Economic & Market Commentary

Stock pickers have been tormented since the end of the financial crisis, five years ago. Macro events have called the shots, correlations among issues have been high, and stocks have tended to move en masse together. This was true for most of the first quarter, as most indices barely eked out a positive return, most of which occurred in the last month. The year began on a down note, with the beginning of the much anticipated “correction”, after the gain of 32% last year. This accelerated as China showed signs of slowing growth, which prompted a flight from emerging markets and their currencies. Reported U.S. economic data was soggy, which increased the fear factor, and stocks “corrected”, down 6%. January was a “risk off” month. February reversed that and stocks surged back, rallying close to 5%, on the back of social networks and biotech shares. The market was back in a “risk-on” mode. Stocks were barely up in the final month, masking several troublesome crosscurrents. The Russian invasion of Ukraine and the grab of Crimea came and went without a major impact. The hottest stocks (social network and biotech), during the February surge got hammered. By the quarter’s end, this resulted in a stock market that was marginally positive for the S&P 500 and a handful of other broad indices, while marginally negative for the Dow Jones Industrials. The U.S. was the best geography, as most others fell behind, with the emerging markets largely negative, while bonds and gold outpaced stocks, reversing recent trends.

Unlike most of last year, large capitalization stocks did better than small, and value better than growth for the quarter. Lower quality continued to outpace high, although that showed signs of change in March, as the popular “momentum” stocks were pummeled and “old economy” issues did well. The breadth of the market was better, as 5 of the 10 S&P industry sectors outperformed the overall index. Utilities led the performance parade, followed by Healthcare, Materials, Financials and Technology. The others were either barely positive or negative. For the last six years stocks have been highly correlated, moving in the same direction in unison, driven by macro factors. This is typified by what has become known as the “risk-on/risk-off” nature of the market. During the first quarter, this high correlation had declined to the lowest level since 2008. While it is still above the long term average, the decline, along with the specific action of stocks in March, gives us hope that stock selection will be better rewarded going forward.

Three months ago we wrote “we have long held the view that the U.S. was in for a period of subpar growth in the range of 2-2.5% for several years after the Great Recession. We are now in the fifth year of recovery and while we continue to feel the premise is valid, there can be cyclical improvement from that path. 2014 could well be an example.” We felt the ingredients were in place to accommodate real growth in the area of 3-3.5%, the best since 2005. The final data for last year has been reported and real GDP grew at just over 2.5%. It now looks as though growth for the first quarter of this year will be closer to 1.5%. Much of this apparent slowdown is due to temporary, nonrecurring, factors. The unseasonable cold and wintery weather has depressed activity in most of the Northeast and Midwest. The expiration of emergency unemployment benefits has cut $20 billion from household disposable income. Finally, inventory accumulation has slowed, which stunts growth as well. The Bank Credit Analyst estimates that these factors depressed growth by 1-1.5 percentage points, implying that underlying U.S. growth remains in the 2.5-3% range. In addition, the rest of the world’s economies are less robust than they looked at the beginning of the year.

- China is softer
- Abenomics appears to be less effective in Japan
- Europe is not as vibrant
- England is plagued by weather issues as we are

In spite of these facts, we still expect a rebound in the second quarter, and the balance of the year. After all, private sector GDP growth has averaged 3.3% per year since 2009, while public sector growth has trimmed 1.5% each year. Last year, real federal government outlays declined 4.7%. The Congressional Budget Office expects outlays to rise 1.1% this year – the first annual increase since 2011. Likewise state and local government finances are improved, which should mean better spending and employment there. Personal consumption growth will not have the same tailwinds of stock market and housing appreciation as last year, but can still sustain decent growth in spending. Lapping the tax hike of 2013, which depressed personal disposable income growth to 0.7%, and continued jobs growth should be enough to do so. The keystone to our view of growth this year, however, is a rebirth of capital spending in our economy. We have talked about this before and have structured portfolios accordingly. Growth in net business investment has not lived up to expectations in this recovery. For example, last year it increased just 2.8%, and as a share of domestic economic output has been trending lower over the past 25 years. This in spite of the fact that the change in the real capital stock of the country has been close to a 50 year low, and the average age of a plant is close to 50 year highs. Since this is an important part of our investment strategy, it demands further examination.

The skeptics point to the fact that the catalysts to drive capex have been elusive for the past 5 years, increasing the uncertainty about this area of the economy. They cite a handful of reasons for this, some of which are secular and some cyclical.

1. A large shift in the makeup of the economy has taken place over the past 50 years. Manufacturing was 27% of GDP in the late 50's and is now only 10-12%. Conversely, the service sector has grown from 36% to 62% of GDP. This has increased the demand for human capital at the expense of physical capital.

2. Technology has increased the productivity of capital investment, making it more efficient. In addition, the price of technology has been falling for some time, meaning it takes less dollars to obtain the desired level of efficiency.

3. A slower secular growth rate in the U.S. economy (which we subscribe to) implies lower growth in investment.

4. Capacity utilization is still low currently at 78.5%.

5. A factor that doesn't seem to get much mention from the skeptics is that of the general level of confidence in the business community. Concerns about Obamacare, the difficulties of heightened partisanship, and an administration that is redistributionist, favors regulation, and without a growth agenda does not inspire business to spend money on a clouded future.

The first three of these are secular in nature and have been in place for some time. While they do not point toward a robust change in capital spending, they can be accommodated, as they have in the past. In spite of these secular negatives, there are enough cyclical positives that can counter those trends.

1. Important is the age of our capital plant and its pace of replacement, which we have mentioned earlier. These are at a 50 year high and low respectively, Merrill Lynch points out that even maintenance capital spending is low.

2. Capacity utilization is coming back. After bottoming during the Great Recession at 67% (a more than 50 year low), it has slowly crept back to 78.5% currently. With economic activity growing and the Purchasing Manager's Index (PMI) reflecting growth, we are close to the 80-81% mark that historically has signaled increased capex.

3. Economic growth continues both in the U.S. and globally. PMI's have improved in 19 of 33 countries, and are expanding in all but 5. The weather related issues of the first quarter will soon be past, and growth should resume. This is crucial, as consumption is a necessary precursor to business capital spending. It is not a question of "build it and they will come", but rather if they come, it will be built.

4. Corporate balance sheets are laden with cash. Merrill Lynch points out that S&P500 nonfinancial firms had more than $1.2 trillion in cash at year end. That, coupled with easing lending standards, provides the wherewithal for increased spending. Corporate profits are strong and margins are at record highs. With return on investment high and the cost of capital low, the ingredients are there. Economic theory states that when the cost of capital is less than the returns to capital, investment should increase.

5. Anecdotal evidence indicates that investors are shifting interest from a return ***of*** capital to a return ***on*** capital. Laurence Fink (Blackrock's CEO) reportedly sent a letter to the S&P 500 companies urging a shift to long term uses of capital rather than more expedient short term uses. This was a call for a more balanced approach to capital allocation, with more emphasis on capital expenditure to foster sustainable long term returns. Capital allocation in recent years has favored share repurchase and dividends which is instant gratification rather than investment for future gains. In recent years, S&P companies have spent only 46% of cash flow on capital investment compared with an average of 57% since 1989.

6. Confidence is a more elusive quality to measure, yet all is not bleak here. Our legislators did avoid a major disruption by passing a budget and extending the debt ceiling during the quarter. The other issues are more difficult to come to grips with, but we have hope that the above mentioned positives will provide enough incentive to spend.

Putting it all together we believe there is enough evidence to expect a boost in business capital spending during 2014. If this transpires, we think the combination of capex, diminished fiscal drag, and a reasonable consumer will be enough to allow GDP growth to reach the 3% area this year, in line with our expectations.

As we write this, stocks are going through another "corrective" phase, with the S&P 500 declining to the 1820 area. Just below where it began the year. We are entering another earnings reporting season, and expectations have been lowered due to increased negative guidance from managements (weather). At its current level, the aggregate market is selling between 15-16 times expected 2014 earnings. This, and several other measures of valuation, indicate the "market" is at the upper end of fair value when compared to several historical data points. As such, valuation is not stretched enough for us to alter our previously stated strategy. We have added offense through sector weightings that emphasize economic sensitivity, and we continue to look for undervalued and underappreciated businesses which may have more immunity to macro economic and political events. Three months ago, we wrote about the list of risks to this strategy. Many of them remain in the background, while a new one has come to the fore. Recent events in Ukraine and Russia's grab of Crimea were unexpected. Alone these events pose little risk to the U.S. However, President Putin's motives and objectives have the potential to be troublesome. In the 90's after the fall of the Berlin Wall, Francis Fukuyama wrote his epic "The End of History", which opined that ideological evolution was complete with the acceptance of Western liberal democracy as the final form of human government. It appears he was premature.

Fixed Income Review and Outlook

Five hundred years ago, everyone thought the Earth was the center of the universe. Sixty years ago, people thought no one could run a mile in under 4 minutes. Forty years ago, Babe Ruth's home run record was thought to be unbreakable. Copernicus, Roger Bannister and Hank Aaron proved everyone wrong. Going into 2014, most people thought rates were going to continue higher as they had in 2013. Instead, we got a modest rally in rates that erased most of the 2013 losses suffered by the bond market.

The Barclays Aggregate Bond Index returned 1.84% for the quarter. All the major bond sectors posted positive returns for the first three months of the year. However, Corporates were the only sector to outperform (2.94%), while Treasuries (1.34%), Agencies (1.24%) and Mortgage (1.59%) underperformed. Much of an individual sector's return was driven by the exposure on the yield curve. Those with shorter maturities (Asset-Backed Securities for example) gained 0.54%, while longer securities (those with durations greater than 20 years) gained 7.1%.

Janet Yellen was sworn in as the new Fed Chair on February 3. The consensus view is that she will follow the path of exiting the current stimulus program, QE3, started by her predecessor, Ben Bernanke. The Fed is expected to curtail or taper its purchases of Treasuries and mortgages by $10 billion per meeting over the next four meetings and by $15 billion at the October meeting. Following the end of QE3, the Fed will start raising the Fed Funds target from the 0%-0.25% range it has been in since December 2008. Yellen caught bond investors off guard at her first press conference following the March 19 Fed meeting. At the conference, she speculated that the Fed could start raising rates after a considerable time or "on the order of around six months, that type of thing" following the end of QE3, implying a first move in the first or second quarter of 2015. Market expectations for the beginning of rate increases had been for late 2015 or possibly 2016. The market reaction was swift, and negative. Two year yields rose 8 basis points that afternoon; ten year yields rose 10; and the five year yield rose 16. It is clear the Fed wants higher rates. High enough to avoid disinflationary fears but not high enough to choke off growth. Bond investors are rarely rewarded for fighting the Fed and it's not our intention to do so either.

We took advantage of the rally in rates and reduced our portfolio durations from 90% of target to about 85% of target, the lower end of our preferred range. While we expect rates to trend higher this year, we do not expect a violent move like that experienced last year. Slow growth in the early part of the year and low inflation should provide support for low rates.

In anticipation of the short term rates moving up more than intermediate and longer term rates, we are holding more cash equivalents and intermediate bonds in order to maintain a short duration, though with different curve exposure than we held earlier in the quarter. In effect, we are adopting a barbell strategy. A happy consequence of this action results in slightly higher yields to the overall portfolios since the curve is still very steep.

We continue to watch the Treasury Inflation Protected Securities (TIPS) market in the event an overly bearish view on inflation provides an opportunity to add inflation protection. We would look for breakeven yields, the rate at which you are indifferent to holding a nominal Treasury or a TIP, to fall about 10 basis points from current levels before taking a position.

As part of our barbell strategy, we are adding bullet Agencies with less than one year to maturity, as a highly liquid cash equivalent in order to generate a small yield advantage over that available in short Treasuries. Further out the curve, we are not looking to add bullets at current spreads. We like callable Agencies with call dates in the next twelve months that are trading above par or have coupons that step-up as they have an increased probability of being called.

Investment grade corporate bonds outperformed the market with a 2.94% return with longer bonds outperforming shorter bonds. Following the strong performance of credit to start the year that brought some spreads back to pre-crisis levels, we have reduced the corporate holdings that didn't offer enough yield to compensate for owning the bond. We exited some bonds that had rolled down the curve and found bonds in the same names with longer maturities that will roll down as 2014 progresses. We intend to remain modestly overweight corporate bonds and look for opportunities to add on weakness. At these levels, we don't think a full overweight is warranted. We continue to prefer credits with the ability to raise prices or those engaged in ongoing balance sheet repair, and avoid those companies that issue debt in order to pay dividends or buy back shares.

We reduced our mortgage positions in late 2013, which was fortunate as mortgages produced a below average return of 1.59%. There continues to be a lot of noise in the market and spreads, in our opinion, do not reflect all the negatives for holding the bonds. However, Mortgages provide a higher yielding alternative to Agencies. If the mortgage sector develops weakness later in the year, we will look to add exposure, but for now are more comfortable sitting on the sidelines