's 2009 Cash for Clunkers program – while designed to provide stimulus to the auto industry – actually reduced industry revenues by around $3 billion over a period of less than a year.

In 1956 the average factory worker had to work 164 hours to purchase a 2,500 BTU room air conditioner from Sears. Today a more powerful Kenmore room air conditioner can be purchased for only 11 hours of average worker pay.

According to a recent KPMG study, the tax cost of doing business in Canada is 46% lower than the U.S. The study included corporate income taxes, property taxes, sales taxes, miscellaneous local business taxes and statutory labor costs.

Demographers suggest that life expectancy at birth for the world in 1900 was about 30 years. Today, according to the World Health Organization, the U.N. Population Division and the U.S. Census Bureau, it is about 70.

The Congressional Budget Office projects that 85% of federal government spending in the next decade will go towards Social Security, Healthcare and Interest on the national debt.

In 1960 15% of all college grades were "A". Today that has risen to 43%. 71% of grades in Education are "A". In Math it's 29%. In general it's much easier to get a good grade in the Humanities than it is in the STEM (Science, Technology Engineering & Math) courses.

According to the Pew Research Center there were 11.3 million unauthorized immigrants living in the U.S. in March, 2013, about the same as the 11.2 million in 2012 and unchanged since 2009.

The Bottom Line: 9/30/2014

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1972	19.7%
Small company stocks *(S&P Small Cap Index)*	635	5.5%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	2.5%	From 2.6%
Inflation *(Consumer Price Index)*	237.4	1.7%
Energy *(West Texas Intermediate Crude Oil)*	91.366bbl.	-10.7
The economy *(Inflation adjusted GDP)*	$17.3 trillion	2.4%

QUOTABLE

"Markets can remain irrational longer than you can remain solvent."

John Maynard Keynes, Economist

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