MANAGED ASSET PORTFOLIOS

MAP VIEWS
Fourth Quarter 2014

After enjoying relative calmness for the past year and a half, volatility has returned to the world's equity markets. Within the first two weeks of the quarter, the Dow Jones Industrials erased all of 2014's gains, after being up over 4% earlier in the year. Other indices such as the Russell 2000 were off 10% year-to-date and many European markets were off double digits including currency depreciation. An anemic global economic picture appears to have been the impetus for the sell-off. However, better than expected corporate earnings, combined with a growing consensus that Central Banks will continue their accommodative stance, allowing stock prices to rebound.

The sluggishness in the global economy does not surprise us. For quite some time we have cited two structural issues that continue to create economic headwinds: an excess amount of debt in the system and a shift in employment demographics. Today, domestically, total debt (federal, municipal, corporate, mortgages, credit cards, car loans, etc.) to GDP (gross domestic product) stands at 330%, compared to a little over 100% half a century ago. Additionally, the U.S. has undergone a major shift in its employment base. As an example, half a century ago, America's largest private sector employers included: General Motors, Ford, Chrysler, General Electric, and U.S. Steel. Today's largest employers include: Wal-Mart, Kelly Services, Target, Kroger, Home Depot, and Yum Brands (which owns KFC, Taco Bell and Pizza Hut). This shift from high paying manufacturing jobs with great benefits to lower paying service jobs with few benefits has put a real squeeze on the middle class and has limited their ability to fund discretionary expenditures.

The situation is similar around the globe. Debt levels are historically high in Europe and Japan, which are hindering their ability to post any sort of meaningful economic expansion. In order to help provide a "prop" for these economies, Central Banks around the world have been very accommodative, forcing interest rates down to historically low levels and by increasing liquidity.

Even the emerging markets are experiencing a sluggish economic environment. This is probably a result of the ending of the Quantitative Easing (QE) program in the U.S., sanctions against Russia and a slowdown in the Chinese economy which is impacting commodity prices. We view these issues as more cyclical in nature as opposed to the structural ones impacting most developed economies.

While much has been written about the success and/or failures of the Fed's QE, it is clear that the primary beneficiaries of the three QEs since 2009 are twofold: those with assets (i.e. bondholders, shareholders, and landowners) and the government. As a result of the QE programs, asset prices have rallied and interest rates have dropped. This has helped asset owners and the government as they pay less interest on an ever growing debt burden.

As the U.S. wraps up its third round of Quantitative Easing, attention begins to focus on Europe. The European Central Bank (ECB) already has negative interest rates. While the ECB has not yet engaged a full QE program, we believe that it is merely a matter of time until it does. And in an almost perverse fashion, the worse the economic headline numbers are, the greater the likelihood of a quicker and more aggressive response from the world's policy makers.

Momentum combined with investor psychology can create a powerful force. As a result, we would not be surprised to see recent weakness continue a bit longer; however, we view this as a correction and not the beginning of the end of the five-year bull market for stocks Typically, equity bull markets end when the economy is running at full speed, with full employment and full plant and equipment utilization. Today, there is ample room in the jobs market. In fact, the labor force participation rate (the percentage of Americans that are employed) is near its lowest level in over 30 years.

At current levels, we would describe stock market valuations as "fair," as they are not historically expensive, nor are they historically cheap. When viewed in the context of a benign inflationary environment (at least for now) and historically low interest rates, we believe a strong argument can still be made for stocks. Corporate earnings have been expanding at a reasonable clip during the post financial crisis era, despite subdued revenue growth. Corporations have been keeping a lean cost structure and have boosted EPS through a record number of share repurchases. As we make our way through earnings release season, companies have reported more positive surprises than negative ones. Through the first three weeks of earnings release season about 70% of the companies have reported quarterly EPS ahead of expectations. Going forward, our concern for U.S. companies is the recent strength in the U.S. dollar. This will create a headwind for U.S. companies that export their goods. Conversely, a weaker euro should help the earnings outlook for European exporters.

For several years we have described stocks as "the best house in a bad neighborhood." Our stance has not changed. We continue to look for global economic sluggishness that will force Central Banks to remain accommodative (and become even more so in the cases of Euroland and China). We believe this will help to create a bullish environment for equities. We continue to favor many of the defensive areas such as foods, beverages, tobacco, and select healthcare. We continue to shun the sectors that are the most economically sensitive, as we believe 2% growth is about all the U.S. will muster up for the next few years and many European countries will be challenged to post 1% growth. We believe the recent decline in equity prices will once again help to place the spotlight on dividend paying stocks. We believe that with this decline, investors will shift some of their focus from recent highflyers (such as GoPro, Facebook, and Tesla) to companies with more attractive valuation metrics. Barring any material "black swan" events, such as a major ISIS attack on Western soil, or a marked worsening of the Ebola scare, we believe value stocks can move higher from current levels. We caution, however, that volatility may be the new norm, and hence would be looking to purchase companies with attractive valuations, if the market presents us with an opportunity to do so.

Thank you for allowing us the privilege to serve as your investment advisor. It is a responsibility we take seriously. We work diligently and ethically every day to maintain your trust. For additional insights into our thoughts on the economy and financial markets, please visit www.managedassetportfolios.com.

As always, please do not hesitate to contact us with concerns or questions you may have at any time.

Kindest regards,

Michael S. Dzialo
President & Chief Investment Officer