Observations and Outlook

July 17, 2014

Through June 30, 2014:

Stocks:
- Dow Jones Industrials: +2.68% S&P 500: +7.14%
- Russell 2000 (small caps): +2.49% (has been up 5.7% and down 5.7% twice this year)
- Emerging Markets: +3.4% after recovering from -11.36% the first two months of the year

Bonds:
- Barclays Aggregate Bond Index: +3.5%
- 20+ Year Treasury (TLT): + 13.15%
- High Yield Bonds (JNK): + 6.42%
- High Grade Corporate (LQD): +7.79%

Commodities:
- Gold (GLD): +10.96% (Gold has been volatile year to date, rising almost 16% and falling by more than 10% through June)
- Oil (OIL): +9.88% (Oil initially fell by almost 7% early January and has climbed substantially from then.)
- Agriculture (DBA): +13.24% (also very volatile having been +22%, but falling since May)

The 10yr Treasury yield has fallen from 3.03% on December 31st to 2.52%, making it a positive year for bonds and very positive for longer dated bonds. Given the price movements in stocks and bonds, moderate to conservative portfolios have benefitted the most while investors who held smaller stocks and shorter maturity bonds have seen lackluster and volatile performance.

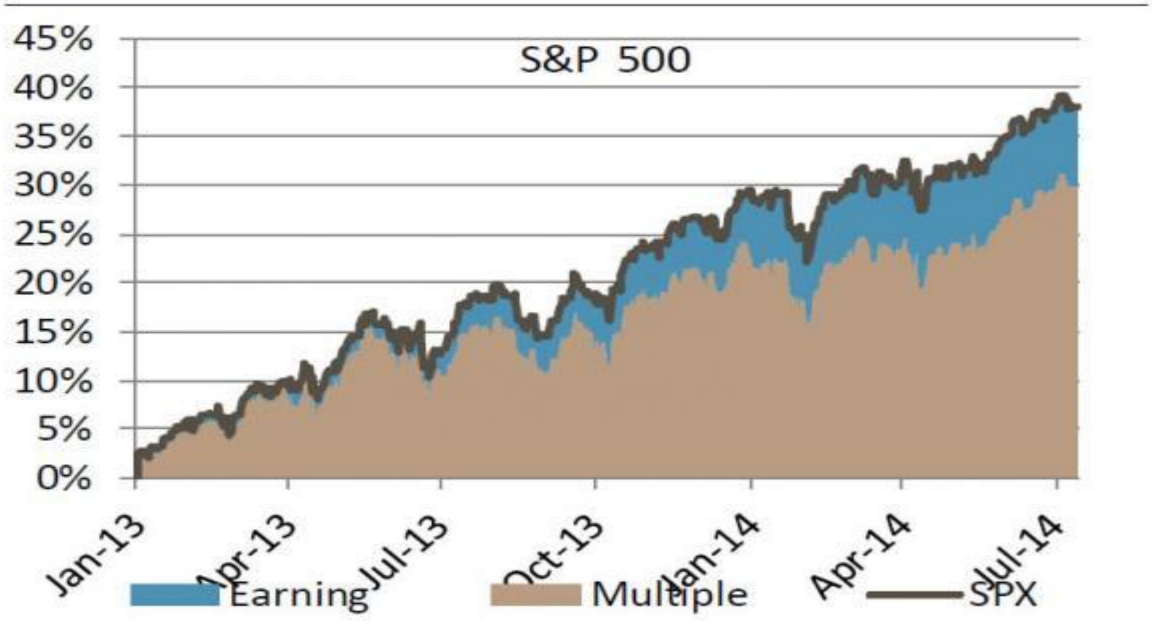
At the end of 2013 it was widely expected for equities and the big momentum movers of 2013 would continue to do well and that interest rates would rise, as a result of a an expanding economy and the Federal Reserve reducing its bond purchases. In fact, GDP the first quarter fell by 2.9% and while the Fed has tapered its bond purchases we are seeing a repeat of interest rate behavior the last few times when a given round of QE has ended, generally down.

While the month of June saw small cap stocks turn positive on the year, and large cap stocks catch up to high grade corporate bonds on the year, we have seen the larger trends evident the first five months (and forecast here previously) reassert themselves since July 3. All the major equity indices hit new highs for the year that week. From that point forward long dated bonds have outperformed and small cap stocks fallen while the blue chip stocks have remained elevated. I think this will likely be the story for the rest of the year.

The 2.9% GDP contraction in the first quarter was significant. It is amongst the 25 worst single-quarter contractions in the past 40 years. The other 24 in this group were all a part of a recession. This does not mean we are in a recession, but we may be as the official definition of a recession is two consecutive quarters of 'negative growth', or contraction. Unfortunately, by the time we are informed we are in a recession, it will probably be obvious.

There has been one primary driver of equity prices since the start of 2013: Price to Earnings Multiple (P/E) expansion. An expansion in the ratio means that prices have grown faster than earnings. The price level of the SP500 was at 1460 January 2013, and grew by 27% to 1850 by the end of December 2013. Trailing 12 months earnings grew from $86.51 to $100.20, a 16.2% increase over the same time period. The most recent six months have seen earnings grow by 2.89% while prices grew by almost 6%. So we see the P/E ratio remaining somewhat stable and earnings growth slowing. A high P/E ratio often means investors are still expecting earnings to increase rapidly to justify paying such a high P/E 'price'. The question really is will earnings grow and will investors continue to pay such a high price?

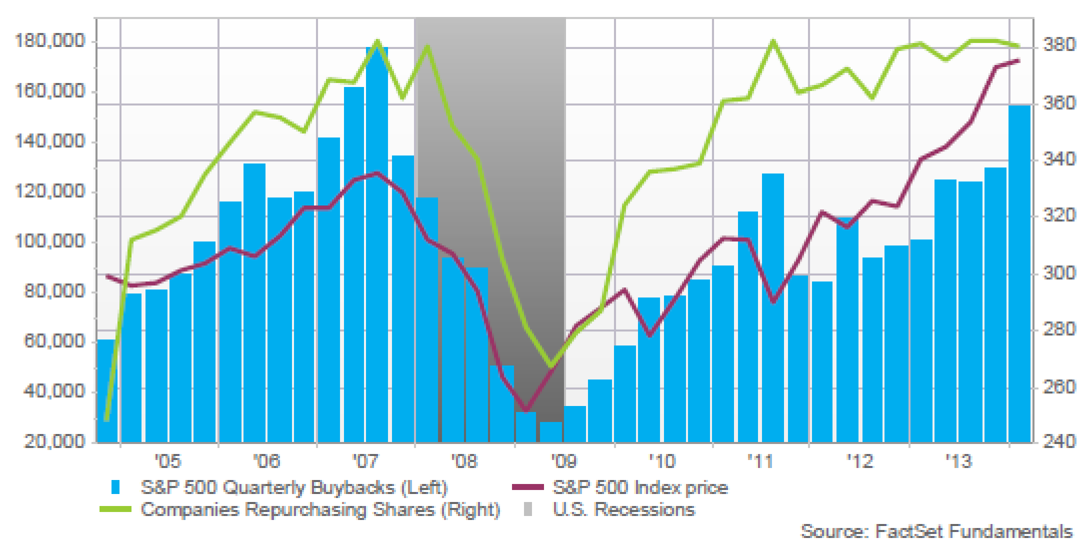
Figure 6: Since Jan-1 2013, 80% of the rally is due to P/E expansion, in Q2 this year more than 95% of the rally was P/E expansion



Source: UBS

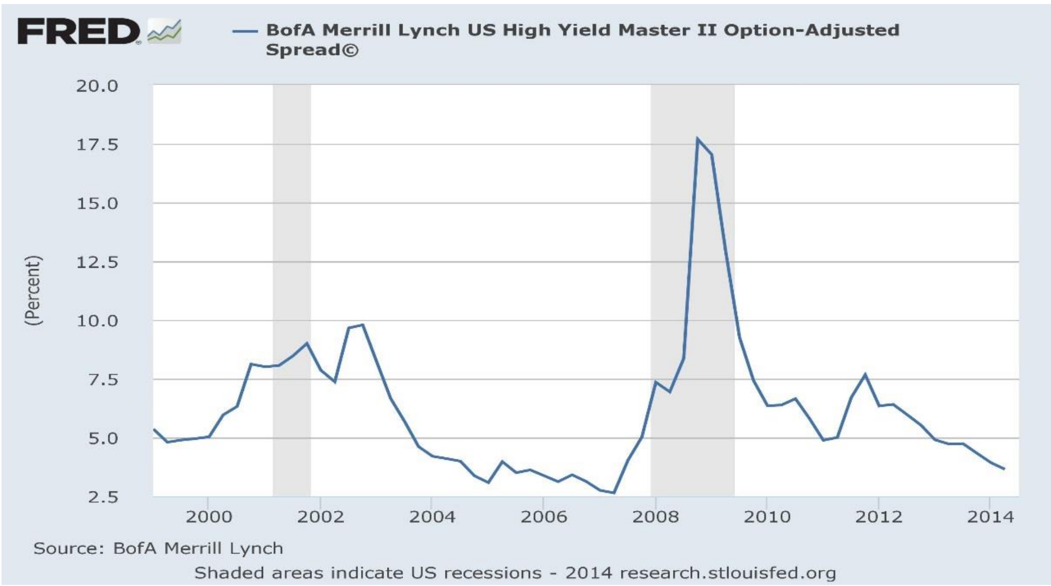
Earnings per share, which is the figure used when finding the P/E number, has been boosted by the massive share buyback programs many companies have been pursuing. When there are fewer shares outstanding the earnings are spread amongst fewer shares, boosting the earnings per share. In 2013 $477 billion were spent on repurchases, the most since 2007. 2014 is seeing an increase of 34% over last year. Additionally, these buybacks have been funded to a large extent by new debt. Companies are leveraging up not to invest for future growth, but to send money back to shareholders. Because the debt has to be paid back, firms are spending future income to pay shareholders today, in order to increase EPS numbers.

Quarterly Share Repurchases ($M) and Buyback Yield (%)



The take away is that even though the SP500 is hitting all time highs, the price increase is not being matched by true fundamental factors. Prices have substantially outpaced earnings, and we are now seeing a slowdown in earnings along with negative GDP. Companies are borrowing and using far more than their free cash flow for share buybacks, increasing firms' leverage. Leverage is a double-edged sword that magnifies Return on Equity, in both positive and negative directions. The markets are getting into a position of overvaluation and fragility where a decline in profits, share buybacks, or investor sentiment could have significant negative repercussions.

The weakest companies will be first effected by continued economic contraction. These low rated companies issue high yield or 'junk' bonds. An early warning, in my opinion, would be so see interest rates move up for junk bonds (prices lower) while Treasury yields remain anchored. The high-yield sector is by far the most overvalued asset sector, shown by interest rate spreads paid by junk bond issuers at the lowest since 2007.



If one considers that markets don't go up indefinitely, many valuation metrics show equities to be overvalued, we are five years into a business and market cycle, all the while the Federal Reserve has been injecting massive amounts of liquidity—but slated to end in October; perhaps one might start thinking about how to protect portfolios and limit volatility. Unfortunately, the stock market is one of the few markets (in addition to Florida real estate) where higher prices attract more buyers, hoping to duplicate the recent past's returns into the future. Often people are more concerned with missing the next, sometimes last 5% up, rather than avoiding large declines. I advise clients to forget about market returns and focus on what returns are necessary to them personally, to achieve their financial goals.

Adam Waszkowski, CFA
awaszkowski@naplesam.com
239.410.6555

This commentary is not intended as investment advice or an investment recommendation. Past performance is not a guarantee of future results. Price and yield are subject to daily change and as of the specified date. Information provided is solely the opinion or our investment managers at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Information provided has been prepared from sources deemed to be reliable, but is not guaranteed by NAMCO and may not be a complete summary or statement of all available data necessary for making an investment decision. Liquid securities, such as those held within managed portfolios, can fall in value. Naples Asset Management Company, LLC is an SEC Registered Investment Adviser. For more information, please contact us at awaszkowski@naplesam.com.