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INVESTMENT COUNSEL

2014 SUMMER INVESTMENT OUTLOOK

For the second time since the recession officially ended in June of 2009, the U.S. economy recorded a quarter of negative economic growth. First quarter gross domestic product contracted at a 2.9% annual rate which was reminiscent of the negative 1.3% growth in 2011's first quarter. Periodic setbacks are not unusual during expansions and it would appear that economic growth has bounced back in the current quarter. Further modest gains are predicted for the balance of 2014 which has fueled investor optimism and rewarded stock market participants with a high single digit total return thus far this year. This builds on the over five year gain in the market which has nearly tripled in value since the lows reached in March 2009.

The current stock market advance is in its 64th month having risen over 190% making it the fourth longest and fourth strongest bull market since 1945. Several factors have contributed to the ongoing rally in common stock prices. Investors remain confident that continued modest economic gains will allow for sustained corporate profit growth with a consensus estimate of high-single digit earnings growth predicted for the current year. Domestically, the important housing and job markets continue to improve. Federal Reserve policy remains very stimulative in this country which has been a key, and perhaps underappreciated, underpinning for common stock prices. Foreign central banks, too, continue to favor pro-growth monetary policies primarily by keeping interest rates low. This benefits the overly indebted by allowing them to refinance existing liabilities, helps promote new borrowings thus aiding economic growth and encourages investors to "go out on the risk curve" in search of returns. This last phenomenon has been a crucial factor in pushing down interest rates globally on a wide range of risky debt securities including troubled sovereign credits such as Greece, Spain and others, as well as on junk rated corporate debt.

Stock investors have also benefited from these policies as marginal investment dollars have flowed into equities both here and abroad. As shown in the chart below, broad market year-to-date gains as measured by the S&P 500 are above long term average historical returns on an annualized basis while the other indices are also displaying solid results thus far in 2014.

<u>Year-to-Date Market Returns (excluding income)</u>

	6/25/14 Price	Change From Year-End
Dow 30 Industrials	16,868	+1.8%
S&P 500	1,958	+6.0%
NASDAQ Composite	4,377	+4.9%
MSCI ACWI-exUS*	290	+3.2%

**MSCI All Country World Index excluding U.S.*

Near and Intermediate Term Outlook

On a long term basis, common stock prices follow the trend in corporate profit growth which, in turn, is closely related to underlying economic growth. Therefore, having an idea where the economy is heading can offer some clues for investors. Of course many other factors are also relevant to the future direction of common stock prices, perhaps most importantly starting valuations levels, so making an economic forecast is merely one step in the process. With regard to the economic outlook, a continuation of positive, but below average, growth is the most likely scenario in the coming quarters with a consensus estimate of full year GDP growth approaching 3%. Given the negative growth posted in the year's first quarter, this forecast may prove to be optimistic but, nevertheless, the economy should experience a full year expansion at a 2% plus rate.

The housing market is an important contributor to broad based gains in the economy due to the related business activity it triggers and recent news on this front has been positive. While full year existing home sales (approximately 90% of total home sales) are predicted to be down some 3% from 2013, the recent trend has been upward with the May figure up 4.9% to a seasonally adjusted rate of 4.89 million homes, the highest rate since October. Meanwhile, new home sales rose 18.6% in May to an annualized rate of 504,000, a six year high. Other positives include rising home prices and fewer homeowners with negative equity. If these trends continue, there is hope that the recent downturn in building permits and housing starts reverses course in the months to come. Mortgage rates have been on a slightly downward trend for much of the past year with the current rate on a 30 year mortgage at about 4.15%, down from approximately 4.50% last September, and this has certainly contributed to recent signs of strength in this market.

The job market, too, has shown signs of improvement as the unemployment rate has fallen to a five and one half year low of 6.3% while the economy has regained all the jobs lost in the last downturn. Non-farm payroll employment reached a new all-time high level of 138.5 million, surpassing the 138.4 million record reached in January 2008. Admittedly, the labor force has grown during this period by nearly 1.6 million people so, after adjusting for this factor, there is still some ground to be made up before victory on the jobs front can be declared. In another important step in the recovery, the long term unemployment rate (those out of work for 15 weeks or more) has fallen below the short term unemployment rate (those out of work for under 15 weeks) for the first in time five years. It is likely that some people have become discouraged and have stopped looking for work (and therefore do not count as being unemployed) which would artificially lower the long term unemployment rate. Nevertheless, the trend in long term unemployment has been downward reflecting the ongoing modest improvement in the job market. Despite these gains there continues to be slack in the labor market as evidenced by weak wage growth. In the 12 months ending in May, average hourly earnings rose only 2.1% which matched CPI inflation over that same period leaving the average worker no better off in inflation adjusted terms.

U.S. corporate profits remain in a modest growth mode which has provided support to common stock prices this year. As noted above, interest rates remain low which has reduced interest expense for corporate America while wages continue to be held in check as the labor market has not returned to full strength yet. Corporate tax rates, too, have moved lower in recent years as more revenues are being earned abroad in lower taxed countries. An extension of this trend has been the recent inclination for entire companies to relocate abroad through inversions whereby a U.S. company buys a foreign one and then elects to change the official corporate headquarters to the country of the acquired company. This accomplishes two important tax saving goals. Specifically, the acquiring company can use its foreign held cash without having to bring it back to the U.S. (and therefore can avoid incurring domestic taxes on those funds) and a significant portion of future earnings can be shifted to the lower taxed foreign country similarly avoiding U.S. taxes. Not surprisingly, Congress has taken note and may enact measures to curtail this type of financial engineering. Until that time, however, this trend will likely gain steam potentially providing meaningful boosts to stock prices of companies that adopt this strategy.

Partially as a result of Federal Reserve policy, broad asset prices have risen dramatically in recent years driven by gains in financial assets and real estate. Creating wealth which would then spur spending which, in turn, was expected to give corporate America reasons to invest in capital and increase hiring thereby encouraging a self-sustaining recovery has been a cornerstone of Fed strategy in recent years. While it could certainly be argued that the Fed has achieved a measure of success in this regard, what remain unknown are the unintended consequences of this “easy money” policy. Certainly, for the estimated one-half of Americans who do not own stock and one-third who do not own a home, this wealth effect has provided little comfort. Furthermore, over five years into this unprecedented course of action it is clear that the economy continues to require government support and is still is not prepared to fully stand on its own. We tend to agree with the sentiment offered in a recent essay penned by former Fed governor Kevin Warsh and famous investor Stanley Druckenmiller who caution that these financial asset gains have not fully translated into the real economy and may prove fleeting. “Balance sheet wealth is sustainable only when it comes from earned success, not government fiat. Wealth creation comes from strong, sustainable growth that turns a proper mix of labor, capital and know-how into productivity, productivity into labor income, income into savings, savings into capital, capital into investment and investment into asset appreciation.” We would feel more optimistic if this type of entrepreneurial led, self-sustaining growth had taken root in the economy and that recent gains were less dependent on government fiscal and monetary stimulus.

We have concerns that one unintended result of the recent course of action has been that investors are becoming complacent to the potential hazards in the current environment. Accommodative Fed policy has encouraged investors to accept elevated levels of risk in their portfolios driving up prices on many types of financial assets. Relative to long term corporate earnings, broad stock market prices appear fully valued today. Nobel prize winning, Yale economist Robert Shiller favors a ten year average price/earnings ratio and by this measure stocks have only been more expensive three times in history: the late 1920s, the late 1990s and the middle part of the first decade of the 2000s. In each of these instances, stocks went on to experience notable declines so investors would have been wise to exercise some caution. Certainly, low interest rates and the absence of wage pressures have contributed to ongoing gains in corporate earnings in this cycle and this is supportive of higher stock prices. However, we are keen students of history and therefore are suspicious of the various “this time it’s different” arguments. While the current trends are undeniable, it remains to be seen how long these trends can continue. One thing that is not different is that corporate America is buying back stock at a near record pace with first quarter repurchases of $154.5 billion. Regrettably, corporate leaders have a relatively poor track record with share repurchase activity as buybacks tend to peak when the market is elevated and cease when share prices fall. In fact, the last time buybacks were this high was in the second and third quarters of 2007, just prior to the last market downturn.

Other warning signs exist in the current market. Initial public offering volumes are increasing with the percentage of companies going public with negative earnings approaching the record highs of the technology bubble era. Insider selling, margin loan debt, junk bond issuance and covenant light loans (i.e. loans lacking typical investor protection clauses) are all increasing. In April of this year the largest junk bond sale in history came to market when a French cable firm raised nearly $11 billion. It is also interesting to note that money has been flowing out of emerging markets this year and finding its way into the so called frontier markets. These countries are one notch lower on the economic development scale than the emerging markets indicating that investors are taking on even more risk in search of returns.

Investors should also keep an eye on geopolitics. While it is impossible to predict exactly how or when geopolitical developments may impact the financial markets, it is worth noting the number of potential flashpoints around the globe. Key among them include both China and Russia flexing their muscles in their respective neighborhoods and rising internal conflicts in the Middle East.

Investment Conclusions

While the path of least resistance would appear to be for the economy and stock market to continue their advance in the coming months, we recommend investors take inventory of their specific situations, assess risks to protect capital and act accordingly. It is important to set asset allocations keeping long term goals in mind while maintaining sufficient liquidity to meet short term needs and also maintaining buying reserves to take advantage of opportunities that may develop.

As noted at the outset, the stock market has nearly tripled in value over the past five plus years. With modest economic and corporate profit growth expected in the coming quarters, it is not surprising that investors are focusing on achieving further gains in their portfolios and have become complacent towards the risks in the current environment. In times such as these, however, investors would be wise to remember the words of investment pioneer Paul Cabot who penned the following in State Street Investment Corporation's 1927 annual report: "Only a reckless optimist could assume that the past four years might be taken as a fair indication of the future course of stock prices over a similar period. The successful handling of funds during the year 1928 will require a greater display of intelligence and more thorough investigation and patient research than has been necessary in the past…A successful investment trust must be able not merely to accept profits in a rising market, but also to curtail losses in a period when securities are declining. The latter phase has not demanded much attention as yet, and when it does it may be found surprisingly difficult to accomplish."

While Paul was early in predicting the market's downturn, his caution was warranted as the investor optimism of 1927 led to rampant speculation in 1928 paving the way for the market crash which began the following year. Paul had the patience and discipline to not get caught up in the euphoria of the day which served his clients well when the inevitable downturn arrived. His focus on managing client funds *through a full market cycle* was one critical determinant to his long term success. While making no prediction on the near term direction of the stock market, we concur with this timeless investment strategy of long term focus and protecting client capital when markets become frothy.

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