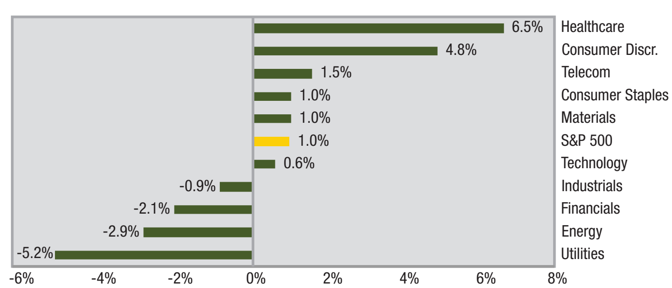
Inverness
Counsel

During the quarter, equity markets struggled for direction, but the S&P 500 ended the period with a positive return, closing at a near record of 2,067. The technology-heavy NASDAQ index finally broke the 5,000 level, last seen 15 years ago during the tech bubble. The U.S. economy continues to expand at a modest pace, and the employment picture has improved. Yet inflation remains at uncomfortably low levels around the world, and deflationary pressures have increased. The U.S. dollar has appreciated considerably versus other major currencies, and the translation effect is having a significant impact on earnings. These factors may slow the timing and reduce the magnitude of the Federal Reserve's increase of interest rates. We continue to position portfolios for modest economic growth, although we expect volatility to remain elevated.

The S&P 500 Index gained 0.95% on a total return basis for the quarter. The Healthcare and Consumer Discretionary sectors led the way. The interest rate–sensitive Financials and Utilities sectors were down for the quarter. Energy stocks experienced continued weakness.

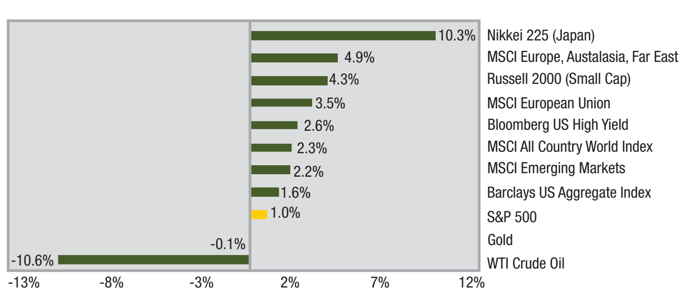
Figure 1: 1Q15 Performance by Sector



Source: Bloomberg. Data as of 03/31/2015.

From a global perspective, most developed markets outperformed the S&P 500. The Japanese Nikkei is up 10.3% for the year, and the MSCI European Union is up 3.5%. Many emerging markets performed in line with the S&P 500. In the U.S., small-cap stocks outperformed the S&P 500, but crude oil and gold underperformed.

Figure 2: 1Q15 Performance by Category



Source: Bloomberg. Data as of 03/31/2015. All returns in U.S. dollars.

Earnings Facing Pressure

The economy as defined by Gross Domestic Product (GDP) continues to expand at a measured pace. Real GDP growth is expected to be 3.0% in 2015, up from 2.4% in 2014. GDP growth running at 3% should continue to create a positive environment for stocks, and we are seeing signs of improved fundamentals for many of our companies. However, currency translation due to a strong dollar is putting pressure on large multinational companies and on earnings for the S&P 500 as a whole. Revenue and earnings from foreign markets are worth less when translated back into dollars. The euro has depreciated by 11% in 2015 and by 22% over the last 12 months versus the dollar. Earnings for the S&P 500 are now expected to grow by 1.3% in 2015, down from an initial estimate of 8.1%. A good portion of this reduction is due to currency translation (which is often discounted by investors as a temporary effect). If the dollar continues to rally versus other currencies, we may see negative earnings growth for the S&P 500, in which case valuations would need to expand for the market to remain at current levels or move higher.

Modest economic growth has been enough to drive continued improvement in employment statistics. The unemployment rate dropped to 5.5% in February, the lowest it has been since May 2008. Civilian wages and salaries are showing some of the biggest gains since 2008. However, some industries are facing pressure from increased minimum wages and health care spending. Overall, the consumer, who represents about 70% of the U.S. economy, is employed, getting a raise, and feeling fairly confident.

Going into 2015, we expected lower gasoline prices to translate into higher consumer spending on discretionary items. Instead, the U.S. personal savings rate as a percentage of disposable income has increased from 4.6% to 5.5%—the highest since 2012. Retail sales have plateaued since November and are even showing slight declines in the most recent reports. But given consumer confidence is at levels we have not seen since before the financial crisis, we believe consumers will eventually spend their gasoline savings.

After a brief bounce, oil prices continue to trade near the lows seen last year. Production levels actually continue to increase, and storage capacity in locations such as Cushing, Oklahoma, may be full in another month or two. The U.S. oil rig count has seen a 40% reduction since September and is now back to 2011 levels. For now, supply remains elevated relative to demand, and earnings for many energy companies in 2015 are expected to be half of what they were a year ago.

The Strong Dollar May Keep the Fed on Hold

At the beginning of the year, the market was expecting the Federal Reserve to increase the federal funds rate from zero to 0.25% in June. With employment continuing to improve faster than initial expectations, this assumption remains reasonable, but the market now anticipates this first increase in September. The two big forces keeping the Fed on hold are very low levels of inflation around the world and the U.S. dollar's significant appreciation versus other currencies.

Falling energy and other commodity prices have brought total U.S. inflation into negative year over year territory. The price of oil is down 60% since last summer, and this has driven price declines in many parts of the global economy. For Europe and Japan—already experiencing very low inflation driven by weak economic growth prior to the collapse in oil prices—this decline has become a strong deflationary force. According to the Bank Credit Analyst, out of the 23 developed countries, 14 currently have negative headline inflation rates, 5 have rates below 1%, and the average rate is –0.2%.

Although the Fed ended its quantitative easing program last October, the European Central Bank and the Bank of Japan have continued to expand their balance sheets to fight the ongoing threat of deflation. In fact, several of Europe's central banks have cut key interest rates below zero, which means they are actually charging depositors to hold their money. Given this environment, the euro and the yen have seen dramatic declines relative to the U.S. dollar (see Figure 3). If the Fed raises interest rates, further strengthening in the dollar as a result may reduce U.S. exports and negatively affect our economy.

Figure 3: Historical Exchange Rates

^Represents value of US Dollars needed to convert into one Euro
^^Represents value of US Dollars needed to convert into one Japanese Yen
Source: Bloomberg. Data as of 03/31/2015.

Focused on Fundamentals

As bull markets age, growth tends to concentrate in certain sectors. According to consensus estimates, about 75% of the revenue growth in 2015 is expected to come from three sectors: Technology, Consumer Discretionary, and Healthcare. In this commentary, we will highlight some important trends impacting the Healthcare sector, a large and growing component of GDP spending that has garnered additional attention from the Affordable Care Act.

An improving economy on its own can spur demand for health care as more confident and optimistic consumers decide to have procedures and tests that they previously delayed. However, there are two strong drivers for increased health care spending in the longer term: the aging population, which will increasingly consume health care products and services, and the Affordable Care Act (ACA), which is providing coverage to those who were previously uninsured. According to the U.S. Department of Health and Human Services, about 14 million adults have gained health insurance coverage under the ACA since enrollment began in October 2013. More than 2 million young adults have also gained coverage due to the ACA provision allowing them to remain on a parent's plan until age 26. Increased health care coverage will generally lead to increased utilization of health care products and services.

Pharmaceuticals is one industry segment within Healthcare that will benefit from this increased utilization. The pharmaceutical industry is shifting from reliance on a few blockbuster drugs to diversification into a broader portfolio of products, risk reduction through sharing economics with development partners, and a focus on more specialty and branded products, which tend to have better long-term margins. Overall, pharmaceutical companies are benefitting from strong unit growth driven by increased utilization, as well as strong pricing in areas where there is less competition.

The drug distribution industry also benefits from the growing unit volumes driven by increased utilization and the strong pricing of both branded and generic drugs. With limited competition, the three largest drug distributors use their market share to get better deals on wholesale pricing, which will give their margins a strong foundation as well as long-term uplift.

The King v. Burwell case currently being decided by the Supreme Court, with a ruling expected in June, is significant for its potential impact on the ACA. The case hinges on whether federal subsidies can be provided to health insurance enrollees who signed up for coverage on exchanges set up by the federal government on behalf of states, or only to those who signed up on exchanges set up by the states themselves. If the latter interpretation prevails, then enrollees from the 34 states that relied on federal exchanges will lose their coverage if they cannot afford it without the federal subsidies.

Course of Action

During the quarter, we continued to increase our exposure in the Healthcare sector. We reduced our exposure in the Financials sector, given the low level of interest rates and the possibility that this level will persist for longer than expected.

In the Energy and Industrials sectors, we are concerned that current valuations are pricing in a recovery in commodity prices that may not materialize soon. In Industrials and Consumer Staples, we tend to favor domestically focused companies due to concerns about slower growth abroad and currency fluctuations.

845 Third Avenue
New York, NY 10022

www.invernesscounsel.com

(212) 207-2122

Inverness
Counsel