HAVERFORD

# 2015 SUMMER OUTLOOK

## Déjà vu: Slow, Steady Expansion

This summer, the economy will enter the seventh year of an expansion that began in mid-2009. In terms of longevity, the current expansion is above average when compared to previous business cycles since WWII. But in terms of aggregate growth, this expansion ranks last. This could be good news! The sub-average growth the economy has experienced — the so-called 2% recovery — may in fact be cause for an extra-long expansion. Simply stated, there has not been enough growth to create the excesses — inflation, inventory builds, employment, etc. — that would normally lead to a recession. Yet the economy's strength is broad enough to sustain external shocks.

The business cycle is important to the equity market. The current bull market entered its seventh year this spring making this bull market both longer and stronger than average. Bull markets do not end because of age. They almost always end in anticipation of the next recession. The traditional economic signposts are not flashing any warning signs of an impending downturn. Inflation remains contained. Employment trends are positive. Consumer confidence continues its uptrend. And the yield curve is positively sloped, not close to inverting. When these trends reverse, there is typically a multi-year lead time before a recession.

As was the case last year, first quarter 2015 GDP growth was again negative. And like last year, the negative print had to do with transient factors: severe weather in the Northeast, the West Coast port strike, and declining net exports. Interestingly, since the expansion began in mid-2009, first quarter GDP growth has averaged 0.4%, while the remaining three calendar quarters have averaged 2.8% growth. There may be some faulty seasonal adjustment causing this anomaly[1], but we expect the trend of better second quarter and second half growth to continue this year based on several fundamental factors. The housing sector

All performance data as of June 8, 2015 unless otherwise noted.

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is looking better. All key indicators of housing activity — housing starts, existing home sales, new home sales and pending home sales — are improving. Housing, a headwind for much of this expansion, can lend an outsized boost to GDP growth through the direct effect of residential investments and the indirect effect on consumer spending. With new homes and apartments comes the purchasing of furniture and appliances.

Auto and truck sales continue to increase. Annualized unit sales are trending above 17 million. If this trend holds, it will be the best year since the early 2000s. Domestic manufacturers have announced a reduction in their normal summer factory shutdowns in order to meet consumer demand. Despite the strong sales over the past two years, the average age of vehicles on the road continues to be at an elevated eleven years. This bodes well for pent-up demand.

The employment picture remains positive. Initial jobless claims continue to trend down and are at a 10-year low. The US economy has added more than three million jobs over the past 12 months for the first time since the middle of 2000. Monthly job growth is averaging 250,000, and wage growth continues to slowly improve.

**Annual Employment Growth above 3 Million**

Source: FactSet Research Systems

There are some notable headwinds keeping the US economy in check. The stronger dollar is taking its toll on exports and corporate profits. The collapse in oil prices has taken the shine off the US energy sector. Energy companies have slashed capital spending, and consumer spending has been relatively tepid this year. So far, consumers have been reluctant to spend their "gasoline dividend." Instead, they have chosen to increase their savings and pay down debt. With continued job gains and wage growth we expect consumer spending will pick up in the second half and will serve as an engine for faster GDP growth. The price of oil has rebounded almost 40% from its March low of $43 a barrel and it seems to have stabilized around $60, which is well off of last year's average price of $93. We continue to believe lower oil is good for the consumer, good for most businesses (excluding the energy sector), and therefore good for the overall economy.

This brings us to the most frequently asked question, "When will the Fed raise interest rates?" There are many opinions regarding the Federal Reserve's monetary policy, but from the start of Quantitative Easing 1 in late 2008, it has paid to take the Fed at its word. During recent speeches, Fed Chair Janet Yellen has indicated she would like to raise the Fed Funds rate at some point this year. As always though, the Fed will be data dependent. She has also said it could take several years for the Fed to complete the forthcoming rate hike cycle once it finally commences. Based on our view of a stronger economy in the second half of the year, we expect the Fed to start the rate hike cycle in the fall or early winter. Taking the Fed at its word, subsequent hikes will likely come sporadically (not stair-step), and lower than average rates will likely persist for a long time to come.

1) The Federal Reserve Bank of San Francisco's recently published Economic Letter 2015-16 (dated May 18, 2015) highlights that since the 1990s, first quarter GDP has been over 100 basis points lower than the subsequent three quarters due to seasonal adjustments that may not be fully capturing seasonal fluctuations.

# Equities

## Market Sees through the Headlines

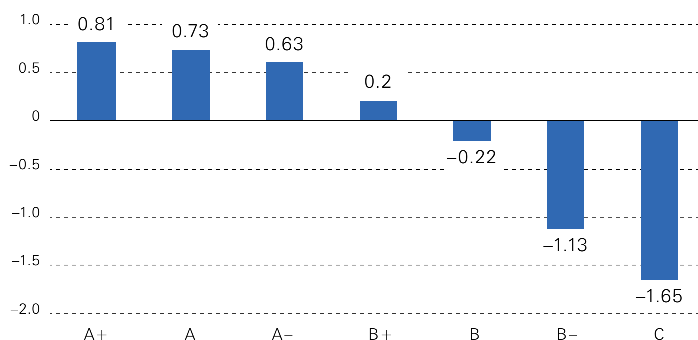
What will the start of the rate-hike cycle mean for the stock market? Not too much, in our opinion. This will have been the most talked about, advertised rate hike in memory. Markets don't usually react to known and highly-telegraphed news; the markets react to surprises. Global events confirm this. Russian aggression, China slowing down, and Middle East tensions are all frequent headlines that are therefore already priced into today's markets.

The equity markets have not had a 10% correction in close to four years. The problems in Europe are well known and are considered old news. Perhaps a Greek default and exit from the Euro, which is not expected by the consensus, will cause a correction. If that were to occur, we believe the correction would be brief and create an excellent buying opportunity. The Greek economy, about the size of Minnesota's, is not too important to the global economy.

The most likely event to end this bull market is a US recession. Not the type of pseudo-seasonally-induced slowdown experienced during the first quarter, but a contraction combined with real weakness in the labor market. For the many reasons highlighted above, we see the probability of a looming recession to be very low. But a prudent investment manager always contemplates the downside risks and seeks to build a portfolio designed to weather adverse markets. The beauty of our investment philosophy is that it places a primary focus on controlling risk, but we can still construct portfolios that provide clients with exposure to most of the financial markets' upside. Nearly every step of our process, from focusing on high-quality companies with predictable earnings streams to properly diversifying the portfolio among multiple asset classes, is intended to control risk to some additional degree. Each of these risk-controlling steps, when put to work in a portfolio, is designed to reduce the risk of the overall portfolio.

A recent report published by Strategas Research Partners demonstrates the defensive characteristics of high-quality and dividend paying stocks. During periods of negative market returns the attributes of quality and dividends shine through. During the past 25 years, there have been 107 months in which the S&P 500 declined. During these months the highest quality stocks outperformed, as did higher dividend paying companies. High-quality stocks (i.e., stocks rated "A" by Standard & Poor's Quality Ranking system) provided positive returns during 19 of those negative months and outperformed the market by an average of 72 basis points per month. Companies paying meaningful dividends provided similarly strong returns during down markets (see accompanying chart.) These results are consistent with the historical observations of Haverford's Quality portfolio.

**Average Relative Return During Down Months for the S&P 500 (1989-2014)**




Source: Strategas Research Partners

Our analysis of the downside risk is not reflective of our view for the equity markets. We remain bullish on equities, supported by a growing US economy and stronger global economies. Last quarter we laid out our long-term view for equity returns. We believe an annualized total return of 8% is a conservative estimate investors should expect. Inflation expectations, interest rates, and growth all support equities trading at multiples only slightly above their long-term norms.

# Fixed Income

## Investors Continue to Wait for Higher Rates

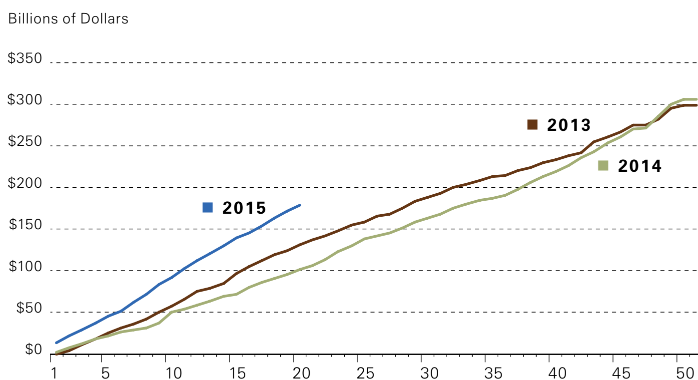
The Fed's impending lift-off from zero has been the focus of much commentary, yet it has had little effect on interest rates. Despite all of the attention paid to each little nuance of every written or spoken word emanating from Federal Reserve officials, cumulative yield changes since the beginning of the year have been relatively modest. From year-end 2014, the yield curve between 2- and 30-Year US Treasury yields has steepened from 208 basis points to the current approximately

240 basis points. This occurred as yields on longer issues have risen more than on shorter issues. That modestly steeper yield curve likely reflects a shift in expectations that the initial policy move by the Federal Open Market Committee (FOMC) will be later than anticipated at the beginning of the year. The higher yields reflect that such a policy move is now perceived as more likely to occur.

In recent weeks, rising yields in Europe have put pressure on US yields. The benchmark 10-Year German yield has risen from an ultra-low 0.07% to approximately 0.95%. While the current yield level is still low, the retreat from the near-zero level does indicate a lessening of fears regarding the European economy sliding into deflation.

Other sectors of the bond market have been dominated by the impact of substantial supply in 2015. Year-to-date corporate bond supply has increased 27.4% to $568 billion, based upon data from SDC Thomson Financial. Last year, we repeatedly noted that supply for tax-exempt municipal bonds was running behind the previous year's levels. The chart below shows that the supply for 2015 is tracking 68% above a weak 2014 and 26% higher than 2013. The supply in both sectors has resulted from issuers desire to lock in low interest rates in advance of the anticipated first increase by the FOMC.

**Municipal Bond Issuance**




Source: Bloomberg

In recent weeks, there have been several court rulings affecting the municipal bond market. State Supreme Courts in Illinois and Oregon ruled against various aspects of attempts to modify pension obligations. The US Supreme Court deemed Maryland's local tax on out-of-state income unconstitutional. These rulings remind investors that solutions to long-term issues such as underfunded pension obligations and equitable taxation in a mobile society are political processes that vary greatly from state to state and that portfolio diversification needs to reflect those variations. Our client portfolio recommendations regarding diversification consider the credit trends of the individual state, taxation levels and available supply to arrive at the appropriate structure that balances risk reduction with tax efficiency.

## RECOMMENDED READING

In closing this quarter's commentary we will not extol the values of long-term investing or highlight the value of compounding returns. Instead, we think it timely to highlight three books that members of Haverford's research team recommend you place on your summer reading list: *The Outsiders*, *The Wright Brothers*, and *Red Notice*. *The Outsiders*, authored by William Thorndike, highlights eight unconventional CEOs that placed a primary focus on capital allocation. Many CEOs are great managers, salesmen, and motivators, but the truly great CEO is also an adept capital allocator. *The Wright Brothers* is David McCullough's most recent biography. He masterfully tells the heroic story of how two Midwestern bicycle mechanics beat all the odds to change the world. His book reinforces our faith in the Midwestern work ethic and ingenuity. Lastly, *Red Notice* chronicles the story of Bill Browder. Browder's Hermitage Capital was an initial investor in Russia following the Soviet Union's collapse. He and his associates risked, and in some cases gave, their lives to bring to light Russian corruption. These three books will leave you with a greater understanding of the world. As Will Rogers aptly stated, "A man only learns in two ways, one by reading and the other by association with smarter people."

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