First Quarter 2013 Commentary

"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria."

Sir John Templeton

The efforts of Mario Draghi and the European Central Bank (ECB) in 2012 to offer potentially unlimited liquidity to banks and sovereigns via Outright Monetary Transactions (OMT) dramatically reduced the tail risk of a Eurozone breakup. Indeed, improvement in confidence in the Eurozone signified by declining sovereign bond yields engendered optimism that the worst of the financial crisis had passed. Little to no return offered from safe investments combined with a flood of excess liquidity provided by central banks paved the way for a powerful 9-month rally in world risk assets culminating in a return to record nominal highs in both the Dow Jones Industrial Average and the S&P 500 in the first quarter of 2013.

As we have seen though, coordinated central bank actions actually do little to reduce the formidable headwinds preventing a return to vigorous growth in both the U.S. and Europe. They are, however, a necessary pre-condition to reduce or eliminate such panics and return confidence to the system. Unfortunately, such confidence in the ability of central banks to successfully navigate through these crises often leads to a return of complacency and sow the seeds for the next crisis.

Cyprus is a small island country in the eastern Mediterranean Sea with a population of just over 1.1MM representing 0.2% of the total economy of the European Union. The economy of Cyprus is mostly known for its banking system with total bank assets more than 8X the level of its Gross Domestic Product (GDP). In March, the troika of the ECB, International Monetary Fund (IMF) and the European Union (EU) changed the rules of the game in how they will deal with failing financial institutions. By deciding not to insure depositors to Cyprus banks with more than €100,000, a message was sent that the risks of bailouts would now be transferred from taxpayers to private investors. Rejected or not, the message that cash in a bank may no longer be safe was sent and may return as a future strategy. Though many have already dismissed Cyprus as a non-event, we are not so sure. With the Fed, Japan and other central banks remaining steadfast in accommodation, bullish sentiment may continue to overwhelm concerns in Europe. But as Cyprus has so recently and so dramatically exhibited, we are far from the end of the crisis.

Basel III (a global regulatory standard on bank capital adequacy) requires European banks to improve deposit ratios. European banks depend more on deposits for funding requirements than do U.S. banks which primarily use the capital markets. The precedent set in Cyprus may have dangerous ramifications for the weaker banks in Italy and Spain and foster the exodus of monies from international banks to the safety of the U.S. banking system. It is the federal deposit insurance mechanism (raised from $100,000 to $250,000 during the financial crisis to prevent such an occurrence) employed via the FDIC that is critically lacking in the European Monetary Union. With deposit ratios further strained, credit expansion will be weak and economic growth further challenged. All of this at a point following the 6th consecutive quarter of economic contraction in the Eurozone and with unemployment at a new high of 12%. Currently the ruinous trajectory of Spain and Italy is now being followed closely by France which teeters on the precipice of a new and potentially enduring recession.

Predictably, the immediate reaction in Europe to the events in Cyprus was a sell-off in equity markets and a troublesome rise in bond yields for the critical periphery economies of Italy and Spain. Enter Japan. New Bank of Japan Governor Haruhiko Kuroda committed the BOJ to perhaps the most intense burst of monetary stimulus yet in this global central bank competition. Kuroda's promises to inject $1.4T into the economy over 2 years will effectively double the monetary base with the primary objective of stoking inflation and breaking the Japanese economy from a 20-year funk of deflation and rolling recessions. This dose of even greater liquidity is now finding a home in other risk assets including higher yielding European bonds. That peripheral sovereign bond yields have declined in the Eurozone is remarkable given recent events in Cyprus and the lack of any real government in Italy.

The U.S. economy entered 2013 with little momentum after a weak 4Q GDP growth rate of 0.4% and full year GDP increasing only 1.6% on a year-over-year basis. This brought the annualized growth rate from the depths of the recession in 2Q 2009 to only 2.1%, the weakest economic recovery on record. The U.S. continues in a slow healing, muddle-through economy consistent with a post credit-crisis environment. The slow growth levels noted above for 2010-12 were supported by strong government stimulus that allowed consumers to modestly repair balance sheets by reducing household debt service ratios (the ratio of debt payments to disposable personal income) from 14.1% in 2007 to 10.4% at last reading, levels not enjoyed since 1983. This more comfortable debt burden in theory might allow consumers to increase consumption to levels consistent with growth in income. Consumers also benefitted from the powerful wealth effect of rising financial markets and home prices that allowed Household Net Worth as measured by the Federal Reserve Flow of Funds Report to show an increase to within 3% of the prior nominal highs reached in 2007. This benefit (largely influenced by the zero interest rate policy of the Federal Reserve) inures mostly to upper income individuals and further divides an already wide wealth gap in our country. It should be noted though that it is estimated that the top 20% of income earners comprise 38% of discretionary spending.

However, into this delicate balance was a consumer facing the immediate headwind of almost $200B in tax increases amounting to almost 1.5% of our national economy. We anticipated the largest impact of $120B might be felt in the first quarter of the year as the expiration of the payroll tax reduction (reverting back to the level of 6.2% from 4.2%) would curtail consumer spending. We were wrong on the timing of that impact. Aided by continued but waning support from government transfer payments that accounted for over 21% of consumer spending and a drawdown in the personal savings rate to a post-crisis low of 2.6%, consumers maintained a real spending pace in the first two months of the year at a 3% annualized rate. Combined with a rebuild in inventories and a positive contribution from trade and residential investment (housing), analysts are raising the estimate for 1Q real GDP growth to over 3%. We cannot extrapolate

continued strong spending, however, as it is not coming from wage growth. Early indications are that March witnessed a slowdown in economic activity and spending as we enter the second quarter on a weaker note with increased consumer headwinds.

Sequestration is the term used to describe about $85B of defense and discretionary spending cuts by the U.S. government (and $600B over 10 years) that went into effect March 1, 2013. This reduction in spending is estimated to have an impact on growth of as much as 0.8% of GDP. Additionally, a rise in prices at the pump of over 35 cents per gallon since the start of the year represents about a $45B annualized impact to consumer spending. With gas prices already representing a three decade high of 6.5% of median family income, we expect the impact on consumer spending to be greatest over the next two quarters. With a softening of consumer spending we look for GDP growth to be below 2% for both of the 2nd and 3rd quarters of 2013 and still anticipate full year GDP in the same area.

Our lack of confidence in the sustainability of these economic head fakes continues to be centered in the job market. The headline narrative focuses upon a slow but steady improvement in payroll growth over the last 2 years along with a rapidly declining unemployment rate. Since the end of 2009, the unemployment rate has continued a steady decline from the 10% level to the most recent reading of 7.6% in April. Additionally, we have managed to recover all but 2.7MM of the 8.8MM jobs that were lost during the recession. Looking deeper into these improving data points, though, paints a darker picture.

The labor force participation rate is a measure calculated by the Bureau of Labor and Statistics to determine the percentage of people that are either employed or actively looking for work. A declining labor force may, therefore, cause an understatement in the actual unemployment rate as people exit the labor force entirely. The most recent labor force participation rate declined to 63.3%, the lowest reading since 1979. If the labor force were held constant to the levels at the end of the recession in 2009, the stated unemployment rate would be almost 11%. The labor force has receded by over 3MM since 2009 and many economists correctly point out that much of this decline reflects an aging demography and increasing amounts of retiring “baby boomers”. Though this is true, estimates by the Wall Street Journal and J.P. Morgan conclude that over 700,000 more individuals have entered the Social Security disability programs during this period than trend would suggest. This accounts for fully a quarter of the reduction in the participation ratio. Irrespective of the source, the impact on productivity of a declining and aging work force is not trivial.

Of the jobs that have been recovered it must also be stressed that although we have regained all but 2.7MM of the lost jobs, full time employment is still over 6MM below pre-recession levels. The Job Openings and Labor Turnover (JOLTS) analysis of hiring and firing just reported a post-recession high of job openings. However, a much larger than normal amount of the positions are in part-time and temporary work a trend that reflects both continued economic uncertainty and employer concerns over the impact of the Affordable Care Act. Further data from the JOLTS analysis indicate that actual layoffs are now at the lowest level on record and the average workweek of existing employees is rising. Employers are battening down the hatches and making due with less.

The almost 12MM that are considered unemployed does not include over 800K discouraged workers who claim they have given up looking for work and 7.6MM more (5.6% of the workforce) who are working part time but desire full time work. More concretely, the poor quality of job growth is reflected in a median household income level in January 2013 of $51,584

(Sentier Research) which is over 7% less than January 2000 and almost 5% less than at the start of the economic recovery.

Of all the direct and indirect impacts of Quantitative Easing and interest rate policies, what Federal Reserve Chairman Ben Bernanke may be most pleased with are rising home values. Over the last 12 month period, the Case-Shiller Index estimates home values on a national level have increased 8.1% while Core Logic pegs this at 9.7%. Low interest rates allow many additional homeowners to refinance a mortgage and they are then much more willing to redeploy the savings elsewhere in the economy. Rising home values stimulate everything from construction activity and remodeling to increased durable purchases. Additionally, the resurgence in new home building (impacted greatly by the current lack of inventory of existing homes) in turn spurs more hiring, manufacturing activity, production of construction materials, etc. Housing is by far the largest single asset on the balance sheet of U.S. households accounting for over 25% of total net worth. Though Residential Investment accounts for only 2.6% of GDP, the multiplier impacts to the economy are great and if continued could be a game changer.

Nonetheless, we are still dubious of the sustainability in this area as the recovery in housing is disconnected from traditional economic drivers that were noted above. Job and wage growth along with expanding and available credit are required for a normal functioning housing market. Total bank mortgage debt has remained flat throughout this recovery. The primary growth continues to be in multi-family units for new construction and the purchase of existing single family structures to be redeployed as rentals. In 2012, 12% of U.S. households rented single family homes versus 9% in 2004. This recovery is heavily supported by both “mom and pop” and private equity investors as evidenced by the number of all cash sales (32%) and the lack of first time buyers (30% versus historical average over 40%). Natural buyers are needed for sustainability as they are more likely to spend on outfitting a single family home and will be an eventual “move-up” seller. That does not occur in the rental space, and the challenges of high unemployment and the burden of student loan debt ($966B currently, up from $253B in 2006) with still tight credit is constraining this market for entry level buyers.

One of the most commonly heard narratives heard to explain the “most hated rally in Wall Street history” is that the market is just keeping pace with corporate earnings growth that have increased at an annual rate exceeding 20% since 2008. Indeed, it has been noted as we retest historic nominal highs in the major averages that forward price/earnings multiples and dividend yields are actually more attractive now than at prior market peaks of 2000 and 2007. Warren Buffet has noted that the ratio of total stock market capitalization to GDP is “probably the best single measure of where valuations stand at any given moment”. This measure currently stands at 1.1, one of only 3 times it has exceeded 1.0. The other times were (you guessed it) 2000 and 2007. This is not comforting. What seems to be ignored is how we are getting the earnings and what it implies for the future.

Corporate profits as a per cent of national income (profit margins) reached 14% at the end of 2012. This is the highest profit margin since 1950. The converse of this statistic, the per cent of national income that inures to employees (including benefits), is 61.7% or the lowest since 1966. Despite wages being at their lowest share in history, consumers have been able to maintain consumption aided by government transfer payments accounting for 21.5% of this total. This stimulus, government deficits, and a reduction in household savings have directly fueled this profit boom.

Now, however, the deficit has declined at the fastest pace on record over the last 3 years moving from 10.1% to an estimate by the CBO of 5.3% in 2013. Little notice has been given to the flattening of corporate profits over the last six quarters directly related to this austerity. S&P earnings finished 2011 at a level of $96. Our way below census call of less than $95 for 2012 was actually closer than the consensus of $107 as the final number from S&P is just over $97. Indeed, not only are earnings flat over the last six quarters but actually declined in the 4th quarter of 2012 by more than 2% on an annual basis. With consensus estimates for S&P 500 earnings in excess of $108 for 2013, we again feel that this forecast may be too optimistic.

We would estimate that we are currently entering the "optimism" stage referenced in the opening quotation of the legendary Sir John Templeton. We have no way of estimating when or even if we will enter the "euphoria" stage. Confidence in the infallibility of central bank liquidity can overcome and obfuscate much deterioration below the surface and may continue longer than we might anticipate. What we can say is that very aggressive positions at current market levels are akin to what Robert Arnott of Research Affiliates has called "picking up nickels in front of steamrollers". We continue to favor high quality companies with sustainable cash flows and a growing dividend stream in just such an environment.