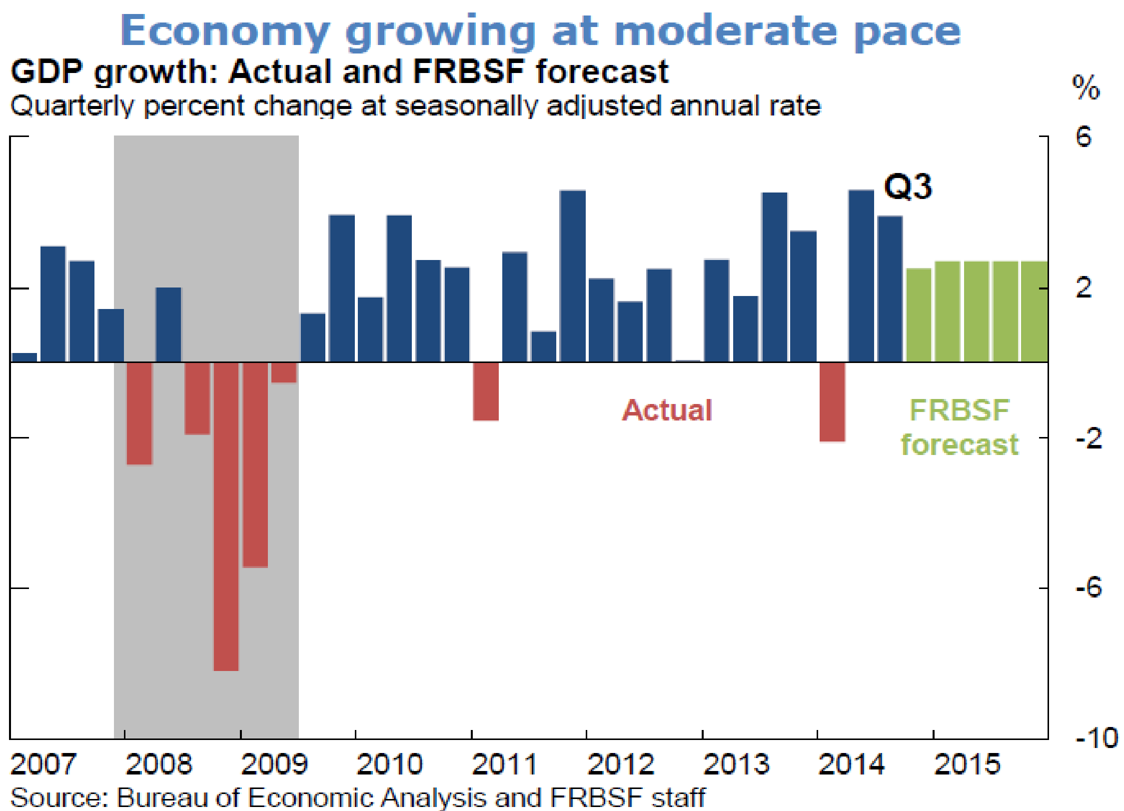
PARAGON
CAPITAL MANAGEMENT

JANUARY 2015
ECONOMY

In 2014, second and third quarter GDP growth was quite strong, after the first quarter decline in real GDP growth. Third quarter growth was revised to 5.0% (annualized), while second quarter growth was 4.6%. Some of the growth was boosted by temporary factors such as exports, so fourth quarter growth is expected to ease.

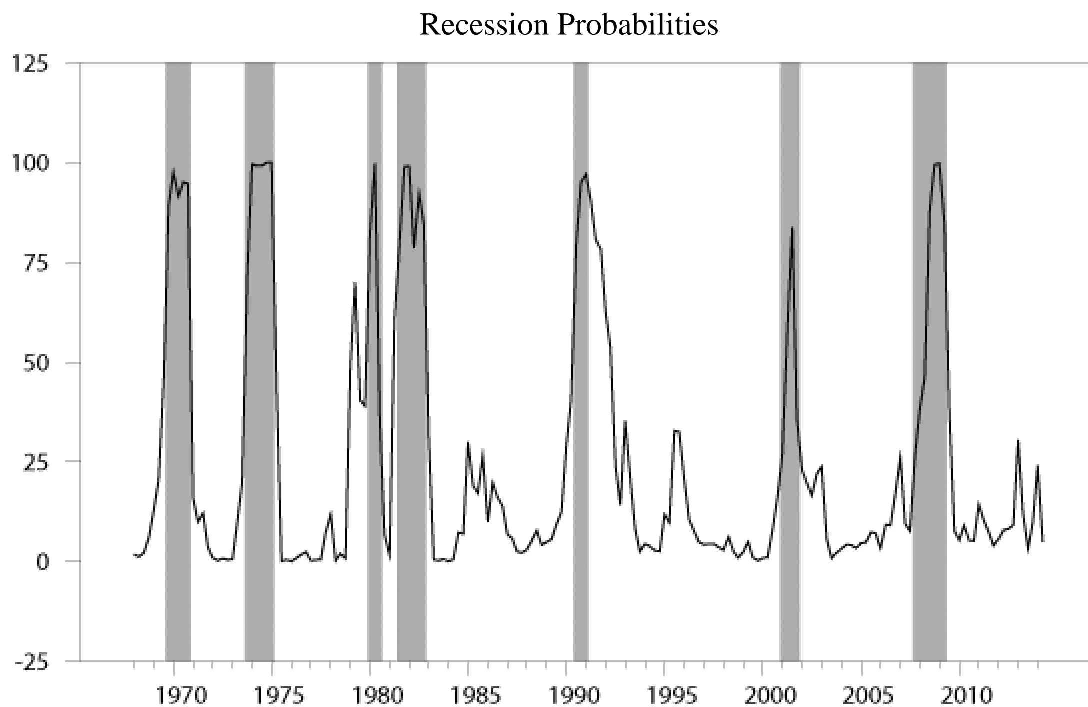
Economists expect continued growth of between 2.5% and 3.0% for this year, as illustrated in the chart from the Federal Reserve Bank of San Francisco. Rising employment, improved balance sheets, and falling gasoline prices will underpin above trend growth at least for the first half of this year; however, slowing growth overseas, a strong Dollar, and energy industry weakness eventually will have a negative effect.



ECONOMY
(continued)

Current recession probabilities are low. The model results illustrated in the chart below are based on what we know about the state of the economy and the past likelihood of an expansion or recession. The probabilities would need to rise towards 50% before a recession is imminent. The probability of a recession rose to 25% earlier last year based on the negative one quarter of growth.

Recession Probabilities

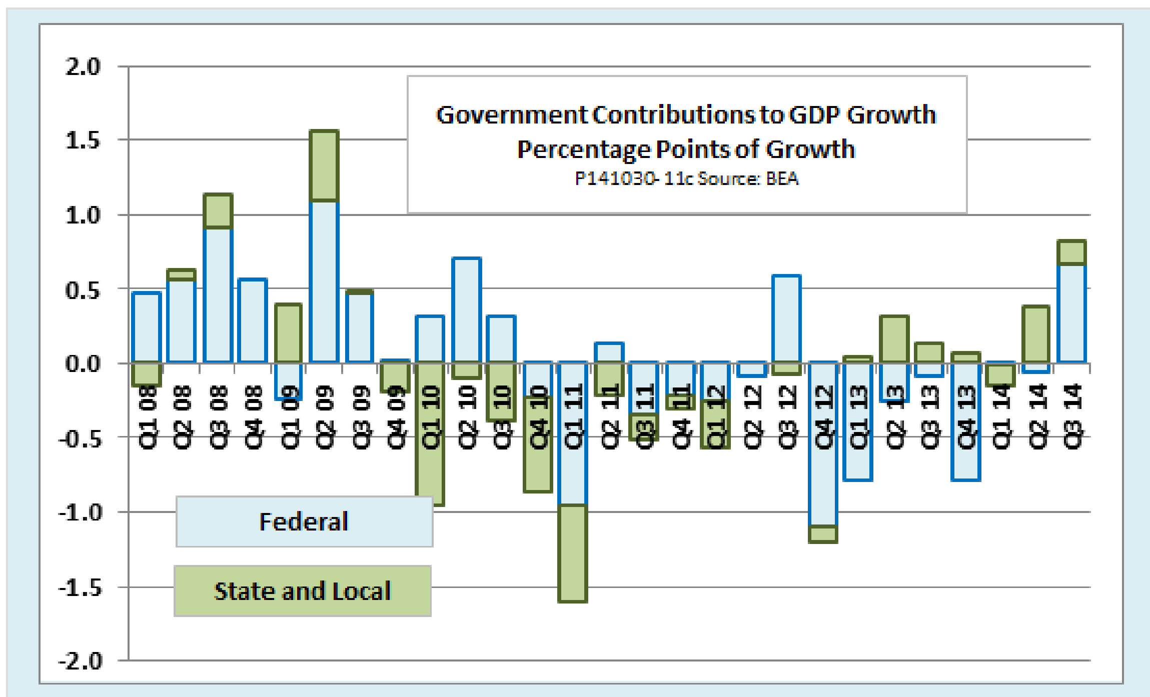


Source: James D. Hamilton (Econobrowser)

While there is a very low correlation between the economy and the stock market, the economic backdrop provides some confirmation that earnings will remain stable, that deflationary pressures, at least domestically, are not picking up, and that the Federal Reserve has fewer reasons to put off interest rate increases.

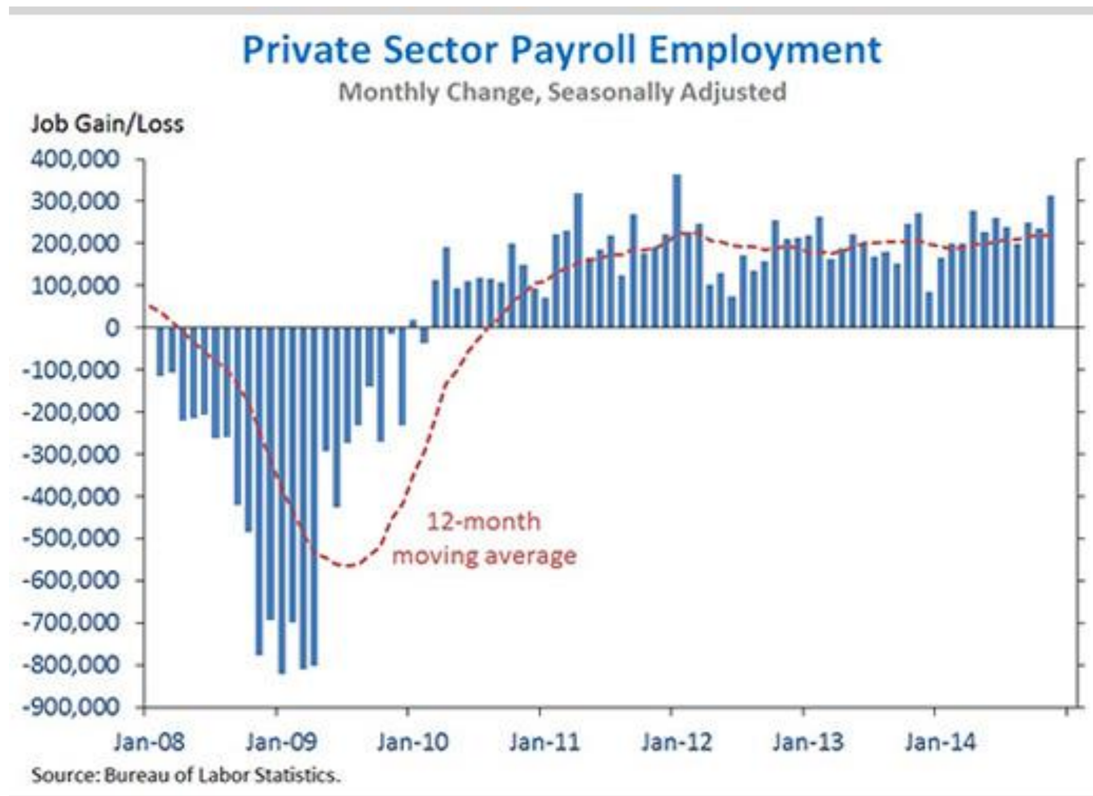
ECONOMY
(continued)

Spending cuts and tax increases at both federal and local governments have subtracted from growth over the last five years. For example, the deficit as a percent of GDP has fallen from 10% in 2009 to 2.5% in 2014. This headwind is reversing as local governments are beginning to spend again. Increased government spending could offset reduced capital spending in the energy sector.



ECONOMY
(continued)

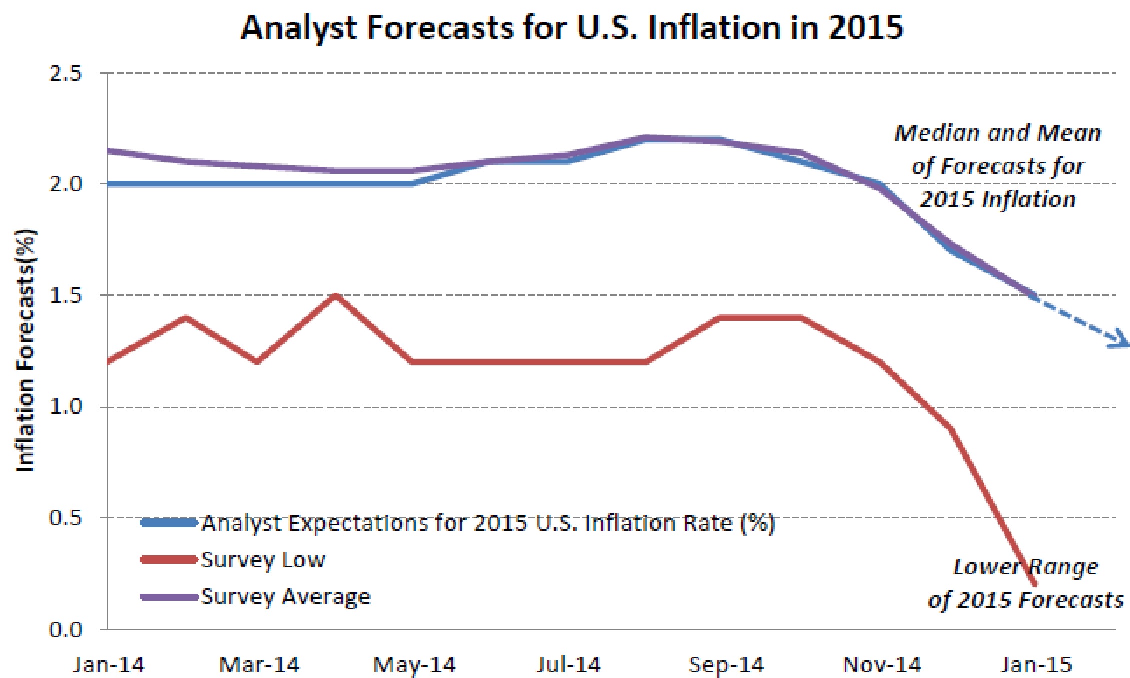
Employment growth was impressive last year with the last six months averaging gains of 250,000 per month in net new jobs. November had a net gain of 321,000 jobs, and the prior two months were revised upward.



PARAGON
CAPITAL MANAGEMENT

ECONOMY
(continued)

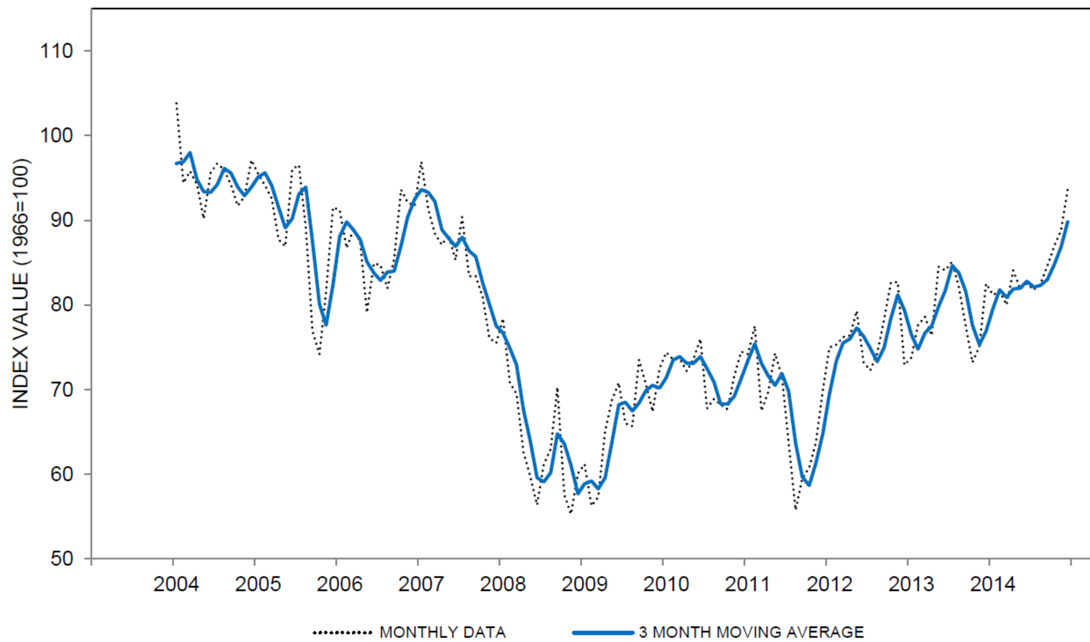
Headline inflation numbers have continued to moderate with lower energy prices. Core inflation, excluding energy and food prices, should be close to 2%, which is in line with surveys and the Federal Reserve's target. However, as illustrated below, headline inflation expectations have dropped in the last quarter.



PARAGON
CAPITAL MANAGEMENT

ECONOMY
(continued)

Sentiment has improved for consumers, for small businesses, and for CFOs and CEOs of large companies. Consumer confidence has regained the pre-recession levels. Small business optimism reached its highest level since February 2007, which happens to be the average level since 1974.

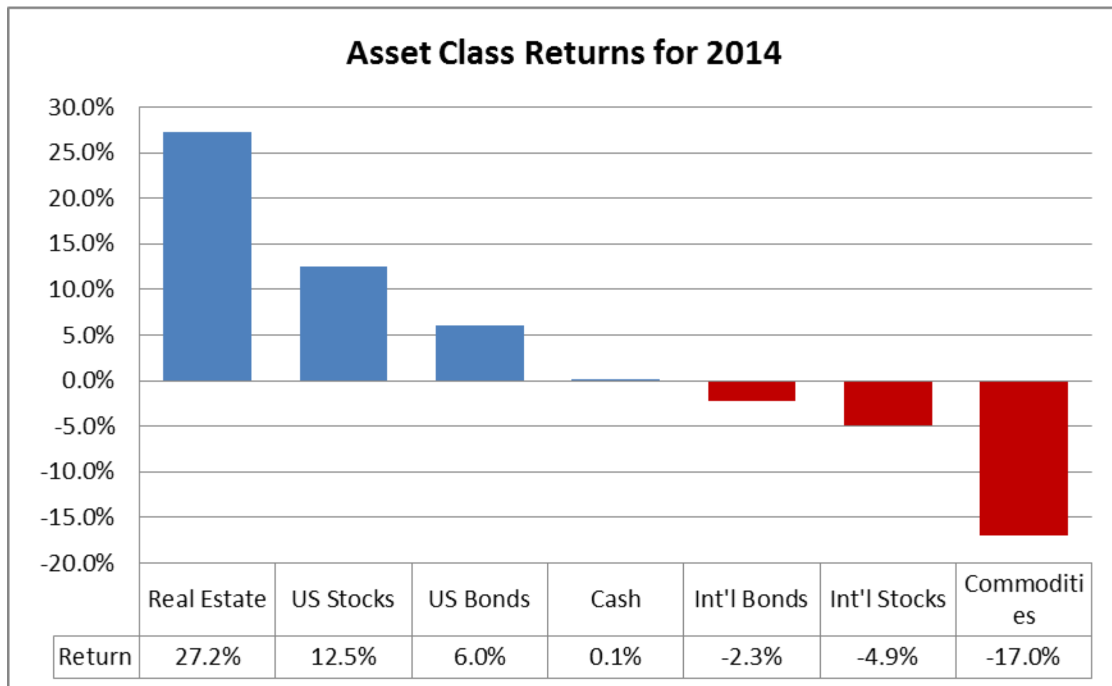


PARAGON
CAPITAL MANAGEMENT

CAPITAL MARKETS

Domestic investments had solid gains, aided by a strong Dollar, accommodative financial conditions and policies, and solid economic gains. Although the Federal Reserve wound down their bond buying program, their communications emphasized that they would keep interest rates low for a “considerable time”. Importantly, central bank policy has under-pinned market risk taking and rising valuations. The expectation of higher interest rates as well as better growth than most of the world has attracted fund flows and supported the Dollar, while lower interest rates and very slow growth in Japan and Europe has weakened their currencies. The Japanese are aggressively pushing down the value of the Yen in order to spur exports, boost their economy, and increase inflation.

The global financial markets ended last year with a dramatic fall in energy prices and a strengthening of the U.S. Dollar. These developments were extensions of trends that were already in place: commodities have been under-performing stocks for three years, while international stocks have been under-performing domestic stocks for the last five years.

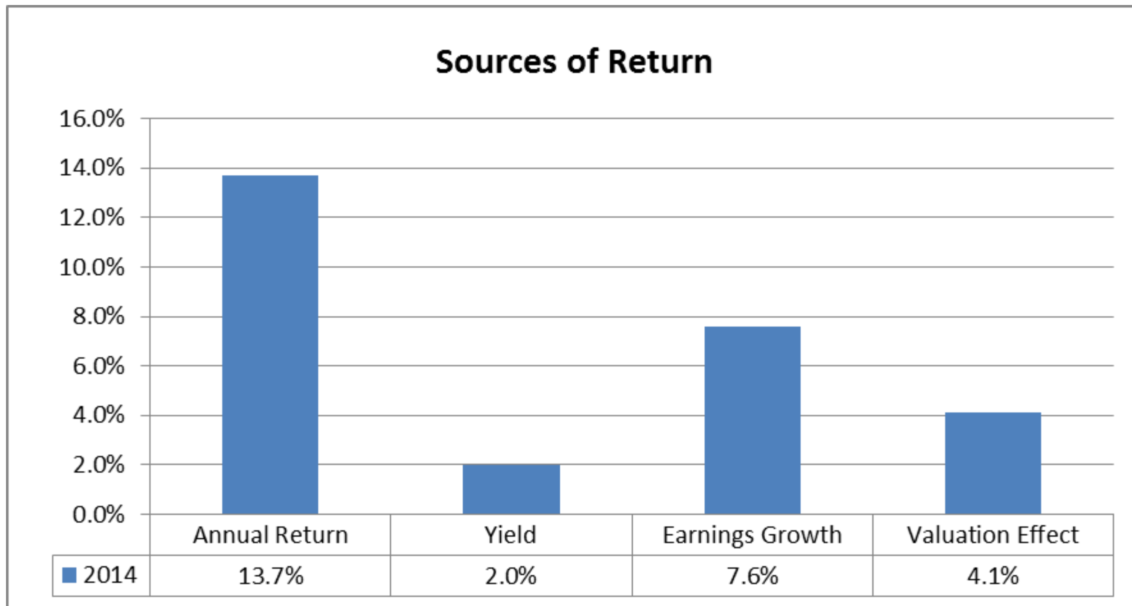


	Real Estate	US Stocks	US Bonds	Cash	Int'l Bonds	Int'l Stocks	Commodities
Return	27.2%	12.5%	6.0%	0.1%	-2.3%	-4.9%	-17.0%

PARAGON
CAPITAL MANAGEMENT

STOCK MARKET

The broad U.S. stock market returned 12.7% last year, while the S&P 500 returned 13.7%. The S&P 500 index return can be broken down into yield (2.0%), earnings growth of 7.6%, and increased valuations. The increase in valuation represents the effect of price earnings ratios having expanded over the last year from 17.0 to 17.6 (based on trailing reported earnings).

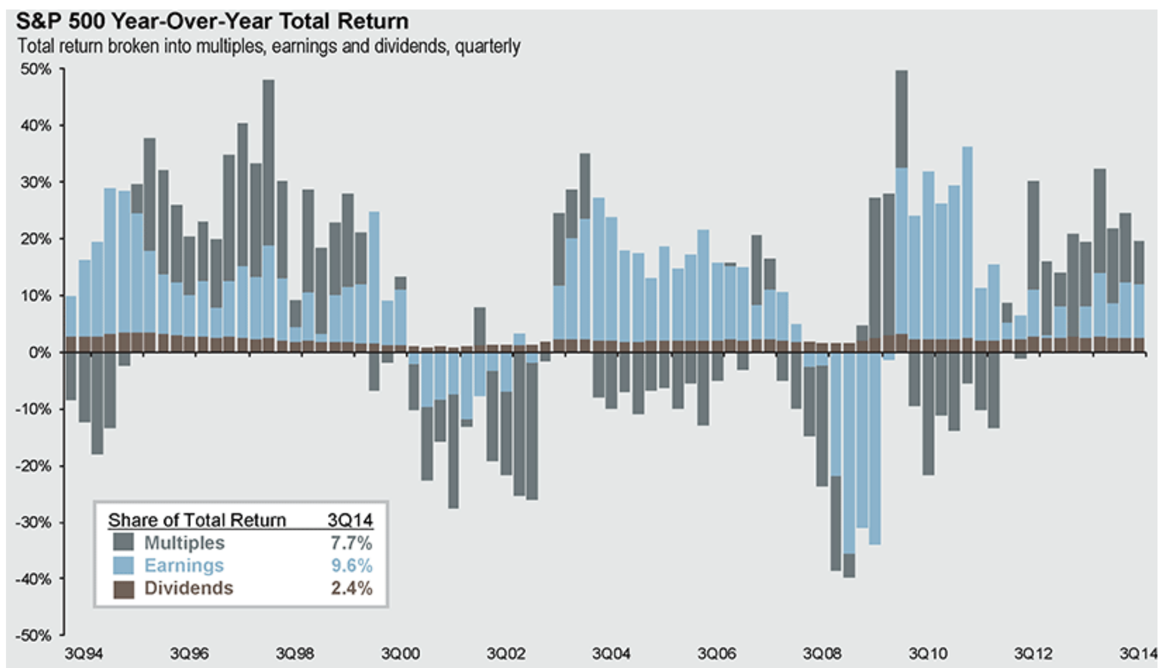


	Annual Return	Yield	Earnings Growth	Valuation Effect
2014	13.7%	2.0%	7.6%	4.1%

PARAGON
CAPITAL MANAGEMENT

STOCK MARKET
(continued)

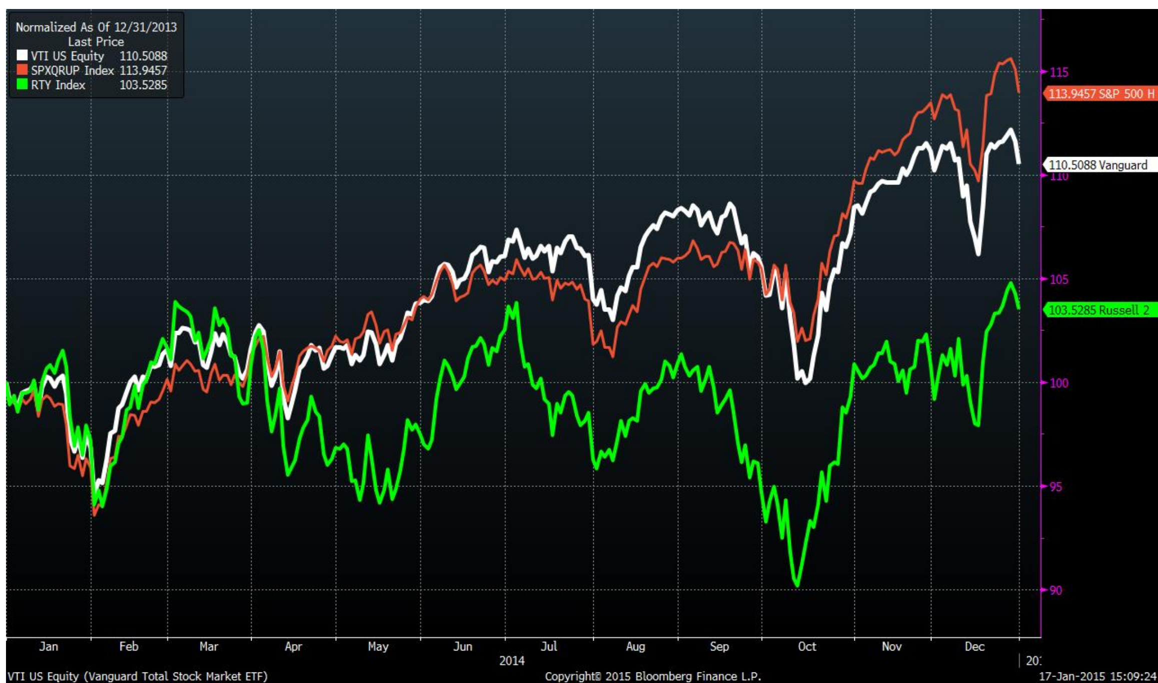
The following chart illustrates how the contribution of valuation (changes in multiples), earnings growth, and dividends contributed to returns over the last couple of cycles. Early in the cycle, the rebound in earnings dominates returns. Later in the cycle, expanding valuations have driven a large part of returns in the current cycle and in the late 1990's. With profit margins at high levels and headwinds on earnings from the strong Dollar and weak earnings in energy related companies, profit growth will be constrained to single digit growth, and, therefore, higher returns will continue to depend on expanding valuations.



PARAGON
CAPITAL MANAGEMENT

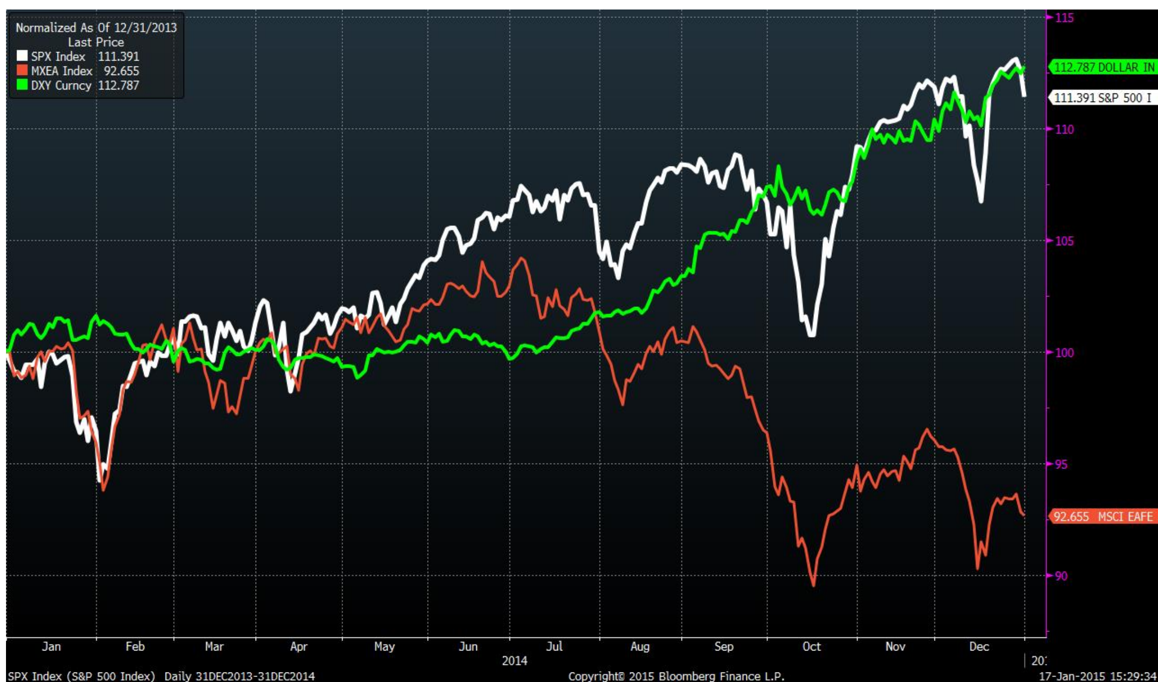
STOCK MARKET
(continued)

While the broad stock market performed quite well, there were divergences. In particular, small company stocks (represented by the green line in the graph) began under-performing after the first quarter. In August, the broad market (represented by the white line) had gained more than high quality stocks (represented by the orange line); however, high quality stocks fell less in the October correction and then rallied more in November and December.



STOCK MARKET
(continued)

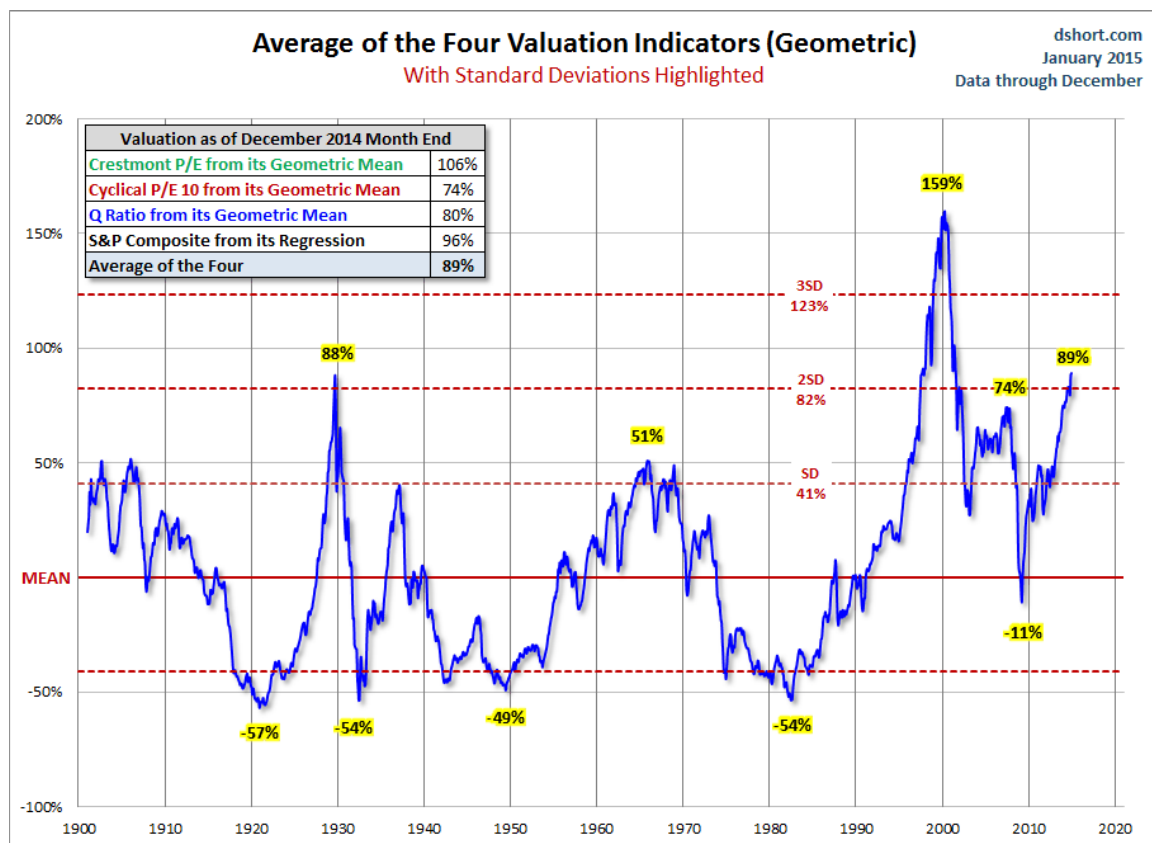
U.S. stocks continued to return more than international stocks. Although U.S. stocks have gained more than international stocks in local currency terms, the strength of the Dollar has added to the returns of U.S. stocks compared to international stocks. The graph below shows not only U.S. stocks (white line) and international stocks (orange line) but also changes in the value of the Dollar (green line) relative to other currencies. You can see that the Dollar made significant gains in the second half of the year that correspond to losses on foreign stocks.



STOCK MARKET EXPECTATIONS

Earnings are expected to increase by a single digit growth rate. Combining with the low current yield produces a 5% to 10% return expectation for the year; However, valuation changes could either boost returns into the double digits or push them into negative territory. High valuations imply that the likely range of returns is skewed to the downside.

A variety of valuation measures indicate that the U.S. stock market is over-valued, as illustrated below. Importantly, periods of over-valuation, especially at extremes, are predictive of low future returns.

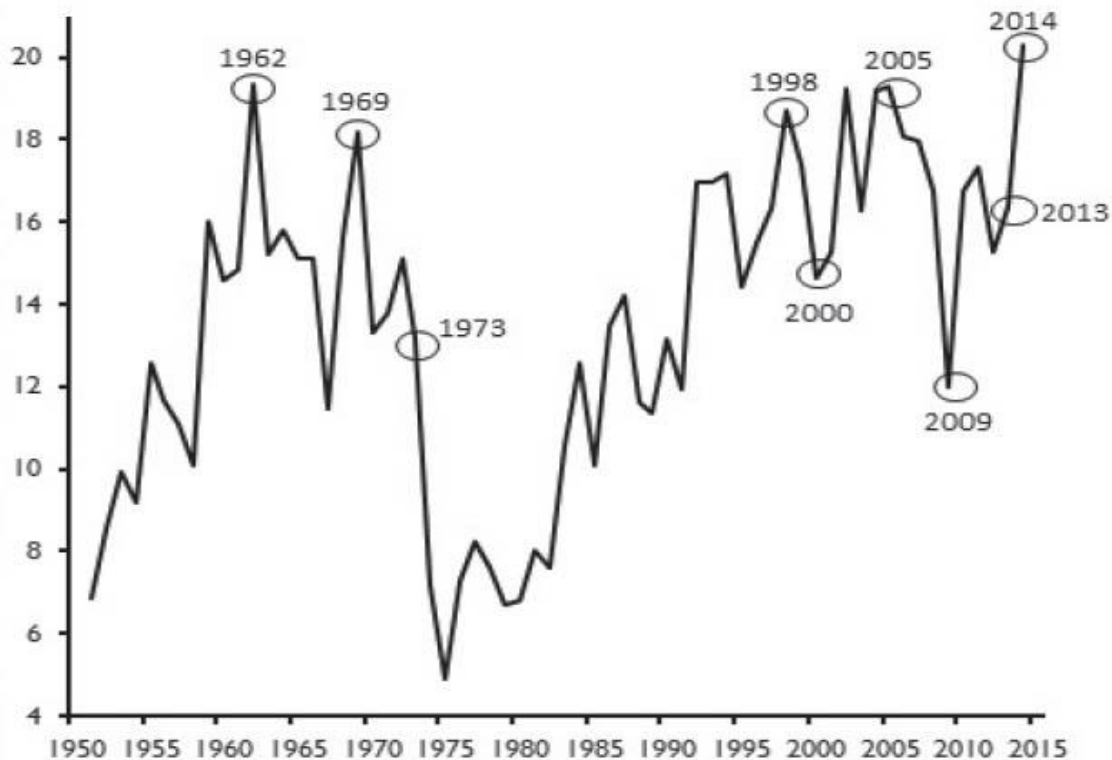


As we have noted in the past, useful valuation measures tend to normalize earnings by taking a multi-year average of earnings and comparing that to the value of the market. Interestingly, even valuation measures based on recent earnings are concerning, as illustrated on the next page.

STOCK MARKET EXPECTATIONS
(continued)

Although generally bullish, James Paulsen at Wells Capital illustrates that the median valuation (price/earnings multiple) of U.S. stocks is at peak levels. While some market peaks were characterized by concentrations of over-valuation such as in the tech bubble or the "nifty fifty" of the 1970's, currently, the market illustrates pervasive over-valuation not only for stocks in the middle or median of the distribution but at every percentile.

Chart 2: Median price/earnings multiple for U.S. stocks*
*Based on all NYSE stocks with positive earnings for the last fiscal year calculated in June of each year since 1951 through 2014



As you will note in the chart, prior valuation peaks in 1998 and 2005 preceded the ultimate market peaks by a couple of years; however, valuations declined for the median stock over that two year period. Prior valuation peaks coincided with market peaks. Therefore, valuations are more likely to contract than expand for most stocks.

STOCK MARKET EXPECTATIONS
(continued)

Our expectation of contracting valuations is also consistent with interest rates normalizing. As interest rates normalize, they will increase, which will depress bond prices. Essentially, future income from bonds is discounted at a higher rate, reducing their present value. Similarly, higher interest rates will discount future earnings at a higher rate, reducing the present value of stocks.

The technical outlook is mixed. The strongest technical (chart pattern) reason for buying stocks is that they have maintained an upward trend and have repeatedly held losses to relatively small corrections. Divergences within stocks, such as the relatively poor performance of small company stocks and high yield bonds, are worrisome. Normally, in a healthy bull market one would expect to see all segments rising in concert. Furthermore, lower risk strategies have been out-performing, suggesting that despite the market reaching new highs, investors are getting more defensive. The over-extended advance in stocks also raises concerns: as illustrated below, another year of positive returns would be quite unusual.

PARAGON
CAPITAL MANAGEMENT

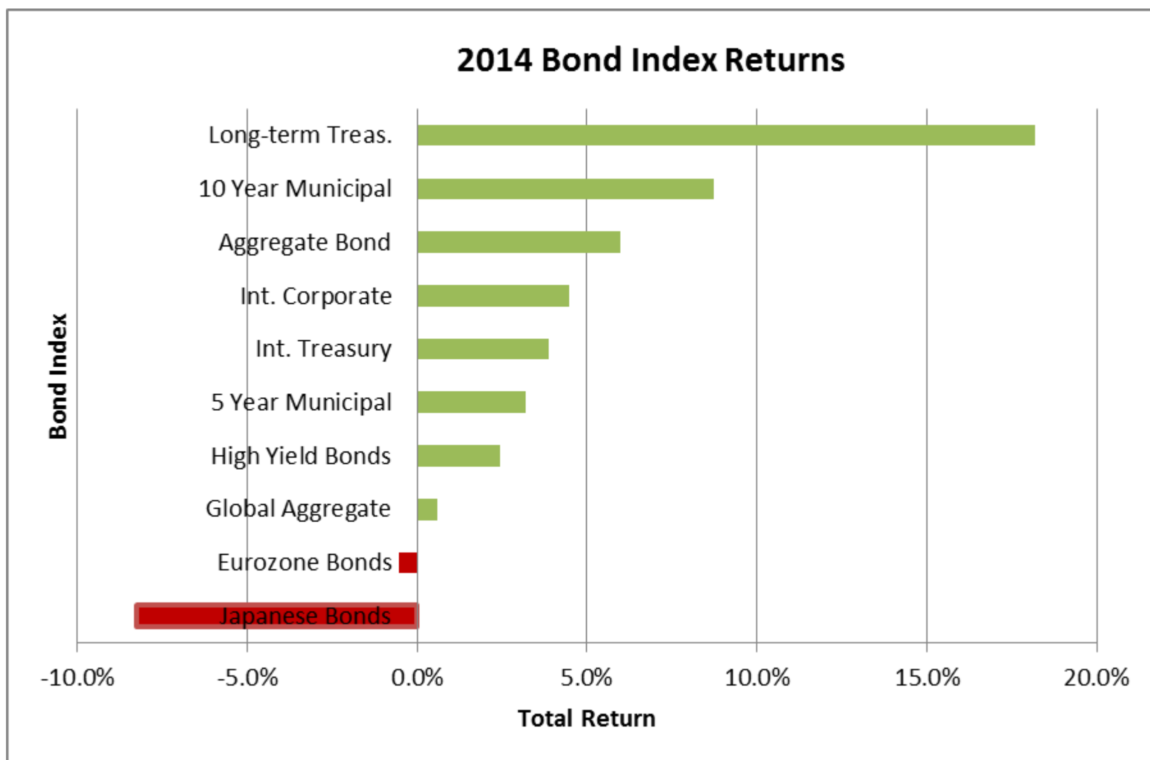
STOCK MARKET INVESTMENT STRATEGY

We continue to pursue a defensive strategy that emphasizes high quality stocks given over-valuation and deteriorating trends. Quality stocks have been out-performing, and these stocks still have reasonable valuations relative to the market. The downturn in oil has, of course, negatively impacted energy stocks. The largest integrated oil companies are traditionally long time dividend payers, so definitions of quality stocks that feature dividend paying blue chip stocks have exposure to these companies. Similarly, multinational companies are and will be negatively impacted by the high value of the Dollar compared to earlier periods. Finally, we continue to see a bifurcation of consumer stocks, with those that focus on the mass market being challenged by the low wage growth in this economic cycle. In conclusion, we are monitoring our quality stocks and funds to ensure that they do not have excessive exposures to deteriorating trends that would compromise their defensive characteristics and that their valuations adequately reflect any negative attributes.

Our preference for domestic stocks over international stocks has paid off over the last several years; last year, domestic returns exceeded international returns by 17 percentage points. Our concern with this positioning is that international stocks now appear to be significantly cheaper than domestic stocks. We have examined this relationship on a number of levels. Looking at how the indices have traded over the last 15 years, the current degree of out-performance is extraordinary. Comparing valuations using normalized earnings suggests a long-term extreme, although this situation has been in place for the last 3 years. Recently, the strength of the Dollar has been a material factor in the out-performance of U.S. securities. We think that the Dollar strength can continue based on the expectation of rate increases in the U.S., higher interest rates in the U.S. than the rest of the developing world, as well as superior U.S. economic growth. As noted in past reports, changes in U.S. stocks vs. international stocks tend to occur around sell-offs in stocks. Furthermore, the Dollar tends to gain when concerns about global risk increase. In conclusion, we are looking for a reversal of Dollar strength, and a sell-off in stocks as catalysts for a shift in our allocation to international stocks.

BOND MARKET

Last year, the bond market confounded investors who had expected interest rates to rise. Falling interest rates resulted in price gains along with income returns. Interest rates fell not only in the U.S. but in every developed country, although the currency losses as the Dollar increased pushed most foreign bonds into losses. Low interest rates and large currency losses made Japanese bonds particularly poor investments for U.S. investors.



Taxable U.S. bonds as exemplified by the 10 year Treasury rate declined from approximately 3.0% to 2.0% last year. Most of the decline was attributable to declining inflation expectations, especially as oil prices declined in the second half of the year. Municipal bonds benefited from not only the general decline in interest rates but also increased demand relative to supply. As states and local governments kept a lid on new spending, financing needs were modest, whereas higher marginal tax rates made tax exempt municipal bonds more attractive to high tax bracket investors.

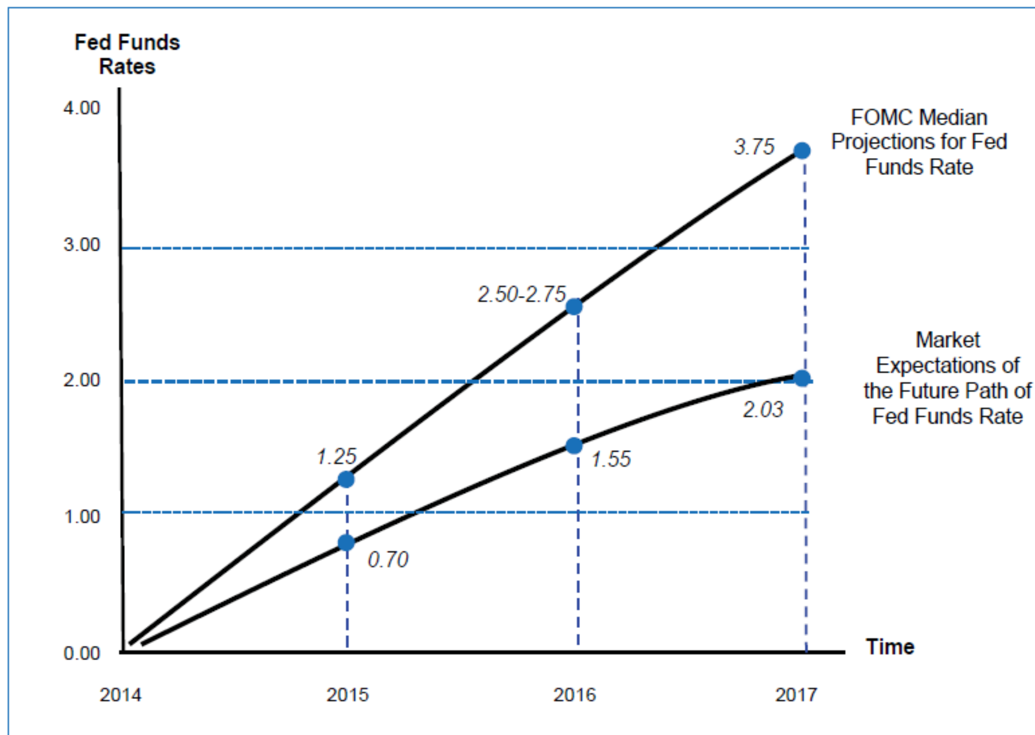
While high yield bonds normally have returns between stocks and bonds, high yield bonds did not fare as well as in past years, as concerns about future defaults and declining oil prices hit the sector. The boom in new drilling has been accompanied by huge amounts of new equity and new debt sales, much of which is low quality.

PARAGON
CAPITAL MANAGEMENT

BOND MARKET EXPECTATIONS

The bond market appears to be at a crossroads, since the Federal Reserve has been indicating that they will raise interest rates based on progress on employment; however, inflation has stayed below their 2% target. As illustrated below, the market forecasts a lower rate trajectory than the Federal Reserve Open Market Committee (FOMC).

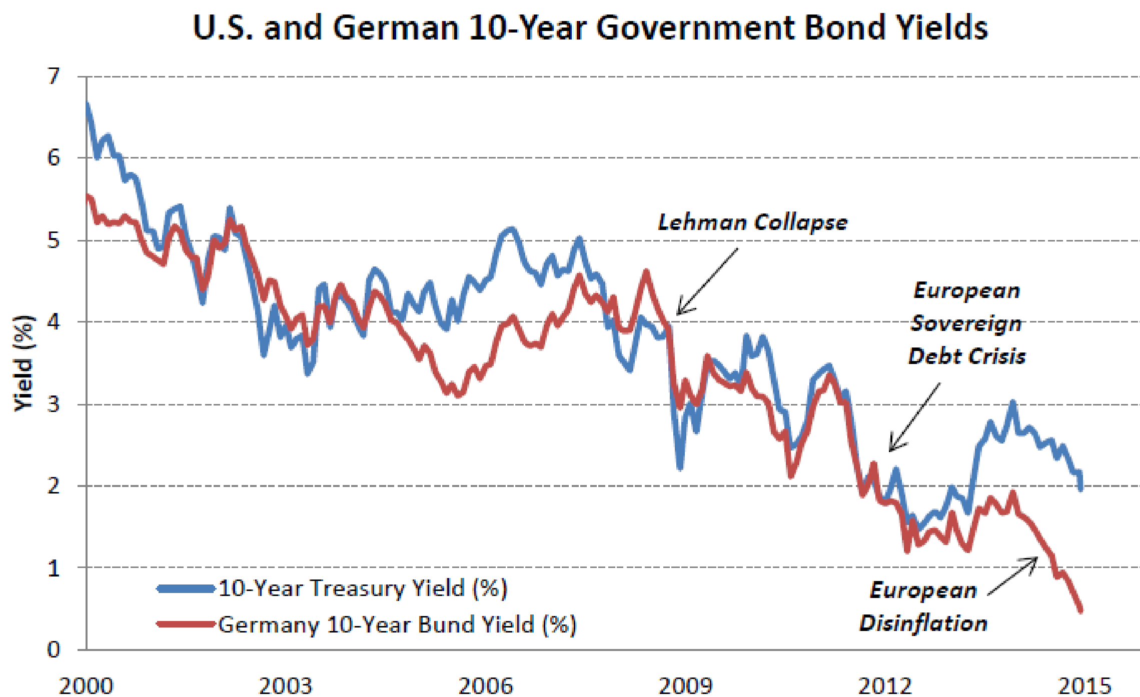
Diverging Projections of Fed Fund Rate Increases
FOMC Forward Guidance and Forward Market for Three-Month Treasury Bills



The market's expectations have been below the FOMC's projections for some time, reflecting skepticism regarding the economy and perhaps the FOMC's projections. The risk to bond prices is that the expectations have become anchored to the low rate regime of the last number of years and that the change in policy will come as a shock.

BOND MARKET EXPECTATIONS
(continued)

The market is pricing in approximately a ¼ percentage point rise in 10-year Treasury yields. This increase in rates appears to be attributable to an expectation for an uptick in inflation by the end of 2015. Thus, there is no expectation of a rise in real (adjusted for inflation) interest rates. This represents a risk given the relatively robust path for U.S. economic growth. It appears that current expectations are colored by rate comparisons with Europe and Japan and the strong Dollar; thus, foreign demand driving rates lower or capping any increase. However, past periods of Dollar strength occurred during periods of both rising and falling rates.



Economic surprises to the upside in the U.S. could undercut the current bond bullishness. Alternatively, if European policies are not as accommodative as expected, the Euro could recover and undermine the current expectations for foreign demand for U.S. bonds.

PARAGON
CAPITAL MANAGEMENT

BOND MARKET INVESTMENT STRATEGY

We continue to maintain bond investments, as short-term trends support continued investment. However, at current low rates the compensation for taking maturity risk is limited, so we plan to maintain average to below average maturities in order to limit price risk. Corporate bonds still provide a reasonable advantage over government bonds, as corporate balance sheets are in good shape.

Municipal bonds appear to be at somewhat greater risk, as the favorable supply and demand conditions are reversing. State and local governments are beginning to spend, so supply will increase relative to demand. Spreads to Treasuries are relatively unattractive compared to recent history, so value in the municipal market is limited. Nonetheless, at top tax rates municipal bonds continue to be attractive.