INVESTMENT STRATEGY
JULY 2014

Events have largely unfolded as we expected during the first half of 2014. The S&P 500 has slowly climbed higher, now up 6.1%. The market underwent a healthy, but minor, correction of 5.8% early in the year and is now setting new all-time highs in a succession of modest daily moves of 0.5% or less. Unrest in the emerging markets continues to grow, with continued conflict in Ukraine, a military coup in Thailand, and a militant insurgency across northern Iraq. Alarmingly, there are now more displaced people in the world than at any time since WWII. Although many things have gone as we anticipated, there have been two major surprises: much lower interest rates in the U.S. and Europe and lower volatility overall. Despite these surprises, we have become more convinced that the U.S. equity market is the best place to find value in today's investment world and the safest place to generate consistent income.

The most significant surprise thus far in 2014 has been the drop in interest rates. The yield on a 10-year U.S. Treasury bond started the year at roughly 3%. Since then, interest rates have consistently declined with the current level at 2.54%. This drop in rates has increased bond prices and pushed money back into bond funds and also into the emerging markets. Although the decline in U.S. interest rates surprised nearly everyone, the current borrowing rates in Europe are truly a sight to behold. The following is a table of the current 10-year borrowing rates for various countries, including the U.S. As you can see, borrowing rates in Europe have fallen much further than in our domestic market.

10-Year Interest Rates

Country	Rate	Country	Rate
Switzerland	0.65%	Sweden	1.85%
Germany	1.24%	Canada	2.24%
Czech Republic	1.48%	**United States**	**2.54%**
Denmark	1.63%	Spain	2.64%
France	1.71%	United Kingdom	2.70%
Belgium	1.70%	Italy	2.84%

The Eurozone's strongest economy, Germany, is currently borrowing money for half the rate the U.S. is required to pay. This could potentially be justified because Germany is carrying a smaller debt load than the U.S., has lower unemployment, and its population is completely averse to deficits and debt. Amazingly, the Eurozone member borrowing money at roughly the same rate as the U.S. is Spain. Spain currently has unemployment over 25%, with youth unemployment at more than 50%. The country's economy is smaller than prior to the financial crisis and they were paying over 7.5% on their 10-year debt as recently as 2012. In short, Spain is a mess economically and has continued to run large budget deficits since 2009.

In our opinion, Spain's ability to borrow at the same rate as the U.S. does not make any sense. This reminds us of the summer of 2008 when we warned clients that oil prices at $140 a barrel in the face of a rapidly slowing economy was not rational. Much like that paradox in 2008, we do not have all the answers to explain why borrowing rates have fallen so far in Europe. The low interest rates in Europe may indicate the Eurozone is falling into a deflationary spiral. We

have been concerned for some time that Europe is making the same mistakes that Japan made twenty years ago. In fact, a senior Bank of Japan economist recently warned Europe to be more proactive in battling deflation. As a result of past mistakes, Japan's economy has been stagnant for two decades and the country is now, by far, the most indebted in the world. At the moment, Japan is trying desperately to emerge from this deflationary trap by engaging in aggressive central bank and taxation policies. Despite these efforts, we are skeptical that Japan will be successful in fully reinvigorating economic growth and generating moderate inflation.

Whatever the ultimate reason for the shockingly-low borrowing rates in Europe, we do know that this "party" will not end well for many investors. At some point, volatility will return to the markets and it looks increasingly likely that fixed income investors are set up for large losses. As it stands, bond yields are at all-time low levels from European government debt to U.S. junk bonds. Meanwhile, bond trading volumes have declined and large banks have significantly downsized their trading inventories. In short, there are more people at the party than ever before, but the exit door has shrunk considerably since the festivities began. Let's hope nobody yells "Fire".

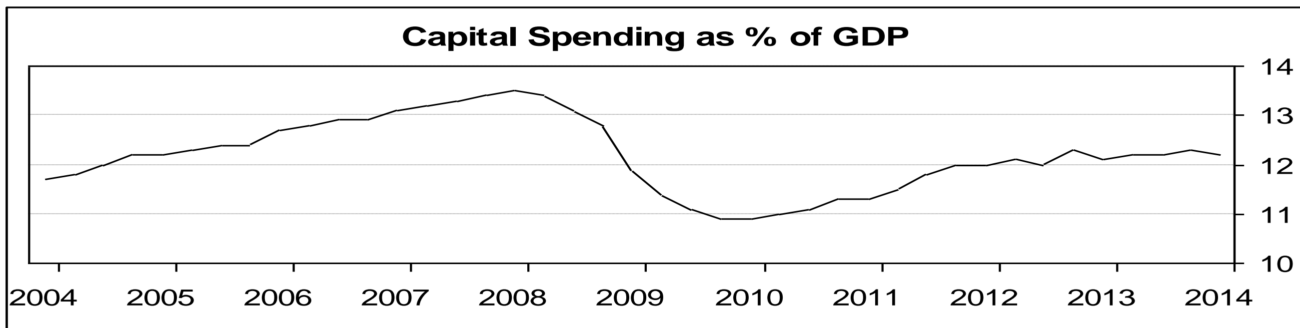
Given the treacherous conditions in the fixed income markets, we believe the best and safest way to generate consistent income is from high-quality dividend paying stocks. Thankfully, U.S. companies have received this message and have sizably increased their rewards for equity investors. At the current pace, the companies that make up the S&P 500 are expected to increase dividend payouts by 10.5% in 2014. In 2013, S&P 500 companies increased dividends by 12%! There are not many investments in the world that have increased income payouts by nearly 25% over the past two years. Although we don't expect companies to maintain this pace, we would not be surprised if dividends continued to increase by 5-8% annually for years to come. At that rate, dividends will grow along with earnings and, most importantly, at double the rate of inflation.

In addition to the consistent income that high-quality stocks provide, investors also get to enjoy the appreciation in stock prices as earnings and valuations increase. During 2013, investors benefited from a strong increase in valuations which led to stock gains of nearly 30%. After that increase, stocks are now much closer to fairly valued at 15.5 times expected earnings. Going forward, we may enjoy higher valuations, but the majority of future stock gains will have to come from increased earnings.

Where we differ from the "market" is that we have more confidence in future earnings growth. Most forecasters and investors argue that profit margins are too high and slower economic growth will restrict profits. A very large and influential bond manager is promoting the idea of a "New Neutral," where profit growth will be below normal for the next several years due to a slow economy. This is the same manager that promoted a "New Normal" five years ago that called for below average gains on equity investments. He was wrong then and we believe he is wrong now.

As we pointed out in our January Investment Strategy, the key to faster economic growth is for corporate CEO's to regain confidence and invest their cash hoards into new projects that expand their current businesses or start new lines of business. The first indication of this renewed confidence is the willingness to make major acquisitions. Thus far in 2014, we have not been disappointed. Through the first half of the year, merger and acquisition activity had already reached $1.77 trillion, up nearly 73% from a year earlier. As to be expected, this surge in acquisition activity has been led by the large multinational companies that have the greatest financial firepower. In particular, there have been several large deals in the healthcare sector and General Electric recently agreed to their largest acquisition ever.

However, acquisitions do not boost economic growth or employment. For that, companies must invest more capital in building businesses in new fields or markets. The following is a chart illustrating the lack of spending by corporations:



As you can see, capital spending as a percentage of GDP has failed to recover over the past few years compared to the last economic cycle. We are confident this will change after the aggressive actions we have seen so far in 2014. If spending does pick up, economic growth in the U.S. will increase to one of the faster rates in the world. This should draw in more investors and encourage even more companies to invest in the U.S.

Overall, we believe the future is still bright for U.S. equity investors. Companies are finally starting to become aggressive, which should drive the next leg in economic growth. Thankfully, companies have all the ability in the world to spend with $4 trillion of cash on corporate balance sheets and borrowing rates at the lowest levels in history. As always, there are any number of low-probability events that could throw the economy off course. Despite this small possibility, we believe that investors searching for attractive values and consistent income have the odds stacked significantly in their favor by investing in high-quality U.S. companies.

Truly yours,

Keating Investment Counselors, Inc.