Q3 2014 Commentary

"…it is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."

Alan Greenspan September 1998

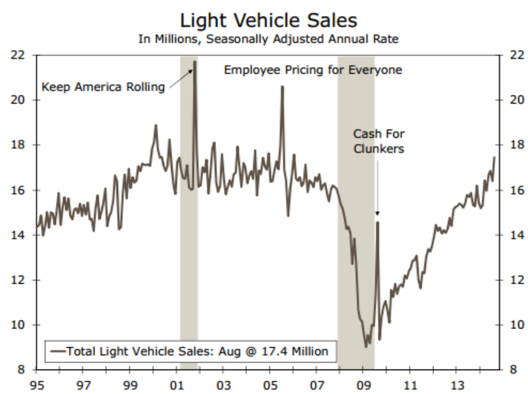
The story of financial markets in the third quarter was the strongest increase in currency volatility since 2008, highlighted by a 7% surge in the U.S. dollar on a trade-weighted basis. Such a movement in the world's reserve currency which is used to price almost all goods and services globally devastated the value of commodities such as oil and gold while wreaking havoc with emerging market currencies. One of the major trends that continues to unfold in the global recovery is one of increasing divergence. With Japan struggling with the after effects of the recent increase in the consumption tax in April to 8% and Europe seemingly on the precipice of another downturn, the modest recovery in the United States does make it appear as if we are again an "oasis of prosperity".

We noted in our most recent commentary our view that the decline in 1Q GDP of -2.1% was anomalous and did not derail our mid-year 2013 thesis of a cyclical economic upturn. While we maintain this view, it does remain a seeming paradox in the face of this global economic divergence and geopolitical risks that appear to increase in number weekly. The East-West tensions of the conflict of Russia and Ukraine and the continued insurgency in Iraq amidst further Middle East turmoil have recently been joined by mass protests in Hong Kong (a global banking center) for political freedom. Can the U.S. continue to navigate these economic waters unaffected by these global issues?

UNITED STATES

Revised data released in July by the Bureau of Economic Analysis (BEA) depicts an even more tepid recovery than previously thought from 2011-2013 with growth averaging 2% annually. What was significant to us, however, was the upwardly revised growth to the already strengthening momentum observed in the 2nd half of 2013. The revised figures indicate a cyclical upturn averaging a rate of growth of 4% for the 3rd and 4th quarter of 2013. When combined with the recently revised 4.6% growth in Gross Domestic Product (GDP) in the 2nd quarter of 2014, we see an economy that is now growing at a rate of 2.6% on a year over year basis despite the major decline in the weather-impacted 1st quarter of 2014. This is no longer noise but rather a trend. It has led us to modestly increase our full year estimate of GDP to north of 2% with gains in the 2nd half of 2014 estimated at 3%.

Manufacturing may account for less than 13% of US GDP, but the pace at which the sector continues to grow provides a major boost to the economy. The Institute for Supply Management (ISM) manufacturing index enjoyed an average reading in the 3rd quarter of 57.6 from a 2nd quarter average of 55.2 (a reading above 50 indicates expansion). The key to this growth in manufacturing may be found in the renaissance of the auto sector which has rebounded to pre-recession levels. The industry has averaged over 16.7MM vehicles sold in 2014, an increase of over 10% from this time in 2013 (see chart below). Capacity utilization levels (a measure of actual output versus potential output indicating levels of demand) are again 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, continues to grow at a pace of over 4% year over year. These are levels that are historically consistent with an economy growing closer to 4%.

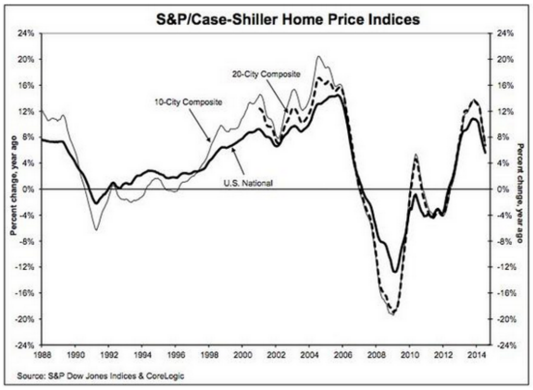


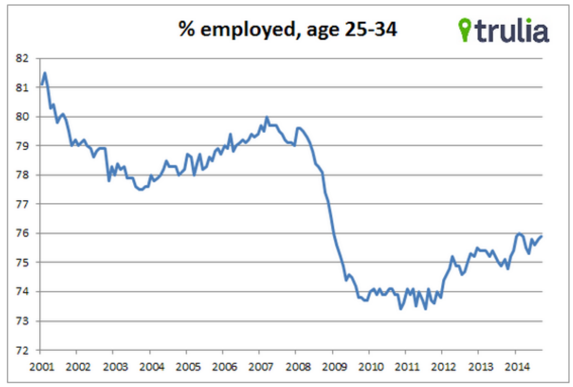
We have been much less sanguine than most on the continuation of the housing recovery and have stressed that home price gains would slow as it transitioned to a market more dependent on the traditional drivers of housing demand including household formation, employment and wage growth. There are many moving parts in the housing market and many seem conflicted. Investor demand is shrinking as distressed sales now comprise about 11% of total sales currently versus a cycle peak in excess of 30%. Though fewer distressed sales may allow prices to stabilize, the exodus of many investors from the market has, for now, caused prices to moderate. As shown on the chart on the following page, the Case-Shiller index of home prices has decelerated recently to annual gains of about 6.7% from over 13.8% earlier in the year.

While some view this as positive to maintain affordability, a lack of continued price gains may constrain supply in some areas of the market. Twenty-eight percent of homes with a mortgage in the bottom third based on price are under water (the house is worth less than the amount of outstanding mortgage). This compares with a national average of 17%. These homeowners are often unable to place their homes up for sale and this is generally the marketplace for the first time buyers.

We are dubious of investor demand being replaced by traditional first-time and mortgage-dependent buyers. First time home buyers currently represent only 29% of new purchases according to the most recent sales figure compared with a historical range of 40%-45% of sales.

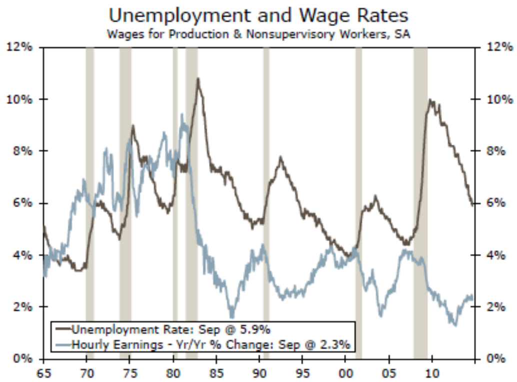
Homeownership currently stands at 35.9% for the 25-34 year old age group, the lowest ever recorded. The average new college graduate now owes over $26K in student loans and the default rate is over 11.5%. The burdens of higher debt ratios and lower credit scores threaten to keep mortgage lending subdued leading to a slower than typical housing market. However, there have been some more positive signs recently in this area. Employment in the traditional first time buying cohort of ages 25-34 is now up 771K in the last year, a gain of 2.5% and a full percentage point above the national total (see chart below, right).

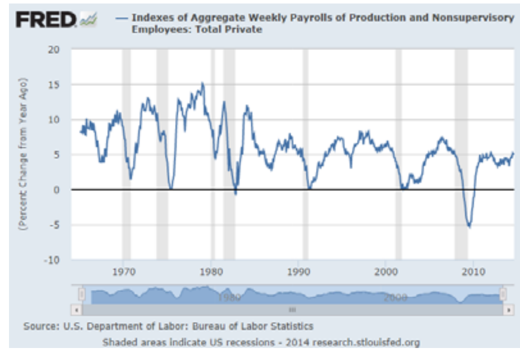




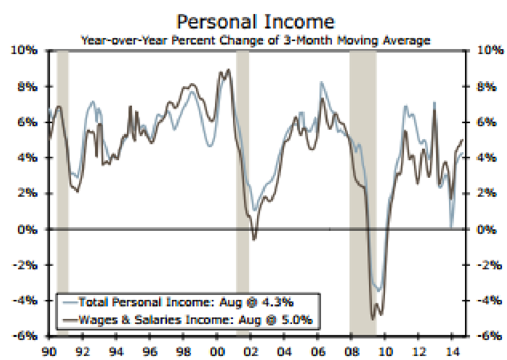
Employment continues on an upward trend recovering quickly from a temporary pause in mid-summer. Through the most recent reading for September, nonfarm payroll growth in 2014 has now averaged 227K per month. This compares with average job gains in 2013 of 194K, 2012 of 186K and 2011 of 174K. While many correctly note the declining employment to population ratios, we feel they incorrectly read this as a cyclical or economic decline in the potential labor force rather than a structural or demographic issue. The Council of Economic Advisors (CEA) estimates that more than 250K Americans turn 65 every month. If the decline as we believe is more structural, then the drop in the unemployment rate reflects a rapidly improving economy. We agree that the aging demography has very large longer term implications but should not obfuscate the current cyclical recovery. The labor force is tightening.

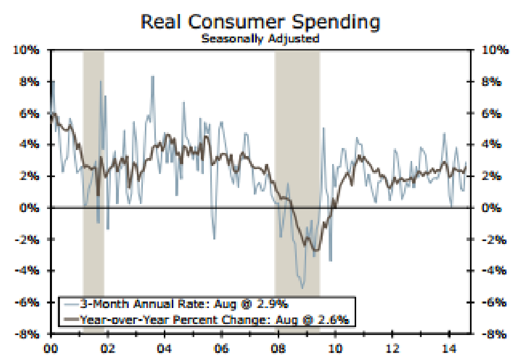
Our greater frustration has been low wage growth. We have been expecting wage gains for much of the last 3 quarters but it has yet to materialize as average hourly earnings are still only growing at 2.3% over the last year. There has been a clear disconnect during this recovery as a declining unemployment rate has not equated to the usual rise in wage rates as the chart below (left) from Wells Fargo clearly shows. However, we are starting to see overall payroll growth. Employers are not raising wages but are increasing the length of the workweek to recent cycle highs. This is often a pre-cursor to rising hourly wages. Aggregate payrolls are the product of average hourly earnings and the average workweek and are now growing at a nominal rate of 5% year over year.





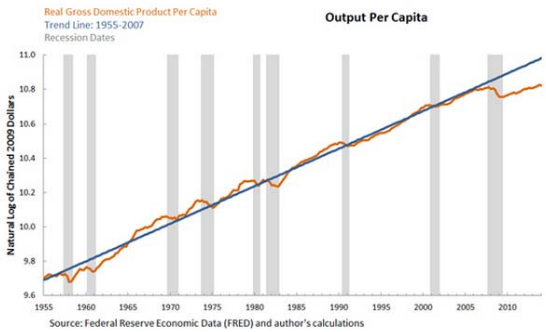
Therefore, we feel that the narrative of a still weak job market and stagnant wage growth is incorrect. According to the Commerce Department data released monthly, personal income has risen at a 4.3% rate over the past year from less than 2.3% at the end of 2013 with the modest pace of inflation supporting real income gains. What has surprised economists expecting this wage and income growth to translate into stronger GDP gains has been the absence of the consumer. As seen on the charts below courtesy of Wells Fargo, these gains in income have surprisingly translated into a *slowing* in consumer spending which has softened to a 2.6% annual rate through August from over 4% at the end of 2013. As a consequence the savings rate has jumped from 4.1% at the start of the year to over 5.4% in August, a rare event outside of a recession.

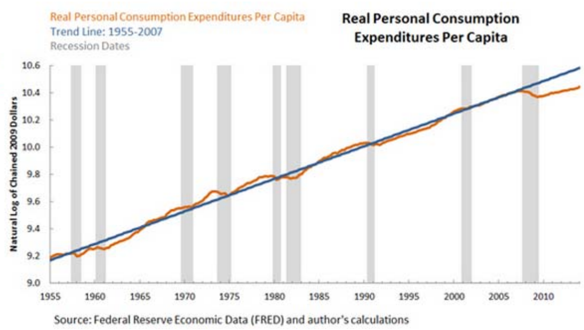




An aging demography, continued high consumer debt levels and inadequate retirement savings may be countering the efforts of the Fed's zero interest rate policy and efforts to foster increased consumer spending. If this is more secular in nature than cyclical, we may find another reason that the concerns of higher inflation may be misplaced. However, we are seeing encouraging signs for the consumer in improving loan growth. Total loans and leases at U.S. banks are up 7.7% on an annualized basis in the 2nd quarter and are 6.2% above year ago levels. This represents the highest level since the first quarter of 2008. Additionally, we believe that the recent decline in oil prices (gas prices have declined over 33 cents since June) should positively impact consumer spending as we enter the Christmas season.

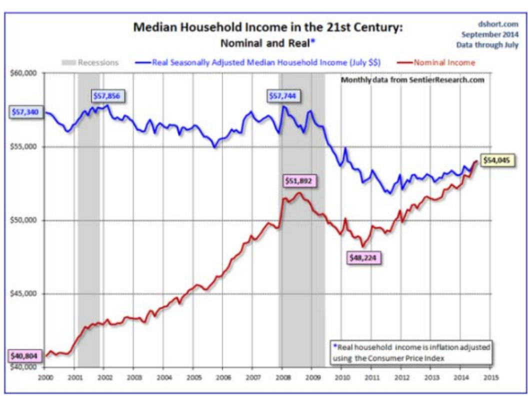
Though clearly in a cyclical upswing and having long ago exceeded pre-recession levels on all major economic indicators, the U.S. economic rebound still feels to many people as if we are still in recession. One reason for this may be found in looking at the long term trend of Gross Domestic Product growth (GDP) and how this recovery compares. According to the St. Louis Federal Reserve, output per capita (GDP divided by total population) required 5.5 years to return to pre-crisis levels but as of 1Q 2014 is still 15% below pre-crisis trend. Between 1955 and 2007, output per capita grew by 2.2 percent annually. After contracting at a 2.5% pace during 2008-09, growth has resumed but at a lesser pace of about 1.6% per year. The figures for consumer spending are very similar and both can be seen on the charts below.





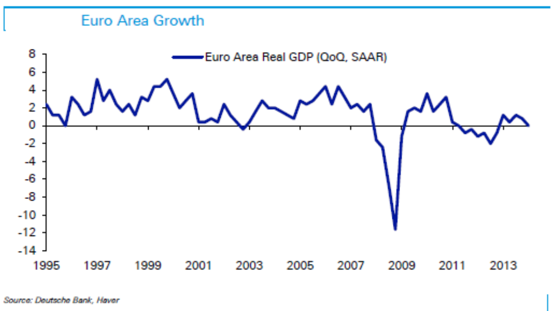
In other words, we are recovering but not at the pace that closes the gap that was created by the Great Recession. Additionally, as long noted on these pages, the recovery has not lifted all boats equally. Not even close. Some of the figures may astound. For instance according to research of the Russell Sage Foundation, the median Household Net Worth in the United States was $89,992 in 2003 but declined to $56,335 at the end of 2013. This contrasts with overall Household Net Worth data that are at all-time highs with the average (not median) Household Net Worth in excess of $700K!

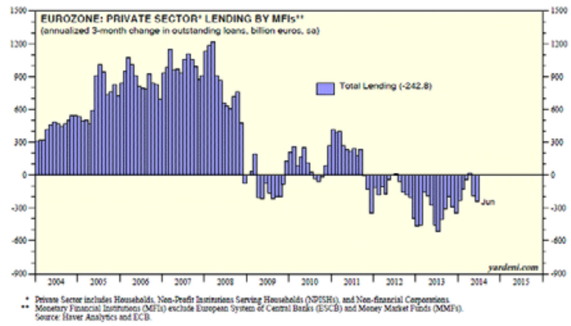
Real median income growth has likewise stagnated (currently at $54,045) according to data compiled by Sentier Research and remains below pre-recession levels of $57,744. What is more telling to us is that even the levels reached prior to the most recent recession were no higher than they were at the turn of the millennium. These income figures correlate well with GDP growth which averaged over 3.6% on an annualized basis from 1949-2000. In the 14 years since, we have grown at a rate of just 1.8% per year. This is the heart of the secular stagnation view of the U.S. economy as espoused by some including former Treasury Secretary, Larry Summers. We anticipate this to be a theme of ours in a future letter.



INTERNATIONAL

Europe is also at risk of secular stagnation. Unemployment is still near crisis levels at 11.5% in the Eurozone. GDP growth in the most recent 2Q release flat-lined and remains only +0.7% year-over-year and +0.4% at an annualized rate through the first half of 2014. The pace of growth has slowed to a crawl with outright deflation a growing risk. In fact the 2-year bonds of Germany, France, Belgium, Finland, Austria, Ireland and the Netherlands all have negative yields as of the end of the 3rd quarter.





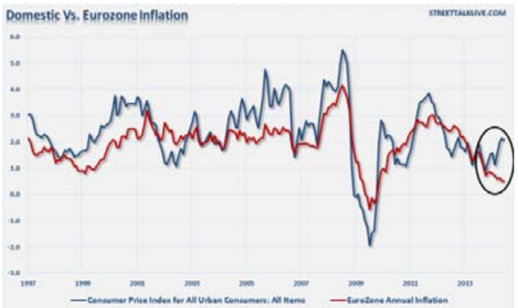
Europe is increasingly mirroring the 20 year malaise of Japan. Both experienced prolonged, debt-fueled asset price booms especially in real estate and have endured a deep balance sheet recession. Despite the European Central Banks policies of zero interest rates, public debt as a percentage of GDP continues to rise (as nominal GDP growth is below the level of the interest payments) threatening future growth as debt service payments crowd out investment. In early September, ECB President Mario Draghi cut the main policy rates to 0.05% and reduced the interest paid to banks on excess reserves to -0.20%. That is right, a negative interest rate to encourage lending.

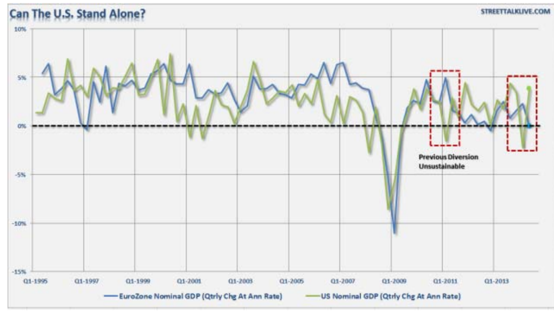
Yet demand for bank loans continues to fall in the Eurozone declining by an annualized €243 billion over the three-month period through June. Though the ECB and Draghi continue to provide easy monetary policy, bank regulators (including the ones at the ECB) continue to subject the banks to stress tests that discourage risky lending. The core of the region is weakening as Germany endured a contraction in growth in the 2nd quarter with France GDP at 0%. Germany is exhibiting the negative effects of tough lending standards, particularly on its large trading partners in the region. The uncertainty caused by the Russia-Ukraine crisis, with the potential for shortages and higher prices of natural gas this coming winter, are additional headwinds for the Eurozone.

The Eurozone is the single largest world economy and the largest trading partner of the United States. The economic relationship between the United States and the European Union is the largest in the world. It is estimated by the Congressional Research Service that the U.S. exports over $265B to Europe each year with imports adding another $350B to the total trade. How does the economic crisis in Europe impact domestic growth?

The U.S. is an economy driven by domestic demand with over 87% of growth outside of international trade. While the strong dollar may reduce export growth, we currently import over 20% more than we export. This implies that the consumer purchasing power would actually benefit by lower import costs which may also benefit the margins of many domestic companies.

Additionally, the strong U.S. $ dampens inflation and may serve to allow the Federal Reserve and Janet Yellen to keep rates lower for longer with less concerns about the inflationary impact. Still the historical high correlations of inflation and economic growth between the two regions (see graphs below) is very hard to ignore and of increasing concern.





Japan appears to be stumbling again which remains no surprise following the increase in April to an 8% consumption tax from the prior level of 5% (with another increase to 10% planned for next October). After a strong 1Q which many attributed to spending in advance of the tax increase, 2nd quarter GDP declined -7.1%. With public debt having doubled over the last 15 years to 230% of GDP, there is little doubt that the Bank of Japan will continue to ease rates and try to stimulate the economy. Following the collapse of what may have been the largest economic bubble in history, Japan has endured a quarter century of no growth. Nominal GDP is almost exactly where it stood in 1989! We have noted that Gross Domestic Product is the sum of labor force growth and productivity growth. If the population is actually shrinking as it is in Japan, this will not end well.

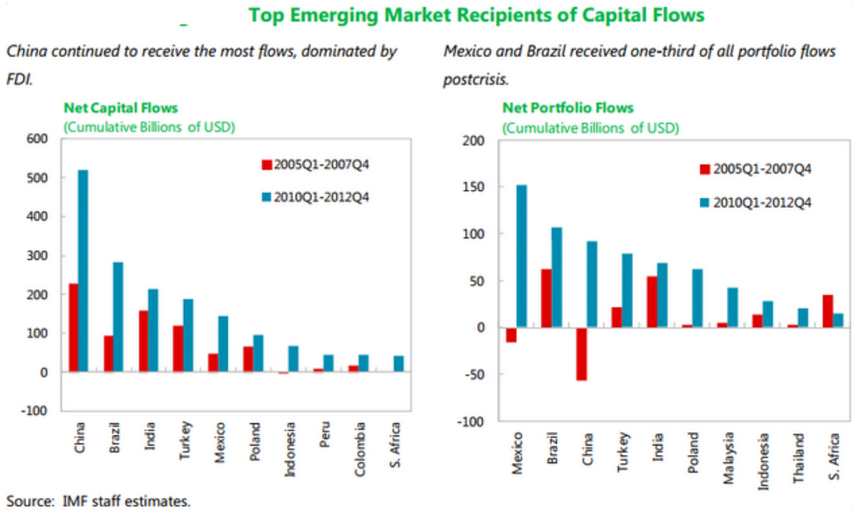
After multiple decades of growth in excess of 8% per year, China continues to slow towards 7% with weak domestic demand and intensifying deflationary pressure across production chains. Our largest concern continues to be in housing (where property values have declined -3.1% from April through September). Residential Investment now represents over 10% of GDP from a level of 3% in 2000. By comparison, during the housing peak in the United States, Residential Investment was only 6%.

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. More and more debt has produced decreasing levels of growth and now both of these tailwinds to growth are diminishing. With the tensions escalating in Hong Kong, we do not see officials and policymakers in China risking social unrest if the economy were to slow further so we expect further stimulus to support growth.

The International Monetary Fund (IMF) recently cut its global growth forecast for the 9th time in the last 3 years as it consistently overestimates the recovery from the global financial crisis of 2007-2009. The growth forecast for the Emerging Markets is now a full 1.5% lower than forecast 2 years ago. For much of the last 15 years, emerging economies would surprise to the upside and after the crisis of the late 90's, they registered strong growth and accumulated large financial reserves. Following the financial crisis, they were, therefore, better positioned than developed economies and exhibited stronger growth rebounds.

Monetary policies of the U.S. and Europe forced many to seek higher yields and growth and emerging markets were the recipients of very strong capital inflows from abroad both for Foreign

Direct Investments and to their capital markets. These flows may have overwhelmed their markets and the net debt of many of the companies in the MSCI-EM index doubled from 2009-2013. We are now witnessing the volatility of these short term flows on these markets. Combined with the sharp fall in commodity prices, this has led to large selloffs in equity, debt and currency markets. We view this as a longer term opportunity as these economies still possess strong financial flexibility and very reasonable market values. The volatility is likely to continue, however.



MARKETS

September was one of the most volatile months over the last 2 years for equity investors outside of the S&P 500 and erased what had been a solid start to the 3rd quarter. While the S&P 500 declined only -1.4% during the month and is still up 8.3% for the year, the Russell 2000 index of domestic small cap companies fell -6.0% (-4.4% in 2014) and the EAFE index for developed international companies declined -3.8% (-1.8% for the year). The MSCI Emerging Market index fared worse at -7.4% shaving the return for 2014 to a still positive 2.4%. Underneath the surface, the markets are undergoing a corrective phase while the S&P 500 hovers within 3% of its high. This divergence is a concern.

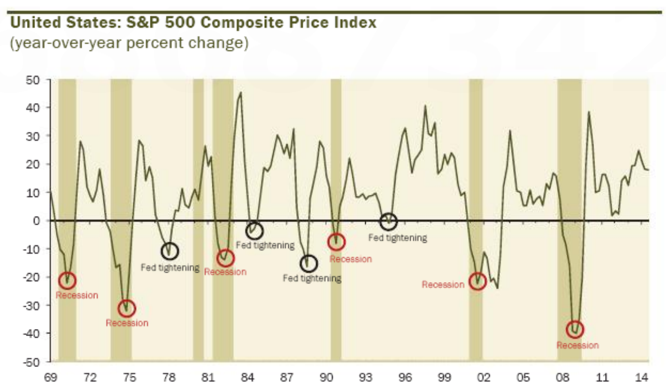
Despite a strengthening U.S. economy, U.S. Treasury yields continued in lock step with declining global yields. Foreign investors continue to represent strong demand for U.S. Treasury bonds which yield considerably more and carry less risk than their non-U.S. counterparts. As an example, the current yield on the 10-Year U.S. Treasury bond is about 150 basis points higher than the similar maturity in Germany. This has been more than sufficient to offset the tapering of bond purchases from the Federal Reserve. Confounding the majority, returns from credit have remained strong this year with the Barclays Aggregate Bond index at +4.1% for the year and the Barclays Municipal index returning +7.6%. Our view has been constructive in the fixed income area and remains so despite the current low yields as we feel the Federal Reserve is further away from raising rates than most believe.

Earnings growth for the S&P 500 continues at a solid pace (up 7.3% from a year ago in the second quarter) and according to FactSet are expected to increase at a slower but still positive pace of 4.5% as we enter the third quarter reporting season. What has previously been missing has been revenue growth which, according to data compiled by Bloomberg, has averaged 2.6% over the last two years while earnings per share have increased at a rate of 6.1%. This has shown a more positive trend recently as revenue growth was 4.4% in 2Q and is expected to be 3.7% in 3Q. According to Howard Silverblatt, an index analyst at Standard & Poors, both operating earnings and as reported (GAAP) earnings for the S&P 500 index set record highs in the 2nd quarter as did profit margins at 10.03%. We must note that the 7% increase in the U.S dollar may create a more volatile earnings season and some disappointments in guidance are likely.

Though our confidence in the cyclical economic recovery in the United States has continued to grow over the last 5 quarters to the highest level of the last five years, valuations for the domestic U.S. market remain somewhat stretched at 19X trailing reported earnings on the S&P 500, with record profit margins. U.S. companies have been major beneficiaries of Federal Reserve policy and reduced interest expense along with lower tax rates have contributed strongly to these record margins. We again remind that valuation is not a catalyst for any market correction but rather a constraint to longer term returns. We have not experienced a 10% correction in over 1100 days.

It should be noted that we enjoyed a 32% increase in the S&P 500 during 2013 and are up another 8% through the end of 3Q. Economic growth is on an upswing, and we are not in the camp that the Federal Reserve is ready yet to raise interest rates. We prefer to acknowledge that corrections of the 10% variety are more commonplace (occurring about every three years) than we have been conditioned to during this cycle and are viewed as the “price of admission” to the equity markets. However, we do not envision a major drawdown with this current backdrop.

As shown on the chart below, major declines rarely occur without recessions or Fed tightening cycles, neither of which we foresee over the next few quarters.



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

What is more concerning is that the economic recovery is still highly correlated to the markets and, though stronger, still vulnerable to more volatility. We are still aware of what a normal market correction of 10%+ might do to a still fragile recovery and investor psychology. This is precisely why we at Coho Partners always strive to construct a differentiated portfolio populated with high quality companies with resilient earnings streams, growing dividends, strong balance sheets and reasonable levels of expectations and valuations.

Sincerely,

Rick Wayne

Rick S. Wayne, CFA