

Jack Adamo's Insiders Plus

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Dear Friend & Client,

Thanks for joining me.

Well, I've said it before and I'll say it again, "Curiouser and curiouser." If Alice were around today, I'm sure she'd think the market was first cousin to the Mad Hatter. The whole market did well this week, with the NASDAQ's 3% rise leading the way and the Dow pulling up the rear with a 1.1% gain. That spread usually smacks of speculative fever, but at least one prominent tech company, Cisco Systems had an excellent quarter. I'm usually skeptical of Cisco's accounting, but I looked into it and it looked legitimate.

We underperformed the market, but did okay with gains of 0.8% and 1.2% in our Main and High Income Portfolios.

The reason the market's action seems so curious to me is that S&P 500 earnings are awful. That index makes up the vast majority of the total capitalization of all the stocks traded in America. Stranger still, is that that sources seem to be making up their own numbers. One source a few days ago said something about the tepid year-over-year earnings growth of the index at just 4.1%, according to Bloomberg projections. I get the spreadsheets directly from S&P and they show year-over-year growth for the index at -5.2% with 381 of the 500 companies reporting. And it's getting worse. Last week with a lower percentage of companies reporting, the drop was only 1.7%. I don't know if the guy was quoting Bloomberg correctly, but if he was, they must think those last 119 companies are going to have a really spectacular Q4.

If that's not strange enough for you, don't worry, there's more. *Sales* are actually growing, and at a decent pace. Year-over-year sales were up 3.6% and Q4 over Q3 were up 2.3%.

So, what gives? Why are sales up, but earnings down?

Operating margins are getting crushed. Year-over-year they are down 11.6%. Sequentially they are down 8.5%. "But wait ... there's more!" EPS at consumer staples stores that sell food and other necessary items, are down 11.7% while profits at consumer *discretionary* stores are up 13.3%. Gasoline and auto sales are not in either of these figures, so that's not a factor. But here again there is internal weirdness. The consumer staples still had decent sales growth of 3.2% while their earnings that took a dive.

Okay, that should be enough strangeness for today. But it's not.

While S&P 500 earnings have been punk, earnings for the Mid-cap 400 and Small-cap 600 index have been stellar. Mid-cap EPS are up 7.9%; small-cap EPS are up an astounding 17.3%.

This, after all, may explain why the market reached new nominal highs. However, it would make more sense if just the Wilshire 5000 or the Russell 2000 did so. The S&P 500 should not be in their company.

An Interesting Chart

I heard a guest on Bloomberg say a few months ago. He was talking about how bullish he was on the market because of falling unemployment claims and strong Non-farm Payroll job growth. The host, Kathleen Hayes, I think, asked him about the lack of growth in hourly earnings, questioning whether the economy was doing better in terms that meant something sustainable or whether there were just a lot of people working more part-time jobs. His answer really threw me for a moment.

He said that wage increases historically have not been in evidence until the very end of a recovery period. At first that seemed odd to me and I questioned it, but the more I thought it through, the more it made sense. During a recession, companies lay-off or fire workers to slim down expenses. When things pick up, they re-hire slowly, sometimes just temp-workers or part-timers. They focus on productivity gains until things pick up enough. Nowadays, that means a good deal of CAPEX and outsourcing overseas.

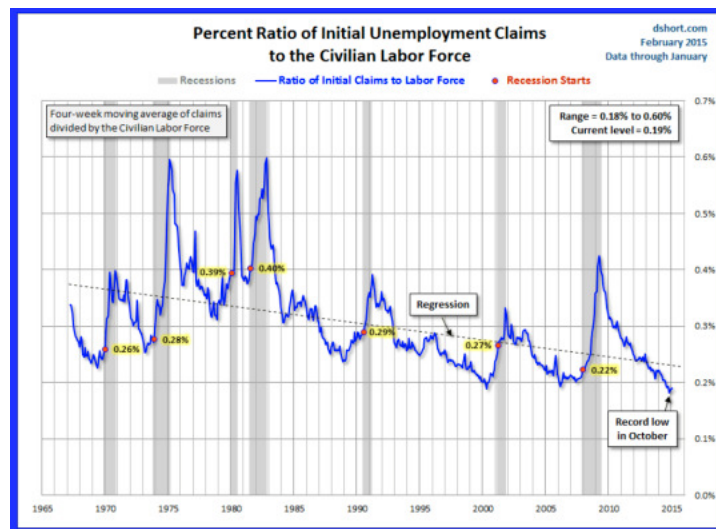
It is only when things really get going that most employers venture to hire more highly paid workers, some of whom are Americans. We have seen this trend in spades in the last few years, exacerbated, I suspect, by the negative business incentives of our ill-conceived national healthcare system. (Please don't shoot; I'm a Democrat. There were only two choices.)

The problem may be that when all the productivity gains have been had and skilled workers want more money, there is no more room for profits to rise except by raising prices. That, however, may cause a slowdown in purchasing, particularly among the most price-sensitive cohorts. The upshot may very well be that while sales in some areas still go up, they go down in others, and the modest net sales gains aren't enough to offset the higher pay of the new workers.

Doesn't that look a lot like what we're seeing in the sales and operating margin figures from the S&P 500 this quarter?

Recall that a few months ago I showed a chart released by the Saint Louis Fed that showed that after-tax profits at U.S. companies were now the highest percent of GDP they had ever been. Do you remember also an accompanying chart from the same source that showed that labor earnings were at very near the lowest they had ever been?

I had been thinking about this when I came across the following chart this week.



(Chart courtesy of dshort.com)

The blue line shows the ratio of unemployment claims to the labor force. The dotted line is regression (trend line) and the faint gray vertical bars are recessions since 1965. Notice that almost in every instance, unemployment drops to new lows just before a recession starts.

Crazy right? Well, no, not when you think it through further. When workers get more choice they get more picky and want more money. Unless it sparks an immediate wealth effect throughout the economy, which seldom happens -- these things take time -- profit margins suffer and earnings come down. In some cases, like we see in the S&P 500 this quarter, the companies even start losing money. Are they going to keep losing money? Of course not. They are going lay off workers. And so the next recession is underway.

If this analysis is right, and there seems to be some good evidence for it, the recessions might possibly be avoided by companies just biting the bullet for a couple of quarters until the money

circulates through the system a bit. After all, the velocity of money is faster the lower the income cohort. A low-wage worker with a family doesn't invest his \$10 raise in a steel mill; he buys food or shoes for his kids.

Nevertheless, this is the world we live in. Wall Street has taught investors to obsess over every quarter's earnings, so the question is, does the action of the S&P 500 and the above chart signal that we are headed into recession, or are the earnings in the small cap indices the right light to guide us?

The answer is way above my pay grade. I'll keep watching. I'm considering buying a small-cap index or two. Stay tuned.

In the meantime, I have one recommendation for the week.

TAKE PROFITS IN TELENOR

I'm a little apprehensive about this call, since I bailed out on Verizon and Vodafone too early a few years back. However, I simply can't ignore the issues with this company.

We've done okay with **Telenor ASA** (TELNY.PK). Our 15.8% in the last two-and-a quarter years sure beat T-bonds. It has always had a high P/E, which I felt was justified for its potential growth in developing markets. The potential still may be there, but given the currency headwinds the strong U.S. Dollar is causing throughout the world, I can't see the light at the end of the tunnel with these ADRs. They are now selling at nearly 70-times earnings. Maybe on the other side of the next bear market and/or as exchange rates become more balanced I'll revisit the stock, but for now, it's too rich for my blood and I'd rather pocket the profit. SELL Telenor ASA.

PORTFOLIO UPDATES

Our high-flying toy maker **Hasbro Inc.** (NASDAQ: HAS) had another great quarter and year. Q4 net EPS rose 36.7% on a 1.3% rise in revenues; a 3.6% drop in cost of sales, and a 64% drop in amortization of intangibles. The last figure is non-cash and doesn't really mean much in practical terms. EPS were boosted about 4% by share buybacks in Q4 alone. Still, earnings were unequivocally good. For the full-year, revenues rose 4.8% and fully diluted EPS jumped 47.5%. Free cash flow also was very and the balance sheet remains strong. Over the course of the year, the quarterly dividend was raised 7.5%.

The average price per share on the 460 million shares the company repurchased was a bit over \$54, which is below where the stock is now. However, the stock has risen more than 12% in the last week alone and should pull back and consolidate. I suspect, that like most companies, these share repurchases will eventually be shown to be expensive. Companies historically have bought back the most shares near market tops to boost their EPS when growth slows. 2014 saw the second largest amount of share buybacks for the S&P 500 in history.

But I'm being a too testy here. It was a great report from Hasbro and we've made nearly a 100% return on the stock in two-and-a half years. Hold Hasbro Inc.

Avon Products Inc. (NYSE: AVP) reported Q4 and full-year results that were awful, as expected, but improved enough to give the stock a nice boost. Shares were up 2.3% for the week. More importantly, they've recovered most of their year-to-date loss. I'll give you the gory details up front, then we'll look at the mitigating circumstances and the silver lining.

Q4 net diluted EPS plunged to a loss of 75¢ from a 16¢ loss in Q4 2013 on a 12% drop in revenues. Full-year EPS fell to an 88¢ loss from last year's 13¢ loss. Full-year revenue fell 11%.

The vast majority of these negative results stem from currency issues. Most of Avon's sales come from emerging markets. While that explanation doesn't put any money in our pockets, it at least shows that the management isn't at fault, except in lack of foresight by the Chief Financial Officer in hedging currency risk. The company has a new CFO coming on board on April 1.

To look at how sales did within respective countries, we can compare them in "constant dollars", that is, how they would have been if the dollar value hadn't been affected by foreign exchange.

Here things look better. On a CD basis, Q4 sales rose 5%, while full-year sales were flat. The Q4 improvement also shows that, as the year progressed, the measures taken by the company got traction. Furthermore, global expenses fell 31% for the full-year and 67% for the final quarter. To cut expenses that much and still increase sales takes skill and determination. The company took a 19¢ per share restructuring charge for the year on its cost-savings initiatives. Q4 shows it was very much worth it.

Still more encouraging is that fact that a lot of the company's loss was non-cash and of a nature that may be recovered in the future. For the year, 92¢ was an impairment charge against future tax benefits. Avon has tax credits from past losses that may offset future earnings. Accounting rules require that these credits be evaluated periodically. Because of the huge collapse in Venezuela's currency, which alone cost Avon 41¢, the company had to write-down the value of tax credits that may be applied to future earnings, since there's a possibility there won't be enough earnings to use the credits against. So, the 91¢ was not actual cash lost in the period; only the value of the tax asset was written-down. Of course, that may hurt, but it eases the current situation somewhat. Furthermore, should the earnings outlook in the region improve, the value of these credits will be written-up and shown as income.

There were numerous other currency-related effects. The bottom line is that despite the big GAAP earnings losses, cash flow was quite positive, coming in at \$360 million for the year.

That cash helped the balance sheet too. Long-term debt came down 2.7% for the year; total liabilities dropped 3.2% and debt due in the current year fell 27%. The important Interest Coverage Ratio improved from 3.6 to a healthy 6.2. The only discomfort for me was that the company spent \$9.8 million buying back shares. However, almost all of it was in Q4 at an average price of \$8.90 per share, so this may actually turn out to be one of the few share buybacks that proves to be a good long-term investment by a company.

I'm happy with what Avon is doing, however, the road ahead is still a tough one. The company expects the strength of the U.S. Dollar to continue to negatively impact earnings in 2015, and with other Central Banks beginning or increasing their QE programs, that will probably be the case. I suspect only a massive new QE program of our own could even slow that trend.

The flip side of these obstacles is that such rigorous conditions can be like weight-lifting and cardio-training programs for a company. They either collapse or get lean and mean, learning to operate at maxim efficiency. If it's the latter, they come out the other side stronger, faster, more agile and ready to churn out profits. Recent results from Avon tell me it will be one of the winners.

Hold Avon. I may put it back in the buy column soon. I'm worried about the market now, not the company.

One of our preferreds, **Bunge Cumulative Convertible Perpetual Preference Shares (BGEPP)** slipped this week on a bad Q4 report. EPS slid to \$0.56 from \$0.78 in Q4 2013. Adjusted earnings were about double that, but still lower year-over-year. A good deal of the drop came from poor results in hedging, not operational issues.

We won't worry about the short-term ups and downs. In fact, I'd like to see the shares shed 20% in the next bear market, although I don't think they will. Then we would load up on them. In three years the company will have been around for *two hundred* years. It will be here paying dividends long after we're gone. Hold Bunge Cumulative Convertible Preferred.

TELUS Corp. (NYSE: TU) posted good earnings for Q4 and the full year. Quarterly revenues came in 6.1% higher while expenses only increased 5.6%, leaving its pre-tax income 10% higher and net EPS 10.9% higher. Full-year revenues were 5.2% higher, while expenses rose only 4.7%, leading to an 8.9% rise in pre-tax income and 14.9% higher EPS.

I noted sequential earnings (Q4/Q3) were down noticeably. I'm not sure if there's normally a seasonal effect in its business, so I'll take a look at older annual reports sometime in the next few weeks. There was also a large drop in Comprehensive Earnings stemming from re-measurements of the assets in the company's many pension plans. Its liabilities in this area are actually very manageable and nearly fully funded (a rarity these days), however, I'm also going to

look at the assumptions it is using for future returns to see if they are realistic. I don't expect trouble, but better safe than sorry. Meanwhile, don't be afraid to buy it; the earnings report was very good. TELUS Corp. is a buy up to \$39. Take a 3% position in the Main Portfolio.

You can view all of our holdings with their current advice by going to:

http://www.jackadamo.com/main.asp?fn=portfolio_view.asp

The password is: **TinaFey**

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Please see the important legal notice at the end of this letter.

That's it for today. No closing remarks. It's been a very long week.

With stocks reaching new highs, there is really no sign of incipient danger, so feel free to buy any stocks within their buy ranges. However, I would still lean more toward the best dividend payers, especially the preferred stocks.

I look forward to talking with you again soon.

Jack

Questions? Write to Jack at: jack@jackadamo.com

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