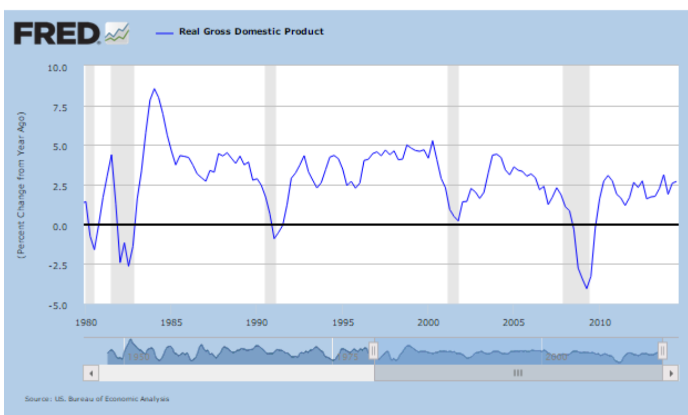
Q4 2014 Commentary

"I don't know where we're going, but we're on our way."

Stymie-The Little Rascals

UNITED STATES

Subsequent to turning more optimistic for a cyclical economic upturn in mid-year 2013, we have witnessed the U.S. economy accelerating at a growth rate in excess of 3% annualized. The momentum engendered during the second half of 2013 framed our expectations that 2014 would be the strongest year of the recovery and we pegged a full year expectation for Gross Domestic Product around 2.75%. The polar-vortex induced contraction in GDP of -2.1% during the first quarter may have altered the full year numbers but not the clear trend of the economy. Indeed the last 3 quarters of 2014 should show a growth rate of over 4% on an annualized basis including a revised GDP of 5% for 3Q (and over 3% for 4Q), the fastest quarterly growth rate in 10 years.



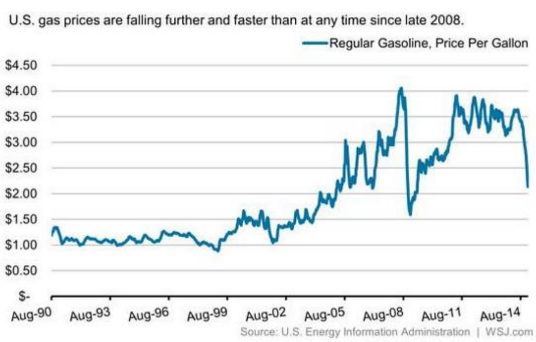
Will 2015 finally be the breakout year for the U.S. economy? Many of the key impediments to sustained growth of recent years are fading. Fiscal tightening and stringent credit conditions especially for small businesses were major headwinds for capital spending and employment growth from 2011-2013. Though a strong dollar and continued malaise in developed international markets will negatively impact export growth, the U.S. economy is almost 90% domestic and

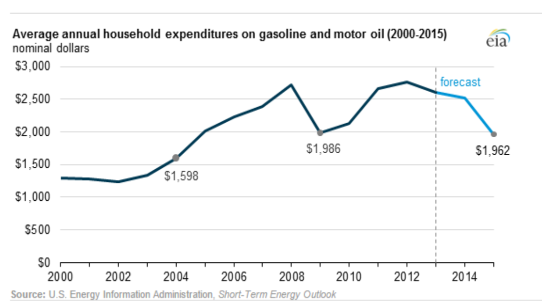
70% is consumer spending. Small business and consumer optimism are consistent with an improving job market and a tightening labor market should foster the increasing wage gains that we have been expecting for more than a year. This stronger payroll growth (buoyed by an increase in the minimum wage in almost half the states) combined with low inflation and declining gas and energy costs should create a major tailwind for consumer spending. We look for real consumer spending to move towards 3% from the post-recession cycle average of 2.2%. This alone should add over 0.5% to overall GDP.

In aggregate, we are looking for a continuation of recent growth trends in excess of 3% for the first half of 2015. However, the second half growth and the real story of 2015 might be determined by the price of oil and the potential reverberations of the collapsing crude market and the associated movements in global currencies. Look for a slowing in 2H 2015 as the rising dollar and overseas weakness impact U.S export demand while a major reduction in energy-related capital spending hits corporate investment domestically.

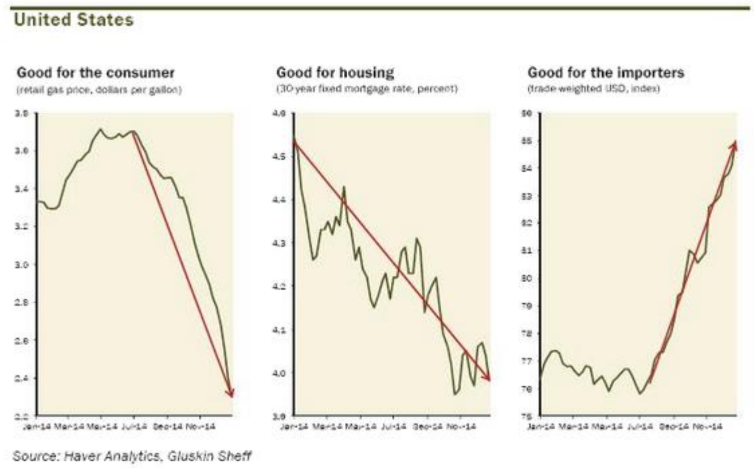
OIL & U.S. DOLLAR: There are many moving parts to the largest collapse in energy prices since the 2008 global recession. As seen in the chart below (left), the futures price for gasoline is below $47 per barrel down almost 60% from its summer high of over $107. The national average for regular gas is down to $2.13 in early January from $3.64 in June of 2014. Wealth and power is shifting from many of the autocratic oil states to the benefit of consumers.

According to data released by the U.S. Energy Information Administration (EIA), the average U.S. household in 2015 will spend almost $600 less on gasoline and motor oil than in 2014 (chart below-right) to the lowest levels in over 11 years. This savings also inures disproportionately to the benefit of lower income households. According to Bank of America Merrill Lynch, households earning less than $50,000 per year spend over 21% of after-tax income on energy compared with less than 9% for those earning more. This savings is, therefore, more likely to be spent.

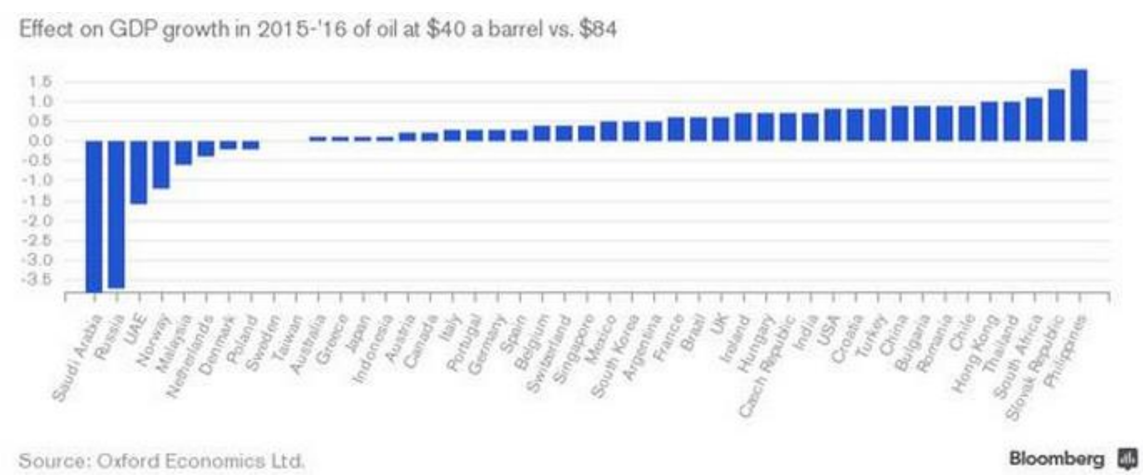




An additional benefit to the U.S. consumer may also be found in the strength of the U.S. dollar which has surged by over 15% during the same period as the drop in oil. Most seem to believe that a strong dollar is bad for the U.S. and clearly it will have a negative impact on exports and probably GDP. However, the U.S. imports 20% more than it exports. This will manifest itself in lower inflation (import costs) for the consumer further increasing purchasing power and partially offsetting the impact of the decline in trade on gross domestic product. Declining energy costs, lower interest rates and reduced import prices should support our thesis for stronger consumer spending in 2015.



Some bears continue to view the decline in the price of Oil as a sign of a global growth slowdown and waning demand. While it is clearly true that European and Japanese economies remain weak and China is slowing, these are not new stories. What is different now is the supply dynamic within the market itself with a glut estimated at almost two million barrels a day. Saudi Arabia has the financial reserves to wait this period out and has made it clear it will not cut production at the same time that U.S. and even Russian output are hitting new highs. The U.S. stands to be a net beneficiary of lower oil but there are clear winners and losers globally. The impact of the drop in oil on the 2015 growth in various economies is estimated by Oxford Economics in the chart below.



But do lower oil prices unequivocally improve our domestic economy? There are conflicting arguments but one thing is clear, the benefit to the domestic economy is more front-loaded in the first half of 2015. The immediate decline in energy costs inure to consumer spending and additional advantages of lower shipping and production costs for many businesses should also aid growth in the early part of 2015. The longer term impact to the energy sector in the U.S. economy is more uncertain.

According to research by the Manhattan Institute for Policy Research, the oil & gas boom in America has added between $300-$400 billion annually to our economy or between 1.7% and 2.3% of GDP growth without which our economic recovery may have stagnated. Additionally, the shale oil & gas industries have been the nation's largest single creator of solid-paying, middle-class jobs with nearly 1 million Americans working directly in the oil & gas industry and another 10 million jobs associated with this industry. In addition to the impact on many high paying jobs, it is estimated that 25% of total capital spending is centered around the energy sector. Unlike the savings to the consumer, capital spending cuts should not happen quickly as producers tend to hedge the price movements in the futures market. Despite this expectation, Reuters reported a drop of almost 40% in new well permits issued in the United States in November alone.

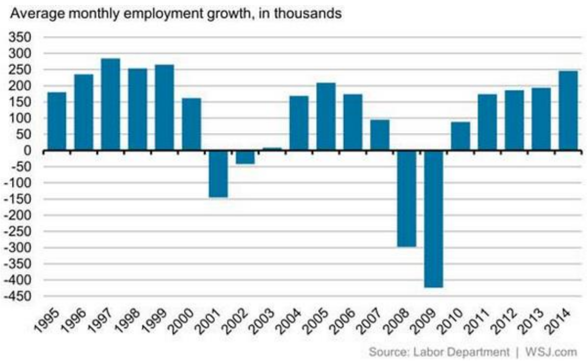
INFLATION: With declining commodity inputs, CPI moderated in 2014 to a 1.3% y/y level (through November) down from over 3% in 2011 and 2.1% in 2012. Core CPI (which excludes food & energy) shows consensus expectations to remain around 2% for the new year. With a rising U.S. dollar offsetting stronger aggregate demand and a modest pickup in wage growth, we anticipate CPI to be closer to 1.5% for the full 2015 calendar year.

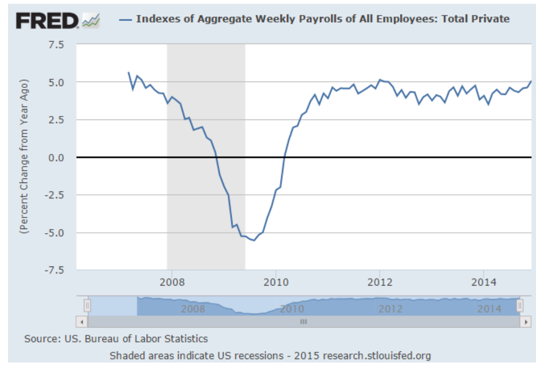
However, it is very possible that early in the first quarter of 2015, we could see the headline inflation reading near or even below 0% and the core below 1% as the influence of the decline in input prices (energy may be down almost 50% in 1Q) work their way through the pipeline. As this price decline is centered in the goods area rather than services, this is very good news for the U.S. consumer in 2015. How will the Federal Reserve address expected interest rate increases if inflation remains so low? Currently 95% of economists surveyed in the Blue Chip survey expect a rate hike in the new year.

FEDERAL RESERVE: Declining interest rates are usually a reflection of diminishing inflation prospects. If this is the reason for the current decline in rates, it would most likely prompt the Fed to hold off on raising short-term interest rates in the months ahead. However, if lower long-term rates are a reflection of investors pouring money into U.S. dollar assets due to the paucity of attractive global alternatives, (flows that could spark a further U.S. asset price boom), it might prompt the Fed to push rates higher sooner or more aggressively than planned. We feel that the speed with which the Fed raises rates will likely be most correlated with the pace of wage gains. On this front we also anticipate Chairman Janet Yellen to be sure that wage gains have traction and are not just temporary. We are, therefore, in a minority in feeling there is a very strong possibility that the Federal Reserve does not raise rates at all in 2015. With global central banks anticipated to ease even further, U.S. rates should remain low throughout the year though higher than current levels.

Can the Federal Reserve raise rates in the face of global central bank easing? The Fed's embrace of prospective ECB action is all the more striking because it could cause challenges for the U.S. central bank. Market anticipation of higher rates in the U.S. coupled with new money-printing measures by the ECB has driven the U.S. dollar higher. The dollar rise holds down already-low U.S. inflation by pushing down import prices and spurring more capital flows to the U.S. that may distort financial markets. As noted, this will also curtail U.S. exports by making them relatively more expensive in global markets.

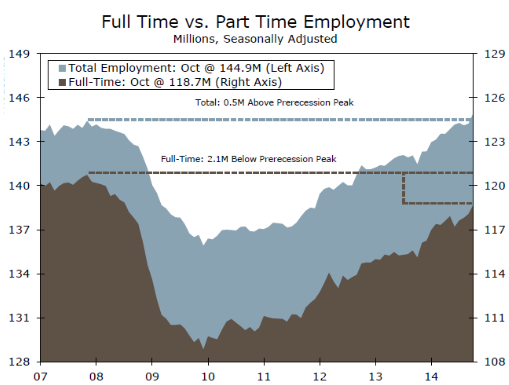
EMPLOYMENT & WAGES: One of our anticipated themes for 2014 was a tightening of the labor gap which would engender the early stages of wage increases. Employment growth has continued at an accelerating pace in 2014 averaging over 245K new jobs per month through December with the most recent 4Q numbers averaging over 288K. As the chart below (left) depicts, this is a breakout increase over the prior three years which averaged less than 185K per month. Despite the best annual job growth since 1999, average hourly earnings are actually lower at 1.7% y/y. We feel this recent report to be inconsistent with other wage and consumer confidence metrics and view the tightening labor market to be on the verge of generating greater wage gains. Indeed, aggregate weekly payrolls which account for increasing hours and is more reflective of total compensation, are now up 5.1% y/y (see right hand chart below).

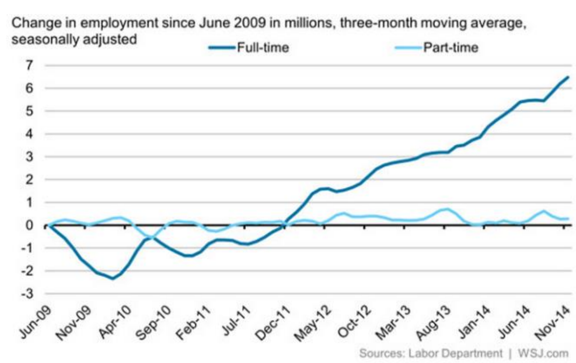




The common narrative in conflict with the improving job numbers (and partly borne out by the tepid hourly earnings growth) remains the struggle of good paying full time positions. While job gains have broadened into better-paying industries during the past year, the number of full-time jobs in the economy has yet to recover to its prerecession level (see chart below left). During the recession, total employment declined by over 8.7 million jobs from the peak of January 2008 to the trough of February 2010. However, full-time jobs fell by a much larger 11.3 million, as weak demand led employers to slash hours and relegate many workers to part-time status.

In May of this year, household employment surpassed its pre-recession peak, but 1.9 million fewer Americans are working full time today than in November 2007. This may help to explain why various surveys, such as the NBC News/Wall Street Journal survey, show that a large proportion of Americans continue to believe the U.S. economy is in a recession more than five years after the recession technically ended. This also may explain the continued struggle to attain the wage growth necessary for economic escape velocity. We believe this to be reversing. Of the total employment growth for 2014 of 2.952MM jobs, 2.694MM (91%) are in full time positions.

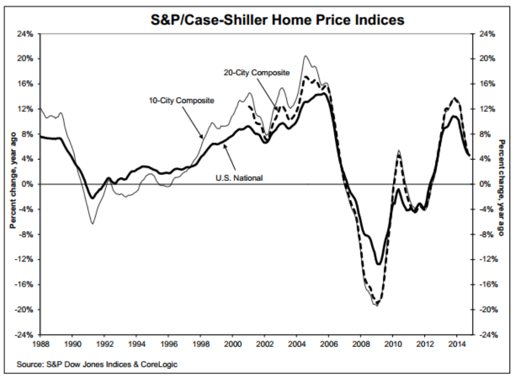


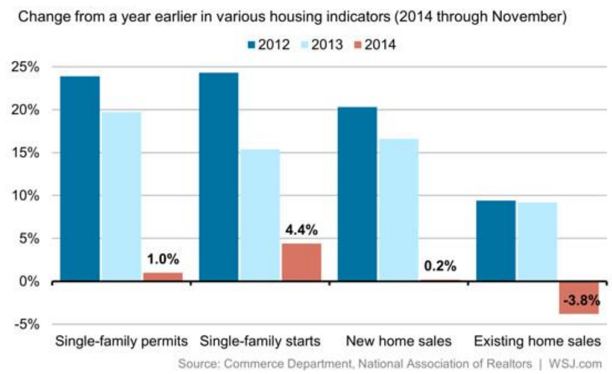


With the unemployment rate declining to 5.6%, we continue to expect stronger payroll growth in 2015. Additionally, as 29 states have passed legislation to increase the wage floor, the Economic Policy Institute estimates that as many as 3.6MM people will see their pay increase in 2015 related to this initiative. With lower inflation, real incomes will be growing.

HOUSING & AUTOS: As long time readers are aware, we have been much less sanguine than most on the continuation of the housing recovery and 2014 was a disappointing year for most housing metrics. We have continued to stress that home price gains would slow and even flat line as the market transitioned to one 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 9% of total sales 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 below-left, the Case-Shiller index of National home prices has decelerated recently to annual gains of about 4.6% from over 13.8% earlier in the year. Additionally, we note that most housing data has slowed markedly each of the last 2 years with new and existing home sales showing an outright collective decline in 2014 (chart below-right).



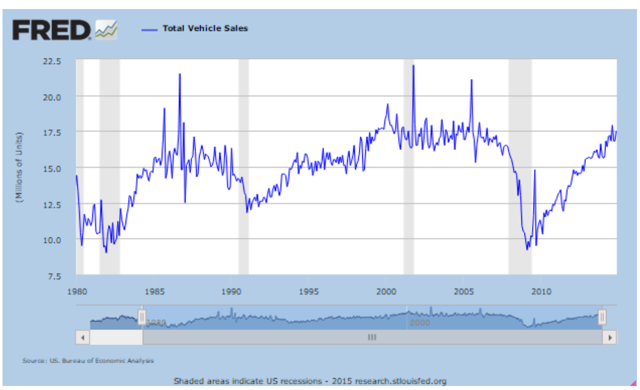


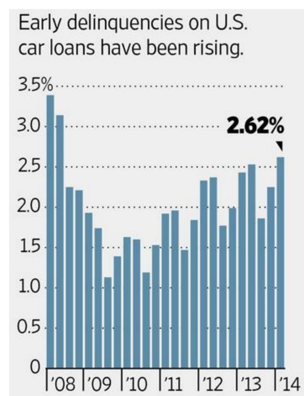
As noted above, the dearth of new full-time jobs is another reason the housing market recovery remains so excruciatingly slow. Few part-time workers buy homes and the percentage of first time buyers still remains under 30% compared to a more normalized level of 40%-45%. Homeownership for those under 35 has declined from 43.6% in 2004 to just 36% in 3Q 2014. Much of this may be laid at the doorstep of a generation that came of age during the financial crisis and housing collapse into an incredibly weak job market. Many carried large burdens of student debt which now average $26,000 for recent college graduates.

While some view moderating and even declining prices as positive toward maintaining affordability, a lack of continued price gains may constrain supply in some areas of the market. Of homes in the bottom third on a price scale, 27.4% are under water (the house is worth less than the amount of outstanding mortgage). This compares with 9.3% for the highest-price tier and 15.7% for the middle-price tier. These homeowners are often unable to place their homes up for sale and this is generally the marketplace for the first time buyers. Additionally, to improve affordability, not only do mortgage rates need to remain accommodative (and they are currently back near cycle lows), but wage gains will also have to exceed house price appreciation which has yet to occur.

The burdens on the first time homebuyer of higher debt ratios and lower credit scores threaten to keep mortgage lending subdued perpetuating a slower than typical housing market. However, some positive signs have gathered momentum recently. Among 25-34 year olds, 76.4% are now in the work force (highest since 2008) moving total employment growth among this cohort up over 800K in the last year. This gain of 2.5% is above the national total (see chart below-right). This is critical to household formation growth as 21% of the unemployed within this age group live with their parents compared with just 12% of those who have jobs. We anticipate increasing household formation for 2015 though still below historical averages.

Auto sales continue to be one of the strongest sectors of the U.S. economy and represent an area where lending standards have been extremely supportive of sales (many say too much so). Total vehicle sales for the full year of 2014 are approaching 17MM, a level in the range of a decade prior. However, early delinquencies (defined as within eight months of obtaining the loan) are now at levels last breached in 2008. This high level of delinquencies is clearly at odds with all other consumer lending data and, more likely, reflects very loose lending standards.



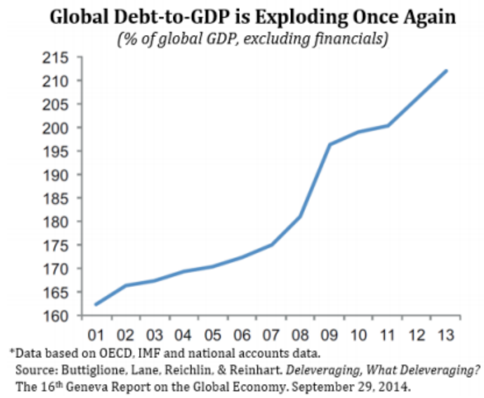


INTERNATIONAL

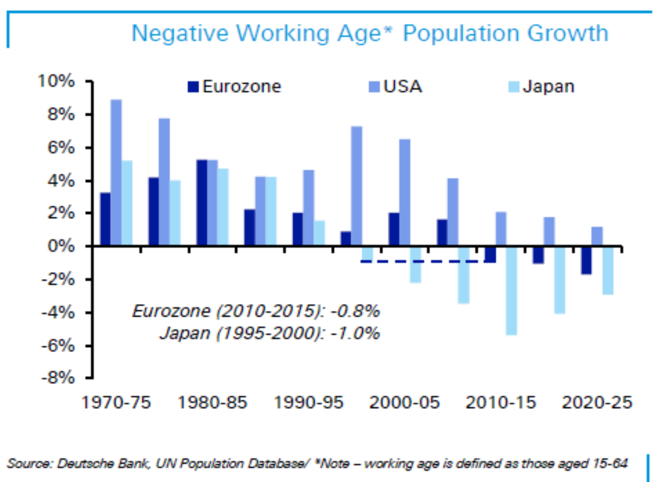
We noted last quarter that the recent breakdown of historically high correlations of inflation and economic growth between the U.S. and Europe are of increasing concern. However, it is a superficial comparison to discuss global markets without addressing the respective debt loads. Increasing debt brings forward yet ultimately crowds out future consumption. The difference in debt loads among the Eurozone, Japan and the United States explains much of the economic divergence we have seen over the recovery.

As pointed out by economist Lacy Hunt, "US growth is outpacing that of Europe and Japan primarily because those economies carry much higher debt-to-GDP ratios. Based on the latest available data, aggregate debt in the US stands at 334% of GDP, compared with 460% in the 17 economies in the euro-currency zone, and 655% in Japan. Economic research has suggested that the more advanced the debt level, the worse the economic performance."

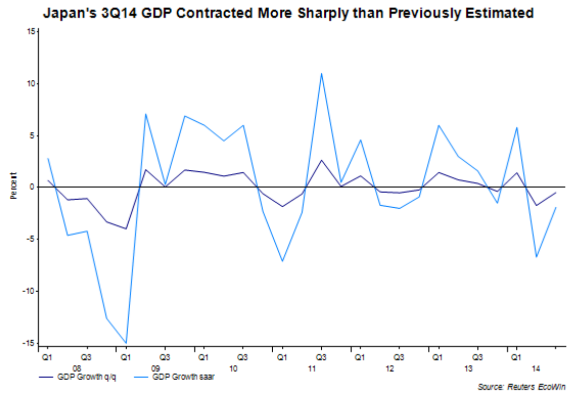
As virtually all developed economy central banks (U.S., Eurozone, Japan, United Kingdom, etc..) are exercising extremely accommodative monetary policies by keeping interest rates close to the zero bound, global debt-to-GDP has exploded even further. This will continue to constrain global growth rates.



In addition to burdensome debt loads, developed markets face other issues fostering the discussion of secular stagnation. Europe and developed Asia have not been exempt from the concerns of income inequality and an aging population. Indeed, Euro area demographics are much worse than that of the U.S. and Japan is even more troublesome as the chart below of declining working age population depicts. A country's growth potential is simply the product of labor force increases and productivity growth. The consequential economic impacts are lower growth, inflation and interest rates.



Against this backdrop of debt and demography, Japan has officially slipped into a third economic recession in as many years despite the Bank of Japan's efforts to stimulate a return of economic prosperity and inflation. Following a contraction in 2Q growth of -7.1% a/r, 3Q GDP surprised further on the downside with a decline of -1.9%. Subsequent to this release, the BOJ announced a massive expansion of its own asset purchase plan along with the government pension fund decision to start purchasing global equities instead of government bonds.



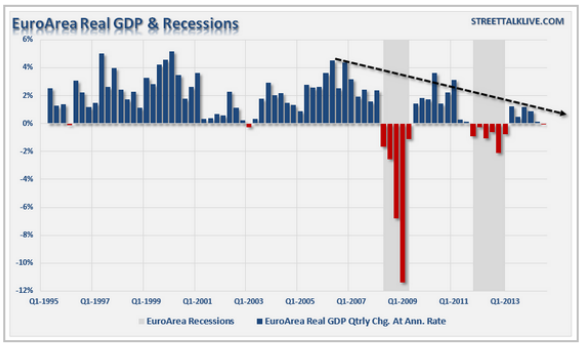
Japan has been fighting deflationary pressures and rolling recessions in their country for the last 30 years. Japan has now endured a quarter century of virtually zero growth. Nominal GDP is almost exactly where it stood in 1989! The internal struggle with an aging population, lack of savings (a 24% rate in 1974 and less than 3% now) and accelerating debt/GDP ratios continue to plague economic prosperity. Moreover, 15.6% of Japanese tax revenue is now needed to pay the interest on the debt alone (compared to less than 6% in the U.S.). This is the eventual impact of extreme debt loads as productive spending and investment is crowded out by debt service. It is a primary reason as to why we expect global rates to remain low as countries simply cannot afford to let rates (and thus debt payments) rise and will do everything possible to prevent this.

While the declining working-age base remains the biggest obstacle in Japan, one that remains unaddressed has been the lack of structural reforms (including expansion of the labor force through incentives for more women to enter the work force). Third quarter data was impacted by the lingering effect of the April sales tax hike but this should not have anything to do with the continuing decline in corporate investment. After declining 18% in 2Q, capex fell another -1% in the most recent quarter. One of Abe's initial set of pledged reforms was to lower the corporate tax rate from the current punitive 30% rate to 20%. Until these issues are addressed, this lack of sustainable growth will persist with growth rates turning positive in 2015 but barely.

Europe is increasingly mirroring the 20 year malaise of Japan. Both experienced prolonged, debt-fueled asset price booms especially in real estate and have similarly endured a deep balance sheet recession. Despite the European Central Banks policy 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. As with Japan, member countries continue to avoid making necessary structural reforms to cure their burdensome debt, dependency and unemployment ratios (11.5% in the Eurozone).

Europe is perilously close to falling back into recession amidst rising deflation risks and political risks in both Greece and Spain. Over the past four quarters (Q4 2013 – Q3 2014), quarter-over-quarter GDP growth in the Eurozone has averaged 0.2%. We expect this trend to continue in Q4 2014. Though we are not projecting another recession as our base case for 2015, a growth rate around 1% for GDP remains the most likely scenario as modestly improving export growth is offset by continued weak domestic demand.

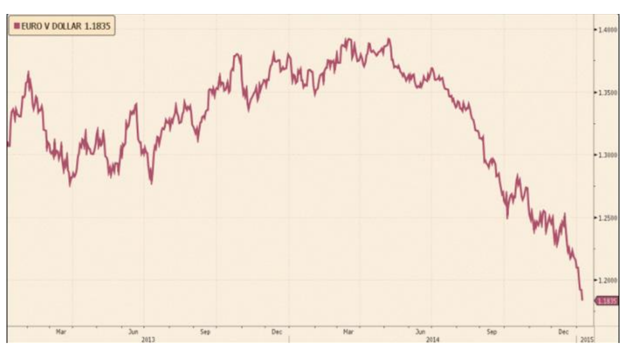
As shown below, the declining rate of economic growth since 2007 illustrates the extent of the malaise. Despite successive rounds of monetary interventions and suppression of interest rates by the European Central Bank (ECB), the Eurozone has experienced fits and starts of declining economic activity. Plummeting energy prices have now moved year over year inflation readings to negative territory (-0.2% y/y). The threat of deflation brings the ECB another step closer to full-scale quantitative easing (QE). However, further action is by no means a foregone conclusion, as core inflation picked up slightly (+0.8% y/y) and policymakers may see lower oil prices as helping fuel an economic recovery in 2015. The collapse in oil prices is a material global event and we estimate that global consumer prices which rose about 2% in 2014 may fall below a 1% rise in 2015. However, most economists now anticipate that a large scale QE program will be announced by ECB President Mario Draghi in late January.



In 2012, Outright Monetary Transactions (OMT) was initiated by Draghi, with the primary objective of helping governments maintain bond market access. The objective of QE has little to do with sovereign solvency but is rather used by the central bank when its policy interest rate has hit the zero bound and cannot be pushed lower. The debt level of the government is not germane to the decision to employ it.

But, by lowering long-term interest rates, central-bank purchases of government debt can help contain government debt service. As already noted regarding the debt service concerns in Japan, QE can prolong solvency for a government that in a more normal interest rate environment, otherwise might be insolvent.

However, the major problem for additional rounds of QE by the ECB is that the bulk of the funding for further QE falls on the shoulders of Germany. Jens Weidmann, the head of Bundesbank, continues to push back against further stimulus efforts due to the liability imposed upon the German taxpayer. All of these concerns have combined to push the Euro to levels last seen in March of 2006.



After multiple decades of growth in excess of 8% per year, China's GDP growth is expected to slow further in 2015 to below 7% as the ongoing property downturn leads to further weakness in construction and industrial production, and related investment. Tepid domestic demand and falling commodity and energy prices are expected to bring CPI inflation down to 1.5% while producer prices decline further. Rising deflationary pressure will spur the central bank to cut benchmark lending rates by at least 50 bps in 2015.

Our largest concern continues to be in housing (where property values have declined over 4% in 2014). Residential Investment now represents over 10% of GDP versus a level of 3% in 2000. By comparison, during the housing peak in the United States, Residential Investment was only 6%. Local Chinese governments have taken on massive debt in recent years to fund many infrastructure projects encouraged by Beijing to fend off the global financial crisis. However, fiscal revenue growth has slowed in the face of a weaker national economy and the real estate downturn. Debt pressures are mounting.

As noted previously, 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 becoming the largest in the world. More and more debt has produced decreasing levels of growth and the tailwinds to growth are diminishing. We do not see officials and policymakers in China risking social unrest if the economy were to slow too quickly. We expect further stimulus to support growth and engender a controlled slowdown. If growth in China were to collapse, the global fallout could be even worse than that caused by a more normal recession in the United States.

A strengthening U.S. dollar and a slowing China will herald a more challenging environment for emerging markets as flows of cheap dollars and the commodity import demand slow markedly. The results 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 the impact is dramatic in Venezuela (credit default swaps indicate over a 95% chance of default on bonds within 5 years) and Russia (a recession in 2015 with a contraction of over -5% of GDP is expected).

The International Monetary Fund (IMF) recently cut its growth forecast for the Emerging Markets and it is now a full 1.5% lower than forecast just two years ago (though still expecting 5% GDP). Excluding China, developing markets in aggregate currently account for 40% of global GDP.

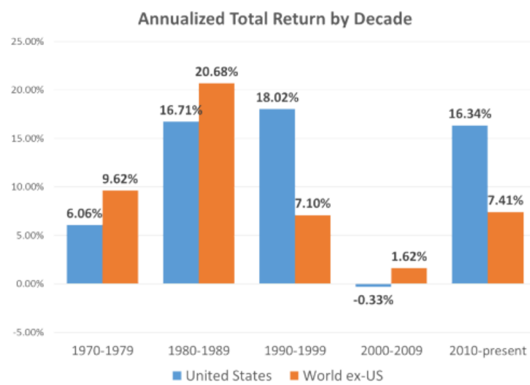
For much of the last 15 years, emerging economies would surprise to the upside and after the crisis of the late 90’s, they registered strong growth and accumulated large financial reserves. Following the financial crisis, they were, therefore, better positioned than developed economies and exhibited stronger growth rebounds. Large flows from developed economies (both for Foreign Direct Investments and to their capital markets) during the global recovery may have overwhelmed their markets and the net debt of many of the companies in the MSCI-EM index doubled from 2009-2013. These debts were usually denominated in U.S. dollars. Now a rising dollar is quite toxic for these borrowers because their liabilities rise as the dollar rises while their domestic assets do not.

Flexible exchange rates and large foreign reserves (estimated by the IMF to be over $8.1T versus $659B in 1999) should allow emerging markets to avoid the full blown crises of 1998 but the ride will be bumpy. As growth has slowed, the budget surpluses seen previously have reversed and reduced the cushion that many governments enjoyed to buffer against weakening growth. With interest rates already at or near zero, there is little room for interest rate policy to aid debt-service relief. Rather the impact will be felt in widening (or even collapsing) credit spreads that could create problems in these markets.

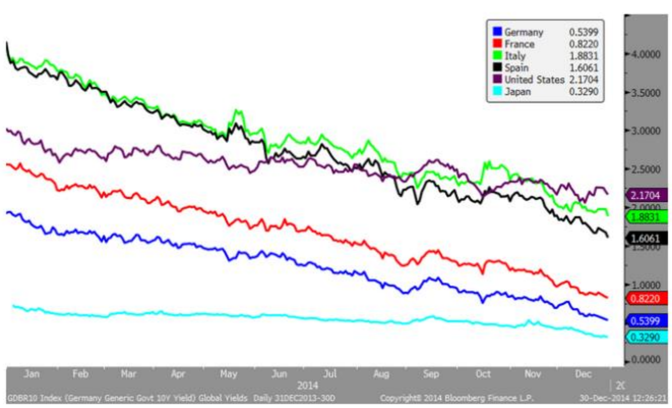
MARKETS

2014 was another very strong year for the U.S. equity market which continued to outperform global indices. Following a 32% gain in 2013, the S&P 500 achieved a total return of 13.7% in 2014. This represents the 6th consecutive advancing year and is now the 4th longest post-war advance on record. The Russell 2000 index of small capitalization companies enjoyed a powerful 9.7% bounce in the fourth quarter that helped erase prior losses and generated a 4.9% return for the full year.

The MSCI EAFE index of developed countries and the MSCI Emerging Market index declined -4.9% and -2.2% respectively further widening the current valuation gap between domestic and foreign equity markets. The concerns about the economies of non-U.S. developed markets and emerging economies are well documented and should be reflected in current valuation divergences and recent relative price movements.



Despite a strengthening U.S. economy, U.S. Treasury yields continued in lock step with declining global yields (chart below). Foreign investors continue to drive demand for U.S. Treasury bonds which yield considerably more and carry less risk than their non-U.S. counterparts. For 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 sufficient to offset the tapering of bond purchases from the Federal Reserve. Confounding the majority, returns from credit enjoyed a strong year with the Barclays Aggregate Bond index at +6.0% for the year and the Barclays Municipal index returning +9.0%. Our view has been constructive in the fixed income area and remains so despite the current low yields. However, we feel gains will be more tempered in the coming year.

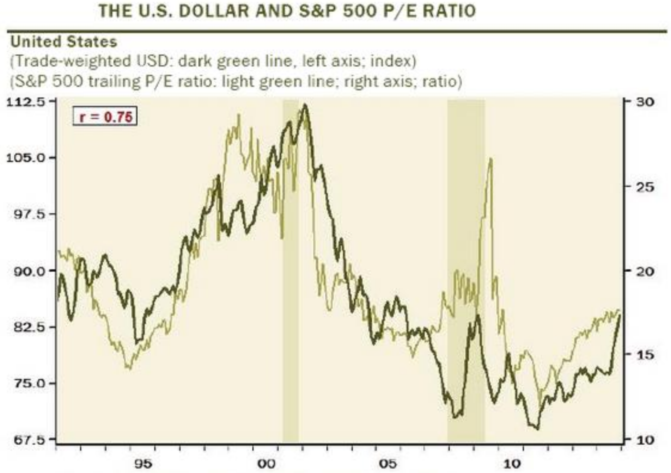


Though U.S. nominal GDP growth should be supportive of the profits of domestic-based companies, between 40%-50% of S&P 500 revenues are from overseas operations (13% from Europe and 10% from Asia-Pacific according to Factset). Continued weak growth in developed markets and the softening of many emerging markets will combine with the negative currency impact of a dramatically rising U.S. dollar to pressure earnings growth in 2015.

According to Factset, the S&P 500 has averaged earnings growth of 5.4% over the last 3 years on 3.5% revenue growth. The outsized returns that we have enjoyed have been largely due to the expansion of the price/earnings multiple that has increased over 25% in just the last 2 years. With energy earnings expected to reduce full year S&P 500 EPS by over $5, 2015 earnings growth should again slow below cycle averages. We expect full year 2014 S&P 500 earnings to be around $116 and look for 2015 in the range of $120.

Can P/E multiples continue to widen? History has shown a high correlation between a rising U.S. dollar and S&P 500 multiples. Our expectations outlined in this letter for Japan, China and the Eurozone should all be bullish for the continuing rising trend in the U.S. dollar and should thus remain supportive of historically extended price/earnings mulitples.

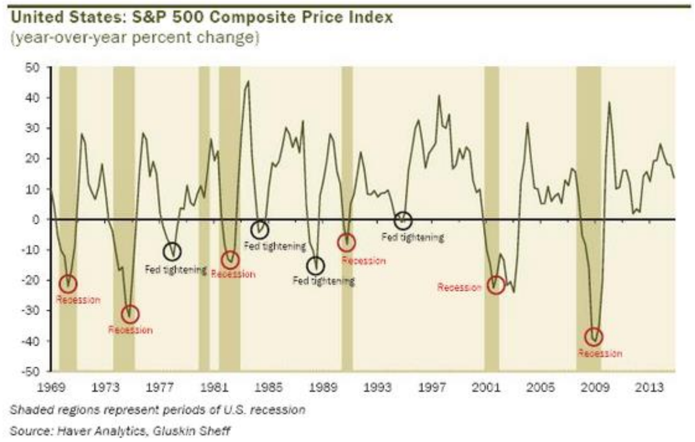
THE U.S. DOLLAR AND S&P 500 P/E RATIO



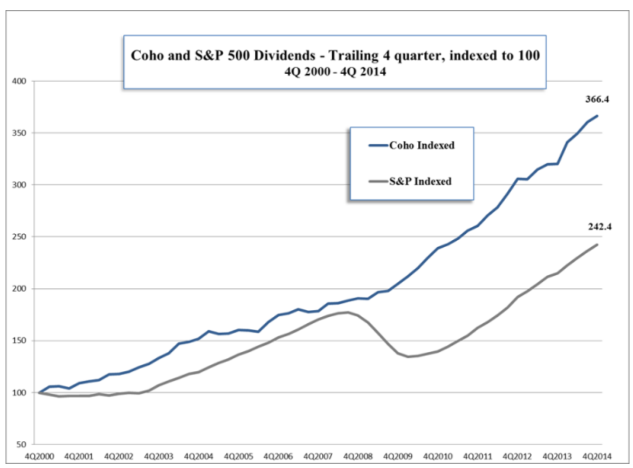
Shaded regions represent period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Most valuation metrics that have enjoyed a historically high correlation to future returns are flashing a caution signal. Total Market Cap/GDP, Cyclically-Adjusted P/E ratio (CAPE), Median Price/Earnings ratio, etc….are all extended versus history. Valuation is not a catalyst and will not, in and of itself, precipitate a market correction. It does, however, act as a more accurate barometer of reasonable longer term return expectations. Though we remain constructive on equity markets, this is not a time to be increasing one's risk profile.

What does give us additional comfort is that we believe the downside risks to be somewhat controlled. Historically large market drawdowns tend to occur during periods of Federal Reserve tightening cycles and recessions (as shown in the chart on the next page). We feel the Fed will remain quite accommodative and that the momentum that is growing in the domestic economy places a very low probability of a recession over the next 12-18 months.



At Coho Partners we remain focused on identifying companies whose business models tend to be reasonably impervious to exogenous factors and 2014 was another good year for our defensive equity strategy, as performance modestly exceeded that of the S&P 500. Additionally, the actual income growth (dividend increases) for the Coho Relative Value Equity portfolio exceeded 14%. In economics that which is scarce is highly valued. With global interest rates at or near historic lows, the demand for secure income is heightened. However, we believe the focus should be even more on the future *growth* of that income stream. One of the most compelling attributes of our portfolio and philosophy is the growth of the income stream that we provide for clients. Since inception in 2000, our portfolio has realized a compound annual growth rate of dividends of 9.7% with no year achieving less than a 4.7% increase. This is best illustrated in the chart below.



Sincerely,

Rick S. Wayne, CFA