

# Strategy Quarterly

Second Quarter 2015

## Executive Summary

❑ Despite the most recent weak GDP reading, the Fed still expects inflation to rebound, as the temporary dampening effects of lower energy prices and the stronger dollar fade. It stated again that it will not begin to hike interest rates until it is "reasonably confident" that inflation will climb back to the 2% target.

❑ Notwithstanding an eventual rate increase, global monetary conditions are still very accommodative, as the world's major central banks have kept policy rates close to zero and some have continued with large scale asset purchases (QE in Europe).

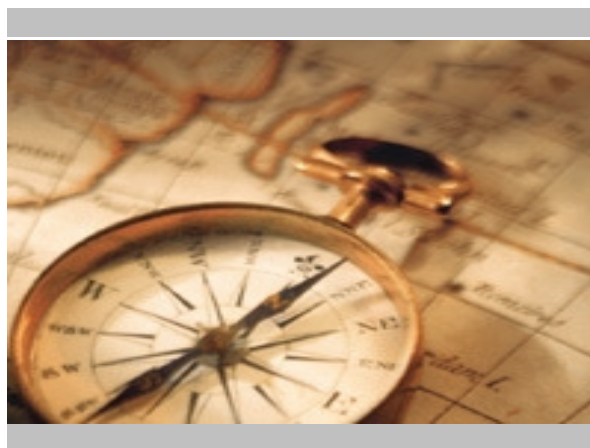
❑ We expect U.S. companies to generate slow but stable revenues and earnings. However, profit margins may come under pressure as productivity gains decay and higher wages partly offset low input cost inflation and debt service obligations.

❑ Corporate debt leverage is at an historical low. Strong corporate cash flows have been redeployed towards dividends and share buybacks. These trends could continue over the next few quarters and support current market valuations and stock prices.

❑ The negative yields associated with European quantitative easing is driving European investors across the Atlantic and into the U.S. bond market, thus fueling the continued performance of our domestic bond market.

❑ This multi-year tidal wave of global quantitative easing runs the risk of lulling investors into a complacency that values return over risk management in the search for yield. Again we recommend not chasing yield and remaining disciplined with regards to the overall asset allocation.

❑ New in this issue: Trust and estate planning.



---

### Massimo Santicchia

Chief Investment Officer

Cypress Trust Company

[Massimo.Santicchia@CypressTrust.com](mailto:Massimo.Santicchia@CypressTrust.com)

---

### Ryan Kuyawa, CFA

Vice President, Senior Portfolio Manager

Cypress Trust Company

[Ryan.Kuyawa@CypressTrust.com](mailto:Ryan.Kuyawa@CypressTrust.com)

---

## U.S. Economic Outlook

The most recently released FOMC statement (April 29) suggests that Fed officials still believe economic growth and inflation will rebound. But until they see evidence of such a rebound, which could take another few months, they are in no rush to raise interest rates from near-zero.

That statement acknowledged economic growth had slowed "in part reflecting transitory factors," which presumably means the unseasonably cold weather in the Northeast, the dollar's appreciation, the West Coast port dispute, and the drop in mining investment triggered by the slump in oil prices.

These factors should be transitory and we expect a rebound in consumption growth and GDP growth. Real incomes rose robustly in the first quarter and consumer confidence remains high.

The Fed was surprisingly dovish in its assessment of the labor market, suggesting that "the underutilization of labor resources was little changed." However other indicators point to a shrinking slack in the labor markets.

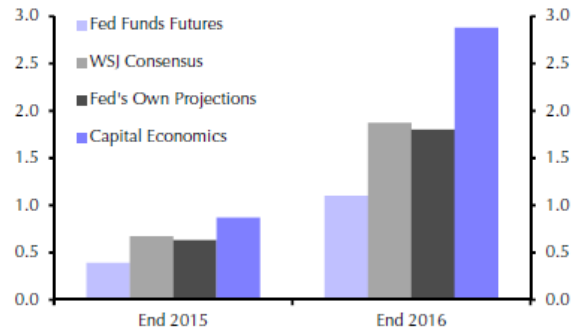
The Fed still expects inflation to rebound, as the temporary dampening effects of lower energy prices and the stronger dollar fade. It stated again that it won't begin to hike interest rates until it is "reasonably confident" that inflation will climb back to the 2% target over the medium term.

According to Capital Economics, given the importance of the first rate hike, which would be the first policy tightening in almost a decade, the conventional wisdom is that the Fed would then wait until at least September, which would be the next FOMC meeting with a scheduled press conference.

We expect the Fed will start to raise rates as wage growth and price inflation rebound. However, the timing of the first rate increase is uncertain and data-dependent.

We believe that the reduced outlook for growth and inflation imply a less aggressive path of interest rate hikes in the quarters ahead.

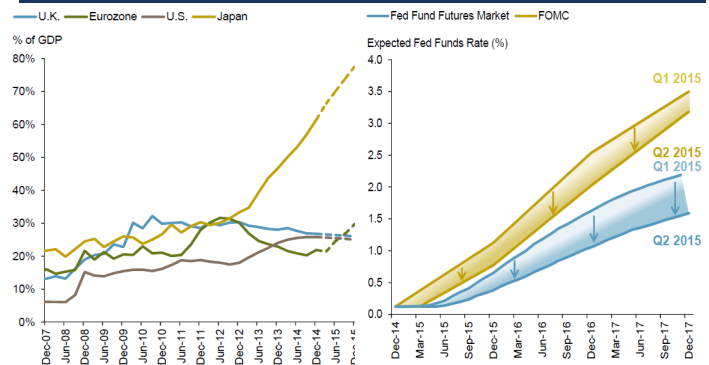
Chart 1. Fed Funds Rate Expectations



Source: Capital Economics, Federal Reserve

Notwithstanding an eventual rate increase, global monetary conditions are still very accommodative, as the world's major central banks have kept policy rates close to zero and some have continued with large scale asset purchases (QE in Europe). In addition, private sector credit growth in the Eurozone has recently accelerated and credit to the corporate sector is still growing most rapidly in the U.S. According to Capital Economics, this is in line with other evidence which suggests that the U.S. economy is holding up better than implied by the first quarter GDP data. Broad measures of the money supply are increasing at a steady pace in all of the G4 economies (see Chart 2). Uncertainty about the future trajectory of monetary policy is likely to remain an ongoing concern for investors as the strong dollar undermines U.S. multinationals' earnings. However, the domestic economy is supported by a resilient consumer spending on lower gasoline prices and eventually higher wages.

Chart 2. Major Central Banks Balance Sheets and Fed Funds Expectations

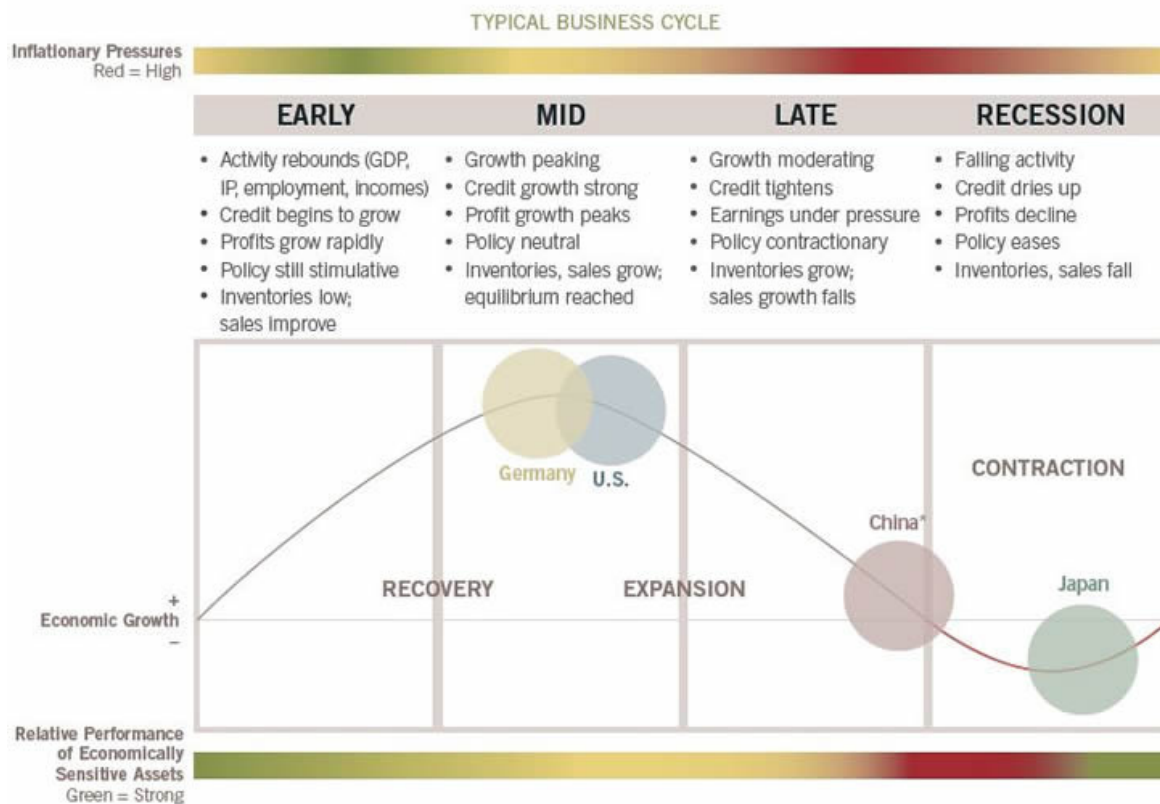


Source: Fidelity

## Global Business Cycle

Recent weak U.S. economic data is a result of the impact of a stronger dollar on the pace of manufacturing, exports, and other globally focused sectors. This is offset by positive consumer outlook and low inflation, typical of a mid-cycle expansion. The labor market remains on a trend of steady improvement; inflationary pressures remain muted on collapse of oil prices, slow wage gains and overall global disinflation trends. As we have stated in the past, as long as inflation is contained, monetary policy does not have to become overly restrictive and therefore the current economic expansion can last longer. The housing market continues to slowly improve, supported by lower mortgage rates, easing lending conditions, and declining unemployment.

Chart 3. Global Business Cycle Evolution



Source: Fidelity

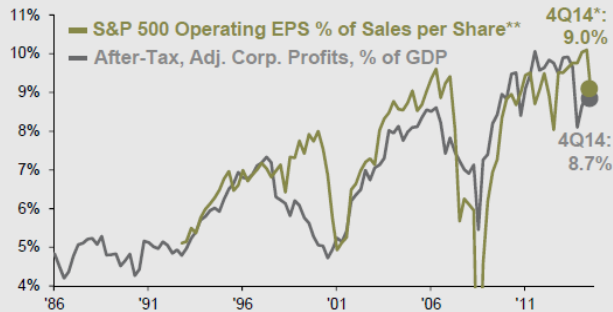
The Eurozone is showing signs of an improving mid-cycle expansion, as monetary and credit conditions are becoming increasingly favorable. The European Central Bank's quantitative easing has had a stronger impact than expected; the manufacturing sector remains in expansion, banks continue to ease lending standards, and a cheaper currency and lower oil prices provide further support. Thus, favorable cyclical conditions should more than offset political risks in peripheral countries such as Greece and Ukraine. China's slowing (but still respectable) growth could become the greatest obstacle to a broad-based global economic reacceleration.

Divergence in global policies and an eventual move to monetary tightening in the U.S. could cause foreign exchange volatility with potential spillover to other asset classes and markets. As a result, investors should get accustomed again to significant and recurrent volatility spikes.

## U.S. Equity

Corporate profit growth has been slowing after the rebound from the 2009 bottom but it is still positive. We expect U.S. companies to generate slow but stable revenues and earnings. However, profit margins may come under pressure as productivity gains decay and higher wages partly offset low input cost inflation and debt service obligations (see Chart 4).

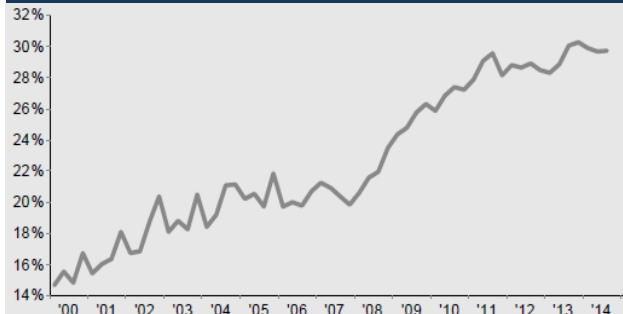
Chart 4. Profit Margins



Source: J.P. Morgan, Standard & Poor's

Corporations continue to generate and redeploy strong cash flows towards dividends and share buybacks (see Charts 5 and 6).

Chart 5. Corporate Cash as % of Current Assets



Source: J.P. Morgan, Standard & Poor's

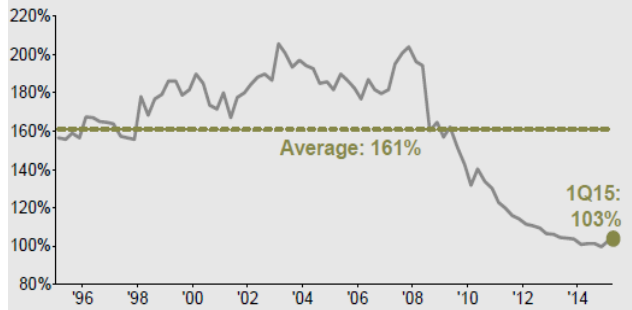
Chart 6. Cash Returned to Shareholders



Source: J.P. Morgan, Standard & Poor's

Companies have also been reducing their debt leverage which today stands well below its 10-year average as Chart 7 displays. We believe that this analysis of cash generation and uses illustrates favorable trends supporting current equity valuation and prices.

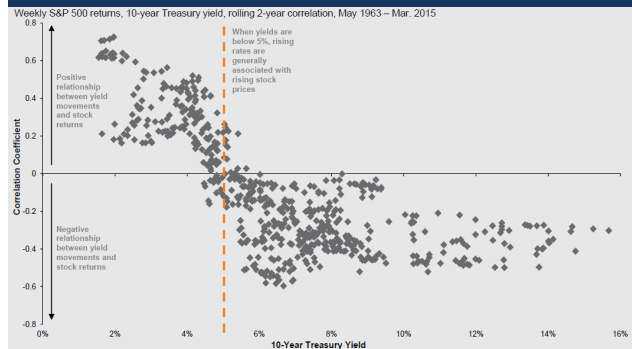
Chart 7. Total Debt to Equity – S&P 500 Companies



Source: J.P. Morgan, Standard & Poor's

The prospect of the Fed starting a new phase of increasing short-term rates has caused investors anxiety about the impact of higher rates on market valuation and the overall stock market. We have argued that, first, an increase in rates would be a positive sign for the economy as it would signal a sustainable economic expansion. Second, Chart 8 below shows the correlation between stock prices and long-term interest rates over the last fifty years. Correlation was positive (negative) for yields below (above) 5% (vertical dotted orange line). Given that the current yield on 10 year Treasuries is about 2%, we don't expect a rate increase to have an immediate negative impact – particularly if it is a gradual increase as the Fed has stated.

Chart 8. Correlation Between Stocks and Yields



Source: J.P. Morgan, Standard & Poor's

## The European Tidal Wave of Cash

We have been featuring the chart below in recent quarterly pieces positing that it is one of the key factors keeping rates low and the U.S. bond market chugging along in spite of historically low rates.

Chart 9. Sovereign Bond Yields- 5/6/15

	10 Year Govt Yields
US	2.20%
Switzerland	0.13%
Europe	0.54%
Germany	0.54%
Denmark	0.65%
Netherlands	0.71%
Belgium	0.83%
France	0.82%
Ireland	1.18%
Spain	1.74%
Italy	1.77%
UK	1.99%
Portugal	2.34%
Canada	1.76%
Norway	1.66%
Japan	0.36%
Sweden	0.70%
Australia	2.93%

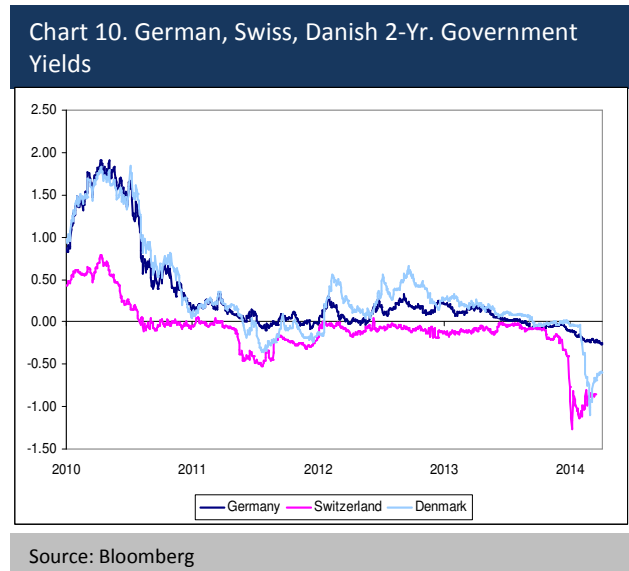
Source: FactSet Research Systems

We draw the reader's attention to the European countries shaded in blue on Chart 9 above. We are living in a world where the 2.20% yield on the U.S. 10 year Treasury actually represents value! The €1 trillion European quantitative easing program which is aimed at stimulating growth in the Eurozone by lowering interest rates to spur on investment activity is the dominant player in the bond market with global implications. A few facts to consider:

- 24% of government bonds in Europe pay a negative yield with 52% yielding below 0.50%
- €1.5 trillion in European government bonds pay a negative yield with €3.4 trillion yielding less than 0.50%.

With yields so incredibly low in Europe, massive pools of European capital are searching for a place

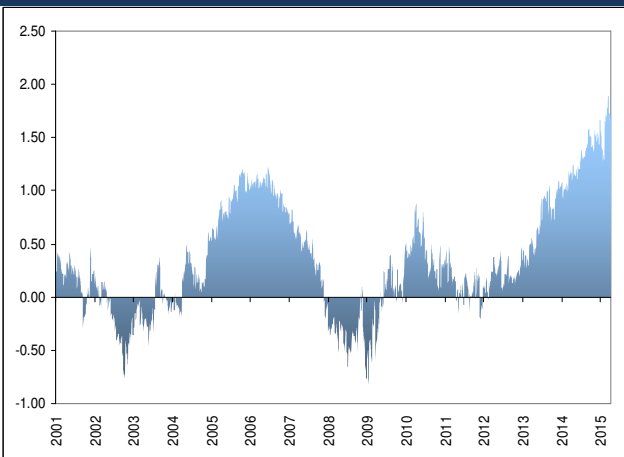
to park their money that earns any yield. Japanese investors as well, with their 0.36% yield. Where do they go? The United States. In Germany, Switzerland, Denmark and several other European nations you are actually *paying* the government to keep your money with them. Chart 10 is just one of many examples as it depicts the negative yield on short-term government debt of higher quality European nations.



With global quantitative easing drawing large pools of foreign capital to the United States in search of yield we see U.S. rates continually low. These quantitative easing programs (Europe and Japan) are pushing down the price of bonds in the U.S. Mortgages, corporate bonds, loans of all types, and municipal bonds are benchmarked off of the U.S. Treasury so the European quantitative easing creates a ripple effect which stretches far beyond Treasuries as it depresses yields across so many sectors of the bond market. With this massive wave of cash pushing against interest rates and an economy that is growing at a much lower rate coming out of the Great Recession than has been experienced historically, it is difficult to see materially higher interest rates in the future. The Federal Reserve will raise rates in 2015, but this is likely to be a more symbolic move as the Fed wants to philosophically move off of their ZIRP or zero interest rate policy. Caution should be exercised in thinking that this will now signal the return of rates back to prior historical levels.

The 10 Year Treasury yield is at a 14-year wide to the German government bond yield. This is a good proxy for relative value as the German bond market is relatively large, liquid, and of high credit quality. If you think that a 2.2% yield in the U.S. is paltry, imagine the frustration of being a German investor who is earning 0.54% for lending his money to the government for 10 years. By comparison, that 2.2% yield looks rather attractive. Outside of government bonds, U.S. corporate bonds are also yielding 2% more than their European counterparts.

Chart 11. Yield Difference between German 10 Year Bond & U.S. 10 Year Treasury

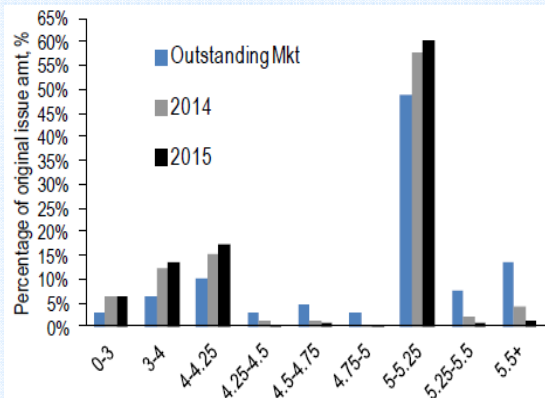


Source: Bloomberg, Cypress Trust Company

One of the themes we have been reiterating is that of investor complacency. This multi-year tidal wave of global quantitative easing is providing a strong bid on government debt which is producing consistently attractive returns within fixed income and in many cases lulling investors into a complacency which values return over prudent risk management. It is easy to jump into riskier asset classes to search for yield or higher risk credits. Again we recommend the importance of focusing on quality, not chasing yield, and sticking to your asset allocation.

## Low Rates, High Prices: The Coupon Structure of the Municipal Market

We have written in the past about how the municipal bond market is dominated by retail investors. The term retail investor refers to individuals and households. This is logical as they, unlike corporations or institutional investors, can take advantage of the tax exemption. Most retail investors choose to purchase municipal bonds through mutual funds, but many also purchase individual bonds in personal investment accounts. As interest rates have stayed historically low the dollar prices of new municipal bonds coming to the market have been sky high. Why is this? Why would anyone want to buy a newly issued municipal bond with a dollar price of \$120? Many retail investors buying individual bonds in their investment accounts are finding this option very unappealing. The answer lies in the structure of the municipal bond market and the concept of duration. Let's start with defining duration. Simply stated, duration is a measurement of a bond's sensitivity to interest rates. The higher the duration, the greater the interest rate sensitivity. All things being equal, the higher the coupon, the lower the duration, and vice versa. The reason for this is that a bond's coupon is fixed whereas a bond's price is not. So as interest rates increase and a bond's price decreases, this decrease will be offset by the bond's interest payment. The higher the interest payment from the coupon, the greater the offset or "cushion" there is to offset the price decline of the bond. For this reason so-called "cushion" bonds with 5% coupons are preferred by the largest buyer of municipal bonds, mutual funds. The municipal issuers are simply providing the type of bonds that their largest buyers want, those with high coupons that can offset future price declines. When you have market yields around 1-2% and 5% coupons, the dollar price needed to equate those 5% bonds with a 1-2% yield is quite high. As noted in the chart below, 5% coupons dominate the market. With interest rates so low, they are here to stay and unfortunately for many buyers, so will the high dollar prices.



Source: J.P. Morgan, S&P

## **Estate Planning for Pets**

By Anita Calabro

Your pet – your constant companion, your pride and joy, your loyal and faithful friend – is always there for you. What happens when you can no longer be there for your pet? Planning for care of your pet when you no longer are able to do so generally tends to be a heart-to-heart conversation - asking a friend, family member, or a neighbor to carry out your wishes for your pet's care. But have you thought about what would happen if that conversation never took place, or the person in whom you've entrusted your pet's care - or thought would be a suitable fit - is no longer willing or able to do so?

Pet planning has grown in popularity. The need for more formality has grown significantly, particularly as we experience an increased segment of our elderly population living longer, and in a lot of cases alone, with a pet as a sole daily companion. There are over 170 million pet owners in America. Unfortunately, most have not formally planned for their pets should the owner become disabled or die. Pet planning gives you the ability to allow another person to care for the welfare and needs of your pet, financially as well as emotionally, and the peace of mind in knowing your pet will be cared for when you are unable to do so.

### **Do I Need a Trust to Properly Plan for my Pet?**

You can make arrangements for your precious pet in your Last Will and Testament or in your Trust documents. When you die, under Florida law, pets are handled the same way as your personal property. Under the terms of your Last Will and Testament you have the option to specifically state how you wish your property to be divided. Should a pet be unclaimed by someone willing and able to care for it, in some cases it may be destroyed, subject to local and state law. Additionally, the process of probate can be long and drawn out. A Trust, on the other hand, speeds up the process for the designated caregiver of your pet and can be customized with provisions for the maintenance, care and support to which you feel your pet is accustomed. Pet Trusts can be funded during your lifetime or at death, and are legal and enforceable by law. Some pet owners purchase insurance owned by their trust to ensure money will be available for their pet should a disability or death arise of the pet owner.

## **Whom Should I Consider To Care for My Pet If I Am Unable To?**

Who you choose to care for your pet is as important a decision as how you choose to care for your pet. When you consider a designated caregiver, it is important to also choose a worthy alternate in the event circumstances change and your initial designate cannot fulfill your wishes. Your caregiver of choice needs to be willing to step in your shoes should you become unable to make decisions for yourself and your pet.

For some caregivers, taking on the emotional task of caring for another's pet is easy, but it can be a financial hardship. A Pet Trust, skillfully drafted, will include financial support provisions for the benefit and protection of your pet, which generally eases the job of the caregiver and the worry they may have in taking on additional costs associated with caring for your pet during its lifetime. As with any other planning document, any remaining funds can be distributed at your pet's death to whomever you choose, including charities. Because the funds are set aside, held in trust for the benefit of your pet, your designated trustee has a fiduciary duty to ensure the funds are used for the purposes intended.

Lastly, you will also need to consider the level of care your pet receives - things like medical bills, costs for grooming, medication, and daycare, even insurance. As an example, if your pet has a skin irritation, does your pet require special medical care as a result? Perhaps your pet has a special food that you prefer to serve that a caregiver would not be aware of. All of these items can be specifically stated as provisions designed by you in a Pet Trust tailored to meet the daily needs of your pet.

### **In Conclusion**

Pets are a part of the family and, like any family member, you want to provide for them if and when the need arises to ensure their ongoing well being. Pet planning gives you assurance and peace of mind that your trusted companion has safeguards in place to protect him. It is a legally affordable arrangement that your attorney can put in place.

*Reference: § 736.0408, Fla. Stat. (2012)*



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.



Ryan Kuyawa, CFA is a Portfolio Manager and Fixed Income Trader for Cypress Trust Company. He is responsible for security selection and research, yield curve positioning, and directing the firm's fixed income strategy. In addition, he performs equity research, manages client portfolios, and helps shape the overall investment outlook. Ryan has over 10 years experience in the financial industry working as a senior credit analyst for Fidelity Federal Bank & Trust in West Palm Beach, Florida and as an Equity Analyst and Equity & Fixed Income Trader for Northstar Capital Management in Palm Beach Gardens, Florida. Ryan has earned the right to use the Chartered Financial Analyst designation (CFA).

---

#### **Important Notes**

This does not constitute an offer or solicitation. Opinions expressed are current opinions as of the date appearing in this material only. This information should not be considered investment advice or a recommendation to buy or sell any particular security. While every effort has been made to verify the information contained herein, we make no representations as to its accuracy. The information in this material and specific securities mentioned are not representative of all securities purchased, sold or recommended for advisory clients. Actual portfolio holdings will vary for each client and there is no guarantee that a particular client's account will hold any, or all, of the securities identified. It should not be assumed that any of the securities or recommendations made in the future will be profitable or will equal the performance of the listed securities. Past performance does not predict future results.

**NOT FDIC INSURED | NOT GUARANTEED | MAY LOSE VALUE**