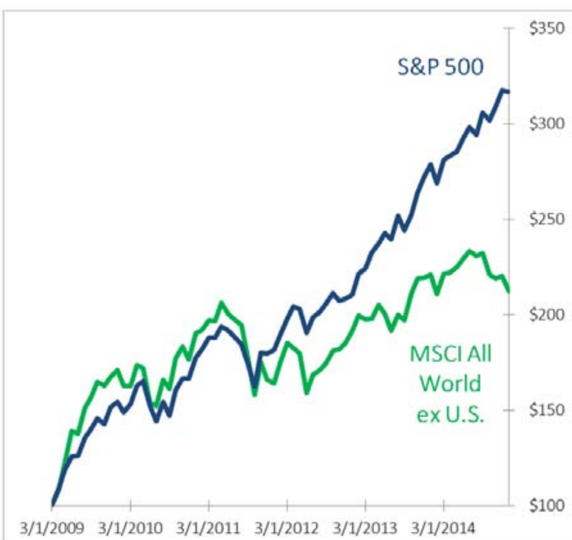
PCA PERSPECTIVES

Permit Capital Advisors' Thoughts on the Investing Landscape

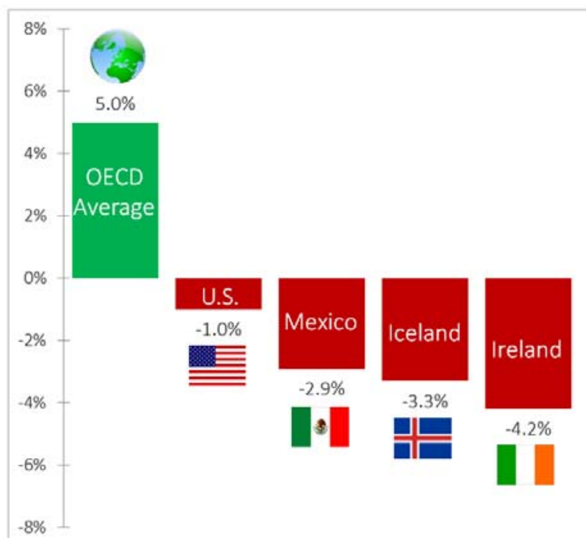
There is a stark dichotomy that has developed since the end of the Great Recession in early 2009, and it may not bode well for our future. It is a reflection of two U.S. policy stances – monetary policy and education policy. On the former, the Federal Reserve has pumped money into the system at unprecedented levels, in an effort to keep the economy from falling off a cliff. Many economists and market observers would tell you that the most pronounced actual impact of Quantitative Easing (QE) has been the inflation of financial asset prices, as reflected in the performance of the U.S. stock market, shown below relative to foreign equities. Where the U.S. has fallen short in relation to much of the rest of the world is in growth in education spending, relative to GDP. Also shown below is a graphic indicating that U.S. education spending is decreasing when compared to all but three (Mexico, Iceland, Ireland) of the 34 OECD countries. It is fair to ask in both cases if we are sacrificing long-term interests for short-term gains.

Equity Market Comparison (through 2014)



Source: Bloomberg

Education Spending Comparison



Source: OECD - Programme for International Student Assessment

The decrease in spending on education may be even more alarming than the figures from the most recent OECD testing that show students in the U.S. landed 21st out of the 34 included nations, in a test that covered math, science, and reading. This is partly because some of the skills in which U.S. students excel – creativity, dynamism, and entrepreneurialism – can't be measured in such tests. To this point, consider the fact that the U.S. ranks second in the world in venture capital investments as a

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percentage of GDP, while Israel ranks first and Sweden is sixth. Yet Sweden and Israel performed even worse than the U.S. in the OECD assessment, finishing 28th and 29th respectively.[i] The link between test scores and ultimate financial success may prove flimsy, but the link between the prioritization of education and future growth may not. Thus, the failure to properly support education is a problem that may have negative long-term consequences for the country. However, the distortion of typical investor behavior, predicated by a crisis-driven monetary response, may create more immediate difficulties for investors.

Valuations

The availability of cheap money has created enhanced risk-taking by institutions and retail investors, within both credit markets as well as equity markets. The equity market that has seemingly benefitted the most in recent years is large cap U.S. stocks, with the S&P 500 up 249% from March 6th of 2009 through the end of February. This appears to have left stocks trading at what could be considered expensive levels, as the Shiller P/E ratio (popularized by Yale University professor Robert Shiller and valued for its attempt to smooth earnings by eliminating fluctuations in net income caused by variations in profit margins) is trading at over 27x, compared with 15x at the beginning of the market's run in March 2009. It has only been higher on the eve of the 1929 market crash and in 2000, at the peak of the tech bubble. While valuations are not considered a good short-term market indicator (nothing is, really), they help to determine long-term investment fortunes.

In some ways, the market is even more expensive than it was in 2000. Back then, overvaluation was concentrated in mega-cap and technology names, but other segments of the market remained reasonably cheap. Today, lofty valuations are more broad-based, as the median stock trades at a P/E multiple that is higher than the 2000 peak. Further, while the smoothing effect of Shiller's methodology uses profit margin figures over the past ten years, that period itself has been extraordinary. If profit margins over the past ten years averaged what they did during the 1990s, the S&P 500 would trade at a Shiller P/E of 36x, not far from the 2000 peak of 43x. Low interest rates have helped profit margins, but a) interest rates won't stay low forever (we think), and b) low borrowing costs often encourage bad capital allocation decisions by corporations, just as they do with individuals. This has been evident in Japan where, despite a challenging economic backdrop, business investment as a share of GDP has exceeded that of the U.S. since 1990. Ultimately, this dynamic depresses the rate of return on capital.

It also keeps certain companies (often called "zombie companies") in business that may not be otherwise, by allowing them to cheaply tap into public credit markets.

While profit margin figures tend to evolve slowly, that is not necessarily the case when it comes to earnings. Here, too, there is concern, as companies have been issuing poor guidance lately, with full year, bottom-up EPS estimates for the S&P 500 down from $131 late last year to $120 today. Thomson Reuters estimates that corporate profits will drop 3.8% in the first quarter and 1.9% in the second quarter, which would represent an earnings recession. One factor that could help stave off this possibility is a continued increase in stock buybacks. U.S. companies in February announced stock repurchases totaling $104.3 billion, topping the previous monthly record of $99.8 billion set in July of 2006.[ii] The expected decline in corporate earnings has come from two primary culprits: oil prices and the strengthening U.S. dollar. Both factors have had a more pronounced impact on U.S. equity markets than on the U.S. economy.

As of March 31, 2015

INDEX	ASSET CLASS	YTD	1 Year	3 Years (ann)	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	1.0	12.7	16.1	14.5
Russell 2000	Small Cap Equities	4.3	8.2	16.3	14.6
Russell 3000 Growth	US Growth Equities	4.0	15.8	16.4	15.7
Russell 3000 Value	US Value Equities	-0.5	8.9	16.3	13.7

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

INDEX	ASSET CLASS	YTD	1 Year	3 Years (ann)	5 Years (ann)
INTERNATIONAL EQUITY					
MSCI World exUS GR	Global ex US Equities	4.0	-0.9	8.8	6.2
MSCI EAFE GR	Developed ex US Equities	5.0	-0.5	9.5	6.6
MSCI Europe GR	European Equities	3.6	-4.4	10.0	7.0
MSCI Japan GR	Japanese Equities	10.3	12.4	9.6	6.1
MSCI EM GR	Emerging Mrkts Equities	2.3	0.8	0.7	2.1

Oil Weakness, Dollar Strength

In the case of oil, the price of the commodity can actually have a divergent impact on Wall Street and Main Street, particularly over short periods of time. The recent plunge in oil prices has been stoked by a surge in supply and a dwindling level of storage capacity. Several weeks ago both crude oil production and crude oil stock registered record highs. While this can create a stimulative impact on consumers and businesses, oil producers are overrepresented in the financial markets – both within the equity and credit universes – when compared to the broader economy. Specifically, among U.S. listed companies, those in the energy sector represent 8% of market capitalization, 11% of earnings, and 33%

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of capital expenditure. For the economy as a whole, firms engaged in energy extraction account for only 1.7% of value added, 3.3% of profits, and 10% of non-residential investment.[iii] As a result, while the U.S. economy benefits from the direct cost savings of lower oil prices for households and corporations, there are crosscurrents for the S&P 500. The net effect for the index is negative, as the marginal savings enjoyed by the 92% of the companies that lie outside of the energy complex are more than offset by the damage suffered by the sector itself.

Exacerbating the Wall Street/Main Street divergence, while S&P 500 companies should benefit less than the broad economy from falling oil prices, they will likely suffer more from a stronger U.S. dollar. While a strong dollar can, to some extent, hurt both the economy and the market, it tends to have a more pronounced effect on market fortunes. Consider that while exports account for only 13% of U.S. GDP, foreign sales account for over 33% of S&P 500 revenues. It is estimated that the combination of a stronger dollar and lower oil prices could reduce S&P 500 earnings by $7, or roughly 6% relative to its underlying trend. This could leave EPS growth roughly flat this year compared to 2014.

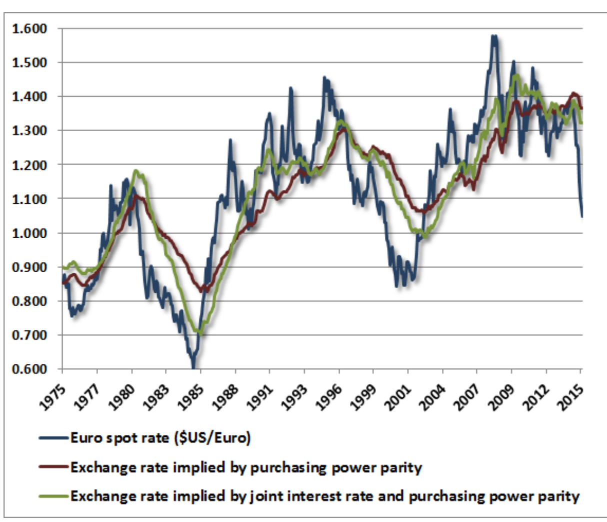
Even the recent gains in the market have come despite some weaker economic data, though some of this weakness could be the result of bad weather and the recent West Coast port slowdown. Auto sales have been disappointing and housing improvement has stalled, with housing starts, building permits, and existing home sales all falling in the most recent readings. On the employment front, the overall job market continues to improve. U.S. companies added 295,000 jobs in February, and the unemployment rate fell to 5.5%; however, many of these jobs represent part-time positions. As a result, the number of full-time workers remains one million below its November 2007 high despite the fact that the working age population has increased by 7.5 million since then.[iv] Still, what strength we've seen in the labor market may finally be translating to higher wages, as unit labor costs rose by a surprisingly strong 4.1% in the fourth quarter, and more companies are mentioning wage pressure as they revise down earnings estimates.

This, of course, has the Fed-watchers on alert. There are some who feel that we may see liftoff in the target Fed Funds rate as soon as June, but last week's FOMC meeting seemed to reinforce the notion that rates could stay "lower for longer." One thing that seems clear is that the Fed appears more focused on dollar strength, as the word "dollar" was mentioned nine times in Janet Yellen's recent press conference, after having been mentioned only once in her previous press conference in December. While differentials in interest rates are but one in a basket of factors that influence exchange rates –

along with differentials in inflation, current-account deficits, political stability, and debt levels – the FOMC statement and Yellen's remarks did acknowledge concern that dollar strength had contributed to weakening export growth. To attempt to quantify this impact, the IMF suggests that a 10% appreciation in the real trade-weighted dollar is the equivalent of a 100 basis point rate hike. Given that the real trade-weighted dollar has risen by 12.5% since July, this equates to a 125 basis point rise in the Fed Funds rate.

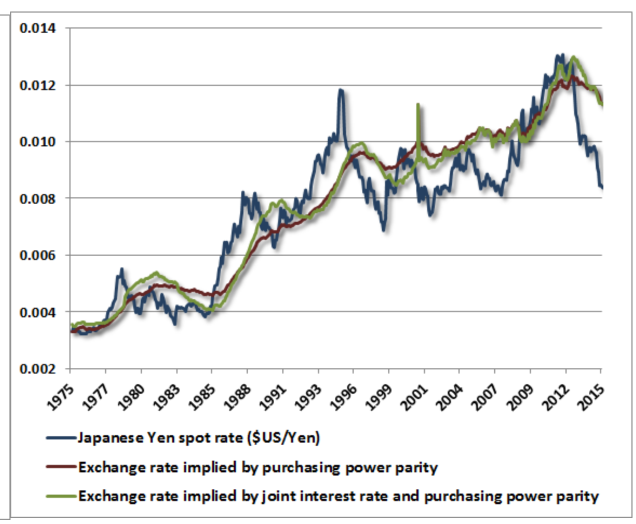
These wild swings in exchange rates have created significant imbalances within the global economy, though currencies alone won't bring about the rebalancing that's needed. That will require comprehensive policy responses from political leaders around the world. Sadly, too many of these politicians, both in the U.S. and around the world, are unwilling to risk taking potentially unpopular stances that are necessary to restore engines of growth, balance aggregate demand, and eliminate significant debt overhangs. In the case of the strong dollar, the impact has been shared by the economy and the market. Recently, U.S. market participants who are investing in companies outside the country are getting fewer dollars back for the foreign currencies these companies' shares are denominated in, relative to when they originally bought the shares. We believe that U.S. dollar strength has led to an extreme and measurable valuation gap in currencies. While this measurement of valuation, known as Purchasing Power Parity, doesn't always correct in the short-run (much like other valuation metrics we've discussed), it does tend to revert towards parity in the intermediate term. This could benefit U.S. investors investing in non-dollar denominated assets, with two of the more common currency exposures graphed below.

Euro Relative Value



Source: Hussman Funds

Yen Relative Value



Source: Hussman Funds

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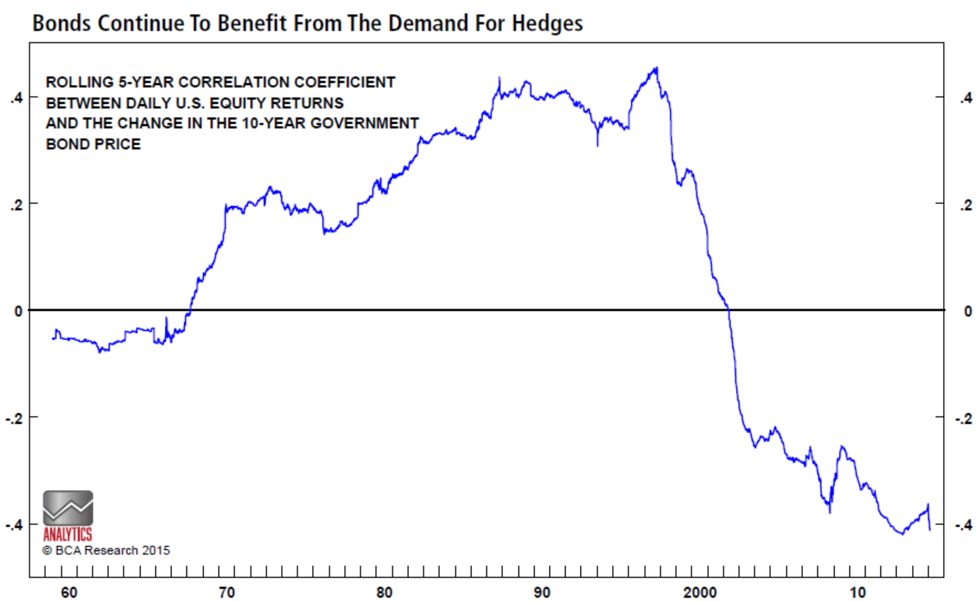
International Equities

When it comes to making allocation decisions, our tendency is to stick close to long-term strategic guideposts, while allowing valuations to guide rebalancing decisions. When the valuation picture is reinforced by other variables, it simply turns the conviction dial in the right direction. In the case of equity allocations today, we believe that there is an attractive long-term opportunity in foreign equities relative to domestic markets. We referenced earlier that the S&P 500 was up 249% since early March 2009. Over that same time period, the MSCI All Country World ex-US Index was up just 138%. We also believe that the S&P 500 is fundamentally expensive. Given our preference to overweight stocks in markets with (1) attractive valuations, (2) financial conditions that are easing, and (3) where growth expectations have room to surprise on the upside, certain options outside of the U.S. seem more attractive right now. This analysis is paired with the recognition that apparent misvaluations may continue unabated for a considerable period of time, so it is important to have a longer-term investment horizon.

Europe is one interesting option, as all three variables seem to be pointed in the right direction. Euro area stocks are trading at a Shiller's P/E ratio of 15x; the European Central Bank (ECB) has just begun a 1 trillion euro Quantitative Easing program; and it appears likely that European GDP will be closer to 2% than the 1% originally forecast. Japan is also interesting based on the same criteria. Its equity markets are attractively priced, trading at 8x cash flow and 14x forward earnings, with operating profit margins that are roughly half of what they are in the U.S. The Bank of Japan (BOJ) is purchasing government debt to force domestic institutions to seek out other investment opportunities; and growth could surprise to the upside, as corporate balance sheets are in good shape, consumer confidence is increasing, and the primary drivers of deflation (falling land prices, corporate deleveraging) are starting to recede. Couple these factors with currencies that seem to have gotten unduly cheap, and we think both European and Japanese markets have appeal. Although they have rallied, Chinese stocks are still trading at reasonable multiples of earnings and book value that are close to the levels that U.S. stocks traded at in 1982, at the outset of a nearly two-decade bull market. Further, just like the ECB and the BOJ, the People's Bank of China (PBoC) is easing monetary policy with recent cuts to its reserve requirement ratio.

Fixed Income

Even in this low interest rate environment, we continue to find value in fixed income. Understanding where to position investments on the yield curve will become more important in the coming years. While the short-end seems vulnerable based on an evolving monetary policy regime (although there is still value in certain floating-rate corporate securities we are purchasing for clients who have significant cash exposure), the long-end of the curve has been supported by deflationary forces, including the recent drop in oil prices. The pieces look to be in place to prevent an upward spiral in rates on the long-end, as the monetary easing in Japan and Europe should result in foreign investors having both the means (more liquidity) and the motive (higher relative rates) to keep U.S. yields contained. In addition, government bonds have done a better job of reducing portfolio risk in recent years, since their correlation to equities has dropped, as indicated in the chart on the next page.



Source: BCA Research

Most of our fixed income focus continues to lie within municipal bonds. We have written about higher yielding unrated munis in the past, but even traditional munis have become modestly more attractive recently. This is largely due to heavy supply which has been issued so far this year - $58.5 billion over the first two months. This marks the strongest start to the year since 2010, when Build America Bonds drove issuance. Refundings represented the majority of the supply, comprising 63% of January issues and 56% of February issues.[v] This strong issuance will likely continue as long as rates remain rangebound, so investors who have come to count on the sizable coupon checks they receive need to make sure they're positioned accordingly.

Of course, regardless of an investor's objective, there is a need to be particularly vigilant during periods of heightened volatility. This pertains to both risks and opportunities that may present themselves. While equity volatility has indeed picked up this year (30% of trading days have experienced at least a 1% move)[vi], the more dramatic moves have come in commodities and currencies. With the Fed on the verge of action, there is no reason to believe that volatility will wane anytime soon. Meanwhile, as the Fed tries to decide if easy money is inflationary (as they hope), or deflationary (which appears to be the case lately), the uncertainty may cause dislocations, which disciplined investors can capitalize on. We look forward to working with you towards this effort.

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

As of March 31, 2015

INDEX	ASSET CLASS	YTD	1 Year	3 Years (ann)	5 Years (ann)
ALTERNATIVES					
HFRX Global Hedge Fund Index**	**Broad Hedge Funds**	1.7	-0.2	2.7	1.3
HFRX: Systematic Diversified CTA Index**	**Managed Futures**	3.3	7.9	-0.4	0.4
DJ UBS Commodity	**Commodities**	-5.9	-27.0	-11.5	-5.7
Wilshire US REIT	**REITs**	4.7	25.2	14.2	16.1

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

** Performance as of 2/28/15

	As of 3.31.15	Prior Yr End (12.31.14)	One Year Ago (3.31.14)	Five Years Ago (3.31.10)
CURRENCIES				
US Dollar Index Value	98.36	90.27	80.10	81.07
USD vs. Yen	120.13	119.78	103.23	93.47
Euro vs. USD	1.07	1.21	1.38	1.35
GBP vs. USD	1.48	1.56	1.67	1.52
COMMODITIES				
Gold ($ / ounce)	1183.68	1184.86	1284.01	1113.25
Crude Oil ($ / barrel)	47.60	53.27	101.58	83.76
Copper ($ / ton)	6064.50	6368.00	6650.00	7759.25
Corn - Generic (Usd/bu)	376.25	397.00	502.00	345.00

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Clients are encouraged to discuss any of the opinions or topics in this publication with a representative of Permit Capital Advisors, LLC.

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[i] Washington Post- Why America's obsession with STEM education is dangerous- 3.26.15

[ii] Barron's- 3.9.15

[iii] BCA Research- US Equities: From Leaders to Laggards- 2.6.15

[iv] BCA Research- Fed Trips Up Dollar Bulls- 3.20.15

[v] BMO Capital Markets- US Bond Market Outlook- March 2015

[vi] Northern Trust- Perspective- 3.20.15