FIRST NEBRASKA Trust COMPANY

Second Quarter 2014
Quarterly Letter to Clients
By Scott A. Wendt, CFA
July 15, 2014

"And then what?"

It is funny how over the years you pick up little tidbits of wisdom that you may find useful later in your work. Many years ago (I'm not even sure how many), I remember being at a Berkshire Hathaway meeting when Charlie Munger, who back then was more prone to grunts and short phrases than today's soliloquies, answered a question with just three words: "And then what?" Mr. Buffett picked it up from there, urging all the budding analysts out in the audience, not to give up too soon when checking the facts of a management or company's story "de jour." To me, it was a friendly reminder not to get complacent or be drawn into the siren song of the investment crowd which usually sings the loudest when the tune has a lively beat and a catchy melody.

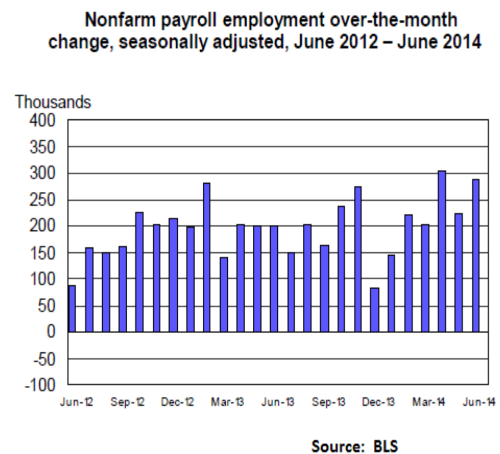
In today's markets, one should well heed this admonition. Despite the best efforts of Central Bankers around the globe, who have spiked the punch bowl heavily and composed a complicated score, the global economy continues to grow at lackluster levels, providing little cushion for the potential of a geopolitical shock, let alone another test of the underlying structure of the modern financial system. And while audiences around the world are basking in the better returns of the last year, they appear to have been mesmerized with the breadth and depth of their soothing symphonic timbre of a low volatility stock market, which is lulling many into an illusion of security and safety. However, like all great performances, the concert eventually will come to an end. Sure, an encore is also a possibility. But eventually the music will stop.

Investors are currently wrestling with the questions of what might happen if and when the music stops. Most are now well aware that the credit markets have been distorted by the Fed's policy actions. However, most are still obeying the conditioning of a financial market engineered to provide subpar returns in safe, high-quality investments, and pushing them to the point where they "reach for

yield" because there appear to be no better alternatives. The steady drumbeat of "new records" (both in stock index highs and bond interest lows) only reinforces the false sense of security in a stock market with many sectors in the very expensive range, which on a relative basis, looks more attractive than the bond market's very, very expensive levels.

The domestic **Economy** provided little support to the recovery in the first quarter of 2014, with the final reading on Q1 GDP revised down to a stunning minus 2.9% on an annualized basis. While we commented in our last quarterly letter that we felt the weather (Polar Vortex) would have a meaningfully negative impact on economic activity, the results were much worse than expected. Significant downward revisions to the first estimates lie in the large reduction in healthcare expenditures. Healthcare spending, which was supposed to double from the prior quarter, actually dropped 6.4%. Falling exports and rising imports both contributed to the negative revision. Most economists are expecting a rebound in the second quarter from deferred "weather-related" spending. However, the improvement is not expected to be enough to place 2014's GDP growth rate into the normal post recovery growth range. This means that this tepid recovery most likely won't see significant acceleration until sometime in 2015. More importantly, the current expansion, which began in June 2009, has grown at a rate of 2.1%, significantly below the average of 4% post-recovery growth seen since 1960.

We have opined in the past that improvements on the labor front are a critical component to sustaining future economic activity. The past six years have seen an extended period of frustratingly slow labor growth that only recently saw employment return to the levels seen before the 2008 financial crisis. Last week, the Bureau of Labor Statistics (BLS) reported that nonfarm payroll employment increased by 288,000 in June, with favorable upward revisions for April and May.

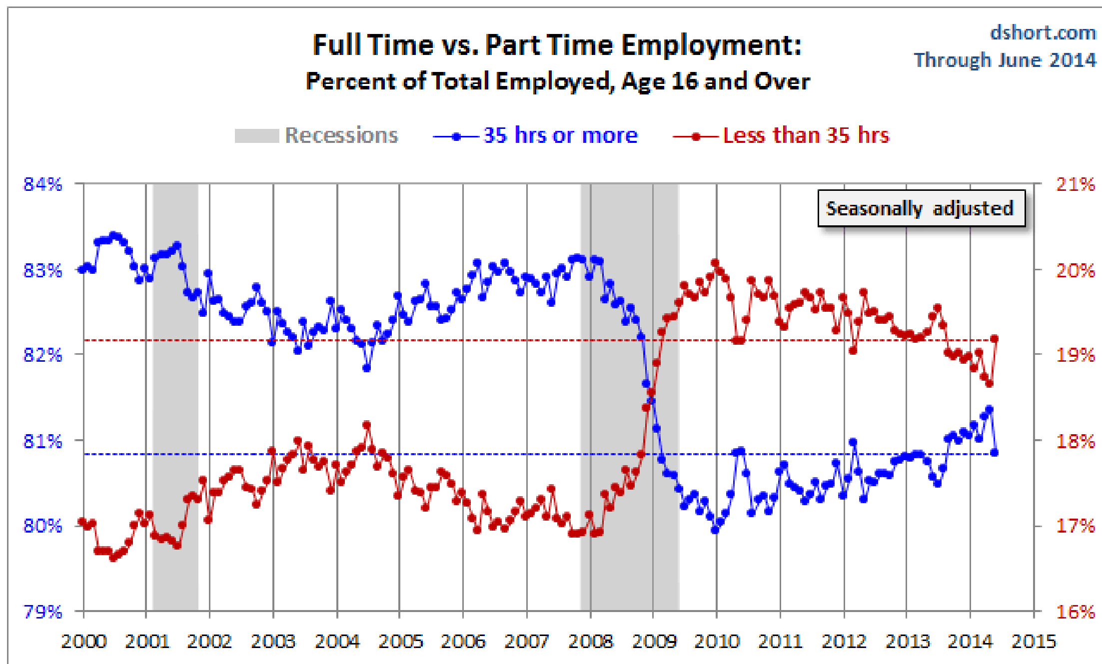


Yet, a closer look finds the economy continues to struggle under what appears as a structural change in employment:

- Unemployment fell to 6.1%, but the broader unemployment measure, U-6 (sounds like a rock band) barely moved from its 12.1% reading.

- The participation rate was unchanged in June at 62.8%
- If one included the estimated 6 million people that in June 2014 had dropped out of the workforce (off the official radar screen) and added them back to the calculation, the unemployment rate would be about 9.5%.
- A more interesting shift in the reported numbers: Full-time workers declined by nearly 523,000 people and part-time workers increase by some 840,000.

This latter point is significant. While the ranks of the employed continue to grow, the composition appears to have changed during the 2008 Great Recession, only to find that the trend in hiring part-time employees has increased, while full-time employment continues to be a challenge to find. The chart below provides a graphic of the change in trends.



Source: http://www.advisorperspectives.com/dshort/charts/employment/Full-Time-vs-Part-time-16-plus-since-2000.gif

Numerous reasons for this shift have been forwarded, including the hesitancy of corporate America to rehire quickly because of soft demand, increased regulatory and tax burdens, and the impact of the Healthcare Affordability Act (ACA or popularly called ObamaCare) and its requirements and penalties for not providing healthcare to full-time workers. While this shift appears to be slowly correcting itself, the lag in full-time job recovery has added to the struggle of the consumer to

regain his former glory. This may also partly explain the soft retail results seen in the past few months and the general weakness in consumer spending. With the labor force participation rate near its lowest levels since the late 1970s, and higher participation of part-time workers versus full-time workers, aggregate wage growth has been almost nonexistent. Additional evidence of an increasingly thrifty consumer is seen in spending on travel and tourism, which declined 1% on a quarter-over-quarter basis. This was again somewhat surprising, coming off the prior quarter's healthy increase of 4.5 percent.

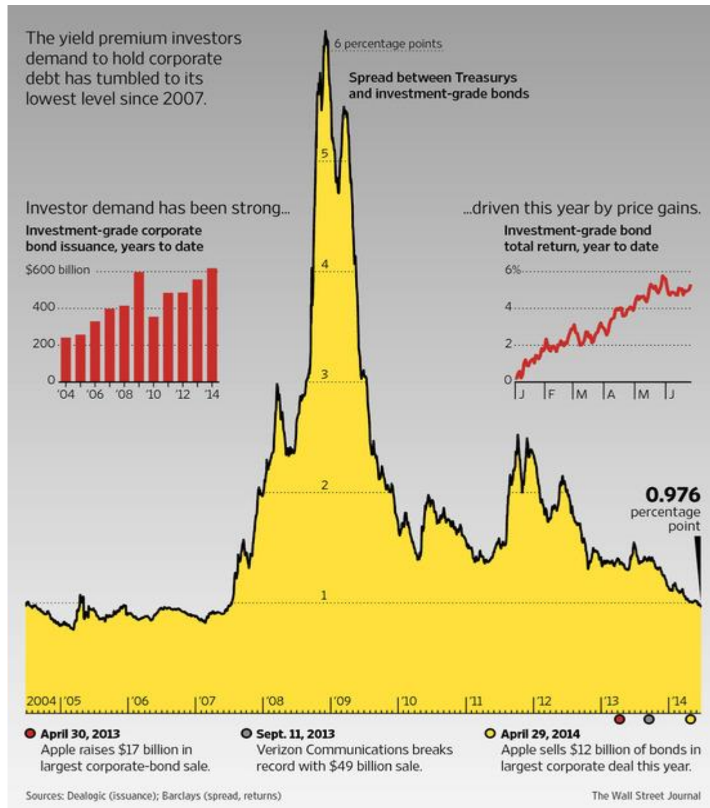
These facts put the markets and the Federal Reserve chairwoman in a bit of a quandary as they try to sort out whether or not these pockets of softness, combined with the poor first quarter results, are just temporary or an indication of things to come. In any event, the labor market remains a primary and necessary factor to sustain economic growth for the foreseeable future.

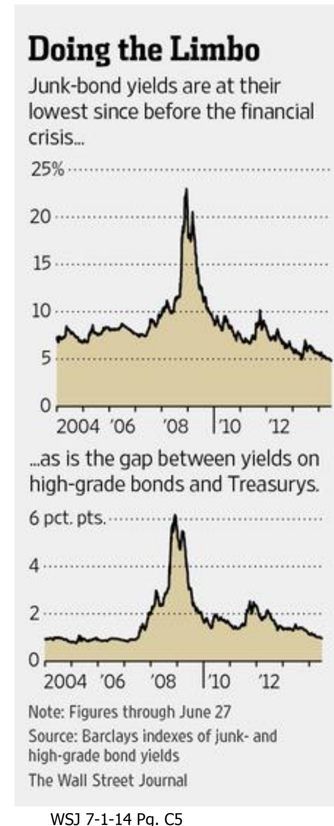
The **Bond Market** continues to provide investors with a challenging investment tradeoff, as some segments reported record low yields during the quarter. For the most part, bond valuations across the board are getting very high. U.S. Treasuries humbled the pundits who were predicting higher rates, based on the expectation that the Federal Reserve would continue to taper its Quantitative Easing program, thus reducing the level of intervention in credit markets and allowing rates to rise to market clearing levels. However, rates provided a head fake in the pundit's direction, only to reverse course on the blitz of global political events (South China Sea, Mideast unrest, and Russia invading Crimea) which appeared to cause a "flight-to-quality" that was more than enough to offset the countervailing forces of the Fed's transitional policy.

As a result, the U.S. Treasury 10-year closed the quarter at 2.53%, down from the 2.73% seen at the end of the 1st Quarter and down from 3% at the end of 2013. Most segments of the bond market followed a similar glide path, with corporate spreads again tightening to unattractive levels. In fact, the yield premium investors demand to hold corporate debt has toppled to match levels last seen in 2007, allowing higher quality, U.S. investment-grade corporate bonds to show quarterly returns of 5.6%, nearly the return level seen in the S&P 500 Index (see left graphic below).

High yield, or more commonly called "junk" bonds, are nearing an extreme level of overvaluation. As the graphic on the right below illustrates, investors have bid up

prices in this riskier sector, resulting in the average yield hitting an all-time low of 4.8% in June, while the spreads which measure the incremental return that is compensating investors for extra risk has shrunk to levels not seen since before the 2008 Financial Crisis (WSJ 7-1-14 Pg. C5).





WSJ 7-1-14 Pg. C5

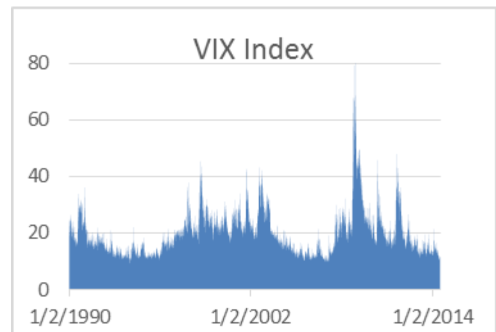
The risk and return dynamics of the bond market appear to be favoring our strategy of focusing on maintaining long-term capital preservation, while matching your risk tolerances to the investments we are making. We continue to favor a shorter-duration portfolio that is constructed with high-quality issues that can withstand the periodic changes in fixed income markets.

The **Stock Market** appeared to ignore the third most severe winter in the last 55 years and continued its climb up the proverbial "wall of worry" on its way to setting numerous new record highs. During the second quarter, the Dow Jones Industrial Average (DJIA) posted a 2.2% increase, while the S&P 500 Index rose 4.7%, and the NASDAQ climbed 5.0 percent. The average mutual fund manager posted a 3.4% return for the same period.

While most folks are satisfied with the recent equity performance, there is a growing concern with three aspects of the current market:

- The low levels of **volatility**.
- The low levels of **volume** supporting the new highs.
- The high **valuation** levels, which imply future stock returns will be subdued.

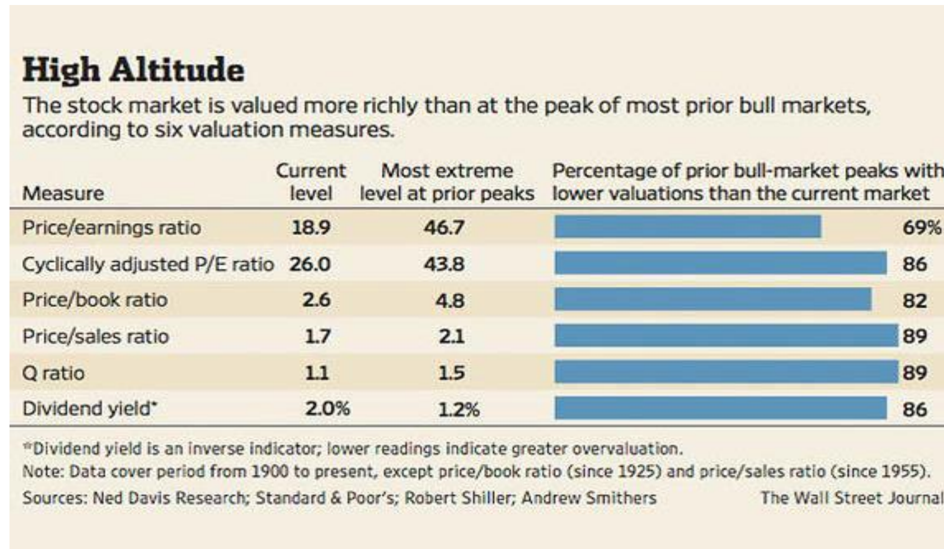
In a recent Wall Street Journal article, former Fed Chairman Alan Greenspan's now infamous "irrational exuberance" statement appeared to be reiterated in a softer form as policymakers, "including Federal reserve Chairwoman Jane Yellen and Federal Reserve Bank of New York President William Dudley, have warned that high prices and low volatility suggest ***investors may be growing too complacent, taking on too much risk for too little reward***." (Emphasis added ~ WSJ June 28, 2014 p. A2).



Volatility measures, including counting the number of times the S&P 500 has closed up or down 2% or 1% respectively, and the S&P 500 volatility index or "VIX" all indicate unusually high levels of stability. In fact, through the end of June, the S&P 500 index had not seen a 1% increase or decrease in 51 straight trading sessions – an unbroken series that a statistician would have to go back to 1995 to find a similar occurrence (WSJ July 7, 2014 Pg. R2). Similarly, the "VIX" stood at 11.6, well below the 20.1 historical average experienced since 1990. Generally speaking, the lower the VIX index, the lower the level of volatility and fear in the stock market. In fact, since 1990 the VIX index has only been lower than current levels around 5% of the time. Both of these measures support the Fed policymaker's forewarning that investors increasingly are being lulled into the risk of complacency.

While the major stock market indices continue their steady ascent to new all-time highs, trading **Volume** continues to languish, implying that there is less and less conviction supporting price advancements. According to Credit Suisse, the average daily volume in June was down 18% year-over-year at 5.8 billion shares, the lowest quantity for any June since 2006.

Finally, **Valuations**, while not at the extreme levels seen in the NASDAQ bubble of 2000, are pushing into the top quintile ranking of most valuations measures. Five of the six valuation ratios in the chart below demonstrate that the market is more overvalued today than it has been in between 82% and 89% of the prior peaks. As we've cautioned in the past, valuations are not a good timing indicator and therefore should not be misconstrued as meaning a correction is imminent.



High Altitude

The stock market is valued more richly than at the peak of most prior bull markets, according to six valuation measures.

Measure	Current level	Most extreme level at prior peaks	Percentage of prior bull-market peaks with lower valuations than the current market
Price/earnings ratio	18.9	46.7	69%
Cyclically adjusted P/E ratio	26.0	43.8	86
Price/book ratio	2.6	4.8	82
Price/sales ratio	1.7	2.1	89
Q ratio	1.1	1.5	89
Dividend yield*	2.0%	1.2%	86

*Dividend yield is an inverse indicator; lower readings indicate greater overvaluation.
Note: Data cover period from 1900 to present, except price/book ratio (since 1925) and price/sales ratio (since 1955).
Sources: Ned Davis Research; Standard & Poor's; Robert Shiller; Andrew Smithers — The Wall Street Journal

The following provides a brief definition of the popular valuation measures:

- The traditional price/earnings ratio, which focuses on the trailing 12 month earnings.
- The cyclically adjusted price/earnings ratio championed by Shiller, calculated by dividing the S&P 500 by its average inflation-adjusted earnings per share over the past decade.
- The price/book ratio, calculated by dividing a company's stock price by its per-share book value, an accounting measure of net worth.
- The price/sales ratio, calculated by dividing a company's stock price by its per-share sales.
- The Q ratio, calculated by dividing a company's market capitalization by the replacement cost of its assets.
- The dividend yield, which is the percentage of a company's stock price represented by its total annual dividends. (Source: Market Watch Mark Hulbert Column, July 11, 2014)

However, buying at higher valuations does imply that investment returns over the next decade will most likely be below the long-term average, rewarding those investors that have the patience and persistence to wait for more attractive buying opportunities. Finding value, without sacrificing quality, in a high and rising valuation environment is increasingly challenging. Nevertheless, we will continue to be disciplined in our process, purchasing those stocks that can be bought at prices that meet our investment standards while providing an adequate margin-of-safety, while selling those stocks that exceed our estimate of fair value, irrespective of the gyrations of the general markets.

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