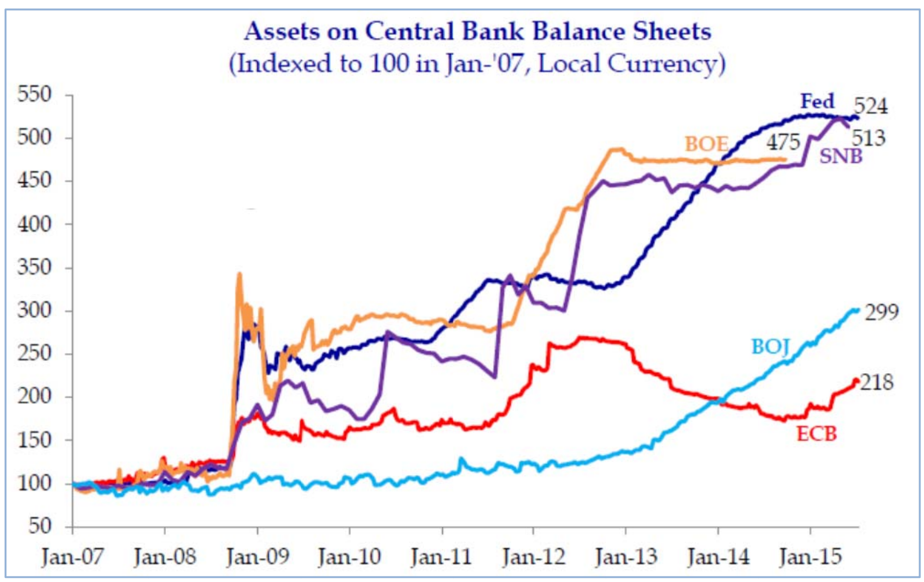
August 20, 2015

Visitors today to the Philadelphia Museum of Art will not only have the opportunity to view a world-class exhibit, but they will also receive a reminder of one of the keys to long-term investment success. The remarkable collection of paintings currently on display brings to light the story of Monet, Renoir, Degas, Manet, and their visionary art dealer and advocate, Paul Durand-Ruel. In the early 1870s, Durand-Ruel, who had inherited a successful gallery from his parents, discovered a group of young, unknown artists, later to be known as the Impressionists. Immediately drawn to their work, he just as quickly learned that the rest of the art world failed to see value in his discoveries. Rather than adhering to the conventional wisdom of the day, he negotiated exclusivity to the work of the artists by offering stipends in return for first rights to their most recent paintings and began to accumulate the eventual treasures.

The payoff was not immediate. His first exhibition, which would be deemed a success in the annals of history, was labeled an abject failure at the time. However, because of his willingness to stay the course, the art world was rewarded with classic masterpieces depicting colorful landscapes, beautiful portraits, and scenes reflecting French life. With a brilliant eye and steady nerve, Durand-Ruel was rewarded with the fortune (though his sons sold the biggest ticket items in America after his death) and satisfaction that goes along with finding value where others see none and sticking with your conviction when faced with the doubts of the establishment.

Global Equity Markets

Investors today have not had to stray from established principles to find opportunities for profit, as one of the first tenets of investing that we learn in this business—"don't fight the Fed"—can be used to tell the story of markets thus far this year. The stalwarts of global equity markets to date have been Europe and Japan, where central banks and other government-sponsored entities have been purchasing government, corporate, asset-backed and agency bonds, and equities in the case of Japan, to unprecedented degrees. In the US, along with England and Switzerland, the liquidity tailwind is weakening and will likely deteriorate further as the Fed moves towards tightening.



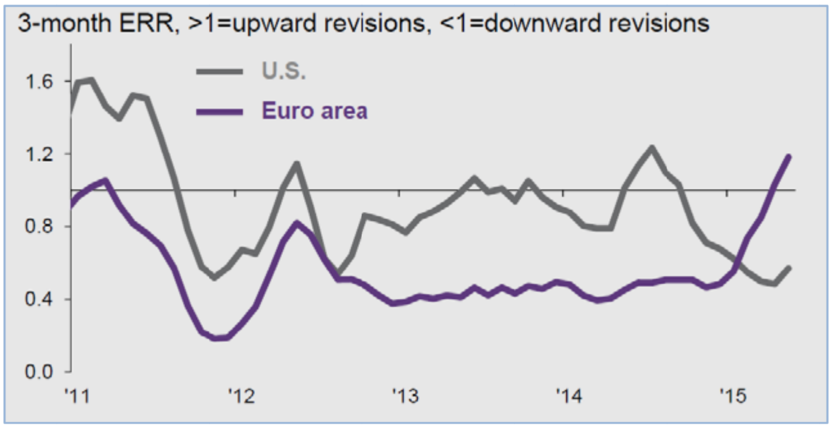
Source: Strategas Research Partners

This has been a headwind for US equity markets, which have seen muted but disparate performance. Nearly all of the gains in the S&P 500 index year-to-date have come from two sectors: healthcare and consumer discretionary. More than half of the S&P 500 stocks and over 70% of the Russell 2000 stocks are down 10% or more from their peak.[i]

The divergence in central bank balance sheet trends is evident in the graph above. What is not immediately evident is the second derivative impact that Fed policy is having on emerging markets. Emerging market equities typically underperform developed markets when the Fed is slowing the flow from the liquidity spigot, and their performance thus far this year has not belied that tendency.

Our belief in the relative value of European and Japanese stocks in this market is supported by, but not fully dependent upon, the monetary policy component. European equities are reasonably priced, as the MSCI Europe Index trades at about 15x forward earnings compared to a long-term average of 20x. Economic growth is benefitting from the thawing of credit markets and the lagged effect from a weaker euro. Further, inflation is below targets, and retail sales, employment, and consumer confidence are on the upswing. These factors are all contributing to an improvement in earnings revisions, which represents a stark contrast to earnings revisions in the US.

Earnings Revisions Ratios: U.S. versus the Eurozone



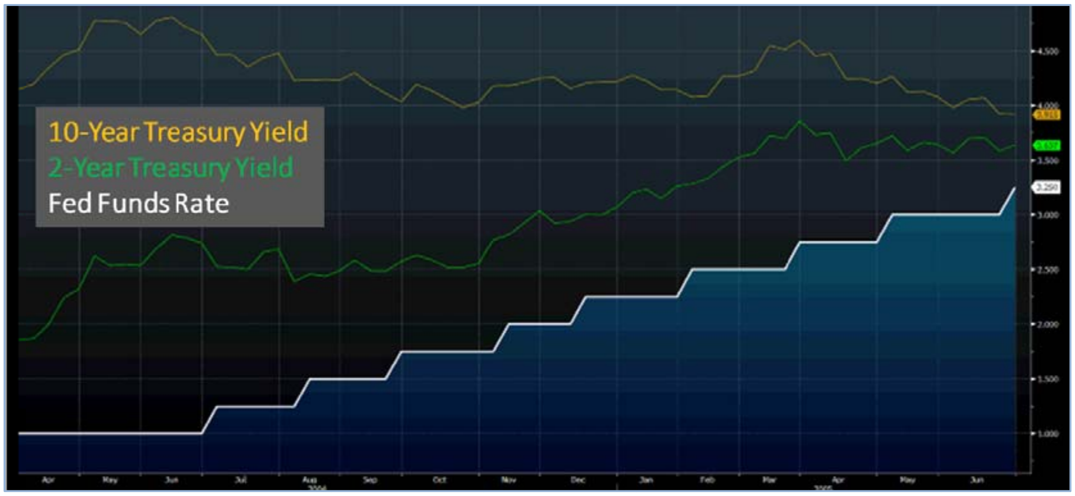
Source: JP Morgan "Guide to the Markets" as of June 30, 2015

At 20x this year's earnings, Japan is slightly more expensive than the US, but profits are growing much faster than revenues. In part driven by profit margin expansion in Japan, recent estimates have the Nikkei 225 Index earnings coming in at 45% higher than two years ago, compared with US earnings growth at 8%. Clearly yen depreciation is helping exports, but this is about more than that. This is also about Japan's commitment to improved corporate governance and government reform. Japanese companies are diversifying boards and putting cash to work through dividends and stock buybacks. Not coincidentally, foreign ownership of Japanese shares has ballooned from under 5% in 1990 to over 30% last year.[ii] Japan's massive pension funds have taken notice, slashing bond holdings and adding to equities. On the government front, Prime Minister Shinzo Abe has continued his plan of aggressive stimulus, monetary easing, and institutional reform.

Monetary Policy and Fixed Income Investing

One area where we are taking a cue from Durand-Ruel and diverging from the conventional wisdom of today's market landscape is within the fixed-income arena. We believe there is value in going out further on the yield curve, while many participants look to shorten the duration of their portfolios in the face of seemingly imminent Fed rate hikes. We believe that, in an effort to take protective measures, others are setting themselves up for enhanced volatility. We are focused on the shape of the yield curve, not simply the general level of interest rates, and we favor a structurally long duration strategy (with some exposure on the short-end to create a "barbell"). We recognize that there is short-term risk while the reality of higher rates is digested, but we believe that there will be long-term reward. A review of the last time the Fed began a rate hike cycle takes us all the way back to the spring of 2004.

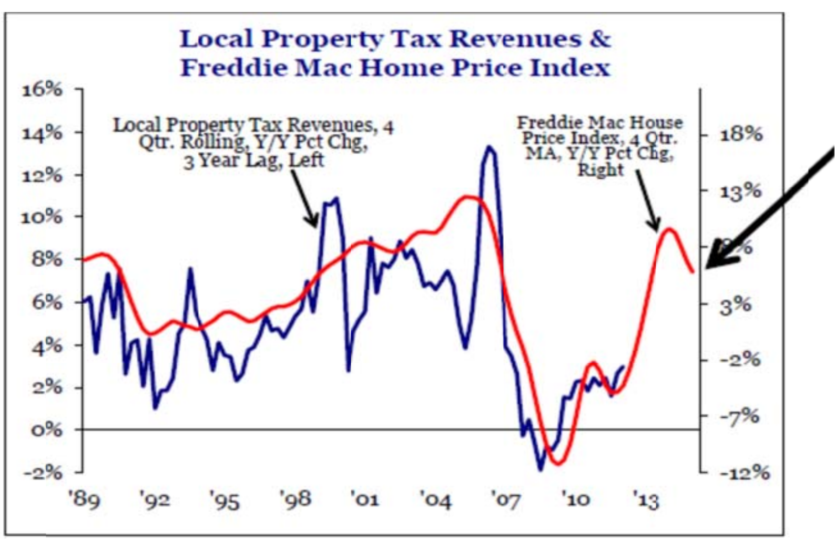
Last Fed Tightening Cycle: April 2004 thru June 2005



Source: Bloomberg; Permit Capital Advisors, LLC

In our view, Fed tightening cycles generally impact markets in two phases. The initial phase represents the short-term risk, as both short- and long-term bonds sell off, which we've seen in the US since March, though rates have come down recently on macro developments. The second phase is one where short-term rates tend to grind higher, but long-term bond yields stabilize and eventually come down as the market gains confidence that inflation is under control. By the end of the last cycle, which continued into 2006, the yield curve was inverted, with 2-year Treasury notes yielding more than 10-year bonds. That extreme is not the objective, and it represents one of the potential Fed missteps that we are vigilant about because it could trigger additional problems, potentially including a recession.

Municipal bonds are another sector of fixed income where we believe things are not as bleak as they are generally considered to be. Sentiment amongst muni investors has focused on the difficulties swirling around Puerto Rico, but in general the financial condition of most municipalities should be improving. A big driver of this belief is the recent surge in home prices. Property taxes make up approximately 75% of local tax revenues, and they should be increasing from their current 3% growth rate to almost 8% by 2017, based on the historical three-year lag period, as illustrated below.[iii] Wage taxes may also provide support, as new minimum wage increases took effect in 13 states at the beginning of the year, and more gains can be anticipated as we move towards full employment levels.



Source: Strategas Research Partners

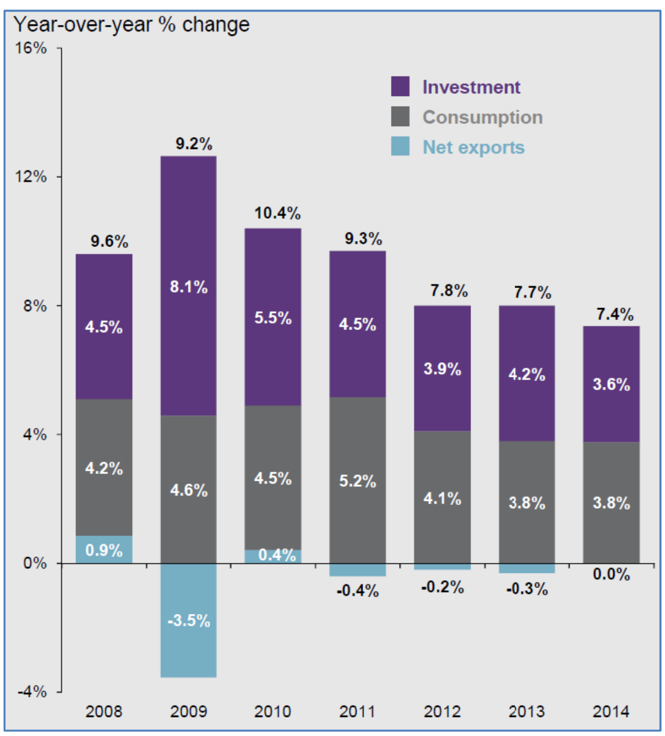
China and the End of the Commodity Supercycle

Unlike the mundane world of municipal bonds, where trends tend to evolve slowly, the energy complex has experienced a vertiginous descent for much of the past year. More broadly speaking, commodities have felt significant pain as we approach the end of the "Commodity Supercycle," kissing cousins with the more frequently discussed "Debt Supercycle." Of course, we cannot discuss commodities without talking about China. The world's second largest economy has consumed a disproportionate share of commodities over the past ten years. Commodity demand growth in China represented between 50% and 100% of global consumption increases across most major commodity markets. The impact of the recent investment slowdown in China, in a manufactured attempt to shift towards a more consumption driven economy, has been felt worldwide, but perhaps the biggest effect is being felt within its own hemisphere. Australia (which has been known as "China's quarry"), as well as China's three major trading partners—Taiwan, Korea, and Malaysia—have all seen significant slowdowns.

The impact of the deceleration in China, which has been the back-end of a one-two punch, along with a less generous Fed, is rippling through Latin America as well. Brazil was a tremendous beneficiary of China's real estate bubble, producing steel, cement, and a wide range of petrochemicals for the industry. In response to the recent news out of China, the Brazilian government has lowered growth estimates from a small gain to a contraction of 1.5%, Standard & Poor's has downgraded Brazil's debt outlook to "negative" from "stable," the Brazilian real is the weakest it has been in 12 years versus the dollar, and the stock market is at a 6-year low.

It's a delicate balancing act that China is attempting to execute, and the outcome is going to reverberate across all markets. It's fair to question whether the shift to a more consumption-oriented economy has proven effective to date. The chart below seems to indicate that reduced investment is proceeding according to plan, but the consumption increase has not yet materialized. The recent decision by China to let its currency, the yuan, adjust downward based upon market forces likely won't be supportive of the increased consumption goal, as it will probably raise the prices of imported luxury goods.

China Real GDP Contribution



Source: JP Morgan "Guide to the Markets" as of June 30, 2015

Where the impact on equities has been most acute from the end of the Commodity Supercycle has been within the energy sector. Unfortunately for the producers, the pain may be on the verge of accelerating, as there are several less-discussed factors, which we believe may soon begin to weigh on the group. The first deals with the practice of reserve-based lending. This is a feature that is unique to the energy industry because of its vulnerability to big swings in the prices of commodities. In addition to obtaining capital in more traditional ways, energy companies also rely on reserve-based revolving credit facilities to fund their working capital needs and drilling activities. These credit facilities are mostly backed by a borrower's lower-risk reserves, which, when multiplied by a bank's estimates of future energy prices, form what is known as the "borrowing base." In times of steep declines in commodity prices, banks cut the amount they are willing to lend, and therein lies the problem for energy producers.

Per the terms of these credit agreements, banks hold semi-annual reviews of the value of the assets pledged as collateral for the borrowing base, usually around each March and September. Last September, NYMEX Light Sweet Crude oil was still selling at $95 per barrel, while natural gas was around $4.00 per mmBtu.

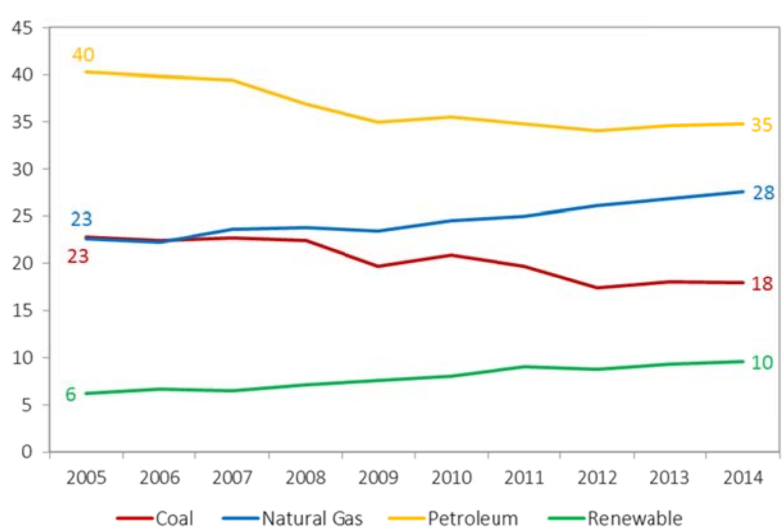
This September many US high yield energy companies will likely face a painful round of cuts to their revolving credit lines. Wall Street analysts have a name for this—"revolver raids." During the last sharp fall in energy prices in 2008, banks cut these loans by an average of 15%. However, this time around, under the pressure from regulators to play it safe, banks may slash reserve-based credit facilities by much more. This is why many energy companies are now scrambling to line up emergency financing to replace what they anticipate to be billions of dollars of reduced borrowing capacity.

While oil and natural gas prices were low in March as well, these companies had a safety net afforded by the hedges that they put in place in 2014, when energy prices were much higher. Because of this insurance, oil producers were still receiving $90 per barrel or more, even as market price for oil was nearing $50, and banks were happy to continue to lend as much as they did before the collapse in price. In April, Bloomberg reported that US shale drillers stood to get paid $26 billion on insurance they bought to protect themselves against a bear market.[iv] But the protection of hedges won't last forever, and most contracts are set to expire this year. Buying new insurance today is often not feasible, since it would either be too costly or would mean locking in prices below $50 a barrel, a level at which some companies cannot generate a profit.

This is not meant to imply that there aren't opportunities within energy. As is often the case when there is enhanced volatility, most investors fail to discriminate between the good, the bad, and the ugly. Within the Master Limited Partnerships (MLPs) group, we believe there are segments of the market where "the baby has been thrown out with the bathwater." While MLPs have sold off sharply year-to-date, the fundamentals that overlay the market are very different from the last sharp sell-off in the space, in 2008-2009. Then, soft demand and a capital markets dislocation were the culprits. Today, supply considerations are triggering concerns, even though only 30% of the MLP index has oil supply driven exposure.[v] The nuance that is lost is that pipeline companies in areas that are capacity constrained (such as the Marcellus and Utica basins), and those focused on natural gas and liquefied natural gas (LNG) distribution, as well as refined products, represent areas of fundamental strength. Natural gas-focused MLPs should be particularly insulated, as the proliferation of LNG, driven by both economic and environmental considerations, will likely feed demand.

As shown in the graph below, natural gas is already growing its presence as an energy source in the US, a trend likely to continue as coal and nuclear facilities come offline. Further, a relatively new EPA standard called MARPOL Annex VI, which ramps up in 2016, places sharp restrictions on nitrogen oxide and sulfur emissions for ships operating within 200 nautical miles of US shores. This is expected to make LNG the predominant maritime fuel going forward (the Korean energy ministry projects that the market for LNG ship manufacturing will grow by nearly 25 times over the next decade), as ships powered by LNG are reported to emit 98% less nitrogen oxide, 97% less sulfur, and 72% less carbon dioxide than comparably sized conventional ships.[vi]

Primary U.S. Energy Consumption by Source (in Quadrillion BTU)



Source: US Energy Information Administration, "Monthly Energy Review," May 2015

On balance, a traditional analysis of current market conditions would suggest that we were in a lukewarm environment. The deterioration in leading economic indicators and plunging commodity prices point towards weak global growth and rising deflationary pressures ahead. However, while US equities may be overpriced, most sectors do not appear to be in bubble territory. The real problem in framing an investment strategy is that there are few historical parallels from which to take perspective. It would be very easy for the Fed to make a mistake and kill the economic expansion—where corrections become crashes is when policy errors magnify existing problems. Witness the 1929 crash, when the Smoot-Hawley tariffs and the slashing of banking system reserves did just that.

Our approach is to look for attractive opportunities where we think we can take advantage of some of those same principles that guided Paul Duran-Ruel and launched the Impressionist movement. To look for value in places that the market may be eschewing, to recognize when short-term volatility is likely to lead to long-term benefit, and to accumulate positions in less traditional assets so that we are rewarded when the haze of market turbulence wears off. We wish everyone a happy end to their summer and look forward to connecting in the coming weeks.

Thank you for your continued interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

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[i] BCA Research, "Global Investment Strategy: That Sinking Feeling," July 31, 2015

[ii] Barron's, "Time to Buy Japan's Blue Chips" by Jack Hough, July 18, 2015

[iii] Strategas Research Partners, "Policy Outlook: Municipal Government Finances Are Improving Despite The Negative Headlines of PR & Chicago," August 11, 2015

[iv] Bloomberg, "The Oil Industry's $26 Billion Life Raft," by Asiylyn Loder and Dakin Campbell, April 8, 2015

[v] Barclays, "MLPs: This time, It IS Different," August 7, 2015

[vi] Fortune, "Here's Why Ocean Shipping Companies Are Switching to Natural Gas" by David Z. Morris, July 23, 2015