Bahl&Gaynor
Investment Counsel

October 2015

3Q 2015 Review and Outlook

Bahl & Gaynor Economic Outlook

"Trick or Treat"

The origins of Halloween trace back to Medieval times in the Christian practice of "souling," where peasant children would sing and say prayers for the dead in return for food and coins. Souling progressed to "guising" in the early 20th century where we first witnessed costumes and what would ultimately become today's lanterns. The Christian roots quickly faded and it became a night of playful extortion.

> *"Hallowe'en provided an opportunity for real strenuous fun. No real damage was done except to the temper of some who had to hunt for wagon wheels, gates, wagons, barrels, etc., much of which decorated the front street.* ***The youthful tormentors were at back door and front demanding edible plunder by the word "trick or treat"*** *to which the inmates gladly responded and sent the robbers away rejoicing."*
>
> Herald, (Lethbridge, Alberta) November 3rd 1927

As we approach Halloween, we are faced with much more aggressive "tormenters" than first surfaced in Canada in 1927. The tormenters upon the market have multiplied over the last quarter. Weakness in commodities has accelerated and the pain we had predicted in the levered-energy sector is coming to fruition. Credit concerns have spread beyond just energy as deeply cyclical industrial names have entered their own recession. Global deflationary pressures have again come to the forefront and emerging market economies have accelerated to the downside. Additionally, political grandstanding ahead of the 2016 elections has created material uncertainty regarding "rule changing" in many sectors, specifically biotechnology.

All of these tormenters are now demanding "treats" from the market. In an attempt to offer a treat, Janet Yellen and the Fed decided to forgo raising interest rates in September and acknowledged emerging market weakness in prepared remarks. In our view, the Fed made a critical error in its policy shift. In introducing emphasis on emerging market weakness in addition to the domestic employment and inflation picture, the Fed has painted itself into a corner as the Global Central Bank.

With the Fed policy rate at zero and tasked with a tightening bias, Yellen faces the predicament of a house that has no candy with a group of rowdy, sugar-loaded teenagers at the doorstep. Words without immediate action will do little to placate

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Bahl & Gaynor Economic Outlook *Continued*

these tormenters. Future volatility, or "tricks," on the market are likely to be commonplace until more clarity exists regarding global growth and Fed policy, now intertwined.

Bahl & Gaynor's thesis remains that Janet Yellen faces a globally unstable economic picture with no real precedent. We view that the extreme weakness in highly-levered corporations and countries now represents a PLOP or "Permanent Loss of Principal" risk. We continue to believe the foundation of any enduring investment thesis needs to be built on well-capitalized companies that have the ability to withstand volatility and not fall captive to global tormenters.

Tricks: "The Tormentors"

Commodities:

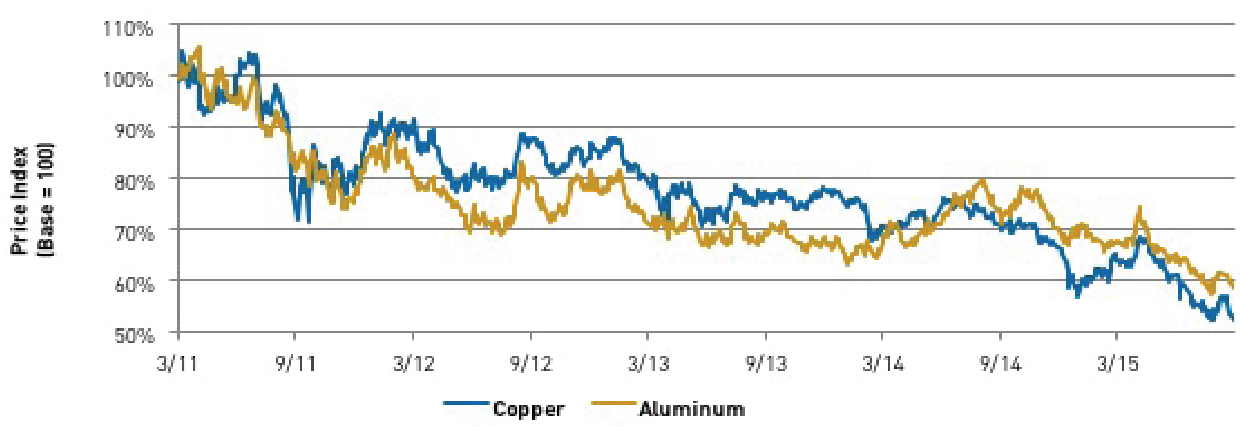
Corporate and Sovereign Stress Accelerating

The well-publicized slowdown in China and emerging markets has transmitted ripple effects to the balance of the globe. As Chinese construction slows amid the country's efforts to shift to a more service-based economy, the demand for copper and other raw materials has hit a vacuum.

For example, since peaking in early 2011, both aluminum and copper prices are down nearly 50%! For commodity-based companies that have significant up-front and fixed extraction costs, such a decline turns many projects into money-losing propositions. Adding pain, these projects were funded at high loan-to-values and with forward production commitments. In many cases, the costs of shutting down a mine would bankrupt a company.

While eliminating production would be the best outcome for all producers, each company faces a classic "Prisoner's Dilemma." Each individual firm is incented to continue their extraction operations hoping that other firms cease and prices rise. One of Bahl & Gaynor's investment rules is: "Hope is not an investment strategy." We are likely in the early innings of a default wave among these companies as hope fades to a grim reality.

Copper & Aluminum Indexed Performance



Source: Bloomberg, 2015.

The commodity price impact outlined above is not limited to companies; it has also affected entire countries that depend on high commodity prices for exports to support their local economies. Brazil, the "B" in the BRICs, is now squarely in the crosshairs of this commodity bear market as evidenced by its domestic stock market performance and investor confidence in the country's government debt obligations. The Brazilian stock market has dropped nearly 40% YTD. The cost of insuring $10 million of Brazilian debt is now over $500,000 per annum, implying a 30% chance of default within five years. As shown by the velocity of the move below, when the market smells weakness, it is quick to re-price aggressively. Foresight and "margin-of-safety" are required investment tools. Once a move happens, exiting the wrong risk positions likely represents a material PLOP.

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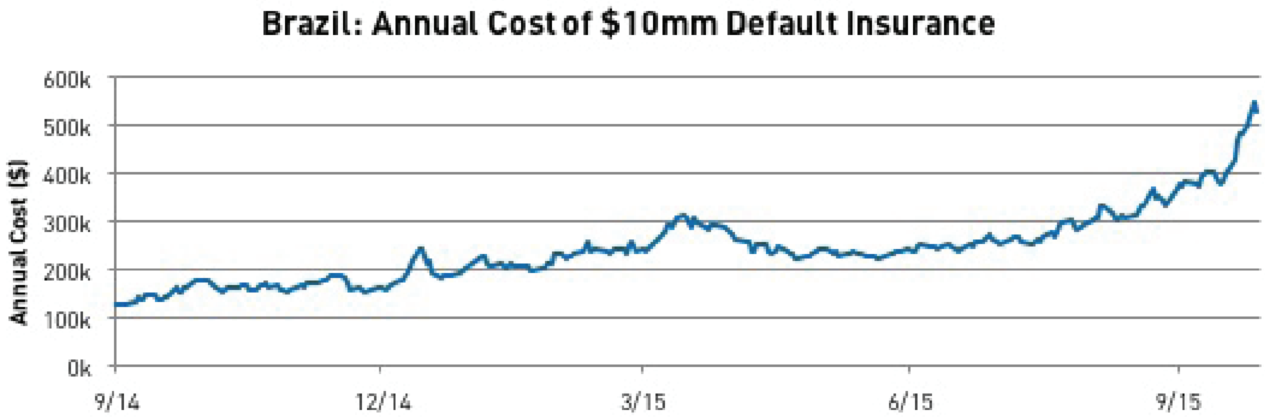


Source: Bloomberg, 2015.

The circumstances observed in Brazil are not an isolated issue. Nearly all emerging market economies experienced booms, largely commodity-related, during China's investment surge over the past few decades. These booms have manifested themselves in significant private sector credit growth. However, China's decelerating demand and the associated drop in commodity prices has resulted in extremely challenged growth for these emerging market economies. Faced with the unattractive realities of rising leverage and slowing growth, the only option for many of these countries is to aggressively de-value their currencies versus the USD to spur foreign investment and re-ignite export-driven growth. Unfortunately, the significant amount of government debt denominated in USD issued by these countries creates a liability squeeze as principal and interest payments become more onerous.

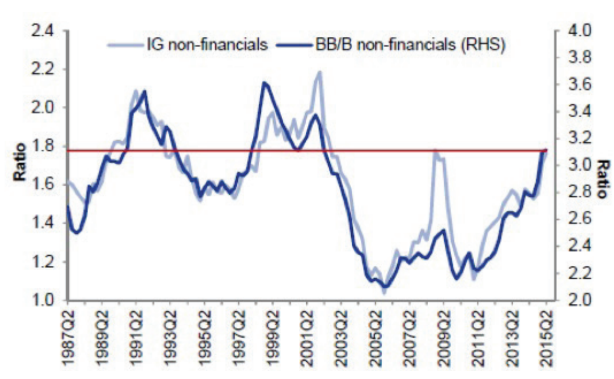
Credit:

Credit Quality Deteriorates and Financial Conditions Tighten

It is very evident over the past quarter that general market credit quality continues to deteriorate. The confluence of both weak (or negative) earnings growth and a continued accumulation of debt has resulted in net leverage for both investment grade and high-yield companies moving toward the 75th percentile of observations over the past three decades.

Of particular concern is net leverage residing at levels not seen since the financial crisis for investment grade companies and the tech bubble for high-yield companies. Both of those periods ended badly for risk assets and corporate access to financing was only available under the most punitive and restrictive terms. Debt-funded share repurchases have been a significant support for equity markets of late, but this management and activist investor lever is likely on its last leg amid deteriorating credit quality.

Net Leverage Ratio for Investment Grade and High-Yield Companies



Source: Compustat, Goldman Sachs Global Investment Research, 2015.

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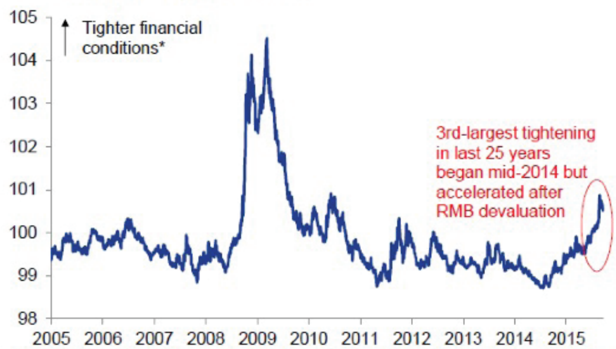
Credit *Continued*

The increase in leverage in the recent past is of particular concern given tightening financial conditions. Financial conditions began to tighten moderately after the Fed removed accommodative policy (quantitative easing) in 2014, but accelerated over the past quarter with the adverse commodity, currency and credit spread moves. This presents a real danger for negative credit events in many sectors that will no longer have access to easy financing.

Sharp Tightening: GS US Financial Conditions Index



*Weighted average of riskless interest rates, spreads, equities, and FX, based on effects on 1-yr fwd. US GDP growth.

Source: Compustat, Goldman Sachs Global Investment Research, 2015.

Politics:

Biotech Replacing Banks as Focal Point

Healthcare has become the latest issue for investors to digest in an already fragile market. After a +450% run-up in the biotechnology index, concern regarding Hillary Clinton's new prescription drug proposals has caused a material drawdown as the biotechnology index dropped over 30% in the last two weeks of September.

Hillary Clinton's Proposals:

- Significantly reduce the cost of prescription drugs
- Limit deduction for pharmaceutical advertising expenses
- Mandate R&D spending

Any of the three above-listed proposals would materially impact profits for parts of the Health Care industry. However, the combination of all three could impact the corporate *viability* of many firms. Given the lack of earnings (or revenues in many cases) of many fledgling biotech firms, there would appear to be very little valuation support for this industry in general. We fear this sudden and negative change in sentiment and resulting biotech bubble pop represents another unforeseen "trick" on the market.

Peter Theil, the first outside investor in Facebook and co-founder of PayPal, on biotechnology:

There is **disturbingly little intuition into what biotech companies are worth.** If you are able to produce a drug that cures some sizeable disease for which there is no cure at all, that is worth billions, or tens of billions of dollars. And if you don't succeed it's worth nothing.

You have to get through basic research, preclinical, Phase I, II, and III, and then marketing. So approaching it analytically, the question is how do you discount the risk of failure at each step? If you do half on each step, and there are six steps, that's 2 to the 6th, or 64. So something worth a billion at the end means you start at a value of $16 million.

The thing I don't like about this as an investor is that the numbers are totally arbitrary. They are just made-up numbers. And our feeling with many biotechs is that people understate these probabilities. They say it's half, but maybe it's just one in 10. And even if just one of these steps is one in 10, you are really screwed. I would be very nervous to invest in a company where it gets pitched as a series of contingencies that "this has to work, and this has to work, and this has to work."

Source: MIT Technology Review, September 12th 2015. Interview with Antonio Regalado. Emphasis is Bahl & Gaynor's.

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Fed:

Painted Into a Corner as the Global Central Bank

Bahl & Gaynor believes the Fed made a critical policy error during the September 17th "no hike" announcement. By acknowledging emerging market weakness in its "no hike" decision, the Fed for the first time shifted the focus from traditional domestic inflation and employment concerns to the global capital markets.

This effectively acknowledged the Fed has become The Global Central Bank and beholden to the volatility of global asset prices. Let us pause to consider the significance of that statement.

With "the rules" changing, the Fed will continue to be a headwind as opposed to the tailwind it has been for the market over the past seven years. Looking forward, there is still significant uncertainty regarding the potential timing of a rate hike and the forward path of interest rates thereafter. If the Fed would like to move in December, we expect significantly hawkish commentary will be heard through October and November so the move will not come as a surprise.

The Line Between Ben Bernanke and Janet Yellen Is Blurring

Source: Zerohedge

The Bottom Line

Similar to our last update, we reiterate we are in an unprecedented period. The "Tormenters" in the market right now will continue to wreck havoc until both the global growth and Fed path become more transparent.

This is not a time to engage in a high-risk investment strategy. Such strategies are predicated on a marginal buyer paying more for an asset than one purchased without support from earnings and cash flow.

In times such as these, we believe Bahl & Gaynor's investment strategy of owning well-capitalized companies with established economic moats should provide *downside protection* and a *growing income stream.*

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