Review & Outlook

2Q 2015 Market Review

Reflections

Market remains little changed amidst volatility

The market remained largely range-bound in the quarter and for the year. The S&P 500 index ended the quarter basically flat, gaining +0.28%, bringing year-to-date total return for the first half of 2015 to +1.23%. Investors remain in somewhat of a holding pattern as they continue to monitor signals from the Federal Reserve in anticipation of the end of the prolonged period of easy domestic monetary policy. Market consensus has shifted expectations for the first rate hike forward into September, albeit with a fair amount of uncertainty due to conflicting economic data signals.

The recent macro backdrop has been challenging for companies who have been facing a unique and diverse set of challenges in the form of muted global growth, currency headwinds due to the strengthening US dollar, anticipation of higher interest rates (thereby increasing borrowing costs), along with volatile commodity movements. This confluence of factors has increased the complexity of navigating and predicting the investment landscape in the short term as these dynamic forces work their way through company earnings.

Mixed Economic Data and Weaker GDP Growth

Prolonging the outlook for higher rates? How will the Fed interpret recent trends?

Final readings for GDP in the first quarter reflected a (0.7%) contraction in the U.S. economy, down from initial estimates for a muted 0.2% expansion. The downward revision was greatly influenced by a change in the trade balance as higher than estimated imports coupled with lower than expected exports served to detract (1.9%) from overall growth. A slowdown at West Coast ports driven by labor disputes likely contributed to this, along with the pressure that a stronger dollar places on the affordability of US goods to overseas buyers, a headwind to domestic manufacturers and exporters.

While the weakness in GDP has largely been attributed to the impact of harsh weather conditions and the port slowdown, it remains unclear when a more robust growth picture may emerge. During the quarter, economists began revising down their expectations of GDP growth for the second quarter as a string of mixed economic data have somewhat obscured the growth outlook. As we look toward the second half of the year, we expect consumer spending to continue to accelerate buoyed by lower energy costs and a continued improvement in employment. This trend is beginning to be reflected in the data. Most recently the Atlanta Fed's GDP forecast model for Q2 was increased to 1.9% from 1.1% in early June due to higher expectations for consumer spending growth.

Investor focus remains keenly attuned to the timing of when the Federal Reserve will raise interest rates. The contraction in GDP in the first quarter, while largely attributed to influences deemed to be transient in nature, contributed enough uncertainty to essentially take a June rate hike off the table, shifting expectations for the first rate increase since 2006 to September at the earliest, and possibly not until later in the year. Core inflation readings remain below target, and are likely to remain muted given the lag effect of when energy price declines, already captured in headline readings, begin to work their way into the core metric. Global growth concerns exacerbated by the potential of a Greek shock are also likely serving to elevate caution at the Fed, potentially influencing timing to some degree as they look to embark on the first rate hike cycle in 9 years. Bright spots in data releases have come from employment and housing figures. These countervailing forces continue to perpetuate a level of uncertainty in the market that rates will rise this September.

Greek Woes Re-Emerge

Will Greece remain in the Euro?

Volatility in the quarter picked up due to a reignited focus on the Greek crisis and heightened odds of the struggling nation's possible exit from the Euro (termed "Grexit"). Imposed capital controls at banks and halted markets escalated the urgency of the situation, topped by Greece's Prime Minister Alexis Tsipras' call for a referendum vote on Europe's bailout proposal while in the midst of negotiations with Eurozone leaders, a risky strategy geared towards increasing the country's leverage to combat increased austerity measures in exchange for continued financial aid. The struggling nation's appetite for additional austerity measures has long been waning in the face of record high unemployment. This strategy relies on an assumption that the rest of Europe does not wish to see Greece leave the Euro. A Grexit would mark the first instance of a member leaving the Euro after its 15 years of existence, and has raised fears that should that occur, it may not be the last.

Affordable Care Act Survives Another Challenge

Overhang weighing on healthcare sector lifted

In late June, with a definitive 6-3 ruling (King v. Burwell), the Supreme Court removed a key overhang that had been weighing on the healthcare sector. The decision marked a victory for the Obama administration in overcoming the most recent challenge to one of the President's signature legislative achievements, the Affordable Care Act ("ACA"), by affirming the eligibility of patients covered under federally established health insurance exchanges to receive tax credits. A ruling against the administration would have placed subsidies for millions of Americans at risk and greatly impeded administration of the ACA. This would have resulted in downward revisions to earnings for companies (such as hospitals) benefitting from these newly insured patients.

A Stronger and More Selective Consumer

Tailwinds for the consumer set up nicely for the second half

A strengthening labor market, rising wages and an incremental boost from continued savings at the gas pump are bolstering a recovering consumer. Unemployment claims continue to trend lower and are consistent with an improving employment and overall economic picture. The most recent unemployment rate came in at 5.3%, with expectations for that measure to fall to 5.0% by the end of this year. While the consumer has steadily improved, they are behaving in a wiser and more selective fashion than the pre-crisis spender Wall Street was accustomed to. This newer and more risk-averse shopper has become far more selective in their spending patterns, and continues to demand value for their dollar. They also appear more focused on maintaining solid balance sheets, with the savings rate holding above 5% in recent readings, especially as they are faced with rising healthcare expenses and concerns over security in retirement. Areas of consumer strength have been seen however, in furniture, restaurants, technology and healthy lifestyle products, offset by weakness in areas such as apparel. Now that savings have been rebuilt and wages are rising, the consumer is in a healthy position to increase spending, albeit more cautiously than perhaps in the past. This bodes well for a longer and steadier consumer spending cycle ahead.

Productivity Slowdown

Are demographics to blame?

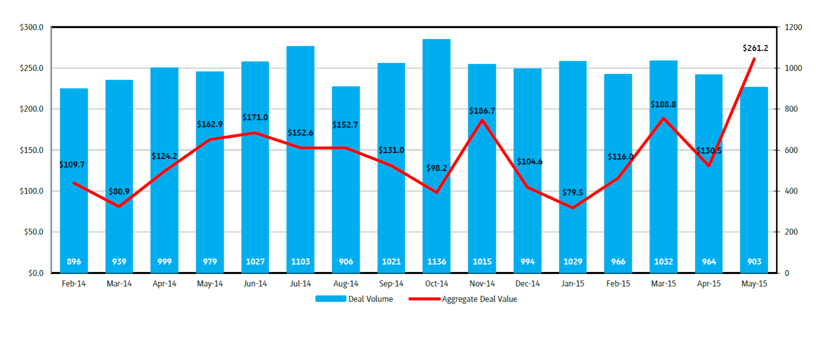
A lot of attention has been paid recently to recent weakness seen in global productivity growth. Global output per worker grew last year at the slowest rate since 2000. Revised figures for US productivity in the first quarter of 2015 read (3.1%), worse than consensus expectations, while Q1 labor costs were +6.7%, 100bps higher than expected. With the combination of rising labor costs (while good for employees/consumers) and the productivity of that labor declining (bad for efficiency), company profit margins may face some pressure. Some argue that there is a lag before new technology increases productivity, and that when labor was cheap, less focus was paid to efficiency. There is a demographic element at play here too, as a younger and less experienced workforce takes the place of an aging and retiring demographic. It will take some time to reach maximum efficiency for these newer workers.

M&A Taking Lead From Share Buybacks in Capital Deployment

Companies shift focus toward driving growth

A prolonged period of relative underinvestment by companies has many of them searching to bolster their growth profiles via acquisition. After years of allocating cash more conservatively toward share buybacks, companies are shifting their sights to M&A as a more aggressive means to deploy capital and drive growth. Data from Dealogic revealed a new record of $243B in M&A volume in May. The top 3 areas for activity in the month were Telecoms (38% of activity), Technology (20% of total), followed by Healthcare. Such moves have been largely rewarded by market participants with the stock prices of acquiring companies also increasing in the majority of large (>$1B) deals in the US in 2015 year to date.

The US Mergers & Acquisitions Market Index



Looking Back To Look Ahead

How today's landscape has been shaped by the recent past

The enormous industrial investment cycle brought on in the mid-90s fueled a 15-20 year period of rapid expansion enabled by easy capital. This expansion has left a legacy of excess capacity worldwide that is serving to restrain a new and more robust capital expenditure cycle from emerging. The slower growth environment seen globally is a derivative of this legacy and as investors, we are closely monitoring these influences as we look forward to find the most compelling investment opportunities in this new "slower but longer" growth backdrop.

On the consumer side, the investment cycle in housing fueled by easy lending standards led to unsustainably high debt loads which triggered the recent deleveraging cycle and repair of consumer balance sheets. The newly healthier consumer is not re-leveraging to spend, but is rather poised to recover off the lows based on a steadily improving employment backdrop and tangible earnings growth. There are many tailwinds for the consumer going into the second half of 2015, and we see exciting opportunities to invest behind more selective consumer preferences that present outsized growth opportunities relative to the overall macro growth rate.

Our philosophy has always centered on identifying companies that demonstrate a differentiated value proposition with identifiable catalysts supported by sustainable business models and superior management teams that can generate healthy and accelerating free cash flow, leading to outsized returns over our investment horizon.

GRANITE LONG-TERM CATALYSTS FOR CHANGE

TECHNOLOGY & PRODUCTIVITY

- Global demand for energy efficiency and lower emissions
- The proliferation of "Big Data" opens up a new world of analytical software tools
- Increasing risks around cyber crime necessitates advanced security solutions
- Cloud computing enables worldwide access to information from any device
- Software as a Service migration is accelerating
- Internet of things

HEALTHCARE TRANSFORMATION

- Higher utilization and strong operating leverage as healthcare becomes universal
- Evolution of ACA and private healthcare exchanges
- Baby boomers demand more healthcare
- Genetic testing innovation and FDA regulatory pathways help accelerate personalized medicine
- On the cusp of revolutionary breakthroughs in the area of oncology

EVOLVING CONSUMER TRENDS

- Changing consumption behavior
- Focus turns to individual health
- Rise of the middle class in emerging markets
- Evolving demographic trends
- Mobile computing

DOMESTIC MANUFACTURING COMPETITIVENESS

- Less dependence on labor costs, more on technology
- Lower cost of energy and transportation
- Productivity of regional logistics
- Leveraging efficient U.S. distribution infrastructure

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Granite's only business is providing investment management services. Granite specializes in the management of equity and balanced portfolios for private and institutional clients including defined benefit and defined contribution retirement plans, endowments, foundations, public, Taft-Hartley and corporate funds.

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