Overview of global industry trends

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Economic Backdrop

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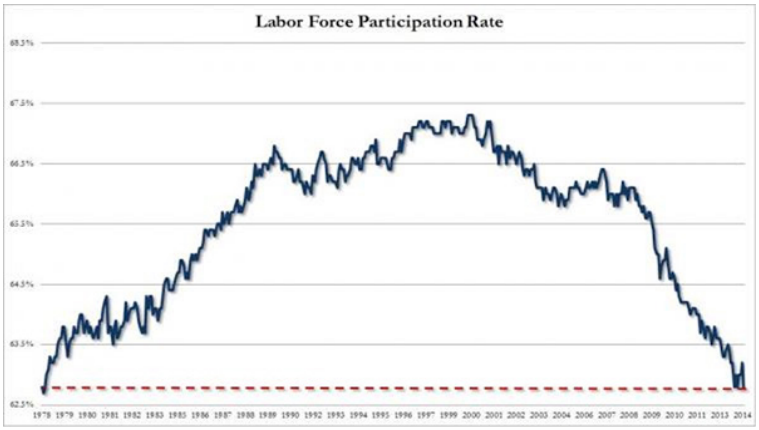
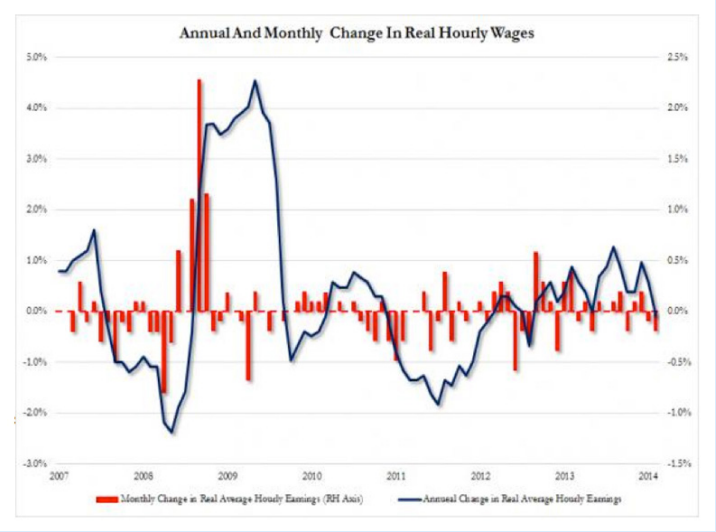
The most recent jobs report tells us that the U.S. has now clawed back, through a long, grinding recovery, all of the jobs lost during the great recession. However, the number of manufacturing, construction and government jobs – typically well-paying fields – has shrunk, while lower-wage work has grown. More than 40 percent of the jobs added in the past year, such as food service, retail and temporary help, are generally in lower-paying fields.

The job landscape has been particularly discouraging for the 25- to 29-year-old demographic, whose labor-participation rate fell to 79.8 percent in April, the lowest the BLS has recorded since it started tracking the data in 1982. This trend is symptomatic of a longer-term risk to human capital formation in the U.S, as individuals who begin their careers in a weak labor market tend to carry that with them forever.



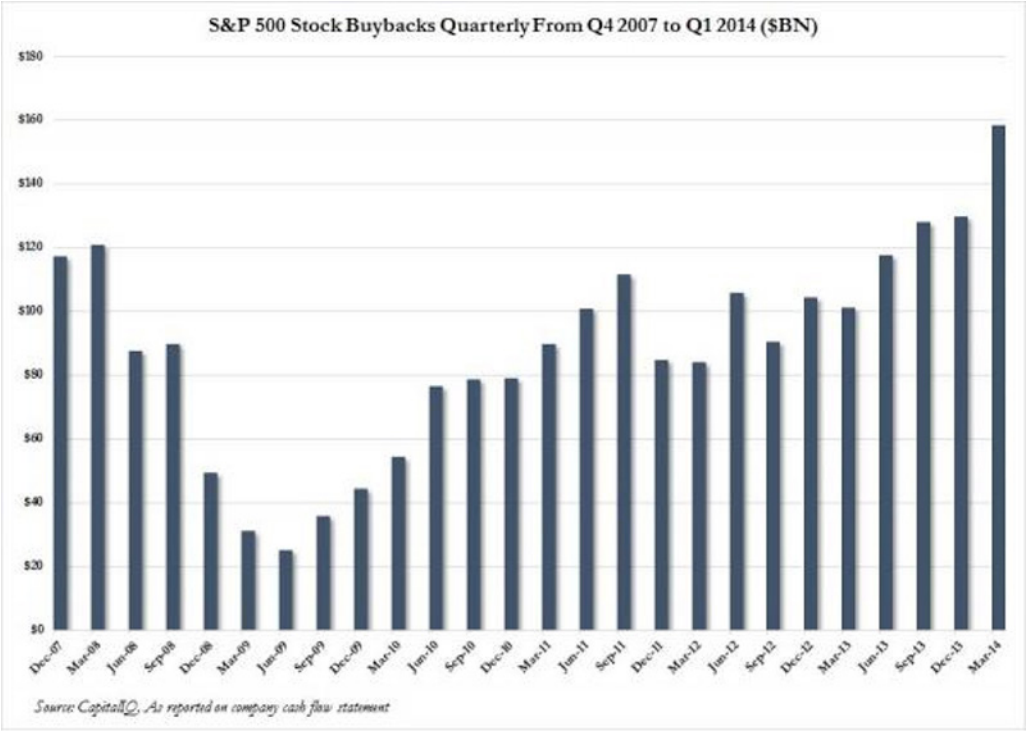
Despite massive gains in stock markets and asset prices, wages have failed to make material progress. According to the Wall Street Journal, "When adjusted for inflation, Americans' earnings are little changed since the recovery started in mid-2009."[1] With fewer high-paying jobs being created, we're also seeing low household formation, which is constraining growth in the housing market. Interestingly, housing prices have made dramatic gains and the supply overhang has reduced significantly. Unfortunately, a large proportion of recent buyers are institutional investors, as well as wealthy foreigners seeking a savings vehicle.



Real economic recovery has also not been evident in international trade. Any acceleration of real economic growth would be precipitated by rising demand for raw materials that require shipping. However, the record-setting lows of the Baltic Dry Index indicate that fleet expansion has not been met with adequate demand for transportation of goods and commodities. Further, there is no significant increase in industrial metal prices, such as copper, whose widespread applications cover several economic sectors, including homes, factories, electronics, and power generation. Demand for copper is considered a leading indicator of economic activity, but it has not – as of yet – pointed to growing or stable demand.

So why does the U.S. stock market continue to reach record highs?

Low interest rates are part of the equation and let's explore why that's the case. There's a lack of real growth in aggregate demand, and there are hindrances to business formation and growth such as healthcare law and regulatory tightening in industries that include refining, coal, and trucking. As a result, there has been tepid business investment and little capital expenditure beyond maintenance needs. Once companies wore through their cost cutting and restructuring initiatives, their opportunities for achieving EPS growth were limited. In order to satiate the asset owners, these companies are repurchasing shares to drive stock returns. These are often funded with additional borrowings, enabled by the very low interest rates in today's market. Thank you Federal Reserve! Debt-financed buybacks are not harmful unless the companies employing them fall on hard times and are unable to repay or refinance when "it's time to pay the piper."



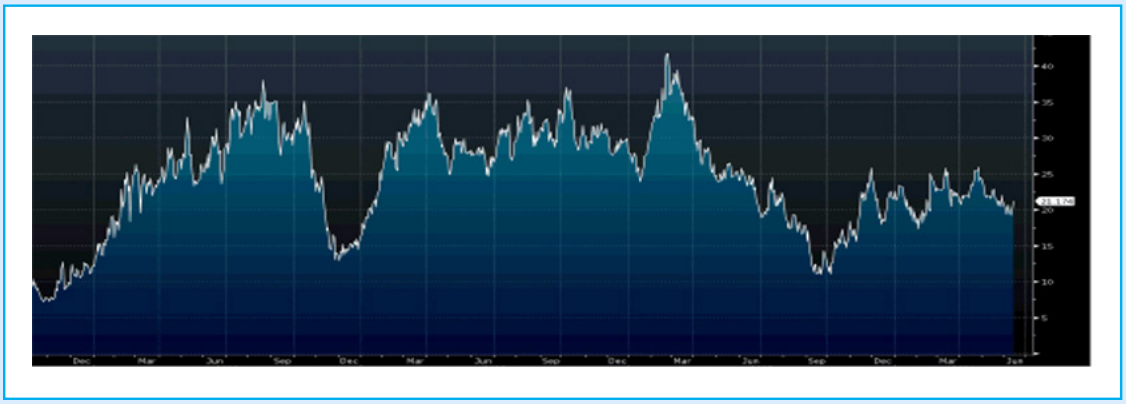
Outside of the U.S., Europe continues to struggle with its path to growth. In order to encourage banks to lend to the real economy rather than hoard cash or move it to other banks, the ECB recently reduced the rate on deposits to a negative 0.10 percent. In Asia, China is experiencing a slow down as credit tightening constrains consumption, housing, and investment, it's not in great increments. Other parts of Asia appear relatively stable. Japan is showing signs of increased economic activity, while India's election of Modi signals the possibility of growth-enhancing reforms ahead.

Industry Trends

The automotive sector has benefitted from pent-up demand and customers returning to dealer lots to make car purchases. May's vehicle sales report showed light vehicle sales of 16.7 million annualized units – the highest level since February 2007. European autos are experiencing moderate increases in new vehicle registrations, which indicate improving prospects for original equipment manufacturers.

Crack spreads for North American refiners with access to West Texas Intermediate or the Bakken region remain elevated, yielding strong profitability as the refined products continue to see steady, although not strong, demand. In light of strong industry profitability and union concessions in the last round of agreements, both refiners and automakers face union negotiations in 2015 that may be difficult. In fact, the United Automobile Workers has already raised membership dues to prepare for a strike fund.

Crack Spread (3:2:1 of WTI:RBOB:HO) – 3-Year Chart:



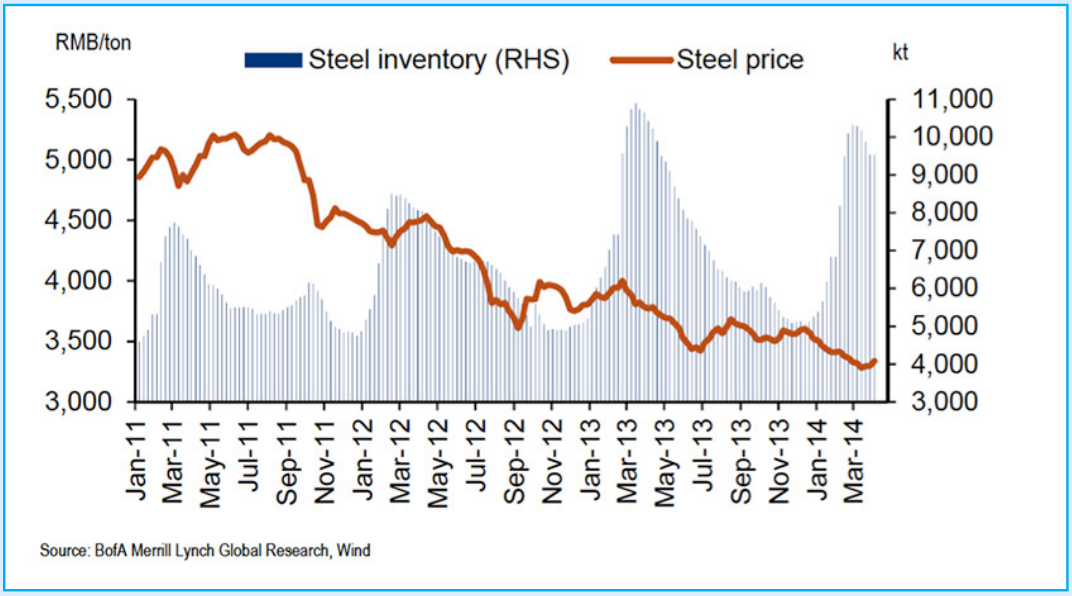
After a brief spell of improved profitability, global airlines are facing headwinds in the form of greater competition from new entrants, low-cost carriers, and expanding fleets in the Middle East, where carriers have the advantages of lower fuel costs and near-unlimited funding. However, the cost of fuel, a key factor in profitability, may be affected by the increasing violence in the Middle East.

The retail sector continues to be multi-faceted with sales occurring in stores, on websites and on smartphones. When consumers have so much choice and convenience, there is little room for retailer errors. Strategies that miss the mark by departing radically from a company's traditional product category can lead to a death spiral (e.g., RadioShack and JC Penney).

Wireless carriers face significant spectrum and capacity constraints on their networks in certain markets, and they rely on licenses issued by the FCC. These licenses are issued for a fixed time period, typically ten years, and carriers have to renew them after that time. The FCC has made a compromise for the 2015 auction, whereby it will reserve part of the spectrum in each market for smaller carriers. This was done to ensure that AT&T and Verizon don't dominate the auction and to increase the amount of spectrum that will be available so large carriers have enough to grow upon. Further industry consolidation to drive returns seems to be on the horizon – a prime example is the potential Sprint/T-Mobile transaction.

Steel remains an oversupplied market, with China weighing heavily on both the demand and supply sides. "China's crude steel output hit a record of 70.43 million tons in May, up 2.6 percent from a year ago."[2] Warmer weather typically drives stronger steel demand in Asia as construction activity picks up, but the mills may cut output because of a weak property sector and slowing general economy. The mills have been aided by the rapid fall in iron ore prices, which reached a 21-month low in June, supporting higher profit margins for steel producers. Thus, there is little incentive to reduce production, which would be a risk to the credit quality of this sector overall.

Chart of Steel Prices Compared to Inventories:



While global market forces clearly present risks to the health of corporate credits, we continue to look for risk-mitigating factors that allow companies to succeed. Strong management and financial flexibility are critical components of creditworthiness and must be considered in conjunction with macro industry and economic conditions.

[1] ***Jobs Return to Peak, but Quality Lags*** written by Eric Morath in the Wall Street Journal on June 9, 2014.

[2] ***China Crude Steel Output its Record in May – Stats Bureau*** written by Ruby Lian and Fayen Wong for Reuters on June 13, 2014.