January 8, 2015

Our 2015 Investment Outlook: Earnings, Jobs, Monetary Policy, and Europe

The big events of 2014

In 2014, the S&P 500 returned 11.4% in what appears like a steady continuation of the bull market that began in March of 2009. This is somewhat misleading. Some of the broader and global indices are more representative of what the year was like in equity markets: the Russell 2000 returned 3.5% during the same time-period, while the MSCI World Index eeked out a 2.9% gain. The year started with Emerging Markets showing signs of trouble, dragging down the S&P alongside.[1] Momentum stocks rallied aggressively early on, before a blow-off top in late February.[2][3] Momentum issues then experienced a rapid unwinding to much lower levels. The recovery in these stocks has been disparate and for the most part, tame, with biotech the notably strong exception. Commodities collapsed throughout the year with iron ore looking particularly bad throughout. Meanwhile, crude oil's late year slide stands as one of the most notable market moves which will surely have consequences for years to come.[4] The U.S. dollar rallied mightily to multi-year highs in the second half despite prognosticators perennially declaring its death. Absolutely no one predicted interest rates would fall in 2014, but fall they did.

2014 was a year in which the unpredictable happened frequently, with almost an air of predictability. It was a year filled with proverbial minefields where most investors were forced to "dodge bullets" more so than generate significant returns. Our 2014 outlook proclaimed, **"**it is quite possible, almost probable that 2014 will be a better year for the economy than it will be for the stock market.**"** Despite the S&P's double-digit return, we think the story played out largely along these lines. Our 2014 outlook further explained that, **"**While we did not see the economy's traditional metrics of success reach 'normalized' levels in 2013, it has been clearly positioned for the long awaited, but elusive escape-speed breakout from the Great Recession.**"** Weather

[1] RGAIA January 2014 Commentary: Emerging Markets, Discounting the Obvious http://www.rgaia.com/emerging-markets/

[2] RGAIA February 2014 Commentary: Rational Expectations Through Pockets of Momentum http://www.rgaia.com/pockets-of-momentum/

[3] RGAIA March 2014 Commentary: Flushing Out Momentum http://www.rgaia.com/flushing-out-momentum/

[4] RGAIA October 2014 Commentary: Flooded in Oil http://www.rgaia.com/october-2014-investment-commentary-flooded-in-oil/

threw a wrench in the economy's trajectory early in the year, but once that headwind lifted, a crescendo of accelerating growth commenced.

For the most part, 2014 concluded with the U.S. economy on as solid a foundation as it has been in years, though we continue to expect markets to be weak and volatile compared to the economy. It is important to remember the economy and the stock market do not necessarily move in tandem. In our notes below we will both cover what has happened in the recent past and what we are prepared for moving forward. Take any remark about the future with a grain of salt, for we perceive these expectations as a series of hypothesis from which we structure our portfolios, but never lever them to. We think it is extremely important to remain flexible enough to revise any thesis; as John Maynard Keynes once said, "when the facts change, I change my mind. What do you do sir?" Our investment decisions are always based on the bottoms-up fundamental analysis we do on individual companies; however, these macro questions provide an analytical framework through which we can hone in on areas with promise and avoid undue risk.

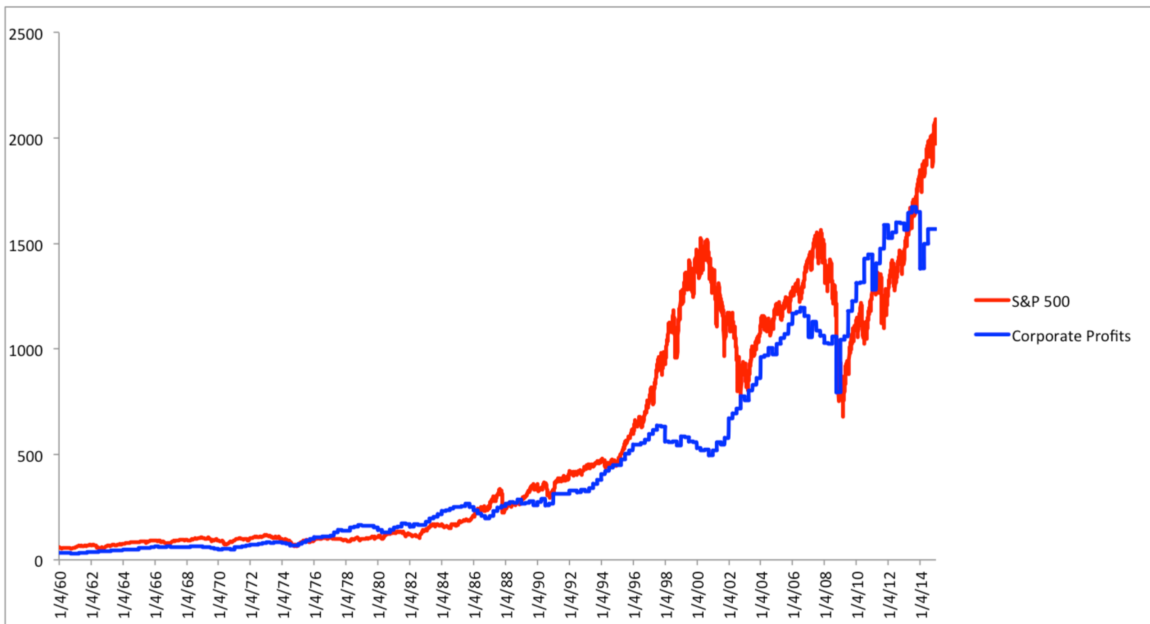
A visual overview of stocks and the economy:

Earnings (not the economy) drive the stock market:

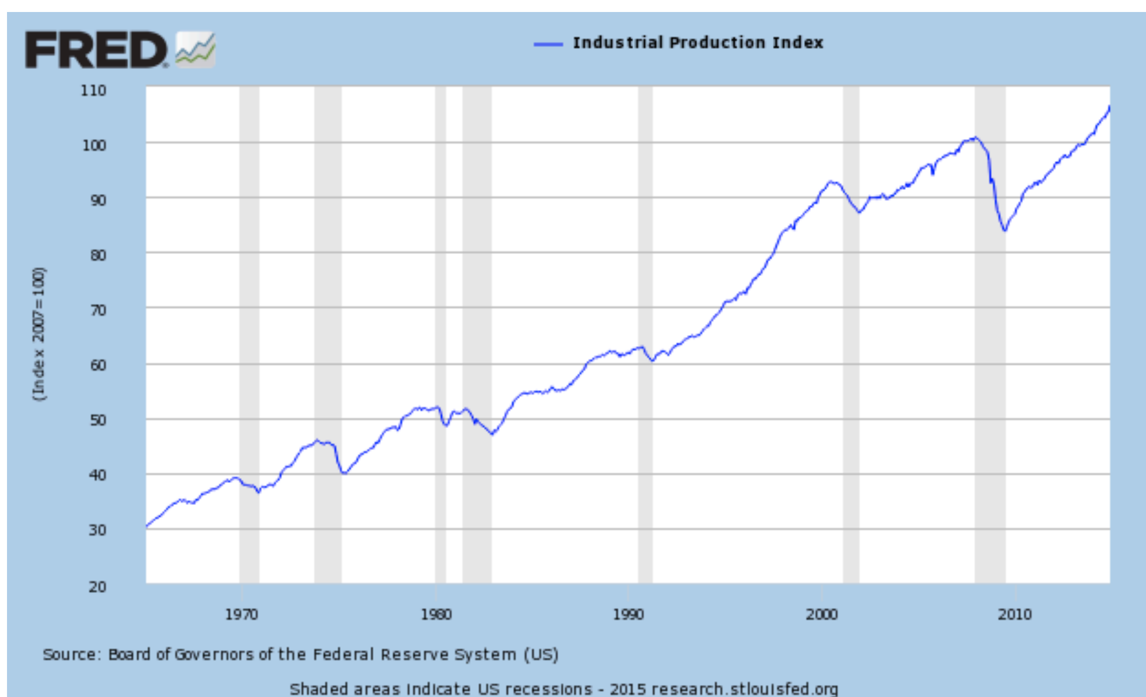
Many complain about the market's strong performance relative to the economy since the March '09 bottom. We think this perspective is flawed due to incompleteness and ideology. A common gripe maintains the market's performance is merely the outcome of aggressive monetary policy. Cause and effect in markets is never simple and always dynamic. Such a simplistic argument ignores the most significant long run driver of stock markets: earnings. Since the March bottom, the S&P has closely tracked the trajectory of its earnings per share, with earnings actually leading the way most of the time.

(Source: Bloomberg)

Importantly, this is the most significant driver of stable stock returns over the long run. Take a look at the S&P verse earnings since 1960. The index has deviated over time, most notably in the dot.com bubble era; however, each deviation has been met with the market reverting back towards a steady trajectory relative to earnings. Recently the market has moved slightly ahead of earnings, yet once the fourth quarter of 2014 is reported this will look more benign. Further, this discrepancy will be relatively small such that it can be worked off with the kind of volatile sideways action we expect.



Industrial production is surging which supports the rise in EPS. Notice that the chart below looks a little like the S&P (though with a more persistently positive slope). Also notice how severe the impact of the Great Recession was on production. It's worth repeating yet again that this was no run-of-the-mill recession. This one chart is great proof that this recovery is real and the claim that this is merely a result confined to asset prices is wrong.



(Source: https://research.stlouisfed.org/fred2/graph/?graph_id=74717&category_id=)

The Strong Dollar Yellen Fed (take THAT conventional wisdom):

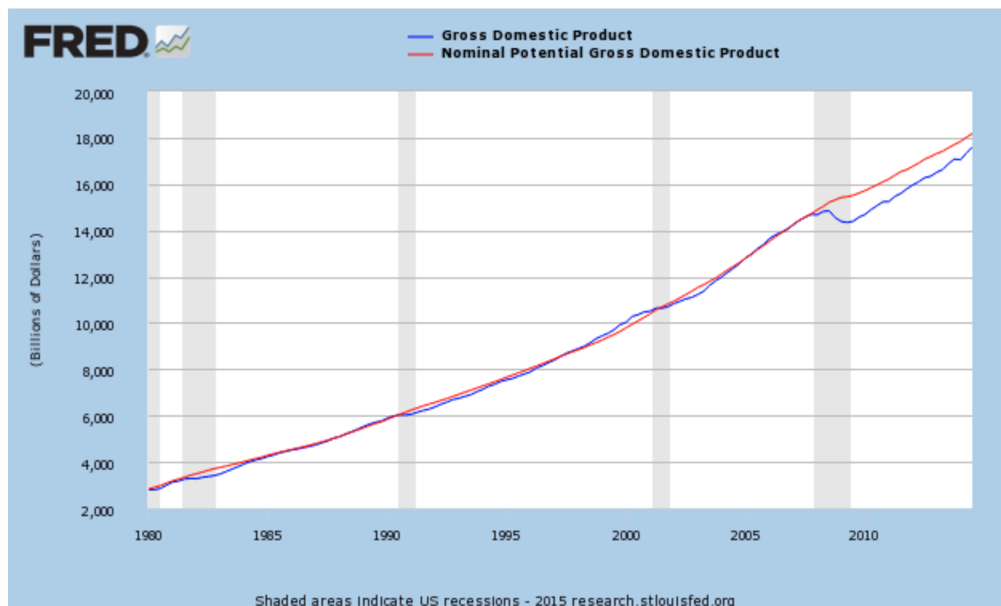
In the same vein that people complain about the market's performance verse their perception of the economy; they similarly bemoan the impact monetary policy is expected to have on the value of the dollar. To that end, people have been calling for the demise of the dollar, dollar doom, and the end of the dollar as a reserve currency. Remember when it was conventional wisdom that the U.S. dollar had only one way to go and that was down? In 2014 the dollar reached its highest levels on a trade-weighted basis since before the Financial Crisis (below).

(Source: Bloomberg)

This all happened despite the growth in money supply and is contrary to what textbook economics says will happen in a vacuum. People point to a plethora of reasons behind this move ranging from a flight to safety out of struggling global economies, technical trading action, a strengthening U.S. economy, and a divergence in monetary policy between the US and the rest of the world. As is often the case, no one reason is the answer—a little bit of each of these factors adds up to a strong move.

Will 2015 hammer the final nail in the "secular stagnation" meme?

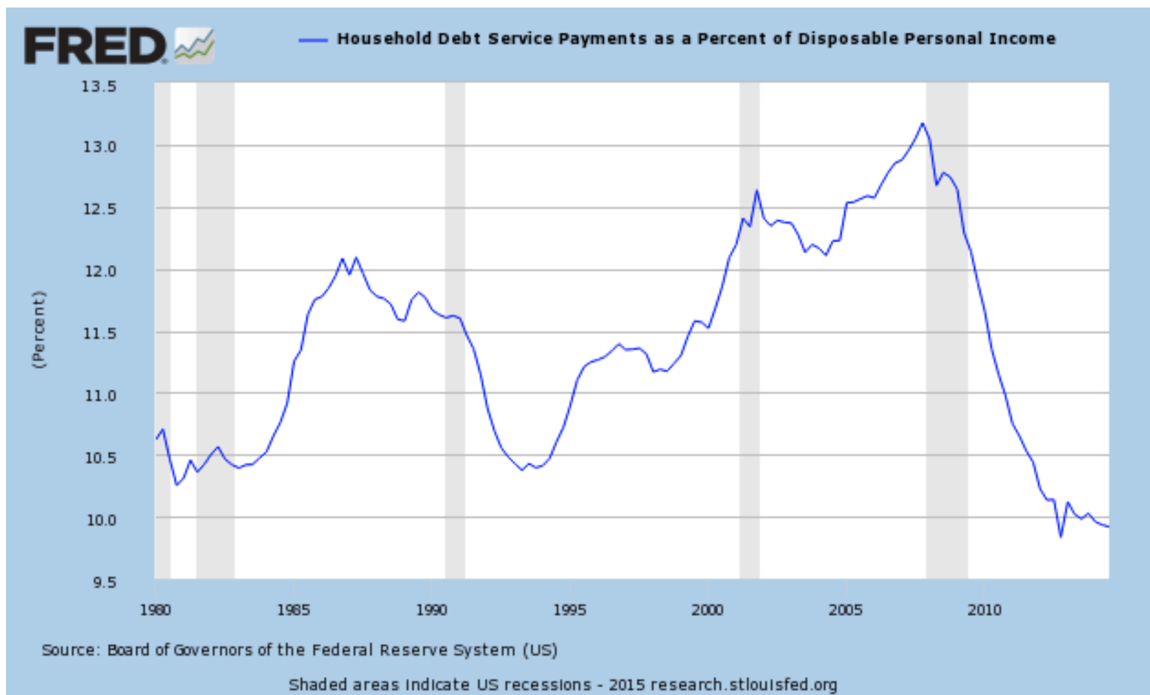
One thing economists look at to measure the depths of the Great Recession is called the GDP output gap. In the chart below, the spread between the two lines represents the degree to which the economy is underperforming its potential. Notice how closely the blue and red lines tracked each other until the Great Recession. This was distinctly not a run-of-the-mill recession. When people speak of "secular stagnation" they mean the blue line will permanently stay below the red line. Further, they mean the red line should be redrawn to reflect a new permanence to the lower growth trajectory (as it has in below). Though the blue and red have yet to converge, 2014 went a long way towards easing concerns that they never will. The efforts taken by policymakers to counteract the Great Recession have the economy legitimately on track to recoup all of the lost ground. We believe that in the coming years convergence will in fact occur and only then will we need to worry about when, where and how the next recession happens. **Importantly, we think the next recession will come from an economy that accelerates too much and must be slowed down via a tightening of monetary policy, rather than one where a credit contraction puts us on the precipice of deflation. In other words, the next recession will be of the run-of-the-mill variety, which are never fun, but are far less troubling than once-in-a-lifetime financial crises.**



(Source: http://research.stlouisfed.org/fred2/graph/?g=VWx)

A clean balance sheet with a solid foundation for growth:

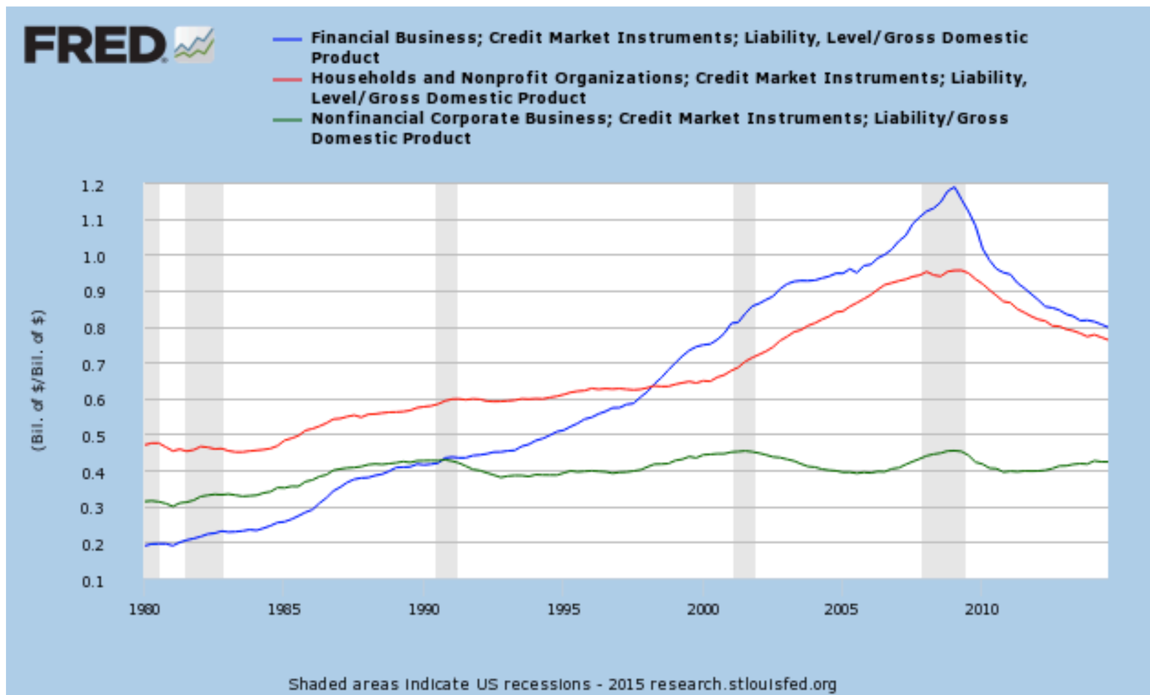
One of the most constructive factors in our outlook several years running has been the status of debt service payments as a percent of disposable income. Previously, we explained how two important catalysts fueled the decline in debt service: first, the impact of deleveraging; second, the impact of falling interest rates. While many remain unsatisfied because gross debt levels have not contracted significantly, this need not happen when the service of debt becomes consequentially cheaper. Debt burdens remain at generationally low levels and increasing confidence on the household level can go a long way towards maintaining the momentum of the economy.



(Source: http://research.stlouisfed.org/fred2/graph/?g=VWn)

Further, sectoral leverage in each component of the private sector continues to improve. 2014 saw notable continuity in the financial sector and household sector components' leverage, while the corporate sector's debt levels increased slightly. Importantly, it is the corporate sector that has the greatest capacity for increased leverage. This is but one of the forces underlying the rise in activist investing this past year and the consistently large share repurchases from companies the past few years. Note that these numbers are as a percent of GDP, so while gross leverage

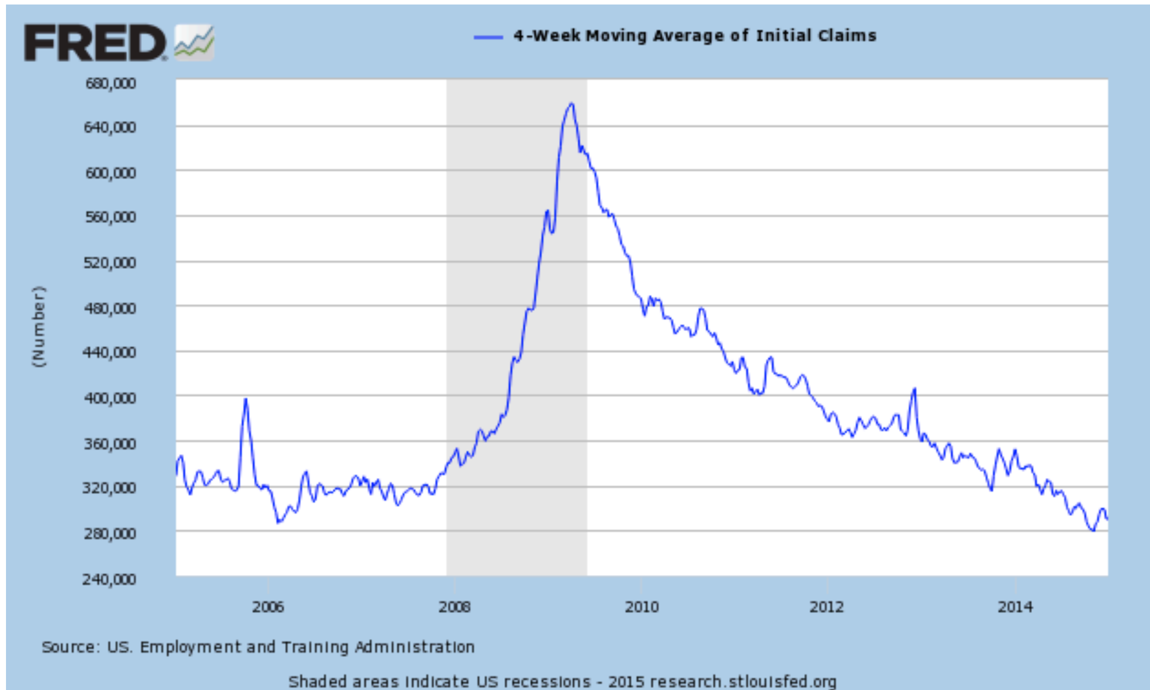
did increase in all areas, it was grew at a slower rate than GDP. This highlights the importance of speaking about debt in the context of GDP and the significant role that nominal GDP growth in particular can play in mitigating the damage inflicted by the kinds of excessively large debt burdens present prior to the financial crisis.



(Source: http://research.stlouisfed.org/fred2/graph/?g=VWA)

Job security is high and Millennials are finally finding their way out of the basement:

The unemployment rate started 2014 at 6.6% and as of the end of November was at 5.8% (as of the time of this writing we do not know the December number). While many focus on the unemployment rate exclusively, we find more value in looking at the four-week average in continuing claims. This is a higher frequency number, but also has fewer moving parts. Continuing claims are hovering at incredibly low levels indicating those who are employed are maintaining employment and the supply of potential new hires is becoming increasingly scarce:

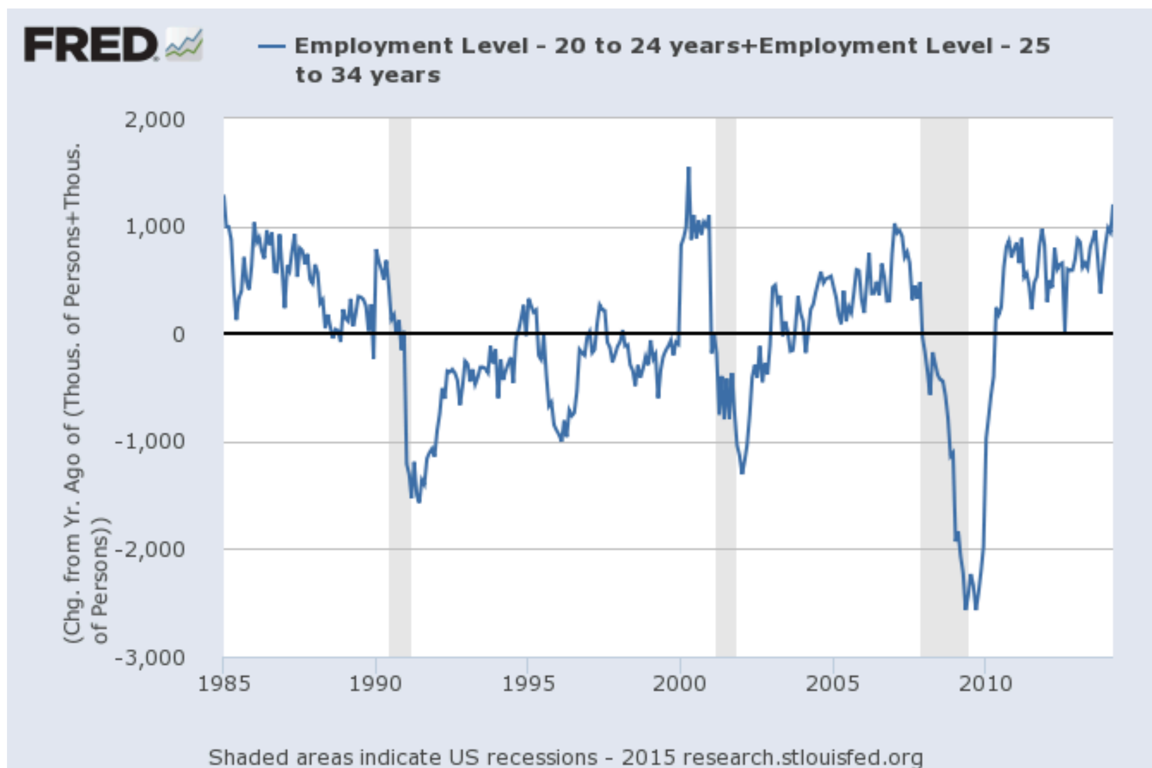


(Source: http://research.stlouisfed.org/fred2/graph/?g=VWt)

One of the groups hardest hit by the Great Recession were the young adults of the Millennial Generation. 2014 will mark the year that the Millennial employment situation finally took a turn for the better. This bodes well for the economy. Demographically, this age group will have to foot an increasing burden of consumption and investment in order to maintain the long-term growth orientation of our economy. The lack of household formation has been a big force holding back the economy. Household formation results in increased demand for dwellings, an area that generates considerable investment and a high multiplier of follow-on spending.

In order for household formation to recover, we need the youngest generation of workers to find lucrative, productive and enduring jobs.

Further, household formation is a necessary precursor to an improvement in the birth rate. Birth rates took a severe hit during the Great Recession and as of 2013 had not bottomed yet. While data on a national level is slowly aggregated and we will not know the final birth rate for 2014 until one year from now, we strongly believe this was the year that the birth rate did in fact bottom. Nothing gets Americans spending like buying a new house and making babies. It is no coincidence that economic booms have come alongside demographic booms (and vice versa).



(Source: http://research.stlouisfed.org/fred2/graph/?g=VWu)

Some deeper thoughts on monetary policy:

We have long maintained the end of the aggressive monetary policy deployed to stave off a deeper crisis would not be a cause, but rather would be an effect. The distinction is important. While conventional wisdom holds that the Fed normalizing policy could lead to volatility in financial markets, we think this misses the point. There will always be volatility around inflection points. More importantly, the Fed normalizing policy will be an acknowledgment that the economy has legitimately accelerated and the financial crisis was comfortably left in its wake. As the Fed has maintained all along, normalization will come with "escape velocity" from the crisis period.

In other words: normalization of Fed policy will be a reflection of a "normal" economy; not an imposition of risk moving forward. To that end, while we think some volatility would be normal; volatility in and of itself is not risk (contrary to the efficient market hypothesis).

It is never comforting to say something that can be perceived as "mission accomplished" in financial markets in particular; however, we think it's safe to say that right now the Fed has successfully staved off the risk of deflation in the U.S. economy. That does not mean there is no risk from monetary policy moving forward. It does mean that longer-term, the biggest risk for the economy is inevitably heating up to an uncomfortably, unsustainable pace with inflation the unfortunate byproduct. This cannot and will not happen until the output gap discussed above is closed. Or alternatively, it could mean that the Fed tightens a little too early thus staving off a fuller recover before it can materialize. We welcome the Fed's insistence that further action will be "data dependent" for it is important to remain flexible in the face of a dynamic situation.[5]

The death of commodities as an investable asset class:

This is one of the most consequential happenings of 2014. While many are looking for some kind of normalization and a return to a higher price range on key commodities like oil, we take a different perspective. In our estimation, this past year is a "regime change" (we are using this phrase with the economic, not geopolitical meaning) of the variety that happens only once a decade or so. Commodities experienced a decade where demand grew quicker than supply. Demand came from a combination of surging infrastructure investment in the developing world and increasing financialization in the developed world. This put upward pressure on

[5] http://www.businessinsider.com/janet-yellen-press-conference-sept-17-2014-9

commodity prices during the entire period and climaxed in a wave of neo-Malthusians calling for “Peak Oil” and a permanence to the high prices of commodities.

The problems with Malthusianism are many, with the biggest misses obvious in hindsight. High prices were premised on demand growth consistently outpacing supply. While demand continues to grow, the rate of growth has slowed down. More importantly, high prices led to investment in increased supplies and technologically based alternatives (with fracking being an intriguing combination of both supply-driven investment and technological innovation).

The concept of regime change is not receiving the due respect it deserves; though, this is typical. When something lasts for a decade—as the surge in commodity prices has—it is far easier to extend a trend in perpetuity than to position for a reversion to a longer cycle (think 100 years) mean. The status quo of a decade long trend is mentally challenging to part with. Yet, in reality, a “permanently high plateau” in prices (sorry for the misappropriation of the infamous quote Irving Fisher quote, but it perfectly applies here) as had been called for in commodities is the exception, not the norm.[6]

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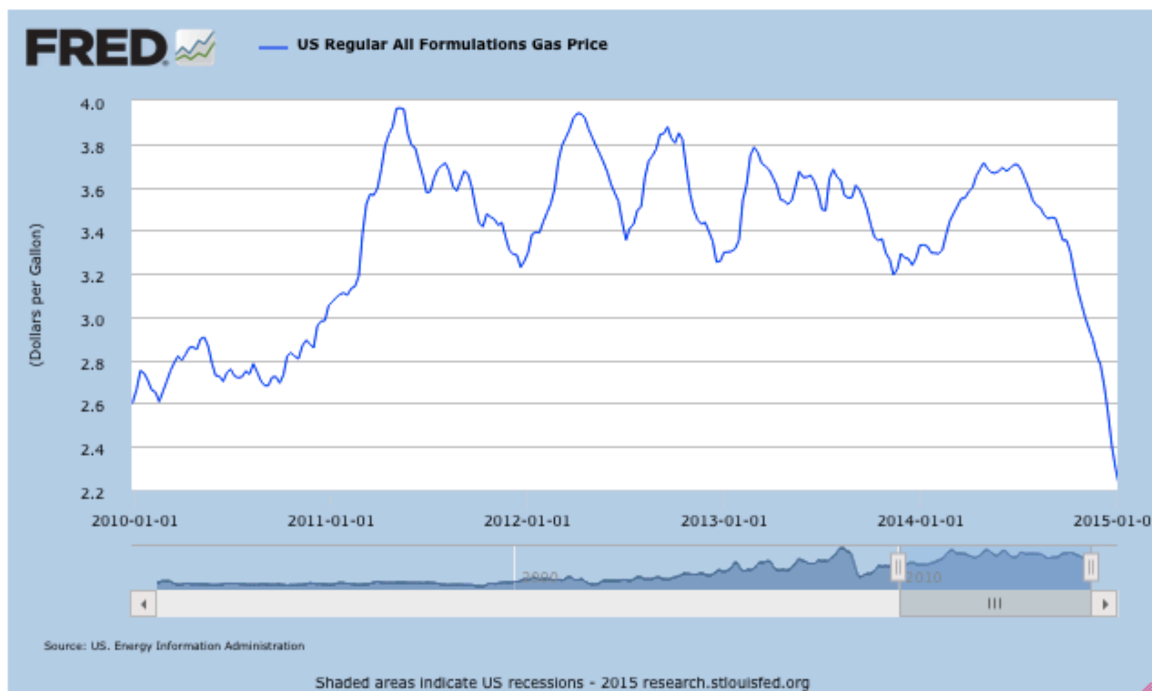
[6] https://www.youtube.com/watch?v=y4oMStJevCw

Consumers will feel the savings from cheaper commodities in many different ways. While some worry about the lack of CAPEX spending that results both directly and indirectly from investment in commodity supplies, the benefits in nearly all respects outweigh any reason for concern. This is most evident in the price of gasoline at the pump:



(Source: http://research.stlouisfed.org/fred2/graph/?g=VWk)

In the coming year, global citizens will spend far less on fueling their cars, heating their homes and powering their electronics. This money will be split between increased spending in other areas and increased savings. The benefits of cheaper oil will be most pronounced for households with the highest marginal propensity to consume. Such spending has a high multiplier for the economy and down the line will provide a strong buoy for growth.

What now serves as an unexpected consumer surplus ready for spending or investment formerly was profit margin for energy producers. With much of the world's oil supply dominated by state-funded enterprises, these funds were not spent or saved in a way that was beneficial to the U.S. economy. In many respects, the producer surplus these sovereigns enjoyed were wasted as reserves hoarded to accomplish monetary, fiscal and ideological policy goals. Hoarded reserves act as a

suppression of demand. With oil producers now forced to dip into their stashed savings there will be a new round of dollar-based savings unleashed as demand. Latent, in other words, will turn patent.

2015: The year Europe finally embraces policies for growth?

For a long time the powers that be in Europe wanted a cheaper euro. Today we have that cheaper euro, yet its actuality is stoking fears amongst investors and pundits alike. The surest sign to us that these fears are unwarranted comes from the convergence in sovereign interest rates across countries (excluding Greece)

(Source: Bloomberg)

This purple line on this chart is the important one for it represents Germany's 10-year bond yield. The white line is Spain, the yellow is Portugal and the green is Italy. During the depths of the crisis, there was huge space between Germany and the other three countries. This divergence in yields represented the risk premium the market was assigning to Spain, Portugal and Italy relative to the safest European country—Germany . While only Spain is now an equal of Germany as far as 10- year yields are concerned, Italy and Portugal have moved a long way towards convergence.

This is a fundamental change for policy endeavors moving forward, and private sector credit access and stability. The fears today are primarily about growth, whereas the fears yesterday were about viability. In the peak of the European crisis, policy efforts focused on taking the euro from the brink of demise to some kind of stability. Today's efforts can be aimed towards growth without the overhang of

collapse. Clearly at some point a lack of growth can become a problem that imperils viability; however, that is a two-step process whereas before the Eurozone was literally staring at the abyss.

While 2015 begins with many fearful of another acute phase of crisis for the content, we are much more sanguine. Notice however that we left our preface to this section an open question rather than a statement. We are quite confident that Mario Draghi will do what is necessary at the ECB; however, in a high stakes situation with national pride on the line, one can never speak with absolute certainty. The fact is, despite Europe's lackluster economic environment today, the earnings outlook for European companies is improving significantly on the backs of a weakening currency (this is a huge boon to exporters) and some catch-up demand on durables. Per Barron's, the range of the earnings growth outlook in Europe runs from six to thirteen percent.[7] Notably, the low-end growth would high enough as to warrant material multiple expansion in European markets. We see evidence of upcoming growth with several of the continent's weakest markets experiencing rising car sales for the first time in over half a decade.[8] We will continue to maintain our overweight posture to Europe with a focus on high quality, global companies.

Yield trade is reaching its limits:

In this low rate world, people have searched for yield wherever they can. Vehicles like MLPs and REITs, and safe areas like utilities and consumer staples have become incredibly popular for their stable, growing yields. Needless to say, these yields are as compressed relative to their historical ranges as can be. To simplify this point, there is literally no upside left from further yield improvement. All upside must come from growth here on out. Meanwhile, growth is threatened in many ways for the two most popular yield trades. Energy infrastructure benefited from a massive build out that was reaching its limits even before oil collapsed. With growth CAPEX set for a severe cut from the energy industry, there is little reason to expect upside from the extremely popular retail trade long the energy-MLPs. This is an area in which we foresee much pain.

In utilities, the business model is under its biggest threat in years—this threat is two-pronged. Energy consumption has been on the decline for the first time in ages as investment in technological efficiency come to fruition. Further, new sources of

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[7] http://online.barrons.com/articles/european-stocks-could-rise-10-1419655992?mod=BOL_hp_we_columns

[8] http://www.inautonews.com/europe-car-sales-up-in-december-in-spain-and-italy#.VKrhPmTF8IQ

energy like solar change the nature of the game. Utilities must pay to maintain the grid for energy distribution, yet do not get the revenues commensurate with that portion of energy consumption. While solar is still in its early stages of adoption in the US, it is accelerating tremendously and its potential disruption is growing nearer. The valuations in utilities are downright frightening heading into 2015.

What do we own?

While the New Year period is an arbitrary time to review the past and look towards the future, we welcome any good opportunity for reflection. At the end of Q1 2013 we introduced this section featuring our three best and three worst performers. As time marches on, due to our limited turnover and the presence of a few volatile securities within our portfolio of 25-30 holdings, this section has functioned differently than our intent. Specifically, the same few securities have ping-ponged back and forth between the leaders and laggards, leaving us covering the same companies over and again. Moving forward, we will simply list our three best and worst performers each quarter, while focusing the written portion of this section on our one or two favorite ideas that we subjectively determine are worthy of elaboration. A great subjective determination would come from a client request to cover a given security, so we welcome any and all feedback on a) how you would get the most value out of this section; and, b) what specific stocks you would like to learn more about. Please do reach out to us with any thoughts or suggestions.

The Leaders:[9]

Platform Specialty Products (NYSE: PAH) +64.0%

Teva Pharmaceuticals (NASDAQ: TEVA) +48.7%

Walgreens Boots Alliance (NASDAQ: WBA) +33.9%

The Laggards:

UCP Inc. (NYSE: UCP) -26.8%

Siemens AG (OTC: SIEGY) -16.7%

The New York Times Co (NYSE: NYT) -15.7%

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[9] Please note: these are not the 2014 returns for each security. Returns are reflected from our point of purchase or sale and only cover our holding period.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

Jason Gilbert, CPA/PFS, CFF
Managing Director
O: (516) 665-7800
D: (516) 665-1940
M: (917) 536-3066
jason@rgaia.com

Elliot Turner, CFA
Managing Director
O: (516) 665-7800
D: (516) 665-1942
M: (516) 729-5174
elliot@rgaia.com

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