Driving Miss Daisy

Fourth Quarter Commentary **October 2014**

In the movie **Driving Miss Daisy**, Miss Daisy says to her chauffeur Hoke: "I like to go under the speed limit...The slower you go, the more you save on gas". And Hoke replied: "I can hardly move, may as well walk".

This dialog reminds us of the economic and investment environment we find ourselves in today. In the US, economic growth is running below its historical speed limit, creating an environment where it feels like we are walking, not driving. Reflecting that view, US stock markets rose a modest 1–2% during the third quarter of this year and have seemingly stalled out after the first half when stock markets rose at a 4-7% clip (excluding small company stocks that are down around 5% this year). Bonds are also up modestly this year, providing about a 2% return. This recent market activity appears to be a consolidation of the 40% stock index gains of the past two years and a pause to assess coming economic prospects.

We have written that the economy is moving along at a slow steady 2-3% growth pace that can continue for a good while longer. While this is an ok environment for progressive companies to grow their business and profits globally, it nonetheless feels like faster growth is constrained by an economy where the driver has one foot on the accelerator and the other on the brakes.

We believe the pick up in market volatility at the end of last quarter and moving into October is a reflection of this driving style. The Federal Reserve has been pressing on the accelerator for five years and is now using the brake pedal as it exits quantitative easing and plans to raise interest rates some time next year. The consumer is showing better confidence about the future, but confidence indicators are at levels about ½ of what they were in the '90s. Consumer aggregate incomes are growing with more jobs and lower commodity costs (energy) but consumers are also seeing price increases in health insurance premiums and home prices (accelerator/brakes). Businesses have experienced better profits but are also reluctant to aggressively invest given slow global growth. US export trade is stronger but at risk from a rising dollar. Government spending has flattened but monies redirected from the military are going towards increasing social program payments. Also, aggressive federal lending for student loans are in part crowding our mortgage lending, exacerbated by the banks' reluctance to make higher risk loans for fear that again there will be government reprisals should any of these loans go bad. And finally, global geopolitical risk is being met by NATO countries with only a slight tapping on the accelerator. All this put together feels like walk speed.

Not only has walk speed growth served to dampen market gains lately, but volatility of stock prices has increased because of new strategies in investing. Seventy five percent of daily trading volume is done by hedge funds and fast traders, using primarily ETFs. Many of these traders use sophisticated computer techniques that trade off headlines and various subtle business and economic changes. These investors have served to narrow the breath of stocks participating in the advance to include the largest of the big capitalization stocks. More than 40% of all stocks traded are more than 20% below their all time high, even though the large cap S&P500 index has seen only 5% corrections over the past 2 years. Investors struggle with the impact of these traders even though in the long run they are generating noise around the trend. Also, October tends to be the most volatile month over the years as it has produced 25% of the most volatile days historically. So far this month the S&P500 is trading in a plus or minus 5% range (although smaller companies in the Russell 2000 are in a 10% range). After a 2 year run up in equity prices of about 40%, a correction of 10% or so could occur should further headline issues alarm investors.

With all that said and even though the economy is at walk speed, we see upside in the stock market ahead. Economic indicators have flashed a number of positive signs. Aggregate consumer incomes are improving as a result of the rising number of people working. Income gains – plus some further benefit from falling gasoline prices - should be reflected in better Christmas spending. Corporate earnings continue to move ahead at high single digits rates. Overseas economies are struggling to advance in Europe and Japan and slowing in China as central banks in those regions press the gas pedal while government policies ride the brakes. However, relative to those developed markets, US growth is pretty good comparatively. Slower foreign growth and lower bond yields also are encouraging foreign money to move into the US stock and bond markets. The S&P PE valuation is fair at 16 times (not overpriced) and 40% of the S&P companies have a dividend yield higher then the yield on the 10 year Treasury bond. Many companies are using excess cash flow to raise dividends and buy back shares while others are developing new products and services or undertaking business restructurings that make their stocks more attractive. All in all, economic growth could be better without a foot on both pedals, but the economy's gaining momentum and rising corporate earnings provide opportunities for stock investors in selective areas.

In the environment we see going forward, our research work indicates placing emphasis on the consumer discretionary, health care, technology and financial sectors. The more globally cyclical areas of materials, energy and capital goods should be underweighted in light of weaker global growth and a stronger dollar. In the consumer area, we see an increasingly discerning customer who looks for differentiated products, attractive technical product features, convenient delivery solutions and appealing brand cachet. The consumers' increased spending of their improving income will gravitate in these directions. Healthcare success will occur in those companies that provide cost savings and convenience, leading edge drug development, consolidations to improve scale and costs, and products and services that benefit from increased health utilization as more people are insured and live longer. In technology, evolution in content delivery worldwide will have new winners, data analytic and large legacy technology companies should benefit from complex data management and cloud services, and devices and application companies that disrupt traditional consumer behaviors should all do well. Finally, in finance we see improvement in bank lending opportunities as the economy grows and Dodd-

Frank lending regulations are finalized. Further, rising interest rates will improve bank profitability and increase insurance company returns on their large investment portfolios.

Finally, in any fixed income portion of portfolios, we are mindful of the rising interest rate risk, but are not anxious to move too quickly in light of a slow growing global economy. Additionally, a strong dollar is also keeping inflation low in the US and is taking some pressure off the Fed to rush to higher rates. We expect the up trend in rates to be gradual, but we continue to diversify among less correlated fixed income securities to minimize that risk.

As always, we thank you for your business and welcome your questions or comments.

The Optimum Investment Committee