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July, 2013

The 2% Problem

The US economy is growing at 2%, plus or minus. The states have mostly done what they had to do to balance their budgets (though not resolved their pension liabilities) and thus are no longer acting as a drag on the economy by cutting spending and raising taxes. Federal tax increases and sequester spending cuts are estimated to detract 1.8% from economic growth this year and .8% in 2014. So, the economy could be growing at a rate over 3% this year if not for the fiscal drag and many economists expect the economy to accelerate into next year as the federal toll on GDP declines by about 1%. All else being equal, their forecasts would be a lock, but in the real world, all else is never equal.

There are several important drivers of current US economic growth. Facilitated by the availability of low-cost financing and pent-up demand, growth in spending for housing and autos is a sizable contributor. Spending in the 17% of our economy that is related to health care continues to grow. The commercial aerospace cycle is still ramping up and energy investment is a large regional contributor to growth. Those are some of the more visible and sustainable sources of growth.

On the other hand, there are a number of headwinds for the economy beyond the current fiscal drag. Real disposable personal income is only growing at about 1% and the savings rate is already down to 3%. The 150 basis point increase in mortgage rates should not derail housing, but may dampen the ascent as housing starts move up towards the level of household formations. Ongoing uncertainties may continue to weigh on business confidence. As proven recently, the markets will be obsessed with every utterance from the Fed as it finally starts to wean the economy off its monetary stimulus. Congress will begin wrangling over the federal budget and appropriations process before the new fiscal year begins October 1st. The debt ceiling debate escalates in October and the implementation of the Affordable Care Act will provide ongoing planning challenges for years. If only we could count on the rest of the world to offset our domestic issues and accelerate US growth.

Unfortunately, growth in the emerging markets, that generated 75% of global growth over the last decade, has decelerated sharply. Of the BRIC countries, Brazil and Russia are growing at about the same anemic pace as the US. India grew 4.8% in the first quarter but is decelerating. Likewise, growth in China continues to slow while the new leadership attempts to deflate speculation in real estate and rebalance the economy. Slower growth in China feeds back into commodity rich countries such as Australia, Brazil and Canada as well as exporters in the rest of Asia, Europe and the US. Europe has been mired in a recession and Japan, the third largest industrial economy, is attempting to devalue its way out of its 23 year long economic malaise.

Net, net, we hope that the economists are correct that the US economy will see growth accelerate in the second half of 2013 to 2.5% and to 3% in 2014. Some improvement in US employment trends is encouraging, but it has not yet reached a run rate that will get the economy to the next level. We do see a major energy infrastructure build coming over the next five years to take advantage of low-cost US natural gas reserves, but incremental help for the economy won't begin to ramp up until later next year. Beyond that, it is difficult to see economic sectors or countries poised to accelerate overall growth in the near term. **At least for now, we are living in a 2% economy.**

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The problem with 2% US growth, combined with sluggish economies around the world, is that there is not enough lift to elevate the revenues of many industries and companies. There are just less places to find growth and many of those are in the US in the sectors previously mentioned. In fact, S&P 500 earnings were up only 3% in the first quarter and sales and earnings are expected to be up only 1% in the second quarter (FactSet). It will be easier to show earnings growth in the second half of the year against weaker results in the back half of 2012, but a stronger dollar is now developing into another prospective headwind for revenues and earnings.

With lackluster top-line growth and record high corporate profit margins, the playbook for companies is limited. To grow earnings per share, companies need to take out costs and use their cash flow to make accretive acquisitions, buy back stock or pay down debt. Some companies will benefit in coming quarters from cost reductions in Europe finally catching up with the depressed level of sales. Unfortunately, expense reductions do nothing to boost economic growth. Acquisitions are pricey and may not work out in the long term, but with low cost funding, can quickly be additive to earnings. Buying back stock is a low risk way to grow EPS and the overall market has benefitted from a 3% reduction in shares outstanding over the year ended March.

This is not a bad overall environment for stocks as long as growth doesn't further decline, which we're not expecting. **Low interest rates, low inflation and low global growth make US stocks one of the more appealing investment options. In addition, nagging uncertainties keep investors from getting overly exuberant and valuations are reasonable.**

At the same time, this environment does warrant some adjustments in our approach. Companies are at risk of missing current earnings estimates and may need to reduce future expectations. We need to be confident that our companies can live up to expectations and grow their earnings over the next 18 months. Because earnings shortfalls will be punished, **cash is not a bad thing if there are not enough high confidence stocks at any given time.** In fact, (as we often say) cash is a strategic asset which can be utilized when stocks are overly penalized. **We will be ready if they are.**

With fewer companies able to match growth expectations, those that can, may see their valuations expand. Part of the art of investing is to enjoy the success of companies performing well and to capture a reasonable portion of the upside. However, too much of a good thing can become difficult for disciplined value managers. At some point, the risk/reward outlook becomes unattractive and positions need to be trimmed and then outright sold. If this type of environment persists, valuations on a narrowing group of favored stocks will be stretched, we will hold more and more cash, and it will be uncomfortable to watch until the dynamics change (and they always do). Fortunately, that is a potential problem for another day.

Today, we believe that **we continue to be well positioned for this market with a portfolio of attractively valued companies with their own internal drivers of earnings growth and reasonably healthy end-markets.** We are always looking for more of those to add to the mix, but we will also be looking for casualties of this environment that are developing internal catalysts and are deep in the value zone. If growth does pick up in 2014, with some patience, some of this year's outcasts may blossom into some of the leaders down the road!