2013 Financial Market Update and Look Ahead

—December 31, 2013

A Year to Remember

Stocks had a banner year in 2013, and much of the commentary will concentrate on the forces that fueled U.S. equities. Not only did the S&P 500 Index post its best advance since 1997, 90% of S&P 500 stocks ended the year positively, the highest since records began in 1980 (Thomson Reuters).

The Dow Jones Industrials, the oldest and best-known index, registered its best performance since 1995 (MarketWatch). Meanwhile, riskier small-cap stocks easily outperformed their larger counterparts, with the S&P SmallCap 600 Index racking up a gain of nearly 40%.

<table>
<thead>
<tr>
<th>Index</th>
<th>Q4 Return %</th>
<th>2013 YTD Return - %</th>
</tr>
</thead>
<tbody>
<tr>
<td>DJIA¹</td>
<td>+9.6</td>
<td>+26.5</td>
</tr>
<tr>
<td>NASDAQ Composite²</td>
<td>+10.7</td>
<td>+38.3</td>
</tr>
<tr>
<td>S&amp;P 500 Index³</td>
<td>+9.9</td>
<td>+29.6</td>
</tr>
<tr>
<td>S&amp;P SmallCap 600 Index⁴</td>
<td>+9.5</td>
<td>+39.7</td>
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<thead>
<tr>
<th>Bond Yields</th>
<th>Yield* - % a/o Dec 31, 2013</th>
<th>Yield - % a/o Dec 31, 2012</th>
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<tbody>
<tr>
<td>3-month T-bill</td>
<td>0.07</td>
<td>0.05</td>
</tr>
<tr>
<td>2-year Treasury</td>
<td>0.38</td>
<td>+0.05</td>
</tr>
<tr>
<td>10-year Treasury</td>
<td>3.04</td>
<td>+0.40</td>
</tr>
<tr>
<td>30-year Treasury</td>
<td>3.96</td>
<td>+0.27</td>
</tr>
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<thead>
<tr>
<th>Commodities</th>
<th>Dec 31 price, quarterly change</th>
<th>Year end 2012</th>
</tr>
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<tbody>
<tr>
<td>Oil per barrel⁵</td>
<td>$98.70</td>
<td>$91.82</td>
</tr>
<tr>
<td>Gold per ounce⁶</td>
<td>$1,201.50</td>
<td>-125.00</td>
</tr>
</tbody>
</table>

Sources: MarketWatch, U.S. Treasury, CNBC, St. Louis Federal Reserve, Standard & Poor’s

*Includes quarterly change

But the brighter outlook for the economy and talk for much of the year that the Fed was poised to start reducing bond purchases lifted Treasury yields and weighed on bond prices.

Before we jump into the “why” behind the rally, let’s briefly examine a couple of major hurdles that, once removed, enabled the bulls to run freely on Wall Street.
Remember the swoon in stocks in the summer of 2011? Seems like a distant memory, but a number of factors created a large degree of uncertainty, including an ominous and expanding debt crisis in Europe. Extraordinary measures taken by the European Central Bank in late 2011 and again in 2012 calmed credit markets and bought time. Hurdle #1, Europe, removed.

As 2012 progressed, the fiscal cliff loomed large over the markets and the economy. Without any action by Congress, hefty across-the-board tax increases beginning in 2013 threatened to throw the economy back into a recession. But Congressional negotiators crafted a narrow deal at the midnight hour, permanently enshrining nearly all of the Bush tax cuts into law. Hurdle #2 removed.

With a couple of stiff headwinds out of the way, investors found solace in a number of strong tailwinds, which drove the DJIA, the S&P 500 Index, and small-cap stocks (BigCharts) to new highs.

A super-easy monetary policy

In order to stoke economic activity and hiring, the Federal Reserve has been holding the fed funds rate at near zero since late 2008 and has embarked on a series of long-term bond purchases, popularly called quantitative easing or QE for short.

Two goals—

- Keep interest rates low in the hopes that spending and borrowing by consumers and businesses spark economic activity and hiring.
- Boost asset prices, such as stocks and housing, hoping the so-called “wealth effect” will encourage spending. In theory, an improving net worth may aid consumer confidence and boost spending.

Undoubtedly, QE has been controversial and it has its detractors. Still, most agree the bond buys have boosted stock prices – see Figure 1, though some would argue it has been an artificial lift.

**S&P 500 Index performance and Fed bond buys**

![S&P 500 Index performance and Fed bond buys](image-url)
Note: QE1, QE2, QE3 are the popular names for the three rounds of bond purchases initiated by the Federal Reserve with newly created money. Operation Twist is the popular term for the purchases of longer-term Treasuries financed by the sale of shorter-term Treasuries.

Nonetheless, Fed policy has not been without costs. Low rates have punished savers that rely on safe investments for income, encouraging some to climb the ladder of risk. Some of this additional risk-taking, what I call “engineered risk,” has led investors to the doorstep of equities.

While QE has fertilized the equity fields, I believe other, more fundamental elements have also contributed to the rally.

**Don’t discount earnings**

We’ve experienced a subpar economic recovery, but that hasn’t prevented companies from posting record profits, on near record profit margins (S&P Dow Jones Indices). Reason – a gradual improvement in the economy has led to very modest improvements in sales. Coupled with a laser-like focus on expenses and you’ve created the perfect recipe for record earnings.

Longer-term, stocks are heavily influenced by corporate profits – see Figure 2. In fact since 1960, the correlation between the S&P 500 Index and earnings per share (EPS) stands at a very high 0.91, where 1.0 reflects two variables that are perfectly correlated, -1.0 reflects two variables that are perfectly inversely correlated, and zero would mean there is absolutely no relationship.

As Figure 2 underscores, there are times when EPS outpaces stocks, such as the late 1970s, when inflation noticeably accelerated and interest rates surged. Just the opposite occurred in the late 1990s, when stocks zoomed ahead of profits.

But over the longer-term, profits have been the mother’s milk of equities, and record earnings have played a role in lifting stocks to new highs.
**Stock buybacks**

Given record profits and few opportunities to expand and re-invest, corporations have returned an enormous amount of cash to shareholders via stock repurchases and dividends.

The repurchases of shares in the open market represent real demand for stocks, and buybacks are up significantly over the last year – see Figure 3.

Yet, it is not just the repurchases of shares that count, but whether companies are also selling new shares to the public. Howard Silverblatt, Senior Index Analyst at S&P Dow Jones Indices, noted in December, “We are starting to see excess buying, where the repurchases outnumber the issuance, and therefore, reduce the share count. The lower share count leads to higher EPS, and the market likes higher EPS.”

Note: S&P Dow Jones Indices estimates the stock repurchases for Q3 2013 at $128.16 billion (latest data available)

While the repurchase of company stock has underpinned the market, dividends have also sweetened the pot. S&P Dow Jones Indices estimates that companies returned a record $310 billion last year in the form of dividends.

**The road ahead**

The global economy has yet to shake off the shackles of the 2008 financial crisis that threw the U.S. economy into a tailspin.

The International Monetary Fund expects global GDP to run at 3.6% in 2014, up from an expected 2.9% this year. But that’s below the rate of 5% from 2005 – 2007 (Bloomberg News).

The U.S. economy did show signs of perking up at the top of 2011, 2012 and 2013; yet, it failed to break free of the low growth orbit it has been stuck in since the recovery officially began in the second half of 2009 (NBER).
Once again, the U.S. economy is exhibiting signs of strength heading into the New Year.

Employment is rising per government data. Nothing spectacular yet, but we’re gradually moving in the right direction.

<table>
<thead>
<tr>
<th>Nonfarm payrolls – Monthly Average</th>
<th>Private Sector – Monthly Average</th>
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<tbody>
<tr>
<td>2011 175k</td>
<td>202k</td>
</tr>
<tr>
<td>2012 183k</td>
<td>189k</td>
</tr>
<tr>
<td>2013 190k</td>
<td>190k</td>
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Data Source: BLS – Establishment Survey of Businesses; 2013 through November

New home sales have sharply accelerated over the past couple of months (U.S. Commerce Dept), manufacturing activity is growing at a respectable pace – see Figure 4, and consumer spending, which accounts for almost 70% of GDP (BEA data), ticked up in the fall (U.S. Commerce Dept).

Another temporary upswing before we settle back down? Maybe not. A two-year budget deal just approved by Congress provides a degree of certainty coming out of Washington, and the easing in the sequester (automatic spending cuts) translates into a little less of a fiscal drag in 2014.

But lest we get carried away, about $44 billion in additional 2014 spending (between defense and domestic programs – Source: scribd.com) is barely a ripple, as the total value of the U.S. economy stands at $16.9 trillion (BEA).
Business spending – poised to assist

It’s no secret we’ve been stuck in a low-growth economy, and the lack of overall demand and a high-level of uncertainty have been a drag on business expenditures (BEA, Credit Suisse). But the coming year could provide us with a pleasant surprise.

Economists at Goldman Sachs believe business investment in 2014 could climb 7.5%. Its “capex tracker,” of 15 indicators, which includes loan demand and capital-goods orders, suggests a ramp-up in business outlays may already have begun (Bloomberg News).

In the meantime, investment in structures, electrical, industrial and railroad equipment are all sitting near multi-decade lows as a share of GDP (BCA Research). If we see a gradual recovery in Europe, Japan continues to stabilize, and the U.S. consumer begins to engage, we could, at a minimum, see a replacement cycle in many long neglected industrial sectors.

Further, let’s not disregard the energy revolution that has lifted U.S. oil production by an astounding 60% since the 2008 low (Energy Information Administration).

All-in-all, more robust outlays by businesses could be the key that unlocks a more aggressive expansion.

Fed watch

At its December meeting, the Federal Reserve announced a $10 billion reduction in monthly bond purchases. At $75 billion each month, monetary policy remains unusually accommodative. Following the expected conclusion of the latest round of bond purchases, Fed Chief Ben Bernanke has pledged to keep the fed funds rate at near zero for a considerable period.

Bernanke also made it clear at his December press conference (Fed transcript) that Janet Yellen, who takes the helm of the Fed early this year, supports the current monetary roadmap, which suggests QE will be pared back in a thoughtful and deliberate manner through most of 2014.

However, Bernanke added that any continued reduction in QE is highly dependent on the economic data. If we continue to see faster-than-forecast growth, expect the Fed to taper at quicker pace. Softness in the data has the potential to slow any tapering.

Either way, short-term rates are likely to remain very low for quite a while, which has historically been a plus for equities.

How the Fed plans to unwind its bloated balance sheet will come into view as QE ends per current central bank plans. Many analysts have fretted that excess liquidity could eventually spark unwanted inflation. History, however, may be on the Fed’s side.
As Charles Schwab’s Chief Investment Strategist Liz Ann Sonders recently summed it up, “The Fed’s holdings of U.S. securities totaled about 22% of GDP in the post WWII era – the same as the current level.

“In the 1940s and 1950s, the Fed pursued very similar policies to deal with the debt that was incurred during the war. Eventually the Fed's policies were unwound and the balance sheet restored to normal with limited disruptions, including no major uptick in either inflation or interest rates.”

Potential clouds

The skies never really clear and market corrections rarely follow the script laid out by the consensus. The list below is not exhaustive but represents some of the potential problems the U.S. and global economy could face.

1- The two-year budget deal does not eliminate the possibility of another down-to-the wire debate on the debt ceiling. Recall the agreement that ended the October government shutdown extended the government’s ability to borrow until early February, but the Congressional Budget Office estimates the use of extraordinary measures could extend the deadline until early March.

Its forecasts are highly dependent on the magnitude of tax refunds and receipts in the early part of 2014 so it’s possible the deadline could extend until May or even early June. Whenever the clock strikes 12, another bruising debate, if it were to occur, could unsettle markets.

2- If the economy were to speed up significantly (probabilities remain low), could we see a big spike in Treasury yields and talk of a tightening cycle by the Fed?

3- Europe appears poised for a very slow economic recovery. Banking woes have subsided but structural reforms are still needed. There’s always the possibility that smoldering embers could reignite.
4- China is attempting to transition from investment-led boom to a more balanced, consumer-led economy. But debt levels are up and some worry about overcapacity (Barron’s).

1 The Dow Jones Industrials Average is an unmanaged index of 30 major companies which cannot be invested into directly. Past performance does not guarantee future results.

2 The NASDAQ Composite is an unmanaged index of companies which cannot be invested into directly. Past performance does not guarantee future results.

3 The S&P 500 Index is an unmanaged index of 500 larger companies which cannot be invested into directly. Past performance does not guarantee future results.

4 The S&P SmallCap 600 Index is an unmanaged index of 600 smaller companies which cannot be invested into directly. Past performance does not guarantee future results.

5 New York Mercantile Exchange front-month contract; Prices can and do vary; past performance does not guarantee future results.

6 London Bullion Market Association; gold fixing pricing at 3 p.m. London time; 2012/2013 year-end price fixing at 10:30 a.m. London time; Prices can and do vary; past performance does not guarantee future results.
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