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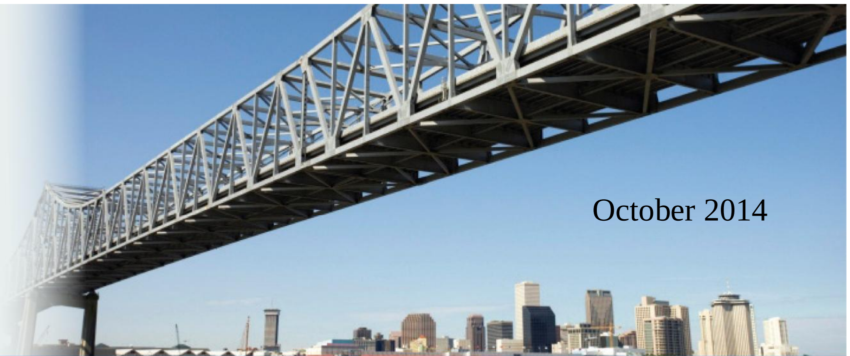


October 2014

IN THIS ISSUE

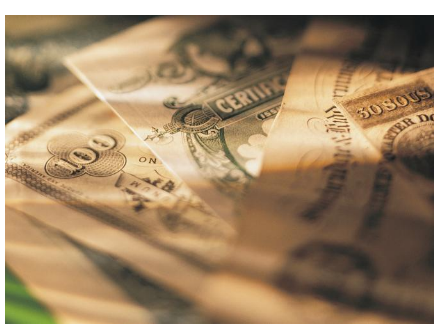
Economic Comments

Following their mid-September meeting, Federal Reserve policymakers remained firm in their belief that the economyôs recovery remains on track. As a result, the U.S. central bank announced a further reduction of its bond buying program to $15 billion/month. This move created expectations that the Fed will totally cease the QE3 bond purchase program within coming weeks. Based upon this most recent Fed input, the consensus is that rate hikes will start no later than the summer of 2015 and possibly as early as this coming January. Nonetheless, all was not sunny from the central bankôs perspective as the meeting notes highlighted concerns on several fronts: the recently appreciating dollar, the slack labor markets, the continued low inflation rates and the renewed economic weakness in both Europe and Asia.

Through August end, the Federal Reserveôs preferred inflation indicator, the personal consumption expenditures, was up a modest 1.5% - appreciably less than the Fedôs target rate of 2%. With inflation having undershot the Fed's 2% target for the last 2+ years, Chair Yellen currently believes that the central bank has substantial leeway to keep short-term interest rates close to zero in order to further stimulate economic growth.

Moreover, the current economic slack should allow the Fed to be slow and measured once it starts its anticipated rate hikes next year. Until appreciable strengthening in the labor market occurs, Ms. Yellen anticipates the Federal Reserve to only implement modest incremental rate hikes. While the unemployment rate has continued to decline, it has been partially due to shrinking participation in the labor force rather than as a sign of renewed economic strength. Moreover, real wage increases remain largely absent.

Actual jobs creation has been quite good with September seeing a better than expected 248,000 new jobs along with prior monthsô estimates being revised upwards by an additional 69,000 jobs. With an average monthly job creation of 227,000, this year is now on track to have the strongest job growth since the late 1990s. With this increase in payrolls, unemployment hit a six-year low of 5.9% - the result of employment gains but also due to additional people leaving the job market.



Data for September showed that the labor force participation rate hit a new 36ï year low in September at 62.7%. The share of the population now employed stands at 59.0% - lower than the 59.4% rate seen at the end of the recession in June 2009. 9.3 million workers are still searching for work, and almost a third of job seekers have been unemployed for greater than six months. Using a broader unemployment measure, which includes part-time workers who cannot find full-time jobs and those too discouraged to apply for work, unemployment now stands at 11.8%.

The key question for the labor markets is whether the historically low rate of participation in the work force is permanent, thanks to demographic changes and aftershocks of the slow growth recovery, or whether improving pay and economic conditions will lure workers back into the job market. To put the current situation more in context, the 0.4 percentage point decline in the employment ratio seen over the last 5 years compares poorly with the average

(Continued on page 2)

Economic Comments continued from cover

expansion of 1.7 percentage points in the employment ratio in the 5 subsequent years following more recent recessions. Contributing to the ongoing labor issue, hourly wages have increased by only 2.0% year over year, barely keeping ahead of inflation. There is little surprise that many Americans still believe the economy is in recession 64 months after the downturn officially ended.

Despite the mixed jobs data, the most recent economic growth report cheered many hearts as GDP surged upwards 4.6% for the yearôs 2nd quarter. The spring quarter marked a sharp snapback from the yearôs first quarter where relatively severe weather idled factories and kept consumers at home. Meanwhile, projections for the 2nd half remain largely unchanged at a 3% rate to close-out the year. Other potentially positive foreshadowing came from the workweek data where average hours worked climbed to 34.6 hours - the highest level since the recession and a possible sign that companies may need to step up hiring to meet stronger demand.

In recent months, a mixed blessing has come in the strengthening of the dollar to 4 year highs. With most central banks continuing to hold down their interest rates and the wide expectation of higher U.S. interest rates by next year, the greenback has surged more than 7% versus the yen and the euro over the last 3 months with even greater gains against the currencies of a number of critical emerging economies. While the recent dollar strengthening will make imports less expensive for American consumers, the downside is that American based multinationals' international sales and profits will be hurt by this currency shift.

Even as the labor market had some positive news, the U.S. manufacturing sector slackened somewhat in recent weeks. Based on the Institute for Supply Managementôs September survey of purchasing managers, the reading slipped to 56.6 in September from an August reading of 59.0. While still indicative of growth, the reading suggested a step back from the more elevated levels of recent months.

Looking forward, the key near term factor for the economy will be whether the currently modest inflation pressures will allow the Federal Reserve to be restrained as it starts to return interest rates to more historically normal levels. Economic observers appear to be optimistic that a Goldilocks situation of not too cold and not too hot might be achieved. We are not necessarily convinced that this rosy outcome will be realized. The only thing that we are certain of is that if the current labor market situation does not substantially improve, the U.S. could find itself stuck in a prolonged period of sub-standard growth. If the diminished growth situation were to continue for an extended period of time, the long-term consequences for American prosperity could be appreciable.

Analyst Corner

If you are in the market for a helicopter, elevator or jet engine, odds are you will, at some stage, be talking to United Technologies Corporation, *NYSE: UTX*. Based out of Hartford, Connecticut, the company is one of the worldôs largest manufacturers of industrial and aerospace equipment. Two key attributes that stand out for UTXôs product line are both their strong market position and the depth of their relationships with customers. With a very solid balance sheet and strong cash flows, the company has well earned its place in the Dow Jones Industrials index. However, in the face of continued global growth concerns, the companyôs shares have been under pressure as of late. Given the strong balance sheet and attractive dividend yield, UTX now appears to be more reasonably priced. For the appropriate client, UTX could provide a nice lift to their portfolio!

Market Comments

On the back of the stronger than expected GDP data, Wall Street surged to record highs in mid September before retreating slightly from these levels; the month ended with the S&P 500 showing a gain of more than 8.25% for the year-to-date. Leading the yearôs market advance has been the healthcare sector with an almost 17% upward surge as the Obamacare rollout has, so far, provided few of the problems that many had anticipated. Playing tail end Charlie for the year has been the consumer discretionary sector. Although usually tracking very closely with economic growth, this market sector has eeked out an extremely modest 0.7% gain in the face of limited real income gains by consumers.

With the U.S. labor markets having substantial slack and inflation remaining appreciably below Federal Reserve targets, interest rates have declined appreciably since the beginning of the year. As expectations for the timing of the central bankôs first rate increase have been pushed back, ten year bond yields have declined by more than 0.5 percentage points. However, the risk premium attached to lower quality, better known as junk, bonds has sharply increased as investors have faced increasing concerns over the ability of these weaker companies to afford higher debt costs.

On the back of last yearôs huge gains, the question has often been raised as to whether the stock market is now overvalued. To be blunt, by some measures the market is expensive. However, other valuation measures suggest that stock prices are at more reasonable levels. While we think it is a good question to ask, we instead believe that the more critical investor concerns should be focused on matters such as investment time horizons, diversification and risk tolerance.

For those who believe that stocks are too rich, history has shown that overvalued markets often become even more overvalued before correcting. For instance, if someone exited stocks in 2000, they would have had to wait until 2009 before stock prices hit their lows. Few investors who try to time the market by moving to cash with the intention of getting back in when stocks have fallen have proven to have the fortitude to implement this strategy.

While we concede that the market is not currently inexpensive by most measures, investors have become overly complacent of potential risks. The marketôs fear gauge, more formally know as the Chicago Board of Exchange Volatility Index, remains near historic lows even as it has increased by 50% in recent months. Perversely, market expectations of stability often lead to greater near term volatility - some of which has been seen in recent weeks with a large number of daily swings in excess of 1%. More than 700 trading days have now passed since the market last saw a downward correction of at least 10% - the fourth longest run since 1929. As a result, we believe the market is well past due for a correction.

Despite these nearer term concerns, we remain bullish about Wall Streetôs longer term prospects. Unlike the rest of the developed world, the U.S. economy has shown consistent growth. American consumers continue to de-lever their balance sheets and U.S. corporationsô financial strength is at record high. While there are sure to be bumps along the way, an appropriately diversified portfolio that is designed around an individualôs ability to take risk and cash needs should allow for a positive long-term financial outcome.

Performance as of 9/30/14

	Close	Month	YTD	1 Year
DJIA	17,042.90	-0.23%	4.60%	15.29%
S & P 500	1972.29	-1.40%	8.34%	19.73%
NASDAQ Comp.	4493.39	-1.90%	7.59%	19.14%

	Quarter end yield	Prior Year end yield	Yield 1 year ago
10 yr. U.S. Treasury	2.51%	3.03%	2.62%

Planning Thoughts

Reports of hackers breaking into corporate computer systems to steal consumer data have been on the news almost daily. Highlighting this rapidly expanding problem have been recent thefts of customer information on tens of millions of individuals from blue chip companies JP Morgan, Home Depot and Target. These attacks beg the question, what can individuals do to protect themselves from identity theft?

Most importantly, individuals should regularly monitor their key financial accounts along with their credit reports. In addition, unique/more complex passwords should be used for their most vital accounts. Periodically, your account passwords should be changed. As an aside, and to help keep track of all of these passwords, a number of password storage programs are available for free or nominal cost. Wary consumers should also be suspicious of any corporate e-mail requesting personal information as legitimate companies will not (or at least should not) request personal information in this manner. If in doubt, call the company directly from the phone number posted on the companyôs web-site and not the phone number indicated in the questionable e-mail.

For those people who want to add yet another layer of security, a security freeze can be placed on an individualôs credit bureau report where the credit bureaus will not release credit information to any company that does not already have a relationship with the person. Will all of these actions provide complete protection from identity theft? No, but at least it will make it far more difficult for the would be thief and encourage them to move on to an easier target.

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