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AR SCHMEIDLER & CO
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THE OUTLOOK

In this issue of THE OUTLOOK. . .

The US economy is steadily improving in spite of political dysfunction in Washington

The climate is set for a prolonged economic expansion, supported by low inflation and lower interest rates

This environment is favorable for equities and can lead to a gradual multiple expansion

The combination of factors will allow for a continuation of accommodative monetary policy

Investment implications

The US economy is slowly but steadily improving, and that is more important in our view than the distractions caused by Washington's political dysfunction

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Looking Through the Politics – Why Equities Should Benefit from A Low-Growth Environment

The character of the post-crisis US economy augers well for a period of continued low growth, low inflation, low interest rates and rising corporate profits. One of the reasons this period has been so challenging for investors is that we are operating in an economic and investment environment that is unprecedented. While certain characteristics of this period are reminiscent of those past, there are critical differences as well. Few investors have operated in an environment that enjoyed the prospects for reaccelerating US manufacturing growth along with expectations of continued low inflation and near zero interest rates for a sustained period of time. The political dysfunction in Washington highlighted by the debt and deficit debate will likely continue to be a major distraction for investors until a long-term solution is established, but investors who take a longer-term view should be well rewarded.

The US economy is slowly but steadily improving, and that is more important in our view than the distractions often written about in the news media. New technology in energy exploration and recovery along with decelerating growth in emerging markets is relieving pressure on commodity prices and providing an important stimulus for the US economy which is more than 70% consumer-spending driven. This stimulus (in the form of lower gas prices and moderating food and heating bill inflation), along with low interest rates, is making homes and automobiles more affordable and tempering the negative headwind of consumer deleveraging that has been occurring since the financial crisis. Lower energy costs are also making US manufacturers more cost-competitive and stimulating new manufacturing investment.

For the reasons discussed in this Outlook, we expect low inflation to stay in effect for some time, creating the prospects for a prolonged economic expansion, albeit with lower growth than we were accustomed to in prior decades

At the same time, structural headwinds discussed in this Outlook are keeping unemployment stubbornly high which is suppressing wage increases. The combination of stable-to-falling commodity prices with stagnant wage rates is keeping overall inflation low and allowing the Federal Reserve to maintain its current accommodative monetary policy. Most economic cycles are ended when rising inflation prompts central banks to raise interest rates to slow growth. However, we expect low inflation to stay in effect for some time, creating the prospect for a prolonged economic expansion, albeit with lower growth than we were accustomed to in prior decades. It is the unusual combination of these economic factors that make this cycle unique.

Many might assume that structural headwinds to more rapid economic growth would be negative for stocks because of reduced prospects for revenue growth. However, a climate of low but steady growth, but also low inflation and lower interest rates (in contrast to shorter cycles of "boom and bust") can, in fact, be favorable for equity markets, leading to gradual multiple expansion where investors are willing to pay higher prices for a given company's earnings, cash flow and assets. This is particularly true in light of the relatively less attractive comparable offerings in cash and fixed income.

The climate of low growth, but also low inflation and lower interest rates (in contrast to shorter cycles of "boom and bust") can, in fact, be favorable for equity markets

The Federal Reserve is likely to remain a major force in defining the current environment. This view was reinforced by the recent nomination of Janet Yellen to become the next Chairwoman of the Federal Reserve. The post-crisis policies of the Federal Reserve have been in reaction to and in anticipation of the structural impediments, and investors should expect Ms. Yellen to maintain a highly accommodative stance for as long as necessary for the Federal Reserve to meet its dual mandate of full employment and price stability.

A fundamental issue is the mismatch between the skills needed for available positions and the skills available in the labor pool

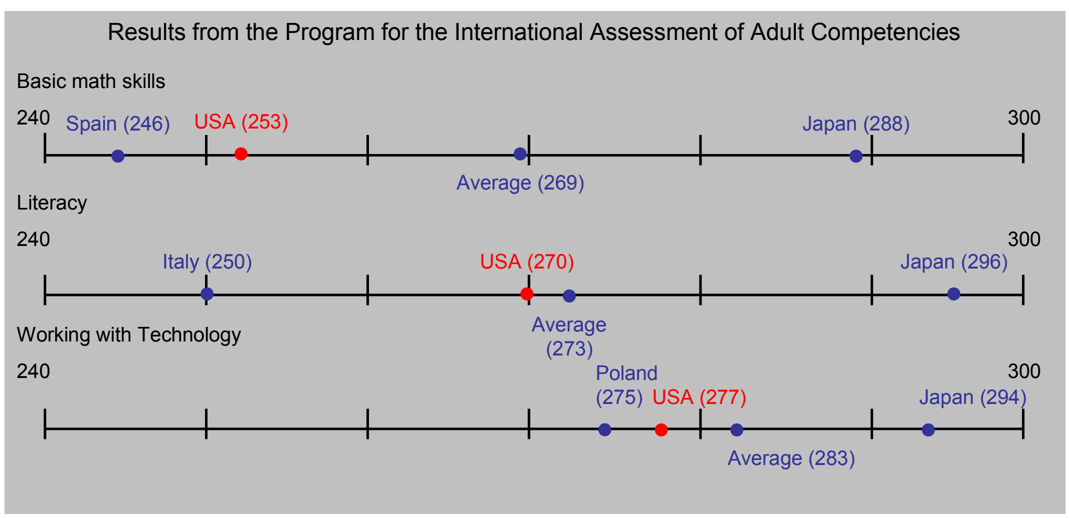
Defining the Structural Impediments

Several structural headwinds are likely to prevent the US from achieving the 3-4% real growth rates experienced in the 1980's and 1990's, including high unemployment, wage stagnation and the need for consumers to deleverage. While many will view these impediments as negatives for the market, the environment remains a positive one for equity investing, as described in this Outlook. The following is a review of the key structural impediments facing the US today.

High Unemployment and Labor Market Issues

The US is experiencing chronic unemployment partially hidden by declining labor market participation rates and made worse by technology-driven productivity improvements. This is a far more complex problem than the US Bureau of Labor Statistics' (BLS) reported unemployment rate (known as U3) of 7.2% or 11.3 million people out of work would indicate. An example of the degree of the problem is that long-term unemployed (those jobless for 27 weeks or more) stands at 4.1 million persons or 36.9% of the unemployed. The U3 measurement of unemployment understates the magnitude of the problem since it does not count those who have stopped looking for jobs as well as those forced to work part-time rather than full-time. The broader measure, known as the U6 unemployment rate, totals more than 20 million people or 13.6%.

A fundamental issue is the mismatch between the skills needed for available positions and the skills available in the labor pool. According to a new report by the Organization for Economic Cooperation and Development (OECD), the skill level of the American labor force has fallen dangerously behind its peers based on assessments of literacy, math skills and problem-solving. The US needs to refocus its education system on the skills required to reduce the current level of unemployment.



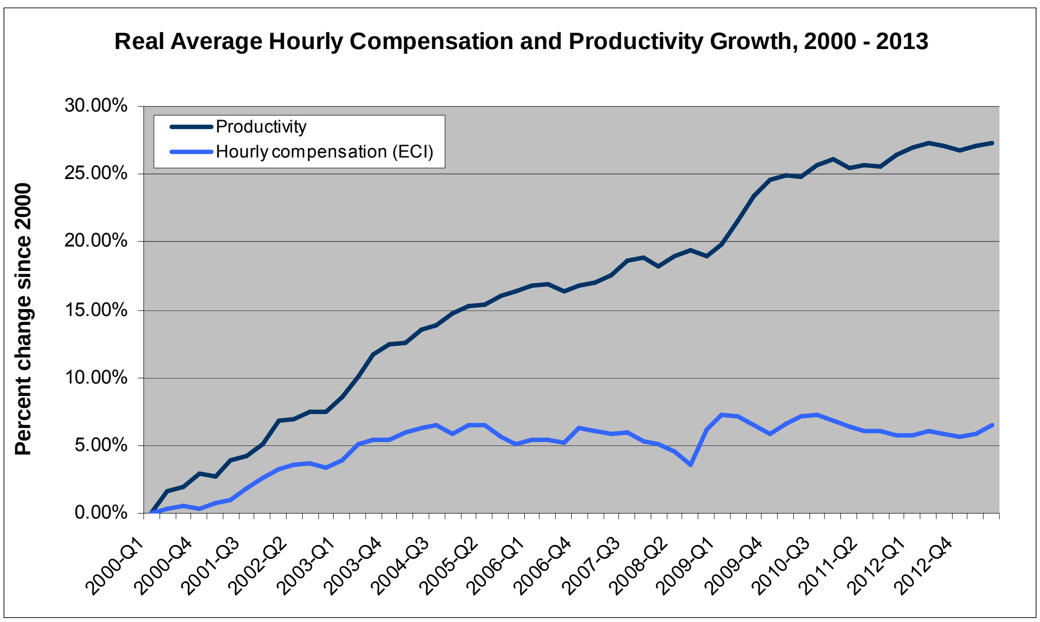
Source: National Center for Education Statistics, "Literacy, Numeracy and Problem Solving in Technology-Rich Environments among U.S. Adults."

The anemic rate of expected job creation will weigh heavily on Federal Reserve policy in the coming years

Other factors are also impacting the employment market, including the inability for US workers to move easily to other areas for a new job. This had historically been a key advantage for the US in previous recoveries, but the collapse in the housing market made it more difficult for many workers to move to find employment because they were unable to sell their homes. Moreover, many companies were reluctant to hire new workers due to uncertainty regarding tax and fiscal policies. Given the present rate of new job creation, it could take years to resolve the problem and return to acceptable employment levels. The Federal Open Market Committee (FOMC) recently forecast that job creation would remain challenged, as the committee members are estimating it will take until the end of 2016 for the U3 unemployment number to return to a more normalized range of 5.2-5.9%, and this anemic rate of job creation could weigh heavily on Federal Reserve policy for a considerable period.

Wage Stagnation Issues

Further compounding the growth problem is the fact, that for most of the American population, wages have not grown in the past decade. According to the Economic Policy Institute, during the period of 2002-2012 "the vast majority of wage earners has already experienced a lost decade, one where real wages were either flat or in decline." In fact, the real average hourly wages of workers with a college degree were lower in 2012 than they were in 2002 according to the BLS, and the college wage premium (the amount by which wages of college graduates exceed those of high school graduates) narrowed considerably.



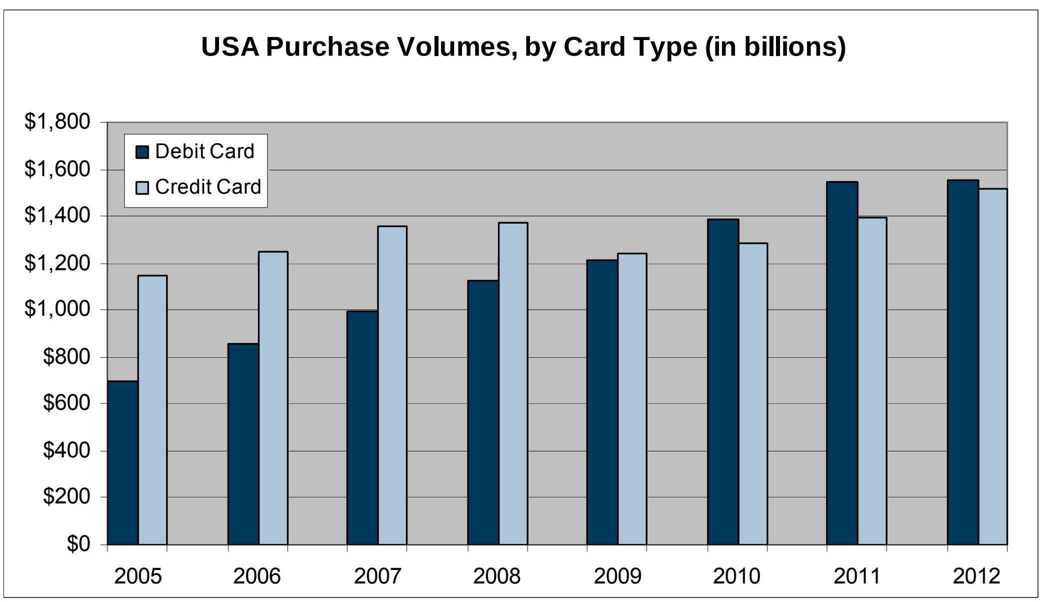
Source: EPI Briefing Paper, "A Decade of Flat Wages" By Lawrence Mishel and Heidi Shierholz.

Economic growth in the US should remain muted by the loss of rising credit that previously fueled the economy

Consumer Spending Considerations

For those readers who are children of the depression or children of children of the depression, you remember the time when credit was used sparingly and usually for essential items and durable goods such as homes or cars. Even after World War II, credit use, while rising, was measured and supported by large amounts of accumulated savings. In the early-to-middle 1980's, credit use began to accelerate, driving Gross Domestic Product (GDP) higher. It was also around this time that the United States government lost its status as the world's largest creditor nation and began the move to become the world's largest debtor nation. Debt use runs in both short and long term cycles, and will stimulate or slow economic growth. When debt use is rising it tends to stimulate until such time that borrowers need to slow the use of credit and pay down the debt. From the late 1990s up to the financial crisis in 2008, credit is estimated to have added 1.5% to GDP growth annually as people used their homes as ATM machines through the use of over $1 trillion of mortgage equity withdrawals. At that time it was low interest rates and a flawed belief that housing prices would continue to rise that drove debt levels higher.

Since the financial crisis, debt reduction has been an important restraint on economic activity. One area where this is manifesting itself is in the increasing use of debit card purchases. The importance of this trend is that debit purchases do not add additional dollars to GDP, while increasing credit use does. Under these circumstances, market participants can anticipate that economic growth in the US should remain muted by the loss of the rising credit that previously fueled the economy.



Source: Visa and MasterCard SEC filings.

Economic Consequences

In large part, to counter the structural issues described in this Outlook, the Federal Reserve has introduced a monetary policy not seen in investors' lifetimes to stimulate the economy, avoid a severe recession or depression and buy time for the deleveraging process to work through the system. As we have highlighted, this environment is distinct in its character, and therefore investors need to view this investment climate through a different lens than previously used on the US economy. There are some important economic consequences for the United States as described below.

The Federal Reserve would not be able to maintain low interest rates or its quantitative easing (QE or money printing) program if the economy were experiencing inflationary pressures

Low Inflation for the Foreseeable Future

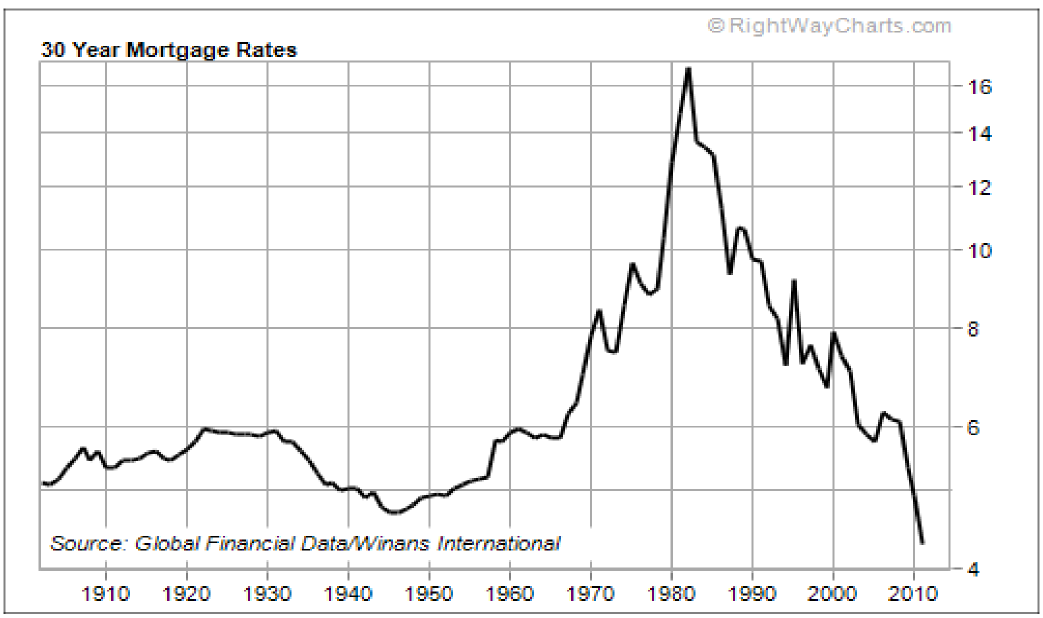
Several deflationary forces are at work in the US economy allowing monetary policy to remain highly accommodative and support the argument for a prolonged period of muted growth. The Federal Reserve would not be able to maintain low interest rates or its quantitative easing (QE or money printing) program if the economy were experiencing inflationary pressures. Among the forces suppressing inflation are lower energy costs, lack of wage growth and lower import costs. US corporations and consumers have seen a reduction in costs as the energy sector has dramatically reversed decades of production declines leading to lower levels of energy imports. It is estimated that for every ten cent decline in gasoline prices, US consumers benefit by about $13 billion. Moreover, US manufacturers are paying less than $4.00/MMBtu for natural gas compared with $11.00/MMBtu in Europe and $16.00/MMBtu in Asia, providing a key manufacturing cost advantage versus their foreign competitors. High unemployment and wage stagnation are also deflationary forces. In the 1970's, guaranteed cost of living adjustments (COLAs) for many employees drove up labor costs annually. As noted above, the US has not experienced any wage pressures for nearly a decade and the supply and demand dynamics of the labor market will suppress upward wage pressures for some time. Finally, the slowdown in the emerging economies, particularly China, is resulting in lower commodity prices, and therefore we are importing less inflation. Lower energy prices and import costs are good for consumers and corporations because it increases their discretionary income.

Historically Low Interest Rates

Lowering interest rates is usually the first response by a central bank to slowing growth and typically the economy responds fairly rapidly, often within two to three quarters. Even though the US already had relatively low interest rates at the start of the financial crisis, the Federal Reserve introduced a Zero Interest Rate Policy (ZIRP) to cushion the economy and stimulate growth.

The housing and auto sectors are major beneficiaries of the ZIRP initiative which is allowing for a once-in-a-generation financing opportunity for consumers

Historically, economic recoveries in the United States have been led by the auto and housing sectors, and both have played a key role in aiding the current US recovery. The housing and auto sectors are major beneficiaries of the ZIRP initiative which is allowing for a once-in-a-generation financing opportunity for consumers. As the absolute yield level and the duration of record low rates are unprecedented, investors should not underestimate the impact of a prolonged period of low interest rates on the economy and on consumer behavior. This policy discourages savings, fosters investment and promotes consumption. As indicated in the charts below, mortgage rates are now at a level not seen since the 1950's and auto financing rates can be obtained at very low levels. Americans refinanced nearly $6 trillion of mortgage principal since 2008. For every 1% reduction in mortgage rates, consumers will save $60 billion in annual interest payments, increasing their discretionary incomes meaningfully. The rates to finance the purchase of an automobile are also quite attractive, which has helped the industry recover considerably since the crisis. General Motors recently reported that it is running at the highest capacity utilization levels of any time in recent history with more plants scheduled to add a third shift to move to full production in the coming months. The proportion of GM's North American plants operating at full capacity (53 percent) is more than twice the level of 2006 (26 percent), which was near the top of the previous cycle. Importantly, corporations have been refinancing higher cost debt at significantly lower rates and the savings on interest costs drop directly to the bottom line.



Ms. Yellen's economic studies focused on the causes, mechanisms, and implications of unemployment which remain one of the key issues facing the US

One of the uncertainties weighing on the markets in recent months had been the naming by President Obama of the successor for Ben Bernanke as Chairman of the Federal Reserve. In the post-crisis economy, this is a particularly important appointment as the Federal Reserve has employed aggressive and unconventional monetary policy to stimulate the economy in the face of the structural impediments and inadequate fiscal policy. The next Chair will be the one responsible for managing a major transition to a more normal monetary policy. It is important to bear in mind that the Fed's balance sheet has grown from $900 billion to over $3.75 trillion over the past 5 years and at some point should be reduced. Vice Chair Janet Yellen was recently nominated to replace Mr. Bernanke and is expected to be confirmed as the first woman to lead the Federal Reserve. Ms. Yellen has been with the Federal Reserve for several years, and her background is well-suited for the challenges ahead. One reason is that she has been instrumental in the implementation of the policies in place today. Another is that her economic studies focused on the causes, mechanisms, and implications of unemployment which, as described above, remains one of the key issues facing the US. The FOMC has previously stated that it would not reduce its accommodative stance until such time as the employment situation has demonstrated significant structural rather than cyclical improvement including the broader measure of U6 unemployment.

ARS would expect interest rates to remain low for an indeterminate period. Unless there is a significant change in fiscal policy, present monetary policy will be required to remain in place

The two key elements of current monetary policy are the ZIRP and the printing of money (quantitative easing) which have been in place for far longer than many anticipated. A close reading of the FOMC minutes over the past few years provides important insights into the members' concerns about unemployment, deflationary forces and the slow growth trajectory of the economy. The initial market expectation was that these policies would be relatively short-term initiatives. Looking ahead, unless the economy's growth meaningfully accelerates, it is our expectation that any tapering of bond purchases will likely be measured, small in scale and quite possibly delayed for several months. As we have written for several years, ARS would expect interest rates to remain low for an indeterminate period. Unless there is a significant change in fiscal policy, present monetary policy will be required to remain in place.

The outlook for anemic yields on cash and fixed income investments presents a compelling case for capital to flow into equities

Investment Implications

As we head into November, we are constructive on the potential for equity returns driven by price earnings multiple expansion resulting from the distinct characteristics of the prolonged, low-growth business cycle described in this Outlook. This view is further supported by other positive factors for corporations including record corporate profits, fortress balance sheets and increasing cash flows as well as corporate activity including mergers & acquisitions, share repurchases, and dividend increases. Due to some of the uncertainties surrounding the dynamics of the global economy and long term US fiscal and tax policy, corporations are generally investing cash for the most certain shorter-term economic results rather than investing where future uncertainties make commitments more difficult. Taken in the aggregate, these factors create a favorable environment for equity selection as a combination of low interest rates and low inflation levels will tend to drive higher valuations for businesses with strong and stable growth characteristics. The outlook for anemic yields on cash and fixed income investments presents a compelling case for capital to flow into equities.

Based on this Outlook, we are constructive on the equity markets and in particular on the following themes: America's industrial and manufacturing resurgence; energy companies and the beneficiaries of the US shale gas development; the evolution of media consumption and the importance of proprietary content; growth in mobility and data; the financial, housing and auto recovery; companies with attractive and growing dividends; and companies with special situations or company-specific drivers. Due in part to the challenges of the global economy, US small and mid-capitalization stocks have been strong performers and are attracting continued interest as they often derive most of their revenues from within the US. While the global economy is also in a low growth mode, those US companies with strong earnings growth should continue to be well rewarded.

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