Outlook

A Quarterly Newsletter from Roffman Miller Associates

05 April 2014

“A good scare is worth more to a man than good advice”

Edgar Watson Howe
1853-1937
U.S. Journalist

It has been five years since the end of the great bear market. I refer to it as the “great” bear because it was the worst market since the depression. As a client said to me the other day, “things look good now but I don’t want to ever again go through what happened in 2008.” He obviously had a good scare and I have to admit, so did I. I would like to be able to assure everyone that 2008 is not going to happen again but there are no guarantees.

We all know that a 5% or 10% correction happens frequently. Bear markets (which by definition drop 20% or more) happen less often but should be expected by a long-term investor. The lesson to be learned is that we must prepare for the difficult times. That means having a plan for the long-term and the asset allocation that you can live with during the ups and the downs. That is why we must revisit your allocation from time to time. You should not invest in a vacuum - as things change in life you need to see if that means a change in your investments. That’s what we’re here for. After 24 years in business I have learned that this is a journey and we’re your guide. We all had a good scare in 2008, but our advice was sound.

I don’t want to give the impression that I have a negative outlook on the market or the economy. In fact I am positive! The US economy continues to grow and at a rate above the rest of the developed world. There are certainly many problems but the market has held up well. As an example you would’ve thought that what is going on in Russia would rattle the markets. After such a strong market last year I am pleased to see a positive return in the first quarter, albeit a small one. With little inflation and low interest rates, it’s a great environment for the companies we own. The tough winter certainly had its effects on profits in the first quarter but spring is here and hopefully those cold headwinds are behind us.

I was sad to learn that our oldest client recently passed away. She was one hundred and one. I enjoyed our meetings and liked the fact that she was not afraid to challenge me. In fact what I enjoy most about what we do is that we get to meet a lot of interesting people. If we managed a mutual fund then we’d only deal with the dollars and not the people. That is why it’s important to me that we provide a high level of personal service, and in that regard we hope to continue to exceed your expectations.

As always I welcome your thoughts or concerns.

Sincerely,
Peter Miller
Chairman and Founder

Is a Capital Spending Cycle Imminent?

Key Points

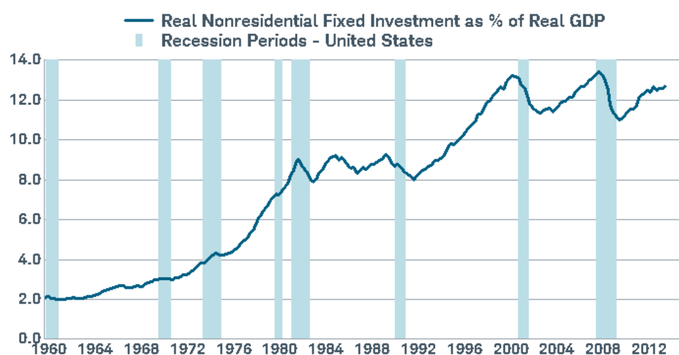
- Capital expenditures ('Capex') are monies spent to help drive sales and profits of corporations, such as for new computer systems or manufacturing plants.
- Preconditions for a pickup in capital spending appear to be lining up.
- The technology and industrial sectors are likely the biggest beneficiaries.

One of the most arresting characteristics of this cycle's recovery is the surge in corporate profitability. Clearly, shareholders have benefitted recently from companies' preference for returning cash via buybacks and dividends vs. making capital investments. But the tide may be turning.

Are we are poised to see a pickup in investment spending? I think the preconditions are lining up.

Where are we in the cycle?

Relative to real gross domestic product (GDP) as you can see below, capex is not only still well below its prior high, it's been range-bound since the late-1990s. The last major secular upcycle in capex was between 1960 and 1980. It is too soon to suggest this cycle will be of the secular variety, but we can point to several indications of ample pent-up demand.



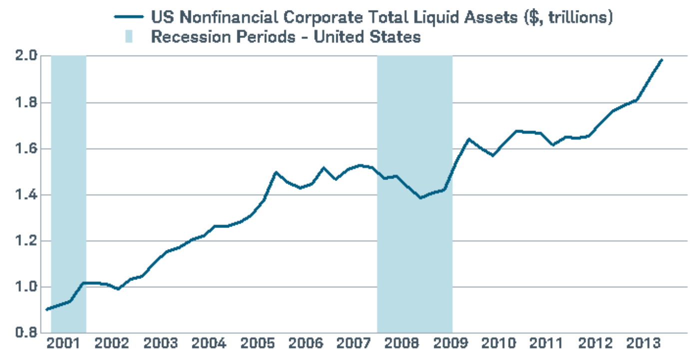
Getting old!

Then there's the age problem (one I'm fighting personally!). The average age of the capital stock is now at historical peaks, even for quickly-depreciating sectors like software and information processing equipment. Tech investment has dropped to a near 15-year low as a share of overall investment. We do believe the technology and industrials sectors will be the most significant beneficiaries of a more meaningful upturn in the capex cycle.

This article is excerpted from a presentation by Charles Schwab's Chief Investment Strategist, Liz Ann Sonders

Corporate Cash at All-Time High

We know companies have the means. As seen below, nonfinancial corporate liquid assets are at levels unseen since World War II (WWII), with a notable pickup in the pace of accumulation over the past two years.



Rising confidence

It's also essential to have rising confidence on the part of corporate leaders. There have been endless macro and policy uncertainties plaguing business confidence over the past several years, including debt ceiling fights, the government shutdown, a ratings downgrade of US debt, the sequester, the Affordable Care Act and regulatory burdens. But some of these uncertainties are easing, while returns on capital remain higher than the cost of capital, meaning the financial incentive for capex remains healthy.

A special Philly Fed survey question revealed that nearly 50% of the firms in the district expect to increase capital spending in 2014.

Finally, we can look at lending trends as a sign that business demand for loans tied to longer-term investments is rising alongside a greater willingness to lend by banks. Both small and large banks are showing a sharp acceleration in commercial and industrial (C&I) lending, particularly over the past couple of months.

Consumer confidence is also crucial given that consumers are typically the core of a self-reinforcing economic expansion. According to BCA Research, the "Classic Cycle" experience is that household deleveraging typically lasts no more than five-to-seven years, with spending reviving even before deleveraging is complete. With household debt-to-income back below its long-term trend, net worth well above its prior high, and consumer debt outstanding up for two consecutive quarters, we may have passed the inflection point for the consumer.

The conditions appear ripe for a recovery in spending on technology, plant, and equipment, and we appear to be on the verge of another wave of capital spending.

A Tough Act to Follow

Did you ever wonder what it was like to be the guy who followed Seinfeld in the comedy clubs? If so, then you can start to understand how I feel as a Portfolio Manager trying to follow a year like 2013.

It seems the market feels somewhat the same. So far this year, there have been plenty of ups and downs but at the end of the first quarter stock prices are still seeking a general direction and the broad indexes did not move with any conviction.

As always, we're not concerned with the indexes or the short term price movements of stocks. Instead we look at the health of the overall economy and specifically of the companies we follow and invest in. For many of our investments, the health of the global economy is important to their business and one local company, Honeywell (Morris Township, NJ) is no exception.

Recently I met with Honeywell CEO David Cote and other senior managers from the company where they discussed their growth targets through the year 2019. Even for a proven management team who met and exceeded the goals of the previous five-year plan, the new plan seems ambitious. But by taking "great positions in good industries," they believe they can achieve the goals set forth.

24% of Honeywell's sales are in the Home and Building end-market. These products run the gamut from simple thermostats to commercial building security and environmental control. Specific areas of innovation include 'smart' thermostats which are accessible via your smartphone or any web-enabled device. Additionally, energy management is a technology driver as the power grid gets "smarter" and all the interacting devices must be designed to keep up.

The Transportation Systems division feels that the world and the US in particular is at a critical point in automotive fuel economies. Cars are mandated to deliver better fuel economies to meet increasing efficiency standards, which usually mean smaller engines. Drivers, however, do not want to give up power, but the traditional 'naturally aspirated' gas engine is at its limit. The solution: turbochargers, which force air into the engine and can provide power boosts of 50 to 100% when power is needed. This allows for smaller, more efficient engines with little change in 'feel' to the driver. This is no small business - the division saw $3.8 billion in 2013 sales, and Honeywell has won 40% of new engine designs that will be launched worldwide in 2014. While turbos have been nearly standard in Europe (57% of sales), the US market is ripe for deeper penetration (19% of sales) and the manufacturers seem to agree.

Another large division of Honeywell is Aerospace where they deliver key on-board systems for new airplanes and also airport and air-traffic management and safety systems. At $12 billion in sales this division makes up 30% of the company and has the highest margins. As Dave Cote put it, there is still plenty of 'runway' for this business: airplane manufacturer Boeing forecasts that the civil aviation force worldwide will grow from approximately 20,000 to 40,000 planes over the next twenty years. That's an estimated $4.8 trillion in new aircraft spending, or about $240 billion per year. And that doesn't include maintenance spending.

Honeywell

China is a large growth engine for Honeywell. Surely China is a risk. But it's also a risk *not* to be there. And Honeywell isn't selling commodities like concrete or steel or copper. They're selling critical solutions for real problems like air pollution, food safety, and water quality. Most of these products flow through the Performance Materials and Technology division, the fastest growing part of the company which also happens to have the second-highest margins of the four divisions.

Some of Honeywell's peers in the industrial segment are able to generate higher operating margins (a measure of profitability). Cote explained that Honeywell will close this gap by 2.2 to 3.7 percent over the next five years, translating to upward of $1 billion of extra profit every year. This will help drive double-digit profit growth, and Cote promises to grow the dividend even faster than that. That could mean a 50% rise in your income over that time period (for the record, the

dividend has risen 49% over the past five years as well). That will be paid from an estimated $30-35 billion in free cash generated over the five years, and with their pension 100% funded at year-end 2013, half of that free cash will go to fuel further growth and half will be returned to shareholders in the form of dividends and stock buybacks.

The two things I admire most about Honeywell are the people I met and the way they go after good industries with a great product offering. Somehow those things were overlooked when, after 83 years, Honeywell was kicked out of the Dow Jones Industrial average in February 2008 and replaced by Bank of America. The people who manage the index have since realized their mistake, removing Bank of America last year, but they did not reinstate Honeywell. Honeywell is making it a point to make them regret that decision.

- Mark Frombach, Chief Investment Officer

FIXED INCOME

US Treasury	4-Apr-14	Month Ago (Chg)		Year Ago (Chg)		Global Benchmarks	
30 yr	3.63%	3.56%	0.07%	3.06%	0.57%	German	1.60%
10 yr	2.79%	2.61%	0.18%	1.81%	0.98%	U.K.	2.75%
5 yr	1.79%	1.46%	0.33%	0.73%	1.06%	Japan	0.65%

Bond Indexes	Yield	CD's (Phila)	Yield	Consumer Benchmark Rates	
Barclays Aggregate	2.00%	1 yr CD	0.50%	Federal-funds target	0-0.25
U.S. Agency (Barclays)	1.40%	3 yr CD	1.00%	Prime rate*	3.25
Mortgage-Backed (Barclays)	1.45%	5yr CD	1.60%	Libor, 3-month	0.23

Quick Facts: RETIREMENT

1. According to Aon Hewitt's "The Real Deal" 2012 study, an average full-career contributing employee needs 11.0 times pay at age 65, after Social Security, to expect to have sufficient assets to last through retirement. For example, if your salary is $80,000, you will need to have accumulated $880,000 by the time you're 65 and ready to retire.

2. In reality, the same employee is expected to have only 8.8 times pay in resources at retirement, which translates into a 2.2 times pay shortfall. To reuse the example above, this means you'd be $176,000 short.

3. The 2013 Transamerica Retirement Survey found that the percentage of participants who have taken a loan from their 401(k) plan has increased from 16% in 2008/2009 to 21% in 2012, then slightly decreased to 17% in 2013.

4. Wells Fargo conducted a survey of 1,000 middleclass Americans. The study shows that across middle class members of all generations, only 24% are confident in the stock market as a place to invest for retirement. The apprehension about the market is stronger for those age 25 to 29, with 56% expressing fear of losing their nest egg. When asked if given $5,000 for retirement where they would invest, 58% of those age 25 to 29 said they would invest in a savings account/CD.

5. Only 18% of workers are very confident they will have enough money to live comfortably in retirement (according to the EBRI 2014 Retirement Confidence Survey).

Sources: Aon Hewitt's "The Real Deal: 2012 Retirement Income Adequacy at Large Companies." "14th Annual Transamerica Retirement Survey of American Workers," Transamerica Center for Retirement Studies, July 2013. Wells Fargo news release, "Middle Class Americans Face a Retirement Shutdown," October 2013.

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