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About Legacy

Legacy Asset Management, Inc. is an independent Registered Investment Advisory firm, committed to providing the best solutions for our clients' success.

We offer professional money management and sound objective advice throughout a full range of investment and Qualified Retirement Plan consulting services for the institutional and high net worth client.

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WAIT AND SEE

"Noise"

No need to worry about the rising cost of food and gas prices that are impacting consumers at all levels – it's just "noise" according to the new Chair of the Federal Reserve Bank, Janet Yellen. In fact, she stepped in it deeper, at her post-Federal Open Market Committee meeting press conference on June 18th, when she indicated that "I see things roughly in line with where we expected inflation to be." I'm not sure where she is shopping (or if she is shopping) but I would venture to guess that everyone reading this might have a different opinion. So where is the break-down in interpretation? I guess according to the Fed, it is all perspective. The Fed's key gauge of inflation is based on Personal Consumption Expenditures (PCE) which has been growing at 1.5%. Everyone else, including the Federal Government, watches the Consumer Price Index (CPI). In fact, the CPI which is running in excess of the Fed's stated inflation target rate of 2%, is used to calculate the cost-of-living increases for Social Security and other benefit programs. If the CPI is good enough for the Federal Government, shouldn't it also be the critical metric for the Fed as well?

Surprise

Those who read my quarterly musings on a regular basis, know that for over the last half decade, I have been less than pleased with the policies of the Federal Reserve. The Fed has two mandates – price stability and full employment. Former Fed Chair Ben Bernanke, was willing to sacrifice the dollar (price stability) in the name of low interest rates. I fear Janet Yellen will follow in his footsteps. Based on her comments in the press conference last month, it appeared that she is possibly nothing more than an extension of the Bernanke policies. I know this will probably surprise everyone but some of what she said actually made sense. The economy is not as robust as advertised and there are troubling signs with the consumer that could prove to be headwinds for the economy. I'm willing to give her the benefit of the doubt. In retrospect, it was probably a miscalculation for the Fed not to acknowledge that the buildup in commodity, food and energy prices could become problematic, if not addressed. Strategically, Yellen is walking a fine line between price stability and inflation. She is not alone; all Central Bankers, throughout the world, are trying to create some type of inflation in order to create consumption. Consumers will typically buy now to avoid paying higher prices in the future.

What makes this whole conversation about inflation tricky is timing. Some areas of the economy are showing signs of improvement while others continue to lag. Portions of the Manufacturing sector have picked up a considerable amount of steam. For example, the auto industry is on fire due to pent-up demand from the harsh winter, low interest rates and incentives. Automotive News reports, production of light-vehicle sales in June represented the fastest selling rate in the U.S. in almost eight years. Meanwhile, both Durable Goods and Factory Orders have reported lumpy and uneven results throughout the year, as manufacturers have stockpiled large amounts of unfilled orders to smooth future production - indicating uncertainty regarding impeding demand.

One of the Fed's biggest concerns centers on the consumer. As Yellen noted in her comments, without a pick-up in PCE (demand) any rebound in manufacturing would be short lived. While consumer confidence has improved considerably, consumer credit and household debt has spiked while real wages growth turned negative. According to current government data, U.S. revolving credit balances (credit card debt) increased at an annual rate of over 12% in April, the fastest increase since 2001. Overall U.S. consumer debt rose last quarter, at the highest rate in more than six years as Americans borrowed to buy homes and cars and to pay for education, according to a survey by the Federal Reserve Bank of New York. In fact, consumers have become creative in how they finance expenditures. In order to afford new car purchases, consumers are stretching out payments over record periods of time. The current average length of a new car loan is now 7.2 years. Depending on the make and model, it is likely that over the life of the loan, the car will be worth less than the amount owed – does this sound familiar?

Household debt jumped 2.1 percent to $11.52 trillion, the biggest gain since the third quarter of 2007. Home-equity lines of credit (HELOC) and home-equity loans jumped 8% in the first quarter. Wilbert van der Klaauw, senior vice president and economist at the New York Fed, said "After a long period of deleveraging, households are borrowing again." Total household debt-to-GDP currently sits at 77%, down from the March 2009 peak of 96%, but significantly higher than the long-term average of 55%. A logical question keeps gnawing at me – if real wages are negative and interest income is limited, how can consumers continue to leverage their spending habits without increasing their income or reducing consumption?

Unquestionably, the biggest negative surprise through the first-half of the year has been the weak housing market. Housing has been lack-luster and in spite of recent improvement in May. The Federal National Mortgage Association. (FNMA) expects existing home sales to decline annually due to weak volume, rise in mortgage rates in 2013 and a shortage of supply of lower-priced homes. What's more ominous is that the Agency indicated that "we do not expect to see 'normal' levels of new residential construction, in the region of 1.6 million new housing units per year, before the end of 2016." "Such a feat would require a pace of growth in housing starts not seen in decades." Supporting this view is the fact that mortgage applications are down by 20% from the peak in April 2013.

The Fed's ability to successfully navigate through building inflationary pressures will have far reaching ramifications on all Americans. I recently read a research report by Hedgeye Risk Management which quantified the impact of commodity inflation on the median consumer. They uncovered that the average consumer spends more than 20% of after-tax income on food and utilities. When gas and motor oil are included, the combined total exposure to commodity prices is closer to 28%. A spike in inflationary costs could send that number significantly higher. I'm not convinced that there is any difference between Janet Yellen and Ben Bernanke. The stakes are high and the Fed needs to get its policy right. However, for the time being, I am hopeful. I am going to sit back and watch how her policies unfold.

Quarterly Review

Ho Hum

Not much changed over the last quarter - the status quo remains. The 10 yr. Treasury rate continues to hover near the lows of the year around 2.5%, Wall Street is still convinced that economic growth will pick up in the second-half of the year and TINA (There Is No Alternative) is the psychological factor driving equity prices higher. Again, sound familiar? The fact that this dynamic has lasted as long as it has explains why 5+ years after the recession, the U.S. economy continues to labor along, and the equity markets continue to rise.

The momentum was clearly higher in the quarter – not even a surprisingly negative 2.9% GDP number in the first quarter, Russia's invasion of the Ukraine, a new civil war in Iraq or ballooning food and gas prices could temporarily derail stocks. The daily market activity seemed choppy as investors rotated from one sector to another. What was out of favor one day became the darling the next. By the end of the quarter, the Dow and the S&P 500 reached 12 and 16 new daily highs, on their way to recording gains of 2.2% and 4.7%, respectively. The NASDAQ jumped 5%, but remains 15% below its all-time high set on March 10, 2000.

Gains in the market were broad based as every sector of the S&P 500 was higher. Turmoil in Eastern Europe and the Middle East pushed oil prices higher. This propelled the Energy sector to lead the market with returns of almost 12%. Utilities jumped 7% as investors continued to seek out higher dividends and the undervalued Technology sector was up 6% as investors were looking for cheap growth potential. As concern over inflation started to creep into the market, the Material sector popped 5%. On the flip side, investors rotated out of Financials as lower rates and a flatter yield curve compressed margins. Even still, the sector was up almost 2% on the quarter which represented the worst performance in the S&P 500.

The catalyst responsible for the bull market run continues to be the Fed's easy money policies. Low rates force income needy investors into the stock market-pushing risk ever higher as they pay inflated prices for yield and return. In this perpetually low rate environment, corporations don't need to spend money to grow earnings. Rather, they have become quite accomplished at financial engineering – creating paper wealth out of balance-sheet manipulations. For example, companies borrow money cheaply to buy back stock. This technique grows earnings per-share because for a level of income, there are fewer shares. According to S&P Senior Analyst Howard Silverblatt, buybacks, this past quarter, were the highest since 2007 at $188 billion. For all of 2013, buybacks grew 19% to $476 billion. Corporations are on pace to blow that out of the water this year. In the current low interest rate environment, growing earnings through reducing share count is more efficient than hiring full-time employees or investing in new production. With total corporate revenue growth of only 3.1%, in the first quarter, companies are looking to maintain efficiencies or else margins could turn negative and earnings would fall.

Corporations became a bit smarter in the quarter, and added a new wrinkle to financial engineering - mergers and acquisitions (M&A) and as a result, tax inversion. There were several large M&A deals that helped get the markets bubbling over with excitement and speculation. In healthcare, Valeant Pharmaceuticals reached out to Allergen Inc., for $55 billion, AbbVie Inc sought Shire PLC for $47 billion and Medtronic made a move for Covidien (two companies very familiar to our investors) for $43 billion. Not to be outdone, AT&T grabbed DIRECTV for $48 billion (pending regulatory approval). Here is the wrinkle, the catalyst behind some of these acquisitions were to take advantage of "tax inversion" – the practice of buying a foreign company to change domicile to gain more favorable tax treatment. Valeant, AbbVie, Walgreens and even Pfizer tried to implement this strategy in an attempt to lower their tax expense. How long do you think it will take Congress to jump on this issue? With the need for more tax revenue, the government will likely NOT let this go unchecked for long.

The bond market followed equities higher (bond prices and rates move in opposite directions) as rates fell on the 10 yr. Treasury to 2.5%. This has been the typical pattern over the last 2 years throughout the Fed's Quantitative Easing (QE) experiment. However, it was assumed that as the Central Bank began to reduce their bond buying activates, rates would move higher. The theory behind the assumption is that as the economy improves and the government reduces QE, rates would move higher in anticipation of greater economic growth. However, there is a disconnect – stocks are moving up in anticipation of better economic growth, yet the bond market (with its low rates) is signaling that the economy will remain sluggish. The markets can't have it both ways. Either rates will rise (bond prices fall) as the economy improves, or equities will fall as the expectation of better economic activity (which is priced into the market) fails to materialize. The juxtaposition is that simple. We have been living with QE or an artificial market for several years. According to the Fed Chairwomen Janet Yellen at last month's Open Market Committee meeting, QE will be over by the end of 2014, so there will likely be some fundamental shift in the market psychology.

Preference

If I were the Fed Chair for a day, I would begin the process of raising rates in an effort to change the slope of the yield curve from flat to upward sloping, even though there are some troubling signs with consumers. An upward sloping yield curve benefits both consumers and investors. Higher rates support a stronger U.S. dollar which attracts investments from foreign countries. Greater demand for U.S. dollars decreases the price of imported goods which reduces the prices on everything from food and energy to home construction and jewelry. Investors would earn higher rates of return (income) for lending their money to governments, corporations or municipalities over longer periods of time. Higher yields would also temper the need for investors to increase risk just to achieve income.

Higher rates also force corporate America to drive profitability through organic growth and incentive capital spending. When capital becomes more expensive, corporations need to focus on growing the business and return on invested capital (ROIC). This creates capacity and better paying jobs. Finally, from a fiscal point of view, higher rates reduce the amount of government debt on the books. As rates rise, prices fall and the U.S. government could buy back long-term bonds at lower prices. Since rates are at such low levels, any minor increase will have a huge psychological impact on the market. While rising rates might initially cause a bit of an equity correction, the overall fundamental health of the markets would improve.

The Equity Portfolio

What to Do

Last quarter, I wrote about the short sidedness of "haters" – those analysts, investment advisors or investment personalities that pile on unwanted stocks because of a miss in earnings, a snafu in operations or a miscalculation in the business environment. As an investment manager, I relish opportunities that haters provide as unloved stocks can make good investments. Stocks we bought last quarter because of opportunities created by downgrades and poor performance were Nike, Baxter Citigroup and Bank of America. While the two bank stocks lagged the market, Nike was up big after posting better than expected earnings and Baxter, which jumped over 10% shortly after we added it to the portfolio, was down slightly.

Time is not a barometer of a successful investment; rather it is required rate of return. When a new security is added to the equity portfolio, our future valuation is based on a minimum required rate of return of 20%. In other words, if we don't believe we can earn at least 20% we will not add the security to the portfolio. So what happens when our return bogey is achieved, do we automatically sell? Not necessarily. We look at the valuation to see if there continues to be a compelling reason to hold the stock. The natural cycle of an equity is that it starts as an undervalued stock and moves toward growth as earnings being to grow. Typically, the market anticipates improvement and the price of the stock moves up faster than earnings causing the P/E multiple (and valuations) to expand. If earnings continue to improve, growth investors will jump in and the demand will drive up the price of the security higher. True value investors typically sell their shares just as growth investors become interested causing a natural rotation. Once earnings peak and the business begins to slow, growth investors dump their shares and the price falls and the cycle starts all over again.

It is important to differentiate the normal investment cycle with what has been going on in the equity markets over the last two years. When artificially low interest rates create limited income opportunities, investors have to chase yield or investment income. Income deprived investors piled into dividend paying stocks pushing equity prices higher even though organic growth was non-existent. Indeed, much of the earnings growth can be attributed to financial engineering.

The cycle between value and growth was not the root of the current multiple expansion. Rather, it is the lack of income options which has forced investors to hold their high dividend payers even as prices have escalated. There is a potential for a bubble forming in these high dividend paying stocks that are traditionally known as safe and less volatile. For example, utility stocks are the best returning sector of the market this year. This is crazy! Utilities are heavily regulated and earnings grow only 3% – 4%, on a good year. Nonetheless, the group is up 18% year-to-date which is almost 3X that of the S&P 500. Can you say bubble? It may be time to take some money off the table in some of these overvalued dividend stocks.

Over the last several quarters we have maintained an aggressive 3% cash position (on average) in our equity portfolios and we did not buy any equities in the 2nd quarter. If fact, based on valuations and concern over market fundamentals, we made the strategic decision to take some money off the table. We recently sold all positions in **US Bancorp (USB)**. While this regional bank has a strong capital position and margins that are back to pre-recession levels the company's valuation is extremely high on both a relative and absolute basis. The preferred valuation metric for banks is the Price/Book ratio. US Bancorp's P/B is at a 20% premium to the next highest peer in its industry. Its P/E ratio is at the highest level since 2000 and its stock price is at an all-time high. When considering industry fundamentals and valuations, we decided it would be prudent to take the profits. USB is one of our favorite regional banks and should the stock price fall back to more attractive levels we would not hesitate to get back in.

We also sold **Foot Locker (FL)** after the stock jumped over 40% from when we added it, back in June 2013. This is a classic example of a stock that went from value to growth. When we purchased FL, valuations and dividends were attractive; the company was in the early stages of international expansion. After two really good earnings report in the 1st and 2nd quarter of 2014, growth investors started to pile in pushing the stock higher by 22%. Valuations expanded abruptly. When we bought the stock its P/E ratio was 11.9X and its Free Cash Flow yield was 6.7X (you want a high FCF yield). Now the P/E is almost 15X and significantly exceeds its 5 and 10 year median. The FCF yield has fallen to 4.7X and the dividend has dropped from 2.2% to 1.6% as the stock price has risen. We like FL and their growth potential overseas but believe the stock has gotten ahead of itself in this recent run. Besides, we added Nike to the portfolio last quarter which adds duplication based on its merchandise. Like USB, should the price recede to more attractive levels we would not hesitate to jumping back in.

The turnaround at **Bed Bath and Beyond (BBBY)** has taken a painful turn for the worst. The stock has lagged the general market as sales and profit margins continue to weaken. We thought that the improvement in housing would generate some type of revenue momentum. But so far, it has not. BBBY's is trying to make the right moves by investing in technology and ecommerce but the cost is compressing margins. The company remains very cheap but the business model is proving inefficient. In-store sales are flat to falling and intense ecommerce competition is making it difficult to gain any traction. While we are typically patient investors, we are also tax efficient managers. We opted to use the losses in BBBY to partially offset the realized gains in both Foot Locker and US Bancorp.