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The End Is Not Nigh We're Just Getting Started

As has become a Bodnar Financial tradition, let me be the last to wish you a *HAPPY NEW YEAR*. I am annually astounded by how quickly the media can segue from “peace, goodwill and family” to “gloom, doom and boom.” Reminds me of the Simon & Garfunkel tune *7-O’Clock News/Silent Night*. But, that’s the nature of news; more interested in what’s going wrong than with what’s going right. For the Bodnar Financial “newbies”, let me put it this way....**We Don’t Do Armageddon Here.**

Judging the world through the January headlines is like judging a city by spending a night in the ER – you only see the worst problems. This past year may have felt like the year of Ebola and ISIS but in fact, objectively, 2014 has probably been the best year in history. (I know I said that last year, but it’s not my fault the numbers came out even better this year.)

Take war, for example – our lives now are more peaceful than at any time known to the human species. Archaeologists believe that 15% of early mankind met a violent death, a ratio not even matched by the last two world wars. Since they ended, wars have become rarer and less deadly. I read recently that more British soldiers died on the first day of the Battle of the Somme than in every post-1945 conflict put together. The ISIS barbarity in the Middle East is so shocking, perhaps, because it comes against a backdrop of unprecedented world peace.

Recently the world celebrated a quarter-century since the collapse of the Berlin Wall, which kicked off a period of global calm. The Canadian academic Steven Pinker has called this era the “New Peace”, noting that conflicts of all kinds – genocide, autocracy and even terrorism – witnessed a sharp decline the world over.

Global life expectancy now stands at a new high of 71.5 years, up six years since 1990. In India, life expectancy is up 7-years for men and 10 for women. It’s rising faster in the impoverished east of Africa than anywhere else on the planet. In Rwanda and Ethiopia, life expectancy has risen by 15-years! Imagine a headline that read: *Africans enjoy life expectancy renaissance*. Sadly you will never

read that headline. Instead, we were bombarded with the Ebola crisis, which led to over 7,000 deaths, each one a tragedy; but far more lives have been saved by the progress against malaria, HIV and diarrhea than have been lost to Ebola.

With peace comes trade and, ergo, prosperity. Global capitalism has transferred wealth faster than foreign aid ever could. The World Bank's rate of extreme poverty (those living on less than \$1.25/day) has more than halved since 1990, mainly thanks to ... ready for another surprise.....
.....CHINA....where economic growth and the assault on poverty are being unwittingly supported by any parent in America who shopped at Walmart and put a plastic toy under the tree December past.

Americans don't need to look abroad for signs of progress. Since 1990 life expectancy in the USA is up by over 5-years – thanks, mainly, to fewer deaths from cancer and heart disease. Forward thinking politicians (oops – was that my first oxymoron of the year?) are now fretting about a “time bomb” created by citizens living longer and healthier lives. The TODAY SHOW now needs a “lottery” to determine who to recognize as “centenarian of the day”.

Prosperity does not get a PASS from the law of unintended consequences: obesity, the resulting diabetes and the costs of far longer end-of-life care are but a few of the problems of success. But these are what my father would describe as “elegant problems.”

THE RECENT PAST

We learned in 2014 that consensus forecasts made by experts are almost always wrong.

- a) Interest rates were supposed to rise. Instead the yield on the 10-yr Treasury note dropped from 3% to less than 2.2%.
- b) Inflation was expected to rise, it remained basically unchanged.
- c) The price of oil was supposed to close at \$95. Instead it collapsed to around \$50 at year-end.

The United States emerged from 2014 as the best house on a troubled block. Civil war in Ukraine, a slowing Chinese economy, a stagnant Europe worried about potential deflation, a new recession in Japan, the threat of a new Russian economic meltdown triggered by plummeting oil prices—it all made an improving situation at home look even brighter by comparison. (I can't help myself here. The sudden re-discovery that the Eurozone is a moribund economy, will remind those of a certain age of the iconic Saturday Night Live news headline: “Our top story tonight: General Francisco Franco is still dead.”)

Even apart from the troubles overseas, the United States by almost any measure was stronger than it's been in years. The labor and housing markets improved, corporate profits were solid and even Congress did its part by managing to avert another shutdown. All in all, it was a Goldilocks



economy: not too hot, which could have brought on higher interest rates from The Fed, and not too cold, which let the Fed end the QE3 bond purchases begun in the wake of the 2008 financial crisis.

That domestic strength fueled greater gains for domestic equities than had been envisioned by most pundits, for the fifth year of this bull market. The S&P500 ended 2014 up more than 200% from its March 2009 low, and the Dow saw its sixth straight yearly gain. Stunning.

THE PRESENT

It is often repeated that business cycles always end the same way: The FED “murders” them with rate hikes. By the time that happens, equity valuations are typically elevated, complacency has set in, credit growth has been robust and less discriminate, and investors are ignoring clear warning signs from the bond market (i.e.: usually a flattening yield curve).

Today, equity valuations are generally fair in absolute terms and cheap relative to bonds. Inflation is not a concern, the yield curve is relatively steep, credit is not indiscriminately issued, companies have buckets full of cash-on-hand, technology continues to open new businesses and yield jaw-dropping efficiencies and investor psychology is fairly positive.

THE FUTURE

Investors and media talking-heads, mistaking this environment for a normal cycle, have focused on rate hikes, when instead the real story has always been continued global economic weakness and an ongoing global deleveraging cycle. As we embark on 2015, the U.S. economy has mended and is growing modestly, and larger emerging market countries like India and China are recovering. The old adage of not fighting the Fed (and the European Central Bank and the Bank of Japan) applies.

Investors waiting for a robust synchronized expansion, or, less political dysfunction (HA!), or, world peace, or the end of infectious diseases, are missing the point and making it too complicated. Here’s what investors need to know:

- Nearly half of all issued government bonds yield less than 1%.
- 1.5 billion people around the world are experiencing negative real yields on short maturity bonds.
- Nearly 80% of the global equity market capitalization is supported by zero interest rate policies.

Going forward, the U.S. economy enters 2015 with the strongest momentum in a decade while global growth remains uncertain. March 2015 marks the start of the 7th year of the bull market!



Valuations have moved higher – rightfully, but none of the usual end-of-cycle trappings are evident. Thus, my three takeaways:

- 1) The current cycle may ultimately prove to be the longest on record.
- 2) Interest rates will remain low for a long time.
- 3) The case for stocks to outperform bonds continues to be compelling.

As you have read in these White Papers before, **the stock market is random in the short term and highly predictable over the longer term (periods of 5-10 years and longer)**. The past six years have been an exceptionally robust, yet tranquil environment for stocks. Returns over the next six years may be more volatile and less robust than the past six. How do I know this? I don't. I simply infer it from the only source I trust – history. Experts speak of a “new normal” – 2015 may be a return to the old normal – stock markets that go UP and DOWN. I suggest you re-read [Was 2012 the Best Year Ever?](#) *Life Boat Drills White Paper*, it is posted on www.bodnar.net in the LIBRARY section.

2015 should prove to be another year of adding and deleting to the list of mankind's problems and triumphs. There has never been a better reason for people the world over to wish each other another glorious year to be a human on planet Earth.

John Bodnar, CFP, CIMA

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“Buffett's real secret, beyond the IQ and the emotional hard drive, is optimism. Berkshire is just a big levered-up play on the economy. Trains, ice cream, Coke and banking. Buffett's famous for saying 'be greedy when others are fearful', but his real gift is believing in America and levering up on it. He generates cash betting against super catastrophic events in insurance and uses the money to bet against the collapse of the economy. That's been his formula for more than 60-years. If you take nothing else away from Buffett's notes, it's that the richest man in the world got that way by betting against Doomsday. There's a lesson in that for all of us.” -- Jeff Mache, Yahoo Finance, “Four lessons from Warren Buffet's biggest quarter ever.”

