

1Q15 US Note

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1/15/2015 – When a market continues higher for longer than four years, history says the trend will only be broken by a full on recession. Despite all of the short term noise surrounding global growth, deflation, and central banks, etc., one has to remember that economies and businesses operate in cycles:

An economic peak occurs when an exuberance of credit creation and spending exist. Following the peak comes a recession, where monetary and fiscal policy makers pull every lever to lessen the blow. These levers (and corporate/individual deleveraging) will usually put the economy into a recovery phase, followed by the policy normalizationⁱ phase, where economic policies are slowly moved to a more normalized state. After policies become normalized (reversion to the mean), the expansionary phase will take hold, where capital spending, investment, and inflation all increase above normal, leading to the exuberance that causes a peak.

The current state of the US economy is not at a peak, seen by the lack of exuberance in overall market multiples, a compressed capital spending to GDP ratio (currently 12.5% vs. ~15.6% average¹), and very low consumer leverage (75% of consumer debts are mortgages and 90% of those are fixed at the lowest average rate in historyⁱⁱ). The US has also come a long 6 years since the recession, posting the most monthly job increases in November since 2007 on our way to 5.8% unemployment. Corporate defaults are at all-time lows, real GDP² is growing at a steady pace (2.1% in 2014), and earnings have grown 2% on average the past 6 years, all of which point to a successful (albeit slow) US economic recovery. With the recovery in the rearview mirror, 2014/2015 will appear to highlight the volatile transition period into an economic expansion for the US defined as ‘policy normalization’. **2015 S&P 500 target: 2150 on \$125 in earnings. Themes for 2015: EU over US, small/mid over large/mega, cyclicals over staples.**

The coming year is set up to be defining in the growth trajectory for the global economy as the world’s four central banks diverge policies from one another, all fighting the continuous battle against low inflation, or ‘disinflation’. Disinflation is bad for three reasons: ⁱⁱⁱ

- 1) Lower than expected inflation harms those who carry high debt (real interest rate is higher). This puts a strain on the private sector with debt issued pre-crisis, and the public sector with debt issued post-crisis.
- 2) The zero lower bound (where nominal interest rates cannot be negative) will come into play if disinflation is persistent, and can escalate an economy into a deflationary spiral.
- 3) Credibility of the central bank can be compromised. Many financial instruments are based on a central bank’s guidance, so undershooting a target for a prolonged period will undermine a bank’s ability to set effective policy.

On every level, each bank is trying to avoid the mess of disinflation and kick start real GDP growth through all the monetary levers that are widely publicized (QE’s, Abenomics, EU QE, etc.³). This year, all four (ECB, BoJ, BoE, & the Federal Reserve⁴) central banks will hold assets of about 22% of their respective countries GDP, but the Fed & BoE are decreasing that share, whereas the ECB & BoJ are going to inflate it. 2015 should mark the start of Euro QE, the increase of Abenomics, and the start of the

¹ 20 year average, quoted nominally

² Real gross domestic product is net inflation

³ Quantitative Easing

⁴ European Central Bank, Bank of Japan, Bank of England

end of US and UK ‘easy money’^{iv}. As these policies *diverge*, we expect the markets to *converge*, leading us to prefer international equity over US equity. The US has outperformed the international index for 7 years and recorded just over an 18% spread in 2014. History points to this trend reversing, tightening the spread to normal levels. **This divergence & future policy catalysts are the main driver to believe international will outperform the US in the coming years.**

In the US, much debate for the year surrounds the timing of the Federal Reserve’s decision to raise the federal funds rate^v. The US economy seems to be supporting itself, seen through employment and consumer/producer confidence data, which would support a move toward policy normalization (rate hike). However, low wage inflation and core inflation data have kept the Federal Reserve from acting. These two data points will be critical to watch through the first half of the year and can directly influence the Fed’s hand on whether they tighten policy in the summer (June) or later in the year. Although hiring has really picked up steam in the past couple of years, wage growth has remained stagnant, especially for the bottom half of workers (around 90% of wage growth occurred in top supervisory positions⁵). Meanwhile, the average rent in America rose just above 3%,⁶ giving that average American less disposable income year over year. Although the average rent rose, as mentioned, headline inflation was next to flat (see 1Q15 Oil update) and core inflation continues to be sub-2%, the fed’s target. **We expect to see an uptick in both wage and core inflation in the next couple of months, causing the Fed to take action at a policy meeting in mid to late summer.** If our base case plays out, increased volatility will define the spring and summer since it is not estimated that the market completely prices in a summer rate hike, while the end of the year could see a good rally because of the telegraphed trajectory of rate increases to come. **We see the US 10 year note to end 2015 between 2.5% & 2.75%, a roughly 60 basis point⁷ increase y/y.**^{vi} *Note: Janet Yellen maintains the stance (precedence from Ben Bernanke) that the immense decline in the price of oil remains transitory for the foreseeable future and should not materially affect policy in the short term.*^{vii}

As the base case implies above, we believe equity will outperform fixed income again this year, more like they did in 2013 than in 2014. In the US equity space, two things stand out to us: average margins for large/mega cap names and currency risk. **We believe small/mid-caps will outperform the large/mega names⁸ in 2015 because of a bigger upside for margin expansion in the former.**^{viii} As the S&P 500⁹ is market cap weighted, large and mega sized companies have a big influence on the overall market. These companies on average operate at a profit margin of 10.1% verse an 8.6% average, so we see limited margin expansion from here, although a margin contraction is not likely either. We believe that 10% is most likely the new normal because a larger number of these big companies are tech companies, which inherently have higher margins. Another 2015 headwind to margin expansion is currency risk, which is concentrated in the multinational large cap names in the S&P 500. The dollar surged in late 2014, and roughly 40% of revenue in those 500 companies comes from abroad, forcing companies to write down an estimated average 3% of earnings due to currency loss in the coming quarter^{ix} and reducing demand for US exports going forward.

2014 Look back:

We maintain the view that a twelve month forecast is hardly reliable when talking about the public markets, but nonetheless, we will always try to quantify our outlook. Looking back on the year completed, our forecasts undershot the index by about 300 basis points, and we were admittedly early to some themes in most portfolios (Europe, Mexico, energy additions). Our thesis for investment in Europe

⁵ BLS Survey, Jan 2015

⁶ Zillow average, Jan 2015

⁷ One basis point = .01%

⁸ Defined by market capitalization, >\$10bn would qualify as large/mega cap

⁹ Standard & Poors 500 Index, the 500 biggest companies in the US

and Mexico remains unchanged fundamentally as the second half weakness was nearly completely attributed to the dollar strength. Energy has been a staple of our models for some time, and we continue to hold a very strong long term thesis on the sector. Additions to our energy positions in late November/December have proved to be early, but we are willing to take some volatility to buy in at current prices. **Energy companies are at valuations (using price/book¹⁰ and EV/EBITDA¹¹) that have only been seen in recessions and continue to present very compelling long term value.**

2015 Estimates:

Our 2015 price target for the S&P 500 is 2150, giving an investor a 4.5% return for the year (6.5% total return). We arrived at this base case by assuming 6% earnings growth, net buybacks and currency devaluations, which gives us \$125 from \$118. As multiples are hovering just above long term averages^x, we believe the market got ahead of itself in the past two years, and a more normalized policy this year will keep multiples in line with those averages on a forward and trailing basis (forward P/E 10 yr. avg. is 15.1x). We assign a 20/70/10 probability to the bull/base/bear scenarios based on two reasons: the move *toward* policy normalization is likely to increase volatility and pause multiple expansion and an actual earnings decline seems relatively improbable based on the state of the US economy and consumer.

Scenario	Probability	2015E EPS	2016E EPS	FPE Multiple	YE2015 Target
Bull	20%	\$128	\$140	18x	2500
Growth		8%	10%		
Base	70%	\$125	\$135	16x	2160
Growth		6%	8%		
Bear	10%	\$116	\$118	14.5x	1700
Growth		-1.5%	2%		

Looking into sectors for the US, we believe that 2015 will let the cyclicals¹² play catch up while the defensives and blue chips take a break. **Dividend blue chips¹³ and utility companies will have a hard time extended their already inflated multiple as policy normalizes and the yield curve continues to flatten in US treasuries.** A multiple is paid on your earnings to factor in future growth...healthcare and utilities both have a multiple of around 17.5...yet our healthcare industry has an average double digit growth rate verse our utility sector growing around 2% annually.^{xi} Consumer staples are trading at historically high multiples above 18, also with single digit growth rates. We continue to believe that the yield trade is crowded and emphasis must be put on investing in a company that has strong growth prospects, along with a good dividend or buyback. We expect energy shares to rebound materially from current valuations, continue to like technology and consumer discretionaries, and have an eye on the financials. We estimate utilities, defensives, and REITS¹⁴ will take a breather from their multiyear outperformance.

The United States continues to be one of the best places to live and invest in the world. We have the deepest and widest capital markets, a strong currency and central bank, low relative corruption, a strong military, and the most innovative companies on the planet. Our universities and medical institutions are unrivalled. We produce the most oil in the world. We create thousands of jobs through

¹⁰ Market Price / Book value

¹¹ Enterprise Value / Earnings before interest, taxes, depreciation & amortization

¹² Industry that is very correlated to the growth of the US economy

¹³ Implying the companies in the Dow Jones Industrial Average

¹⁴ Real Estate Investment Trusts

ideas like Uber, Amazon, and Tesla.^{xii} We have come a long way from the last recession, and our core thesis continues to maintain that an expansionary phase is in front of us, but 2015 may be a year where we let everyone else catch up a bit. ♦

Endnotes & Citations

ⁱ Policy Normalization is estimated by Goldman Sachs to have long term rates between 3%-3.5%.

ⁱⁱ Citing '2015 US Equity Outlook', Adam Parker, MS, Dec 2014

ⁱⁱⁱ Citing 'The Global Battle Against Lowflation', Joachim Fels, MS, Jan 2015

^{iv} Easy money is a term meaning very low interest rates, or meaning access to credit is cheap

^v The rate at which the Federal Reserve lends to qualifying banks for a very short period of time

^{vi} Citing 'GSAM Macro Insights', Goldman Sachs, Dec 2014

^{vii} Citing FOMC press conference, Dec 2014

^{viii} Citing '2015 US Equity Outlook', Adam Parker, MS, Dec 2014

^{ix} Quarterly earnings estimates come from Factset Research

^x 10 year avg forward multiple is 15.1x

^{xi} Citing 'The Great Rebalancing Act', Michael Wilson, MS, Jan 2015

^{xii} Number of US jobs created cannot be estimated based on company variables

Important Information

The views in this report are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns. Keep in mind, like all investing, that multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Doxa Capital believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment. The Business Cycle Index (BCI) forecasts the strength of economic expansion or recession in the coming months, along with forecasts for other prominent economic measures. Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve, and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts.

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Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to subprime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

The S&P 500, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

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