Strategy Quarterly

Third Quarter 2014

Executive Summary

❑ Our current cycle seems to lack a self-sustainable expansionary drive. On the positive side, a tepid pace of growth keeps in check inflationary forces, reduces the risk of overheating, and delays the eventual start of a restrictive monetary policy. Historically, the start and the subsequent progression of rate increases have preceded the eventual end of the bull market.

❑ The current rise in numerous key macro-indicators have lagged well behind previous recoveries. Its weak intensity and long duration may have distorted investors' perception about where we are in the cycle and may have prompted some investors to call the end of the bull market.

❑ We believe we are, finally, entering the expansion stage – the phase of the cycle typified by GDP growth above potential. The good news is that historically this phase has been good to equity investors; the bad news is that it is the phase that precedes the contraction and recession phases – periods distinguished by high volatility and poor stock returns.

❑ A compelling counter argument can be made for continued low interest rates based on Federal Reserve guidance, tepid economic growth, the U.S. fiscal situation, continued geopolitical uncertainty, and the demographic shift in the U.S.

❑ Instead of predicting interest rates, the more practical discussion is how to properly prepare bond portfolios for the future. Investors should maintain a high credit quality bias, not compromise liquidity within their bond holdings, avoid the temptation to reach for yield by taking on additional risk, and stay disciplined and diversified within their bond portfolios.

❑ Return continues to dominate the risk/return equation in the minds of investors. Risk premiums across several credit sectors such as investment grade debt are very close to pre-financial crisis levels. Compensation for risk taking is expensive.

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A Slow-Moving Economy

The ongoing economic recovery has been characterized by contradictory trends within an overall sluggish pace of growth. The most recent quarter of negative GDP growth (-2.9%) came as a negative surprise but it did not spook investors as other data supported the belief that economic growth will continue in the next few quarters.

For example, the June U.S. employment report was quite positive with payrolls up +288k versus a consensus of +215k. Indeed, according to many economists, most of the monthly data, including the important PMI surveys, have been consistent with annualized GDP growth of 3% or more.

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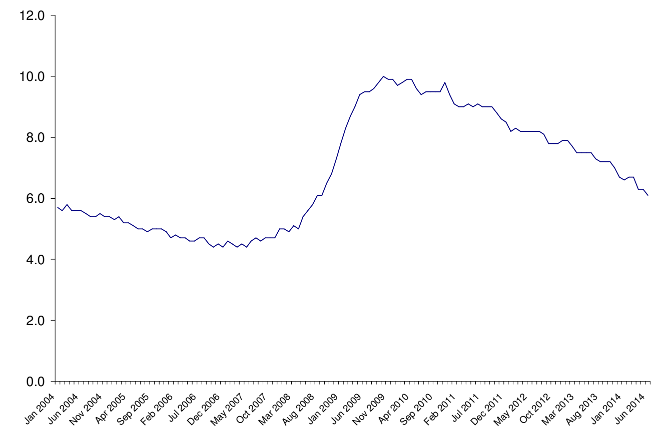
With this perspective in mind, lack of wage growth (average hourly earnings was recently up only 2.0% year over year) – although a negative for workers and consumer spending – actually reduces the risk of cost-push inflation and keeps the Fed at bay.

As the labor market continues to improve, talk of Fed tightening could intensify and have a negative impact on equity markets.

Chart 2. Unemployment Rate



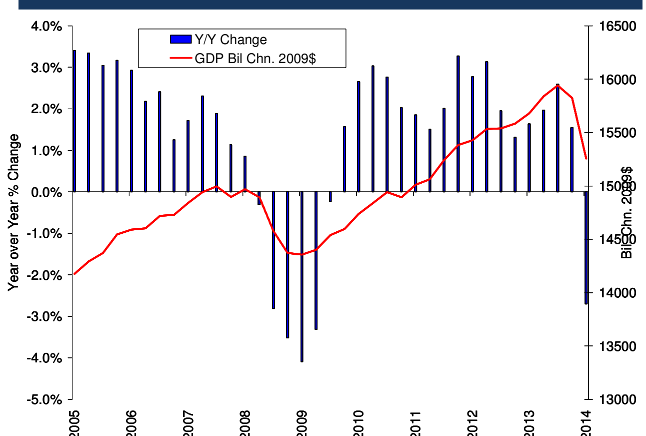
Source: Bureau of Labor Statistics

However, while it is true that the equity markets have performed the strongest after the trough of the business cycle (which has historically coincided with the troughs in the Fed funds rate), higher rates do not mean unavoidably lower stock prices.

If the Fed is moving towards a more restrictive monetary policy in response to an improving economy, investors should be cheering such a move rather than fearing it.

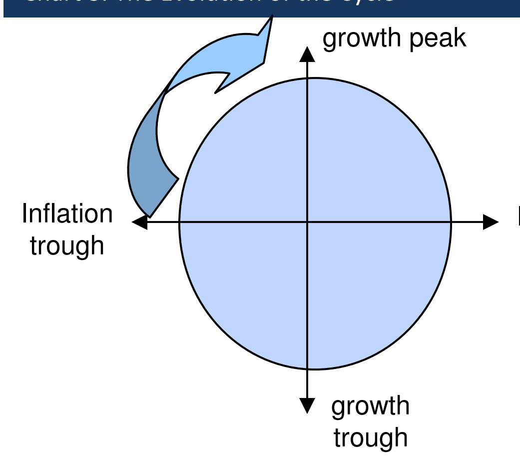
Although we have had several quarters of positive economic growth (except the last one), given the muted magnitude of the current recovery, we believe we just entered the "expansion phase"- a phase characterized by acceleration of growth above potential and higher inflation.

Chart 1. U.S. GDP Growth



Source: BEA

Chart 3. The Evolution of the Cycle

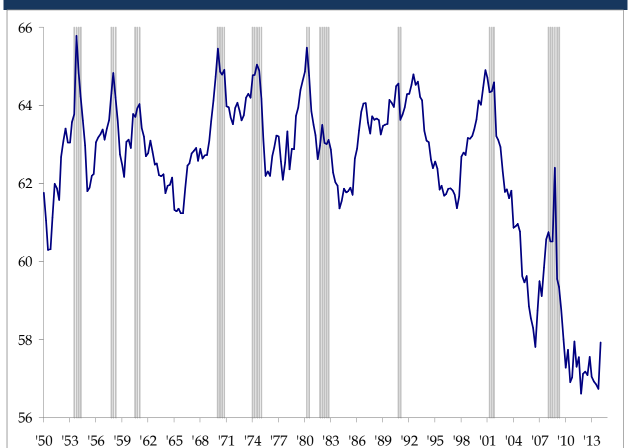


Source: Cypress Trust

Historically, on average, in this phase equities have done quite well as earnings growth remained robust on improving consumer spending and higher corporate investments.

As pointed out by Strategas Research, productivity gains are becoming increasingly important at this stage of the U.S. business cycle. The past mid-cycle slowdowns were the same points at which the labor share of GDP stopped falling (see Chart 4). If labor's share is rising, it suggests that the profit share (profit margins) is coming under pressure. Chart 5 depicts the trend in average hourly earnings for private industries - a measure of change in wages. From the chart, it is apparent that a sustained increase in wages has preceded an economic recession over the last forty years.

Chart 4. Labor Share of GDP

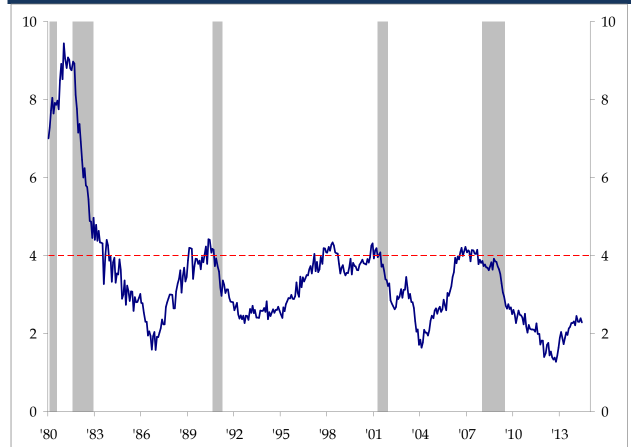


Source: Bureau of Labor Statistics

While based on historical evidence that higher wages are a sign of a maturing business cycle, it appears from Chart 5 that we may have a long way to go before we hit that 4% mark that has historically coincided with the wage peak that preceded recessions. Thus for the stock market to continue to do well, on the one hand, we need higher wages to support consumer spending; on the other hand, we need corporate profitability not to deteriorate. High productivity may help to accomplish that by pushing up output per hour.

It may sound almost surprising but we have been five full years into this business cycle. As we stated above, despite its relatively long duration, the current recovery has been characterized by a slow and choppy pace.

Chart 5. Average Hourly Earnings – Y/Y % Change

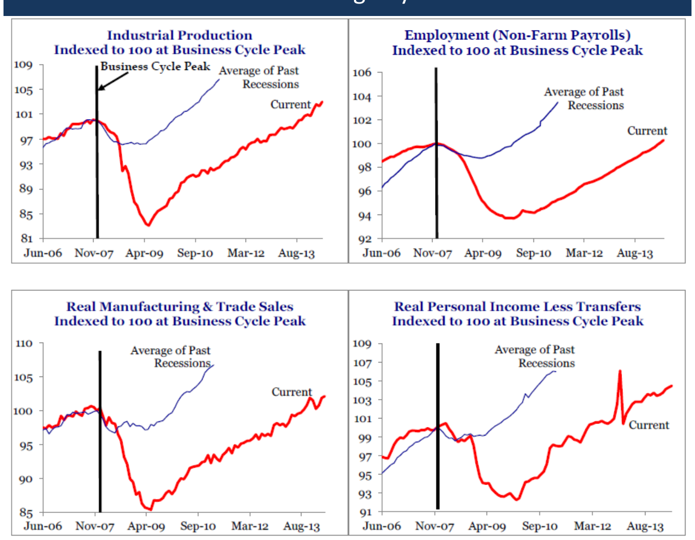


Source: Bureau of Labor Statistics

As Chart 6 illustrates, the current rise in numerous key macro-indicators have lagged well behind previous recoveries. Its weak intensity and long duration may have distorted investors' perception about where we are in the cycle and may have prompted some investors to call the end of the bull market.

We believe we are, finally, entering the expansion stage – the phase of the cycle typified by GDP growth above potential. The good news is that historically this phase has been good to equity investors; the bad news is that it is the phase that precedes the contraction and recession phases – periods distinguished by high volatility and poor stock returns.

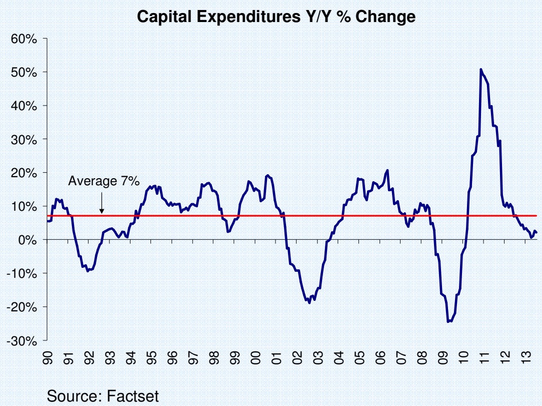
Chart 6. Current vs. Past Average Cycles

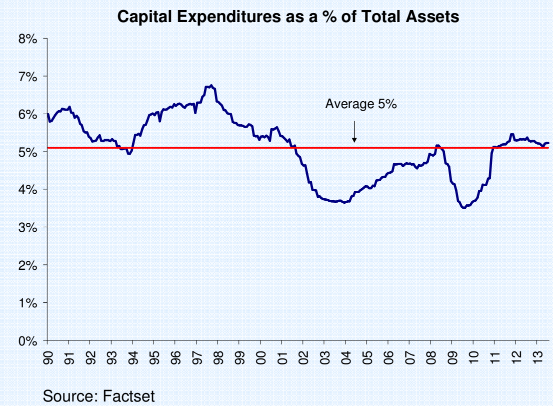


Source: Strategas Research

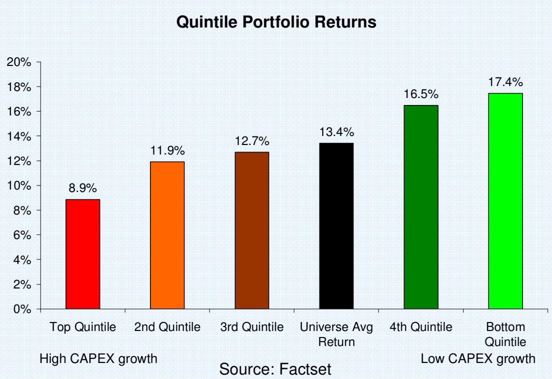
Capital Investments and Stock Returns

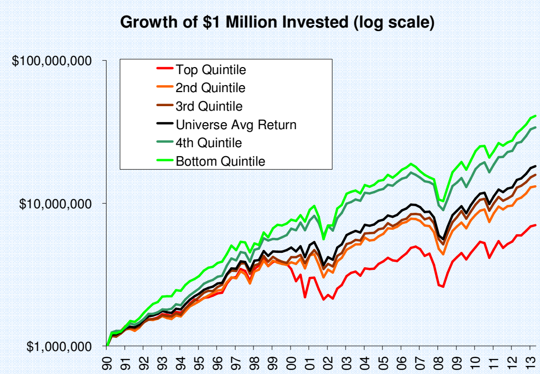
In an effort to track the business cycle we analyze a number of indicators which have typically characterized the distinct stages of the cycle. In a recent issue of this quarterly piece, we stated that for the progression of the cycle to continue into the expansion phase it is necessary that business investment finally picks up. With less political wrangling and more agreement at the government level, confidence should return to boost corporate investment and hiring plans. This in turn should bring down unemployment and boost consumer spending while at the same time corporate profits could remain healthy even as labor costs rise. In this scenario with monetary policy still very accommodative the economy could finally gain steam and the equity markets could continue to rise. Although some macro indicators point to a pickup in capital investments, the charts below, based on the S&P 500 constituents, reveal a still muted growth in capex.





Undoubtedly, growth in capital investments would have a positive effect on the overall economy. But at the equity portfolio level, what is the relationship between strong growth in corporate investment and stock returns? In other words, would investors benefit from investing in companies with high capex growth rates? To answer this question we turn to empirical analysis of fundamental data. We form portfolios of stocks based on their trailing annual growth of capital expenditures and measure their forward returns. We rank and rebalance the portfolios to equal weights on a quarterly frequency over the 1990-2014 period. The chart below reports the portfolio returns that an investor would have achieved by investing in the strategy of selecting companies based on their capital expenditures growth.





The evidence is counterintuitive to many investors: the best strategy is to invest in the companies with the lowest growth of capital expenditures (bottom quintile). Conversely, the worst strategy is to invest in companies with the fastest capex growth rate (top quintile). The results are not only contrary to expectations, they are also striking in terms of magnitude of return differentials. The portfolio of companies with the lowest growth outperformed the average market by 400 bps/year, while the portfolio of companies with the highest growth underperformed by an astonishing 460 bps/year. Risk-based explanations cannot explain such a large and consistent return premium. We believe that the premium achieved by low asset growth stocks is consistent with compensation for risk and extrapolation of past growth trends: a) Firms maintain a mix of growth options and assets in place, and growth options are inherently riskier than assets in place; b) Investors systematically misprice growing businesses by extrapolating past gains into the future. In conclusion, the lesson is that what is apparently good for the overall economy – growth of capital investments - is not necessarily good for investors. Investors should focus on how productive are the investments in terms of cash flow generation and return on invested capital rather than getting excited about growth per se.

The Case for Low Interest Rates

If there has been one consensus amongst investors regarding the bond market going into 2014 it is that interest rates were going up. The argument is based on interest rates being at historical lows supported by unprecedented monetary stimulus which is being wound down by the Federal Reserve. While there is certainly merit to this argument, the idea that interest rates are set to spike or move materially higher in the near future is not so certain. In fact, a compelling counter argument can be made that there are several very legitimate barriers to higher rates:

- Federal Reserve Guidance
- Tepid Economic Growth
- Fiscal Situation of the U.S. Government
- Geopolitical Uncertainty
- Demographics

Federal Reserve Guidance

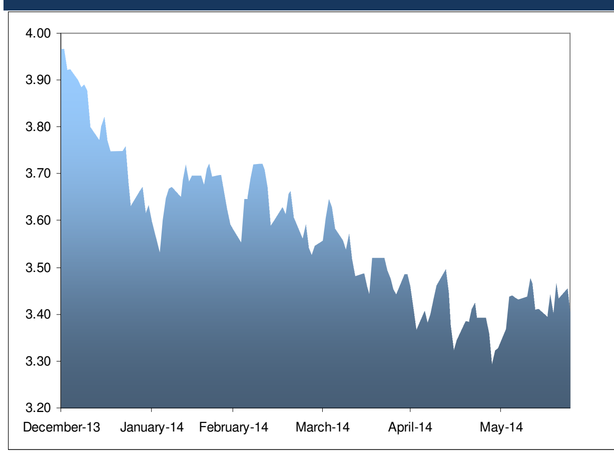
Language out of Fed officials has been pretty strong in recent months regarding the future path of the federal funds rate. First, there was outgoing Fed Chairman Ben Bernanke who in mid-November was quoted saying, "The target for the federal funds rate is likely to remain near zero for a considerable time after the asset purchases end, perhaps well after." This was followed up by media reports of high-priced private speaking engagements by the now former Chairman Bernanke in which attendees reiterated his "low for long" opinion, with one story even suggesting that Bernanke does not believe the fed funds rate will rise to 4% in his lifetime. 4% is the Fed's long-term estimate for the fed funds rate, with 4.25% being the historical average. This treads a little more on speculation and hearsay, but we can look to the current Fed Chairman Janet Yellen, a Bernanke disciple, who earlier this year stated that the fed funds rate will stay low for a "considerable period" after quantitative easing ends. However, she then clarified that a "considerable period" could be six months which caused a spike in short-term yields.

However, the six month time frame that Chairman Yellen threw out was a bit of a blunder. One thing is for certain: The market does not believe the six month time frame, with futures contracts on the fed funds rate pricing in a nearly 90% probability that rates will remain the same six months from now.

Tepid Economic Growth

The bond market is not a believer that economic growth will be sufficient enough to drive rates materially higher. A few figures support this: One is the yield on the 30-yr. Treasury which has been falling this year, down almost 60 bps on the year with long-term Treasury bonds up over 11% on the year. A rally in long-term bonds is just not consistent with a market that believes in strong economic growth. That is not to say no growth, but tepid growth.

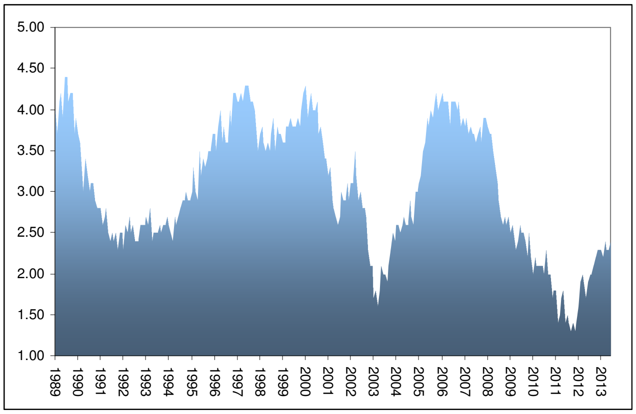
Chart 7. 30 Year Treasury Yield (Year to Date)



Source: Bloomberg

Inflation could be a catalyst for higher rates. However, wage growth of 2.4% (through May 2014) is below the 50-yr. average of 4.3% and below the 4% level that is typically seen coming out of recessions. Wage growth is needed to lift inflation.

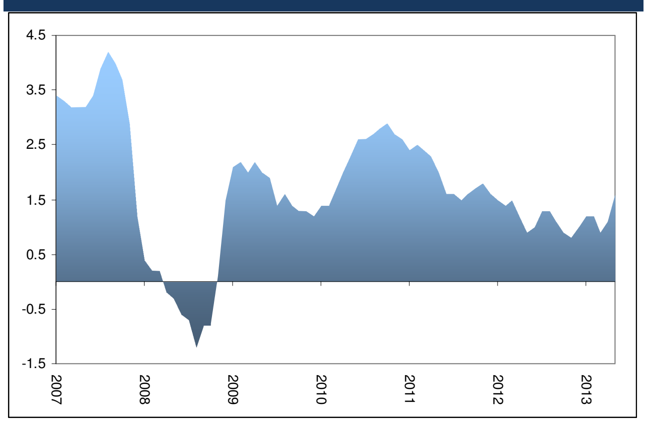
Chart 8. U.S. Average Hourly Earnings Private Nonfarm Payrolls, Seasonally Adjusted, Year over Year % Change



Source: Bureau of Labor Statistics, Bloomberg

The Fed's own measure of inflation, the PCE Deflator, has been trending below the Fed's soft inflation target of 2% for several years.

Chart 9. PCE (Personal Consumption Expenditure) Deflator, Year over Year % Change



Source: Bureau of Economic Analysis, Bloomberg

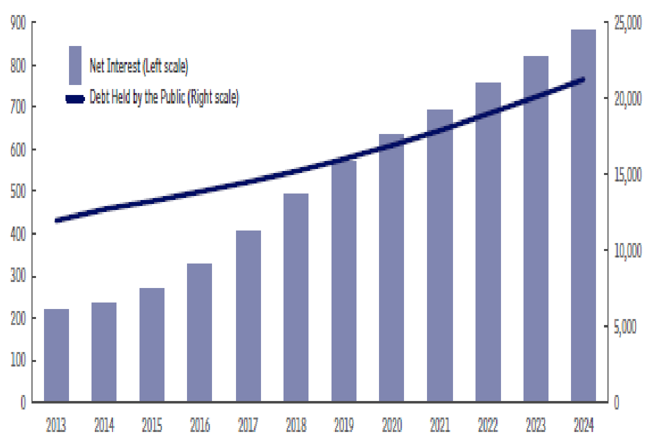
The bond market is and has been pointing to a slow path of economic growth. Catalysts for a meaningful and sustained acceleration in wages, and therefore in inflation, are limited.

Fiscal Situation of the U.S. Government

It is no secret that the United States is not in the best fiscal situation. One aspect of this that often goes overlooked perhaps because of the excessive focus on the short-term by the financial media is the long term impact of high levels of federal debt and budget deficits on the bond market.

Consider the government a corporation which unlike any other corporation has the ability to dictate what interest rate they pay on their borrowings. If you were not in the best financial shape, you would probably want the interest you pay on your debt to be pretty low. According to a Congressional Budget Office (CBO) report[1] debt/GDP in 2013 was 72% and is projected to be 79% by 2024 which would be the highest level in more than 75 years, and double the average of 40% from 1974-2013. History clearly tells us that high levels of government debt are associated with lower economic growth (which is not supportive of higher bond yields). Over this time period, net interest payments are expected to rise by an average of 14%/yr. as debt increases and interest rates normalize.

Chart 10. Projected Debt Held by the Public & Net Interest (in billions)



Source: Congressional Budget Office

By 2024, net interest will quadruple to $880 billion and, more importantly, consume 18% of revenue vs. only 8% today. If interest rates were only 1% higher than the CBO's 5% projection for the 10 year Treasury, then the additional interest cost would be $174 billion in 2024 and consume 22% of revenues. With this in mind, the 50 year average on the 10 year Treasury is 6.6%. So to reiterate, the incentives are there to keep rates low to avoid excessive interest costs due to already high government debt levels. This is more a secular, long-term theory on future rates than a story that will play out in the next few quarters.

[1]"The Budget and Economic Outlook: 2014 to 2024," Congress of the United States Congressional Budget Office

Geopolitical Uncertainty

In spite of the challenges domestically, the debt of the United States is still seen as the safest around. Geopolitical uncertainty, armed conflicts, global asset bubbles and all sorts of calamities will unfortunately continue to occur. Just in the past few months we have had the civil war in Syria, chaos in the Ukraine, the annexing of the Crimean peninsula by Russia, and now the resurgence of terrorist groups in Iraq. If we go back just a few years ago we had the fear of the disintegration of the European Union, a sovereign default by Greece, and subsequent fear of a global meltdown that would spread quickly across continental Europe and then across the entire globe. When fear and uncertainty are high, Treasury yields fall as investors seek a "safe haven." Future events will occur that will strike fear in the hearts of investors and Treasuries will see inflows. As the saying goes, "History repeats itself."

Demographics

The number of people reaching retirement in the United States will double by 2030 from 12% of the population to 20%. By 2050, those aged 85 and older are projected to increase by 350% while the population aged 16-64 is projected to grow by only 33%[2]. While this demographic shift has obvious implications for healthcare it also has some interesting investment implications. As baby boomers age and enter into retirement their risk tolerance decreases. Asset allocations within investment portfolios will be altered to meet their changing needs. A lower risk tolerance will lead to a shift from stocks to bonds. The desire for capital appreciation through stocks will take a backseat to income generation and capital preservation found through bonds. This seismic demographic shift has the very real potential to keep rates lower than otherwise thought as investment portfolios become more bond-focused to meet the needs of those retired.

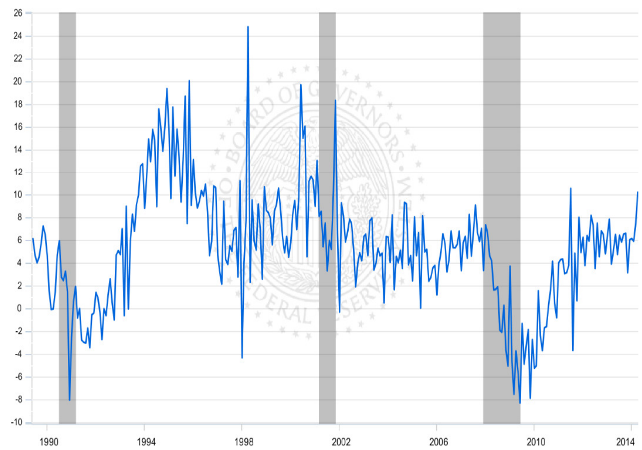
Similar to the U.S. debt theory this is admittedly a phenomenon that will play out over decades as opposed to quarters.

[2] International Journal of Epidemiology, Volume 31, Issue 4, pg. 776-781, Wiener & Tilly

Credit Markets: Return over Risk

Credit markets have been characterized by low volatility, credit spreads falling to near pre-crisis levels, and rich valuations. The credit cycle is in an expansionary phase which is consistent with these characteristics.

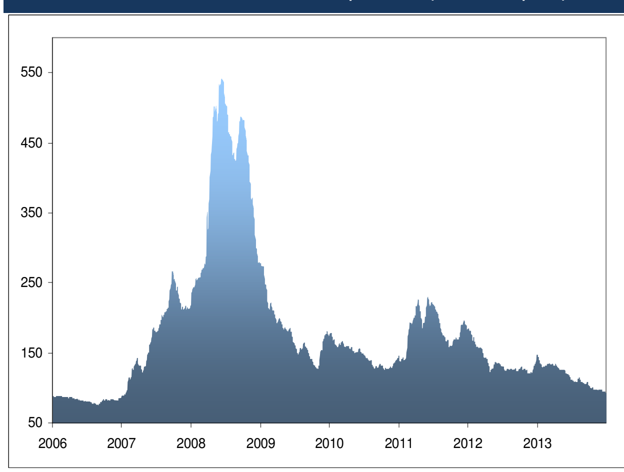
Chart 11. % Change of Total Consumer Credit, Seasonally Adjusted (Recessions in Grey)



Source: Federal Reserve Board

Investors now have a pronounced preference for return over risk. Times like these are associated with peaking asset prices and lower future returns. We can see that investors are getting paid little for the risk they are taking as credit spreads have continued to drop. The chart below shows investment grade credit spreads since 2006. With spreads in the low 90's, less than 20 basis points off of pre-crisis levels, risk compensation is becoming more and more expensive.

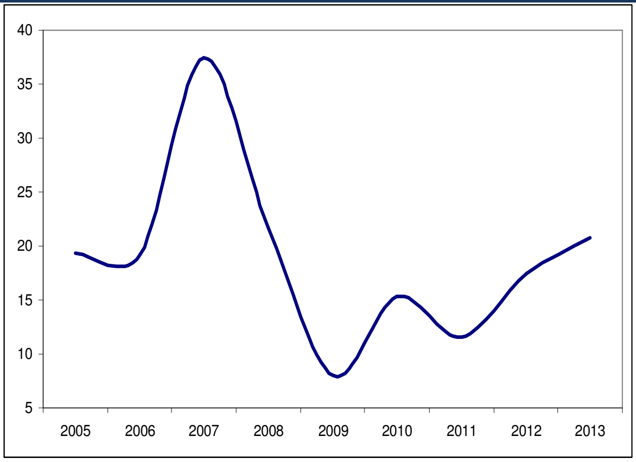
Chart 12. Investment Grade Spreads (in basis pts.)



Source: Barclays Capital

The highest risk borrowers are taking advantage of is the increased appetite for risk. One example of this are companies which carry a CCC credit rating. They are the lowest rated issuers in the high yield bond universe. Of all CCC issuers, 48% will default 5 years after issuance and 60% within 10 years of issuance. CCC borrowers are taking advantage of investor enthusiasm for yield at any cost. As lower rated issuers make up a greater proportion of the high yield market this is suggestive of a future increase in default rates, and lower future returns.

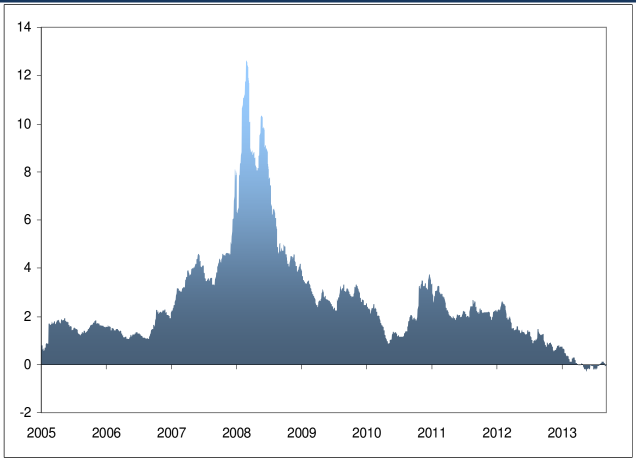
Chart 13. CCC Rated Issuers as a % of High Yield Issuers



Source: Bank of America Merrill Lynch, Cypress Trust

Lastly, we point to an interesting anomaly occurring in the bond market that supports the "reaching for yield and ignoring risk" sentiment. Historically, high yield bonds offer a yield premium to emerging market sovereign debt. Logically, this makes sense as emerging market sovereign debt is backed by a sovereign nation, a government with taxing authority supported by rule of law. High yield bonds are backed by a corporation which offers less credit protection. As a result, the median yield premium since 2005 has been 215 basis points. This trend has now reversed with high yield debt yields now at either parity or a slight discount with emerging market yields. Investors are ignoring the lower credit protection available in high yield debt, again, reaching for yield and ignoring risk (see the bottom right corner of Chart 14).

Chart 14. Yield to Worst Differential: High Yield vs. Emerging Market Sovereign



Source: Barclays Capital

Conclusion

In spite of the discussion about the future of interest rates, the game of predicting future rates is futile. As we have mentioned in past quarterlies, it is much better to prepare than to predict. Prepare bond portfolios by following a few key themes: 1) Maintain bond quality vigilance, as now is not the time to increase your risk taking as compensation for risk is quite poor; 2) Bond liquidity is still very important and should not be overlooked; 3) Avoid the temptation to reach for yield - at this point in the credit and risk cycle, it is not worth it; and 4) Stay disciplined and diversified within the bond sectors your account is allocated amongst. It is alright to have a little exposure to some higher yielding areas as long as it is limited and not excessive.

Massimo Santicchia is the Chief Investment Officer for Cypress Capital Group, Cypress Trust Company and Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages his own custom equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as creator and portfolio manager of JNL/S&P 4 funds and co-manager of the JNL/S&P Managed and Disciplined funds.

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