Economic & Market Commentary

A recent issue of *The Economist* suggested that America should abolish the first quarter of the year, which would allow the economy to look much better. After the past two years, that's not a bad idea. Last year's "polar vortex" was followed this year by another harsh winter, along with a severe decline in oil drilling, a West Coast dock strike, and a strong dollar. These conspired to cause all sectors of the economy to operate well below trend. Last year, the domestic economy declined 2.9% in the first quarter, yet closed the year at a +3.3% pace in the second half. This year, the reduced estimates for the quarter range from +0.2% to 1.4%, well below trend, and with many of the aforementioned issues not going away soon, the full year is under question. Like last year, this has had a telling effect on most asset prices, and monthly stock performance has been alternatively negative/positive, but the quarter ended marginally in the plus column again.

The narrative influencing investors during the quarter has been the pace of the U.S. economy as delineated by the monthly reported economic data. Whether the economy will continue to grow at a modest pace or show signs of cyclical slowing will impact the pace of corporate earnings and when the Federal Reserve Board begins its much anticipated increase of interest rates. Investors' response to these factors has caused volatility to increase (there have been 19 daily moves of +/-1% in the quarter, the most in 3 years), and stock prices to rise at any sign of delay in the timing of the Fed's move to increase rates, or fall at any sign of hastening its timing.

A perfect example of this was the recently released March jobs report, which was poorer than expected. Investors took this as a signal that the economy would slow (which is usually not good for earnings or stocks), and that would delay the Fed's expected date of increase in the Fed Funds Rate. The knee jerk reaction of the stock market was several days of increasing prices. The perversity of this reaction is that we want the economy to grow, which should be good for earnings and stocks, in spite of the fact that a growing economy may lead to increasing interest rates.

Stocks ended the quarter marginally positive, lagging behind most other asset classes. Bonds outperformed U.S. stocks and most foreign markets did as well. Small and midcap equities did better than large, growth did better than value and low quality did better than high quality. We have cited the narrowness of stock performance in the past. This trend continued in the first quarter with only two of the ten S&P sectors outperforming the index (Healthcare and Consumer Discretionary). All in all, it was a directionless and lackluster quarter.

Our broad economic framework for 2015 has changed little over the last three months. To reiterate we see the following:

- 2-3% real GDP growth
- Continued adequate job growth
- Contained inflation
- Modest corporate profit growth
- The beginning of Fed normalization of interest rates leading to higher rates
- Europe, Japan, and China showing improved economic results
- Positive returns from stocks

There are three areas of the broader picture that have been important parts of our strategic thinking that deserve more commentary.

The first is capital expenditures. The case for expanding business spending has been made in earlier issues of our quarterly Economic and Market Commentaries. These points are still in place, yet capital spending has been slow to develop and is well below trend. It now seems more likely that we will not have a particularly robust capital spending cycle going forward. It is true that our capital stock is old and aging, that corporate balance sheets are strong and that the spread between the return on capital and the cost of capital is wide. All this suggests that capital spending should help prolong our economic expansion. However, countervailing factors have subdued the amplitude of the current contribution. As we pointed out in our last quarterly Commentary, capital has become more efficient over the last 35 years. *BCA Research* points out that the GDP/Capital Stock Ratio (how much GDP is produced by a unit of capital stock) has increased about 40% over that period. This increase in capital efficiency mitigates the need to spend, particularly in a time of uncertainty. This, plus the ongoing shift in the makeup of the economy from manufacturing to service, has dominated the demand for capital, and is reflected in the fact that capacity utilization of the economy remains below 80%, a key data point, and left business spending less robust than in past recoveries.

Our investment in capital spending-oriented companies has been productive for most of the time it has been in place, yet has developed more slowly than we had hoped. As a result, we have taken steps to reduce the weighting. This began with a reduction of holdings engaged in energy capital spending, given the dramatic decline in the price of oil. Energy capital spending had more than doubled as a percentage of total capital spending, to about 12%, over the past several years. Clearly, with reduced cash flow from production, the energy companies will be spending less on capital projects.

The second area worth discussing is interest rates, or more pointedly “what’s the Fed going to do, and when will they do it?” This is important because it can have an impact on asset prices – witness the so called “taper tantrum” in May 2013 when stocks hit an air pocket based merely on the Fed’s statements. Today’s question is not whether the Fed will increase the Fed Funds rate, but by how much and when? This has been the most advertised Federal Reserve action in memory, and has been debated ad nauseam by investors. You would think a rate increase would be baked into the market, yet investors remain addicted to excess liquidity. *The Economist* points out that there have been 29 instances of monetary easing by Central Banks around the world in the past four months. Global investors have an ample supply of the narcotic, yet their reaction to withdrawal continues to be violent. In past rate hiking cycles, stocks have wobbled a bit around the time of the announcement, yet six months after the first rate increase are usually higher. In fact, looking at rising rate cycles over close to 60 years equities have performed quite well. Over that time frame, equities peaked on average 29 months after the first Fed Funds increase. So, while stocks may experience a downdraft on the Fed’s first move, it should be short lived. In our view, it makes little difference to the real economy whether the funds rate is at zero, 25 basis points, or 50 basis points at year end, and trying to handicap whether the Fed will move in June, September or later, is not something on which to base our investment strategy. More important is the pace of policy tightening. Too much too quickly could do more lasting damage to financial assets. Our conclusion is that the Fed will be very careful and gradual in its action, as this is what they seem to be telegraphing, and their benchmarks (inflation and economic growth) are subdued. A final note on this topic is we hope the Fed’s actions serve to steepen the yield curve. We do not want to see a repeat of the 2004 – 2005 period (Chairman Greenspan’s “conundrum”) when the funds rate went from 1% to 4%, while the 10 year Treasury stayed in the 4.0 – 4.5% range, causing a flattening yield curve. This is important to all financial stocks so we will be watching closely.

Finally, we should say a few words about corporate profits and company earnings. We are in corporate reporting season for the first quarter, and it is fair to say that expectations have been declining since the beginning of the year. From recent peaks in both margins and aggregate profits, which reached the highest level as a proportion of GDP since the Second World War, estimates have been coming down. Aggregate profits (as measured by the Bureau of Economic Analysis) declined by 1.6% in the final quarter of last year. This measure of profits does not square with profits of the S&P 500, as the latter includes foreign earnings and are helped by share repurchases. However, the national account data are indicative of a trend. The energy collapse and dollar strength will weigh on 2015. To put this in some perspective, the energy sector accounts for about 10% of S&P 500 earnings, and there are some who estimate energy company profits will decline 40% or more. Likewise, foreign profits are estimated to represent 40% of S&P 500 company profits. While not all of that is denominated in foreign currencies, the 13% appreciation of the dollar against the Euro and modest appreciation against the Yen this quarter will take its toll. As a result, the expectations for reported Q1 earnings is negative, while the expectation for the full year has come down to a 2-3% increase.

The S&P 500 index ended the quarter at 2068, a mere nine points higher than at year end. Yet, with earnings estimates coming down, the market's price/earnings ratio had climbed to between 17X – 18X. In early April the market has risen further placing the P/E ratio at about 18X. We consider this close to full value. Last time we wrote that in view of the level of the market, the compression of valuations, and the narrowness of breadth, finding candidates for purchase had become difficult. We can certainly say the same today. We have already discussed the adjustment made to the portfolio regarding energy and capital expenditures. We expect these adjustments to continue as we look for candidates with better prospects. We are currently finding opportunity in companies where management is taking action to unlock value and increase the share price. These usually have some form of catalyst, which could include corporate restructuring, capital structure change or acquisition, often accompanied by activist investor involvement. These situations typically are less impacted by general economic events, and more in control of their own destiny. Included in this list are Hudson's Bay Company and Teekay Corporation, both of which are going through internal changes that we think will be very positive. We will continue to look for opportunities like these, where we have a high conviction of adding value.

Fixed Income Review and Outlook

The bond market started 2015 in very good spirits. Rates rallied hard in January, with the yields of the five to thirty year maturity Treasuries falling about 50 basis points (0.50%) or more. When the month was over, the thirty year Treasury had touched its modern day low yield of 2.22% and the 20+ year component of the Treasury market had returned more than 9%! As the quarter progressed, yields moved higher and gave back some of their gains. Overall, the Barclays U.S. Aggregate Bond Index generated a 1.61% return for the three months ending in March.

The market continues to focus on when the Fed will start to raise the Fed Funds rate target. In their statement following the March meeting, the FOMC removed the assurance that it would be "patient in beginning to normalize the stance of monetary policy". Instead the Fed will look for further improvement in the labor market and signs that inflation will move back toward 2% in the medium term. Interestingly enough, following the March meeting, the Fed released the summary of the Governors' economic projections which included Core Personal Consumption Expenditure inflation guesses that were lower in March than they were after the December 2014 meeting. In December, the upper end of the range stood at 2.2%; in March, the high mark was 1.6%. Similarly telling is the projection of where the Governors themselves believed Fed Funds target will be at the end of the year. The median estimate in March was 0.625%, which equates to two or three 25 basis point tightening moves. In December, the median estimate was 1.125% or four to five moves. “Lower for Longer” is the new mantra.

As for Europe, European Central Bank (ECB) President Mario Draghi vowed in July, 2012 to do “whatever it took” to preserve the Euro and get the economy going. On January 22, we learned what that meant. Effective in early March, the ECB began monthly purchases of €60 billion of government and private sector bonds. The program is slated to last at least until September of next year. The purchases could extend further if the ECB isn’t meeting its inflation target of just below 2%. An extension seems likely. In December, the Consumer Price Index (CPI) in the Eurozone stood at - 0.2% year over year and continues to trend lower, reaching -0.3% in February. The Eurozone CPI will be battered by countervailing forces of falling commodity prices (deflationary) and the weakening of the euro (inflationary). In the first quarter, the euro lost 11% relative the dollar. That’s good for U.S. consumers who can buy European products cheaper and bad for U.S.-produced goods.

Agencies returned 0.50% for the quarter, and are instrumental in our barbell strategy. We prefer to add 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. We continue to add callable Agencies opportunistically as volatility moves higher. We look for those bonds with short call dates and two to four year maturities to minimize extension risk.

Investment grade corporate bonds outperformed the market with a 2.32% return in the first quarter. Longer bonds outperformed shorter ones and lower quality did better than high. We increased the allocation to credit late in the quarter as corporates represented better value relative to Treasuries and other sectors. We’ve focused on the 7 to 10 year part of the curve and added to our holdings there. We continue to prefer credits with the ability to raise prices or those engaged in ongoing balance sheet repair. As always, we tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

As expected, bond volatility increased as investors expect the Fed to tighten U.S. monetary conditions while much of the world increases simulative measures. We see these increases in volatility as an opportunity to add to mortgages. We increased our allocation in the middle of the quarter, as volatility trended toward levels not seen since late 2013. We prefer Collateralized Mortgage Obligations (CMOs) carved from high quality Fannie Mae and Ginnie Mae mortgages with yields comparable to corporate debt. We like structured paper priced below par ($100) designed to be less interest rate sensitive in the face of rising interest rates.

We are continuing to maintain a defensive strategy with durations of about 90% of our target. We are positioned with most of our interest rate exposure using the five to ten year part of the curve. As the year progresses, we expect to move toward a greater barbell strategy: holding securities with little time to maturity and longer securities that are less affected by changes in the Fed Funds target.