2013 Annual Commentary

"You and I know that one day the orchestra will stop playing and the wind will rattle through broken windowpanes. We are all at a wonderful party and by the rules of the game we know that at some point in time the black horseman will burst through the great terrace doors to cut down the revelers; those who leave early may be saved, but the music and wines are so seductive that we don't want to leave. But we do ask "what time is it?" Only none of the clocks have any hands"

Adam Smith, *The Money Game*. 1967

Though averaging an already anemic 2.2% annual growth rate since the end of the recession in June 2009, a stabilizing U.S. economy entered 2013 facing perhaps its biggest challenge. The passing of the Taxpayer Relief Act, certain tax provisions to fund the Affordable Care Act, the expiration of the payroll tax holiday, along with the phase-out of certain tax exemptions and additional sequestered government spending cuts combined to create a fiscal headwind that was estimated to drain as much as 1.25%-1.75% from potential GDP growth. With the largest impact of this retrenchment expected to affect the consumer in the first half of the year, we cautioned that GDP growth might slow to around 1.5% and could not rule out the possibility of even a mild recession should the impact on consumer confidence create a negative ripple effect.

Indeed the year over year growth rate which exceeded 3.1% in late 2012 markedly slowed to a 1.6% rate by the end of mid-year 2013. While we started to turn more optimistic in our 2Q Commentary noting how well the economy had navigated the worst of the fiscal headwinds, we are still impressed with the very solid pickup in growth to end the year and feel the private sector has weathered this storm well enough to engender greater optimism entering 2014. Though a substantial portion of the gain may be attributed to a large increase in inventories (increasing the risk of an early 2014 reversal), the second half of 2013 should show annualized growth of about 3.3%. While we would not categorize the economy as having reached "escape velocity", we do feel a more sustainable foundation justifies the December 18th announcement from the Federal Reserve to take the first steps towards cutting stimulus by reducing the $85B per month of treasury and mortgage backed securities purchases by $10B.

Over most of the year, we have continued to note the following positives: an unfolding housing recovery especially in terms of reduced excess supply and rising home values; strong auto sales; private employment growth that is now only 0.5% below the level of 2008; real gross domestic product that has increased over 10.3% from the trough and is now 5.6% above its pre-recession peak; extremely low inflation levels (CPI up 1.2% y/y); and a Federal budget deficit that has declined from 10.1% of GDP in 2009 to 4.1% for fiscal year ended 9/30. The CBO now estimates the deficit will decline below 2% of GDP by 2015. In addition, the long discussed energy renaissance is having pronounced and immediate impact on our plunging trade deficit (down to 2.4% of GDP in November from 6% in 2008). According to the Energy Information Administration (EIA), since 2006 U.S. petroleum exports have risen over $59B while imports are down $82B. The American energy boom is underpinning the export growth we have seen and reducing demand for foreign oil. This increase in net exports may add as much as 1% to 4Q GDP.

Does this mean that the subsequent rounds of QE have been successful? This will remain a controversial and open question for years to come with no material change in policy direction as the Federal Reserve transitions leadership from Ben Bernanke to Janet Yellen. As noted previously, our view has continued to be that while the U.S. economy remained fragile, any benefits of the most recent rounds of Quantitative Easing were clearly diminishing.

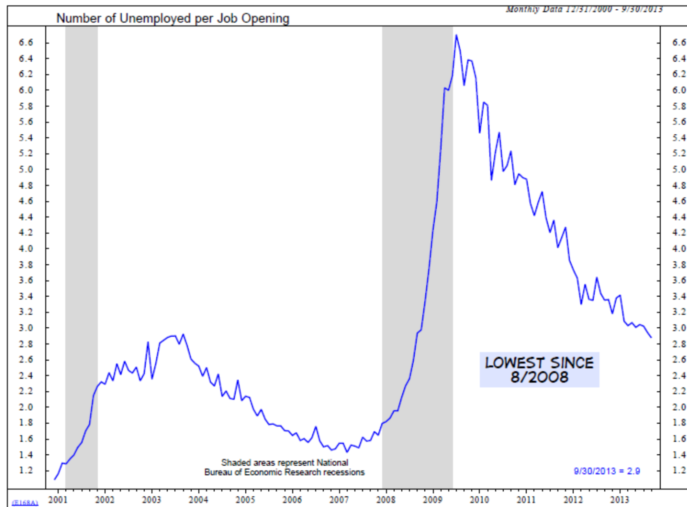
A policy originated during and designed as response to a deep recession and early post-crisis recovery, QE appears to be succeeding mostly in elevating financial markets to an even greater degree of disconnect from the underlying economic fundamentals. The Fed had lost the ability to directly stimulate the economy when interest rates approached the zero bound. No longer would reducing rates have the effect of reducing debt service burdens and increasing demand. Since then, the Fed has been relying on the “trickle down” impact of those most benefitting from the increased wealth gained from rising asset prices. While this has clearly had some positive influence on personal consumption in aggregate, it is logical to assume this to be a fairly inefficient transmission mechanism as the marginal propensity to spend of the affluent is far less than the average consumer. What is truly needed for escape velocity would be sustainable job and wage growth. It is in these critical areas that we are becoming incrementally more optimistic.

Much of the popular narrative during the “muted” jobs recovery has centered on both the declining labor force (shrinking the denominator and overstating the precipitous decline in the unemployment rate to the current 6.7%) and the quality and part time nature of the jobs that have been created. Indeed our favorite gauge, the employment-to-population ratio (which measures the proportion of the country's working-age population that is employed) has declined from 62.7% in December of 2007 to the most recent reading of 58.6%. Though we have recouped all but 1.2MM of the total number of nonfarm jobs lost during the recession, we still remain about 4.8MM below the prior level of full time positions. We do not feel that this accurately captures either the changing demographic landscape (negative for long term productivity and growth) or the improving employment picture (more positive for a cyclical improvement).

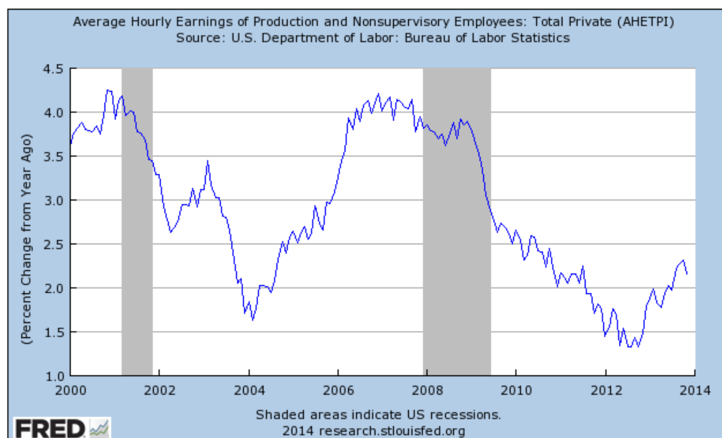
We note that the decline in the employment-to-population ratio actually commenced in 2000 from a peak of 64.7% indicating more of a demographic impact than economic. We believe that much of the decline is structural in nature due to an aging demography (and many moving to Social Security Disability Insurance from which few will return to the work force), truncating the impact of a typical cyclical recovery. The shrinking potential labor force is juxtaposed against nonfarm payroll employment growth that, despite month-to-month volatility, has been remarkably consistent (averaging 175K-183K) over each of the last 12-month, 24-month, and 36-month periods. These actually represent levels that are as high as any 12-month periods during the

expansion from 2003-2007, despite the inflated levels of construction and financial jobs during that time.

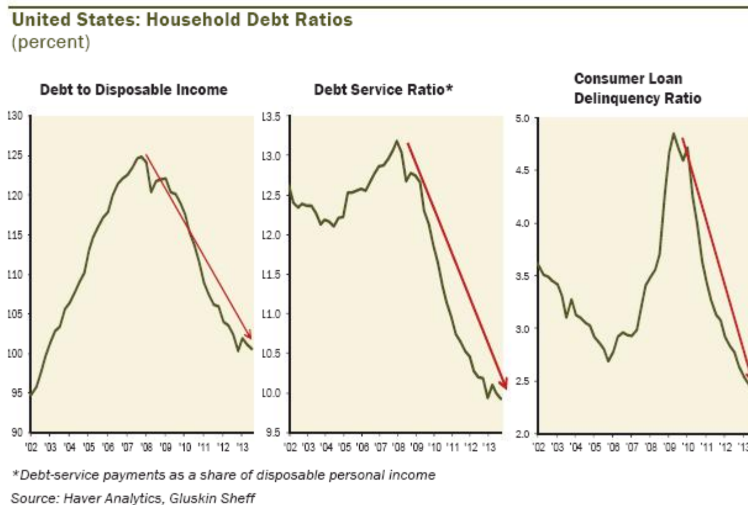
The Household Survey released by the Bureau of Labor & Statistics (BLS) each month notes that over the last year there have been over 1.4MM full time positions created and an actual decline in the number of part time jobs. The BLS also notes that the pool of available labor has declined 11.7% over the last year to the smallest levels since 2009 while the Manpower Survey of hiring intentions reached a 5-year high. As the labor force declines, the supply of labor is quickly coming into equilibrium with the demand. The Job Opening and Labor Turnover Survey (Janet Yellen's favorite employment report) shows just this tightening in labor market conditions and is shown in the graph below courtesy of Ned Davis Research.



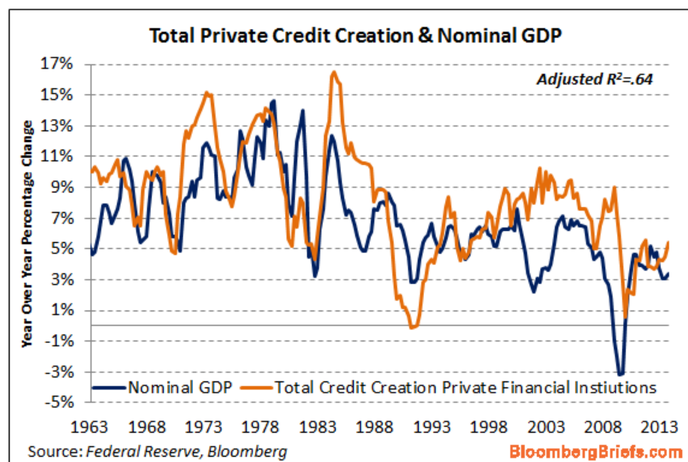
This tightening of the labor market is in the early stages and we feel is underappreciated by many but is clearly a reason for improving consumer confidence. As seen in the graph below, Average Hourly Earnings are on an upswing rising from a cycle low of 1.3% annual growth in 2012 to the recent level of 2.2%. Additionally, employers are working the staff longer hours due to this labor force tightening and this is showing up in an increase in the Index of Aggregate Weekly Hours of 1.9% y/y. Most importantly, this leads to Aggregate Weekly Payroll gains (proxy for wage income) now up 4.5% y/y.



Though the record Household Net Worth of $77.3T recently reported by the Federal Reserve in their Flow of Funds report unevenly reflects 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 November 2013 is $52,163. This figure is depressingly down -4.2% from June of 2009 when the recovery began and down -7.9% from the peak of $56,648 in 2000. However, consistent with the trends we are seeing, the most recent reading is up 2.4% from the $50,927 cycle low reached at the end of 2011. 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.

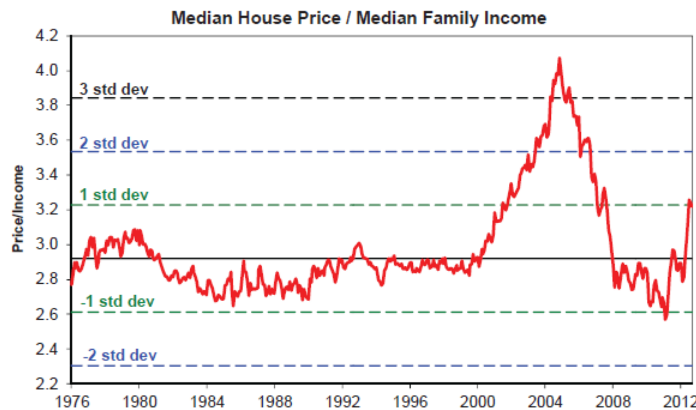


Increasing consumer confidence is also manifested in recent reports showing U.S. Household debt for 3Q 2013 increasing at a 3% annualized rate (highest since 1Q 2008) and total private credit creation is now on the upswing increasing at over 5% year over year which can augment consumer spending. None of the consumer figures that we have noted are particularly strong on a historical basis. However, it is critical to understand that most of the 5 year headwind of debt deleveraging is now behind us and can support levels of consumer spending that, while still historically soft, are gaining momentum. It is not so much the levels of historic comparison upon which we are focusing but the trend and that is improving.



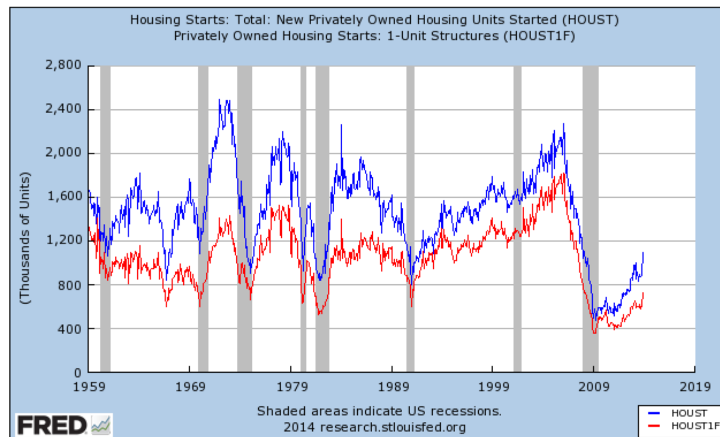
We have been dubious about the sustainability of the housing rebound as the traditional drivers of housing demand of household formation along with employment and wage growth have been absent during much of this period. Despite this, housing has continued to be one of the bright spots in the economic recovery though clearly at a decelerating pace. The most recent Case-Shiller home price data show year over year increases nationally of 13.6%. The cynic notes this is still about 21% below the 2006 peak and that all cash sales continue to dominate the market. The critical first time buyer remains absent at near historic lows of 28% of purchases. Indeed, Trulia notes that household formation which averaged over 1.5MM per year in the decade prior to the recession has slowed even further in the most recent quarter to 380K y/y. Studies from the Pew Research Center note that fully 36% of the 18-31 year old market ("Millenials") lived with their parents in 2012, up from 31% over a decade ago.

Though we continue to point out the interest rate sensitivity of much of this investor-driven improvement, the optimist would view this through a different prism. As home values have risen almost 5MM homeowners have moved from an underwater mortgage (mortgage exceeding value of the home) to positive equity. Total homeowners equity as reported by the Flow of Funds data hovered between 60%-70% of the total housing market value for the 50 years prior to the crisis before plummeting to a low of 37% in 2009. It has since risen to 51% increasing consumer wealth and confidence and loosening up the demand side of the marketplace as more potential buyers are unearthed. Below trend household formation and population growth over the last 5 years creates potential "shadow demand" of as much as 4MM units according to some analysts who project a return to more normal, slow growth markets. Though housing affordability is very attractive historically, that is a very interest rate sensitive metric that only showed one brief period of overvaluation even during the housing bubble. We prefer to view the valuation of median home price to median household income which pre-bubble has had a very stable historical relationship and removes the interest sensitivity (which can and will reverse) from the equation. House prices on this metric (chart from GMO) are not cheap.



Though Housing Starts have rebounded from less than 500K on an annualized rate during the recession to a 2013 average of 918K, this remains significantly below the 30-year average of almost 1.38MM. More important for both employment and spending is how the market is evolving. As depicted on the chart below, the rebound in the single family construction market is almost unnoticeable and averaged only 618K during 2013 compared with a 30-year average of 1.038MM. With residential construction representing less than 3% of GDP versus a 5% long term average, there is still room for a stronger augment to growth. Housing construction and home

sales not price movements have a greater contribution to growth as the multiplier impact of jobs and spending filter through to the economy. We see growth in construction, but little in prices, as supply increases more quickly than demand and mortgage rates move higher.



It is around this backdrop that we frame our growth expectations for 2014 at the strongest levels of the post-recession period. Though the Federal government (fiscal policy) is still in a tightening mode, both State & Local governments are mostly finished consolidating. 3Q data show municipal spending increasing at a 1.7% annual rate with a commensurate increase in job growth, both to the highest levels in the current expansion. The lessening of the fiscal drag of 2013 along with consumer spending that while still historically soft is modestly improving should support incremental gains in growth in 2014. Additionally, we look for an increased contribution to growth in private fixed investment and residential construction to combine with an improving trade picture. Taken together we look for GDP that should grow between 2.75%-3% for the year (though we look for a weaker 1Q number as inventories are reversed). As we are still in the early stages of wage improvement, the biggest risks domestically to this expectation may be found in the possible expiration of the Emergency Unemployment Compensation (EUC) program and rising interest rates which would pressure spending on housing and autos. The expiration of the EUC on December 31, 2013 immediately eliminates the benefits for 1.3MM unemployed workers. Additionally, another 1.9MM and 1.6MM would lose their checks on June 30 and December 31, respectively.

While the U.S. has been the strongest economy of developed markets, there have been signs of incremental improvement overseas. Europe enjoyed a stabilizing 2013 emerging from 6 quarters of recession to post modest annualized growth in the 2Q and 3Q of 1.3% and 0.4% respectively though still showing a decline of -0.4% on a year over year basis. Though much has been made of this return to growth, a clear distinction must be drawn between stabilization and growth, especially as cumulative aggregate Eurozone GDP remains more than 3% below pre-crisis levels (only Germany at +2.6% has exceeded its prior peak). Though the imminent risk of a bond crisis amidst sovereign funding concerns has been averted, Europe may be as close as ever to a deflationary bust. While the European Central Bank (ECB) may have forecasts expecting an inflation rate rising to 1.2% in 2014, the fact remains the most recent reading has declined to 0.8% in November down from a level of 2.2% the prior year.

Moreover, Eurozone money supply has been contracting (no help from the ECB as there has been with other central bankers in printing money) and flat GDP growth has fostered the increase in

debt-to-GDP levels to 93.4% in 2013 from 80% at the depths of the recession in 2009. The problems associated with such a period of extended and declining levels of inflations are exaggerated in the peripheral countries that will have a harder time servicing and extinguishing their debt without the boost to nominal GDP that rising inflation provides. However, this deflation is not only emanating from the smaller countries but has enveloped Italy and France who are experiencing rapid deceleration in inflation and Spain that officially fell into deflation for the first time since 2010. With Eurozone unemployment levels still over 12.1% (youth levels at 23.9%), we envision a continued malaise over 2014 with GDP growth at less than 1%. Despite a strong move in European equity markets since June of 2012, they still appear attractive at a slight discount to longer term valuations. The risks are appropriately reflected in prices in our opinion.

China so far appears to have successfully engendered a soft landing after an about face mid-year on restricting domestic lending. Nonetheless, the export-led growth and investment model (unfortunately leading to large amounts of unproductive private debt) is slowly transitioning to a more consumption-based economy. Few other emerging markets have the financial strength to weather such potential loss of growth and still stimulate the economy during the transition. Clearly growth in China is downshifting to an estimate of about 7% in 2014 which will continue to restrain global growth as China represents 15% of global GDP. We must also note the recent deceleration in Japan (6% of global GDP) which appears to be losing momentum following the initial massive burst of money printing form the Bank of Japan and Prime Minister Abe Shinzo. After growing at 2.4% early in the year, Japan's economy weakened throughout and appears poised for modest growth of just over 1% in the new year.

According to the World Bank, GDP growth in the developing economies has now slowed from 7.5% in 2010 to 4.5% in 2013. In addition to the slowdown in China noted above, India (<5%), Brazil and Russia (<2.5%) are growing only half of what they were at the height of the boom. Excluding the 2009 rebound from recession lows, emerging market total growth is estimated to be the slowest in the last decade at a time when these developing economies now make up 50% of global GDP versus 38% the decade prior. Their slowdown, therefore, has an increased impact on other economies.

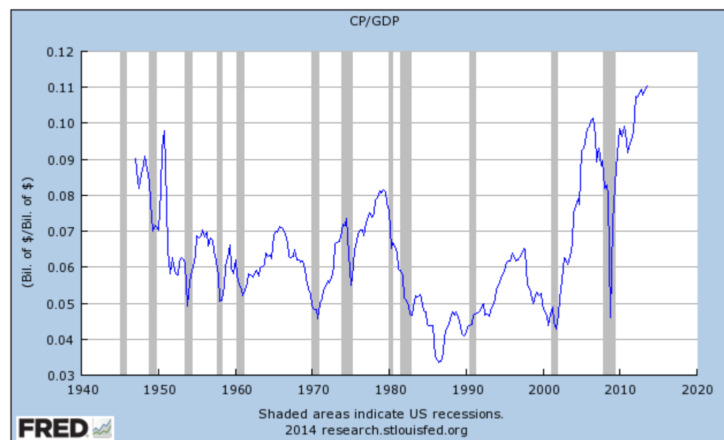
The threat of rising global yields continues to be the key near term risk for these economies. Since the credit crisis, credit growth in many emerging markets grew over 7% per year far exceeding GDP growth and, therefore, increasing leverage. According to Bloomberg, net debt of emerging companies in the MSCI-EM index is now 1.25X EBITDA (earnings before interest, taxes, and depreciation) up from 0.68X in June of 2009 while average borrowing costs jumped to almost 7%, the highest since March of 2010. It is just that fear of rising global borrowing costs that sparked a major mid-year sell-off in both emerging market equities and debt on the concern that it could trigger a surge in non-performing loans and expose a fragile financial system. Though the risks of negative capital flows remain high for this area in the early part of 2014, we feel this is more than discounted for the long term investor as emerging market equities are priced at their cheapest relative (and absolute) valuation since 1998.

2013 was a fantastic year for the markets provided one's portfolio had no diversification and only owned U.S. equities and those of developed Europe and Japan. The S&P 500 enjoyed the best year since 1997 with a total return of 32.4%. The Russell 2000 index of small capitalization companies was even better with a gain of 38.8%. The MSCI EAFE index of developed countries posted a powerful 22.8% advance. Basically, all positive returns stop there. The MSCI Emerging Market index declined 2.6% for the largest negative divergence from U.S. stocks on record. Gold posted a loss of over 25% while both REITs and Preferred Stocks also posted modest declines.

The Barclays Municipal Bond index and U.S. Aggregate Bond index experienced the worst returns in 19 years at losses of 2.5% and 2% respectively.

We entered 2013 with an expectation of GDP growth centered just south of 2% (consensus over 3%) with S&P EPS growth slowing below consensus (+11%) to a flat to modestly higher year (EPS growth is now +4.9% y/y) and with an inflation expectation around 1.5% (about right). Pretty close to actual results. Yet we were cautious on equities noting that though there appeared to be much fear, skepticism and global risk awareness, investor actions were in contrast to those concerns.

The bullish narrative of strong earnings growth needs to be analyzed further. Over the last 7 quarters, S&P 500 EPS growth has slowed to an annualized rate of 3.3% (though picking up slightly in the last quarter) while revenue growth per share over the last 2 years has averaged 1.5%. Looking at near flat growth, we realize that the largest beneficiary of the policies of Quantitative Easing may have been corporate America.

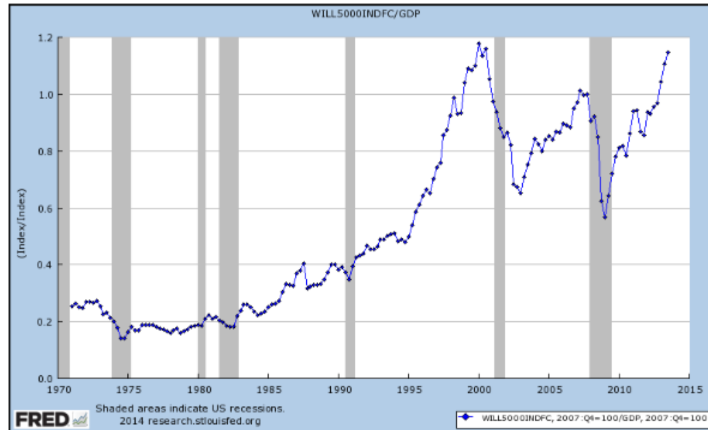


Though many skeptics correctly point to all time high (and unsustainable) profit margins (chart above), the superficial interpretation has been this was due to improving operating efficiencies (lower labor costs, productivity, etc…). The real story on corporate profits has been more financial engineering as firms benefit from ultra-low interest rates and a near insatiable market demand for yield (their debt). 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 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%. The magnitude of that decline is best stated by Stephanie Pomboy of Macro Mavens who notes that holding interest expense for the S&P 500 to 2007 levels would reduce 2013 EPS by $35.90!

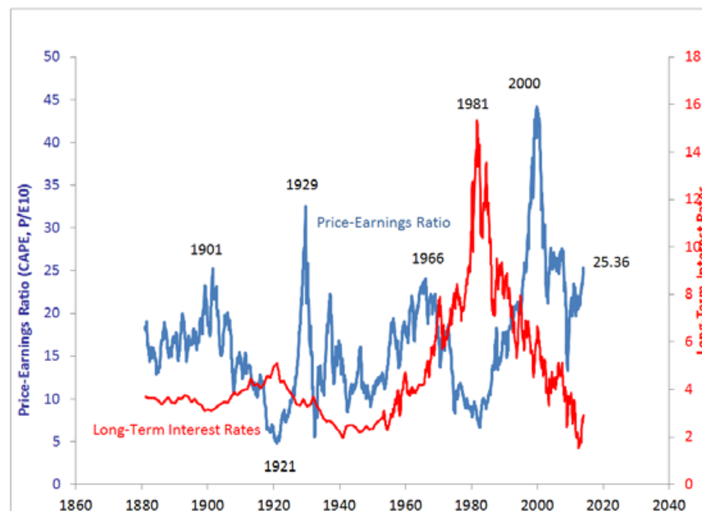
In addition to the 35% influence on S&P earnings from reduced interest, J.P. Morgan suggests that as much as 60% of the increase in EPS since 2011 (the period from when we noted EPS growth has slowed) has come from record corporate buybacks of shares (reducing the denominator of the EPS calculation) and not organic growth. Reduced interest expense and corporate share buybacks are not as desirable as top line growth and have created artificially high profits. We do not expect this to reverse in 2014 but rather unfold over time. As the economy improves, companies will increase hiring and capital expenditures. This may reduce the amount available for share buybacks (or dividends) and will also not be additive to margins. However,

the improved interest expense will only slowly reverse as little debt rolls over initially (and can even be funded by the currently high corporate cash levels for now). Importantly, profit margins are a mean regressing statistic that overstates current profits from which growth rate should not be extrapolated upon. But profit margins are not our only valuation metric flashing caution. There are hands on the clock.

- The total market capitalization of stocks (Wilshire 5000)/GDP ratio now exceeds the 2007 level and approaching the peak of 2000.



- The cyclically adjusted price earnings ratio (CAPE) popularized by Nobel Professor Robert J. Shiller that uses inflation adjusted earnings over 10 years to smooth out economic cycles is more than 50% above historic averages.



- The median P/E ratio of the stock market is now 25% above the historic mean (Ned Davis)
- The median Price/Revenue ratio of the S&P 500 is at an all-time high
- Margin debt on the NYSE is now at record levels
- The ratio of Bulls-to-Bears on the Investors Intelligence survey is the highest since 1987

Valuation is not a catalyst and will not, in and of itself, precipitate a market correction. What it does, however, is act as a more accurate barometer of reasonable longer term return expectations. Markets can normalize in many ways, one of which is via low returns over time allowing fundamentals to catch up to price levels. One should also note that we have not had even a 10% correction in over 830 days. Investors should ask themselves one question. What time is it?

At Coho Partners we remain focused on identifying companies whose business models tend to be reasonably impervious to exogenous factors and 2013 was a good year for our defensive equity strategy, nearly matching the performance of the overall market. We continue to be rigorous in our valuation analyses and reduce positions where we feel that future return expectations have been lowered and add to new and existing holdings where the underlying fundamentals remain strong and our confidence in their future earnings continue to be high. Our companies have well-articulated operating and financial strategies with managements that have consistently delivered against realistic long term goals. We are optimistic that this is precisely where one should be invested at this stage of the market cycle.

Sincerely,

Rick S. Wayne, CFA