Pinnacle Capital Management, LLC

July, 2014

COMMENTARY

ECONOMIC STATISTICS					
	2nd Qtr (6/30/14)	1st Qtr (3/31/14)	*% Change*	1 Yr Ago (6/30/13)	*% Change*
S&P 500 Index	1,960.23	1,872.34	*4.7%*	1,606.28	*22.0%*
10 Year Treasury Yield	2.53%	2.72%		2.49%	
Gold Spot ($ / oz)	$1,327.32	$1,284.01	*3.4%*	$1,234.57	*7.5%*
WTI Crude Oil (next future)	$105.37	$101.58	*3.7%*	$96.56	*9.1%*
GDP Qtr / Qtr	N/A	-2.9%		2.5%	
CPI Y / Y	2.1% (May)	1.5%		1.8%	
Unemployment Rate	6.3% (May)	6.7%		7.5%	

In our April Commentary we noted how the market ignored events that a year ago would have shaken it. We were referring specifically to events in the Ukraine. Now in July, we have to ask, what's changed? Well the Ukraine is still in dire straits with Russia and its allies pushing for territorial concessions. To that we've added turmoil in Iraq. In the course of a very short period of time, the Iraqi government has come under serious threats, with the army melting away in the face of insurgent forces. Meanwhile, first quarter U.S. GDP was revised downward to –2.9%. Granted, much of this was due to weather and onetime factors. Yet the S&P 500 returned 5.23% in the second quarter inclusive of dividends bringing first half 2014 returns to 7.14%. Like the Energizer Bunny the markets keep going and going.

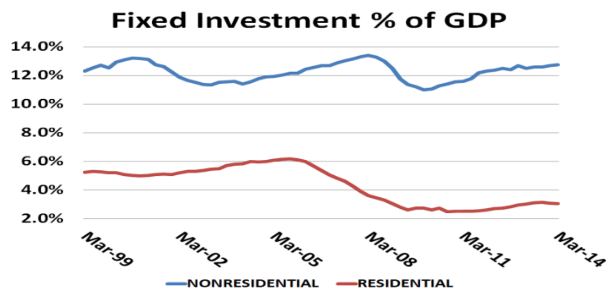
Given recent events and the extraordinary slow expansion of the economy, what could the markets be seeing? Quite simply, we think the answer is continued expansion. To that point, we think it would be advisable to discuss what's going on in the economy. For starters, while most agree that growth has been slow, few appreciate the flip side; that is, with slow growth there can be a prolonged time period over which the economy expands.

To understand this, we have to ask, why do economic expansions falter? Traditionally, there are three factors which may act independently or in combination: 1) external shocks, 2) normal disruption to the business cycle, and 3) monetary tightening. Let's look at these one at a time. First, the threat of external shocks is always there. That's why we worry about places like Iraq or the Ukraine. These threats are not only always there, but they have always been there and will always be there. The simple truth is that by their very nature, they surprise and cause disruptions. Thus

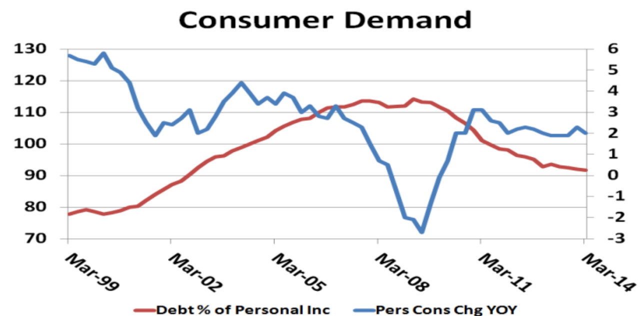
far, there have been no shocks which have significantly disrupted growth since 2009, and despite threats on the horizon that we're monitoring, we see none that are both imminent and potentially significant enough to derail the economy in the near future.

So let's move on to the business cycle. Business cycles are typically disrupted by shifts in inventories, capital spending, or final demand. The following chart shows the ratio of inventory to sales in the U.S. economy since 1999. While inventories are up a bit, they are nowhere near where manufacturers and retailers need to cut back. The lack of optimism, then, has a beneficial side. Inventories have not gotten ahead of themselves, and as a result, there are unlikely to be inventory reductions which derail the economy.

The same can be said of fixed investment. In the chart below also dating to 1999, the red line represents housing and the blue line represents capital expenditures. As was the case with inventories, overbuilding is not apparent. In fact spending on housing is considerably below past peaks. When things are not overdone, the impetus to cut back is significantly reduced, and therefore, growth is likely to continue.



But what about final demand? Might the consumer just cut back? This is always a possibility, but the consumer has been getting in much better shape. In the chart below, the red line represents consumer debt as a % of GDP. After peaking at 114% in 2007, US consumers have reduced their debt to less than 92% - levels not seen since the end of 2002. Meanwhile, consumers continue to spend modestly. As the blue line shows, year over year growth of consumer spending remains in a tight band of 2-3%. We're not seeing the high levels of growth that we saw in the late 1990s; and that is a good thing. Once again, the impetus for a rapid reduction does not exist. With less of a debt burden to be concerned about, we expect consumers to maintain their modest buying pace.



Finally, where does monetary policy fit into all of this? We do not see Fed tightening as a threat to the economy. We have been out of recession for five years and the Federal Reserve has not raised its target Fed Funds rate. By comparison, it took less than three years for the Fed to raise that rate during the past two recessions and less than one year during the prior four recessions. If anything, we believe Fed easing is the problem. As long as the Fed doesn't reverse course too quickly or too sharply, the economy should be in good shape.

So overall, we believe that despite painfully slow economic growth, this slowness has set the stage for sustained upward progress. In the past, by the time we've experienced five years of expansion we'd be very concerned about an imminent contraction. But as things stand, we see no such contraction. We would expect growth to continue until at least the first year of the next President's first term….if not longer. Of course, those potential shocks can always jump out of nowhere. We'll keep a watchful eye, but for now the sentiment is, cautious optimism for continued economic expansion.