WILSON CAPITAL
INVESTMENT ADVISORY

As an investment advisor, we feel investors should have an information outlet for the financial markets that is thorough, but does not require a prerequisite degree in economics. Thus we have included a glossary of terms at the end of this commentary. Each term with an asterisk has a corresponding definition in the glossary. We hope this makes our commentary informative and educational for all levels of investors.

Quarter in Review

With the turbulent first quarter safely in the rear-view mirror, stocks increased steadily, continuing the now 5-year bull market. The S&P 500 returned 5.2% and interest rates edged slightly lower, giving bonds, as measured by the Barclay's Aggregate index, a 2.0% return for the quarter (interest rates move inversely with bond performance).

Underscoring the steadiness of stock returns, in May, the VIX, a measure of stock market volatility, sunk to its lowest levels in over 7 years. While steady, the increases are finally catching up with underlying valuations as the price-to-earnings ratio* of the S&P 500 rose to 18.8, which is in line with the 50-year average, but the highest level since late 2010.

Given the recent returns and low volatility it is almost unbelievable that this recent quarter of prosperity comes amid increasing global tension, lower company earnings and continued talk of higher interest rates. Even more confounding is the fact that the latest reading of U.S. economic growth, as judged by Gross Domestic Product (GDP)*, decreased 2.9% from 2013. Much of that decline can be attributed to the bad weather that plagued the country, but bull markets can only sustain for so long on the anticipation of better times ahead.

Outlook

With growing concern over growth of the U.S. economy, there is increased focus on the consumer and the impact inflation and stagnant wage growth plays in the broader economy.

Inflationary Pressure

As we noted in our 4th quarter 2013 Investment Letter, the Federal Reserve has a dual mandate to achieve maximum employment and price stability. The current low interest environment is intended to increase employment, but can also mean higher inflation, or rising prices on consumer goods. The Federal Reserve's job is to strike a balance where the largest amount of people have money to spend while also making sure that the demand for goods and services isn't accelerating at a pace that makes items too expensive.

The basket of goods the Fed uses to judge inflation includes almost anything Americans can buy, from cars to coffee and everything in between. However, the most preferable "core" inflation is a measure that excludes food and energy costs since they are more prone to short-term price volatility. While volatile, these prices have a real impact on the wallets of the American consumer and lately the impact has been significant. The May Consumer Price Index* showed that all items except food and energy rose at a modest 2.0% since the prior year, with food (+2.5%) and energy (+3.3%) both rising higher. Digging deeper, staples like eggs (+10.1%) and milk (+7.3%) rose higher than the average. This, in conjunction with higher gasoline prices (+2.3%), can make a material impact since they are items without substitutes. This stands in contrast to bigger ticket items like washers and dryers (-7.5%) and televisions (-14%) that have fallen dramatically, but are both discretionary and largely one-time purchases. While the headline number might suggest that inflation is tame, it could be hard convincing an American consumer who feels the heat with everyday purchases.

Stagnant Wage Growth

The basic idea is that with lower interest rates, companies are likely to expand their businesses which in turn leads to increased hiring and wages. This leads to a larger base of people with higher incomes that will spend their money on goods and services. While companies have taken advantage of the low interest rates by taking on record high levels of debt, they have largely chosen to use this debt for "financial engineering". This is a strategy where companies will use the cash raised through low-interest debt to buy-back shares of their own stock or issue dividends. Such policies are easy ways to increase their stock price and reward investors, but do little to jump start growth through labor force expansion.

With the U.S. economy still recovering from the financial crisis of 2008, a return to normalized inflation and wage growth may be the finale to full recovery, but it is still troubling given the strengths elsewhere in the economy.

Glossary

Price-to-earnings ratio - a standardized measure of how much investors are paying for each dollar of earnings. An 18x p/e ratio means investors are paying 18 times each dollar of earnings.

Gross Domestic Product – The total value of the goods produced and services provided in a year. Increases in GDP mean that a country's total economy is growing, Mature economies, such as the U.S., tend to grow slower that those of emerging economies, such as China.

Consumer Price Index – An estimate of price changes of a large basket of goods consumed in the U.S.

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