Q2 2015 Commentary

"Put some Windex on it"

Gus Portokalos-My Big Fat Greek Wedding

As much as we have tried, it is impossible to construct an opening to an economic commentary without leading with Greece. Though our expectation is still for a settlement with Greece remaining in the Eurozone, here is some perspective. Greece is a country with a population of just over 11 million people or the size of Ohio. The most recent estimate of the total Gross Domestic Product (GDP) figure from 2013 is €258 billion or roughly equivalent to the output of Connecticut. Indeed, the total outstanding government debt that is due currently to the International Monetary Fund (IMF) and the European Central Bank (€8.8 billion) later in July would represent less than the gains that Mark Zuckerberg has accrued in his shares of Facebook stock over the last year alone. If the current concern were just about Greece and its debt crisis, there would be little consternation about any global repercussions.

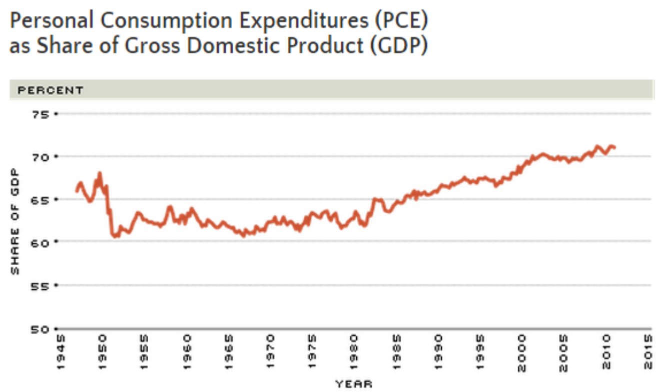
The larger fear regarding this current Greek tragedy is the potential for contagion that might envelop other highly indebted southern European countries such as Spain and Italy with over €3.5 trillion of collective outstanding government debt. While Greek debt is almost entirely held by European countries and the IMF, the debts of the governments of Spain and Italy are widely held by financial institutions throughout Europe. Defaults by either of these governments would reverberate throughout the world. That is not the case with Greece.

If Greece defaults, would the owners of all of the government bonds of Spain and Italy now demand higher compensation for the perceived increased risks? Would much of the progress of falling bond yields and the improvement created on debt sustainability reverse? The European Central Bank (ECB) has made major progress over the last three years in creating backstops to ring fence just such contagion concerns. The European Stability Mechanism (ESM) was designed for this purpose and is capitalized with over €500 billion to be tapped by member countries that find themselves in financial need. This did not exist three years ago and we feel the Greek crisis to be more of a humanitarian concern than an economic one though the potential for heightened risk aversion remains and should not be ignored.

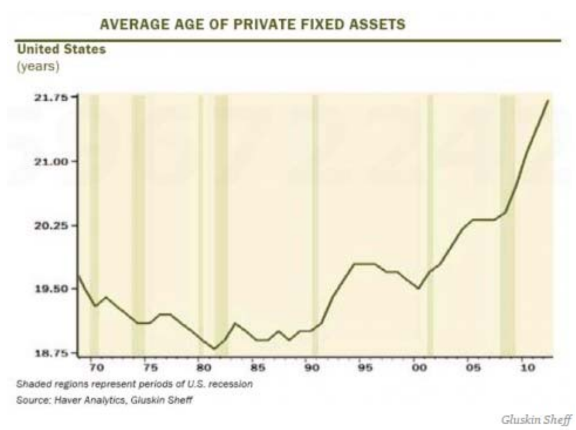
Moreover, we would regard the looming default of one or more of the bonds issued by the Commonwealth of Puerto Rico (with a total of as much as $72 billion in total debt at risk of default) to likely to be more concerning to domestic investors. Unlike the debt of Greece, these bonds are held by many investors individually and via mutual funds and by many hedge funds who have thought it wise to accentuate the trade via additional use of leverage. Nearly 80% of these municipal bonds are owned by mutual funds, and they represent a greater than 5% position in over 180 of these funds. There may be no bailout here for bonds now rated by Standard & Poors to be CCC-. Increasing risk in the search for yield continues to be an unintended consequence of global Central Bank policies.

UNITED STATES:

The U.S. is more dependent upon domestic spending and consumption than other developed economies. Personal consumption expenditures (PCE) is the metric used by the Bureau of Economic Analysis to gauge consumer spending. During the decade leading up to the Great Recession, PCE (adjusted for inflation) grew at an annualized rate of 3.5%. As a share of GDP, PCE has grown since the 1970's from 62% to the current levels around 70% where it has been for much of the last two decades. Though this is considered one of the most important barometers of the health of domestic economic activity, it is really a short-sighted view more impactful to current GDP calculations. There are other important headwinds that have rendered economic escape velocity unlikely for the forseeable future.

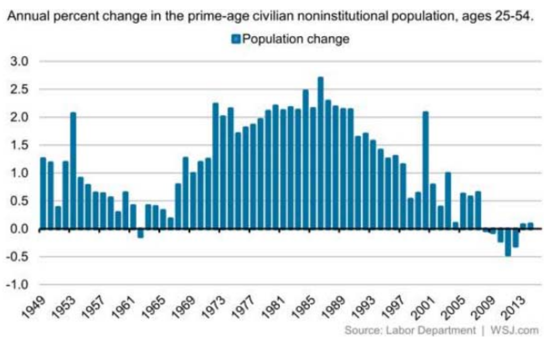


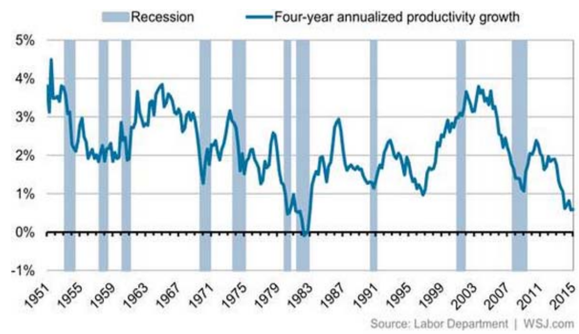
An economy must continuously invest in new capital goods and structures in order to grow, become more productive and raise citizens' living standards over time. An improving standard of living is often defined as productivity growth. Empirical evidence confirms the supposition that economies that invest a higher share of their incomes tend to grow at faster rates. Today's investment is tomorrow's consumption. If consumer spending "crowds out" investment spending, the economy may not grow as fast. This has been missing in the debt-fueled spending binge upon which the U.S. embarked over the last few decades and now the age of the private capital stock (factories, IT, etc..) in the U.S. is the oldest since the 1950s. There has been little capex investing in this cycle.



GDP is the product of increases in total hours worked (correlated with labor force growth) and productivity growth (growth in output per hour). As noted in prior commentaries, the U.S. has seen an increase in total hours worked over the last couple of years with strong hiring. However, due to our aging demography (people leaving the labor force), the Congressional Budget Office (CBO) now estimates that labor force growth should average only 0.5% over the next decade (see chart below left on prime age population growth) the same as it has over the prior 4 years. In the absence of massive immigration reform, this critical input into growth will most likely limit the economy's long run GDP potential to closer to 1.75%-2.0%.

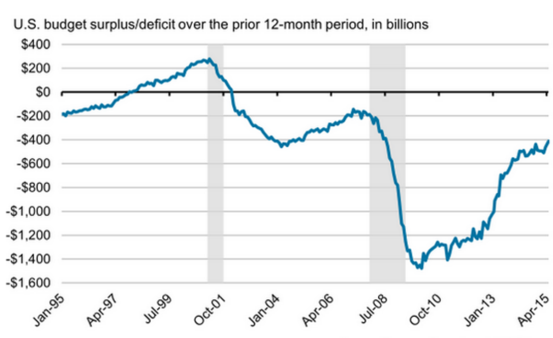
Year-over-year productivity growth has actually turned negative. This is not anomalous as annual US productivity growth from 2010 through the just completed 1Q of 2015 has fallen to an average of 0.6%, the worst 5-year run since the early 80's and the worst on record outside of a recession. It actually fell at a -2.6% annual rate in the two most recent quarters for which we have data (4Q 2014 and 1Q 2015).

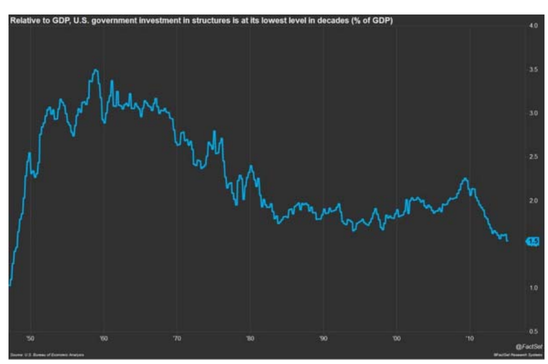




The U.S. cumulative budget deficit is now down to an estimated $365 billion (CBO projection from a deficit of $412B in the past 12 months) or about 2% of GDP. This represents a more than 60% reduction from the record deficit in 2009. Though this deficit reduction is viewed as very welcome news by many, the reduction in government expenditure and investment has now declined for four consecutive years (despite annual revenue growth around 10%) and has reduced our growth rate by an estimate of 1/3rd of 1% during this period.

In addition to the lack of corporate capital spending, America's infrastructure has also long been ignored. Every four years, the American Society of Civil Engineers (ASCE) publishes a scorecard rating the condition and performance of our nation's infrastructure along with an estimate of the needed investment. Today that grade is a D+ with an estimated cost needed to upgrade of $3.6 trillion by 2020. The chart below right shows the U.S. governments investment in structures as a % of GDP. This is now 1.5%, the lowest in over 50 years.



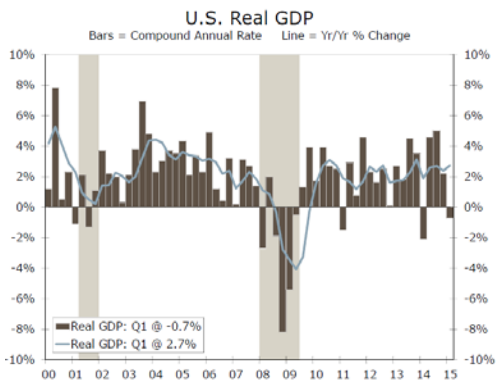


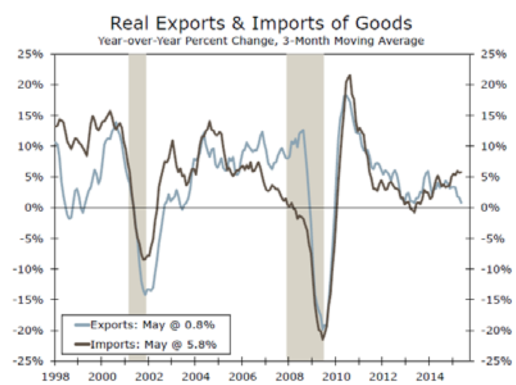
Since the end of the Great Recession, monetary policy has had to act alone and we are perhaps even past the juncture where a continuation of this may do nothing more than exacerbate potential bubbles in real and financial assets. The focus on deficit reduction may be misplaced in a world of historically cheap money. High levels of job creation would be accomplished as would future productivity increases by focusing upon long overdue infrastructure spending. Increasing our deficit to finance these projects at a period of historically low interest rates might be the wisest use of funds as the return on investment via job growth and improved productivity would pay back multiples of the cost.

However, political pressure continues to keep government expenditures down. Addressing the nation's infrastructure deficiencies has often been at odds with reducing the budget deficit and the national debt among politicians, so this situation is unlikely to change anytime soon.

We noted above how the PCE averaged 3.5% per year prior to the recession and the second half of 2014 returned to the highest level of the recovery at 3.8%. It is no coincidence that the rate of GDP growth in the second half of 2014 was 3.8%, the fastest pace of economic growth since 2004. We entered 2015 optimistic that the United States would enjoy the fastest pace of full year growth since before the Great Recession of as much as 2.75%. Though still below the consensus of Wall Street economists, our view centered upon the tailwinds of declining energy costs, import prices and inflation combining with continued gains in employment and improving wage growth to kindle stronger consumer spending in 2015.

The 1st quarter of 2015 represented a toxic cocktail of horrific winter weather in parts of the northeast; a West Coast Port strike crippling trade betwween the U.S. and Asia; and the meteoric rise of the U.S. dollar. Together the largest impacts were on consumer spending (PCE in 1Q was 2.1%) and GDP where declining exports alone subtracted -1.9% from the final calculation. Early 2Q trade reports indicate a bounce back but exports (ex-petroleum) are still running at a decline of -4.5% y/y in May.



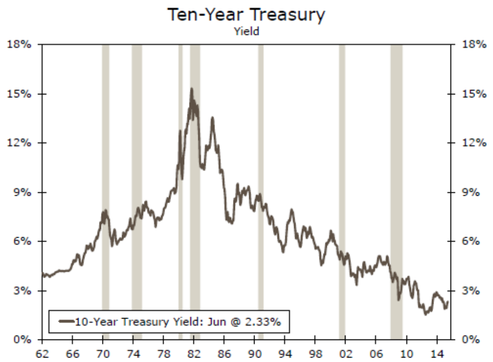


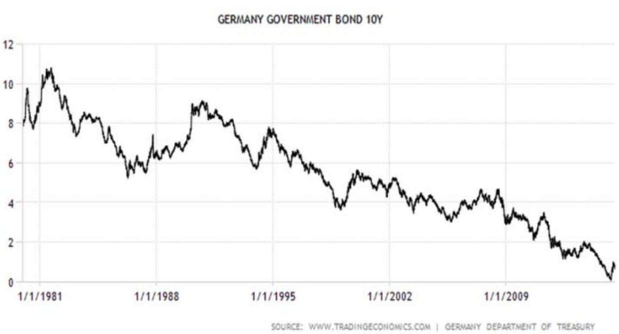
Following the -0.2% contraction in U.S. GDP (annualized q/q percent change) in the first quarter, the OECD (Organization for Economic Co-operation and Development) revised their forecast for U.S. growth down significantly to 2.0% in 2015 and 2.8% in 2016, compared to 3.1% and 3.0%, respectively, in the November forecast. Consensus on Wall Street is now for growth to approximate 2.25% which is in line with the post-recession cyclical average. So far in 2Q we are seeing an upswing in consumer spending (PCE estimated at a 2.9% level) that gives us confidence that 1Q was anomalous. Within the framework of a longer term deceleration in our growth potential, we do feel we are on a cyclical upswing. We look for 2Q GDP to approximate 2.75%-3% and see a solid second half of 2015 in excess of 3% growth. We are lowering our full year forecast to a still above consensus 2.5%.

INFLATION, INTEREST RATES & THE FEDERAL RESERVE:

Interest rates as measured by the 10-year U.S. Treasury yield rose during the second quarter from 1.92% to 2.35% (from a low of 1.64% at the end of January) flaming concerns of rising inflation and increasing expectations of the Federal Reserve commencing the long awaited process of raising the Fed Funds rate.

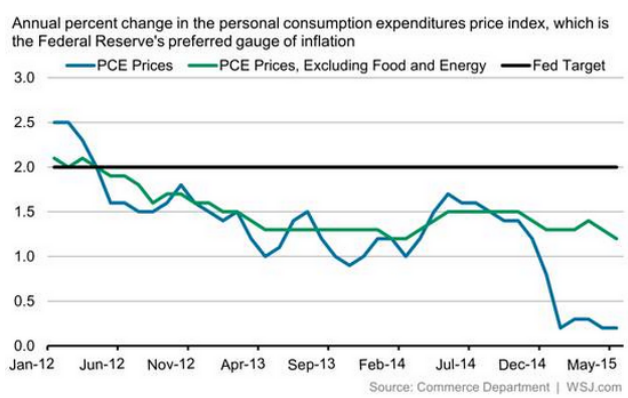
One simple historical model of the 10-year bond yield compares it to the growth rate of US nominal (i.e. including inflation) GDP on a y/y basis. Despite the contraction in 1Q, U.S. GDP was still up 2.7% y/y, with nominal GDP 3.8%. That's well above even the latest yield. In the Eurozone, nominal GDP increased 2.0% over the last year. Not coincidentally, the 10-year German Bund (the highest quality benchmark for the Eurozone) also hit its nadir during this period at 0.07%! This period may have been the peak of deflationary concerns for the Euro Area as it experienced a year over year decline of -0.6% during February.





This suggests that what the fixed income markets have been experiencing with the rebound in yields is an abrupt normalization relative to nominal economic activity. As deflationary fears ebbed, yields rose. In addition, growth prospects seem to be improving in both the U.S. and Eurozone. While the ECB is committed to its QE program through most of next year, the large majority expect the Fed to begin raising the Federal Funds rate later this year, another explanation for the abrupt rebound in bond yields.

The Federal Reserve has long promulgated the goal of a 2% inflation rate fearing that an economic downturn while inflation is extremely low may stoke deflation fears. While most investors are familiar with the consumer price index (CPI), the preferred inflation measure for the Fed has long been the PCE price index with a changing composition of spending more closely aligned with assumed consumer behavior. Core personal consumption expenditures in June continued to move in the wrong direction for the goals of the Federal Reserve decreasing to 1.2% y/y with headline up just 0.2% y/y.

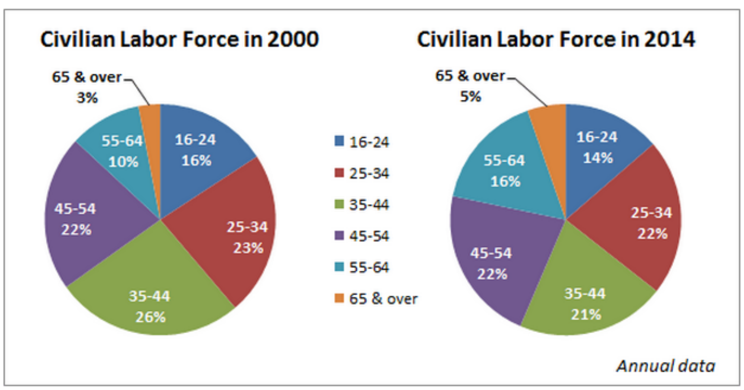


We noted earlier how the near 20% y/y increase in the value of the U.S. dollar has dramatically impacted U.S. exports and manufacturing competitiveness. An increase in interest rates domestically would perversely also accelerate the increase in the currency, potentially curtailing an economic rebound as it commences. For these reasons we have long suggested that there will be no Fed Funds rate increase until 2016 and the turmoil in the Eurozone and China increase our confidence in this minority opinion.

EMPLOYMENT & WAGES:

With the recent release of the June payroll report, we have now averaged 216K monthly job gains so far in 2015. This compares with an average of 260K in 2014 but is an expected slowdown as the labor market gap is clearly closing with the unemployment rate down to 5.3% from 5.7% at the start of the year. As noted earlier, labor force growth has slowed due to demography and it is estimated that only about 80K new jobs per month are required to maintain the current level of unemployment. Additionally, with productivity stagnating, corporations may be more circumspect in hiring decisions to protect margins. There are additional and not surprising energy related concerns. The shale oil and gas industries have been the nation's largest single creator of solid-paying, middle-class jobs during the economic recovery. But the fall in oil prices has led to big cuts in capital spending and layoffs.

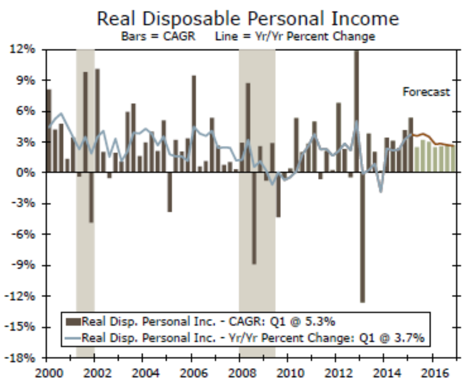
Much has been written of the declining Labor Force Participation rates (LFPR) and we have filled the pages of these commentaries with such charts. An important way to analyze this data is to look at the changing composition of the Civilian Labor Force (people over the age of 16 that are employed or seeking employment). We have long argued that this is a structural and not cyclical change in our labor force.

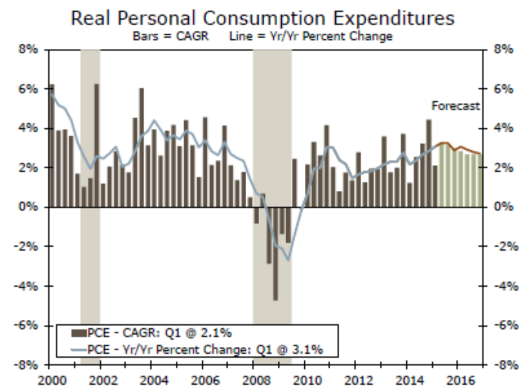


In 2000, the three youngest cohorts (16-44 years old) constituted about 66% of the total labor force. In 2014 that demographic has dwindled to 56% while the over 45 cohort has grown to 44% from 34% of the labor force. Though this is primarily a manifestation of our aging demography, there is, nonetheless, some cyclical component to this change and much of that is due to the zero interest rate policy of the Federal Reserve.

After years of insufficient savings and debt accumulation, many baby boomers are facing an uncertain retirement. Low interest rates for savers translates into a shortfall in expected income and the need to spend less, save more and delay retirement. According to the U.S. Department of Labor, the percentage of workers between the ages of 65-74 that are still working has increased almost 40% since the turn of the century.

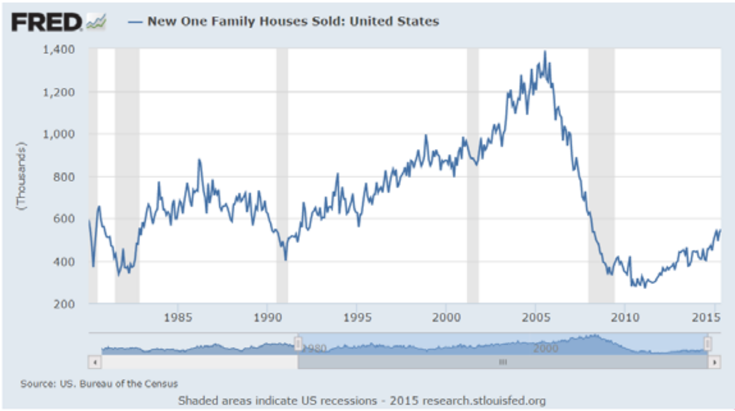
So the U.S. consumer now appears to have an increasing ability but not propensity to spend. With lower inflation, real incomes are growing. Real disposable personal income adjusts for inflation and subtracts current taxes from personal income data. It is now increasing at an annualized rate of 5.3% in 1Q vs. 3.7% y/y (chart below left). The Employment Cost Index (ECI) through the end of 1Q showed that wages and salaries of private workers are now increasing at a 2.8% year-over-year rate from the cyclical average of 1.7%. Rising wages have been a theme of ours for much of the last year. Now with a tightening labor market, improved real disposable income and a savings rate that has increased from 4.7% in 4Q to 5.4%, we feel the consumer is coiled with a potent reserve of spending firepower for the second half of the year. We feel that private sector wages and salaries will increase over 3% in 2015 and will bolster consumer spending and the economy for the balance of the year.



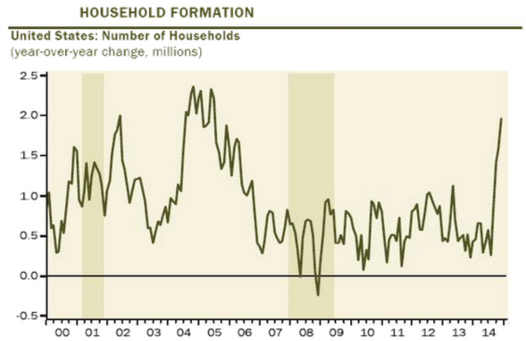


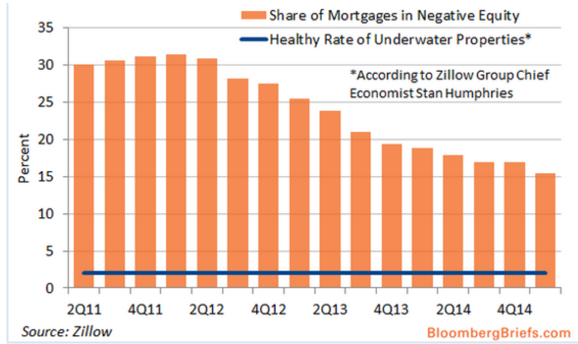
HOUSING & AUTOS:

Following another slow start to the year, housing data have recently begun to support our view of a positive contribution to growth from residential construction (over 9% annualized growth in 1Q GDP). On June 23rd, the Bureau of Census reported that new single family home sales (a timelier barometer of the strength of the housing market than existing home sales) rose 5% to an annualized rate of 546,000 units in May the best level through five months since 2007. We have long noted that the housing recovery would need to morph from an investment driven one to a more traditional market based more on improving job and wage growth. The good news is that we continue to see improvement in those metrics and housing remains on an uptrend that started in mid-2011. The bad news is that the latest pace of activity isn't much better than the previous cyclical lows in this series starting back in 1970.



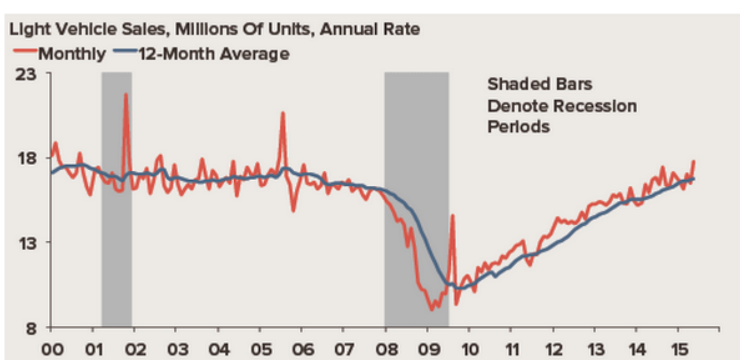
The recent rebound in household formation and gains in employment for the 25-34 year old cohort (first time homebuyers) should continue to be bullish for new and existing home sales. Over the past year through March, the number has increased about 1.9 million from the levels of one year ago, back to a pace last seen in the middle of the previous decade. The problem is that the number of households renting rose 2.1 million, while the number of home-owning households fell -0.2 million. The demand side is clearly starting to percolate. It is supply that continues to hold back the normalization of housing and the recent increase in the 30-year fixed mortgage rate (now over 4.2% to the highest in nine months), may challenge our thesis.





A decade after U.S. home sales peaked and despite recent house price gains, 15.4 percent of owners (more than 8 million homeowners) in the first quarter owed more on their mortgages than their properties were worth (4 million owe at least 20% more), according to a report on June 12 by Zillow, a real estate data provider (chart above right). While that's down from a high of 31.4 percent in 2012, it is still alarmingly above the 1 or 2 percent that marks a healthy market. Additionally, More than 25% of homes with values in the bottom third of their market were underwater in 1Q. This continues to impact the economy by restraining the housing recovery and by preventing the job market from becoming even more vigorous. It also will probably exacerbate wealth inequality for years to come as homes valued in the bottom third of the market are more likely to be underwater.

The strongest area in consumer spending (and manufacturing) continues to be in the auto market. According to researcher Autodata, auto sales in 2Q moved to the highest level in almost 10 years at an annualized rate of 17.1M and above the 1Q average of 16.7M. Car pricing firm Kelley Blue Book estimates transaction prices for the industry grew 4.3% to $33,363 a vehicle in May compared with last year. According to Edmunds, the average new-vehicle loan term was 67.9 months in May, the highest ever, with the average monthly cost now $488 and loan amount over $28,700. While the quality of these loans continues to erode in both terms and credit quality of the borrowers, we feel there to be little risk or concern. However, we do anticipate the pace of auto sales to slow as we have cannibalized future sales with loan terms (and thus potential negative equity) likely to keep many consumers in their cars for longer and unable to trade.

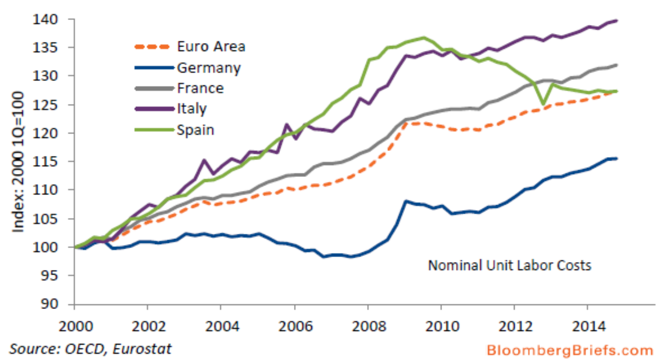


INTERNATIONAL:

In 1992, the European Union was formed via the Maastricht Treaty to extend to the European community shared foreign policy, military and judicial cooperation. The foundation was set with certain criteria being met and maintained (government debt, deficits, inflation rates, etc...) by member states for the creation of the European Monetary Union (EMU) in 1999 with the euro as the common currency. These fiscal standards, however, have no way of being enforced by the ECB and member nations who might be facing economic challenges have no way of devaluing their currency to foster export growth.

Peripheral countries benefitted by enjoying much lower interest rates than they would otherwise command independently and used this benefit to take on debt financed by the healthier economies such as Germany. Germany benefitted by maintaining a much lower currency valuation than it would have experienced if it were not a euro member and by extension, exported its way to prosperity. Everyone danced while the music continued to play. Over the last five years, the music stopped. Without a concurrent fiscal union, it is difficult, if not impossible, to have a monetary union as it is not compatible with the distinct cultures (and the lack of labor mobility that this engenders) along with each country's respective desire for sovereignty.

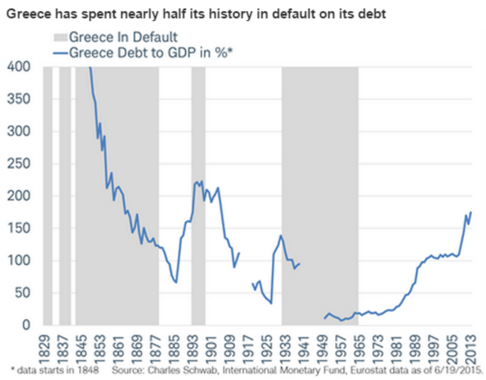
A large driver of the competitiveness gap between member nations may also have been weak wage growth in Germany. Despite similar productivity performances, wage gains in France exceeded those in Germany by more than 15% between the turn of the century and the crisis. Employees agreed to pay restraint in exchange for employers keeping production in Germany following the 2004 enlargement of the EU and in doing so further widened the labor cost divergence between nations.

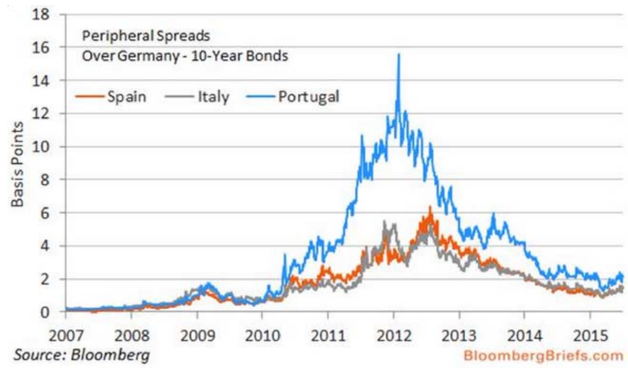


Post-crisis, relative wage costs have not moved nearly enough to close the competitiveness gap, and a prospective adjustment in wages is by far the region's best chance of achieving internal balance. With unemployment in Germany now lower than at any time at least since reunification, pay growth should soon pick up and, hopefully, start to close the competitiveness gap

Sadly, a potential default by Greece and the referendum to not accept the terms of the euro group agreement is far from unprecedented as they have spent 46% of the time in the last two centuries in default at varying levels of debt to GDP (chart on top of next page on left)! This potential outcome illustrates the extent to which party politics rather than the country's needs drive decisions in Greece. Under the current government, tax collection has stalled, investment all but vanished, consumption has suffered, and the state has only been able to continue paying salaries and pensions by not paying its private suppliers and contractors. Now even pensions have been difficult to access.

With capital controls currently in place and limiting citizens to €60/day in ATM withdrawals, liquidity has been drained from the financial system. However, with over 75% of Greece's debt having been moved off the balance sheets of highly leveraged banks and onto the books of government institutions, the risk of contagion is dramatically lessened from that of just 3 years ago. A distressed market is always categorized by heightened risk aversion which in fixed income would manifest in a widening of the relative yield spreads between high grade and low grade debt. This has not occurred in the Eurozone as shown by the very modest spread increase between Spain, Italy & Portugal (the other challenged peripheral economies) and German debt (chart on top of next page on right) even after the "no" vote in the referendum on July 5th. This bears watching.

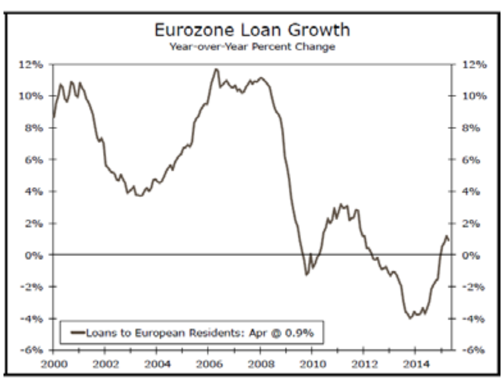


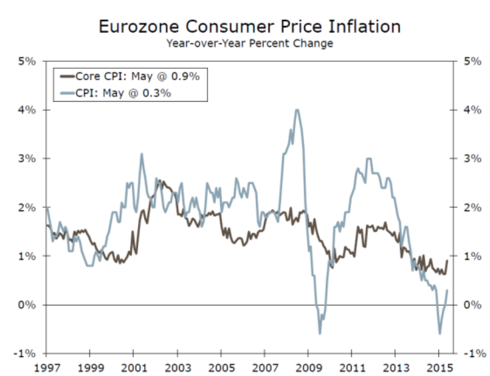


As Europe tries to regain its economic footing, the OECD has raised its outlook for the Eurozone countries because of aggressive quantitative easing, euro depreciation, low oil prices and improved bank lending. The region grew GDP by 0.9% in 2014, and the OECD expects growth to continue to accelerate over the next two years, with forecasts of 1.4% in 2015 and 2.1% in 2016 (compared to forecasts of 1.1% and 1.7% in the November Outlook). This is now more in line with our prior upwardly revised estimate. Results from 1Q were a gain of 0.4% q/q or 1.6% on an annualized rate trending up from the 1.2% rate in 4Q.

What really should be noted, and is contrary to the popular narrative, is the solid improvement in the debt-challenged periphery where debt loads (though still high) have stabilized, fiscal reform has commenced and growth has re-emerged. Spain (+2.7% GDP y/y) and Portugal (+1.5% y/y) have accelerated from 0.6% GDP growth at this time last year. Ireland enjoyed a 4.1% growth rate in 2014 while Italy has swung from a decline of -0.8% last year to 1.2% GDP growth currently. There may be hope for Greece and contagion appears much less likely.

The stabilization of commodity prices and currencies in 2Q has eased much of the deflation fears that gripped the Eurozone most of the last year. Though headline CPI inflation has only moved up to 0.2% y/y with the core CPI (ex-food & energy) +0.8% y/y, these inflation readings are annualizing at a +2.3% and 1.3% rate over the last three months.





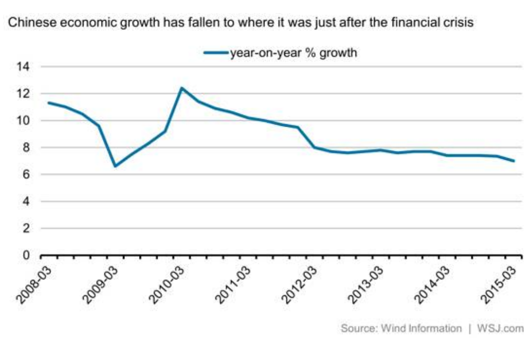
More concerning to global growth than the looming debt default in Greece remains the deepening economic slowdown in China which has been accompanied by increasingly easy monetary policy and an extremely volatile stock market (down over 30% since June 12 after a meteoric rise of 100% to start the year).

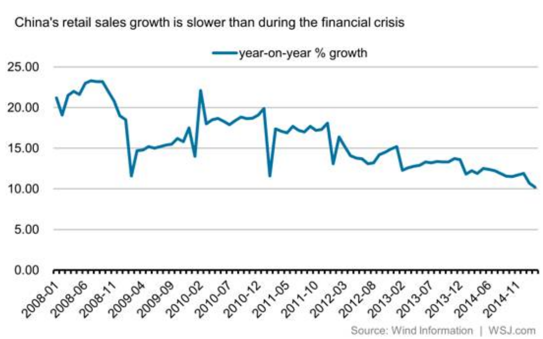
Much of the growth since the Great Recession in China has been debt-fueled and the country's debt-to-GDP ratio soared to 350%. The recent slowdown in growth in China was now acting as a headwind to the government's objective of paying off much of this debt. Monetary stimulus including four reductions in their benchmark interest rate and three in bank lending rates (to encourage lending) had little impact. It is quite probable that the puppeteers in China felt that rising stock values would allow domestic companies to raise cash by selling stock at high valuations and, thus, pay back much of the debt. Such governmental manipulation of financial markets may be hard for us in the United States to comprehend. 🙂

After encouraging retail investors (via additional and easy use of margin debt) into the Shanghai market, the index soared through the first half of 2015. The government of China, facing a threat to public confidence, is now unleashing various measures to stabilize the markets in the face of this rapid decline. Unlike the U.S., however, the ownership of equities in China is still quite narrow and the financial impact should be manageable. As with Greece though, it is the psychological impact that may have greater ramifications. China remains the world's second largest economy with a gross domestic product estimated at over $11.2 trillion so its continued growth is critical to the global economy.

Though boosting government spending may be a prescription for many countries to lift their economic performance, China is looking to move away from its reliance on the government as a driver of growth. Language from government officials indicates a desire to move towards an economy driven by private consumption and investment, however, the Chinese economy has a long way to go before the Chinese consumer will be a significant driver of economic growth on par with major developed countries. For example, the Chinese enjoy a very high savings rate, currently estimated to be as much as 40%-50% on income. China's consumer represents just 36% of GDP, compared to an average 60% for the G-7 and 70% in the U.S.

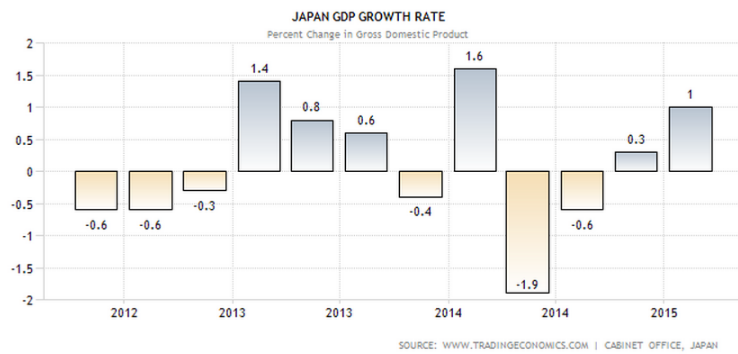
Progress towards these objectives has been slow. A -17.6% y/y decline in imports is a strong indication that consumer demand in China is still soft. Real income growth increased over 8% in the last year driving a greater than 10% rise in real retail sales, a level that while appearing high, is lower than during the financial crisis. This transition will engender at best a soft economic landing. China's GDP growth slipped to 7.4% in 2014, the slowest growth rate since 1990.





The OECD is predicting a continued slowdown in growth over the next two years, with the economy only expanding by 6.8% in 2015 and 6.7% in 2016. This may be optimistic as the year-over-year GDP numbers have decelerated to 7% in the most recent quarter. However, this is calculated as a year-over-year growth rate unlike how we calculate this in the U.S. Using our methodology of quarter-over-quarter growth rate annualized shows a 5.5% rate of growth. This economic slowdown is taking place as the economy faces a potential collapse in its property market with property sales in 1Q -9.3% y/y and housing starts -18.4% y/y. The Chinese government is again tapping into its arsenal of monetary policy tools to prevent a hard landing. Towards the end of June the People's Bank of China (PBOC) cut both its main lending rate to a record low 4.85% and reduced its reserve requirement for banks to stimulate lending.

Japan was in recession until last quarter, precipitated by a sales tax hike that took a huge bite out of consumer spending. Poor economic growth fueled critics of Abe, quick to point out that his "Abenomics" plan -- a massive bond-buying campaign coupled with structural reforms and stimulus from the central government -- had largely failed to lift wages, or dramatically boost growth. We are now starting to see the benefit of the aggressive expansion of the BOJ monetary base as 1Q GDP came in stronger than expected at an annual rate of +3.9%. However, the continuing slowdown in China (Japan's second largest export market after the U.S.) is impacting growth in the second quarter. With exports to China -4.5% in May and roughly at half the level of 2014, Japan may be facing another small contraction in growth. Eventually, greater structural reforms will be needed to sustain this growth.



The policies of the Federal Reserve during the height of the financial crisis of lowering interest rates to near zero levels and multiple programs of QE have flooded the emerging economies with dollars. For these emerging markets, borrowing could be done more cheaply in dollars than if they took out loans in their local currencies as interest rates in the U.S were much lower. This was during a period of extended dollar weakness and most of these loans were not hedged as many companies in these countries expected to benefit from the continued fall of the dollar. According to the Bank of International Settlements (BIS), emerging markets have borrowed over $9T in dollar-denominated debt up from about $2T at the turn of the century. As the dollar has risen over 25% versus many of these currencies, these debts will be more expensive to repay and the next five years represent periods of heavy scheduled redemptions. As much of this debt has been incurred by private companies and not governments, major financial stability risk is not elevated at this time though internal economic issues may be heightened.

The results across countries will be very uneven with the commodity exporters (Brazil, South Africa, Indonesia) struggling while the large fall in oil prices may benefit the net commodity importers (emerging Asia) and the manufactured goods exporters (India, Turkey). Already this is having a major impact on the growth prospects in Latin America. Brazil, for example, is now grinding into recession with inflation rising to 9%. With a current account deficit still above 4%, Brazil is one of quite a few commodity producers and exporters that are vulnerable to rising rates amidst declining global demand for its exports.

The International Monetary Fund projects that economic growth for emerging economies worldwide should approximate 4.3% this year. Though this still dwarfs the estimate of 2.4% for advanced economies it is a major slowdown from economies that grew as much as 8% collectively as recently as 2007. We anticipate a more pronounced slowing to levels below 4% as we note these transitions rarely occur so seamlessly.

MARKETS:

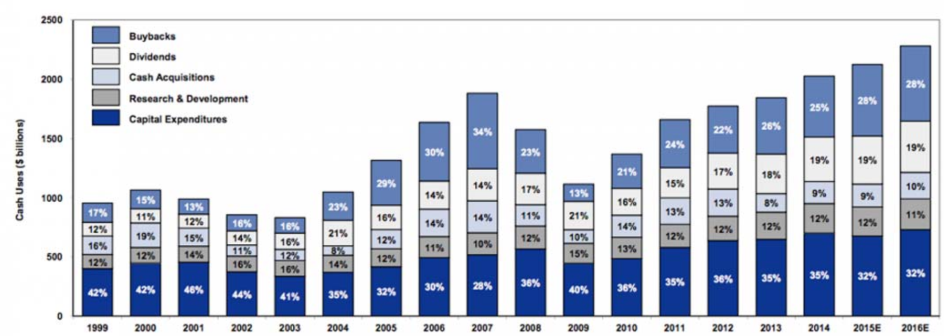
In the early stages of the recovery, we noted that many corporations were wisely accessing inexpensive debt to extend the maturities of existing debt and raise cash at historically low interest rates. The reduced interest expense improved profits and was an understandable and appropriate response. In recent years however, debt has increasingly been used to fund stock buybacks and increase dividends.

A continued and prolonged zero interest rate policy such as practiced by our central bank tends to promote a misallocation of resources. With rumblings from the Federal Reserve about raising interest rates, there has been increased pressure on management to lever up to improve returns while rates are still low. U.S. companies may now be borrowing money at the fastest pace since the financial crisis.

However, instead of reinvesting to build plants and factories or hire workers and expand product lines for future growth, companies are increasingly using this cash to fund deals and return cash to shareholders. Stock repurchases by companies reached a full year all-time high in 2014. While buybacks in and of themselves may be a prudent capital allocation strategy, it is worth noting that the all-time quarterly high for buybacks occurred in 3Q 2007 (prior market peak) while the low point was 2Q 2009 (market trough).

Companies in the S&P 500 index paid a record $93.55 billion in dividends and repurchased $144 billion in shares (up another 8.7% from the prior quarter) in the first quarter, according to S&P Dow Jones Indices. Goldman Sachs predicts index-wide buybacks will hit a record above $600 billion this year and will represent 28% of companies' total cash spending. These share count reductions continue to add a tailwind to earnings growth as net income is now divided by fewer shares to alchemize into great earnings per share growth.

The chart below goes back to 1999. It divides corporate uses of cash into growth capital (capex, R&D, M&A) and return to shareholders (buybacks and dividends). At the millennium, fully 74% of corporate cash was being reinvested into the company's growth. By 2015, that has declined to an estimate of 53%.



Use of cash:	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015E	2016E
Invest for Growth (capex + R&D + M&A)	71%	74%	75%	70%	68%	57%	56%	55%	52%	60%	65%	62%	60%	60%	56%	56%	53%	53%
Return to Investors (buybacks + dividends)	29%	26%	25%	30%	32%	43%	44%	45%	48%	40%	35%	38%	40%	40%	44%	44%	47%	47%

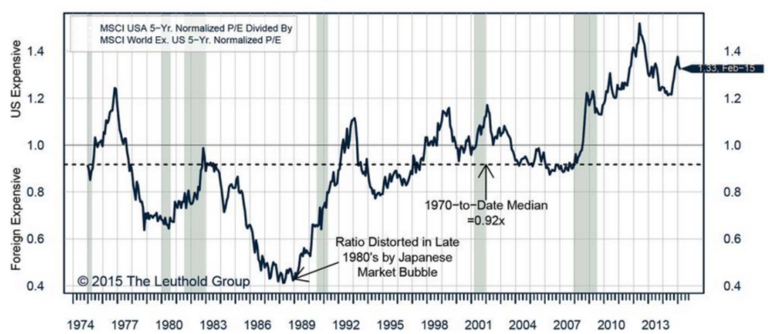
June was a difficult month for virtually all equity indices especially those with high interest rate sensitivity. With interest rates backing up, the indices for REITs and Master Limited Partnerships (MLPs) suffered the most during 2Q with losses of -4.5% and -8.3%, respectively. Domestic equity indices fared better with the S&P almost flat and now up 1.2% for the year. The continued turmoil in Europe and Asia created heightened volatility for these markets with the MSCI EAFE index of developed international markets declining -2.8% and MSCI Emerging Market index down -2.6% bringing the year-to-date returns for both to around 0.6%.

The Barclays US aggregate Bond index along with the Barclays Municipal index are now showing losses of -1.7% and -0.90% respectively for the year but the largest declines are found in the long term U.S. Treasury market off over -8.3% for the year.

We noted in our Annual Commentary our below consensus view and caution on continued corporate earnings growth in 2015 despite an economic upswing. Our view was predicated upon a 50% collapse in oil in the second half of 2014 and the commensurate earnings impact on the Energy sector along with our concern for the impact of foreign sourced earnings after a 20% year-over-year rise in the dollar. Our long held view of potential peak profit margins and rising cost pressures also led us to a below Wall Street consensus view of a 2% increase in earnings growth for the year. We are now lowering our full year view to a flat growth expectation based on our view of a modest full year decline in S&P revenues and a profit margin decline from over 10% to 9% or less.

There is a clear and understandable willingness to pay up for U.S. equities given the continued uncertainty in Europe and Asia and this has resulted in several years of P/E multiple expansion for the U.S. (the S&P 500 currently trades at 18 times the earnings of the prior 12 months compared to the 10-year average of 15.7). While some may view current valuations in the U.S. markets as justified given today's low interest rate and inflationary environment, they are clearly stretched relative to international and emerging markets. In spite of and perhaps partially due to the continued turmoil in foreign markets, we continue to find international markets attractive as relative valuations (the Euro Stoxx 50 is priced at 14.5 times earnings or a 20% discount to the U.S.), accommodative monetary policy, and currency declines should all act as major tailwinds.

U.S./Foreign Relative P/E Ratio
(Using Normalized EPS)



Sincerely,

Rick S. Wayne, CFA