Strategy Quarterly

Fourth Quarter 2014

Executive Summary

❑ Just when the U.S. economic recovery appeared finally to be shifting into a higher gear, the recent rise in the dollar and the latest global slowdown may have started to impact growth. However, investors should not be particularly concerned by the current situation, as the U.S. is a fairly resilient economy and as such, is not highly sensitive to overseas developments.

❑ Historically, business cycles have died of overheating (over-investment and excess debt) with corresponding overreaction by monetary authorities in terms of hikes on short term rates. With inflation pressure still muted, we don't expect short-term rates to move upward rapidly any time soon.

❑ Other positive factors are: low volatility of economic fluctuations compared to the past cycles; deleveraging seems to be completed and balance sheets repaired; interest payments on debt are very low thus offering a cushion in a rising rate environment; and finally, corporate capital spending is just starting to pick up.

❑ The credit cycle indicates that the credit markets have largely moved out of the recovery phase and are now in the early expansionary phase. Credit spreads are bottoming out, and as such, aggressive risk taking should be restrained.

❑ An expansionary phase sees the gradual flattening of the yield curve which is supportive of long-term debt, by far the best performing maturity this year.

❑ The municipal market has been a stellar performer this year as falling yields have not stopped the demand for tax-free income. Prudence is still recommended to maintain a high quality bias. Those who have had an overt bias to short-term paper should consider diversifying by maturity through adding some exposure to longer term paper.

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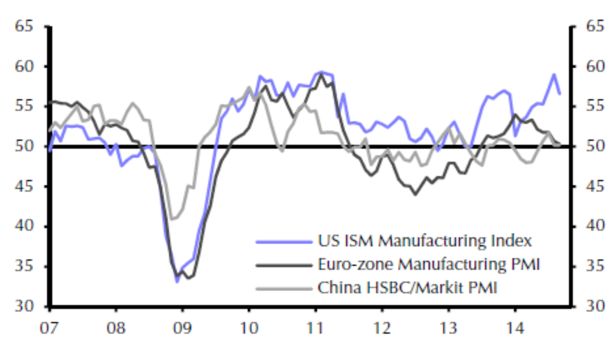
Economic Landscape

Economic news in the U.S. has been overall positive, with a number of indicators pointing to a 3%-3.5% GDP growth in the third quarter of 2014. Particularly, positive readings for the U.S. manufacturing activity index seems to indicate that the economic expansion is on solid footing (see Chart 1). However, just when the U.S. economic recovery appeared finally to be shifting into a higher gear, the recent rise in the dollar and the latest global slowdown may have started to impact growth. In fact, the drop in the new orders index partly reflects the decline in the new export orders index. However, the consensus among economists is that the rise in the dollar will not significantly dampen U.S. activity and that the weakness is rather being driven by the paucity of demand overseas. And while the risk of an external shock that derails the U.S. recovery can never be fully discounted, investors should not be particularly concerned by the current situation, as the U.S. is a fairly resilient economy, which means it is not highly sensitive to overseas developments.

Chart 1. Manufacturing Activity Indexes



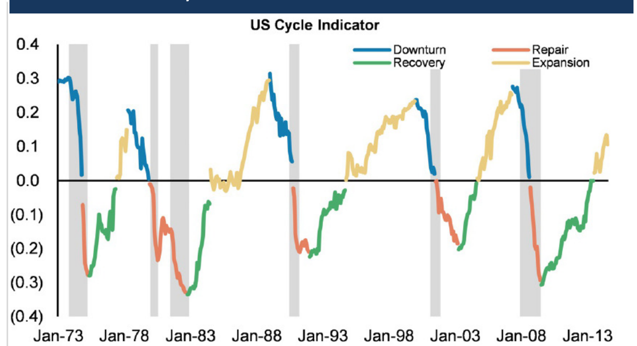
Source: Capital Economics, Datastream

Historically, business cycles have died of overheating (over-investment and excess debt) with corresponding overreaction by monetary authorities in terms of short term rate hikes. Other causes of recessions were shocks such as sharp oil price increases – although the current U.S. GDP is less sensitive to oil price changes than it was in the past. In any case, we are actually currently experiencing weakness rather than strength in oil prices. In addition, with inflation pressure still muted, we don't expect short-term rates to move upward rapidly any time soon.

With the U.S. economy having entered recovery in July 2009, the current recovery has lasted a little over five years thus far - prompting the question, how long could this expansion last? Five years is longer than the postwar average, but about half the length of the longest expansion.

According to Morgan Stanley, the shadow of the financial crisis lingers over the U.S. economy, expressed primarily through deleveraging of private debt.[1] During financial crises the credit-to-GDP ratio balloons in the 10 years leading up to financial crises, and the retrenchment tends to last as long as the surge in credit. Further, in the decade following the financial crisis, deleveraging of private debt damps credit and employment growth, resulting in GDP growth that is about one percentage point lower over that time. This period of deleveraging can be seen as a "repair phase" of the business cycle. According to the Morgan Stanley's economic cycle indicator, the U.S. economy has largely completed the repair phase and is entering the very early stages of expansion (see Chart 2).

Chart 2. U.S. Cycle Indicator



Source: Morgan Stanley

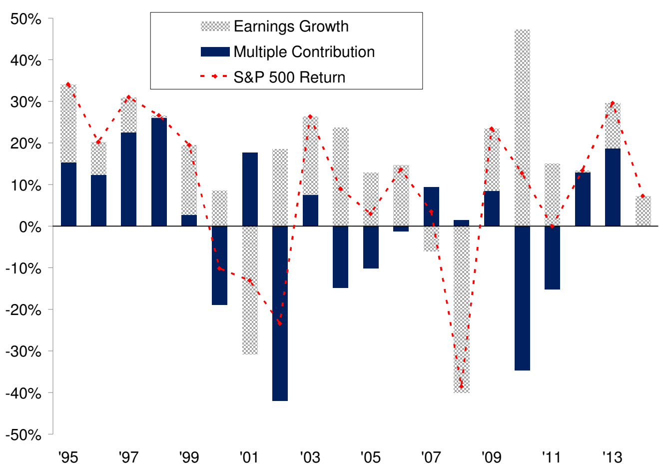
Other positive factors supporting this thesis are: low volatility of economic fluctuations compared to the past cycles; deleveraging seems to be completed and balance sheets repaired; interest payments on debt are very low thus offering a cushion in a rising rate environment; capital spending (capex) is just starting to pick up; and finally, several broad economic indicators have only just reached "normal" expansionary levels and are far from looking unsustainable.

[1] Morgan Stanley strategy report: "2020 Visions: Long Live the Expansion," September 2, 2014.

Earnings Cycle and Corporate Margins

In past editions of this report we have focused often on the business cycle and its progression from one stage to the next. After an elongated, but somewhat subdued recovery phase, we estimate we may have entered the expansion phase. Historically the expansion phase has been positive for equities as the economy gains traction, corporate investments pick up and unemployment comes down. However, market gains tend to be more choppy and volatility higher as we move closer to the eventual business cycle peak.

Chart 3. Contribution to S&P 500 Price Returns



Source: Strategas

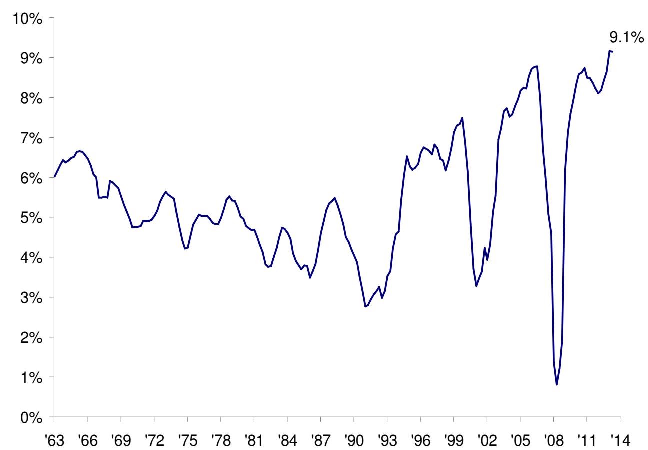
Chart 3 shows that market returns are driven by a combination of earnings growth and price-to-earnings multiple expansion. Specifically, in economic recovery phases multiple expansion is a strong driver of returns, as stocks rebound from depressed levels and monetary policy is accommodative. During economic expansions, there is less room for increase in multiples as valuation levels tend to be already high and rising interest rate expectations act as headwinds.

As the economy pushes through the expansion phase, further equity gains will likely come from earnings growth rather than multiple expansion.

Perhaps the strongest driver of the current corporate profit expansion has been record-high profit margins. Chart 4 depicts the net profit margin for the S&P 500 companies in aggregate.

A number of observations deserve attention here. First, there appear to be two main long term regimes: from 1963 to 1987 margins seem to structurally decline from about 6% to less than 4%. In the second period 1987-2014 margins display significantly higher cyclicality (both in duration and amplitude). They are also overall trending higher and reach “new highs” as the economic bounces from recessions. There are structural underpinnings to support this steep upward trend in margins such as corporate outsourcing, globalization and greater impact of service-based, asset-light industries.

Chart 4. S&P 500 Net Profit Margin



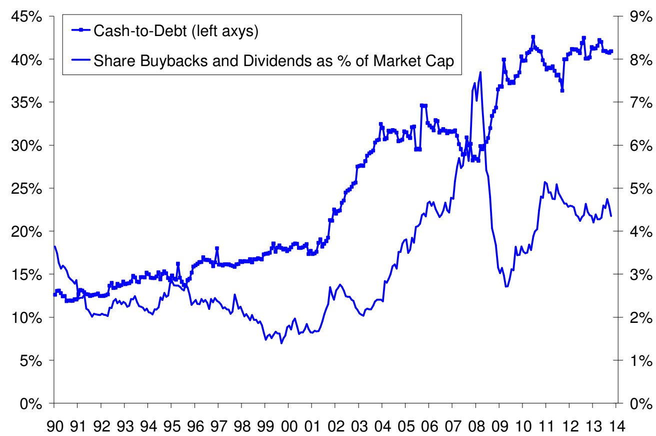
Source: Strategas

However, there are also cyclical factors at play specific to the most recent years such as easy monetary policy and a prolonged period of extremely low interest rates. This has helped companies to refinance their debt to very attractive rates and to lower their interest costs and increase their net earnings. However, easy financing has been used by companies mostly to repurchase their own shares rather than for capital investments. As monetary policy becomes less accommodative and rates start to move higher, this tailwind to corporate margins will dissipate. It is important to keep in mind that the market has historically peaked on average four quarters after margins peaked. This lag is likely due to the fact that strong, peaking margins are the result of economic and business momentum which continues for a while until the cycle changes direction.

Cash Flow Generation and Deployment

Chart 5 somewhat mirrors the one on the profit margins in that starting after the 2000-2002 bear market, corporations have been accumulating cash on their balance sheets at an increasing pace. As we stated before, this is the result of companies becoming more cost-efficient and a shift in the industrial composition of the U.S. economy towards industries with lower fixed asset requirements and reinvestment needs. Investors should keep in mind that in assessing the attractiveness of both individual stocks and the market as a whole, cash generation and

Chart 5. Cash , Debt, Dividends and Buybacks



Source: Factset

deployment are as, if not more important than, earnings growth. A strong balance sheet with low debt and excess cash removes the risk of bankruptcy and provides operational flexibility. In addition, cash returned to shareholders via dividends or share repurchases add directly to investors' returns. Lastly, but not least important, excess cash enters directly in the valuation equation by increasing the firm value. Chart 5 shows a contemporaneous increase in cash and decrease in debt over the last fifteen years for the S&P 500 companies. This higher liquidity has been partly returned to shareholders via dividends and buybacks.

In sum, strong cash flow generation and low and decreasing debt have allowed U.S. companies to return significant amounts of cash to shareholders. This trend appears sustainable at least as long as earnings growth remains intact.

Valuation

Chart 6 reports several equity valuation metrics and compare them to their historical averages. Currently the market does not appear particularly expensive or attractive based on these measures. We believe that at this phase of the business cycle, sustainable earnings growth plays a more prominent role than valuation level in determining the direction of equity prices. If earnings growth is sustainable, current valuation levels should still allow for stock gains.

Chart 6. Equity Valuation Measures

	Recent	5-year avg.	10-year avg.	25-year avg.
Price to Earnings	15.2x	13.4x	13.8x	15.6x
Shiller's P/E	26.3	22.1	22.9	25.2
Dividend Yield	1.9%	2.0%	2.0%	2.1%
Real Earnings Yield	3.8%	4.2%	3.2%	2.2%
Price to Book	2.8	2.3	2.4	2.9
Price to Cash Flow	10.8	9.2	9.7	11.3

Source: J.P. Morgan Asset Management

Chart 7 reports the relative valuation of specific equity style groupings based on growth/value and market capitalization size.

Chart 7. Current P/E as % of 20-year average P/E

	Value	Blend	Growth
Large	106.0%	89.2%	86.1%
Mid	116.2%	110.1%	91.6%
Small	111.9%	103.0%	91.5%

Source: J.P. Morgan Asset Management

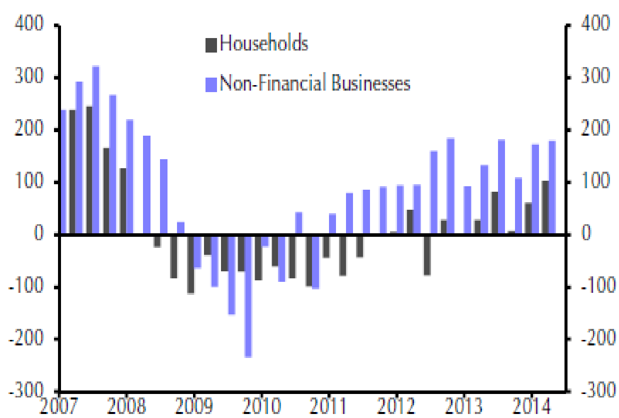
Thus, for example, the large cap blend stocks are trading at 10.8% discount to their 20-year historical average in terms of price-to-earnings ratio. Conversely, mid cap value stocks are trading at a premium of 16.2% versus their historical average.

Credit Cycle Supports Economic Expansion

We have written in the past about the credit cycle, the expansion and contraction of credit creation that moves in a cyclical pattern. The position of the credit cycle provides valuable insight on investor attitudes regarding risk taking, future return expectations in the bond market, as well as insights on the broader economy.

Credit expansion is supportive of economic expansion and that is what we are currently experiencing. Bank lending has improved as has demand for credit.

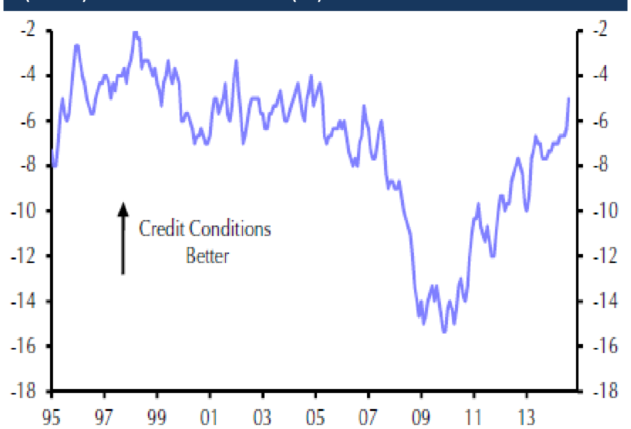
Chart 8. Quarterly Change in Debt (in billions)



Source: Thomson Datastream, Capital Economics

While credit is growing at the household level, we also see signs of growth in the all important small business level. Fewer small businesses than at any time since November 2006 are reporting that credit is hard to get.

Chart 9. National Federal of Independent Business (NFIB) Credit Conditions (%)

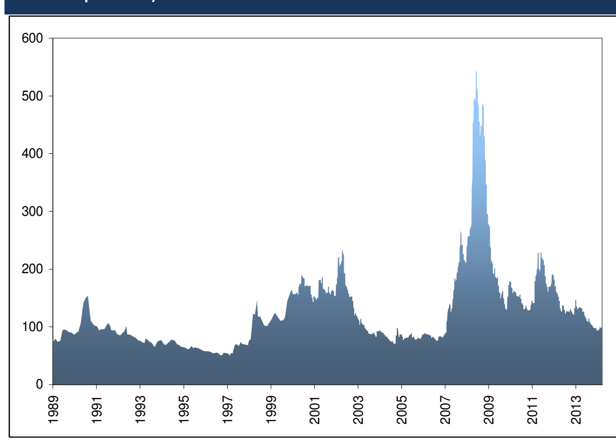


Source: Thomson Datastream, Capital Economics

As the credit cycle matures and credit growth accelerates, insights on valuation can be gleaned from credit spreads. Credit spreads, which represent the difference in yield between a bond carrying credit risk (eg., a corporate bond) and a similar maturity U.S. Treasury bond (which theoretically carries no credit risk due to its backing by the U.S. government), also move in a cyclical pattern along with the credit cycle. Spreads begin to narrow as credit markets recover from a recession as they have been doing for the past several years. Historically, recovery periods are excellent times in which to invest. As the credit market completes the healing process and expands, spreads will begin to widen. During this period debt levels and speculative corporate actions increase and corporations take increasing investment risk which is often fueled by debt. During expansion periods returns on credit are often less appealing with losses even occurring. The transition from recovery to expansion is well underway. However, debt levels are very reasonable, cash levels are near all-time highs, earnings are outpacing the growth in debt, and corporate balance sheets look very healthy, suggesting that fundamentals should support solid, if less spectacular, returns going forward.

Corporate credit spreads in both investment grade and high yield debt are hitting trough levels, suggesting that the recovery is nearing its end with expansion now becoming a reality.

Chart 10. U.S. Investment Grade Credit Spreads (in basis points)



Source: Barclays Capital

Taking a closer look at Chart 10 we can make a few observations. First, credit cycles can be quite lengthy in duration. Over the past 25 years we have had only three: From 1991-2002; 2002-2008; and 2008 to the present. Second, the period of time when credit spreads narrow and flatten out, which we can classify as a bull market in credit, can last quite a while. Morgan Stanley[2] noted 12 credit bull markets since 1932 which lasted roughly 4 years on average. While spreads may continue to stay at low levels for quite a while, the current bull market of spread narrowing is 5 years old, suggesting further price appreciation in credit is limited on a historical basis and valuations are rich. Last, similar to the economy the recovery period in the credit markets has been longer than normal. We would make the argument that this has been a 5 year recovery in the credit markets that is coming to a close.

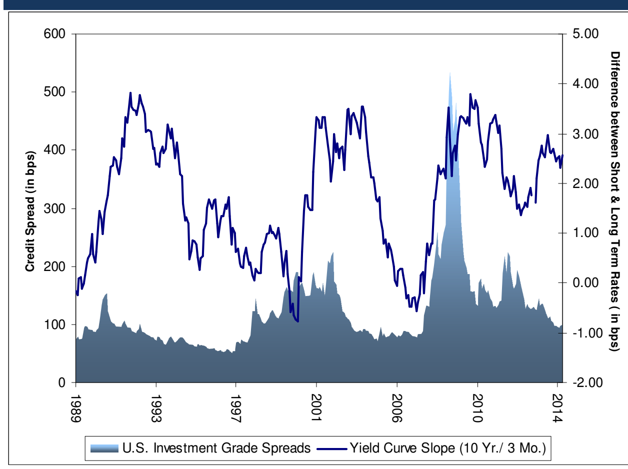
Preparing for the Future

As the credit cycle matures the yield curve will begin to flatten. The yield curve is the difference in yield between short-term U.S. Treasuries and long-term Treasuries. The 3 month or 2 year Treasury is often used as a proxy for short-term yields while the 10 year Treasury is used as a proxy for long-term yields. The slope of the yield curve, the difference between short and long rates, will reveal very important information about the economy. For example, history tells us that when the economy is headed for a recession the yield curve will invert (short-term rates higher than long-term rates) prior to the recession. The predictive power of this phenomenon is unquestioned. Conversely, as the economy recovers the yield curve will become sharply positively sloped, with long rates materially higher than short rates.

As credit spreads bottom out, which for investment grade spreads is typically around 75-100 basis points, and the economic recovery matures and enters an expansionary phase the Fed will increase rates and the yield curve will flatten as the difference between short and long-term rates becomes narrower.

Spreads are currently right around 100 basis points or 1%. The process of flattening the yield curve until it reaches inversion historically takes several years. For example, as noted in Chart 11, 1991-1997 and 2002-2008 represent two episodes of 1) credit spreads hitting a trough and staying low for quite a while, 2) an expanding economy, and 3) a gradual flattening of the yield curve. Higher rates and the gradual flattening of the yield curve is supportive of longer term debt while being a negative for short-term debt. Investors should not be afraid of adding exposure to longer term debt. The yield curve has flattened by roughly 45 basis points this year and long-term debt has returned approximately 14% vs. a 0.5% return on short-term debt .

Chart 11. Credit Spreads & the Yield Curve



Source: Barclays Capital

At the risk of sounding like a broken record we reiterate that within credit, now is not the ideal time for risk taking. Risk compensation (spreads) is low; investors are not getting paid much to take on risk. Stick with high quality, avoid reaching for yield and compromising diversification. Reaching for yield and taking on additional credit risk often require investors to compromise liquidity as higher yielding, lower quality credits are less liquid. Liquidity as well should remain an important part of a bond portfolio.

[2]Morgan Stanley Research, U.S. Credit Strategy, "Where Are We In the Credit Cycle?" 7/18/14

Lastly, we follow up with a theme we wrote about last quarter which has current implications and this is the case for lower than expected interest rates. While we avoid predicting the future of interest rates, the prevailing sentiment seems to be that rates *must* return to historical levels. Looking out over the available options of investment grade sovereign debt, at 2.28% (as of 10/13/14) the 10 year U.S. Treasury actually represents good value vs. comparable sovereigns. Global quantitative easing, particularly in developed nations, has driven yields to rock bottom levels. For pools of capital looking for safety, liquidity, and some yield, U.S. debt offers the best choice, bar none. Look at Chart 12 below. Where else are you going to go for safety, liquidity, and a little yield? And when risk levels increase due to geopolitical events or turmoil in the markets, Treasuries still retain their "flight to quality" status in the global marketplace. This is unlikely to change any time soon. Of the 19 countries noted below, only 5 offer yields higher than a 10 year Treasury. Of the 5, three do not offer safety (Italy, Greece, & Portugal) and the other two can not come close to matching the liquidity of a Treasury. Not much competition - which is a good thing for Treasuries.

Chart 12. Sovereign Bond Yields- 10/13/14

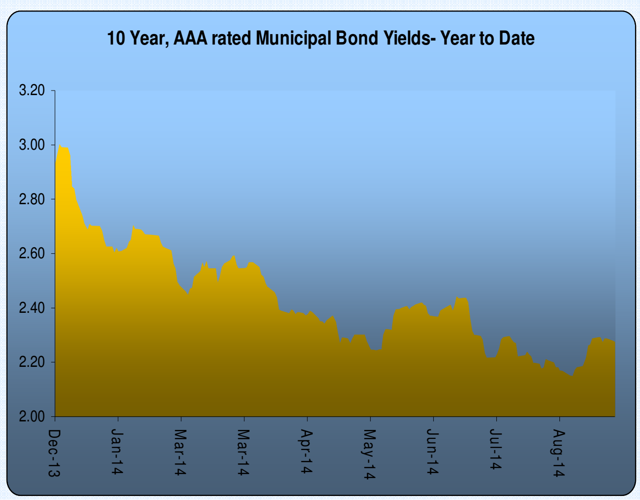
	10 Year Govt Yields	Spread vs. US 10 yr
US	2.28%	-
Switzerland	0.45%	-184
Japan	0.50%	-179
Europe	0.85%	-143
Germany	0.85%	-143
Netherlands	1.04%	-124
Denmark	1.14%	-114
Belgium	1.18%	-111
France	1.26%	-102
Sweden	1.37%	-91
Ireland	1.71%	-57
Canada	2.01%	-27
Spain	2.08%	-21
Norway	2.14%	-14
UK	2.17%	-12
Italy	2.33%	5
Portugal	3.03%	75
Australia	3.29%	101
New Zealand	4.03%	175
Greece	6.63%	435

Source: FactSet Research Systems

Municipal Market: Still All About Supply

Year to date, the municipal bond market has experienced its strongest return in multiple decades, recording 8 consecutive months of gains through August 31st. As of this writing, that streak looks to be coming to an end in September. The story continues to be all about supply, or the lack thereof. Through mid-September, issuance is down 12% YTD compared to last year. Basic economics dictate that when supply is falling while demand is increasing or even constant, the result is higher prices. Investor demand for tax-exempt debt continues to be strong with historically low yields failing to scare off muni investors. The market has largely shrugged off issues with Puerto Rico and Detroit and as we have mentioned in the past, those are more issue-specific than indicative of broader problems in the municipal market.

The best areas of the municipal market this year have been long-term paper as well as lower quality, high yield munis which are typically revenue bonds that lack a general obligation guarantee and are not backed by an essential service such as water, sewer, power, or transportation. High yield munis tend instead to be backed by tobacco payments, aging care facilities, sports arenas, and real estate developments, to name a few. Just as the Treasury yield curve has flattened in 2014 so too has the municipal yield curve as the demand for yield has continued. Municipal yields have followed Treasury yields downward as the chart below notes. Similar prudence is recommended in the muni market just as in the taxable market: High quality, highly liquid bonds are a good call. Investors also should not be afraid to add exposure to longer maturities if they have been overly biased to the short-term over the past several years.



Source: Bloomberg, Cypress Trust

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