INVESTMENT STRATEGY
OCTOBER 2014

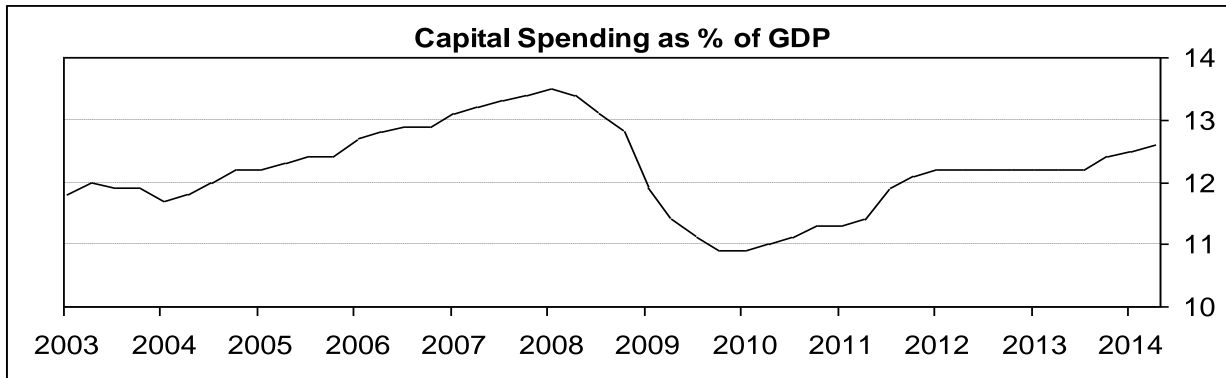
The S&P 500 Index has continued to slowly grind upwards this year. Thus far, 2014 has been eerily devoid of volatility while remaining positive, gaining 6.7%. Despite a lack of excitement in the major U.S. averages, most other markets have left investors both disappointed and perplexed, including U.S. small-cap stocks, commodities, the global bond market, and emerging markets. With record amounts of liquid investment capital sloshing back and forth in the global markets, it has become more and more difficult for short-term traders to anticipate new trends. However, for long-term investors, we believe the trends are clear. The U.S. economy is strengthening, America has become the top investment destination in the world, and high-quality U.S. dividend-paying stocks remain the best choice for the average investor.

It seems that hedge funds are once again trailing the market by a sizable amount this year exacerbated by their exorbitant fees. We believe the biggest problem is their short-term focus. Unfortunately, the majority of investors have become very short-term in today's 24/7 media-dominated world. During the current bull market, this has been a treacherous path to follow with the slow and uneven recovery we have experienced. Over the past five and a half years, the economy has been choppy, but the U.S. recovery has been persistent. For investors who took a long-term approach, the bull market has been unbelievably rewarding. In fact, the S&P 500 Index is now up 192% since its low in March 2009.

After such strong performance, most pundits question how much longer the market can continue upward. In contrast, we are confident the market will go higher for several reasons. You will recall from our last letter that the key to further stock price appreciation is the ability for companies to grow earnings. We believe this potential is considerable because the U.S. economy has finally become self-sustaining and growth is accelerating. Over the past six months, the U.S. economy has consistently surprised to the upside, producing faster job growth and increased business and consumer confidence. For instance, over the past year the number of unemployed has dropped by 1.7 million people, causing the unemployment rate to fall from 7.2% to 5.9%. Importantly, the number of long-term unemployed has dropped by 1.3 million over the same period. This means that a good portion of job gains are now going to the long-term unemployed. As a result, the total number of people on benefit rolls has fallen to the lowest level in more than seven years. For this and other factors, government deficits are rapidly declining.

The improved employment picture in the U.S. is having a noticeable effect on both consumer and business spending. For example, the hotel industry is coming off its strongest summer travel season since figures began being tracked in 1987. This contributed to service industries in the U.S., which represent 70% of the economy, expanding in August at the fastest pace in nine years. Meanwhile, capital spending by businesses was up 9.7% in the

second quarter. You may remember that we included a chart in our last letter showing the trend of capital spending by businesses. Here is an update of that chart:



The trend has clearly turned up in 2014 after pausing for the prior two years. As consumer confidence and spending have increased, companies are becoming more aggressive by hiring workers and boosting capital spending. As workers are hired, more consumers have money to spend. This virtuous cycle is exactly what the Federal Reserve has been desperately trying to jumpstart over the past five years by significantly lowering borrowing rates for consumers and businesses. Now that this cycle is firmly established, the Federal Reserve has been systematically reducing their involvement in the bond market and intends to be fully removed by the end of the year.

As the U.S. central bank is reducing stimulus, the European Central Bank has finally decided to stimulate their economy. Unlike the U.S., the European economy has not recovered from the financial crisis and unemployment is still above 10%. On top of that, the region is barely growing, if at all, and the Russian standoff may send it into a shallow recession. Meanwhile, the Chinese have shown great fiscal and monetary restraint in the face of a slowing economy. In our April strategy we stated that China has two choices to deal with their credit bubble. They could install market reforms and slow their economy or continue to pump out credit and risk a much larger crisis. Following his ascension nearly two years ago, China’s president, Xi Jinping, has proven to be a much stronger leader than his predecessor. China has so far resisted launching a major stimulus program and has implemented some reforms. This has caused China’s economy to slow, resulting in falling commodity prices and big trouble in commodity-based economies. As examples, Brazil is already in a recession and Australia’s economy may be nearing its first recession in 23 years.

A key trend that has become apparent over the past twelve months is that America’s economy is without any doubt the healthiest major economy in the world. Although this may be hard for most Americans to appreciate, international investors and businesses have fully latched onto this fact and are acting accordingly. During 2014, we have seen a considerable amount of foreign capital purchase American businesses and real estate. For instance, the

investment arm of Abu Dhabi purchased 90% of the famous Chrysler building in New York this summer. Meanwhile, European firms have gone on a buying spree during the past quarter by announcing $87 billion in deals for U.S. companies. This is more than the previous twelve months combined. More telling may be the 7.7% gain in the U.S. dollar index over the past quarter, its biggest gain since 2008. Contributing to the strength of the dollar is the fact that international buying of Treasury bonds is up by $600 billion over last year.

A byproduct of this influx of foreign investor capital is further economic momentum for the United States. As residents of South Florida, this is easy to accept after watching Miami's real estate market go from a disaster to unbelievably strong as South American wealth flooded in. Real estate markets on the west coast have seen a similar surge as wealthy Chinese move assets out of their country. In both cases, foreigners view America and the U.S. dollar as the safest place to keep a large portion of their wealth. With uncertainty growing overseas, this behavior is entirely predictable.

Given this backdrop, we believe the long-term trends for investors are quite clear. The U.S. economy is picking up speed as a result of a positive feedback loop between personal and business spending. Meanwhile, foreign investors are rushing to the safety of our shores, adding further momentum to our economy. We believe these strong trends will become more recognized in the U.S. in the coming months and will finally draw more investors into stocks. Up to this point, we have yet to see average U.S. investors or the foreign capital coming ashore move into the stock market. Despite a five-and-a-half year bull market, it is difficult to find enthusiasm in the stock market outside of a few small areas. From our experience it is notable that media coverage of business and stock market news is the lowest in at least 20 years. This lack of interest in the market is another reason we believe stocks still have the potential to move considerably higher.

When nervous investors finally re-enter the stock market, the most logical place for them to invest is in the safest assets available: large, high-quality U.S. companies. Large companies continue to be attractively priced despite outperforming their smaller peers by a sizable amount this year. They also provide income equal to that supplied by investment grade bonds. However, unlike bonds, the dividend income has been growing well ahead of inflation each year and we expect this to continue. This combination makes high-quality stocks a critical asset for any retiree or pension plan trying to provide for the longer life spans people now enjoy. Although there will always be some short-term media-hyped worries, high-quality, dividend-paying stocks offer the best combination of safety, income, and long-term appreciation potential for the average investor.

Truly yours,

Keating Investment Counselors, Inc.