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Financial Markets Perspective

FUNDAMENTALS MATTER

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A BRIEF SUMMARY OF THE CURRENT ECONOMY

Last year the U.S. stock market surged to record highs with the S&P 500 rising 32%, the Dow Jones Industrial Average rising 30% and the NASDAQ up 40%. These returns are three to four times the average annual gain in the stock market going back to 1926 when technical data to measure market performance was available. At the bottom of the financial meltdown on March 9, 2009 the market was telegraphing an end to the financial world as we knew it. Since then the stock market as measured by the DJIA has rallied 10,000 points in less than five years. This growth in the stock market is equivalent to a $5.3 trillion increase in national wealth! What could have transformed the environment to attract investors to equities and drive stock markets across the board to all-time record highs?

This transformation has been gradual and powerful and includes changes occurring at various sectors across the economy. Beginning in 2008 with the role played by the Federal Reserve in providing enough liquidity to stop the financial meltdown, Fed Chairman Ben Bernanke "bridged" the chasm from the domino collapse of financial institutions. Mr. Bernanke, a student of the 1930s depression, should be given the most credit for keeping the financial house in order. His guidance through this difficult time was quickly reflected in the stock market as the DJIA year-end 2009 eclipsed 10,400 -- or a gain from that March low of 6,594 or 58%. The Fed continued to nurse the economy back to health by providing ongoing liquidity through a program known as Quantitative Easing (QE) where the Fed purchased both mortgage-backed securities and government notes and bonds to insure that the economy would not fall back into recession as it did back in the mid-1930s when the government raised both taxes and interest rates. Although Chairman Bernanke is retiring this month, his successor Janet Yellen is expected to follow similar policies of managing monetary policy to promote economic growth.

During the height of the financial crisis, fiscal policy (the federal government's spending and taxing decisions) also provided financing for the "bridge." The Troubled Asset Relief Program (TARP) provided loans totaling over $700 billion (subsequently reduced by Congress to $475 billion) to the Cash for Clunkers program that funded increased purchases of automobiles. The federal government played a very important role when the private sector was trapped in the financial crisis. As of December 31, 2012, the Treasury had received over $405 billion back on TARP investments, equaling nearly 97% of the $418 billion that was actually disbursed under the program.

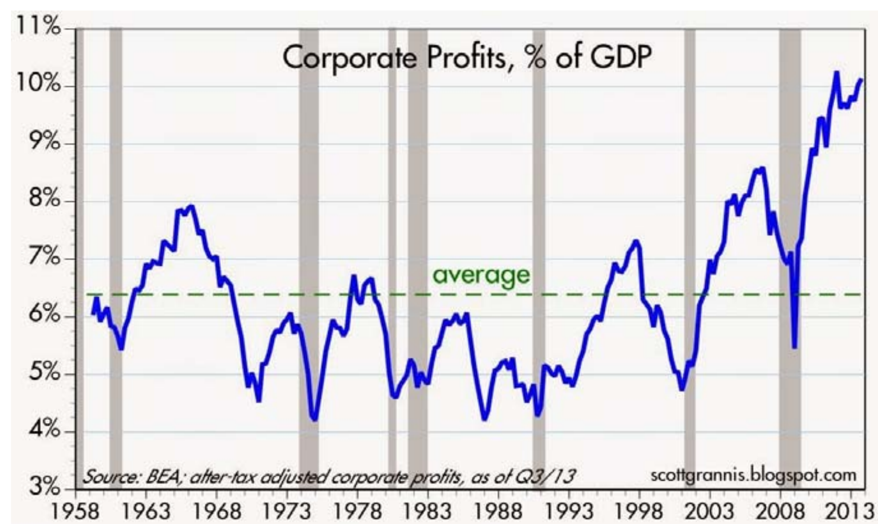
Unlike favorable monetary policies, government austerity measures including tighter fiscal policy and reduced spending kept the economy from recovering more quickly as in prior expansions.

Battles over the debt ceiling and a lowered credit rating on U.S. government debt introduced uncertainty into the sustainability of the recovery. By the end of last year, the fiscal battles in Washington appeared to subside with a bi-partisan agreement to modify the sequester—about $1 trillion in automatic and arbitrary across the board budget cuts— and to allow increased federal spending. This accord was undoubtedly triggered by the surprising surge in tax revenues as a result of growth in the private sector.

Another factor undermining the pace of recovery was due to the financial crises in Europe from 2010 to 2011. Initially the European Union could not intervene to help individual countries resolve their economic problems so that fears of individual country bankruptcies roiled financial markets. However, in November of 2011 the European Central Bank appeared to take on a role similar to that of the Federal Reserve and announced funding for individual country assistance if necessary. This sponsorship removed fears of financial insolvency in Western Europe and helped stabilize financial markets.

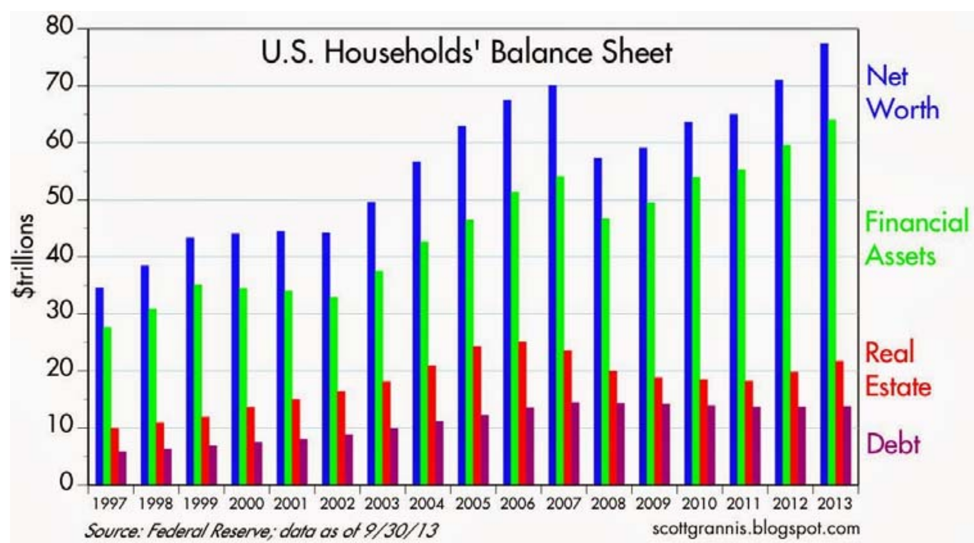
The Emergence of the Private Sector

The two major components of the private sector are the consumer and business. Taking a closer look at the fundamentals of these two groups provides some insight as to why the stock market performed so well in 2013. Let's start with the corporate sector.



The chart above shows after-tax corporate profits as a % of nominal GDP. Profits are very close to an all-time high on this basis, and significantly above where they have been over the past 55 years. More importantly, corporate profitability has grown steadily since the profit low point in the fourth quarter of 2008 despite the slow pace of economic growth. Low interest rates have allowed companies to refinance debt at a lower cost boosting the bottom line while huge cash reserves have funded stock repurchases, dividend increases and mergers and acquisitions. All of these activities have contributed to an overall rise in stock prices. Companies have learned from past mistakes and have been slow to make optimistic investment decisions without sufficient reason to make those decisions and, as a result, have conserved wealth in the process. This wealth is likely to be deployed as the economy grows faster.

Consumer balance sheets have improved as the net worth of U.S. households hit a new all-time high of more than $77 trillion last September. Home prices have stabilized and are now rising and with the stock market surge financial assets have increased. In the meantime, consumer debt has declined somewhat making the consumer picture a healthy one.



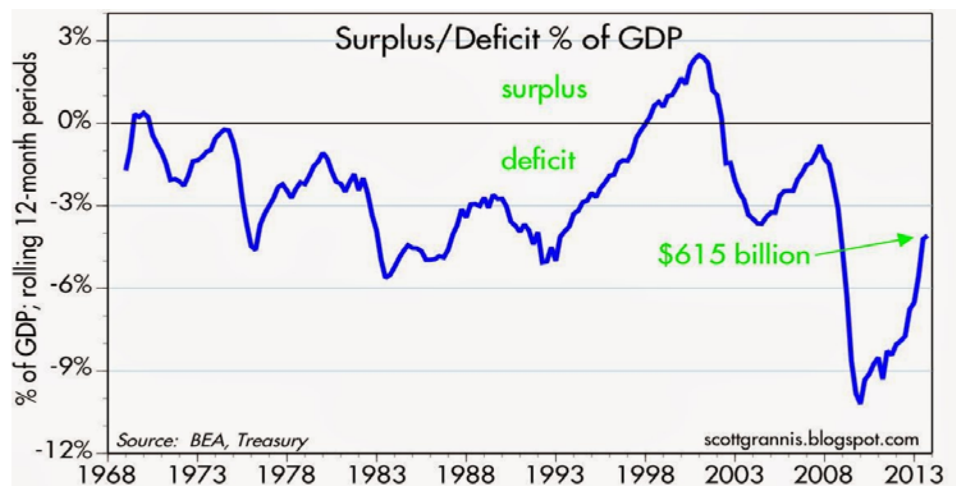
The Energy Renaissance is also having a favorable influence on consumers and businesses as increasing supplies of oil and gas have kept energy prices low. Hydraulic fracturing is the most important energy innovation of the 21st century and continues to expand to other areas of the United States and Canada. Moreover, this Energy Renaissance is contributing to economic growth and allowing consumers and businesses to save money while increasing employment in domestic energy industries, energy producers and electric utilities. For example, North Dakota is experiencing extremely low unemployment as demand for workers has surged. We expect this trend of falling unemployment to continue through 2014 and 2015 as domestic oil production continues to expand. The bottom line is that the Energy Renaissance is creating jobs and economic growth and will result in North America being energy independent by 2020 (according the International Energy Agency).

Revisiting the Outlook for Inflation

We view inflation as a major roadblock to economic progress. Therefore the recent history of low inflation is encouraging and prospects for continued low inflation are rising as energy prices remain stable. The consumer price index is a viable measure of price increases that affect spending. The latest reading is an annual increase of 1.2%. Fears that Federal Reserve monetary policy would balloon inflation have dissipated in the face of continued low inflation rates. In other words, the “printing” of money has not translated into an increase in inflation. Rather that rate seems likely attributable to the government’s regulatory impositions into the economy that force businesses to raise prices. Fortunately a robust corporate sector has been able to resist these pressures with the implementation of technology that has also allowed companies to keep price increases in check.

The Fiscal Condition of the Federal Government

Politicians have been wrangling over the budget deficit and the national debt ever since the economic meltdown in 2009 when the federal deficit was 10.2% of GDP as you can see in the chart below. The pundits told us that deficits exceeding 9% of GDP would bankrupt the U.S. economy and burden our children with huge debt payments. At the time, nobody predicted that the deficit would decline to 3.6% of GDP within four years. Economic growth can be a great healer. With a combination of increasing growth and reduced federal government spending we find ourselves in a position where the deficit is shrinking dramatically and nothing other than moderate growth will be needed to eliminate that deficit. The battle over the debt ceiling, tax rate increases and spending restraint are all factors that are reducing the economic risks of runaway federal debt.



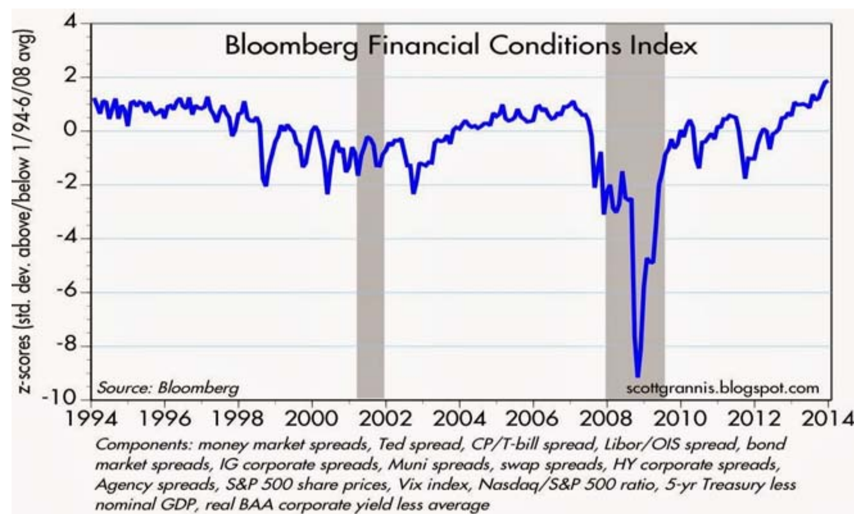
The Financial Markets

With the stock market hitting all-time highs in 2013 many are asking if the market is overvalued. The experts on Wall Street are at it again and debating over market valuation levels. When we started in this business more than three decades ago, an historic 100+ year valuation range for the stock market was well established. With a century worth of data across multiple metrics confirming these ranges, most investors have utilized these valuations in making a decision about investing in stocks or not. However, in 1990 something changed: as the 80s bull market extended into the 90s, the historical valuation range was breached and most valuation measures have remained elevated for almost 25 years! So how do we value the market?

Two of the most widely followed measures are the traditional trailing PE (price-earnings multiple) utilizing the S&P 500 series since 1870 and the newly popular Shiller PE ratio based on a ten year moving average of real stock market earnings (created by Bob Shiller, the Sterling Professor of Economics at Yale University). Currently, the former ratio puts the S&P 500 into the upper quartile of its historical range at about 16 times. The Shiller PE is currently at 25 times -- higher than it was prior to the 1990s. Looking at the valuation ranges post 1990 we find that both metrics are in the lower quartile of the range established over the last 25 years. Jeremy Siegel penned a piece last summer called: “The CAPE Ratio: A New Look” that highlighted the change in

accounting conventions that forced the write-down of assets. By changing the data inputs from the S&P 500 series to corporate profits from the National Income and Products Account (NIPA), he was able to more accurately identify the business cycle over the past 85 years. The result was that Shiller's over-valuation of the market disappeared. In other words, stocks are reasonably valued even after the 30%+ gain of 2013!

More importantly, the Bloomberg Index of Financial Conditions is at an all-time high as you can see in the chart below. This index consists of the following metrics: market sentiment, risk aversion, liquidity, credit risk and profit expectations and is a good indicator of the health of financial markets. Need we say more?



CONCLUSION

Over two years ago we warned that there would be some "potholes and speed bumps" on the road to higher stock prices. Last year, in the midst of stock market turbulence, we urged patience along with a prudent investment approach. We can look back at 2013 and conclude that we avoided most of the problems and patience was truly rewarded.

While we do not foresee another record year for the stock market, we do expect to see both an improving economy and rising stock prices for the next couple of years. The market will not go up in a straight line and will have some corrections along the way as news stories make investors bearish. But stocks will likely end 2014 on a positive note. On the other hand, the bond market is likely to be flat with some possible loss in principal value if interest rates rise. Federal Reserve monetary policy will have a lot to do with either keeping interest rates low or letting them rise if the economy continues to improve. From our perspective, stocks are the asset class of choice for 2014.

The upside surprise will likely be related to the continuing expansion of the North American Energy Renaissance and the likely contribution this expansion will have on both U.S. and global standards of living. The clouds of uncertainty appear to have dissipated and we expect clear investment skies for 2014 and beyond. Now please sit back and enjoy the flight!