CAMPBELL CN NEWMAN
Asset Management, Inc.

Tomato, Tomahto?

March 31, 2014

Reflections & Perceptions

The markets have been trying to decipher how a Yellen Fed will be different. March's Open Market Committee meeting was the Chairwoman's first in her new position. Out of that meeting came the announcement that there would be no change to the near-zero interest rate policy on Fed Funds and the Fed will reduce its monthly bond purchases to $55 billion. The central bank also rewrote its guidance regarding the path of short-term interest rates, putting less emphasis on the level of the unemployment rate as a guidepost for when rate hikes will begin. Instead, the Fed will look at a broad range of economic indicators while assessing when to increase short-term rates from near zero, where they have been since December 2008. Ms. Yellen mentioned 10 different labor-market indicators she is watching, including the share of workers who have been unemployed for six months or more, the share of adults who are holding or seeking jobs, the portion of workers who hold part-time jobs but say they would rather have full-time occupations, and the rate at which people are quitting jobs.

To paraphrase from an old George Gershwin tune, "You say tomato, I say tomahto"… After sifting through the verbiage, we expect the Yellen Fed will be very similar to the Bernanke Fed. This should come as no surprise: When asked at her first news conference as Chairman how her tenure would differ from her predecessor, Ms. Yellen could not come up with a single difference. As has been the case, decisions will remain data dependent on "dots" that are dynamic and difficult to predict. As a result, any timeline on a rise in interest rates will remain elusive--just like it has in the past.

Wall Street Journal columnist Spencer Jakab pointed out in his March 18th article "*What Will It Take for the Fed to Raise Rates?*" that the Fed has changed its timeline for raising the Fed Funds rate no fewer than six times since the current rate was established over five years ago.

> *First there was 'some time' which became 'an extended period.' Seeking more specifics, the market was then told rates would begin to rise in mid-2013, by late 2014 and then mid-2015…. The latest threshold, an unemployment rate of 6.5%, barely below today's level, will likely get the chop Wednesday following the Fed's two-day meeting. **
>
> **Held March 18 & 19*

Indeed Jakab's prognostication proved correct.

As with the Fed's modus operandi, our assessment of the economy remains unchanged from our base case of "muddle through" first articulated 28 months ago. The U.S. economy will expand at an annual rate of less than 3% with the recovery weighed down by weakness in the global economy, restrictive U.S. tax and spending policies, and persistent business caution. The cautious Fed will slowly increase interest rates only as the environment permits because inflation may be bad, but deflation is worse.

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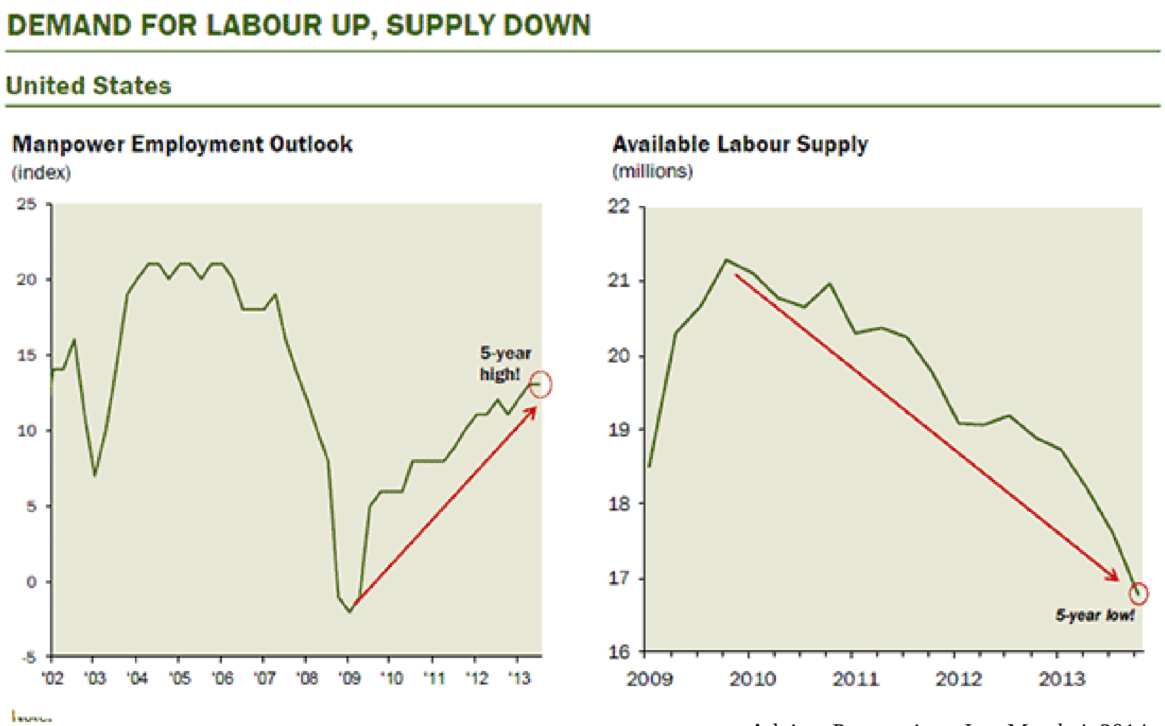
Although the recovery that began in June 2009 remains lackluster, it is important not to be overly pessimistic. The economy is growing and there are indications that progress is being made in several areas, with the job market being one.

Economist David Rosenberg recently pointed out that the demand for labor is at a five-year high (Figure1) and that the number of small businesses intending to increase labor compensation is at its highest point in this business cycle. The end result is a transfer of income from the part of the economy that has a 40% savings rate (corporations) to that with a 4% savings rate (consumers). That shift would create a “real multiplier impact on spending” for both consumers and corporations, according to Rosenberg.

Figure 1



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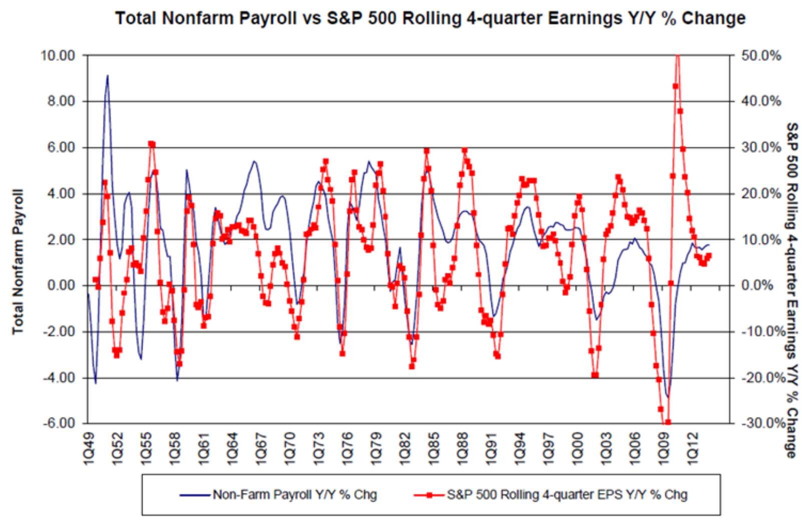
Additionally, increases in payroll (growing employment) is correlated with higher earnings for corporations. This relationship is depicted in Figure 2, constructed by Citi Research’s strategist Tobias Levkovich. In the past, employment gains have helped economies grow and generate further profit opportunity for companies--suggesting that the feared profit squeeze from job growth is not in the cards. Specifically, jobs and earnings have generally improved and declined together. Consequently, investors should not view improvement in employment as anything but a good thing (which is contrary to the prevailing point of view).

Figure 2



Sources: Haver Analytics and Citi Research – US Equity Strategy

Longer-term, higher earnings growth will drive higher stock prices. But, given that last year's strong equity market performance outpaced earnings growth, which caused valuations to expand, a more tepid market return is expected this year, with corrections along the way.

As first quarter earnings are reported over the coming weeks, and management provides their views on how 2014 is developing, we will have more information to incorporate into our analysis. Given the information available today, we find the best opportunities in the Industrials, Consumer Discretionary, and Information Technology sectors. Our underweighted Sectors are Consumer Staples and Utilities. Based on our work, the stocks in these groups appear overvalued.