GREENWOOD REPORT

MID YEAR REVIEW:
MONETARY POLICY, THE ECONOMY, AND INVESTMENT OPPORTUNITIES

In our previous commentary we assessed the 2015 economy in the context of both long-term positive underpinnings and short-term challenges. Since then, we have traveled to Florida, Washington, London, Paris, and Munich attending conferences focusing on monetary policy and the consumer industry. Attending these conferences, we believe, provides our firm with a key competitive advantage in our investment management process. By going directly to the source: policy makers, CEOs, economists, and other investors, we avoid the filter of the often biased news media. S**ome of our best investment ideas over the years have come from these meetings, increasing client returns measurably.**

As always, the 2015 conferences provided us with an opportunity to network with some of the world's best investors and economists and immerse ourselves in the intellectual process of investment research. The delegates' opinions (representing government, industry, consumers, housing, and finance) were divergent and the challenges and opportunities discussed reinforced much of our investment thesis to date. **We returned, however, with an even better understanding of the unique economic environment in which we currently invest**. Our synthesis of this information informs our investment strategy going forward.

ASSESSING THE ECONOMY: POSTSCRIPT

The U.S. economy continues to move forward with a positive trend, even as first quarter results reflected bad weather, currency translation loss (due to the strong dollar), oil price volatility, and concern about insufficient aggregate demand. As we conclude the second quarter, **a new conversation is emerging concerning the United States' role in global monetary policy.**

The U.S. no longer has a uniquely domestic monetary policy tool. As the dominant economic player and home of the Reserve Currency, all of our monetary tools (interest rates, quantitative easing, excess reserve rate, etc.) affect financial institutions globally. **U.S. monetary policy is global monetary policy.** Consequently, the U.S. walks a fine line in pursuing tight monetary policy (quantitative easing tapered and now concluded) when the rest of the world needs accommodative or "easy" monetary policy. The adage *"so the U.S. goes, so goes the rest of the world"* may also read: *"so the world goes, so goes the U.S."*.

For instance, with quantitative easing concluded, U.S. policymakers may pivot (in September or December) to higher interest rates to pursue its 2% inflation target at home. However, it risks doing so at the peril of its trading partners – a politically and economically sensitive move. Additionally, policy decisions made elsewhere across the globe compound the issue. In an attempt to spur economic growth, increase cash lending, and combat the liquidity trap (printed money not permeating the economy), European policy makers are pursuing a negative interest rate policy (Eurozone minus 20 basis points or -0.20%, Sweden -0.25%, Switzerland and Denmark -0.75%). This policy encourages financial intermediaries to lend rather than hold cash at their central bank. But it also may encourage individuals and business to "store" cash to avoid the "penalty" of holding it in banks. In a globally integrated economy this makes the job of raising rates in the U.S. a tricky proposition. It is one reason why **we believe the Fed will proceed slowly as they continue tightening**.

The full employment act of 1946 charged the Federal Reserve with three mandates: economic growth, full employment, and price stability (inflation control). In 1946, fiscal policy centered on the concerns of post World War II debt reduction. Subsequent policy guidelines shifted the economic growth mandate away from the Federal Reserve to Congress. **Today, it may well be that the Federal Reserve again has the responsibility for economic growth.** A dysfunctional Congress makes sound fiscal policy nearly impossible in the U.S. A lack of **conjoined** fiscal policy in Europe makes coordination nearly impossible there as well. Thus, the responsibility for economic growth defaults to central banks and monetary policy makers. With the U.S. as the single source, the U.S. Fed is in the driver's seat and must act responsibly at the wheel.

CEO's

In the first half of the year we heard from nearly fifty CEO's representing primarily the consumer packaged goods (CPG) sector – an industry that drives the Northwest Arkansas economy and a harbinger of the global economy. The opinions of CEO's are especially valuable to investors because they reflect corporate capital allocation decisions. **By and large, corporations do not expect top line revenue to grow above 3-4% in the next year.** As such, we are incorporating these expectations into our valuation models. This fact underscores the issue of insufficient aggregate demand in the global economy. Economics 101 reminds us that insufficient demand can be a recipe for slow growth. However, we do not subscribe to the "stagnation" thesis postulated in some circles.

As a result of low top-line expectations, corporations are implementing yet another round of aggressive cost cutting to drive net profits. We have seen layoffs locally even while Walmart, McDonalds, and others announced pay raises – likely a function of showing leadership in a shifting minimum wage debate. Further, Walmart is challenging its suppliers to cut costs and pass savings on to their customers in the form of price "rollbacks." Will lower prices prompt the decision to make a purchase, thereby increasing aggregate demand, top-line growth and ultimately confidence in the economy? Or will layoffs and cost cutting hamper growth and demand, spurring a vicious downward cycle? Stay tuned.

As investors, we are keeping a keen eye on the priorities of these CEO's. Cost cuts can be positive but only to a point. We propose the questions: *Are corporations cutting fat, or muscle? Are CEO's focusing on short-term earnings at the expense of long-term growth?* The solution to insufficient aggregate demand – and subsequently low revenue – is not solved by cost-cutting to juice the bottom line. Wall Street has responded positively to this one-sided approach to earnings growth for a few quarters. **However, we favor the companies that are investing behind their businesses in an effort to spur demand for their products and drive top-line results.**

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THE ENERGY TAILWIND

Few predicted the rapid decline in the price of oil (over 50%) that began in the second half of 2014. While all energy companies suffered, Greenwood Gearhart's investment performance was helped by diversification in other sectors that benefit from lower gas prices. In fact, we invested capital behind companies who receive an extra "push" as consumers pockets benefit from fuel savings. According to the U.S. Energy Information Administration (EIA), a $10 drop in crude oil fully translates to a 24¢ drop in gasoline prices – nearly a dollar at the pump at current prices. The drop to near $40 per barrel was temporary but consensus expectations are for $60 oil for an extended period – still a major drop from a peak of $120+. We expect the summer driving season to be robust.

The long-term price of oil is more difficult to predict (OPEC influence, temporary shifts in supply and demand, technological change). Since 1973 and the OPEC oil embargo, fear of energy shortages has played a major role in all economic policy decisions. As oil exploration expanded around the world rendering OPEC less powerful, alternative energy (solar, wind, biofuels) gained importance. Today with the U.S. holding 100 years of reserves for shale natural gas and the equivalent of another Iran in shale oil, energy independence is on the horizon. This fact, combined with the surplus supply of oil globally, a producing Iran and Iraq, constrained storage facilities, and decreased demand due to more efficient usage, have all contributed to cheap oil.

On the other hand, cheaply exploitable oil reserves will eventually deplete or be nationalized by OPEC member nations and future oil will likely come from more remote, harsh, deep-water environments. The only companies with the technological know-how and wherewithal to extract this oil are the integrated oil companies, drillers, and servicers. Current technology points to a higher cost structure for extraction and a potentially higher oil price to compensate these companies for the marginal cost of production. However, the wild card is ever-increasing technological advancement that could permanently change the cost equation.

Rather than predict the unpredictable, we remain invested in globally integrated energy companies that will benefit at various oil prices. We are also searching for (and finding) second and third derivative opportunities that benefit from cheap energy prices.

GOLDILOCKS OR THE BIG BAD WOLF?

Is today's economy characterized by low unemployment, increasing asset prices, low interest rates, steady GDP growth, a strong dollar, and low inflation – the Goldilocks of lore? Or do we see frustrated workers dropping out of the workforce, a market "correction" on the horizon, the Federal Reserve eyeing a rate hike, a concerning credit environment, and inflationary pressures due to easy monetary policy? While we have heard all of the arguments, and certainly more for the latter than the former, we have reason to evaluate today's economy with a different framework than historically. Here's why this time is different:

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The last time we had a strong dollar, low interest rates, and low inflation was post World War II when we were primarily a domestic economy. **Today we are a globally integrated economy.** When U.S. Treasuries began trading 24/7 **capital** became mobile. When the service economy transitioned to a digital economy **labor** became mobile. Today there is no shortage of capital (e.g. quantitative easing) or labor (e.g. China and India). Mobility allows both to permeate globally.

So while capital and labor have historically driven economic growth, today it is technological innovation that's our boon. Technology has three phases: **invention** (technical feasibility), **innovation** (economic feasibility) and **implementation** (where the new technology is diffused into the production processes of the economy). Invention can occur anywhere. Innovation needs capital to show financial feasibility. But it is the third phase, **implementation**, that produces income and growth generating benefits.

For technological implementation to flourish, it must incubate in an environment that allows for profitability. The United States is unique in satisfying this requirement: social stability, political stability, economic stability, private property rights to keep profits, and the military capacity to protect. **This is why, in our opinion, the U.S. remains the strongest investment location and why the income and growth generating benefits occur here first and with the greatest impact.**

INVESTMENT OPPORTUNITIES

This fact is also why we remain diligent in finding investment opportunities. We recognize that since March of 2009 (the low of the crisis), the S&P 500 – the index most representative of the domestic stock market – is up over 200%. It is up over 50% since the previous all-time high achieved in October of 2007. It is also selling at a Price to Earnings ratio (P/E) of roughly 18 times, above the long-term average of about 15.5 times. Additionally, the total stock market (using the Russell 3000) to GDP ratio stands at 1.35 (values greater than 1.0 indicate a more dearly valued market). Finally, it has been over three years since we have had a pullback of greater than 10% (defined as a "correction"), which on average happens every ten months.

But in low interest rate environments, with corresponding low costs of capital, the market historically accommodates a higher P/E ratio. Additionally, the 50% total return since 2007 represents only a 6% annualized return – well below the historical 10% average – and certainly not reflective of the current economic environment. Further, on a relative basis, publicly traded stocks continue to be priced attractively versus bonds.

Currently, the dividend yield of the S&P 500 matches the yield of the 10-year Treasury at 2%+. However, after ten years, a hypothetical $100,000 investment in treasuries only returns your original capital which, when adjusted for inflation, will be worth considerably less than it is today (purchasing power of about $82,000 at 2% inflation). With no growth, the coupon of 2% remains the same as well. In contrast, stocks have the ability to grow over ten years. Using the average ten year capital appreciation since 1950 (about 8%) stocks would more than double in ten years. Assuming the yield on market remained the same (2%), the stock investor would be earning over 4% on their original cost. **In this way, a stock is like a treasury bond with an increasing coupon**.

Of course stocks fluctuate, and the principal is not guaranteed as with a Treasury. **But as the time horizon increases, the likelihood of achieving positive rates of returns increases as well**. This is one of many reasons why a long-term time horizon is a key tenant of successful investing. Throughout our history, Greenwood Gearhart has believed there are always buys and sells in the market. Even when stocks are at higher historical values, overvalued positions can be a source of cash to purchase undervalued positions. Thus, there hasn't been a need for us to hold high levels of cash or to be tempted to time the market. Today is no different.

A FINAL WORD: GREECE

For the better part of five years, participants in the global financial markets have been monitoring debt-ridden Greece. European leaders (led by Germany's Merkel) are demanding further austerity in exchange for continued support while young first-term Prime Minister Alexis Tsipras panders to the anti-austerity voters who elected him. In recent days the situation has reached a fever pitch as Greece defaulted on a major loan payment to the International Monetary Fund (IMF) and Tsipras called on voters to reject a referendum. Speculation of a Greece-exit – or "Grexit" – from the Eurozone has provided the media with an opportunity to sensationalize a sensitive, but not necessarily dire, situation. While a Grexit might allow Greece to grow domestically and its tourism industry to benefit from a devalued currency, it could set a dangerous precedent for other Euro nations struggling with their own debt overload (Portugal, Spain, and Italy). **The threat of contagion and the risk of unwinding the euro, we believe, will ultimately force a solution and keep Greece in the Eurozone.** The outcome is uncertain and an adverse solution could always roil financial markets in the short-term. However, clients of Greenwood Gearhart are invested behind companies that will thrive regardless of Greece's fate, as opposed to those whose prospects depend on uncertain, fat-tail events.

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