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JULY 2014 INVESTMENT COMMENTARY

GETTING PERSONAL: ANSWERING YOUR QUESTIONS ON INFLATION AND EUROPE

For this month's commentary, I asked many of my clients as to what topic(s) they would like me to discuss. The two most common responses that I received were in regards to the prospects for higher inflation in the U.S. and whether or not European equities present a compelling value.

When I sat down to think about these two questions, I came to suspect that there are specific underlying concerns related to the future level of U.S. interest rates and where to invest in equities if the U.S. equity market is over-valued. Thus, in this commentary, I hope to not only answer these questions but also address some of the concerns that seem to be on the minds of many American investors in today's economy.

THE FEDERAL RESERVE'S WAR AGAINST DEFLATION: MISSION ACCOMPLISHED

In regards to current levels of inflation and inflation expectations, I believe that the Federal Reserve's policies over the last five years have been aimed at preventing deflationary forces from taking root in the U.S. economy. Unlike the Fed's actions in the early 1980's when Paul Volcker and the Federal Reserve Board of Governors were using extraordinary monetary policy to combat stubbornly high inflationary pressures, Ben Bernanke's Federal Reserve was faced with a much more dangerous threat. Coming out of the 2008 financial crisis and the Great Recession, when unemployment levels exceeded 10% and industrial capacity utilization fell to a forty plus year low of 66.9%, the prospect of deflation was certainly an economic threat. To guard against this threat, many central banks from around the world benefited from observing Japan's attempts to fight low growth and deflation over the last twenty years.

Taking note of Japan's battle against deflationary forces and very low economic growth since the early 1990's proved that deflationary expectations are often difficult to reverse. The Federal Reserve took bold and decisive action in the fall of 2008 when faced with a potential financial crisis that threatened the solvency of the largest and most respected global banking institutions. Thus, Ben Bernanke and the Federal Reserve began a series of extraordinary measures intended to backstop the financial system and restore confidence.

Once the financial crisis was stabilized, the Federal Reserve turned its attention to preventing deflation. Now, after five years of battling deflationary pressures, inflation is finally approaching the Federal Reserve target level of between 2.0% and 2.5%. Additionally, capacity utilization is now just shy of 80%, which happens to be the average level of capacity utilization that occurred between 1972 and 2013. Unlike Japan's economy, which has barely been kept afloat by numerous off-again, on-again attempts to use fiscal and monetary policy to stimulate an economy that suffered from a structurally challenged banking system, our banking system was the first thing that our policy makers repaired. We then took quick action, using both fiscal and monetary stimulus, to ensure that we did not suffer a Japan-like twenty year economic stagnation. As a result, the U.S. economy has out-performed all other major developed economies in the world since 2008, and is now the healthiest major economy in the world.

Additionally, the presence of inflation in today's American economy is indicative of a healthy balance between capacity and demand. The next test for the U.S. economy will be to see if the economy can produce 2.5% to 3.5% economic growth along with a capacity utilization rate at or above 80% without producing unwanted high inflation. With no historic precedent to help guide the Federal Reserve's reversal of its crisis-level monetary policy, the next set of risks that must be managed are unwanted levels of inflation and/or excessive capital market instability. Therefore, all investors must be on alert for unintended consequences as the Federal Reserve embarks on unwinding its extraordinary policies that have been implemented over the last five years.

Investors also must take with a grain of salt those who preach the inevitability of extreme consequences. Many of the same people who, five years ago decried zero interest rates and quantitative easing as irresponsible policies that would lead to the debasement of the U.S. Dollar, hyper-inflation, and economic stagnation, are still forecasting imminent economic failure. I did not believe these of doomsayers five years ago and I most certainly do not believe them to be any more credible today.

Over the next year, I expect that concerns regarding higher inflation will begin to replace those of sluggish economic growth and deflation. However, I am confident that inflation should be able to be minimized by higher domestic interest rates and modest global economic backdrop due to continued gradual slowing of the Chinese economy and a feeble Eurozone economy. As a result of this thinking, I am forecasting that market interest rates, as measured by the 10-year Treasury Note, will resume their accent toward 3% that began last year. Once market rates reach levels generally seen as commensurate with a more normal inflation environment, traditional factors, such as GDP growth and labor availability, will once again dictate interest rate levels. From my perspective, this "more normal" inflation environment will lead to a 10 year Treasury-Note between 3.0% -3.5%, assuming that broad inflation readings, such as the CPI, will remain consistently above 2.0% over the next six months. However, it is much more difficult to predict when the Federal Reserve will begin raising overnight borrowing rates, which currently sit at close to zero. My sense is that the Federal Reserve will give the markets ample time to adjust to higher inflation expectations and the idea of rising interest rates before the Fed provides clear signals that a rate increase is imminent.

ENTICED BY THE EUROPEAN STOCK MARKET DISCOUNT? WE CAN FIND VALUE, BUT SELECTIVITY IS CRUCIAL

I mentioned above that I see the Eurozone economy as feeble relative to the U.S. economy. In fact, I have received many inquiries from clients in regards to whether or not I am seeing compelling equity values in the European countries. However, the answer to this question is not simply yes or no. By almost all basic valuation metrics, most of the European stock markets appear much more reasonably valued in aggregate than those in the U.S. Furthermore, it is easier to find reasonably valued dividend paying stocks among the European stocks compared to the S&P 500. Thus, these facts bring me to the concept of "relative value", which allows an investor to better compare the valuation of one stock or equity market with another. The simplest way to do this is to use the Price Earnings to Growth Rate (PEG) ratio in order to measure value.

Recently, I began buying a European chemical company called Lyondell Basell Industries N.V. (LYB). Below, I will show how LYB currently compares to U.S based Dow Chemical (DOW):

COMPANY	DIVIDEND YIELD	FORWARD PE	EPS GROWTH RATE FY2014 - FY2015	PEG RATIO
Lyondell Basell (LYB)	2.81%	13.14%	15%	1.14
Dow Chemical (DOW)	2.84%	17.68%	22%	1.24

As illustrated above, both companies have almost identical dividend yields. However, Dow Chemical, the largest chemical company in the U.S., has faster expected growth and a higher forward P/E ratio than LYB. By looking at just the P/E ratios of each company, it appears that LYB is substantially less expensive than DOW, and yet, it should be expected that an investor would be willing to pay a higher multiple for DOW given its expected higher growth rate. Thus, using the PEG ratio to compare growth adjusted valuations; it appears that LYB is trading at a modest discount to DOW. Admittedly, the discount that LYB is trading at relative to DOW is slight. If DOW had a higher dividend than LYB, the valuation case to be made for LYB would have been less obvious.

Most of my clients know that the Seven Summits Capital stock selection process is much more sophisticated than simple relative valuation comparisons. The process of selecting a new equity position is driven by a multi-factor valuation process which takes into consideration the quality of earnings, return on equity, and invested cash flow. When the valuation study of LYB is expanded beyond P/E driven measures, LYB ends up looking substantially better than DOW. A glance at some common metrics, such as the ROE and EBITDA margin between the two chemical companies, illustrates the difference between these two very similar looking companies. See below:

COMPANY	EBITDA MARGIN	RETURN ON EQUITY
Lyondell Basell (LYB)	13.90%	30.97%
Dow Chemical (DOW)	12.55%	13.02%

In order to answer the question regarding which equity markets, European markets or U.S. markets, presents the best value, one has to make a macro call on European economic recovery versus the U.S. recovery. Although I do not routinely make macro calls on entire economies, I would choose the S&P 500 if I had to decide between the U.S. market and an ETF basket that represents the more growth challenged and structurally weak European markets. And yet, I selected European based LYB as a new stock position over the American based DOW. This illustrates that we buy companies, not sectors or countries, when we invest. At Seven Summits Capital, companies are screened based upon certain growth and valuation variables. Those variables are weighed against other possible investments and thus, this process dictates whether a particular company will be purchased for our clients.

Finally, I greatly appreciate those clients and interested individuals who took the time to respond to my request for suggested topics for this month's commentary. I not only would like to take a moment to thank them for their interest, but I also would like to encourage others to submit their recommendations for future topics. Hearing from readers not only helps me address any issues that are on investors' minds, but also allows me to better communicate the strategic thought-process that exists behind all investment choices here at Seven Summits Capital.

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