COHO PARTNERS, LTD.

Q2 2014 Commentary

Dean Vernon Wormer: *“Have you boys seen your grade point averages yet?”*

Robert Hoover: *“I have, sir. I know it's a little below par...but we’re hoping that our mid-term grades will really help our average”.*

Scene from Animal House

Upon turning more optimistic on the economy after the 2nd quarter of 2013, we noted how well the U.S. had navigated the worst of last year’s fiscal headwinds. This more positive view was supported by a solid pickup in growth for the back half of the year (3.3% annualized GDP growth) engendering greater optimism entering 2014. Though we anticipated a weaker first quarter with the expected reversal of much of the inventory build (a strong contributor to second half growth in 2013) along with the impact of the expiration of the Emergency Unemployment Compensation Program (EUC), we still looked for full year 2014 GDP in the range of 2.75% or better. Few expected a stunning -2.9% decline in growth in the 1st quarter of the year.

Where do we stand now? Is this a reversal back to our “muddle-through” 2% economy that has been the average of the 19 quarters since the end of the recession? Or was this an anomalous quarter hit by one-time adjustments mentioned above along with the paralyzing Polar Vortex that generated record cold temperatures into early March. As usual, the answer lies somewhere in between.

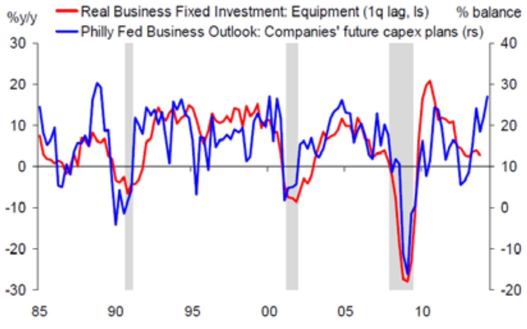
The calculus alone suggests that maintaining a full year estimate of 2.75% GDP growth after this quarter would be as misplaced as the optimism that Robert Hoover and his Delta Tau Chi House fraternity brothers enjoyed. In fact, to generate full year growth approaching 3% would require the final three quarters to average nearly 5% on an annualized basis, a rate of growth not achieved for a single quarter during this recovery. We now feel full year growth will be in the range of 1.5%-2.0% but remain optimistic that our original thesis of a cyclical upturn and improving trend remain in place.

This view remains undented for now despite a volley of bad news outside of the U.S. including renewed East-West tensions over Ukraine and sectarian insurgency in Iraq, which have pushed gas prices over 12% higher from the beginning of the year. There are also signs that the pace of Europe’s recovery is weakening along with that of China and Japan. Many economists are entirely dismissive of the extreme contraction in the first quarter. We cannot ignore that these results point to underlying economic conditions that remain quite fragile despite improvement and exceptionally accommodative monetary policy. Economic “escape velocity” has yet to be achieved. We are still potentially vulnerable to exogenous shocks and the list of potential candidates may be growing. With Federal Reserve policy extended and fiscal policy paralyzed, there are fewer tools remaining in the toolbox to quickly counter a downturn should one occur.

UNITED STATES

Much of the economic data normally correlated with an expanding economy have rebounded sharply in the 2nd quarter and point towards a resumption of growth. Manufacturing may account for only 13% of US GDP, but the sheer pace at which the sector is growing means it will have provided a major boost to the economy in the second quarter. The Institute for Supply Management (ISM) manufacturing index enjoyed an average reading in the 2nd quarter of 55.2 from a 1st quarter average of 52.7 (a reading above 50 indicates expansion). In fact we have now enjoyed expansion in 58 of the last 59 months including the last twelve months consecutively. Capacity utilization levels (a measure of actual output versus potential output indicating levels of demand) are now approaching the 80% threshold normally associated with tightness in productive usage. Even industrial production (an index measuring actual levels of output), which did not exceed pre-recession levels until late 2013, is now up over 5% on an annualized rate through May. These are levels that are historically associated with an economy growing closer to 4%.

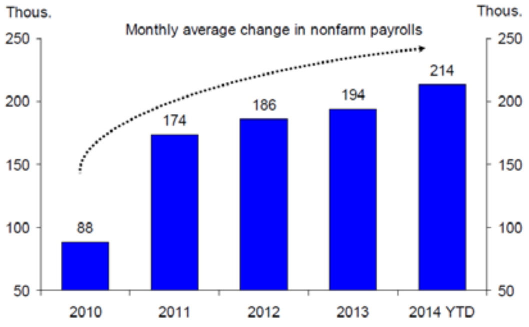
We have long expected improving financial conditions for corporate America to precipitate an increase in capital spending that would sow the seeds of future growth. The growth rate in the capital stock of the private sector has averaged less than 1% in the last five year period representing the lowest half decade trend in the post-World War II period. This long awaited hand-off may now be in the embryonic stage as core capital expenditures are now up 4.9% on a 3-month annualized rate with future spending plans improving.



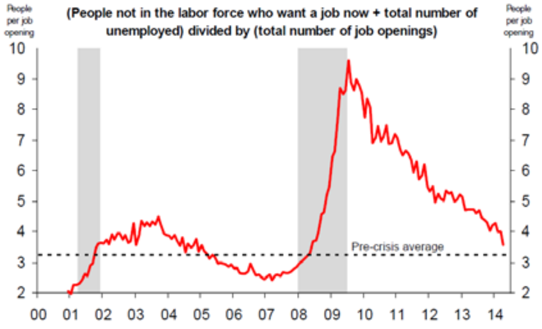
Source: BEA, FRB Phil, Haver Analytics, DB Global Markets Research

Though we continue to underscore that much of the economic recovery is tethered to the stock market and therefore vulnerable to its volatility, the United States has clearly moved past the acute phase of the debt crisis. The large government deficit which eclipsed 10% of GDP ($1.4T) 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. The CBO estimates the current deficit to now be less than $400B or about 2.8% of GDP. Federal Government spending has declined from 24.4% to 20.6% of GDP (in line with historical averages) while tax receipts have grown sharply (+7.5% in fiscal 2014 alone). While the Energy revolution has been a clear and unexpected tailwind to this recovery (reducing our energy deficit below 2% of GDP and falling), the Federal Reserve has so far engineered the continuing growth of nominal GDP while we underwent a fiscal squeeze and avoided a recession. But how have these efforts translated into creating a durable and sustainable recovery?

Though modestly impacted by the weather in the first quarter, the job market appears to be accelerating into the end of the second quarter. Nonfarm payroll growth has averaged 231K for the opening two quarters of 2014 (chart below is only through May) compared with 194K in 2013 and 186K in 2012. The labor market is clearly tightening as depicted on the data from the JOLTS (Job Opening and Labor Turnover Survey) chart below.

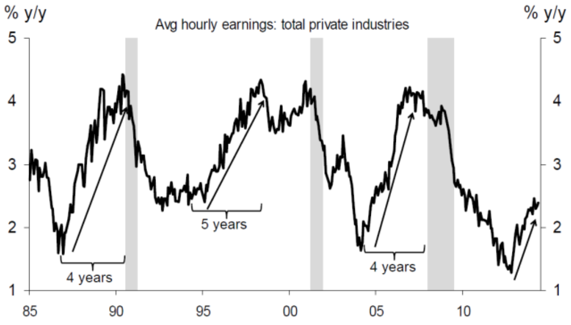


Source: BLS, Haver Analytics, DB Global Markets Research

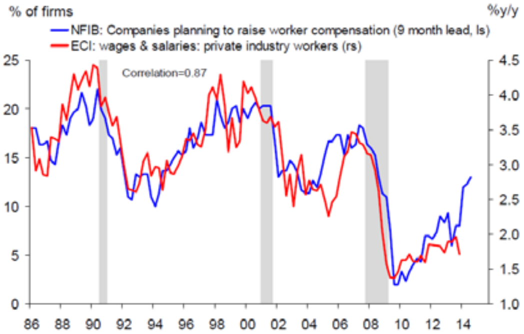


Source: BLS, JOLTS, Haver Analytics, DB Global Markets Research

Average hourly earnings have moved up from a cycle low of 1.3% year-over-year growth to the current level of 2.3% and aggregate payrolls are now up about 4% y/y. Though this should augur well for consumer spending in the second half of 2014, it has yet to manifest itself through the 2nd quarter.



Source: BLS, Haver Analytics, DB Global Markets Research



Source: NFIB,BLS, Haver Analytics, DB Global Markets Research

Sentiment indicators from the National Federation of Independent Businesses index (America's leading small business association) have recently moved to 6-year highs. As 40% of total private payrolls and 60% of new job creation emanates from small businesses, this index is a strong leading indicator and though still low by historical standards is pointing towards greater confidence and increasing plans to raise worker compensation (see chart above). Additionally, consumer confidence has recently reached post-crisis highs while other indicators of confidence are also pointing up. Revolving consumer credit (mostly credit cards) is now up 2.4% y/y (first time since the crisis) while commercial bank lending has risen at an annualized rate of 9% over the last three months. These are positive indicators of increasing willingness to spend and of greater demand.

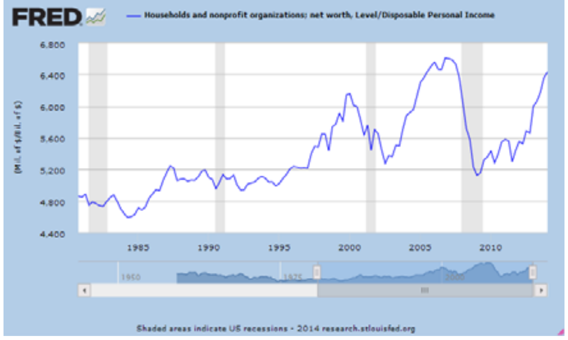
Despite this clear improvement in the labor markets and in confidence, there remain overriding concerns for now that are holding back the consumer and the recovery. Though total payrolls of 138.78MM workers have now eclipsed the pre-recession peak level, the total level of those working full time remains 3.67MM lower. This is acutely represented by those categorized as working "part time for economic reasons". This number still totals 7.5MM or over 3MM more than in 2007.

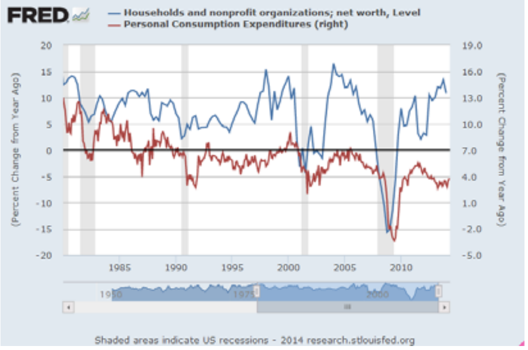
Wages & salary represent about 50% of the total sources of income in 2014 compared with 56% in 2000. Government transfer payments (unemployment compensation, disability, social security, etc…) now represent 17.5% of the total compared with only 12.5% in 2000. With greater fiscal restraint (such as the recent end of the EUC), total incomes are not keeping pace with inflation. Recent data from the Consumer Price Index (CPI) indicate prices are rising at an annualized pace of 2.8% in the most recent 3-month period exceeding the earnings increases in wages noted above. With food and gas prices expected to be almost 4% higher this year, inflation may approach 3% by the end of 2014 threatening the improving wage picture. Putting this all together we can look at recent data from Sentier Research analyzing Census Bureau information on incomes adjusted for inflation. Real Median Household income for April 2014 is $52,959. Though this figure is up 3% from the recent low of August of 2011 ($51,482), it is still down -7% from the peak of $56,941 in 2000.

We cannot underestimate the degree to which Quantitative Easing (QE) has supported growth. In maintaining interest rates at artificially low levels, the Federal Reserve has managed to lower consumer debt burdens as a whole while dramatically expanding Household Net Worth. This has been critical in helping maintain even modest levels of consumer spending in the face of stagnant wage growth. U.S. household debt has declined to 81% of GDP from 98% in less than 4 years while the consumer debt service ratio (debt service payments as a percentage of disposable personal income) has declined to a historic low of 9.9%.

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 1Q 2014 has increased over $25T (to $81.8T) from the trough in 2009 with $21T of that gain in financial assets and $3T via the increase in the value of real estate. The benefits of QE's impact on real estate are both egalitarian and economic. It is estimated that over 5.5M households have been lifted from negative equity on their homes as real estate has appreciated nationally over 22% from the lows of 2011. This low interest rate and rising home price environment has allowed homeowners to improve cash flows via refinancing and increase home sales. QE's impact on the consumer via the "wealth effect" of rising security prices may be more ephemeral.

The chart below on the left indicates total Household Net Worth (HNW) divided by Disposable Personal Income and depicts how growth of assets (a record 71% of HNW is now in financial assets) have dwarfed increases in incomes. The permanent income hypothesis was formulated by the Nobel Prize winning economist Milton Friedman in 1957 and implies that changes in consumption behavior are not predictable, but rather based on individual expectations. Unlike wages, net worth growth is not viewed as permanent. Without commensurate rising incomes, the economy (re: spending) may be more vulnerable to a decline in markets as it was in both 1999 and 2007. The chart on the right may indicate that the benefits of the "wealth effect" are fading as personal consumption expenditures have now decelerated despite a continued increase in total net worth.

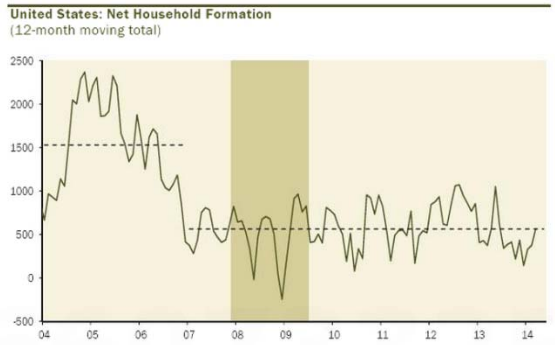


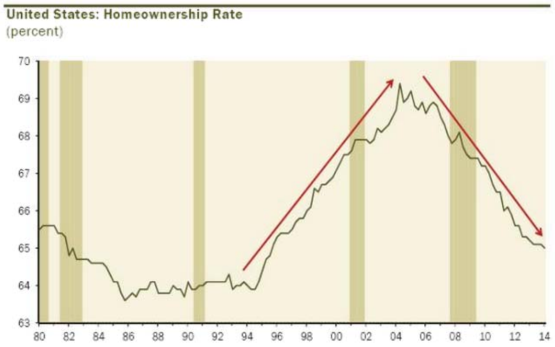


Real consumer spending for the entire 1Q was only 1% after averaging 2.3% in the prior three years and is running at only a 1.5% pace in 2Q. Economist Michael Feroli of JP Morgan has studied the impact of the wealth effect on consumer spending. Feroli points out that employing a standard wealth effect impact and removing the gains from the rising net worth indicates an underlying trend of real consumer spending of only 0.9%. It is just such an analysis that underscores the additional fragility of the recovery and its relationship to financial asset prices. Despite recent encouraging signs on economic growth, consumer spending remains the biggest concern.

QE's impact on housing has been real as many homeowners have been able to enjoy the benefits of improved cash flows via mortgage refinancing and rising home values and the associated benefits. We have been appropriately skeptical of the artificial markets in housing led by investors and speculators though this has served to replace the vacuum of demand and challenges of tight credit while removing much of the excess inventory. Rising prices reduce the amount of homeowners in negative equity and has served to increase inventories (though not at the low end of the market). As prices and mortgage rates have risen, we note that there are now fewer distressed sales and the investors may be slowly exiting the markets. We see the market moving now from one of distortions caused by high negative equity and the resulting low inventories to one more traditionally defined by fundamentals. In the housing market this is based on household formation, jobs and wage growth. Our view entering the year of a slowdown in housing appears to be materializing (we do not see this as a bad thing) and a continuing decline to more historical levels of homeownership along with an absent 1st time buyer will remain headwinds.

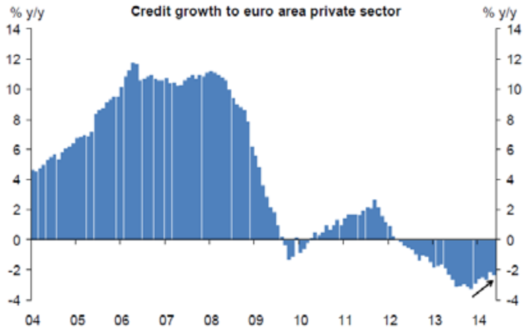
Household formation averaged over 1.35MM per year from 2001-2006. As seen below, this figure has declined to below 570K per year since and has yet to show signs of expanding. According to the Commerce Department, the traditional 1st time buyer (ages 25-34) had home ownership rates in 2003 of 49%. This figure is now just over 41.5%. A toxic combination of a difficult job market, little to no income growth, and high student loan debt indicate it may be a while before this area of the market returns to normal.


United States: Net Household Formation
(12-month moving total)


United States: Homeownership Rate
(percent)

INTERNATIONAL

Though the Eurozone (EZ) recorded an increase in 1Q 2014 GDP of 0.8%, we have been less sanguine about continued economic growth. The persistent debt overhang continues to constrain both consumer and government spending and is evidenced in declining lending by EZ banks. Eurozone private sector loan growth has declined over 2% on a year-over-year basis. This contrasts with loan growth that averaged over 7% per year (and as high as 12%!) from 1999-2009.


Credit growth to euro area private sector

Source: ECB, Haver Analytics, DB Global Markets Research

Current weak levels of demand are insufficient to reverse the deflationary forces enveloping these advanced economies. Indeed, inflation in the EZ has declined from 2.7% less than 2 years ago to the current level of 0.5%, a level perilously close to outright price contractions.

The inability of European central bankers to effectively lower the Euro has triggered the pain of internal devaluations (lower prices and little employment and wage growth) necessary to remain globally competitive. The recent strength in European exports has helped lift GDP from 6 quarters of contraction but comes at a huge cost as unemployment remains near record highs in the Euro Area at 11.6%.

To counter these deflationary forces, the European Central Bank announced in June that it would cut the deposit rate for member banks to -0.10%. Banks would now have to pay for carrying excess reserves in an attempt to generate greater access to credit for small and medium sized businesses. This attempt to increase lending comes at a time when the 128 largest banks in the European Union are undergoing an asset quality review by the ECB. We do not expect all to receive passing grades and we note with some concern the recent weakness in the MSCI Europe Financial index that has declined over 7% from the middle of June.

Making these efforts of Mario Draghi and the ECB even more challenging is the slowdown in China. First quarter GDP in China slowed to a still solid level of 7.4% but inflation is now bordering only 2%. Advanced economies need inflation in China to correct these huge imbalances in wages, costs and capital flows. However, increasing concerns in the Chinese Real Estate sector (now 20% of GDP similar to Spain and Ireland at their pre-crash peaks) and general economic slowing domestically has placed considerable pressure on export growth. In turn the Peoples Bank of China (PBOC) has encouraged a weaker renminbi.

After forcibly tanking its currency, Japan briefly reversed a three decade long deflationary spiral as imports (mostly energy) rose in price. Japanese GDP in 1Q soared 6.7% largely due to a one-time burst of consumer spending in the months leading to a sales tax increase that took effect April 1. But what little reflation Japan has enjoyed has not come from rising wages or prices for domestically produced goods but is rather due to a declining currency and the resulting rise in energy import prices.

Recently released data indicate that subsequent to the increase in the sales tax rate (raised to 8% from 5%), households took a breather from their spending binge while manufacturers cut back on output in anticipation of weaker demand at home. Expectations are now for the economy to contract around 4% in the April to June quarter. How quickly the economy responds may dictate when the Bank of Japan further ramps up their stimulus measures.

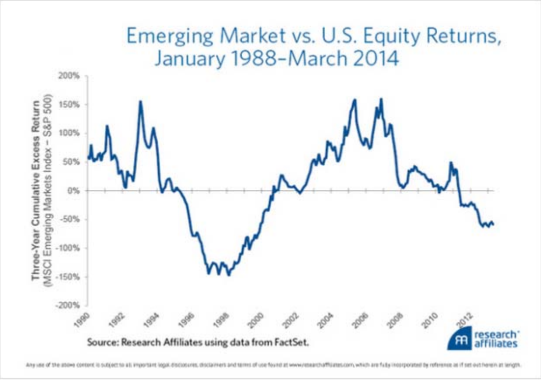
The collective efforts of global central banks to reflate their economies continue to create concerning outcomes. The global economic slowdown in the first quarter along with the worsening deflationary risks in the Eurozone and geopolitical concerns, have pushed global bond yields to levels never collectively experienced. When contemplating how the U.S. 10-Year Treasury bond could yield only 2.55%, one needs to consider the following sovereign interest rates on 10-year bonds: Greece 6.05%; Spain 2.79% (lowest since 1789); Italy 2.84%; France 1.65% (lowest since 1740), Germany 1.22%; and Japan 0.56%. At a time when central bank policies foment an inflationary future, investors are unknowingly accepting greater risks.

MARKETS

For the year, the S&P 500 is now up 7.1% and up over 12% from the challenging start to the year and the lows of February. Gains were found in virtually every asset class save for markets in China and Japan along with copper and wheat prices. Despite near all-time high relative valuations, the Russell 2000 small cap index shrugged off a 5-month decline with a strong June rally to finish 3.19% for the year to date. Foreign markets were also strong as the MSCI EAFE index of developed international companies returned 4.8% while the MSCI Emerging Market index enjoyed a generous 6.1% gain in 2014.

Though still modestly attractive on a longer term basis, much of the discounted valuations in Europe have 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 over 30% this year coinciding with a modest decline of 2% in sales. This will not happen and increases performance risk. Concerns noted earlier about bank asset quality tests have already helped precipitate an end of quarter decline in the European bank index of over 7%. This bears watching.

Emerging markets appear to offer the best valuations for longer term equity investors with cyclically adjusted price-earnings ratios at discounts to the U.S. market of close to 40%. As the chart below indicates, after almost 10 years (1998-2007) of relative outperformance to the U.S. equity market, emerging market indices have dramatically underperformed since. The opportunity is compelling but does not come without risk and increased volatility.


Emerging Market vs. U.S. Equity Returns, January 1988–March 2014

Source: Research Affiliates using data from FactSet.

Any use of the above content is subject to all important legal disclosures, disclaimers and terms of use found at www.researchaffiliates.com, which are fully incorporated by reference as if set out herein at length.

Despite a consensus view of an improving U.S. economy, U.S. Treasury yields continued in lock step with declining global yields. The 10-Year U.S. Treasury bond confounded the majority of investor expectations in declining from 3.03% to start the year to the most recent level of 2.55%. Year to date, the U.S. Barclays Aggregate Bond index has returned 3.93% while the Barclays Municipal Index returned in excess of 6%.

Though our confidence in a cyclical U.S. economic recovery has grown over the last year, valuations in the stock market still remain stretched and we have yet to experience even a 10% correction in over 1000 days and no more than a 4% correction in the prior 10 months. 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 3 years to less than a 5.5% annualized increase while the S&P 500 has appreciated at an annualized rate of about 17%.

We continue to note that valuation alone is not a catalyst and will not, in and of itself, precipitate a market correction. It does, however, act as a constraint to longer term returns. What is more concerning is that the economic recovery is still highly correlated to the markets and vulnerable to more volatility. As noted previously, instead of focusing upon what macro event might derail an overvalued market, we are more concerned about what a normal market correction of 10%-20% might do to a still fragile recovery.

Sincerely,

Rick Wayne

Rick S. Wayne, CFA