MARKET COMMENTARY **April, 2015**

Q1 2015 Market Overview

U.S. equities were up slightly in 1Q 2015. The S&P 500 returned just under 1% as the markets digested moderately disappointing economic data and interest rates actually fell contrary to most expectations coming into the year. The choppy, sideways trade has been accompanied by a lot of media and investor angst, but represents a healthy process of consolidation after five years of extraordinary gains. Market attention has been fixated on two primary concerns, when the Fed will raise rates and the consequences of the rising dollar. It fears the impact of each to the economy and to equities. History, however, indicates that neither development is so one sided, and actually provides some reason for optimism. While the impact has yet to be resolved (and we will offer our opinion below), the underlying trends of relative U.S. economic strength and dollar strength, low global growth rates, and below norm interest rates should continue to characterize the market environment for the foreseeable horizon.

Global Monetary Policy and Its Implications

The ECB (European Central Bank) and BOJ (Bank of Japan) were later to apply aggressive expansive monetary policies and face even greater challenges in stimulating growth than did our Federal Reserve when it began its program of quantitative easing in 2009. This past year the phenomenon has expanded beyond the OECD, with the key emerging markets of China and India also moving to aggressively ease. Taken collectively, it's probably fair to say that central bank balance sheet expansion along with zero interest rates in the world's leading economies represent the most stimulative monetary policy in history.

The implications of Europe's monetary experiment are already influencing financial markets and the global economy in unexpected and potentially game changing ways. Just two weeks ago, Switzerland became the first nation to ever sell 10-year debt at a yield below 0% (investors are actually paying to hold the Swiss government bonds). The Swiss case is not an isolated one. The German 5-year bond has a negative yield and its ten year bond has declined to .09% from 2% just over a year ago. Even Spain, once thought to be at the verge of fiscal collapse, is now able to sell short-term Treasury bills that give investors back less principal than they invest – essentially charging investors and banks to hold their money.

In another landmark event in this era of "easy money", Mexico opportunistically took advantage of the ECB's largesse and became the first country to issue a 100-year bond denominated in Euros (at a yield of 4.2% if anyone is anxious to buy).

Negative bond yields and ultra-low rates also reflect a lack of confidence in near and intermediate term economic growth. German bond yields at $1/10^{th}$ of 1% have profound implications for the global economy and markets: U.S. rates are constrained (the U.S. 10 year bond is down from about 3% in early 2014 to 1.85% at the end of 1Q15 and the yield curve has flattened significantly); corporate deal making is encouraged by the ease and low cost of capital; and global growth prospects are temporarily enhanced.

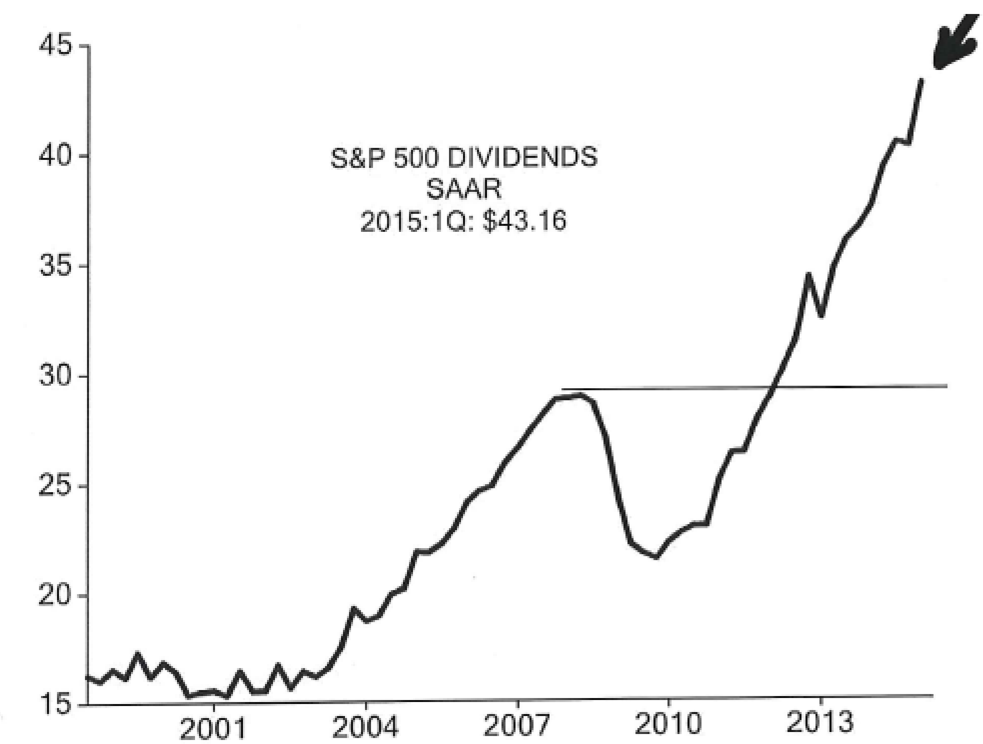
Over much of the past 6 months the market has been preoccupied with the Federal Reserve and the question of when it will begin to raise interest rates. Chairman Yellen is not only intellectually dovish in her monetary views, but we expect her to be a gradualist in style and approach to hiking. Expectations for both growth and inflation have been tempered over the past few months, so while the Fed may raise rates later this year, the timing of that decision and the pace of future rate hikes will be data-dependent. The initial rate hike is likely to be in September and then very gradual and dependent on both economic and market responsiveness over time. U.S. monetary policy is also expected to remain highly stimulative for a considerable period even as the Fed moves away from zero interest rates.

Historically, stocks have actually performed reasonably well during periods of Fed tightening and rising rates. In 15 of the last 17 tightening cycles since 1927, stocks have produced gains following the first hike through the duration of the period of rising rates. Most recently, the S&P 500 rallied during the 1994-2000 and the 2004-2006 Fed tightening periods. Going further back to the last time that interest rates were as low as they are today, the 10 year U.S. Treasury note rose from 1.65% in 1949 to 5.5% in 1966. During this same period stocks experienced the great post WWII secular bull market, compounding at a rate of almost 12% over the 17 year period. The key is whether interest rates are going up for the right reason - i.e. economic growth and earnings are getting better over time.

<u>Corporate Liquidity and Shareholder Total Return</u>

We have always been believers in the power of dividends and dividend growth. Of note, despite a slow earnings growth environment dividends have surged. While current earnings growth is modest at best, according to ISI, S&P 500 dividends are up 14.8% year over year in the first quarter, 2015.

<u>Dividends for Q1 Surged 31% q/q and are up 14.8% y/y.</u>



Source: Evercore ISI

Liquidity is the hallmark of the large dominant US and multinational corporations. They enjoy large cash positions, robust balance sheets, and, frankly, limited investment opportunities. Since February 2014, there have been almost 900 deals totaling roughly $6 trillion in total announced transactions value. For example, in April 2015, Royal Dutch launched an acquisition valued over $85 billion for BG Group; and a few weeks earlier, in a deal backed by Warren Buffett's Berkshire Hathaway, Heinz agreed to buy Kraft Foods in a $36 billion merger to create one of the world's largest food companies.

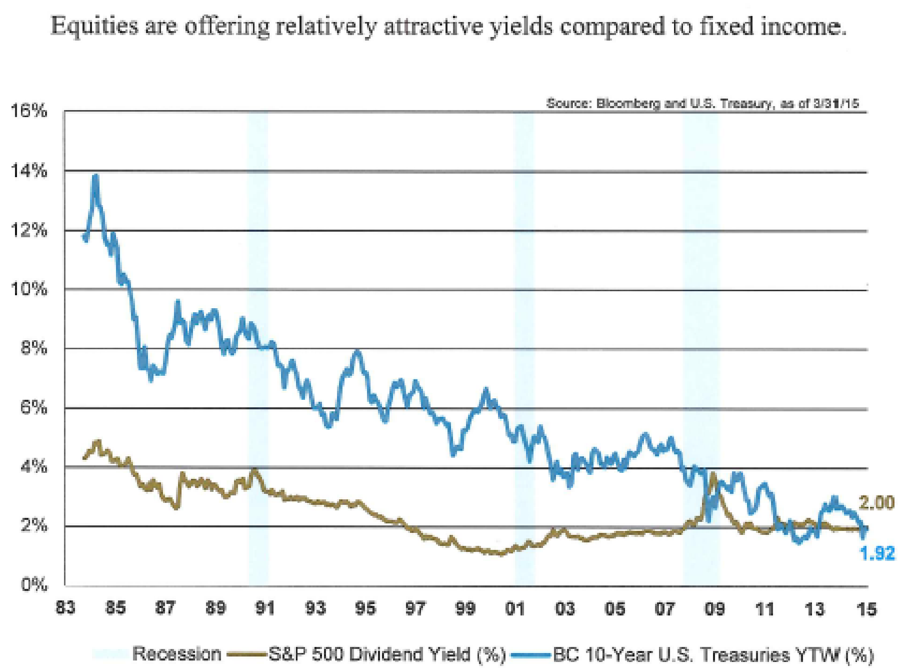
Likewise, in an effort to generate better internal growth and returns, many companies are reorganizing their businesses. General Electric is currently in the process of selling off most of the components of its massive financial services, real estate capital and banking assets, to be completed before year end 2016. According to management, they intend to repurchase up to $50 billion in stock with the proceeds, almost 20% of the company at current levels, and return over $90 billion to shareholders through share buyback, dividends and spin-offs. At the end of the day, GE should look and trade like a premiere diversified global industrial giant.

These trends only reinforce our belief that dividend growth, share buybacks and restructuring will be a significant driver of our portfolio returns. Dividends and dividend growth stand in stark contrast to other investment alternatives. As discussed, German and Swiss bonds now have negative yields, unheard of in history. Money market yields are insignificant and US Treasuries yields remain woefully low and do not grow. Investment funds should continue to migrate to equities and dividend growth as other investment alternatives remain comparatively unattractive.

<u>Relative Yields and Equity Market Valuation</u>

Despite a surge in dividends and the fact that equities offer historically attractive yields relative to fixed income, investors remain skeptical. Investors have pulled $23 billion out of equity funds year to date and put $48 billion into bond funds according to Morningstar. Hedge funds net exposure to equities has also declined to below the mid-point of its historical range (ISI Hedge Fund Survey).

<u>S&P 500 Yields Vs Treasury Yields</u>



Source: Bloomberg

As we have previously discussed, the US market continues to be influenced and characterized by four factors: a strong dollar, slow economic and earnings growth, low interest rates and globally stimulative monetary policy. We believe that domestic US companies are adjusting to the stronger dollar and that earnings growth should improve in the second half of 2015, while it appears the market assigns little more than nominal growth prospects to stocks. The S&P 500 currently trades at about 18 times earnings for both last year's trailing earnings and this year's future earnings, a slight premium to the 50 year Bloomberg average of 16.5 times earnings.

While earnings growth expectations are muted, we would caution against a wholesale dismissal of prospects for positive investor returns in stocks. If the perception emerges that low rates, slow growth, global liquidity and orchestrated monetary stimulus are here for a while, stock valuations could expand. There have been other times in market history where this upward valuation convergence has favored investors.

US Economic Strength and the Dollar

Strong nations often have strong currencies, but the market has been particularly concerned about the negative impact of a rising dollar. Market preoccupation over dollar strength has rivaled that expended over the issue of when the Fed will raise rates. Media headlines warn that a rising dollar is bad for the economy, bad for earnings, and bad for stocks. This is only part of the story, and like most economic developments, the influence is complex and not one sided. Using history as a guide, both the U.S. economy and stocks have done well during periods of dollar strength.

On one hand, dollar strength represents a significant headwind for oil prices and global commodities which are all priced in dollars. It also exerts pressure on export driven and foreign earnings of multi-nationals (particularly in the early stages of periods of dollar strength) On the other hand a strong dollar, also attracts global capital, restrains inflation and lowers input costs, keeps interest rates low and biased downwards, and over time forces local manufacturers to become more productive to remain globally competitive. These trends, along with consumer benefits from lower priced energy and gasoline, are all at least partial offsets to the earnings pressures from increasingly competitive foreign markets. So, somewhat counterintuitively, during the last two major dollar rallies, both lasting five years, both GDP and the S&P 500 actually did well.

	Periods of Dollar Strength		
	1981-1985	1996-2000	Avg
Real GDP Average	3.4%	3.8%	3.6%
S&P Cumulative	48.0%	100.0%	74.0%
DXY Dollar Index	87.0%	46.0%	66.5%

Source: Bloomberg and Evercore ISI

Dollar strength should ultimately be viewed as a reflection of U.S. competiveness and financial strength in an increasingly challenged global economic environment. Given the relative value proposition offered from equities, continued supportive global monetary policy, and the compelling historical perspective dispelling a call for panic over a rising dollar, we believe the U.S. equity market remains attractive and can continue to outperform fixed income and other global capital market alternatives.