Inverness
Counsel

During the quarter, U.S. equity markets continued to rally despite concerns about the U.S. fiscal outlook, Fed policy, bond distortions, corporate profits, and global uncertainty. In fact, this was the best first-quarter performance for the Dow Jones and S&P 500 since 1998, and both indices reached new all-time highs. Given this impressive rally after a strong 2012, we have refocused our efforts on the fundamentals. We are now looking for confirmation that the accommodative monetary environment will translate into an improvement in top-line revenue growth for our companies. We believe this growth will be required to propel equity markets meaningfully higher over the coming quarters.

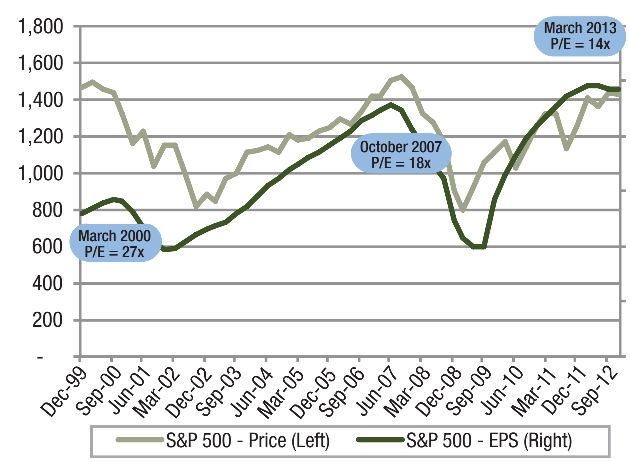
The S&P 500 gained 10.6% for the quarter. On a total return basis (including dividends), the index is now 10% above its prior, October 2007 peak. From a sector perspective, the higher-dividend-yielding Health Care, Consumer Staples, and Utilities stocks led the way this quarter, while Materials and Technology underperformed the broader index.

From a global perspective, many of the international markets (including China and Brazil) have gotten off to a slow start and have underperformed the U.S. indices. The outlier has been the Japanese Nikkei, which is already up 19.2% for the year when priced in Japanese currency (i.e., yen). Given the depreciation of this currency versus the U.S. dollar, the Nikkei is up only 9.0% for the year when priced in dollars. After a very strong rebound in 2012, the European markets are down slightly in dollar terms, with the German DAX down 0.7% for the year and the French CAC down 0.4%. The Brazilian Bovespa is down 6.3% for the year, and the Chinese Shanghai Exchange is down 1.0%.

Third Time's the Charm

As we reach the fourth anniversary of the market bottom, we are mindful of the fact that the markets have rebounded relatively quickly. We also acknowledge that this is the third time in 13 years that the S&P 500 has traded above the 1,500 level and that in the prior two cases it traded down in future months. Although it is true that a large part of the rally since 2009 has been driven by easy money from the Federal Reserve, fundamentals have also seen substantial improvement over this time frame. In March 2000, the S&P 500 traded above 1,500 for the first time. As shown in Figure 1, the commonly used valuation metric of price to earnings (P/E) was at a high level of 27 in 2000. In October 2007, the market again traded at this level and the P/E was at a more reasonable level of 18. In 2013 to date, the P/E is roughly 14. In other words, S&P 500 companies produce twice as much profit today as they did 13 years ago, but the market pays only half as much for it.

Figure 1: Price to Earnings (Dec. 1999–Dec. 2012)



Sources: Standard & Poor's and Bloomberg. Data as of December 31, 2012

Ultimately, we think further improvement in fundamentals will be required to propel equity markets meaningfully higher in the coming quarters. The U.S. Gross Domestic Product (GDP) expanded only 0.4% in the fourth quarter of 2012 and 2.2% for the entire year. In addition, fourth-quarter earnings for the stock market were down 2.4% year-over-year, following a third-quarter year-over-year decline of 5.1%. Prior to these losses, we had seen 10 quarters of year-over-year increases. With the recent rally, the market appears to be anticipating that these factors will improve in the near future. We see a number of possible catalysts that could drive this scenario, including continued improvement in the housing market, a resurgence in U.S. manufacturing, an upturn in capital expenditures, and improved household, corporate, and bank balance sheets finally being put to work.

Since 1960, in every downtown, new unit housing starts have historically bottomed at about 1 million units a year. February starts of 917,000 units brought us closer to these historical low levels, but we are still well below the long-term annual average of 1.5 million new housing starts. Some economists have predicted that housing could add 0.5% to 1% to GDP in 2013.

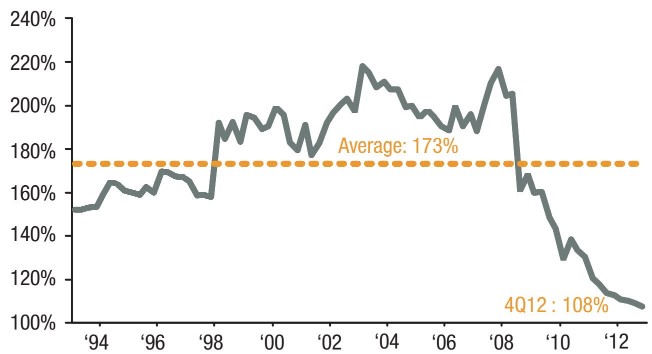
Capacity utilization is a metric to measure the rate at which potential output levels are being met or used. In June 2009, the capacity utilization index reached a low of 66.8%, which is the lowest level this index has seen since its inception in 1967. We have seen a slow climb back to 2007 levels, with the February reading at 78.3%. Historically, the index has topped out at the 85% level, since at that point, companies are forced to increase their capital expenditures on new machines and factories. Although we have not seen these levels since the 1990s, we are exploring the potential for a renaissance of the American manufacturing industry. Ultimately, a resurgence in domestic manufacturing activity could increase job creation and accelerate U.S. economic growth. With capacity utilization returning to 2007 levels, we are watching for signs of an acceleration in the capital expenditure cycle that would benefit many domestically focused industrial companies.

For the past four years, American consumers have engaged in a concerted effort to deleverage. To help accelerate this effort, the Federal Reserve has engaged in unprecedented quantitative easing, expanding its balance sheet by 380%, which has driven interest rates to record lows. Consumer debt is back to 2003 levels. The Standard & Poor's Case-Shiller Home Price Index measures changes in the prices of single-family, detached residences using the repeat-sales method, which compares the sale prices of the same properties over time. For the 20 largest metropolitan areas, this index posted an 8.1% year-over-year increase in January. With the largest asset on many people's balance sheets now increasing in value or at least stabilizing, consumer confidence and spending may increase. This outcome will be important, as consumer spending accounts for 71% of GDP.

As we have highlighted in previous commentaries, the balance sheets for many U.S. companies have never been in better shape. Cash balances are at record levels, and debt to equity, which is a common ratio used to measure leverage, is at the lowest level in 20 years. Despite these factors, merger and acquisition (M&A) activity remained tepid as company boards delayed action and waited for more clarity out of Washington. With the election, the fiscal cliff, and other policy changes now behind us, companies may begin to increase M&A activity. Companies may also decide to use their cash reserves on capital expansion and capital improvements or to return this cash to shareholders in the form of increased dividends and share repurchase programs.

Figure 2: Total Leverage

S&P 500, ratio of total debt to total equity, quarterly



Source: Federal Reserve, Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management

The U.S. banking system has also taken substantial steps to repair its balance sheets since the financial crisis. In early March 2013, the Federal Reserve announced the results from its latest stress test. The environment for this test was a crisis in which unemployment jumped to 12.1%, stocks tumbled 50%, house prices dropped 20%, and the banks lost a combined $462 billion. Even in this scenario, 17 of the nation's 18 biggest, most important banks would still have had enough cash and other high-quality capital on hand. In summary, the banks are much stronger than they were in 2007.

Kicking the Can Becomes a Global Phenomenon

Despite areas of improvement, the United States and other developed nations continue to struggle to address high unemployment, stagnant growth, and unsustainable government debt levels. In some cases, the governments of these countries have been focusing on austerity, which has resulted in slow economic growth or even contraction and therefore higher unemployment. However, in many major countries; the forces for austerity appear to be giving ground to those that favor spending and more aggressive monetary easing.

In Japan, voters elected Prime Minister Shinzō Abe with a supermajority. Abe was outspoken throughout the campaign about Japan's need to confront deflation in a more aggressive manner. Although Japan does not have an unemployment problem, it does have an unsustainable debt burden. With a debt-to-GDP ratio of 230%, Japan cannot continue to experience deflation and service this debt. Prime Minister Abe selected Haruhiko Kuroda as the next head of the Bank of Japan (BOJ). Kuroda has been clear in his conviction about the reflationary power of money printing and has announced that the BOJ will double the monetary base over the next two years. His plan includes buying Japanese government bonds, Japanese equities, REITs, and other investments the BOJ deems acceptable.

In Europe, voters in Italy overwhelmingly rejected Mario Monti's reform and austerity policies. Since austerity is part of the German-led prescription for the improved health of the euro, it remains unclear how this situation will develop in future months. In England, Mark Carney, the next governor of the Bank of England, raised eyebrows when he opened the door to a more growth-oriented approach. As in the Japanese plan, Carney indicated that he thought the Bank of England might even consider buying assets other than gilts.

Looking for Revenue Growth

With the commitment to austerity weakening in many parts of the world and aggressive quantitative easing being embraced, the possibility of asset inflation and higher nominal growth fueled by easy money is increasing. This tide may in fact lift all boats, but we believe that to outperform from here, companies will need to show top-line revenue growth and not just count on margin expansion.

Since the market bottom in 2009, many companies have increased their earnings through aggressive cost-cutting efforts, but strong revenue growth has been elusive. A recent Smithers & Company study of U.S. companies showed that profit margins before depreciation, interest, and taxes as a percentage of output were at 36%. That hasn't happened since World War II. As a share of U.S. GDP, labor compensation has dropped to 33.5%, its lowest level in 60 years, while corporate profits as a share of GDP have soared and are now at 13%. If the economy continues to improve, we believe labor costs may begin to pressure margins. We may also begin to see some margin pressure in future quarters from increased taxes, health-care expenses, and commodity inflation. Many companies have also benefited from lower interest rates. In short, we believe that the incremental benefits from a low interest rate environment and productivity improvements will be more subdued going forward and that it will become increasingly difficult for many companies to expand margins from current levels.

Course of Action

Given this environment, we have refocused our research efforts on the fundamentals of the companies in which we are invested. As we have discussed previously, we seek to invest in companies that have a strong core business that can absorb and pass on input and wage inflation. These companies are frequently secular growth leaders that can expand their market share and drive top-line revenue growth. We also seek to identify companies that may benefit from secular developments, such as the renaissance in American manufacturing and the impact of living in a constantly connected world.

845 Third Avenue
New York, NY 10022

www.invernesscounsel.com

(212) 207-2122

Inverness
Counsel