Q1 2014 Commentary

"Little darling, it's been a long cold lonely winter
Little darling, it feels like years since it's been here
Here comes the sun, here comes the sun
And I say it's all right."

George Harrison

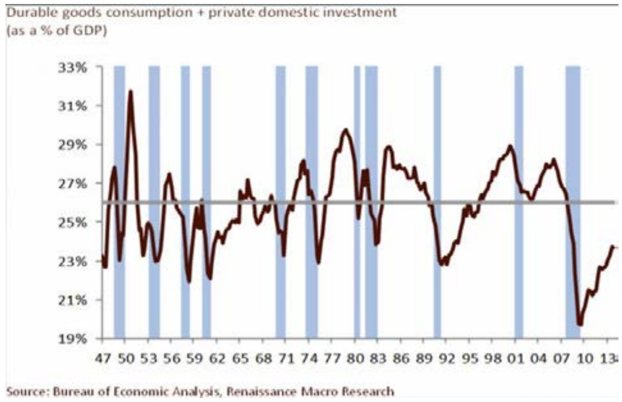
For many, the traditional rites of Spring are centered upon waking to the sounds of owls hooting or woodpeckers drumming. For some it is the sound of bat meeting ball (except perhaps when the Phillies are at the plate) returning to our senses and the most beautiful shades of green that envelopes us at the ballpark. The NCAA pools are now tattered on the floor and some may ponder whether an extension on our tax returns was really a wise idea. For me, the greatest reminder occurs when I inevitably hear the first four chords of perhaps my favorite Beatles song. It never fails to elicit one of the most pleasurable grins I enjoy all year as I know the worst of winter is past and my favorite seasons lay on the horizon. For the U.S. economy, we believe those four chords may soon be playing.

UNITED STATES

We entered 2014 anticipating that our economy would experience slowing growth in the first quarter. The expiration of Emergency Unemployment Compensation (eliminating benefits for 1.3MM unemployed) would combine with an expected drawdown of inventory builds that had engendered a strong finish to 2013. We had little anticipation of the impact that weather would have especially in the Midwest and Northeast regions.

While full year 2013 GDP growth was less than 1.9%, we experienced growth in the second half at an annualized rate of over 3.3%. Increases in payroll and income taxes along with reductions in government spending may have shaved as much as 1.25%-1.5% from the full year numbers. The removal of this drag led us to more optimistically look forward to full year growth for 2014 that would approach 2.75%-3%. As we now anticipate 1Q GDP to come in around 1.5% and the second quarter to still face more inventory drawdowns, there are downside risks to that full year forecast. However, this does not yet alter our view for moderately improving economic trends.

The large government deficit which eclipsed 10% of GDP in 2009 had been a key driver in our economic rebound filling up the spending vacuum created by declining consumer spending and business investment after the great recession. With the current deficit having now fallen to less than 3% of GDP (estimated for 2014), the burden now shifts from the government to the hands of corporations to increase capital spending and sow the seeds for future growth. The growth rate in the capital stock of the private sector has averaged less than 1% in the last five year period representing the lowest half decade trend in the post-World War II period. We have previously noted that growth in GDP is a product of labor force increases and productivity gains with the secular concern of an aging demography and declining labor force acting as a headwind. This has precipitated a fall in productivity growth during this cycle to less than 1% compared with a long term trend over multiple decades of over 2%.

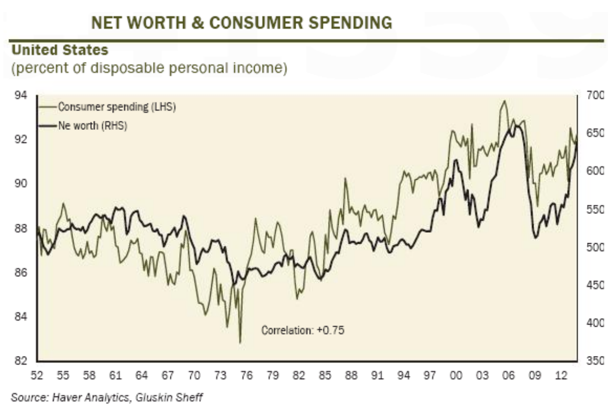


Source: Bureau of Economic Analysis, Renaissance Macro Research

But U.S. corporations are awash in cash. QE has allowed companies to refinance higher yielding short term debt to longer term debt reducing any liquidity risk and improving income statements and balance sheets. Despite nominal levels of debt rising to record levels, short term debt is a record low 20% of total debt. Interest expense as a percentage of sales has dropped from 6.2% in 2007 to 1.8% currently. With corporate America in strong fiscal condition amidst record profits, we need to see signs of greater investment. The results of the first quarter were mixed as core capital goods and real equipment spending were weaker at the end of 2013 into the early part of 2014. As the chart above shows, we still have a long way to go. However, these trends appear to be strengthening into the 2nd quarter.

In late 2010 as the second phase of Quantitative Easing (QE2) was unfolding, then Federal Reserve Chairman Ben Bernanke said he hoped the Fed's bond-buying program would help lift stock prices as lower yields on bonds would cause some people to shift money into stocks and these lower corporate bond rates would also spur business investment. The theory of the "wealth effect" was that higher stock prices and rising home values would boost the wealth and confidence of individuals and businesses. Spending would subsequently rise, lifting incomes, profits and economic growth. Bernanke referred to this as a "virtuous cycle." The ultimate success of this strategy still remains unclear as it relates to increased business investment, consumer spending and job growth.

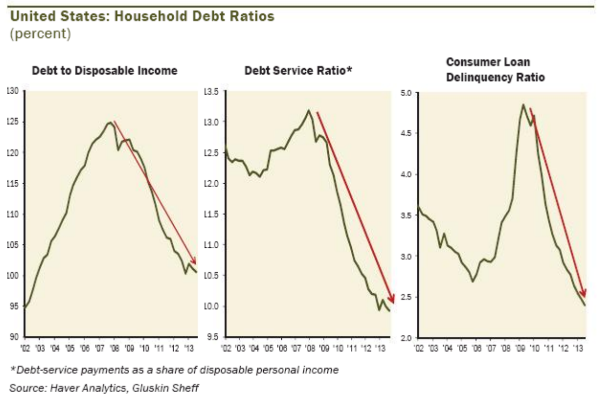
The chart below depicts the correlation at the heart of Bernanke's theory of the "wealth effect".



Source: Haver Analytics, Gluskin Sheff

QE exacerbates the inequality of assets and income as the benefits of rising financial asset prices disproportionately inure to those in the top 5% of wealth and wages. As reported by the Federal Reserve in the most recent Flow of Funds report, Household Net Worth at the end of 2013 reached a record $80.7T more than $13T above the prior peak of 2Q 2007. Homeowners Equity in real estate is back up to 51.7% from the lows of 37% (though still way below levels in the 60%-70% range in prior decades). Though these data points may unevenly reflect the fortunes of the wealthy, there is recent data that is also positive for Main Street. Sentier Research analyzing Census Bureau data notes that Real Median Household income for February 2014 is $53,093. Though this figure is down -6.2% from the peak of $56,648 in 2000, the most recent reading is up 3.8% from the recent low of August of 2011 ($51,152).

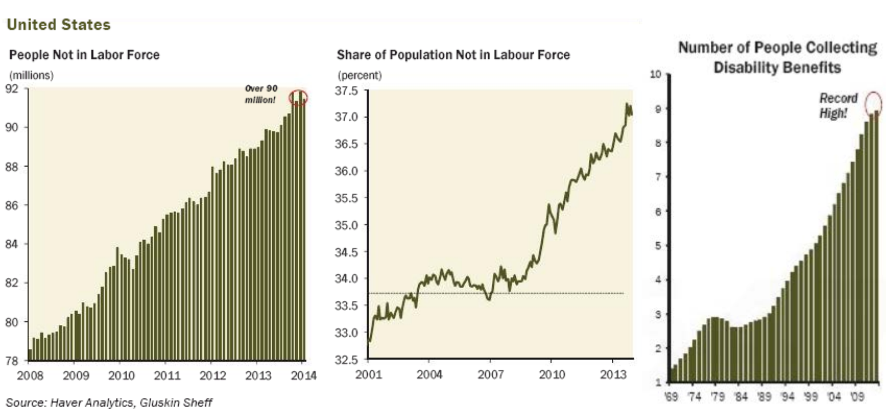
Moderately rising incomes and confidence are now combining with debt levels that, while still high from historical standards, have been reduced and offer some breathing room. Much of the massive credit expansion of 2002-2007 has now been reversed. Debt to Disposable Income, Debt Service Ratios (very interest rate sensitive) and Consumer Loan Delinquencies have all improved dramatically as shown on the graph below.



According to research done by the Federal Reserve Bank of St. Louis, the top 5% of wage earners accounted for over 92% of the increase in spending between 2009-2012 and this undoubtedly continued through 2013. Though consumer spending has increased at an annual rate of about 2.2% in the four plus years since the crisis this compares to the pre-crisis level of 3.6% from 1996-2007. Income growth over the last three years has averaged only about 2% and helps explain why GDP has been mired in the 2%-2.25% area. With a record 71% of total Net Worth in financial assets and economic growth tethered to the discretionary spending of the top 5%, the economic recovery is still highly correlated to the markets and therefore vulnerable to its volatility.

Despite weather threatening the pace of the job recovery, recent revisions to some of the winter data depict a job market continuing to slowly heal. Indeed, the 3 month trend on the nonfarm payrolls through March of 178K jobs created per month compares favorably with the 12-month and 3-year trends of about 180K monthly jobs. Private sector payrolls are now at a level which exceeds the pre-recession peak with total payrolls (which include government job declines) not far behind. Additionally, over the last 12-month period full-time positions have increased by 2.1MM while part-time have only gone up by 191K likely depicting overall improvement in the quality of jobs. Into this trend we continue to note improving aggregate payrolls (earnings and duration of the workweek) following one of our themes of tightening labor markets.

Though conventional wisdom from the onset of QE had been the expectation that inflation would subsequently rise, our position during this period has been contrary. We have long noted that low levels of inflation (perhaps even bouts of deflation) would be the greater threat as massive employment and output gaps made monetary policy ineffective. Despite levels of the unemployed and the share of the population now considered to be outside the labor force now at record highs, we believe we may be in the embryonic stages of rising wage pressures.

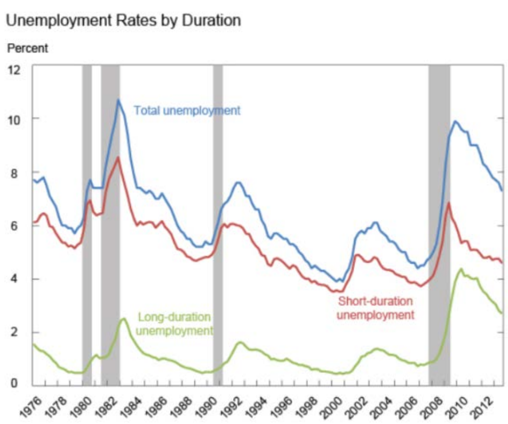


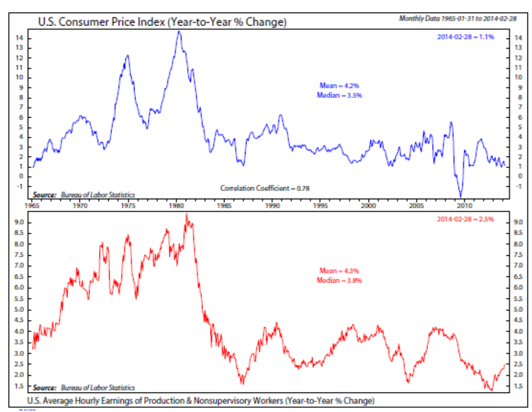
The decline in the employment-to-population ratio (which measures the country's working age population that is employed) from 62.7% in December of 2007 to the most recent March reading of 58.9% actually commenced in 2000 from a peak of 64.7%. We believe that much of the decline is structural in nature due to an aging demography with many more moving to Social Security Disability Insurance (see chart above) from which few will return to the work force. Indeed, from 2010-2013 more than 60% of the people who left the labor force (over 6.6M) were retirees, more than double the prior 3 years. This structural unemployment actually means that we have a much smaller unemployment gap than originally thought and is typically a longer lasting cycle with sustained upwards wage pressure.

On these points Janet Yellen is not yet in agreement noting that tepid wage growth and high levels of "under" employment (those working part time but would like a full time job) during the recovery have not been signs of tightening labor markets. However, the magnitude of the decline in employment in the construction, auto and other industries has left many people inadequately prepared for the changing skills currently in greater demand. Many of these workers now reside in the category referred to as long term unemployed (out of work 27 weeks or longer) and exert little ability to restrain wage pressures.

In a study done for the Federal Reserve Bank of New York, authors Linder, Peach and Rich show that the short term cyclical unemployment rate (now 4.2%) is already down to its historical norms and is a more accurate predictor of wage growth than is the total unemployment rate. Until this downturn, fluctuations in total unemployment were almost entirely driven by short duration unemployment changes. What keeps total unemployment levels still elevated is the long duration unemployment. Though down from a cycle peak of 4%, at 2.6% long term unemployment is way above the historical average of 1% since 1960.

If we are correct, the year over year gains of 2.5% in average hourly earnings (up from 1.3% in the beginning of 2013) may continue to increase. We expect the currently benign level of CPI of 1.1% to remain historically low but start to rise along with these wage gains throughout 2014 as the correlation between these data points is historically 78% (shown below in the chart from Ned Davis Research).





Though recent data on housing has been heavily impacted by weather, we continue to remain more conservative on our estimates for 2014. Affordability levels have been negatively impacted over the last 12 months by rising prices (up over 13% y/y on the Case Shiller price index) and mortgage rates (up over 1% during this period). The combined impact on the average home buyer cannot be ignored as it increases the monthly cost of the median mortgage from less than $800 to over $1,000.

We feel that the housing recovery is now at a critical crossroad. Investor demand is shrinking as there are fewer distressed sales. Will this be replaced by traditional first-time and mortgage-dependent buyers? Employment in the traditional first time buying cohort of ages 25-34 is now up 710K in the last 6 months. However, they currently represent less than 26% of new home sales compared with the historic 40%-45% long term average. The average new college graduate now owes over $26K in student loans with a default rate over 11.5%. The burdens of higher debt ratios and lower credit scores threaten to keep mortgage demand subdued leading to a slower than typical housing market.

Housing Starts rebounded from less than 500K on an annualized rate during the recession to a 2013 average of 929K and averaged 908K during the first 2 months of 2014. These levels remain significantly below the 30-year average of almost 1.38MM. Existing home sales are now down 14.5% from levels of July 2013. However, with residential construction still representing less than 3% of GDP versus a 5% long term average, there is still room for a stronger augment to growth from this area. Housing construction and home sales have a greater contribution to growth than do price movements as the multiplier impact of jobs and spending filter through to the economy. We see growth in construction to continue due to low levels of supply but little upwards movement in prices.

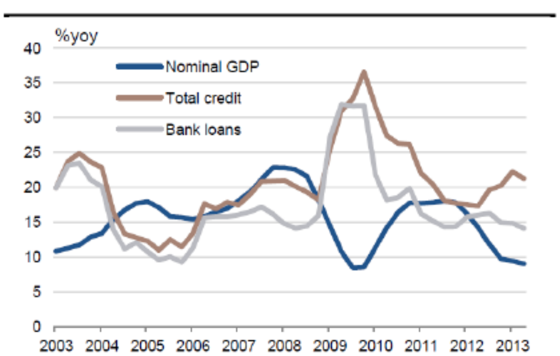
INTERNATIONAL

Though the United States has continued to show the strongest growth of the developed economies, there have been signs of incremental improvement overseas. After six consecutive quarters of economic contraction, the Eurozone GDP has rebounded to a 1.5% annualized rate over the last 3 quarters. Surprisingly, this recovery has been largely export-driven despite an unexpectedly stronger Euro.

Peripheral countries in the Eurozone still maintain high levels of debt that are legacies of the unsustainable trade deficits incurred prior to the crisis. These countries experienced higher levels of inflation than Germany and struggled to compete in global trade. Lacking a national currency to devalue, they have had to depress prices and wages to regain their footing and lower the cost of their exports. The decline of domestic prices and wages impacts domestic demand and retards GDP and employment growth. This has shown little improvement as the jobless rate currently stands at 11.9% and is only down marginally from the peak of 12.1%.

With Eurozone countries focused on global competitiveness against the backdrop of their currency rising from €120 in July of 2012 to €137 in April of 2014, deflationary pressures have increased. Currently the EZ inflation rate has declined to 0.5% y/y from a level of 2.2% just 16 months ago. The ECB has few easy options with the benchmark interest rate already down to 0.25% but so far has made little use of their balance sheet (unlike Japan and the U.S.). Currently the year-over-year growth in their money supply is only 0.5%. Efforts to lower the Euro are made even more challenging in the face of Japan and China also looking to lower the Yen and Renminbi. So far there has been more talk than action.

After multiple decades of growth in excess of 8% per year, China is slowing in the aftermath of a huge credit bubble and aggressive reforms, mini-fiscal packages notwithstanding. Over the last decade the labor force in China grew by over 200MM (by contrast the U.S. labor force in total is only about 156MM) and balance sheets expanded. Since 2008 the total debt in China has increased over 20% per year from a level of 150% of GDP to now over 210% with their corporate debt the largest in the world. As seen on the chart below, more and more debt has produced decreasing levels of growth. Both of these tailwinds to growth are now diminishing.



Source: PBoC, NBS, CEIC, SG Cross Asset Research/Economics

Non-performing loans (NPL) on bank balance sheets have experienced more than double the level of write offs in 2013 from the prior year. With the new leadership in China showing an increased willingness on allowing corporate bond defaults (as with Japan, defaults historically did not exist), risks to a soft landing are increasing and the People's Bank of China (PBOC) may now be actively guiding the depreciation of the Renminbi (down almost 3% since the start of the year) in the face of this debt deleveraging. As China has accounted for as much as 50% of global credit growth during this recovery, a successful transition is critical to overall global growth.

Declines in the currencies of the major economies of Japan and China combined with slides in most commodity prices (especially agricultural) have contributed to a recent drop in inflation levels in the developing economies. This has been especially true in India, Brazil and South Africa which had experienced pronounced increases in inflation during the market and currency turmoil of 2013. We still anticipate further slowing in the growth of emerging markets in 2014 to a level around 4.5% in GDP from over 7.5% in 2010. We had noted in our annual commentary that emerging markets as an asset class were priced at their lowest relative and absolute valuation since 1998. At least judging from market movements in 1Q of this year (MSCI EM Index is up almost 12% from the lows of early February), markets appear to agree and though likely a bumpy road forward, risks appear to be more than priced in for the long term investor.

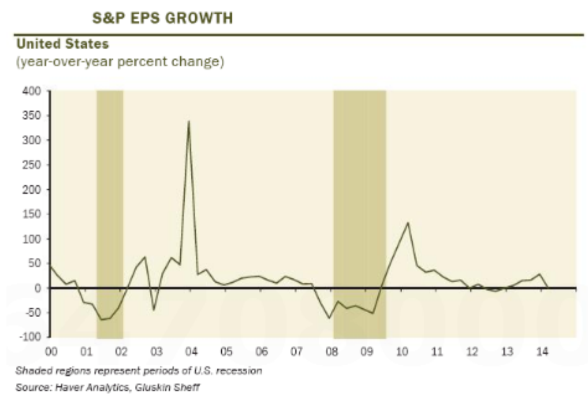
MARKETS

This year has started with even greater difficulty in the developed International equity markets. Doubts have emerged as to the continuation of the global economic recovery highlighted by the previously noted concerns over China. Along with the further declines in commodity markets and instability in Eastern Europe, the MSCI EAFE index (all developed markets ex- North America) followed a powerful 2013 advance of 22.8% with a flat return so far of 0.66% in 1Q 2014. We have noted for the better part of two years that valuations in Europe were attractive on a longer term basis. Much of that value has already been realized and European markets such as the STOXX 600 now enter the "show me" stage of the recovery. After three years of falling EPS growth, consensus expectations for this large cap index now call for growth of 38% this year coinciding with a modest decline of 2% in sales. The margin expansion assumed here is very high and increases performance risk.

Despite a 6% decline during January, returns for the S&P 500 were fairly benign over the first quarter of the year. Total return for 1Q was 1.8% with the smaller cap Russell 2000 index returning 1.1%. This narrow band of index outcomes domestically and internationally may understate what may be in the early stages of a significant rotation. The period from March 20th to April 4th was a flat period for the large cap U.S. indices. However, during this two week span, the Russell 2000 index of small cap stocks was very volatile and declined over 4%. During this same span perhaps the most volatile of all of the equity indices, the MSCI Emerging Market index, gained over 7%.

Interestingly, despite a strengthening view of improving U.S. growth, the 30-year U.S. Treasury yields declined from 3.96% to start the year to a recent level of 3.56%. For the quarter, the U.S. Barclays Aggregate Bond index returned almost 2% while the Barclays Municipal Index returned in excess of 3.3%. In her first public outing since taking the reins of the chairmanship from Ben Bernanke, Janet Yellen commented that the FOMC may look to start hiking rates six months after the conclusion of QE. Since this point in late March we have witnessed an increase in short term yields while at the same time the long end was declining. This flattening of the yield curve is normally associated with a slowing economy.

Though our confidence in the U.S. economic recovery has grown over the last 3 quarters**,** valuations in the stock market still remain stretched and we have yet to experience even a 10% correction in over 920 days. The annual rate of increase in the earnings per share of the S&P 500 appears to be slowing again after a solid 4Q 2013. Earnings growth has decelerated over the last 2.5 years to less than a 5.5% annualized increase while the S&P 500 has appreciated at an annualized rate of over 20.6%.



Valuation is not a catalyst and will not, in and of itself, precipitate a market correction. However, as noted previously, the economic recovery is still highly correlated to the markets and vulnerable to more volatility. Everyone focuses upon what macro event might derail the markets. Perhaps we have it backwards.

In a low interest rate environment, yield is scarce and high quality yield with growth even more so. At Coho Partners, we continue our focus on companies where the underlying fundamentals are strong and consistent and where our confidence in their future earnings and dividend growth continues to be high. We are still finding good value in such high quality companies. We are optimistic that this is precisely where one should be invested at this stage of the market cycle.

Sincerely,

Rick Wayne

Rick S. Wayne, CFA