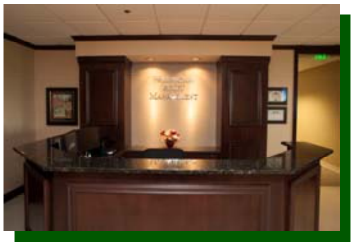
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

QUARTERLY REVIEW

2014: THIRD QUARTER | **103RD EDITION**



8900 Keystone Crossing, Suite 1015
Indianapolis, IN 46240
www.wallingtonasset.com

COMMENTARY

WHERE ARE THE ANIMAL SPIRITS?

"Animal spirits" is a term made famous by economist John Maynard Keynes in the 1930s in reference to risk taking – an essential part of any economic and financial system. Choosing which risks to take and which to avoid determines the fate of economies, companies and investors. In the 1930s, there was a reluctance to take on much risk, thus the lack of animal spirits, likely due to the stock market crash of 1929 and the ensuing Great Depression.

The financial crisis and Great Recession of 2007-2009 had a similar effect on a new generation of corporate executives. In their tenures, they had never experienced a financial crisis or such a severe recession whereby the credit markets virtually shut down, prohibiting the issuance of corporate debt and the ability to increase borrowing from banks. This was the first time credit was constrained for the corporate sector, and it changed corporate behavior.

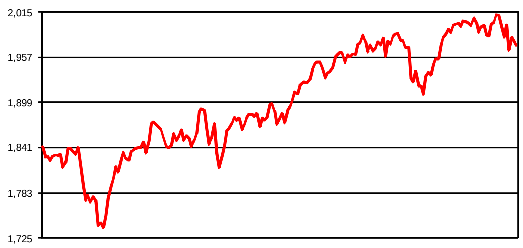
(*Continued on Page 12*)

In this Issue

CAPITAL MARKETS SCOREBOARD

January 1, 2014 – September 30, 2014

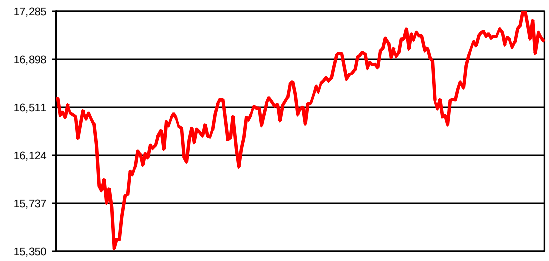
S&P 500



January 1, 2014 - September 30, 2014

3rd Qtr 1.13% YTD 8.34%

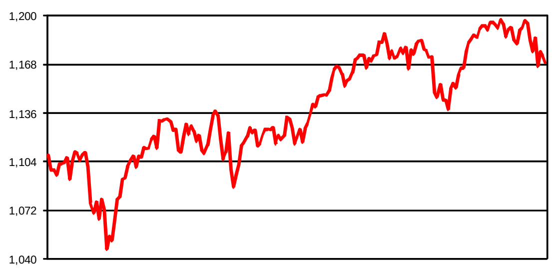
DJIA



January 1, 2014 - September 30, 2014

3rd Qtr 1.87% YTD 4.60%

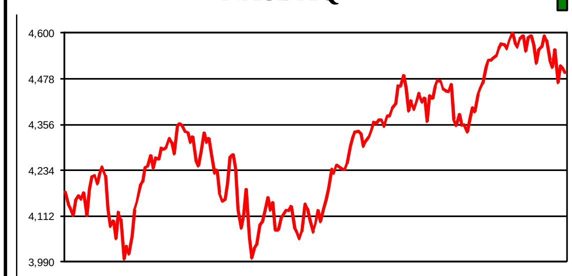
Russell 3000



January 1, 2014 - September 30, 2014

3rd Qtr 0.01% YTD 6.95%

NASDAQ

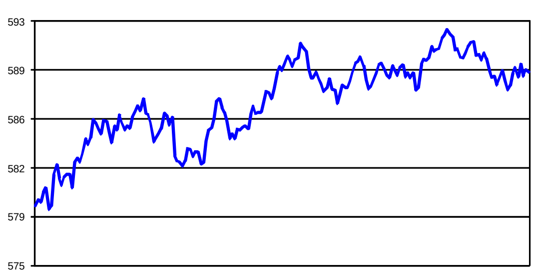


January 1, 2014 - September 30, 2014

3rd Qtr 2.24% YTD 8.56%

Bank of America - Merrill Lynch

Intermediate-Term Government/Credit Index

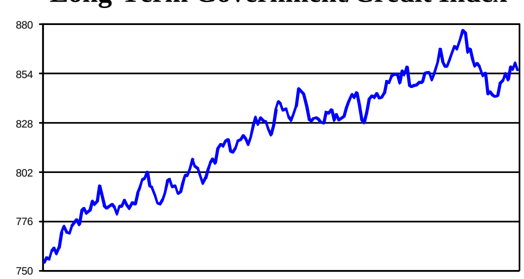


January 1, 2014 - September 30, 2014

3rd Qtr -0.19% YTD 1.70%

Bank of America - Merrill Lynch

Long-Term Government/Credit Index



January 1, 2014 - September 30, 2014

3rd Qtr 1.44% YTD 13.50%

Performance Numbers Reflect Total Returns

EQUITIES

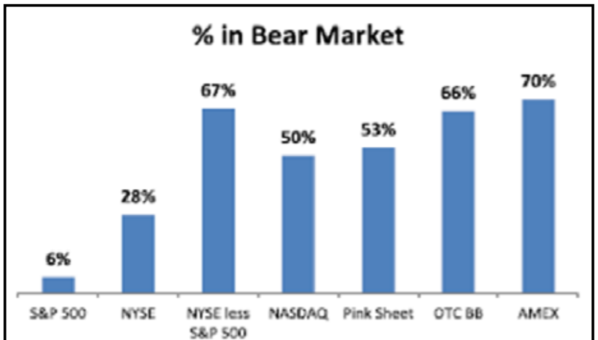
EQUITY MARKET PERFORMANCE

The Standard & Poor's 500 Index (S&P 500) posted a total return (price change plus dividends) of 1.1% in the third quarter of 2014. For the year-to-date period ending September 30, the S&P 500 gained 8.3%. The same respective figures for the tech-laden NASDAQ Composite were 2.2% for the quarter and 8.6% for the year. In contrast to the S&P 500 and NASDAQ Composite, the Russell 2000, representing companies with smaller capitalizations, declined 7.4% in the quarter and 4.4% year-to-date. Returns for the MSCI EAFE (Europe, Australasia and the Far East) also compare unfavorably to large-cap U.S. indices, declining 5.8% for the quarter and 1.0% on a year-to-date basis. The Health Care and Information Technology sectors of the S&P 500 outperformed the other economic sectors of the index by a margin of about 2-to-1 in the third quarter as well as on a year-to-date basis (reference the nearby table). Within Health Care, the Biotechnology industry led the way with a 17.5% return. Industry gains in the Information Technology sector were distributed more evenly, although Electronic Equipment Instruments and Components stood out as the sector's worst-performing industry with a 7.5% decline for the quarter. At the other end of the sector spectrum, Energy's two main industries, Oil Gas & Consumable Fuels and Energy Equipment and Services, provided negative total returns for the quarter (-7.5% and -13.1% respectively).

S&P 500 by GICS Sector	Total Return (%)	
	3Q14	**YTD**
Health Care	5.5	16.6
Information Technology	4.8	14.1
Telecom	3.1	7.5
Financials	2.3	7.4
Consumer Staples	2.0	7.2
Consumer Discretionary	0.3	0.9
Materials	0.2	8.9
Industrials	-1.1	2.9
Utilities	-4.0	14.0
Energy	-8.6	3.2
S&P 500 Index	1.13	8.3

DISSECTING EQUITY MARKET PERFORMANCE

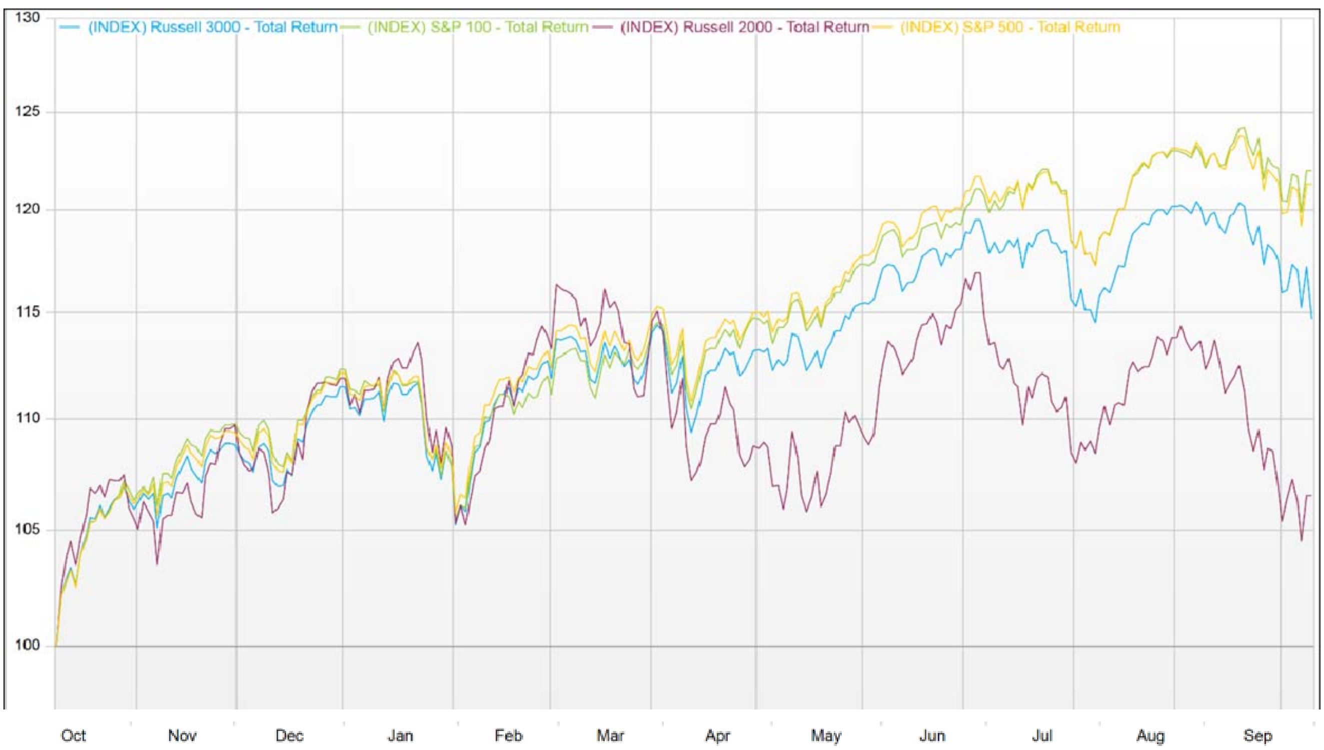
Even as several major U.S. stock indices reached new nominal high values, many stocks were trading at least 20% below their respective 52-week highs and thus were in their own "bear market." Indeed, the NASDAQ Composite's 17.7% trailing one-year gain occurred despite approximately 50% of its component companies trading 20% or more below their respective 52-week highs. The Amex Composite's 10.9% gain seems out of step considering that 70% of its shares were off by 20% or more. The New York Stock Exchange (NYSE) Composite appears better by comparison, which pairs its 10.4% one-year gain with 28% of shares in "bear" territory. However, when you remove shares from this composite which are also part of the S&P 500, the percentage increases dramatically to 67%. In contrast, just 6% of S&P 500 components have recently traded in bear market territory, although Bespoke Investment Group notes that the average S&P 500 stock is down over 7% versus peak prices. The negative breadth of the stock market is troublesome as it reflects bearish momentum regardless of how the indices themselves are faring. Index construction methodologies are responsible for this disparity. The aforementioned indices weight the relative performance contribution of each component stock based on the underlying company's total market capitalization (number of shares outstanding times the price per share). As a result, the price changes of shares from a few companies with the largest market capitalizations in a particular index can swamp the price changes of a vast swath of companies with smaller market capitalizations, and therefore unduly influence index performance.



Source: Cornerstone Investment Services, LLC; Commentary for 2014 09-25 by John J. Riley

SMALL CAP EQUITIES UNDERPERFORMANCE

Shares of companies with smaller market capitalizations (small caps) have recently underperformed large capitalization (large cap) equities as investors have become increasingly adverse to risk. The performance gap began in earnest during the second quarter of 2014 as the graph below illustrates. Beginning in the second quarter, the performance differential between small cap stocks and large cap stocks became increasingly clear as the indices with small cap exposure began to underperform the other indices. First, the Russell 2000 Index (dark red) began falling behind, then the Russell 3000 Index (blue) started to lag. The Russell 2000 index is a small cap stock market index of the bottom 2000 stocks in the Russell 3000 in terms of market capitalization. The S&P 500 (yellow) kept pace or exceeded the S&P 100 index (green) through most of third quarter of 2014, but began lagging toward the end of September. Stocks in the S&P 100 index are generally the largest companies in the S&P 500 and represent almost half of the stock market capitalization of the U.S. equities market.



Russell 3000 || Measures the performance of the largest 3,000 US companies representing 98% of the investable US equity market.

Russell 2000 || Measures the performance of the small-cap segment of the US equity universe representing approximately 10% of the total market capitalization of the Russell 3000 Index.

S&P 500 || A large-cap index that includes 500 leading companies, capturing approximately 80% of the investable US equity market.

S&P 100 || A subset of the S&P 500, it is comprised of 100 major, blue chip companies across multiple industry groups.

Source: FactSet Research Systems

EQUITIES

EARNINGS GROWTH AND GUIDANCE

Companies in the S&P 500 issued negative earnings guidance at a higher rate than usual for the third quarter. Of the 109 companies who offered guidance, 76% did so in a downward fashion. This was above the five-year average of 67%. These numbers must be taken with a grain of salt, as over the past five years, companies who preannounced have reported actual earnings per share (EPS) 12.3% above their guidance and outperformed guidance 82% of the time. Over the same time period, all S&P 500 companies have beaten earnings estimates 73% of the time. This would indicate that, in general, companies would prefer to outperform lower expectations than underperform higher expectations.

On June 30th, the estimated third quarter earnings growth rate for the S&P 500 was 9%; however, it declined to 4.6% as of October 3rd. Individual company EPS estimates fell 4.2% over the quarter. This drop is not out of the ordinary, as the average intra-quarter decline over the past ten years has been 4.5%. Nine out of the ten economic sectors in the S&P 500 are expected to present higher earnings than one year ago with Consumer Discretionary being the one laggard. With revenue expected to grow at 3.6% (compared to earnings growth estimates at the aforementioned 4.6% rate), analysts are anticipating continued year-over-year margin expansion. Net margins are expected to rise to 9.9% for the third quarter after coming in at 9.5% one year ago. This would be a slight decrease from the 10.1% record set in the second quarter. A continued upward trend is anticipated with margins eclipsing 11% for the first time by the end of 2015.

Earnings Growth

	Q3 '14	CY 2014
Name	Growth Blended (%)	Growth 3 Oct '14E
S&P 500	**4.6**	**6.8**
Consumer Discretionary	-5.7	4.8
Consumer Staples	0.95	3.3
Energy	3.8	5.5
Financials	11.2	4.8
Health Care	10.6	13.9
Industrials	5.5	7.4
Information Technology	0.54	5.3
Materials	10.8	5.7
Telecommunication Services	23.3	29.4
Utilities	2.8	4.1

Revenue Growth

	Q3 '14	CY 2014
Name	Growth Blended (%)	Growth 3 Oct '14E
S&P 500	**3.6**	**4.0**
Consumer Discretionary	4.4	4.7
Consumer Staples	3.3	3.4
Energy	-3.0	0.63
Financials	3.7	2.9
Health Care	10.2	9.4
Industrials	3.0	2.5
Information Technology	6.1	6.0
Materials	2.0	1.4
Telecommunication Services	3.5	3.6
Utilities	5.1	5.4

Source: FactSet Research Systems

MARKET VALUATION METHODOLOGIES

The equity markets have been on a tear in recent years, reaching all-time highs during the third quarter of 2014. This has left many strategists pondering whether the market is fully valued or nearly so. Those who view the market as overvalued often reference two market valuation indicators that have gained attention as of late: the "Buffett Indicator" and the "Shiller P/E Ratio."

The "Buffett Indicator" compares the stock market value with Gross Domestic Product (GDP). According to Buffett, if the stock market's capitalization is over 100% of GDP then the market is overvalued. The stock market value is currently 127% of GDP, causing those who place credence in this indicator to worry that the market is due for a fall.

The "Shiller P/E Ratio," which was created by Yale University economics professor Dr. Robert Shiller, is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted P/E Ratio (CAPE Ratio). Dr. Shiller utilizes average inflation-adjusted earnings over 10 years to eliminate profit margin fluctuations during business cycles. Based upon this indicator, stocks are overvalued trading at a P/E of 26.

(Continued on Page 6)

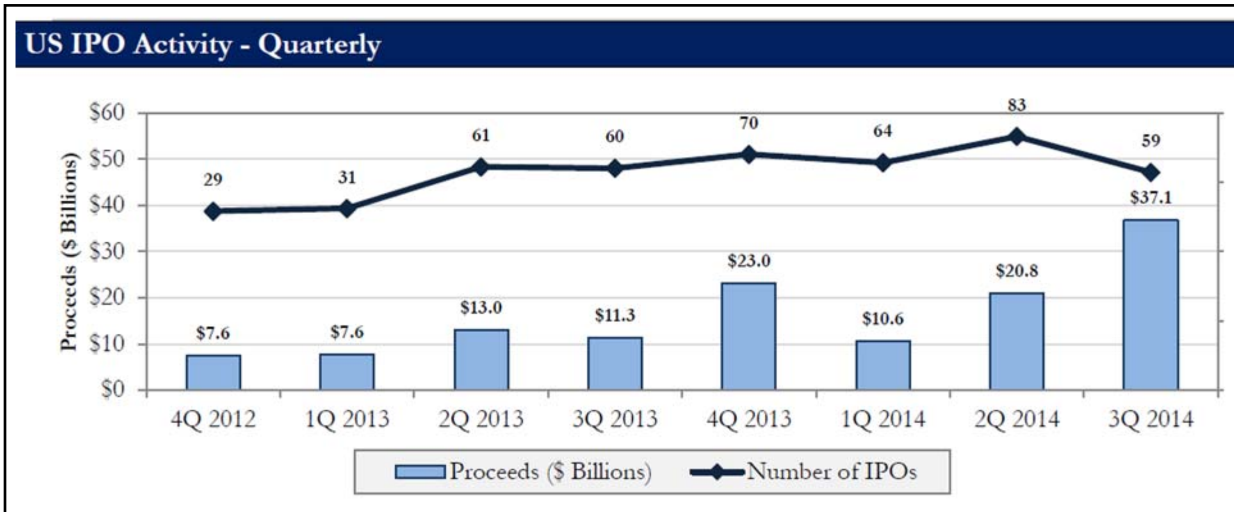
EQUITIES

MARKET VALUATION METHODOLOGIES *(Continued from page 5)*

While the "Buffett Indicator" and the "Shiller P/E ratio" make intuitive sense to some, it is important to understand shortcomings associated with these two valuation models. In the case of the "Buffett Indicator," one large shortcoming is that corporations are becoming more global in nature. In fact, approximately 30% of the revenue produced by companies in the S&P 500 is generated overseas, and thus not counted in GDP. The "Shiller P/E" model is criticized because it does not take into account the low rates that currently exist in the market, which may partially explain the high CAPE ratio. But even if rates rise, there is no assurance of an equity market selloff. In fact, the equity markets posted positive returns the last three times the Fed raised rates. Interestingly, the last two market swoons (2000-2003 and 2008-2009) were both accompanied by the Fed *cutting* interest rates. Hence, it would be safe to assume the biggest risk to equity valuations is a severe economic contraction rather than modest interest rate increases. Finally, it is important to note that the markets can remain under or overvalued for substantial periods of time, and overvaluations can be rectified by earnings increasing at a faster rate than underlying share prices.

THIRD QUARTER INITIAL PUBLIC OFFERINGS

The three months through September marked the busiest quarter for initial public offerings (IPOs) in the U.S. since the fourth quarter of 1999. Globally, IPOs raised nearly $67 billion in capital in the third quarter, bringing the year's total over $180 billion. Nearly $40 billion of the capital raised in the third quarter came from the U.S. Meanwhile, $14.3 billion and $8.6 billion were raised in Asia and Europe respectively. In the third quarter, issuance totaled 59 offerings, 32% of which were in the Biotechnology space. While the total number of domestic offerings in the third quarter was down from the previous five quarters, year-to-date issuance totals 206 offerings, the most through the first three quarters of any year since 2000 and an increase of 36% over the first three quarters of last year. Alibaba Group of China's offering highlighted the busy quarter. The IPO raised a record-breaking $25 billion in the U.S. in September, surpassing the $22.1 billion record previously set by the Agricultural Bank of China in 2010. Alibaba's offering also bested Facebook's 2012 mark of $16 billion, which formerly ranked as the most capital raised for a technology IPO. Excluding Alibaba, the third quarter was still the busiest quarter for IPOs in nearly four years. However, the increase in supply may have negatively impacted the stock performance of IPOs; average U.S. IPO returns slipped for a third straight quarter, and were more than 20% lower than U.S. IPO returns in the third quarter of 2013.



Source: Renaissance Capital. Includes IPOs with a market cap of at least $50 million and excludes closed-end funds and SPACs.

EQUITIES

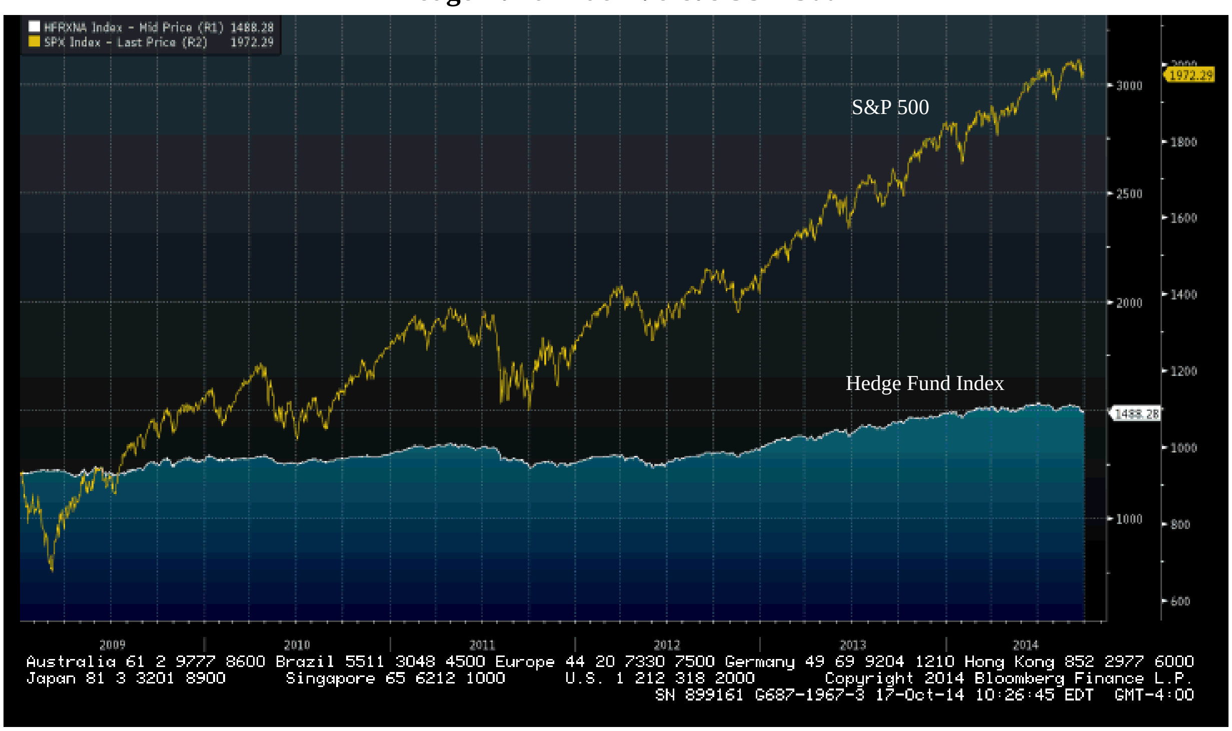
HEDGE FUNDS: THE BEGINNING OF THE END?

The hedge fund industry has grown rapidly as assets under management have ballooned from $800 billion a decade ago to $2.7 trillion currently. They used to be for wealthy individuals, but now are owned primarily by institutions such as pension funds and endowments. Recently, the California Public Employees Retirement System (CalPERS) shocked the industry by announcing it was unwinding its $4 billion hedge fund position. CalPERS is the largest pension fund in the U.S. and any of its moves or strategies have a big influence on other institutional investors.

CalPERS gave several reasons for unwinding its hedge fund positions: 1) the costs of investing in hedge funds – funds charge "2 and 20," meaning a management fee of 2% of total assets under management and a performance fee of 20% on any investment gains generated in the period, although most hedge funds discount those fees for large institutions; 2) the complexities of owning a hedge fund – they can adopt complex investment strategies, use leverage and are not always transparent; 3) underperformance since 2009 – CalPERS did not specifically mention performance in its news release, but hedge funds have generated returns of less than half of the S&P 500 since the bull market started in March 2009; and 4) the hedge fund industry has a somewhat tarnished reputation – the numerous insider trading violations uncovered in recent years, the enormous compensation packages paid to hedge fund managers (the 25 highest-paid hedge fund managers made $21 billion in 2013) and several controversial tax strategies utilized by hedge funds.

In addition to the cost, complexity and performance issues, selecting a hedge fund is difficult. Picking a young hedge fund is risky because the average life of a hedge fund is less than five years. Picking a large established fund is also risky because size appears to hinder performance. So perhaps the CalPERS decision to eliminate hedge funds from its portfolio is the tipping point for the industry.

Hedge Fund Index Versus S&P 500



Source: Bloomberg Finance, L.P.

ECONOMICS & FIXED INCOME

FIXED INCOME PERFORMANCE

According to Bank of America Merrill Lynch's (BOAML) broad U.S. Corporate Master Index, the U.S. corporate fixed income market return equaled just 0.05% in the third quarter of 2014. The year-to-date return through the end of the third quarter, however, was 6.0%. BOAML's U.S. Government Bond Index gained 0.43% in the just-completed quarter, while the high-yield (junk bond) index declined 1.92%. On a year-to-date basis, the "high quality" government bond index return of 3.66% edged out the "low quality" high yield return of 3.61%. Among the major fixed income sub-asset classes, U.S. municipal bond returns have trumped all others. The municipal bond index's returns for the third quarter and year-to-date were 1.64% and 8.33%, respectively. Finally, longer-term bonds, as represented by BOAML's U.S. Corporates – Governments (10+ Y) Index, outperformed the shorter-term version, the (3-5 Y) index, 1.44% to -0.19% in the third quarter.

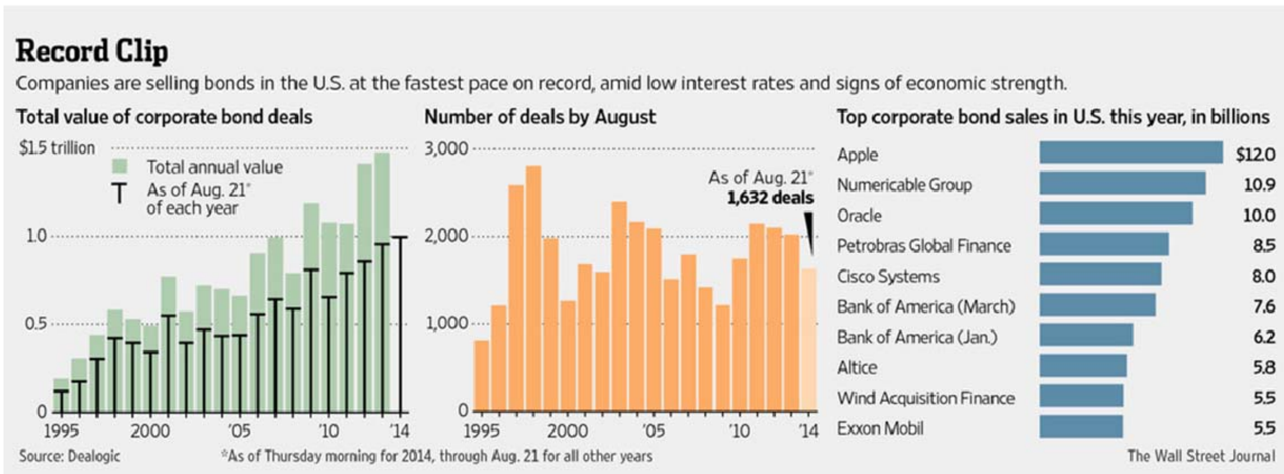
INTEREST RATES

The movement in interest rates has been one of the biggest surprises this year. As we entered 2014, many forecasters firmly believed that we would see higher interest rates by the end of the third quarter. In fact, many felt that rates would rise when the Federal Reserve (Fed) took the punch bowl away in the form of slowing purchases of U.S. Treasury debt (Quantitative Easing). However, the opposite occurred with the 10-year U.S. Treasury note hitting 2.5% by quarter-end after beginning the year at 3.0%. The Fed has been fairly vocal in preparing the financial markets for rate increases. In fact, the Federal Reserve Open Market Committee has even been releasing its median forecasts for interest rates over the next three years, which currently point to higher interest rates in the future. This has caused the bond market consternation since bond prices move inversely to interest rates. One reason the 10-year Treasury rate has declined is because the U.S. is viewed as the "best house in a bad neighborhood." Hence, a 10-year U.S. Treasury note is very attractive to global investors when the yields on 10-year German and Japanese government bonds are 0.9% and 0.5%, respectively. Additionally, while the Fed has indicated that it will raise rates, the European Central Bank unexpectedly cut rates in September in the hope of jump-starting economic growth and starving off the threat of deflation. Consequently, foreigners are piling into U.S. dollar-denominated securities, which should appreciate in value relative to foreign denominated bonds. According to the Fed, foreign investors now hold approximately 50% of the outstanding U.S. government debt.

Source: US Treasury; Bloomberg

RECORD DEBT ISSUANCE

Corporations continue to reap the rewards of low interest rates as Dealogic, a provider of proprietary content to investment bankers, helpfully summarizes in its latest edition of *Global DCM Review*. Total global corporate debt issuance by investment-grade companies equaled $1.33 trillion in the first nine months of 2014, which is the third straight year debt issuance exceeded $1 trillion before October. High-yield issuance amounted to $394.3 billion, with European volume up 53% versus the comparable period in 2013. In recent years, companies have borrowed to fund share repurchase programs, pay special dividends or refinance outstanding debt at advantageous rates. However, companies have begun to use the proceeds of debt issuance on capital expenditures, i.e. equipment purchases, a long-missing aspect of the corporate investment cycle.



Source: Dealogic; The Wall Street Journal

BILL GROSS DEPARTURE FROM PIMCO

The fixed income world received a surprise at the end of the quarter, as William H. Gross announced he would be leaving Pacific Investment Management Company (PIMCO), the firm he co-founded in 1971. Mr. Gross gained acclaim as the lead manager of the PIMCO Total Return fund, formerly the world's largest mutual fund. Rumors of unrest at PIMCO ran rampant, starting with the abrupt departure of former CEO Mohamed El-Erian earlier in the year. Exactly how much Mr. Gross' departure will affect PIMCO is still to be determined, although the departure of $23.5 billion from PIMCO's Total Return fund in September marked the industry's largest one-month outflow ever from a single mutual fund.

GROSS DOMESTIC PRODUCT

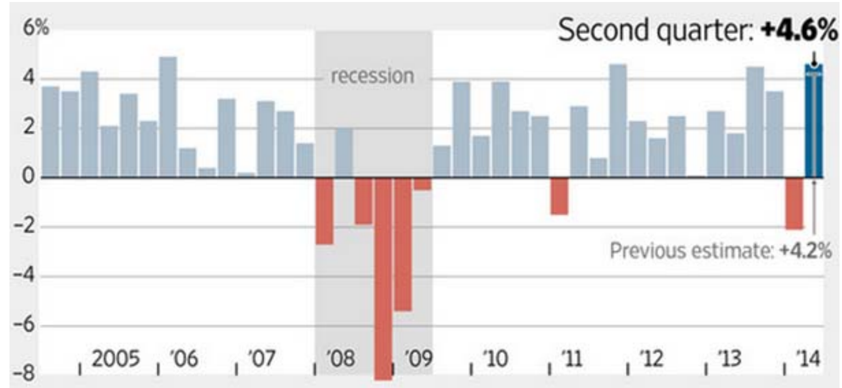
U.S. Gross Domestic Product (GDP) rebounded in the second quarter after dismal results were reported for the first quarter of 2014. The latest report for the quarter-over-quarter seasonally-adjusted annual rate (SAAR) for GDP was 4.6%. This was an increase from 4% in the advance estimate for the second quarter and represented an improvement from the revised -2.1% reported for the first quarter of the year. While consumer growth lagged business growth, personal consumption expenditures were up 2.5%, led by durable goods at 14.1%. Business investment proved to be strong, as gross domestic private investment increased 19.1%, compared to a 6.9% drop in the previous quarter. This SAAR was the highest quarterly increase since the fourth quarter of 2011.The overall increase was also in stark contrast to the Eurozone, which remained flat for the quarter and has not had a quarterly GDP increase greater than 1% since 2006.

(*Continued on Page 10*)

ECONOMICS & FIXED INCOME

GROSS DOMESTIC PRODUCT *(Continued from page 9)*

Deflationary pressures continue in the Eurozone as their Consumer Price Index continued to grow at a slower rate of 0.3%, the lowest level since 2009. Looking forward, estimates for U.S. GDP growth in the third quarter are 3.1% compared to 0.3% for the Eurozone. China is expected to report only 7.3% year-over-year GDP growth for the third quarter. This would mark the lowest year-over-year growth for China since 2009.



Source: Commerce Department; The Wall Street Journal

JOBS AND WAGES

On October 3, 2014, the U.S. Bureau of Labor Statistics released its September jobs report. The headline numbers showed 248,000 new jobs were created and the unemployment rate declined to 5.9%. On first blush, the report would seem to indicate the employment situation is improving at or ahead of the pace needed to maintain the ongoing economic recovery. However, a more complete assessment would need to include wage growth and participation rate. The jobs report stated the average hourly earnings for all employees on private nonfarm payrolls declined by $.01 and the year-over-year increase was 2.0%. The following table shows the average hourly earnings in the U.S. compared to the Consumer Price Index since January 2009. As can be seen, wage growth has barely kept pace with inflation during this economic recovery.

Source: Federal Reserve Economic Data (FRED); Fortune Magazine

Wage growth is an important factor in providing discretionary income leading to demand for goods and services. Healthy demand could help sustain an economic recovery and provide support for the Federal Reserve's target inflation rate of 2%. Historically, the unemployment rate has been a reliable indicator of future wage growth. The lack of wage growth has contributed to inflation remaining below the Federal Reserve's target.

One likely reason unemployment has dropped without a corresponding increase in wages is the participation rate. The latest U.S. labor participation rate has remained relatively stagnant at 62.7%, the lowest since 1978 and down significantly from the 75% - 76% rates experienced in 2007 and 2008. The civilian labor force as of September 30, 2014 actually dropped, showing an estimated 92.6 million people do not participate in the labor force.

Another factor inhibiting wage growth has been the historically low level of productivity growth, less than 1% annually, experienced since 2011. Increased productivity allows employers to raise wages without the need to raise prices and ignite inflation.

ECONOMICS & FIXED INCOME

STRENGTH IN THE DOLLAR

In the last year, the U.S. dollar appreciated 10% against the euro and 15% against the Japanese yen. Most of the decline in the euro has been in the last six months, while the yen has fallen almost 40% in the last two years. Strength in the dollar has been widespread, as the U.S. Dollar Index, which measures the value of the dollar against a basket of currencies, climbed to its highest level in more than four years. Even the venerable Swiss franc has fallen 9% against the dollar since June, as have many emerging market currencies. About the only currency that has not fluctuated in relation to the U.S. dollar has been the Chinese yuan, which is controlled by the government and unofficially pegged to the dollar.

A strong dollar makes foreign goods cheaper and thus helps control inflation. However, a strong dollar also makes exports more costly and thus less competitive, resulting in slower economic growth. It has been estimated that a strengthening of the dollar by 10% reduces economic growth by 1%. It usually pays to invest in a country with a strong currency, so a strong dollar has made U.S. financial assets more attractive to foreign investors. Thus, the dollar has helped lower bond yields and other interest rates and supported stock prices in the U.S.

The strength in the dollar can largely be attributed to the U.S. experiencing better economic growth than Europe and Japan. Both are on the verge of recession and have lower inflation or even deflation, as well as lower interest rates. The European Central Bank (ECB) has initiated a bond purchase program, and Japan has an ongoing program while as the U.S. Fed will stop its program this month. Additionally, the Fed has already given guidance that U.S. interest rates will be increased in the future, while Europe and Japan have given no such guidance. In a broader context, the dollar remains the world's primary reserve currency and a safe harbor in terms of crisis and geopolitical risks.

COMMODITY PRICES TANK

The closely-watched Bloomberg Commodity Index, which tracks 20 commodity prices, has fallen in recent weeks to a four-year low. The decline, 11% since June alone, has been broad-based, including agricultural, energy and metal prices. This is a dramatic change compared to the 2000-2011 period when commodity prices tripled, referred to as the commodity super-cycle, when there was talk of eventual shortages of almost all commodities. Since then, commodity prices have fallen by about 25%. The only commodities that have not experienced price declines have been cocoa, coffee, cattle and hogs.

Commodity prices are a function of supply and demand, and both have had an impact this year. On the demand side, annual global economic growth has slowed from 5% to 3% this year. Global growth may not improve much in the short term as the Eurozone, Japan and other emerging countries are teetering on the brink of recession. China, the largest user of most commodities in recent years, is struggling to achieve annual growth of 7%. Christine Lagarde, head of the International Monetary Fund, recently declared that the global economic recovery was "brittle, uneven and beset by risks," and that slow global growth may be the norm for a long time.

The supply side can be summarized by two words: "supply glut." Agricultural commodities have benefitted from good growing weather, record acreage planted and high yields, resulting in bumper crops and the lowest prices in seven years. The oversupply of most metals can be blamed on the huge investments made at peak prices to satisfy China's appetite for raw materials and recovering global economic growth. Oil prices have fallen 16% since June and are at the lowest level since 2012. Much of this decline can be attributed to the shale boom in the U.S. as it replaces Saudi Arabia as the largest oil producer in the world. The U.S. imports less oil today – 3 million barrels daily – than it did two years ago. Oil prices would be lower if countries such as Libya, Iraq, Iran and Venezuela could produce at full capacity.

The impact of falling commodity prices experienced by any country depends upon whether it is a net importer of commodities or a net exporter. Producing countries that export suffer when prices drop and could be a drag on global economic growth. For the net importing countries, falling commodity prices are like a tax cut, leaving households with more disposable income. Since many commodities such as oil are priced in dollars, the stronger dollar helps the U.S. but hurts other countries where currencies have weakened against the dollar. In general, falling commodity prices are probably signaling slower global economic growth.

COMMENTARY

WHERE ARE THE ANIMAL SPIRITS?

(Continued from page 1)

In addition to credit market constraints, the recession caused corporate profits to decline by one-third for the Standard & Poor's 500 (S&P 500) and two-thirds for the Financials sector alone. As a consequence, the S&P 500 Index fell by 57% from October 2007 to its low point in March 2009, destroying $8 trillion of wealth. Corporate executives usually have a large part of their assets tied up in company stock, so their wealth also took a big hit. If the S&P 500's large decline was not enough, housing prices started to decline in 2006, falling 33% by 2010.

The end result of the financial crisis and economic recession was a loss of animal spirits, or in other words, an increase in risk aversion on the part of corporate executives. In addition to financial and economic uncertainty, they had to face political, policy and regulatory uncertainties such as the Affordable Care Act, Dodd-Frank Act, budget and debt ceiling battles in Congress, problems in the Eurozone and a multitude of other issues. The reaction of corporate America, vis-à-vis its corporate leadership, was predictable.

One of the first steps taken by corporate America was to embark on a cost-cutting binge. Capital expenditures were slashed, employee headcount was dramatically reduced, research and development budgets were cut and just about everything else corporate executives could find to reduce expenses was done. The purpose behind these actions was to maintain and increase profit margins and earnings per share, and on these metrics, corporations have succeeded. As a result, after-tax net profit margins for the S&P 500 were at an all-time high of 10% in the second quarter of 2014 versus a 20-year average of 7.5%. S&P 500 profits increased 82% since 2009 and were more than $1 trillion in 2013. Corporate profits, in general, are at historical highs in both absolute dollars and relative to Gross Domestic Product (GDP). This has become a political issue because labor's share of GDP has declined.

A second reaction of corporate America was to strengthen corporate balance sheets. Nonfinancial corporations were not nearly the factor that financial corporations were in the financial crisis, but have still built up huge cash reserves. Currently they hold $2 trillion in cash reserves, representing 12% of GDP. Companies in all sectors of the economy have increased cash reserves, particularly the Information Technology sector. At the end of 2013, Apple had cash reserves of $147 billion, Google $57 billion, Cisco Systems $48 billion and Oracle $37 billion. Much of the corporate cash is offshore, so there would be tax implications if it was repatriated; U.S. companies do not pay U.S. taxes on offshore profits that are not repatriated to the U.S., which had accumulated to $2 trillion by the end of 2013. With this cash build-up, these companies have been facing intense pressure from investors to return more of it to them through the payment of dividends and/or through the repurchase of shares, and corporate America has been responding. S&P 500 companies have increased dividends by nearly 60% and share buybacks by 100% since 2009. S&P 500 dividends were approximately $320 billion in 2013 and share buybacks about $560 billion, so buybacks were 75% greater than dividends. In the first six months of 2014, share buybacks have been $338 billion, nearly on pace with the record level of $700 billion set in 2007 just as the stock market hit its peak. Of interest, buybacks fell to $150 billion just after the S&P 500 bottomed in March 2009, which has called into question the wisdom and timing of the money being spent on share buybacks today.

While corporate America's recent actions on share buybacks have been questionable, it is not likely the strategy will go away anytime soon. Buybacks reduce shares outstanding and thus increase earnings per share. Since 2009, revenues for S&P 500 companies are only up 10% while earnings per share are up 80%. IBM has been a notorious example of this. The company had 1.646 billion shares outstanding at the end of 2004, 1.304 billion shares outstanding at the end of 2009 and now has only 998 million shares outstanding today. Since 2009, IBM has spent $75 billion on share buybacks, which in conjunction with cost cutting has allowed IBM to increase earnings per share by 40%. Meanwhile, revenues have declined on a year-over-year basis for the last nine consecutive quarters. While buybacks are not a bad idea, *The Economist* recently referred to share buybacks as "corporate cocaine" because the practice of buying back shares to increase earnings can be not only addictive to executives looking for a quick boost in share prices, but also expensive if too much debt is incurred to do so.

COMMENTARY

Corporations have historically strengthened balance sheets by reducing debt, both short-term and long-term. However, in the last three years, large amounts of debt have been issued by U.S. corporations, a record $1.2 trillion in the first nine months of 2014. Today, total corporate debt is 15% higher than pre-crisis 2007. While this may seem to contradict the loss of animal spirits and increased risk aversion by corporate executives, borrowing long-term to finance a business is less risky than borrowing short-term because short-term debt has to be continuously refinanced. The inability to rollover short-term debt was a major problem for corporate America during the financial crisis. Further, corporations can borrow at central bank-induced low interest rates, which has motivated many companies to borrow whether needed or not. For example, Apple borrowed $17 billion in 2013 while sitting on $150 billion in cash. To come full circle, many of the funds borrowed have been used to finance share buybacks, but this has not dramatically impacted debt-to-equity leverage ratios because of the record corporate profits in recent years.

Another reaction to the financial crisis and economic recession has been corporate reluctance to spend more on capital expenditures (capex) and research and development. Capex fell about 25% during the recession, and its growth since then is below the rate of past recoveries. Capex usually lags in an economic recovery but picks up later in the economic cycle. This has not happened yet in the U.S. Standard and Poor's estimated that capex fell by an inflation-adjusted 1% in 2013 and forecasts it to decline by 0.5% in 2014. There has been a capex drought, especially outside of the Energy, Materials and Utilities sectors, which have accounted for 70% of capex in recent years. Numerous reasons exist as to why capex growth has not accelerated: lack of demand by the ultimate consumer, too much manufacturing capacity particularly in China, technological innovations and misaligned management incentives to name a few. Corporate executives consider it less risky to increase earnings per share via share buybacks than to make long-term investments where payoffs are in the future.

At some point, the animal spirits must return and corporate executives must invest in those activities that will continue to allow their companies to be productive and competitive. Productivity is arguably the most important measure of economic progress. Increased productivity allows wages to rise without creating inflation. As the U.S. economy emerged from the recession in June 2009, companies were lean and efficient, and productivity per hour worked increased at more than 5% annually. With the sub-par economic growth in recent years, productivity has grown at less than 1% annually since 2011 and was actually negative in the first quarter of 2014. Productivity rises as capital per hour of work increases (capital expenditures per hour of labor), but there has been no growth in this metric over the course of this economic recovery. The average age of U.S. corporate capital, such as plant and equipment, is the oldest in decades. Old capital is not as productive as new capital. Stagnant productivity will stifle income growth in the longer term and impede economic growth. June 2014 marked the fifth anniversary of the economic recovery, and it has been one of the weakest in the post-WWII era. For the economic recovery to be sustained, corporate America will have to become less risk averse and rekindle their animal spirits to increase funding for capital expenditures as well as research and development and hiring. It is critical for the future growth and competiveness of the U.S. economy.

"When an investor focuses on short-term investments, he or she is observing the variability of the portfolio, not the returns - in short, being fooled by randomness."

~ Nassim Nicholas Taleb