THE VIEW FROM PRINCETON

Market Commentary ♦ May 2014

A VIEW AND REVIEW

ENTERPRISE VARIETY, VIGOR, AND SHARE VALUATIONS TRUMP DISMAY, DISTRUST, AND DISTRACTIONS

There is a question in the air, ubiquitously so: NOW, WHAT? The question naturally rises from five years of an irrepressible uptrend in prices of equity shares, which occurred without the sponsorship of sunny-day optimism, and without unanimity of spirit which was recurrently punctured by fractious political behavior in America, and explosive tensions elsewhere. Lingering trauma from the financial collapse of 2008 and denouements of deceptive practices still foment dismay and distrust. Surely, this is a moment that disposes thoughtful persons to check their bearings in the context of recent changes — domestically, internationally and industry-by-industry. Understanding the present as a platform for tomorrow would seem to benefit from review.

While composing these remarks for presentation to others, the following commentary from the March 1 *London Financial Times*, was encountered. This review is well skilled and so representative of the years just past that it is reproduced in full for the reader's benefit (see following page). Note the depictions of imposing anxieties, and for the contrasts with our Firm's viewpoints.

This commentary has two parts: Part I relates to review, and relies on the report in the Financial Times (see inserted following page). Part II relates to prospective changes, allowing the reading separately, according to one's time and interest.

Now expand from your recall the doubt-driven "watch out" accounts by dramatizations and amplification by way of the talking heads of television, and you will have a large slice of the sort of recent-year indigestible home entertainment. Much of this news and analysis presented is not so much for the edification of the listener as for the ulterior objectives of the presenter.

Most observers of the American scene seem to feel that the recovery movement has been unacceptably slow, deficient, and is still vulnerable while awaiting acceleration. On that, most seem to agree; but, all should also acknowledge that given the reasons for the slowness, the enduring progression should have been reassuring. They draw their judgments from historical comparisons with other recoveries. This financial collapse and recession was incomparable, quite unlike any other. The financial debacle had cut so broadly and had cut so deeply all industry was affected. Consumers were shaken, some shattered. Also interacting negatively, there was a massive hangover from the licentiousness of financing a housing boom that left a surplus of dwellings, and a legacy of deceptive financing, that required time — and more time — to cure. Ascribe full measures of acknowledgments, also, of the extent to which state and local governments cut their payrolls. This has not happened in other recessionary periods. Now, improving governmental budgets can be found almost everywhere. Under prevailing circumstances, the recovery seems to have gone well.

Part I – Financial Times Article

Michael Mackenzie

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Investors defy rising chorus of warnings on stock valuations

US equities are heating up, while the economy is feeling the cold.

A bruising start to the year when emerging market worries briefly boiled to the surface has quickly been transformed by the fear of missing out on the next leg of a US bull market run on the cusp of celebrating its fifth anniversary.

In the space of four weeks, the S&P 500 has rebounded 6.5 per cent from its early February low of 1,740, closing at a record high of 1,854.3 on Thursday. Investors view harsh winter weather as being largely responsible for the recent soft tone seen in economic reports and record stocks reflect the expectation of a spring rebound in activity.

With a string of high profile data releases looming next week, capped by the bellwether monthly US jobs report, sluggish numbers are likely to remain tainted by wintry weather in the opinion of perennially bullish analysts and investors.

The risk, however, is that the cold weather excuse may ring hollow at a time when there are signs that the bull market is becoming very extended and has entered a classic final leg of excess.

Beyond the many examples of price sticker shock in US equities, such as Google trading at $1,220 and Netflix at $450, the US Biotechnology index, laden with companies at the cutting edge of medical research and innovation – dubbed "dream stocks" – has already climbed 20 per cent in the past two months, adding to 2013's surge of 66 per cent.

There are signs the bull market is becoming very extended and has entered a classic final leg of excess

The mania for biotech helps explain why the Russell 2000 index of small companies is handily outperforming both the S&P 500 and the Dow Jones Industrial Average of blue-chip companies. So far this year seven of the best performing eight stocks in the Russell index are biotechs, led by Intercept Pharma, up more than 500 per cent since the start of January, buoyed by positive drug trial news.

Then there is the bubbling merger and acquisition wave in technology, with Facebook's $19bn capture of WhatsApp duly igniting a debate over runaway valuations in the tech sector that echoes the final vestiges of the dotcom boom.

Bank of America Merrill Lynch estimates the value of North American M&A deals will be $1.5tn this year, by far the strongest since 2007.

This week it was Tesla's turn in the spotlight as the maker of electronic cars – dubbed the "Apple of autos" in some quarters – was given a price target of $320 by Morgan Stanley. Shares in Tesla have risen some 70 per cent this year and have more than doubled since November as investors flock to companies that hold the promise of being game changers.

Therein resides one of the more interesting observations to take from a market whose bull run by March 22 will surpass the duration of the famed 1982 to 1987 version.

Betting on aggressive growth candidates and eyeing up M&A candidates is a sign that confidence in the overall prospects of the broad market is not looking as rosy as some think.

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For all of Wall Street's faith in a springtime recovery, some warn the economy is not set to accelerate sharply, a point illustrated by a 10-year Treasury yield of 2.65 per cent, down appreciably from 3 per cent at the start of the year.

"Personal consumption expenditures and personal income after taxes all have been on the decline over the past six months and point to an underlying weakness in the US economy that isn't snow or cold related," says Lance Roberts, chief economist at STA Wealth Management.

Some rebound can be expected in the spring after such a harsh winter, but it may fail to break the pattern of stop/start growth we have seen in recent years. Given lofty valuations for the broad US market, the bull case rests on a solid pickup in the economy, not middling growth in order to justify the market at its current levels.

This week James Montier at GMO published a white paper that concluded the S&P is "significantly overvalued" based on a series of models.

"Some call us 'valuation bears'; we argue that we are simply valuation realists," says Mr Montier.

Now that's a chilly forecast.

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Our Firm holds to our appraisal that the variety represented in shares of American industries, the vigor of America's enterprises, and the sober valuation of their common shares trumped the dismay and doubts that so broadly surrounded, and still surrounds us. The variety of industry supports societal stability, and for investors, allows focus. And focus ever trumps diversification. We have recurrently emphasized the contribution of major enterprises here in America (and elsewhere) for their vigor and leadership as one of the essential and most important of worldwide driving forces. We have also emphasized that the plentitude of money (of the sort that floats all boats) now in its late stage would eventually play a sufficient role in sponsoring growth. Too many analysts gave too much attention to Washington, and too little was given to the strength and driving force of large established enterprises and rapidly growing new enterprises.

An all-things-considered contemporary analysis of recent years seemed always to show pertinent circumstances were propitious for equity investors — most importantly as a slow sustainable growth that called for the help of low-interest rates. The stock market's resilient responses seem to have validated the propitiousness of these surrounding conditions. The net effect of prospective changes will sustain supportive circumstances, it seems, though constituent factors and industries are forming very significant changes, with sources of new vigor making up for losses from former sources. Prospective changes should, as always, guide selection.

Parenthetically, in addition to whatever one's mind might retain, hearts will ever remember March 2014 with awed grief for the families of passengers on Malaysian Flight MH370, and with stunned sadness for the Ukrainians and citizens of Crimea.

Part II – A Changing, Improving Landscape

Expect vast changes in immediate years, especially industry-by-industry, which seem to support the probability that the vector net of the interplay of all forces will continue to be supportive to equity valuations. The attainment of new high ground in stock price averages in contemporary context does not impart vulnerability; this increases the probability of continuing elevation of share prices.

In order to frame immediate years, lets begin with the two most pervasive of phenomena, and thus most influential, that have begun a radical change of direction that is opposite — 180 degrees — to their former courses. These are interest rates, and cost of fuels. Directional, pervasiveness, and long endurance are appropriate words to describe the characteristic additive influences of these changes. As the expectation of endurance becomes more widespread, the influences gain force over that which is now factored in. Interest rates and fuel costs touch the lives of virtually everyone, directly and indirectly.

➢ INTEREST RATES TENDENCIES

Interest rates, the most general (ubiquitous) of supportive influences, will not remain at these policy-driven unduly cheap levels. We have already entered the normalization uptrend of interest rates. Will this compete with equities? Yes, first, at the edges of high-dividend stocks, as these are purchased primarily for dividends. The dividend-income advantage that stocks had formerly over bonds will be reduced as yields from bonds increase — and bond prices erode. Will interest rates rise fast enough to constrain industry or fast enough to constrain the market generally? No, or so it appears now. Expect a year-by-year gentle normalization, not driven upward by a burgeoning demand for funds.

One of the most significant — yet seldom noted — recent-year industrial developments is seen in the important leadership emanating from the many well-managed massive enterprises. All together, these are empowered with trillions of in-hand money validating and energizing their strategic opportunities. And for capital markets, this provides a phenomena, first evident a decade or so ago, of consolidated corporate America sending funds into capital markets, in sharp contrast to drawing funds from the capital market as occurred throughout the earlier lives of living persons.

In essence, this phenomena affirms and confirms that product pricing among many thriving enterprises is quite satisfactory, providing a money flow from customers into corporate balance sheets, from which large portions are used to buy in their stock, increase dividends, acquire stocks of another company, or to reside temporarily in some money market instrument. Such a huge circulatory flow of money seems firmly set in place by the vigor and prosperity of major corporations. How can this aspect of financial flows receive so little attention, when this has been of major importance to prices of bonds and shares? This is a primary consideration, providing a basis for our expectation that interest rates will not be pulled rapidly, or imposingly, higher by large swelling needs for enterprise external financing. From drawing funds in large amounts from the capital markets, to supplying funds to the capital market, is a sea change, and then some.

- **FUEL COSTS IN LONG DOWNTREND**

The long politically driven uptrend is over in the price of liquid fossil fuels (and other fuels ancillary through kinship) from $12 a barrel or so before the first (1991) war in the Middle East to a price double that soon after the end of the war. The managed push from below $40 a barrel moved onward and upward to over $100 a barrel as huge volumes were put underground in the "strategic reserve," and as combined with effects of the second "oil war." A long downtrend in the price of fuels will help nearly every person and enterprise, from household budgets to all manufacturing, some of which typically experience use of energy as a significant element of cost to those which use a great deal, and especially to the chemical industry whose feed stocks are in many instances oil or derivatives therefrom. So, be sure that among the major trends in the years ahead, a downtrend in the price of fuels seems to be meriting the highest of probabilities. It is one of the major reasons for being optimistic on a long-term basis. This is like a subsidy for nearly everyone and a great help to a highly industrial nation such as Japan which has no oil wells — and to many other nations that have to import so much of its fuels. For America, we have the bonanza of having found the opportunity to extract natural gas through a recent-year developed process that increases the available source of natural gas to abundance, according to those who should know. This also brings new wealth to the Dakotas, parts of Texas and to New York, Pennsylvania, and West Virginia that underlie the so-well located eastern shales of the Marcellus Fields.

- **INFRACTURE MUST BE REBUILT**

As summary notations of further anticipated changes by industry or category (with additional comments following), we would consider the very high probability of prospective massive enlargements and improvements in infrastructure, especially that in most aspects of transportation. It is offensively stupid for so many millions of Americans in metropolitan areas to experience twice-a-day crawling speeds on "high-speed" roads. This is a costly use of

fuels and vehicles. In hours of human time wasted, the cost is astronomical. From the windows of your car, and from the windows of your airliner awaiting takeoff (or stacking your plane awaiting landing) you can visualize a prospective vast incremental increase in expenditures at all levels of spending — from Federal to cities, to make up for deficiencies of years past, and to prepare for future years.

So, one does not have to be very perceptive or thoughtful to know that infrastructure spending in all aspects of transportation is going to be huge. This must be. Not only is this simply costless in social terms, it will release time and money. Corresponding to the cost now wasted on highways, that wasted on runways as planes stack up before leaving, and delays before landing because of the inadequacy of airports adds to many billions (possibly trillions) of dollars per year to be saved out of the transportation expenditures — to say nothing of the gain of convenience and self respect. Foreign observers, when they come through our airports, and then try to travel in vehicles to and from our airports, think Americans must have lost all of our sanity to have let things like this happen in so wealthy a nation. This is all so massive, so visible, so urgent, only little comment seems needed. This increment could be many times larger than the effects of a stall in automobile manufacturing which has done so well in recent years.

One might argue that the Federal government cannot afford to do this. On the contrary, not doing so is unaffordable. The financial aspect are made fundable by the enormity of the savings. The Federal government could guarantee the debt of state and local governments, and some states guarantee the debt of localities or newly formed agencies, and toll revenues could service much of the debt. The urgent needs will form and force the way.

➢ THE STEADY INHERENT GROWTH FACTORS

These three (interest rates, fuels, and infrastructure) are among the most conspicuous departures to their former characteristics. Ranking high importance also, from the standpoint of investment selections, there are the ongoing thrusts from sectors that perennially (or very nearly) drive forward on their merits such as:

- Life sciences, ever inventive, ever discovering, ever financially sponsored by foundations and governments.
- Communication facilities, for which usage ever increases as encouraged by increased convenience, enhancement of applications, and available at ever lower user costs.
- Data storage, management, transmission and privacy protection, all have built-in constant growth incentives.
- Education, ever enlarged for its own sake.
- Entertainment, sourced from millions of entities, has its own unlimited variety and vibrancy.
- Travel, expands inherently with aspirations of populations.
- Airlines, restructured and especially benefiting from lower fuel costs.

This list has no intent to be comprehensive; just merely enough to keep investors mindful that growth is endemically probable, as it has been (except for very short periods) through generations.

➢ AIRLINES: THE EXTENT OF CHANGE MERITS SPECIFIC COMMENT

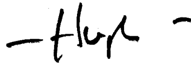
Among major industries, few, if any, are so much changed in very recent years as the airline industry. With fuel costs ranging above a third of their operating costs, there is a great expense reduction break coming their way. In addition, the major element of change is in the consolidations that have taken place among major airlines: American/US Air, United/Continental, Delta, and Southwest. These four majors (with Southwest admitted to the ranks of four) are in fundamentally improved positions. Expect many operating economies, and also expect probably a diminution in competing by lowering of rates for passengers. Years of recurrent earnings disappointments have prompted cost disciplines, mergers, and reduced valuations of share prices. The three largest airlines do not capitalize the extent of improved prospects in their valuations. American might appear to be the cheapest. United/Continental would appear to have one of the greatest of internal operational savings. This has not shown up quite so effectively as first seen, but there is more to come. And Delta (which has not had a large recent acquisition) has better management stability (without the risk that often comes when consolidating managements after an acquisition, however friendly it might have first appeared). United/Continental has the best of route patterns. Travel by air ever increases according to improvement in life style, incomes, industrial growth, and increased convenience of communication facilities that bring the world into closer contact and affinity.

➢ THE MOST FECUND SOURCES OF GROWTH STEM FROM APPLIED SCIENCES

Also from the life sciences, never a month goes by without discoveries and new applications happening somewhere. New understandings for stem cells and regenerative medicine opens opportunities of enormous potential. Constantly, therapeutics are improved through chemical changes and through identification and targeting changes of metabolic acceptances and responses. There is still unmet disease states that attract enormous amounts of research. So from the life sciences, and from the physical sciences, there is never stagnation or patterns of periodic retreat known as business cycles. There is only innovation and growth, year upon year, from the applied inquiry and intelligence to make life on earth safer, better, and more abundant.

And most important among all the aspects that have been so vigorous in creating and sustaining growth is the inventiveness that has come from the sciences. All of the communications facilities are ever being enhanced by thousands of participating companies working to make it better. The use of sending data and voice messages is insatiable, made ever more felicitous and effective by innovation. Youthful use is driven by entities not existing two decades ago such as Twitter, Facebook, Google, and Yahoo. Data storage, the cloud, and streaming provide abundance at ever increased conveniences and reduced costs to all everywhere. The phenomena is here to stay, and is probably the greatest single driver of activity and of new wealth. Twenty years ago, very little of this existed as a mighty force of change.

All things considered we are led to focus as we commonly do on the driving formative forces and concentrate investments in those enterprises where their internal energy and their external circumstances combine to give predictability on a company-by-company, or industry-by-industry basis. We do not see that the American Stock Market as overvalued at these heights. Surely there are fewer undervalued securities than there were, but there are still many, and there are fewer overvalued securities than is common. The market has such variety, and at this moment without an ominously large overhang of excessive valuations, that investors should continue in a fully invested focused way that avoids those shares that are clearly overvalued, as well we those of "also run" enterprises that have little distinguishing merits. The overall course of market measurements seem likely to continue upward from the supplementing of ebbing forces of support with new and wider new sources of support. The important changes — even reversals of the drivers of the last few years —will be more than compensated for by spreading regenerative forces in the American economy.

					
Alfred R. Berkeley	James Fitzpatrick	Hugh Fitzpatrick	Ken Berents	Jordan Schreiber	Steve Reynolds

POST SCRIPT

Not since the Federal Reserve System was created in 1913 has a Chairman had to cope with so complex and such self-inflicted difficulties among banks, as Chairman Bernanke has had to address. Recall, soon after taking office he remarked that the American banking system was apparently in very good shape, and to his everlasting credit he did not let his own words bind him against what he saw in the real world after having left the campus of Princeton University. From many a university campus, there is a long distance to traverse into the realities of commerce.

Professor Bernanke, beset with the most difficult incoming assignment of any Chairman, devoted himself for the common good with a valor and determination that matches or exceeds anything the writer has seen throughout the post-World War II period. With assuming personal privilege, the writer wishes to say that Mr. Bernanke's dedication, integrity, openness, and manner imparts a legacy of rich social worth unmatched by others. America is ever in his debt, and public servants everywhere might take notice of his unfailing willingness to apply all of his energies toward what he thought was needed.

May the easier years that lie ahead bring him the satisfaction of knowing there very likely are many others who concur. It is a mark of such character as just noted that the transition to Professor Yellen follows so easily, so seamlessly forward. We have in this transition yet another continuing blessing from the pattern and values given by Ben Bernanke. And, there is much to do still to avoid another financial catastrophe in a scale to again blight commerce and bring governments of leading nations to rewrite the ground rules for this service industry. From elemental social considerations, the financial industry's role — its *raison d'etre* — is supportive service to enterprises engaged in value-added activities. There is still a foreboding contrast inherent from so much self-serving activity contemporaneously.