



## The Benedict-McLoughlin Report 2014 Mid-Year Update

By Christopher Benedict, CFA

- With the help of central banks, the global economy continues its recovery.
- Financial markets have taken their queue and are performing well so far in 2014.
- While the ultimate outcome is unknowable in regards to debt levels, global equities may continue to post gains as global monetary policy continues to be supportive.

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Global financial markets continue to do well with equities, fixed income and most commodities posting gains so far in 2014. If you believe what these markets are telling investors, then the global economy is in that sweet spot of growing but, not growing too fast so as to invite tighter monetary policy. Central banks around the world remain very engaged and appear determined to ensure that the global economy fully heals itself from the 2008 – 2009 financial crisis. The resulting low interest rates have helped in a number of ways. Probably the most direct beneficiary has been real estate. Lower rates increase the current valuation of future cash flows, all else equal. This dynamic has enabled real estate values to recover and help owners re-finance into lower cost funding. This has been a boon to the commercial real estate market and has also, of course, helped the residential market. If rates remain low and credit continues to loosen in the residential market, we should see continued improvement here. The ancillary benefits of this improvement (increased home construction, higher disposable income, etc.) have been and will continue to be beneficial for economic growth...and the Fed clearly knows this. Easy monetary policy has also helped corporations and governments re-finance at historically low rates, improving

corporate profitability and reducing budget deficits.

What happens next is a bit of a confidence game. If investors continue to believe that the “Grand Experiment” of massive monetary accommodation is working *and* under control, then financial markets can continue to mirror the underlying economy, in my opinion. The first stage of “normalization” began last year in the U.S. and the Fed continues to pare back their bond purchases (i.e., tapering), although the level of assets on the Fed’s balance sheet remains at record levels (see graph on p.6). After a “taper tantrum” in the 2nd half of 2013, bond investors appear to be at ease with the current path of monetary policy. Ultimately, however, while debt is cheap, it is piling up around the world and across entities...and the ultimate end-game is not fully knowable. In fact, total private and public debt is at approximately 650%, 450%, and 350% of gross domestic product (GDP), respectively, for Japan, the Eurozone, and the U.S.<sup>1</sup> These ratios are all more than double what they were in 1980.

Furthermore, geo-politics continues to be a wild card. Whether it is the rising tension between Israel and the Palestinians, the Islamic extremist uprising in Syria and Iraq, or the brewing conflict between Russia and Ukraine, any one of these situations has the potential to wreak havoc for investors and all bear watching. Importantly, as Russia is being reminded almost daily, both information and capital are flowing as freely as ever...and both are mobile.

### The Hawk and the Dove

The debate continues regarding where the economy really stands. Is it still fragile enough to warrant the record breaking monetary accommodation or, conversely, has the massive accommodation been overkill and actually sowing the seeds for significant inflation down the road. Strangely, both camps may be correct to some degree. The main argument of the hawks has been the reflation of asset prices since the financial crisis including significant real estate appreciation and a bull market in stocks, particularly in the U.S. They believe that as asset prices reflate, aggregate demand increases which will eventually drive price increases. They also highlight the risk that very cheap money could invite poor investment decisions as abundant capital and the resulting low “hurdle” rates could spur debt financing of projects that otherwise may not make economic sense in a more “normalized” interest rate environment. Of course, this debt would need to be re-paid regardless of the success or lack thereof of the underlying endeavor.

On the other hand, the doves point to a still struggling labor market in the U.S. While the unemployment rate has dropped down to 6.2% in July (from a peak of 10% in 2009), part of that improvement has been due to a decline in the labor participation rate. In fact, the 88.1% figure for men between the ages of 25 – 54 is at a sixty-six year low.<sup>2</sup> Nobody really knows exactly what is driving this decline, however, theories abound, including rising entrepreneurship on one side of the spectrum to the record enrollment in welfare/disability programs on the other side. In any case, the labor market improvement has been less robust than the decline in the unemployment rate would imply. The doves also point to the relatively lackluster housing market.

Housing starts are just now creeping above the one million per annum rate, which, aside from 2009, had basically represented the lowest levels of the previous recessions of the past fifty years (See graph on p.6).

Importantly, irrespective of who might have the “correct” view of the economy, the head of the most influential central bank is decidedly leaning towards the doves...and her European and Japanese counterparts are cooing with her in the same nest. Essentially, the central banks would rather err to the accommodative side as fighting inflation is seen as a much easier task than fighting deflation. Looking further out to a “post-QE” economy, interest rates will still play an important part, in my opinion. As mentioned above, the world is at its highest leverage ratio in the history of mankind, so, the cost of this leverage (i.e., interest rates) is as important as ever. I think we saw evidence of this during last year’s “taper tantrum” when the yield on the 10-Year U.S. Treasury Note went from 1.60% to 3%. Global equity markets and other risk assets sold off and economic growth slowed, particularly the housing market as higher mortgage rates stalled the re-financing wave and made new homes more expensive. So, when the central banks eventually reduce their influence over the global bond markets, I believe the yield on the 10-Year Treasury, for example, will essentially act as a governor. Any spike in this rate would hurt economic growth enough that fixed income investors will snuff this out and counteract the move with purchases.

One promising area that may provide a positive influence on the economy over the coming quarters is capital spending, irrespective of whether the Federal Funds rate is 0% or 2%. According to Barron’s, the average age of U.S. structures is the highest it has been since 1964.<sup>3</sup> The statistics are similar for equipment and intellectual property products like software. Anecdotally, upon request, I can provide a long list of roads and highways in the Los Angeles area that need “upgrading” (I will refrain, for now, from discussing the productivity boosting potential of better public transportation in L.A.). On the corporate front, capital expenditures are only at 46% of operating cash flow for nonfinancial companies vs. an average of 57% since 1989.<sup>4</sup> It may be tempting to put off upgrading aging infrastructure and equipment as a way to “save” cash flow. However, there

is a fine line and it can be very expensive when that line is crossed. The recent water main break at UCLA is a prime example. Proper investment can increase productivity and I believe there are an ample number of positive ROI (return on investment) projects, even with a slightly higher cost of capital.

**Risks to the economy:** A renewed credit crisis spurred by sovereign debt concerns in Europe (or the U.S. or Japan) may reduce global economic activity and investor confidence; Sustained high oil prices would negatively affect growth; Large, chronic budget deficits (including unfunded entitlement program liabilities) may eventually cause higher interest rates. A sharp depreciation of the U.S. dollar would likely put upward pressure on inflation and interest rates; Terrorism.

## The Stock Market

Global equities have continued their march higher so far in 2014 with seemingly nothing on the horizon to seriously de-rail the story. While the economy continues to recover at a sub-par pace, the direction remains a positive one. Corporate earnings in the U.S. continue to hit record levels, albeit at a slower pace in recent quarters. Japanese and European profits are also improving and likely have more upside vis a vis the U.S., assuming some things go right. Valuations around the world are still reasonable by some metrics but, we may have pulled some future performance forward, particularly in the U.S. Based on a study done by respected money manager, The Leuthold Group, if we assume earnings grow over the next ten years at the same 5.3% rate that they have over the past eighty years and then we apply the median price to earnings (P/E) ratio of 16.7, then the S&P 500 would reach 2646 in 2024 (from the current 2000).<sup>5</sup> This equates to 3% annual price appreciation...if we add a 2% annual yield, we arrive at an expected 5% annual total return.

All else equal, a mid-single digit % annual return over the next ten years is not a bad starting point for discussion, in my opinion. Of course, the economy and financial markets very rarely work in a straight line. One of the main risks in achieving above average or even average returns is the fact that U.S. corporations are already enjoying the highest profit margins in over sixty

years.<sup>6</sup> So, even if margins were to remain at these lofty levels, corporations would still need revenue growth to grow earnings going forward. And, to get revenue growth, real growth in the economy is needed. Absent a continued increase in profit margins, earnings growth is likely to match the underlying growth in the economy, which will likely remain below average. Furthermore, profit margins have and will likely continue to be cyclical. Margins have been helped a great deal by low interest rates (i.e. low interest expense) as well as cost cutting coming out of the Great Recession. Those positive forces may have run their course and may actually reverse in coming years. Given above, the next recession, whenever it may come, may well be a doozy in regards to profit declines.

In regards to current positioning, I am a big fan of trying to visualize my goals as I am sure many of my readers are. If we use this exercise and try and “channel” the Fed Chairwoman, what would she like to see come to fruition in the next couple of years? I believe her main goal is the full recovery of the housing market and maintaining low rates is a key factor in this endeavor. If she is successful, home values should continue to recover along with housing starts. We are overweight companies that are exposed to this dynamic. Certain banks should also benefit as loan volume increases and many of the “problem” assets they have been carrying should become less problematic as the underlying values rise. I believe a full recovery of the financial and banking sector is also a target for her. Along the road of this recovery, the labor market should also continue to improve. Therefore, we are also focusing on companies that would benefit from increased disposable income and confidence, such as, low-to-mid-end retailers, automobile manufacturers and casual dining.

**Risks:** Geopolitical events may cause highly volatile stock prices; A significant up-tick in inflation which could result from too much economic stimulus would likely compress valuations; Conversely, the U.S. Federal Reserve may feel obligated to raise interest rates sooner than otherwise would be expected to quell inflation which may hurt the economic recovery. The pendulum of government regulation in the U.S. may swing too far the other way (i.e., potentially too restrictive) which

could dampen free enterprise and economic growth. Terrorism.

## The Bond Market

After the “taper tantrum” in 2013, global fixed income markets have since stabilized and, indeed, have rallied due to central bank support and a relatively benign inflation outlook. Sovereign debt yields are making historical lows in Europe and yields in Japan and the U.S. remain close to their historical lows. Ditto for high quality corporate and municipal yields. Although the Fed has been reducing their bond purchases, their bias remains very accommodative. And, the central banks of Japan and Europe appear to be moving more in the dovish direction, embarking on their own versions of QE. The European Central Bank has verbalized on many occasions that they feel deflation is the larger risk and they will do what they can to fight it. Japan is attempting to stimulate themselves out of a multi-decade malaise. The pressure for low rates may be with us for a bit longer.

Within fixed income, we continue to keep our portfolio durations relatively short and diverse. Underweighting U.S. Treasuries and other “high quality” bonds still makes sense, in my opinion. “Spread” securities such as high yield and senior bank loans, while not exactly cheap at this stage, are still attractive on a relative basis, in my opinion, due to continued improvement in corporate credit quality. For example, the spread (over U.S. Treasuries) on high yield bonds was at 451 basis points (or 4.51% percentage points) as of 7/31/14.<sup>7</sup> This is below the 25 year median spread of 544 basis points but still above the sub-300 basis point spread achieved in 2007. Additionally, we continue to focus on non-traditional income strategies for our model portfolios.

**Risks:** The Federal Reserve may be either too conservative or too aggressive as it manages monetary policy, which may cause interest rate volatility; Rising budget deficits and/or entitlement obligations may cause a rise in bond supply, which may cause a drop in bond prices (higher yields).

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### Tactical Allocation Strategy For My Model Portfolios (as of 7/31/14)

Equities	Equal	Fixed Income	-1	Alternative Investments	+1
U.S.	-1	Treasuries	-2		
Int'l	+1	Inv. Grade Corporate	+1		
Growth	Equal	High Yield	+1		
Value	Equal	REITS	-2		
Large Cap	+2	Floating Rates	+2		
Small/Mid Cap	-2				

Legend	
+2	20% Overweight
+1	10% Overweight
Equal	Equal Weight
-1	10% Underweight
-2	20% Underweight

**Overweights:** Absolute/Total Return Strategies, Large Cap Multinational Equities (U.S. and Europe), Consumer focused China/Emerging Market Equities, Sustainably High Dividend Yield Equities, Corporate/High-Yield Fixed Income, Floating Rate Loans/Bonds.

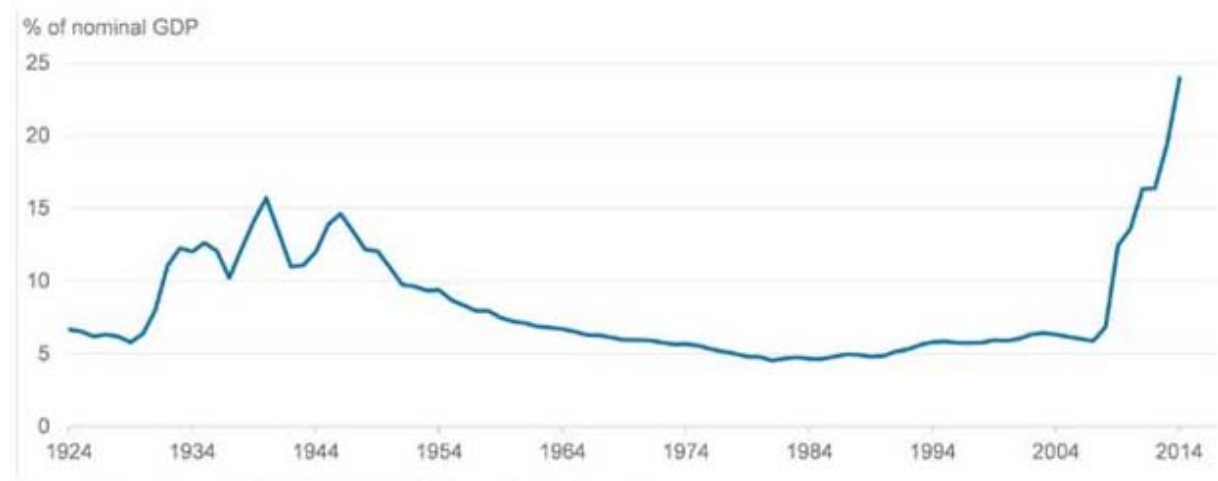
**Changes from the 2014 Investment Outlook:** None

**Underweights:** Long-term Fixed Income, U.S. Treasury Securities, Small Cap Equities, Developed Market Consumer Equities, REITs.

**Changes from the 2014 Investment Outlook:** None

**GRAPHS OF INTEREST**

**U.S. Federal Reserve Assets (1924 - 2014)**



Source: Federal Reserve Bank of St. Louis, BEA, Morgan Stanley Research

**U.S. Housing Starts in 000's (1960 - 2014)**



Source: Bloomberg

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1. Macroeconomic Analysis, Hoisington Investment Management Company, May 2014.
  2. Can an Upbeat June Dispel Winter's Blues?, Barron's, 7/7/14.
  3. Profit from the Next Wave of Corporate Spending, Barron's 3/17/14.
  4. Profit from the Next Wave of Corporate Spending, Barron's 3/17/14.
  5. Bull Market Waning as Barclays sees 1% advance for S&P 500, Bloomberg news, 8/18/14.
  6. S&P 500 Sectors & Industries Profit Margins, Yardeni Research, 9/3/14.
  7. Fixed Income Market Update, Lord Abbett, 7/31/14.

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S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

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