YOUR FINANCIAL FUTURE

Your Guide to Life Planning

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In This Issue

Bond Market Perspectives | Week of February 2, 2015

KEY TAKEAWAYS

- A soft start for the U.S. stock market in 2015 once again illustrates the diversification benefit of high-quality bonds even at very low yields.
- Even in a low-yield environment, bonds provide a cushion as price movements, not yields, are the primary buffer to equity movements.
- An allocation to core bonds, in addition to more attractively valued high-yield bonds, may make sense for investors.

WHY OWN BONDS?

REVISITING THE BENEFITS OF OWNING BONDS

The presence of record, or near record, low yields in early 2015 has diminished bonds' ability to provide diversification benefits for investors. Bonds are off to a strong start so far in 2015, in part due to stocks stumbling out of the gates to start the new year. One year ago, at the start of 2014, strong equity market performance in 2013, combined with a tough year for bonds and still low yields, caused some investors to overlook the fact that bonds can still serve as an effective diversification tool. Fast forward to early 2015 and many overseas bond markets are offering all-time record low bond yields. In the United States, the 30-year Treasury yield closed January 2015 at a fresh record low with the 10-year Treasury not far from its 1.4% all-time low of 2012. This week we revisit our "Why Own Bonds?" commentary from January 14, 2014, to illustrate that bonds, even in a lower-yield environment, can still provide diversification benefits.

As corporate earnings move higher, the case for stock investing remains compelling, in our view. Still, pullbacks can occur without warning and, as mentioned in our *Outlook 2015: In Transit*, we expect more volatility, as is typically common when the economy enters the latter half of the business cycle. Pullbacks of 5% or more have been infrequent over recent years but such calm is rare. Investors with shorter-term horizons may consider seeking protection against an equity market sell-off. After all, the average annual peak-to-trough decline in the S&P 500 has been 16% (over the past 50 years) and pullbacks arrive without warning. Investors need to be prepared and bonds can help provide protection.

Over the last few months, pullbacks have indeed become more frequent. The broad stock market, as measured by the S&P 500 Index, declined by almost 7.5% in October 2014 and by nearly 5% in December 2014. These pullbacks were brief, but the current pullback from December 29, 2014, through January 30, 2015, has been longer and reached -4.1% before a bounce back on Monday, February 2, 2015. In contrast, the high-quality bond market, as measured by the Barclays Aggregate Bond Index, gained 2.1% during January 2015. Clearly, bonds offered a diversification and wealth preservation benefit during a tough month for stocks.

This is nothing new. A look back at prior stock market pullbacks illustrates how bonds have historically provided good diversification benefits. Figure 1 shows all equity market pullbacks of 5% or more that lasted at least three weeks over the past 11 years, with the corresponding returns for stocks and high-quality bonds. The figure also illustrates the hypothetical return of a balanced 60% stock/40% bond portfolio and the dampening impact bonds can have on stock weakness. During stock market pullbacks in excess of 5%, bonds outperformed stocks by a double-digit margin, a significant difference. Excluding the historic mid-2008 to early-2009 sell-off, the performance differential narrows but is still notable at a 9.6% advantage in favor of high-quality bonds.

Click here for Figure 1, Bonds Provide an Offset to Equity Market Weakness.

In a few cases, both stocks and bonds declined together. This is a troubling outcome and reflects a failure of diversification, but it is rare. Still, bonds managed to outperform stocks on those occasions. In 2008, high-quality bonds provided a buffer but not without volatility, as investment-grade corporate bonds declined for the year and even high-quality mortgage-backed securities (MBS) suffered brief declines. While not all segments of the bond market perform similarly every time, an allocation to high-quality bonds can potentially be effective at offsetting stock market weakness. Although the current pullback in equities has not reached 5%, and may not, bonds are once again showing their diversification benefits.

A total of 13 central banks have lowered interest rates so far in 2015, and combined with quantitative easing (QE) from the European Central Bank (ECB), helps explain part of bond market strength early in this year. However, it does not detract from the potential diversification benefit still prevalent.

NOT ABOUT YIELD

Today's very low-yield environment does not negate the potential diversification benefit of bonds. During 2012, the stock market suffered two pullbacks greater than 5%, and bonds rose more than 1% over each period. The 10-year Treasury yield varied between 1.4% and 1.9% during the 2012 equity market sell-offs, similar to today's levels.

In fact, during each stock market pullback in Figure 1, bond market performance was fairly consistent, averaging 1%, despite varied levels of interest rates. Two of the bond market's strongest gains during stock market sell-offs occurred in 2010 and 2011, a post-recession period in which yields had already declined sharply.

Over short-term periods, price movement, not interest income, is the primary driver of bond performance. Interest income accrues slowly, and although it is the primary driver of long-term bond returns, price changes (up or down) often overwhelm the impact of interest income over short periods of time. Therefore, a low-yield environment does not preclude bonds from acting as an effective diversification tool.

CONCLUSION

Low yields will likely translate into lower long-term bond returns, and therefore the hurdle for stock investors to beat bond performance over the long term is lower. However, for investors with shorter horizons or those simply unwilling to endure stock market swings, bonds can play a diversification role even in today's low-yield environment. In conjunction with sectors that historically hold up better against rising rates, such as high-yield bonds and bank loans, an allocation to core bonds may make sense to protect against potential stock market weakness.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market, and interest rate risk.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

INDEX DESCRIPTIONS

The Standard & Poor’s 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

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To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Weekly Market Commentary | Week of February 2, 2015

KEY TAKEAWAYS

- The stock market fell in January, causing some to ask whether the so-called January effect means that stocks will fall this year.
- Recall less than four weeks ago the "first five days" indicator sent a positive stock market signal for 2015.
- We always put fundamentals first when forecasting stock market direction--and on that score, we believe stocks still look good.

DON'T FRET ABOUT JANUARY EFFECT

The stock market declined in January 2015, causing some to ask whether the so-called January effect (or what some call the January barometer) means that stocks will fall this year. One of the best known Wall Street adages, "as January goes, so goes the year," has a good track record when January is positive, but it is mixed otherwise. Although we always put fundamentals first in trying to forecast market direction, in this commentary we look at January market patterns and posit that the January dip may not be a reason to fret about the stock market in 2015.

MIXED TRACK RECORD FOR JANUARY EFFECT

The so-called January effect, or January barometer, has a strong track record in that positive Januaries for the S&P 500 have preceded positive years 90% of the time since 1950, with an average calendar year gain of 16.9%. In addition, the average calendar year gain in the S&P 500 when January is positive far exceeds the average move during years when stocks fall in January (-3.4%). But the indicator's batting average following down Januaries--such as we just experienced--is mixed over the past six-plus decades [Figure 1]. A January stock market decline has preceded a down year just 56% of the time--not much different than a coin flip. More recently, during the past 10 years, this pattern has only held 50% of the time, including failures during 2009, 2010, and, importantly, 2014, when the S&P 500 was down in January and finished firmly positive by year-end.

The S&P 500 also fell in December 2014. So what does a down December and January mean for the stock market? The results are similar. While the S&P 500 is marginally lower, on average, for a calendar year when the preceding December and January of that year are both negative, the batting average in the eight occurrences since 1950 is just 50%.

The key takeaway from this exercise is that although down months in January may reduce the probability that the S&P 500 will rise in 2015, based on the historical data, the numbers still suggest a roughly 50% probability of a gain. And while the 90% odds of an up year after a positive January may look like a missed opportunity, the odds of an up year if the U.S. economy does not enter recession are 82%, based on data back to 1950. We still consider that scenario may be likely and continue to expect a high-single-digit gain for stocks in 2015.*

**Historically since WWII, the average annual gain on stocks has been 7-9%. Thus, our forecast is in-line with average stock market growth. We forecast a 5-9% gain, including dividends, for U.S. stocks in 2015 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5-10%. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2015.*

HOW QUICKLY WE FORGET: THE FIRST FIVE DAYS OF JANUARY WERE UP

Although the focus right now is on the January decline, it was less than four weeks ago when a positive 2015 signal from the "first five days" indicator was issued. Another widely cited Wall Street adage, gains during the first five trading days of the year have done a fairly good job signaling positive years for stocks over time. The last 41 times that the first five days of January were up for the S&P 500, that calendar year saw gains 35 times--a batting average of 85%, with an average gain of 14% [Figure 1]. The more superstitious among us who follow these patterns can take some comfort in that one (and it took back-to-back gains over 1% on days four and five to turn this one positive last month). But before you base your investment strategy on this indicator, keep in mind that the S&P 500 still managed to rise 54% of the time, even when the S&P 500 was down over the first five days of the year.

1 JANUARY EFFECT SENDING MIXED SIGNALS FOR 2015

	Batting Average with Positive Signal	Average Gain/Loss	Batting Average with Negative Signal	Average Gain/Loss	Effective Rate	Signal for 2015?
First Five Days	85%	14.0	54%	0.7	69%	+
January Effect	90%	16.9	44%	-3.4	78%	−

Source: LPL Financial Research, FactSet, 1/30/15

S&P 500 data from 1950–2014.

Past performance is not indicative of future results.

Indexes are unmanaged and cannot be invested in directly.

FUNDAMENTALS FIRST

There are a host of other stock market indicators that market watchers bring up at this time of year, primarily to entertain. We have all heard about the Super Bowl indicator (last night's outcome was bearish for those of you wondering). Some look to Santa Claus, Groundhog Day, the Chinese New Year, "sell in May," and others. Although these indicators are fun to follow--especially for the more superstitious among us--they are essentially random, with no basis in fundamentals, and certainly should not be a meaningful part of anyone's investment process.

Fundamentals always come first, and on that score we believe the outlook for the stock market remains positive. Economic growth in the United States has been steady in recent months and should be supported in 2015 by lower gas prices. Job growth remains steady. Earnings growth is being weighed down by oil and the strong U.S. dollar but is still on pace for respectable mid-single-digit growth in Q4 2014. We believe our high-single-digit forecast for S&P 500 earnings growth in 2015 is still achievable, despite substantial declines expected in the oil patch. Stock valuations are above average, but when compared with opportunities in the bond market given low interest rates, we consider them quite reasonable. The Federal Reserve, European deflation, Greek politics, the oil and gas downturn, and terrorism all present risks, and volatility may rise in 2015, but stock market fundamentals still tell us to stick with stocks.

CONCLUSION

We continue to forecast 5-9% returns for the S&P 500 in 2015, as we stated in our *Outlook 2015* publication, based on market fundamentals, and do not think the January decline presents any cause for concern. We will always put fundamentals first when forecasting stock market direction--and on that score, we believe stocks still look good.

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond and bond mutual fund values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

All investing involves risk including loss of principal.

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Plunging Oil Prices: A Good News/Bad News Story

More disposable income in the hands of consumers is likely to boost consumer spending, which, in turn, feeds economic growth.

Oil prices, which are down nearly one-third since last summer's peak, have come under pressure due in large part to new energy supplies -- notably from the United States -- which are tipping the balance of supply and demand.[1] Over the past several years U.S. oil production has increased more than 70% and, according to *The New York Times*, "the United States is poised to surpass Saudi Arabia as the world's top producer, possibly in a matter of months."[2]

Cheap Oil: Good Medicine or Economic Malaise?

Do lower oil prices have a positive or negative effect on the global economy? The answer is "yes."

Generally, cheaper oil is good for the American economy. It is estimated that savings from tumbling gas prices represent the equivalent of a $75 billion tax cut for U.S. consumers -- or roughly $1,100 per family on an annual basis if prices remain at current levels (as of December 2, 2014).[3] More disposable income in the hands of consumers is likely to boost consumer spending, which, in turn, feeds economic growth. Case in point: Automakers reported total sales for the month of November were up 4.6% to 1.3 million, the best monthly finish since 2001.[4]

In a broader economic context, lower oil prices reduce the cost to manufacturers of producing and transporting their goods, and to airlines of operating their aircraft, thereby improving profit margins and investor sentiment.

On a global scale, lower oil prices should boost consumption and lower manufacturing costs in oil-importing economies, particularly in Europe, where sluggish economic growth has much of the continent teetering on the brink of recession. Yet the immediate positive effects of lower oil prices in Europe need to be tempered by longer-term realities -- namely, weak economic fundamentals and the specter of deflation -- an extended period of falling prices.

The Deflation Factor

When prices fall across the board, consumers put off making major purchases on the hopes that prices will fall even farther. When spending stalls, companies' revenues suffer and pressure mounts to cut costs by laying off workers, freezing or reducing wages, or raising the price of the goods they product -- all of which can further stymie consumer spending and deepen the deflationary cycle.

The good news/bad news nature of deflation has everything to do with what is driving the drop in prices of goods and services. For instance, if it is a lack of demand -- as many economists say is currently the case in the Eurozone -- deflation could be damaging. If, however, it is due to a boost in supply -- such as the oil and gas boom in the United States -- it can prove beneficial to economic growth.[5]

Takeaways for Investors

Similarly, from an investment perspective, lower oil prices present a double-edged sword. On the positive side:

- Low-priced oil should help to buoy U.S. stocks by strengthening the economy and by extending the period of extraordinary monetary policy established by the Federal Reserve.[6]
- The revelation that the United States may be poised to eclipse Saudi Arabia as the world's leading oil producer may spell good news for U.S. equities in general -- and strengthen the dollar against other world currencies.

On the downside:

- In the short-term, investors in the energy sector -- and commodities markets in general -- should prepare to see the plunge in oil prices reflected in the price of the securities they own.
- Should oil prices remain depressed indefinitely, energy companies will likely slash research and development budgets, which could curtail innovation and stunt longer-term growth potential within the sector, particularly in the area of environmentally-friendly, alternative energy sources.

Contact your financial advisor to learn more about oil price trends and the affect they may have on your financial situation.

[1]*The New York Times, "Morning Agenda: Oil Prices in Free Fall," December 1, 2014.*

[2]*The New York Times*, "Free Fall in Oil Price Underscores Shift Away From OPEC," November 28, 2014.

[3]*MarketWatch*, "U.S. households could save $1,100 from falling gas prices," December 2, 2014.

[4]*USA Today*, "SUVs hot in best November auto sales since 2001," December 2, 2014.

[5]*Bloomberg,* "U.S. Gains From Good Deflation as Europe Faces the Bad Kind," October 26, 2014.

[6]*Reuters,* "Low oil prices boost stocks, deflation risk: James Saft," November 25, 2014.

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