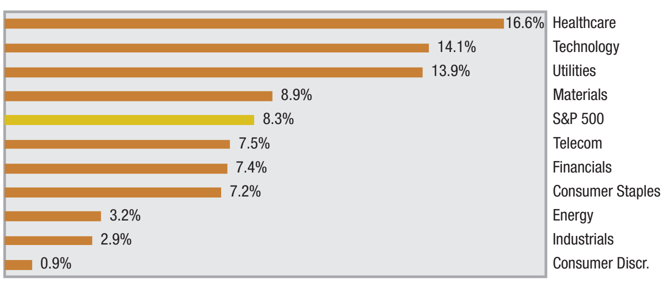
Inverness
Counsel

During the quarter, equity markets continued to rally, and the S&P 500 crossed an important psychological barrier of 2,000, although it ended the quarter at 1,972. After a pause during the first quarter, economic growth surprised to the upside in the second quarter and has resumed the upward trend that began in the middle of 2013. The industrial part of the economy continues to improve. Geopolitical risks continue to grow and may be a source of instability, but for now, volatility for the overall market has remained muted. Earnings have grown at the same pace as stock prices, so valuations remain reasonable. The environment remains favorable for many investments, and we continue to position portfolios for modest economic growth.

The S&P 500 Index gained 1.1% on a total return basis for the quarter and is up 8.3% for 2014. From a sector perspective, the Healthcare and Technology sectors led the way this quarter, while performance for the Energy sector lagged. For the year, the Healthcare, Technology and Utilities sectors have been the leaders. Consumer Discretionary stocks have consistently been the weakest sector for the year.

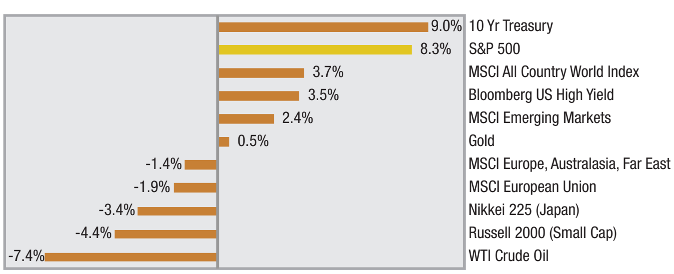
Figure 1: 2014 Performance by Sector



Source: Bloomberg. Data as of 09/30/2014.

From a broader perspective, the S&P 500 has continued to outperform most other market segments. Crude oil saw a decline of 13.5% during the quarter and is now down for the year. Most European markets underperformed the S&P 500 during the quarter and are now underperforming for the year. The Japanese Nikkei has continued to lag. The emerging market index retreated during the quarter, but remains positive for the year. The Russell 2000, which focuses on smaller U.S. based companies, had a weak quarter down 7.4% and this index is now down for the year.

Figure 2: 2014 Performance by Category



Source: Bloomberg. Data as of 09/30/2014. All returns in U.S. dollars.

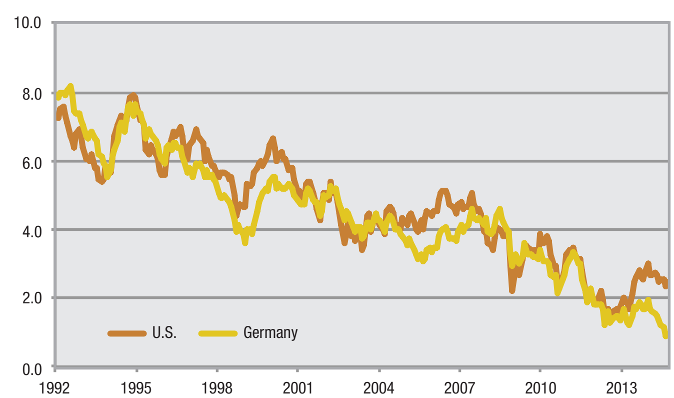
Economic Growth Proves Resilient

Beginning in September 2012, the Federal Reserve bought $85 billion of government-backed and government-issued bonds each month. During 2014, the Fed has tapered this quantitative easing program (QE3), which is on track to end in October. When prior quantitative easing efforts ended, economic growth slowed and the Federal Reserve was forced to react. Many investors fear that history will repeat itself, but the economy has proven to be resilient despite the decrease in liquidity. Nonetheless, the Federal Reserve is likely to be patient before raising interest rates at some point in 2015.

The economy, as defined by Gross Domestic Product (GDP), grew at a 4.6% annual pace in the second quarter, which is the strongest performance since the economy expanded by 4.9% in the fourth quarter of 2011. The most recent measure exceeded consensus expectations of 3.5%, after many economists predicted that the weakness we experienced in the first quarter would linger into the second quarter. Given this strong result, expectations for GDP growth for the full year have increased to 2.1%. In 2015, GDP is expected to grow at a 2.8% real rate, which should be a positive for stocks.

Although U.S. economic growth cannot be described as robust, the economy is growing at a higher rate than many European countries. Eurozone GDP grew only 0.7% in the second quarter. One of the biggest surprises this quarter was the decline of European interest rates to all-time lows in some cases. The bond market is telling us that the European economies are struggling and there is limited faith in a near-term recovery. The yield on the 10-year German Bund, the equivalent of the 10-year U.S. Treasury, dropped to 0.88%, the lowest level since Napoleon's defeat at Waterloo. On the same day, the 10-year U.S. Treasury yielded 2.34%, low by historical standards but well above the low of 1.43% reached in 2012. In the past, the U.S. and German 10-year rates have remained close; this recent dislocation indicates the divergence of our economic realities and policies (see Figure 3).

Figure 3: U.S. and German 10-Year Bond Yields



Source: Bloomberg. Data as of 9/30/2014.

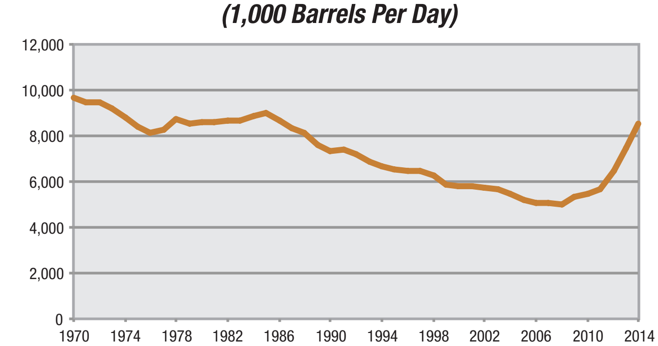
The Manufacturing Renaissance May Be Here

In our first quarter 2013 commentary, we highlighted that for the third time in 13 years the S&P 500 had traded above the 1,500 level. We noted that S&P 500 companies produce twice as much profit today as they did 13 years ago but the market pays half as much for that profit. We also identified catalysts that could drive further improvement. Eighteen months later, the market has returned 28% and valuations have risen substantially. We do not anticipate a further expansion in valuations; rather, we expect earnings growth to be driven by revenue growth from the investment catalysts we identified.

A renaissance in American manufacturing is one of those catalysts. For many decades, manufacturing shifted to low-cost regions such as Latin America, Eastern Europe, and Asia. But years of steady change in wages, productivity, energy costs, currency values, and other factors are now redrawing the map. The Boston Consulting Group (BCG) analyzed manufacturing costs for the world's 25 leading exporting economies along four key dimensions: wages, labor productivity, energy costs, and exchange rates. Cost structures in Mexico and the U.S. improved the most out of the 25, making the U.S. a rising star of global manufacturing.

Major discoveries of domestic energy resources have generated significant natural gas and crude oil reserves, with the majority coming from the Eagle Ford in South Texas, the Bakken in North Dakota, and the Permian in West Texas. U.S. crude oil production has increased 42% since 2011 to 8.5 million barrels a day as of June 2014. In fact, the International Energy Agency (IEA) expects the U.S. will surpass Saudi Arabia as the world's largest oil producer around 2020 and will become a net oil exporter by 2030. In addition, as a by-product of shale expansion, U.S. natural gas production has increased 20% over the last five years, and since 2010, the U.S. has been the world's leading gas producer.

Figure 4: U.S. Crude Oil Production
(1,000 Barrels Per Day)



Source: U.S. Energy Information Administration (EIA). Data through June 2014.

Currently, natural gas cannot be transported over long distances and cannot be exported in gas form. In general, we have more natural gas than we need, and this surplus has driven prices well below the global market. These lower natural gas prices put domestic chemical companies and many manufacturers at an advantage. The chemical companies have responded and are increasing capacity aggressively. New projects will add a total annual capacity of 15.6 million metric tons, which is equivalent to 47% of North America's 2012 ethylene capacity. Much of this energy ends up in basic chemicals that are used in the manufacturing of automobiles, household goods, and packaging.

Capital expenditures for new tools and automation are increasing, and an acceleration in new manufacturing capacity is evidenced both by existing investments and by signals of a robust pipeline in the future. In the latest reading of economic activity by the Institute for Supply Management (ISM), the Purchasing Managers' Index saw a surprisingly strong jump in August, reaching a 10-year high of 59.0%. The manufacturing sector has outperformed the overall economy in this recovery by the widest margin in 50 years. Capital spending in the third quarter ran at a 9% annual rate.

We have also observed significant strength in commercial and industrial lending, which has risen at double-digit rates throughout the year and is generally a precursor to manufacturing activity. Some of the most widely publicized investments have been in chemical, energy (oil and gas), and steel production, bolstered by contributions from the automotive sector, whose assembly volumes are returning to 2004–2005 peak levels. Corporate balance sheets still have record-high levels of cash and record-low levels of debt. What they lack is confidence in the recovery, but this seems to be building.

Given this emerging renaissance, we see encouraging economic transformations spreading across many of the hardest-hit regions of the country. For example, Ohio's unemployment rate fell from a peak of 10.6% to 5.7% in July—below the national average. This improvement is key in a state where manufacturing accounts for nearly 20% of total jobs. The number of jobs that will be needed to support the new national infrastructure remains a highly debated issue, with critics pointing to advances in automation and a lack of necessary job training as factors limiting employment growth. Nonetheless, since hitting rock bottom in early 2010, U.S. manufacturers have added nearly 700,000 jobs, bringing total factory employment to 12.2 million people.

The effects of this renaissance expand beyond manufacturing. In portfolios, investments in energy, chemical and industrial companies, banks and railroads are benefitting from this trend.

Course of Action

We continue to position portfolios for modest economic growth. Many of the investment catalysts we had been looking for reemerged when the harsh winter ended and are now accelerating. Given these developments, we have examined our energy and industrial exposures and have adjusted where needed. We have continued to reduce our exposure in consumer stocks.

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