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Two Economies, Two Stock Markets

Market strategists are always looking for information to analyze. Government statistics of all kinds, institutional research, and endless Power Point demonstrations are readily available on virtually any topic. Sometimes though, a strategist can get his data via anecdotal observations. This type of data is best observed on Main Street. It is here where the outcomes of the government policies and media hype can best be seen.

After sorting through traditional data sources and identifying key anecdotal observations, we believe that there are two separate economies at work at this time. Not surprisingly, we also see two stock markets as well.

On Main Street, there seems to be one economy that is working well, and one that is not working at all.

The economy that is working can be seen in certain statistical data. America's corporations are profitable. In some cases, profits are at record levels. As a proxy for this growth, the aggregate estimate for 2015 profits for the Standard and Poor's 500 Stock Index (S & P 500) is near $125 per share. At the peak of the cycle, 2007, aggregate earnings were just under $100. The earnings trough was hit in 2009 near $60. There has been true earnings growth since the Great Recession.

While the aggregate unemployment rate is hovering near 12% (BLS U6), 14 states have unemployment under 5%, and five more below 5.5%. These states primary employers are in the energy production, agriculture, and industrial production of all types.

The working economy is evident all around us. In numerous areas, restaurants are full, stadiums sellout, and home prices have been rising again. The number of available jobs has hit its highest point since the recession ended five years ago.

But that brings us to the other economy; the economy that is not working very well. We have noted in our commentary many times that real unemployment is near 12%. While jobs are being created, they are mostly part time jobs, with few benefits. In 2014, we have lost more full time jobs than we have created. Wages are stagnant, and the median family income has declined for five consecutive years. This economy sees major retailers lowering their revenue and profit projections to reflect that much of America has less and less disposable income.

Flat retail sales have affected most areas except automobile sales. Major names such as WalMart, Gap, Bed Bath and Beyond, Tractor Supply, Target, and McDonalds have struggled to maintain planned growth levels. 2013 was the first year on record that more small businesses closed than opened. Where the economy isn't working it is affecting both large and small companies.

It is hard to believe that we can have such stark differences on Main Street.
We also see two different stock markets.

To most people the S & P 500 IS the stock market. By this standard, the market is up nearly 10% in 2014. But if we look below surface, there are sectors doing much better, and sectors that are doing poorly.

Using popular ETFs and indices as our guide the following sectors are up more than 15% year to date: biotech, transportation, energy MLPs, pharmaceuticals, and semiconductors. Obviously, parts of the stock market are enjoying another robust year.

However, there appears to be a second stock market. This stock market is full of sectors that are doing poorly vs. the S & P 500: Consumer Discretionary is up 2.9%. Retail is up 1.2%. Small cap stocks, as defined by the Russell 2000 Index, are down -0.26%. The underperformers include Mortgage Finance down -2.2% and Homebuilding -7%.

In 2013, the stock market had a more robust year, with almost all market sectors doing well. This year has seen the market averages mask excellent performance is some places, poor performance in others.

WHAT DO WE EXPECT AHEAD?

We have 37 years of experience studying stock and bond markets. By now we have a long list of sayings and axioms. One of our favorites is "the stock market will do whatever it has to do in the short term to confuse the most number of players in it."

In light of the consensus in predictions for the year, this year has had many surprises. All the predictions of higher interest rates never materialized. The 10 year Treasury bond rate started the year at 3% and today is near 2.5%. The predictions of higher inflation and GDP growth have both fallen short of earlier expectations. The 7-12% correction most, including us, expected this summer turned into a 5% S & P 500 correction.

When we look at economic data daily, we see the stronger areas such as energy production, transportation, industrial chemicals, and technology reporting stronger numbers. While the weaker areas such as retail, homebuilding, and most small caps continue to show tepid numbers.

We expect the two economies and the two stock markets continue to operate in their respective directions.

PORTFOLIOS

Portfolios managed by discretion have been guided by our thought that we are involved in a market of stocks, rather than a stock market. With this nuance, individual selections are more important than macro allocations.

We believe that we can best manage risk and opportunity with this strategy.

Our portfolios do have some third party managed assets. They include tactical allocation products, long/short products and international exposure. They are doing well on their own.

When we look at the most popular single names in our portfolios today, we see those assets that are currently performing the best. Our largest dollar holding is based in materials and petro chemicals. These petro chemicals are produced mainly from natural gas, and we all know that we love natural gas.

Our second largest holding is the Union Pacific Railway (UNP). It is a premier name in the robustly performing transportation sector.

Our next several holdings are in the energy infrastructure sector. They too are enjoying another outperforming year compared to the S & P 500.

We intend to keep a more narrow focus in our overall strategy as long as we see two economies and two markets.

We've said very little in this edition about bonds. As previously mentioned, interest rates have declined somewhat this year. We think this has occurred partially because of weaker than expected growth, particularly in housing. We think the other reason is the dollar/euro shift. With so much uncertainty in Europe, funds have flowed out of euro denominated assets and into US dollar backed assets. This raises the value of the dollar, depresses the value of the euro and pushes domestic rates lower. The common name for this behavior is a flight to quality.

With rates moving very little this year, our bond allocations are "earning their coupons". That is to say prices are moving very little and whatever our interest rate on the bond at purchase should be our return in 2014.

ENCLOSURES

Enclosure #1 is a piece from the Investor's Business Daily (IBD). It's a daily paper that focuses on markets and investing. This article appeared in the September 5th edition. It is an analysis of how the implementation of the Affordable Care Act (ACA) is effecting job creation and wages. We look

at this condition as one of the reasons why the economy acts like a plow horse. Full-time job creation is needed to expect the economy to grow more robustly.

Enclosure #2 is a timely commentary from Brian Wesbury. Brian is the Chief Economist for 1st Trust Advisors. We monitor his weekly commentaries. He is the person who called our current economy a "plow horse economy." A phrase we have referred to in many editions of TWR. In this commentary he explains why he thinks the markets are rising and will continue to do so.

Enclosure #3 will bring us up to date on our favorite investment theme; shale energy extraction. Several years ago we began to track what we thought had the potential to become the economic trend of the decade. When this started, we were importing almost 70% of our crude oil needs from politically insecure places like Venezuela, Nigeria, and the Middle East. The production graph on page one shows our domestic production has nearly tripled since 2009. Many are predicting that the U.S. will be energy self-sufficient in just a few years.

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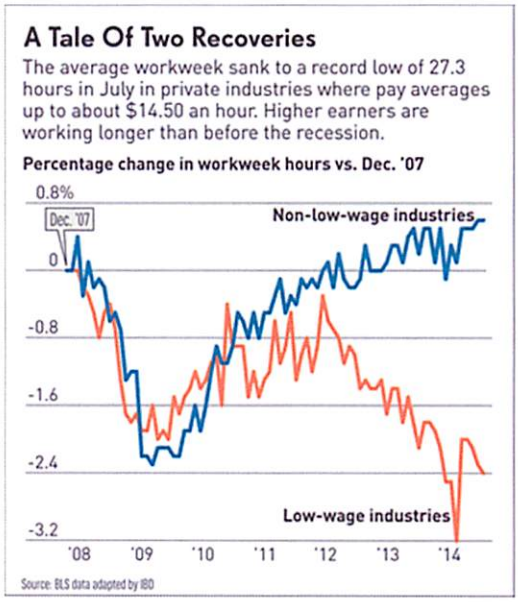
Enclosure #1

The Worst Job Stat Continues To Get Even Worse

By JED GRAHAM, INVESTOR'S BUSINESS DAILY – September 5, 2014



Amid all the focus on boosting the minimum wage and legislating living wages, virtually no one seems to have noticed what is happening to the workweek in low-wage industries.

Since December 2012, private industries paying up to about $14.50 an hour have added, on net, 972,000 nonsupervisory jobs with an average workweek of a mere 17.7 hours, an IBD analysis finds.

That doesn't mean new employees are being hired for such few hours. Rather, it reflects a combination of reduced hours in existing jobs and short workweeks for newly created jobs.

Overall, in these low-wage industries which employ 30 million rank-and-file workers, the average workweek shrank to 27.3 hours per week in July, an IBD analysis shows. That's the shortest workweek on record, except for this past February, when mid-month blizzards wreaked havoc during the Bureau of Labor Statistics survey week.

The conventional wisdom among economists is that there's been no apparent shift to part-time work and that ObamaCare's employer mandate hasn't led to shorter workweeks.

But shorter hours clocked by nonmanagers in low-wage industries are being obscured because the rest of the workforce is now clocking a longer average workweek than even before the recession started.

For low-wage industry workers, on the other hand, the recovery in the workweek from a then-record low 27.5 hours in mid-2009 began to reverse in the latter half of 2012, and it's been pretty much all downhill since then.

Evidence points to ObamaCare as an important factor in the shrinking workweek.

Last fall, White House economists offered up a simple gauge of ObamaCare's impact on the workweek: the number of workers clocking just above the 30-hour-per-week threshold at which the employer mandate hits vs. the number with workweeks just shy of that mark.

If that ratio derived from the Current Population Survey of households were flat or rising, it would show that employers, as a whole, weren't restructuring work hours to avoid ObamaCare's costs. In fact, the ratio of regular 31- to 34-hour workers vs. 25- to 29-hour workers has been plunging — from 0.71 in December 2012 to a record low 0.55 in June.

That shift isn't apparent in the BLS part-time work data because the agency considers 35 hours or more to be full time.

While economists warn not to put too much stock in anecdotes, IBD has compiled 400-plus documented examples of employers cutting work hours in response to ObamaCare. Most of the examples are in the public sector because of its relative transparency about workforce policies, but the private industry examples include a number of department stores, supermarket chains and homecare providers.

Not surprisingly, these are among the industries seeing shorter workweeks. Since the end of 2012, average work hours are down 5.8% (from 30.9 to 29.1 hours) at general merchandise stores, 4.6% at providers of social assistance to the elderly and disabled, and 1.7% at food and beverage stores.

The Weiss Report
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Enclosure #2

First Trust
Monday Morning OUTLOOK
September 8th, 2014
630-517-7756 • www.ftportfolios.com

Why Do Stocks Keep Rising?

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

So far this year, the S&P 500, including dividends, has returned 10.1% to investors. The NASDAQ, including dividends, is up 10.7%.

This has happened even though the Federal Reserve has tapered bond purchases from $85 billion per month, to the current $25 billion. And everyone knows, QE will fall to $15 billion after September 17th and zero after the Fed's meeting in late October.

The market is up in spite of Vladimir Putin invading Ukraine, the rise and rapid spread of ISIS in Iraq and Syria, and even volcanoes in Iceland. It's up even though Ebola is spreading in Africa, there are upcoming Congressional elections in the US, and some members of the Fed are publicly speaking about the need to raise interest rates sooner than next year.

The stock market is up even though some previously bullish analysts have turned skeptical or even bearish. It's up even though it had a little hiccup back in July and even though the 5-year Treasury yield is up 100 basis points since early 2013.

This continues a trend that started sixty-six months ago on March 9, 2009. Since then, the S&P 500 is up at annualized average of 24% (including dividends). And the things the market has worried about in the past year don't hold a candle to the fears stirred up over those previous five years.

During those five years, pundits on many business TV shows, after hearing that we thought stocks could go even higher and that the economy would keep growing, always asked "yeah, but what about _____"?

You can fill in the blank with a hundred things…they certainly did…the Sequester, Greece, Dubai, Cypress, the Fiscal Cliff (twice), part-time jobs, and on and on. This incessant pessimism, the constant belief that things were bound to go wrong seems almost surreal. How can somebody stay negative for so long, but convince themselves that they are always right?

Maybe this is why CNBC viewership is falling. According to Zap2it.com, it's fallen to a 2-year low (click here).

It's important to remember that many people watch business TV at work and ratings services do not do a good job of capturing this viewership. Nonetheless, if these data capture any type of decline at all, it's a real shame.

The 21st century is an amazing period of entrepreneurial activity. Fracking, 3-D printing, robotics, biotech advances, the Cloud, wireless communication technologies, smartphones, tablets, and apps are just a few of the areas of massive advancement.

The business world is vibrant, productive and massively efficient. One broad measure of profits has grown 20% at an annual average rate between Q4-2008 and Q2-2014. How come TV can't capture that vibrancy in a way that attracts more viewers?

The good news is that TV does not drive stock prices, profits do. Rising profits prove that resources are being utilized more efficiently and when resources are used more efficiently, they become more valuable.

One problem the pessimists have is that they look back at 2008 and see a failure of markets and the success of government. But TARP and QE never saved the economy. Stock markets fell an additional 40% after TARP was passed.

But once mark-to-market accounting rules were changed in March/April 2009, the crisis ended and a recovery began. That recovery has been real, not a "sugar high," built on government action.

It may not have been the strongest recovery ever, but in those areas driven by, or that utilize, new technology, it has certainly been profitable.

That's why stocks keep rising in spite of all the negative news that circulates. Understanding profits is the key to understanding why stocks keep rising.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-8 / 2:00 pm	Consumer Credit– Jul	$17.0 Bil	**$17.4 Bil**		$17.3 Bil
9-11 / 7:30 am	Initial Claims – Sep 6	300K	**301K**		302K
9-12 / 7:30 am	Retail Sales – Aug	+0.6%	**+0.6%**		0.0%
7:30 am	Retail Sales Ex-Auto – Aug	+0.2%	**+0.2%**		+0.1%
7:30 am	Import Prices – Aug	-1.0%	**-1.1%**		-0.2%
7:30 am	Export Prices – Aug	-0.1%	**-0.2%**		0.0%
8:55 am	U. Mich Consumer Sentiment- Sep	83.5	**83.0**		82.5
9:00 am	Business Inventories – Jul	+0.5%	**+0.3%**		+0.4%

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Volume 17 Number 4
Enclosure #3

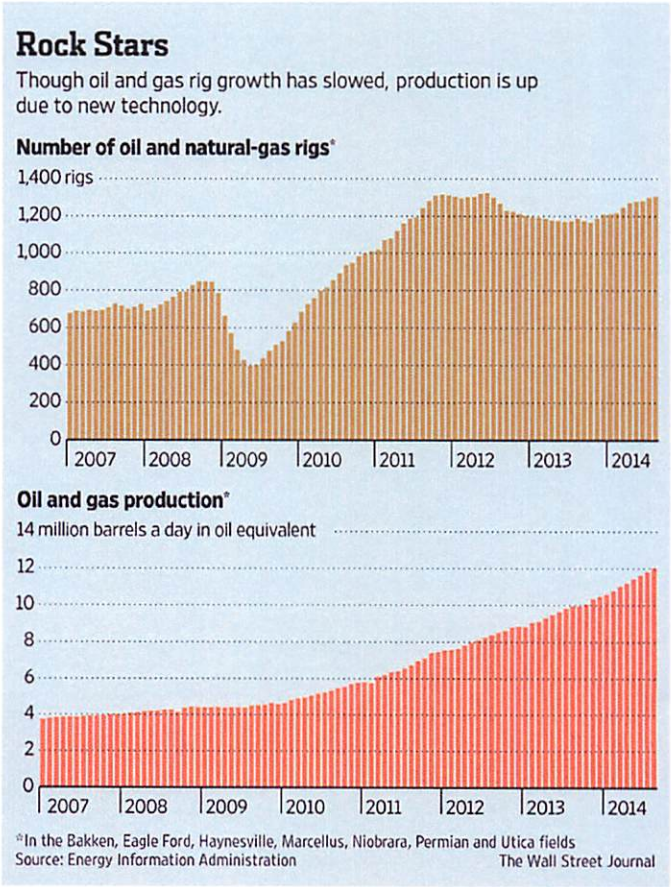
Fracking Gives U.S. Energy Boom Plenty of Room to Run

Current Top Gas Well Produces Five Times as Much as Record Setter a Decade Ago

By: Russell Gold – September 14, 2014

Skeptics of the U.S. energy boom say it can't last much longer because it requires drilling an ever-increasing number of wells.

But the boom already has lasted longer than anyone would have imagined just a decade ago and has more room to run. That's because oil and natural-gas wells have become more productive—an unrecognized but potent trend that should keep the fuels flowing.



Back in 2003, the energy industry had just begun combining the techniques of drilling horizontal bores through shale and then using hydraulic fracturing—shooting tons of water, chemicals and sand into the rocks.

Four Sevens Oil Co. drilled the best gas well that year, in the Barnett Shale, just north of Fort Worth, Texas, according to Drillinginfo, an industry data service that searched its records at the request of The Wall Street Journal.

Four Sevens used what was then considered a whopping 2.8 million gallons of liquid and 221,000 pounds of sand in fracking the well, named the Braumbaugh after the family that owned the mineral rights.

At its peak, 5.9 million cubic feet of gas a day rushed up the well. "We were real happy with it," says Four Sevens co-founder Dick Lowe. When the state published the production data, competitors were envious.

Today, the Braumbaugh looks like a pipsqueak.

Cabot Oil & Gas Corp. drilled the best gas well in the U.S. last year, in Susquehanna County, Pa., about 110 miles northwest of Manhattan. Drilling longer horizontal legs and fracking the well repeatedly, Cabot pumped in 12.5 million gallons of liquid, more than four times the amount Four Sevens had employed, and used 13.3 million pounds of sand.

State of the Art | Two oil wells compared

	Williams 34X-14	Wilde Trust Unit
Year drilled and fracked	2003	2013
Company	Headington Oil	EOG Resources
Location	Bakken (Mont.)	Eagle Ford (Texas)
Gallons of liquid used	326,800	9.1 million
Pounds of sand used	640,774	14.24 million
PEAK OUTPUT (barrels/day)	**828**	**2,748**

Source: DrillingInfo analysis of state records

The well produced 30.3 million cubic feet a day—five times as much as the Four Sevens record setter a decade earlier.

"That's a pretty damn good well," Mr. Lowe says. "I might have dreamed of drilling a well that size."

The U.S. oil-and-gas industry no longer spends its time trying to find new shale formations to tap. Instead, it focuses on finding ways to get more out of the formations it has found. And it is succeeding.

As a result, the U.S. has become the world's largest energy producer, natural-gas prices have remained low and U.S. oil output has helped prevent rising crude prices around the world.

Of course, bigger and better wells come with bigger price tags, leaving drillers more vulnerable to falling energy prices.

These more aggressive operations also can create environmental problems from increased sand mining and the use of more potable water for fracking. Disposing liquids used for fracking can trigger earthquakes. Bigger fracking operations also require additional equipment and truck trips, creating more headaches for surrounding communities.

What's beyond dispute is that the newly drilled wells are better than the ones they are replacing.

The number of rigs drilling in the U.S. is basically flat, but production is rising. The federal Energy Information Administration calls this "drilling productivity" and says it is showing no sign of slowing.

Lynn Westfall, the EIA's director of energy markets and financial analysis, points out that the rig count in South Texas' Eagle Ford Shale "has not changed since 2012, but the production per new well has doubled."

Innovation makes the difference. The federal government recently predicted that oil production would rise through 2019 and then flatten off. But a second scenario in the report assumed that extraction technology would continue to improve, leading crude output to rise through 2040, if not longer.

The recent history of oil wells productivity is similar to that of gas wells.

In 2003, Headington Oil drilled an experimental well into the Bakken Shale in Montana near the North Dakota border. Headington, a private Dallas-area company, pumped in 326,000 gallons of liquid and used 640,000 pounds of sand. The well produced 828 barrels a day in October 2003.

Pat Smith, Headington's chief operating officer, says his approach back then was "to frack the heck out of it."

Turns out he didn't know from big fracks. EOG Resources Corp. last year drilled a well in the Eagle Ford Shale, using 30 times as much liquid. It also used 14.2 million pounds of sand. The result: 2,748 barrels a day.

Headington sold its Montana properties to XTO Energy Inc., now part of Exxon Mobil Corp. for $1.8 billion in 2008. Founder Tim Headington took some of his earnings and bankrolled Hollywood movies, such as "Hugo" and "Rango."

Mr. Smith is still chasing oil and looking to drill in the Permian Basin. But first, he needs to get up to speed on modern fracking. "I have a big learning curve," he says.