Strategy Quarterly

Second Quarter 2014

Executive Summary

❑ After an almost uninterrupted advance since the 2009 bottom, equities recently underwent a correction accompanied by higher volatility . This pullback occurred despite an overall still positive economic environment and friendly monetary policy. Economic data appears positive overall, with industrial production and capacity utilization pointing to an acceleration of growth.

❑However, in order for nominal growth to accelerate, business investment will have to increase . Real growth-inducing investment will be required to bring real wages higher, supporting both spending and savings, and helping to build an inflationary floor under prices that can act as a cushion in the event of aggregate demand risks.

❑ The current economic expansion has been more subdued than in previous advances. As a result, we believe that this slow pace of growth has probably extended the duration of the current business cycle. As the economy keeps progressing slowly through the expansion phase, this part of the cycle may last longer than usual, and may support the advance of the equity market by providing a stable backdrop for corporate earnings.

❑ It is a great time to be a borrower as interest rates are low, access to the debt markets is unrestricted for corporations and municipalities, and underwriting standards by lenders have declined. But what is good for borrowers is less so for lenders.

❑ Credit spread levels continue to indicate that investors are receiving less and less compensation for taking on risk. Do not compromise your risk management standards in order to earn a greater yield - it always comes at a cost.

❑ The municipal market is benefiting from low supply and improving financials. This is priced into valuations. The demand for yield has not eluded the municipal market as evidenced by the Puerto Rico bond sale and the recent outperformance of high yield municipals.

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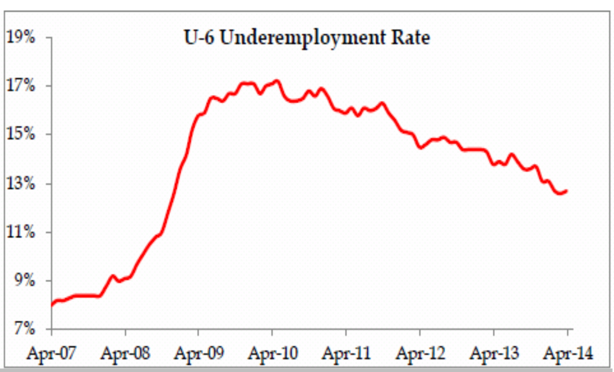
The Macro Picture

After an almost uninterrupted advance since the 2009 bottom, recently equities came under pressure. This correction seemed confined mostly to some specific high growth segments of the markets; however it subsequently spread to the broader market. This pullback occurred despite an overall still positive economic environment and friendly monetary policy. For example recent data appears to be indicating an improving pace of growth, with industrial production and capacity utilization pointing to an acceleration of growth.

However, as we have stated in previous issues, in order for nominal growth to accelerate, business investment will have to increase well-above the normal capital-stock replenishment. Real growth-inducing investment, as opposed to just maintenance, will be required to bring real wages higher. This will support both spending and savings, and help to build an inflationary floor under prices that can act as a cushion in the event of aggregate demand risks.[1]

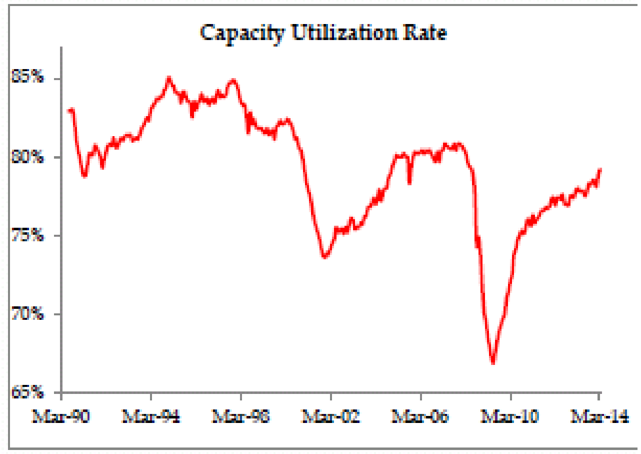
Chart 1. Underemployment



Source: Strategas

There's still no broad sign yet that wage inflation is ready to spur a jump in consumption, and thus higher real and nominal growth. In fact, with the underemployment rate well-above pre-crisis lows, wage pressures are not are concern yet. However, as capacity utilization keeps rising, expansion of capital investments should pick up. Industrial production seems to have bounced after a weak start to the year. Higher production, along with a growing need to maintain and replace existing capital stock, should provide the basis for a near-term boost to real output

Chart 2.Capacity Utilization



Source: Federal Reserve Board, Strategas Research Partners

Eventually, higher wages and general signs of diminished slack should allow the Federal Reserve to maintain its current pace of tapering. The Federal Reserve has already cut its pace of bond purchases from $85 billion per month to $65 billion per month. If it continues at this pace, the Fed should reduce its bond purchases to $5 billion per month at the end of October, and eliminate them altogether by the December FOMC meeting.

The markets seems to anticipate that the Fed will not begin to raise the federal-funds rate until mid-2015 and still hold it at less than 2% by the end of 2016. Given the lag between monetary policy action and the impact on the economy, the risk is that even in the presence of weak economic growth, inflation and long-term interest rates could move significantly higher.

This is the dilemma that the Fed is trapped in: the need to maintain an accommodative monetary policy stance to support economic growth, and the risk of igniting an inflation spiral.

This friction has characterized the last few years and will typify the economic environment and the markets for the foreseeable future.

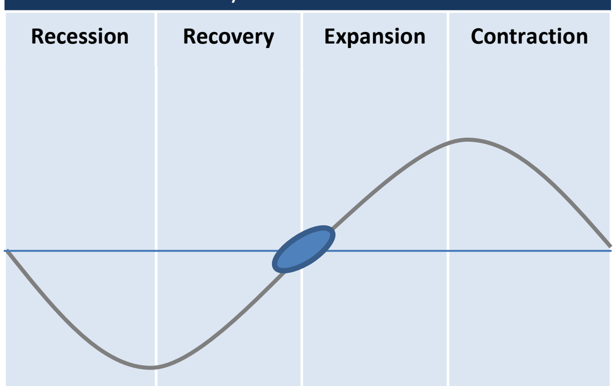
The short- to intermediate-term performance of equity markets will hinge upon how skilled and lucky the Fed officials will be at playing this delicate balance between economic support and inflation risk.

[1] *See: Capex acceleration finally happening, more to go. Strategas Research Partners, April 16, 2014.*

Earnings Cycle and Equity Markets

We believe we are in transition between the recovery and expansion phases of the business cycle (see Chart 3). The current economic expansion has been more subdued than in previous advances. As a result, we believe that this slow pace of growth has probably extended the duration of the current business cycle. Thus, as the economy keeps progressing slowly through the expansion phase, this part of the cycle may last longer than usual, and may support the advance of the equity market by providing a stable backdrop for corporate earnings.

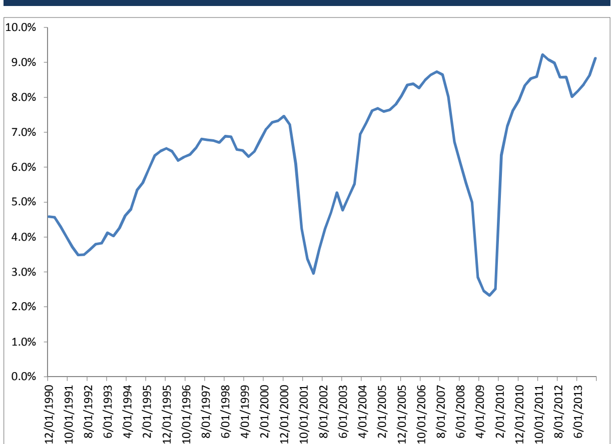
Chart 3. Business Cycle



Source: Crest Investment Partners

As Chart 4 shows, margins are high and stable on strong corporate productivity, contained costs and low debt servicing expenses.

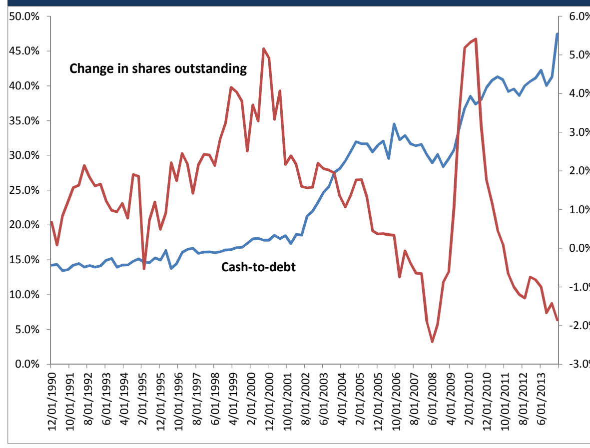
Chart 4. Net Profit Margins – S&P 500



Source: Factset

U.S. corporations have improved their profitability, reduced interest expense and strengthened their balance sheets. These positive trends have resulted in increasingly shareholder friendly actions such as dividend payments and share buybacks. Chart 5 indicates that cash as a

Chart 5. Cash-to-Debt and Change in Shares Outst.

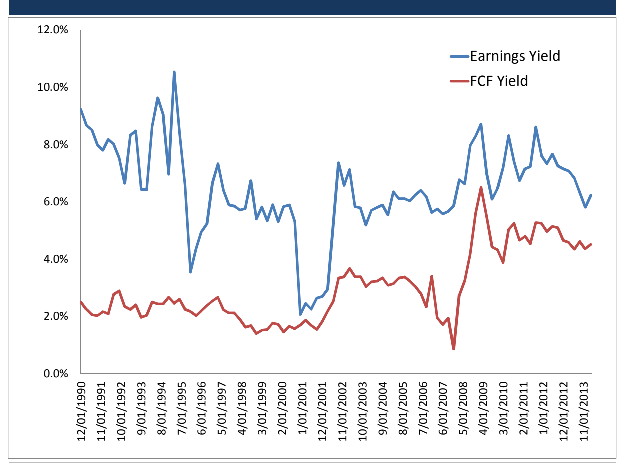


Source: Factset

percentage of total debt is at its highest level since 1990. The red line shows that companies are increasingly buying back shares with the overall count of shares declining year over year by 2%.

Finally, valuations do not appear expensive when considered in relation to the current phase of the cycle and the corporate earnings power typical of expansion phases. Chart 6 reports forward earnings yield and FCF yield for the S&P 500.

Chart 6. Valuation Metrics



Source: Factset

A Great Time for Borrowers, but A Great Time for Lenders?

It is undoubtedly a great time to be a corporation or municipality seeking capital through the debt markets. There are a few tailwinds that have been persistently at the backs of borrowers:

1. Low Interest Rates
2. A Receptive Market with an Appetite for Risk
3. Falling Credit Spreads & Municipal Yields
4. Deteriorating Underwriting Standards

Low Interest Rates

Although rates have moved up (which left bond investors with losses in 2013) from a longer term perspective, interest rates remain decidedly low. This has created an attractive backdrop for borrowers to borrow cheaply thus saving millions of dollars in borrowing costs.

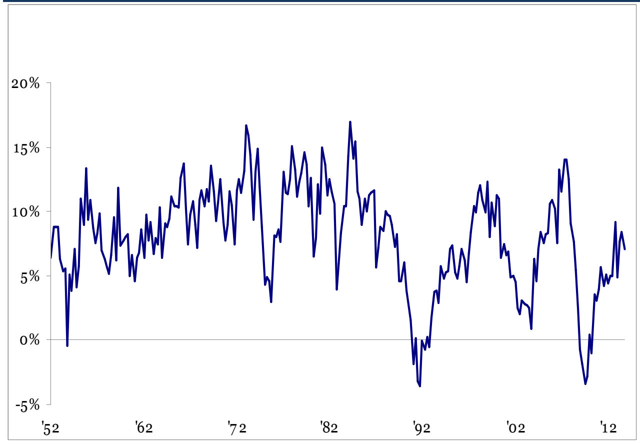
Chart 7. 10 Year Treasury Yield: 1962 to Present

Source: Bloomberg

A Receptive Market with an Appetite for Risk

Credit markets can be best described as benign and open for business with few, if any, restrictions for borrowers seeking access to capital. As we discussed in the First Quarter 2014 Strategy Quarterly piece, risk taking is on the upswing as investor appetite for risk remains high which is associated with credit expansion. As the name suggests, the credit cycle moves in a cyclical pattern. Cyclical peaks tend to exhibit annual growth rates in the 10-14% range with cyclical troughs in the 0 to -3% range. Excluding financials, the credit market has been expanding at a rate of 7-9% over the past several years.

Chart 8. Non-Financial Credit Market Growth, 1952 to Present (SAAR %)



Source: Federal Reserve Board, Strategas Research Partners

Lower quality issuers have seen strong demand for their debt. The additional yield required to own high yield debt stands at only 84 basis points (0.84%). History tells us that the additional yield investors will require to "cross over" from investment grade to high yield debt can decline further, but the important takeaway from chart 9 is the longer term trend which indicates that investors are requiring less return to take on more risk and have been behaving this way for several years. The search for additional yield has largely been the reason for the behavior, but if you are a lender of capital to businesses is this a good thing? You are requiring less compensation to take on more risk. Good for borrowers, less so for lenders (i.e. investors).

Chart 9. Additional Yield Required to Own High Yield (BB rated) Debt vs. Investment Grade Debt (BBB rated)

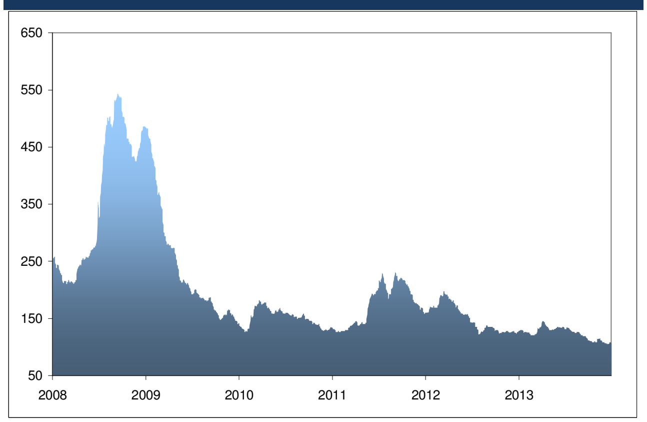
Source: Bloomberg

Falling Credit Spreads

A tightening of credit spreads has been beneficial to total return for investors, particularly in 2013 as it helped to offset losses from rising interest rates. Credit spreads also reveal a lot about valuation and risk taking. The continued narrowing of credit spreads is beneficial to borrowers as it reduces borrowing costs. However, we must recognize that valuation levels have also risen significantly. So the gain for borrowers is a loss for investors.

As noted in Chart 10 the spread on investment grade debt is bumping up against the 100 basis point level (currently 104). By comparison, the median spread level over the past 25 years has been 140 basis points suggesting that we are above the long term fair value. Over the past 5 years the median level has been 154 basis points. Valuations within corporate credit are unquestionably richer. While risk taking is building, it is not near a boiling point and history suggests that credit spreads can drop further and stay at those levels for several years. However, upside potential is limited.

Chart 10. Option-Adjusted Spread of the Barclays U.S. Corporate Credit Index

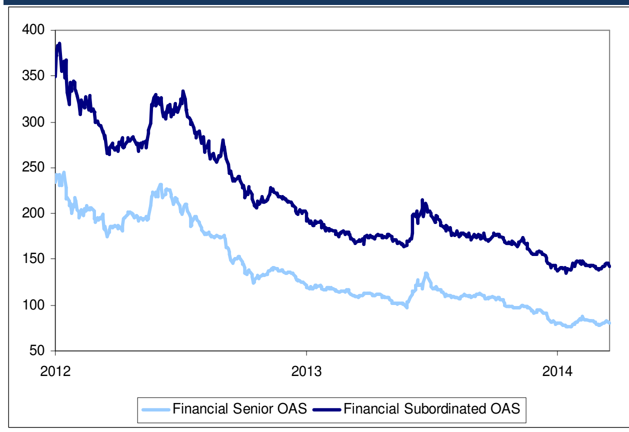


Source: Barclays Capital

Another interesting area to gauge market sentiment is the most maligned segment of the credit market over the past few years, the financial sector. Financials lead the market into the crisis as excessive leverage brought down many financial institutions. Improving capital structures driven by deleveraging have improved the capital ratios of the banks. However, economic growth has been tepid and bank lending at the consumer level has remained subdued.

In spite of these headwinds, credit spreads on financials have been bid down substantially. Irrational exuberance? Not quite, but it does provide further support for the limited upside to valuations within corporate credit as valuation levels of riskier borrowers have expanded considerably.

Chart 11. Option-Adjusted Spread of Senior & Subordinated Financial Sector Debt



Source: Bloomberg

At the risk of sounding like a broken record, high yield spreads are telling the same story, with risk premiums falling considerably as investors pile into the asset class seeking higher yields. Compensation for risk is falling to multi-year lows with spreads not seen at this level since May of 2007.

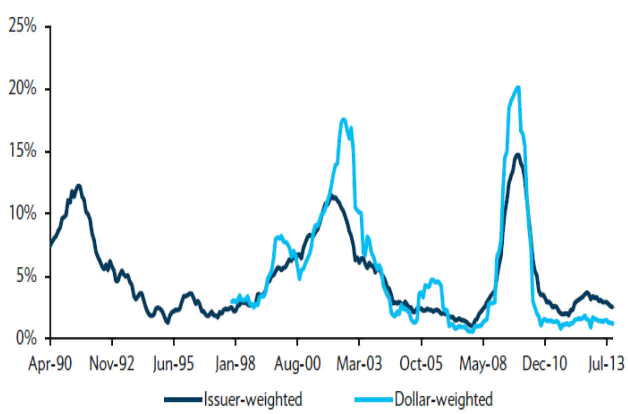
Chart 12. Option-Adjusted Spread of the Barclays High Yield Corporate Credit Index

Source: Barclays Capital

Deteriorating Underwriting Standards

Covenants are agreements written into a debt contract which protect the lender. When lenders are concerned about repayment they will demand stronger covenants from borrowers to lower the risk of default. When lenders are less concerned about repayment they will not require as strict a set of covenants as they are less concerned about repayment and more likely concerned about the yield they will earn on their money. Return dominates the risk/return objective as risk management takes a back seat to investment return when market participants become more greedy and less fearful. Moody's reports that covenant quality has been declining.[1] In a March 11, 2014 report, the agency noted that on a 1 to 5 scale with 1 being the highest quality and 5 being the lowest quality, the Moody's North American Covenant Quality Index on speculative-grade debt was at its weakest level in at least three years with a quality score of 4.36, up from 3.84 in January. Losing sight of prudent risk management will be at the detriment of investors, but to the benefit of borrowers. The cyclical trough of default rates combined with the desire for higher yield has lulled investors into complacency. Underwriting standards have deteriorated.

Chart 13. Trailing 12 Month, Issuer-Weighted & Dollar Weighted Default Rates, Speculative Debt



Source: Moody's

[1] "Junk Bonds at $2 Trillion as Gundlach Pulls Back," Bloomberg, March 19, 2013, Mary Childs.

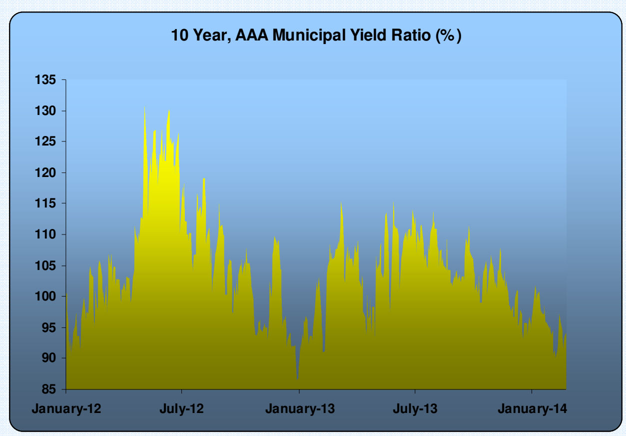
Municipal Market: Lack of Supply Driving Returns & What Puerto Rico Issuance Says about Risk Taking

The municipal bond market is off to a strong start in the first few months of 2014. The broader municipal market is up roughly 3.6% after a difficult 2013 that saw losses for the first time since 2008.

This has been driven primarily by three factors: 1) improving financials; 2) lower supply; and 3) seasonal trends. Two of these factors are interrelated as improving financials mean municipalities do not have to borrow as much. Borrowings for states and cities were at their lowest levels in three years in the first quarter of 2014.

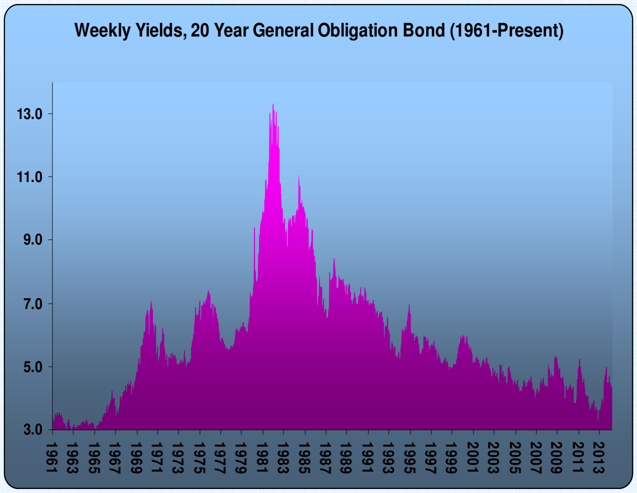
As we have been chronicling, municipal fundamentals have been on a steady path of improvement for several years. For example, municipalities have recorded 15 consecutive quarters of growth in tax collections, according to Census Bureau data. Cities, whose post-Great Recession financial improvement was lagging the improvements seen at the state level, are now showing consistent progress. The National League of Cities is forecasting the first increase in revenue since 2006, while the U.S. Conference of Mayors is forecasting economic gains in 356 of 363 metro areas.

Lower supply is a function of the improving financial picture but also of a seasonal trend which historically sees a lower level of issuance in the first few months of the year for municipalities. Issuance is expected to increase in the coming months which will likely be a drag on returns. Valuations are stretched with the recent rally in municipals reflected by the 10-Yr. AAA municipal yield ratio which currently stands at 94%



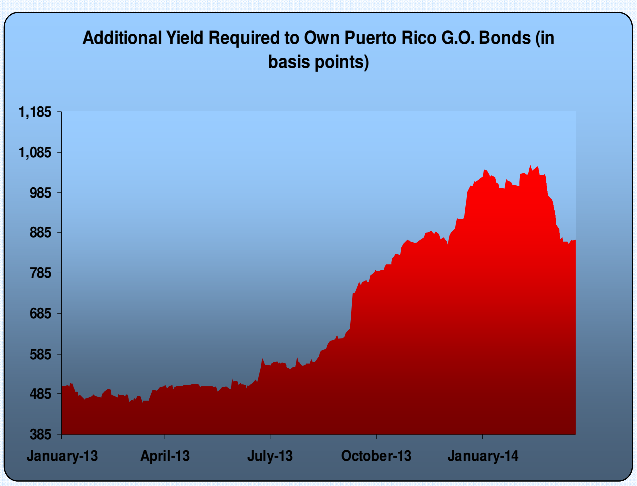
Source: Bloomberg, Cypress Trust Company

The longer end of the municipal curve reveals little value with yields hovering around the 4-4 1/2% range. To see just how rare it is to have long term yields near 4% see the chart below which goes back to 1961.



Source: Bond Buyer, Bloomberg

Just like the taxable market, the demand for yield has driven up the demand for riskier assets. A case point is the March 11, 2014 sale of debt by the Commonwealth of Puerto Rico. The debt sale was the biggest junk bond sale ever for a state or locality. The size of the deal was initially thought to be $2.86 billion, then was advertised at $3 billion and finally increased to $3.5 billion in size when sold in the market. The issuance reportedly brought in a staggering $18 billion in orders as investors clamored for the 8.7% yield, which on a tax-equivalent basis is closer to 14%. This is a clear example of the incredible appetite for risk in the bond market. Clearly the need for return is dominating the risk/return equation. Buyer beware when risk management is neglected in the search for yield.



Source: Bloomberg

Conclusion

Borrowers are benefiting from several tailwinds in the bond market:

1. Low Interest Rates
2. A Receptive Market with an Appetite for Risk
3. Falling Credit Spreads & Municipal Yields
4. Deteriorating Underwriting Standards

All of these factors warrant an increased focus on prudent risk taking by investors. Investors are receiving less and less compensation for the risk that they are taking on. However, abandoning one's asset allocation, away from fixed income, is inappropriate as the diversification benefits of the asset class are still present. However, we reiterate our common theme that fixed income investors should lower their return expectations. A coupon level total return of 2-4% should be viewed as quite satisfactory going forward.

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