GLOBAL PERSPECTIVES

April 20, 2015

SIC TRANSIT GLORIA FUNDING - TAKEAWAYS FROM GE’S PRUNING OF FINANCE ACTIVITIES

Sic transit gloria mundi translates to "Thus passes the glory of the world," but its general meaning is that worldly things are fleeting. The phrase seems a perfect fit for GE, which has long drawn fire for its use of short-term, wholesale funding. But more recently, this type of financing, coupled with its massive scale, earned GE the regulatory designation of SIFI, systematically important financial institution. It’s nice to be important, but not when it comes to tighter regulations and higher hurdles that SIFIs face. So GE recently announced plans to divest another 45% of GE Capital assets on top of those previously announced, stick to core financing activities, and seek de-designation as an SIFI. When all is said and done, GE Capital will shrink by about 75%.

This is no small business news story, but for a small community of GE analysts and watchers, the world shook a little. Like the passing of a 90-year old relative, the news was inexplicably surprising despite its inevitability. We knew the company was interested in a move like this, we just didn’t know how they would deal with the reduction in EPS. As investors, we see a lot of lessons in this story, so it is worth taking a look back on how we got here.

A lost decade for GE earnings

Our analyst covering GE recently gave a revised earnings estimate and price target that sounded familiar. His price target was exactly the same as mine, except my target was from an initiation report I wrote as our firm’s analyst for GE in October 2003. My 2004 earnings estimate at the time was $1.62, 5 cents below consensus. In 2014, GE posted $1.51 in GAAP earnings, and $1.64 when adjusted for pension expense. Earnings did not stay flat in those 12 years, but they didn’t get anywhere either. The Irish have an expression when giving directions: “If I were going there, I wouldn’t start here.”

If I wanted to post solid earnings growth for a decade, I wouldn’t start with the earnings level and makeup that GE had in the early part of the last decade. GE Capital was about half of GE earnings, and the financial crisis was a big setback. And remember Thursday nights on NBC with Frazier, Friends, and Seinfeld? The earnings power of that network and broadcast TV, in general, reached a peak that it will never see again. In 2001, GE had pension income of $2.1 billion, as opposed to the $4 billion in pension expense in 2014. That’s a 40 cent EPS headwind alone! The power generation business was starting its decline form the “power bubble” that saw peak sales of $12.5 billion in 2002, and a bottom of $3.9 billion in sales just two years later. Forget Jack Welch’s shoes. When Jeff Immelt became CEO of GE in 2000, he inherited an earnings base that was challenging to say the least. I struggle to think of a tougher hand dealt a CEO.

Was GE Capital an embarrassment of GE Industrial riches?

The industrial side of GE has generally been a market and profit margin leader in all their segments. And they walked the six-sigma walk, with some businesses posting negative working capital. So even though they made capital goods, they didn’t use much capital to do
GLOBAL PERSPECTIVES

it. As one of my finance professors used to say: “They’ve got cash coming out the windows.” So is it any wonder that these cash flows went to drive the growth of GE Capital and acquisitions within GE Industrial?

Which of these finance businesses doesn’t belong?

Financing GE equipment where the company knows the landscape and the assets better than anyone. Is that a core activity? Check. Other lending to those same or similar clients? Probably. Credit card services? Residential mortgage businesses? Office buildings in Stockholm? Following the company as a credit analyst 15 years ago, I was always impressed with GE Capital. They seemed to be a prudent lender; nimble, yet backed by enough fire power to swoop in and do large, profitable deals. But two things seemed to happen: the world became awash in capital, and it became harder and harder to find a good home for GE Capital assets that were cresting half a trillion dollars in 2003. GE has a lot of “feet in the street,” but it’s hard to find smart deals on that scale.

If it can happen to GE - Lessons for blue-chip stock investing

Play defense when playing defensive stocks: Any good bond investor will tell you that buying out-of-favor bonds is nice, but you outperform by avoiding trouble in the first place. It’s also a good rule for investing in large-cap stocks where the businesses are mature, stable, and already market share leaders. Investors get stability in exchange for giving up exciting growth prospects. But, as we saw with GE, mature businesses can falter, leaving the investor with neither safety nor growth - kind of like a default in a bond portfolio.

Every business has a life cycle: Eventually, companies and industries transition from high-growth, high margin “halo” businesses to lower growth, lower margin, manufacturing-intensive businesses. Appliances and plastics at GE are good examples of this. Rather than pass the torch, managers and companies generally double down on the technology or the brand. Sometimes it works, but it often just results in margins and PE multiples collapsing harder and at the same time. It’s not a question of whether any other large-caps are in a tough spot for earnings growth; it’s a matter of which ones and how acute the problem.

Beware of profit concentration: Analysts used to make the offhand comment that GM made 300% of their profit on large trucks and SUVs. The figure was hard to prove, but not hard to defend. Eventually, gas prices spiked, SUV sales plummeted, and GM filed for bankruptcy.

Earnings quality: Earnings drive the stock until the stock drives the earnings. In the later stages of a stock or stock market rally, management teams are under pressure to keep posting earnings growth, and investors tend to get a little complacent. Rising stock prices tell us that the issues are priced in. It can get lonely shaking your fist at a market that keeps going up. But the issues eventually matter.

What does this mean for stocks right now?

The recovery in corporate earnings since the financial crisis has been more about cost management than demand growth. But I worry that a multi-year run of lean capital investment and restrained R&D spending means that the market might have a bit higher mix of finely tuned mature businesses, and a lower mix of growth businesses. This does continue to put those true growth stories in the position of value due to their relative scarcity, and it might point large cap investors towards casting a net down into smaller capitalization companies.

I also worry that earnings quality is down a bit. If the dollar levels out at current exchange rates, the broad market will have to “spend” about a year’s worth of growth just to keep earnings in place. I also
worry that investors have not applied an appropriate discount to overseas “trapped cash” and the low tax rates that helped create the cash.

And more broadly, we should also consider the ever-growing primacy of “pro forma” and “adjusted” earnings that add back pesky expenses like pension and stock options. I wouldn’t blame it on the companies- the adjustments are fully disclosed and posted right alongside the actual GAAP EPS. It just seems as though adjustments are more widespread and more broadly used by investors. I am no knee-jerk accounting grouch, but I would say that we should factor in a small cushion when comparing today’s earnings-based valuations to those further back in time.

All that said, we still see plenty of places to invest in innovation, and we also see opportunities in large cap companies that have lost their growth luster but still have good competitive advantage and trade at reasonable valuations. Investors should strenuously avoid the middle ground, where valuations reflect levels of forward growth that is unlikely to come to pass.
EUROPEAN EQUITIES - YESTERDAY’S BEARS BECOME TODAY’S BULLS

The recent Merrill Lynch fund manager survey shows that 63% of respondents expect to be overweight Europe this year, up from only 18% a month ago, a record in the history of the survey. Despite this, equity markets in the periphery have been lagging those in core Europe by about 10% since the market lows last October. This is surprising given that the economies of the periphery should outgrow those of the core this year, while their equity markets are cheap and they remain the focus of the ECB’s efforts to head off deflation.

Some of the problems in the periphery are being fixed. Portugal, Spain, Ireland and Greece have seen unit labor costs decline by 10% since the start of the eurozone crisis while the rest of the euro area has seen costs inflate by 12%. This has effectively eliminated the competitiveness gap accumulated over the preceding decade. Wages in Greece are down 35% from their peak, and they are down 13% in Spain versus five years ago. Only Italy has failed to address this trend, but that is changing now following Mr. Renzi’s reforms.

The fall in the euro has helped the periphery’s external balances, and exports in the periphery have risen to 26% of gross domestic product (GDP) from 16% before the crisis. This is beginning to compare favorably with Germany which has effectively been no better than stable over the last few years. It has translated into a rising share of corporate profits as a percentage of GDP: for example, for Portugal and Spain, this figure is now 43% versus 39% for Germany and 34% for France. Large output gaps mean that there are no wage pressures.

The eurozone’s manufacturing PMI is above the expansion/contraction level of 50 and is now at a 10-month high. The euro price of oil is down 36% over the past year, despite the euro/dollar move. The eurozone current account surplus is now $270 billion compared to only $18 billion when we entered the eurozone crisis in 2011. While German government bond yields have fallen to new lows, eurozone economic surprises have been consistently positive all year. Pessimism towards the euro is at an extreme, and it could be susceptible to a recovery. Nonetheless, the medium-term trend for the euro is likely to be downward given that the U.S. economy, financial system and labor market are much further down the road from the crisis. A cheaper currency, on the back of QE, is the primary route that allows Europe to escape deflationary forces.

While European QE has come much later than elsewhere, it is happening at a time where central bank balance sheets in the U.S. and UK are likely to be shrinking. There is no accompanying asset sterilization program, nor any measures for specifically targeting certain needier parts of the economy, so the ‘pushing on a string’ argument remains valid. However, there is no doubt that QE has been a very positive catalyst for European equity market sentiment so far this year.

The impact of the weaker euro

Perhaps the biggest consequence of QE has been the continued weakening of the euro from a level above $1.21 at the start of the year to a low of $1.05 in the middle of March, a decline of more than 13%. While recently the level has risen a little, this still represents a fall of around 10% in Q1 2015. This move has favored dollar earners in the European market, notably aerospace stocks, auto original equipment manufacturers and auto supply stocks, and pharmaceutical stocks. Our portfolios have been overweight all of these sectors. It is worth noting that U.S. dollar investors have had their gains eroded by the currency weakness (unless hedged), so some stability in the currency may encourage further positive flows.
Exhibit 1: Euro vs dollar exchange rate

Source: Bloomberg, data to end March 2015.

Lower energy prices are an additional tailwind

Falling energy prices have several effects, notably boosting consumers in many large economic areas, reducing input prices for many companies and leading to significant reviews of long-term capital expenditure plans in many industries. Recent unrest in Yemen has led to a small rise in the oil price, but the long-term picture is very positive.

Fiscal drag is fading

This factor has been evident since the eurozone sovereign debt crisis first reared its head in 2010. Peak fiscal drag for the eurozone was more than 1.5% in 2012, which has since faded to zero in 2015 (Exhibit 2). Indeed, fiscal policy is forecast to provide a small boost in 2016. Borrowing costs are at rock bottom, and most European economies are now running primary surpluses.

Exhibit 2: Net fiscal position for the eurozone (% of GDP)

Source: UBS, data as at 12 March 2015.
Credit trends and bank lending are supportive

The latest bank lending numbers show that credit is now growing again in Europe and while deleveraging has not ended completely, it is no longer a drag on growth. Banks are being more accommodative towards lenders, and demand from both households and businesses is improving. The recently published results of the ECB’s TLTRO showed a higher-than-expected take up by the banks, which should lead to more credit and liquidity being made available. The flow of credit, severely lacking so far in this recovery, would be a strong signal that the eurozone economy is on an upward path to growth.

Capital flows and positioning

It is certain that much capital has flowed into European equities in Q1 2015, possibly as much as $40 billion (Exhibit 3). Our belief is that much of this flow has been fairly indiscriminate, typically using passive instruments. This presents a danger for markets, as we saw in 2014, if expectations for better growth and earnings are not ultimately met. We believe that it is extremely important to use active management to gain exposure to Europe.

Exhibit 3: U.S. flows into European equities have improved sharply

The road ahead for Europe

Looking forward, we expect to see earnings and economic growth expectations firming during the year. Many economic indicators are showing healthy signs, such as PMIs, retail sales and car sales. Meanwhile unemployment is falling and real wages are starting to rise. European earnings revisions have just turned positive, the first time since January 2011. According to Morgan Stanley, 95% of the rise in European equities since the market trough in March 2009 has been due to multiple expansion and only 5% has been due to earnings growth. So, if earnings really are moving up, there is plenty of room for progress. Earnings expectations for 2015 started the year at 8% and now stand at 9%. We are currently assuming 10% corporate earnings growth for Europe ex UK this year. Similarly, the consensus GDP forecast for the eurozone has been upgraded from 1.0% to 1.3%. While there is little room for disappointment, this could be the first year of upgrades since 2010. Encouragingly, deflation fears appear to have peaked, and we are starting to see signs of structural reforms in two of the laggard countries in the eurozone, Italy and France. Current credit growth, if annualized, would
produce a €120 billion (1.2%) boost to eurozone GDP. Such is the level of operational gearing in European corporates that this could take our earnings growth numbers up to 15-20%.

While the strong move in markets so far this year suggests a lot has already been discounted, European equity valuations are not unattractive, particularly compared to fixed income and cash. The European market is still yielding more than 3%, compared with zero or negative rates in many other instruments. Additionally, should we start to see nominal growth rates improve in the domestic economies of Europe, there will be further operating leverage which should drive European profits much higher in the next few years, against a backdrop of static or falling earnings in many other regions of the world.

The ECB has committed to €1.1 trillion of QE, at least until September 2016. The main risk (apart from policy tightening in the U.S. and UK) is if energy prices recover and put upward pressure on European inflation. This would begin to remove the justification for QE in Europe and so raise the spectre of tightening in Europe. That would cause a severe rise in European bond yields and a fall in equity prices but such an outcome does not look likely any time soon.
### Weekly Market Summary as of 4/17/2015

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<td>Crude Oil</td>
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<th>% Chg</th>
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<td>8.0%</td>
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Source: Columbia Management Investment Advisers, LLC

**Past performance does not guarantee future results.** It is not possible to invest directly in an index.

**DESCRIPTION OF INDICES**

The **Barclays U.S. Aggregate Bond Index** is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and non-convertible investment grade debt issues with at least $250 million par amount outstanding and with at least one year to final maturity.

The **Barclays U.S. Corporate Investment Grade Index** is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least $250 million par amount outstanding. To qualify, bonds must be SEC-registered.

The **BofA Merrill Lynch High-Yield Bond Master II Index** is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The **Standard & Poor's (S&P) 500 Index** tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The **Russell 1000 Growth Index** measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and lower forecasted growth values.

The **Russell 1000 Value Index** measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The **Russell 2000 Growth Index** measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 2000 Value Index** tracks the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The **MSCI EAFE Index** is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australia and the Far East.

The **MSCI EM Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

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