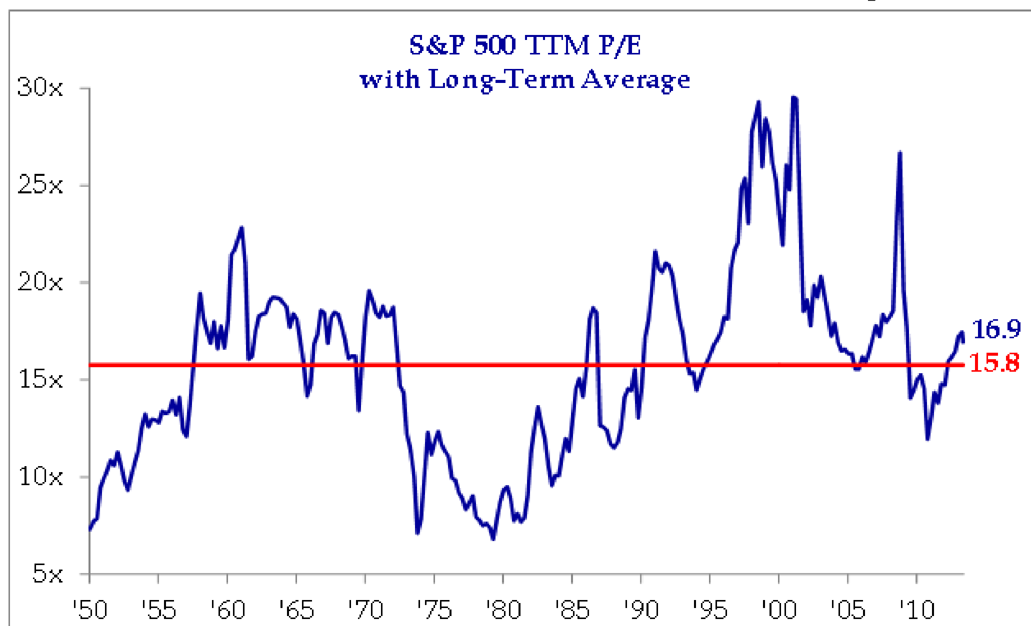
Beacon Trust Quarterly
April 21, 2014

What's Working, What's Not

With the first quarter in the books, we thought this a propitious time to step back and reflect on some of the key imponderables that have emerged this year as well as their potential investment implications. While there's plenty to ponder, we will focus on three areas that could make a difference.

Disinflation is working to give the Federal Reserve a dovish tilt and the stock market a bullish bent. Disinflation is evident when prices rise at a slower pace. This has been the case in the US since 1Q2012. The Federal Reserve Bank's favorite core inflation measure is the Personal Consumption Expenditure Deflator, which has fallen from 2.4% year-over-year growth in 1Q2012 to 0.9% growth in February. Recent growth of 0.9% can be compared to the Fed's target of 2%. This shortfall has drawn the attention of new Fed chairwoman Janet Yellen. In a recent speech, Ms. Yellen warned that a recovering economy may not boost the inflation rate. During her speech, she frequently used the word "slack," which implies that we might be utilizing the same economic models, as slack (or the output gap), is the main reason we think disinflation will persist into year-end. We would observe also that disinflation is prevalent in the developed world, particularly in the eurozone where inflation recently rose only 0.5% year-over-year. The monetary policy implications are for easier policy longer. Easy money is in turn bullish for stock price/earnings (P/E) multiples. Please see chart below which shows trailing twelve month (TTM) P/E for the S&P 500 versus long-term average. In a disinflationary environment, stocks with high free cash flow yields should perform well.



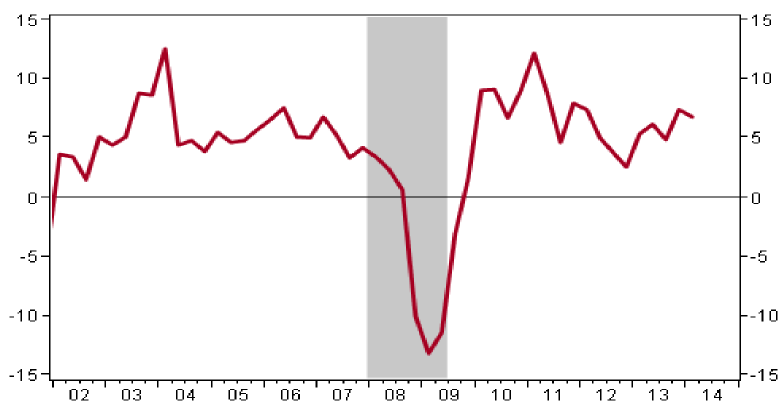
Source: Strategas Partners
**TTM: Trailing Twelve Months*

Business investment is working toward gaining significant momentum. It's no secret that corporations have used cash for share buybacks and dividend increases as opposed to business investments such as capital spending (capex) and research & development (R&D). Capital spending rose only 1% in 2013 to $613.4 billion, while share buybacks increased 23% to $477.3 billion and dividend payments were up 14% to $1.32 trillion. In the nominal GDP accounts, nonresidential fixed investment, which includes both capex and R&D, exhibited healthier gains in 2013. Following a modest decline in 1Q2013, nonresidential fixed investment climbed 6% in the second and third quarters, and 7% in the fourth quarter, as measured quarter-to-quarter. Several recent corporate surveys support an accelerating trend. A February/March poll by the Business Roundtable found that nearly half of CEOs polled planned to increase capital spending during the next six months, up from 39% in late 2013. Other survey data show a similar trend (See Chart). Despite Ukraine and other instances of geopolitical risk, US political issues involving the debt ceiling, the budget, and other distractions, have been resolved and caused a big drop in policy uncertainty. This improved climate should help spur business investment. As company stock has become more expensive to buy back, CFOs might turn increasingly to replacement needs and sources of future revenues in a low nominal growth environment. From an investment perspective, we believe there are significant opportunities among companies investing in their businesses. For example, our proprietary basket of S&P 500 companies with annual capex growth of at least 10% and capex/sales growth of at least 10% performed in line with the general market last year. Strategas Research Partners reports that S&P 500 leaders in capital spending underperformed the Index by 7% in 2013. These results imply attractive valuations among big capex spenders, particularly relative to large buyback companies that beat the Index by 8% last year.

NFIB: Percent Planning Capital Expenditures next 3 to 6 Months 3-month Moving Average SA,%

Source: National Federation of Independent Business/Haver Analytics

Duke/CFO Outlook: Expected Growth in Capital Spending in Next 12 Months %



Source: Duke Fuqua School of Business/CFO Magazine/Haver Analytics

Geopolitical risk is working to increase volatility and choppiness. In the beginning of the year, we identified geo-political risk as the main threat to financial markets in 2014. While Ukraine is a daily news topic, and investors increasingly worry that geopolitical risk will upset the markets, the impact thus far has been limited to higher volatility and choppiness. The US midterm elections will likely delay a sustained stock market rally until the elections unfold in the fourth quarter if past patterns persist. However, additional challenges are likely to unfold. The United States' perceived reluctance to engage in another war or conflict may continue to embolden world leaders to initiate confrontations. Slowing growth, particularly in emerging markets, political instability, corruption, and lack of reforms, will feed social unrest. Because geopolitical events are inherently unpredictable, portfolio construction should be based on sound strategies and security selection, sector tilts and themes, and broad diversification.

Market Expectations

Our markets outlook has changed little. We continue to forecast higher US stock market prices (2,075 S&P 500) as the economic expansion supports a moderate gain in earnings; while subdued credit spreads and dividend growth support P/E multiple expansion. The ride is likely to be volatile and choppy as witnessed in 1Q2014. Factors driving excess returns for individual stocks will conceivably be valuation, quality, size and free cash flow yield. From an asset allocation perspective, we recommend being overweight US equities and underweight emerging markets equities. We are neutral developed markets equities.

Our 10-year Treasury range forecast remains 2.50% - 3.25%. The rise in rates should be limited by tame inflation, reduced net new Treasury issuance, asset/ liability matching institutional demand, and modest dollar strength. Short rates will remain low through year-end and much of 2015 as the Fed is charged with keeping the economic expansion going and raising the rate of inflation. Our asset allocation models are underweight fixed-income with tilts towards high yield bonds and emerging market sovereign debt.

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Guiding you forward.

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