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2013 Year-end Market Comments

A few months ago, we wrote about markets in terms of issues that impact markets legitimately, and in many cases, those that may impact markets but probably should be viewed as so much noise. We likened the ongoing back and forth in Washington between the Executive branch and Congress as this sort of noise, and encouraged investors to pay attention to fundamentals which exist in our markets and exert some effort to avoid the noise that goes on most every day.

Having said this, we confess that in terms of market returns last year, we clearly erred in terms of anticipating the magnitude of the market advance – both here in the U.S. and in other markets around the world. In this instance, perhaps we might be forgiven for this sort of "miss" – to say that most analysts and economists were surprised by the 32% rise in the S&P 500 last year is an understatement.

On the economic front, this recovery is aging and yet while aged in terms of time, not so in terms of growth rates and specifically, jobs growth. There are concrete signs that economic activity is finally beginning to take hold and strengthen, suggesting that the post 2008 recovery is finally gathering some momentum. This is noteworthy in that earlier policy initiatives did not have the desired impact of breathing life into the recovery – surprising considering the monetary and fiscal stimulus brought to bear in the early going after the recession of 2008. GDP grew at a 4.1% annual rate in the third quarter of 2013, marking only the second time since the recovery began that output of goods and services expanded above 4%.

Measures that support the better news in output levels – the job market is finally showing progress, although the December gain was disappointing and a surprise to analysts and economists. Some strategists suggest the December number was distorted by the extreme weather in much of the country, and equity markets since the release, for the most part, seem to agree. Household debt is down, and corporations remain awash in cash suggesting that companies can easily finance new investment in plant and equipment. There is also continuing good news in housing – strength here has been a positive for some months and most analysts see further strength in the New Year.

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This latest spurt of good news is being driven by renewed interest in buying on the part of consumers, so important as consumption represents more than two-thirds of economic demand in the U.S. Consumption is generally driven by jobs growth and in turn income growth and economists point to this chain of events as finally beginning to exert the expected tailwind.

In general, market watchers, analysts and investors accept the view that over time when economic activity is expanding, earnings will grow and markets will move higher. This sort of view is pretty basic, but keeping in mind that public markets are a discounting and pricing mechanism, these outcomes are not always the case and not always easy to forecast. Justin Lahart made the case recently in the Wall Street Journal that a strengthening economy and strong markets are not always in synch – 2013 was an excellent example. Further he writes, 2014 might turn out to be an example of the reverse - there are many periods in the past where economic activity and markets diverge. At this juncture, it is very likely that in the coming year the U.S. economy is likely to improve compared to 2013. Yet there are some reasons for investor expectations to be a little more constrained as we move into the New Year.

Foremost among those reasons are valuation levels – at the end of 2012 the S&P 500 traded at about 12 times expected earning and today the P/E ratio based on earnings estimates for the next twelve months is closer to 16. Secondly, a better economic environment will likely set in motion some of the same rhetoric which has been around for some months regarding the Fed's plans of unwinding the debt on its balance sheet. For some months, commentary regarding an end to the Fed's QE programs has tended to stall markets temporarily. We have emphasized before the difference between the expected slowing of the Fed's bond purchases and steps beyond, where the Fed may actually take more definitive steps to tighten monetary policy.

In the coming year, we expect markets to function in a generally friendly environment of rising earnings and stable interest rates. Having said this though, investors should remember returns last year were a result of considerable P/E expansion rather than earnings growth. A replay of that dynamic is not likely and expectations for returns should be viewed in this context *(see chart on next page)*.

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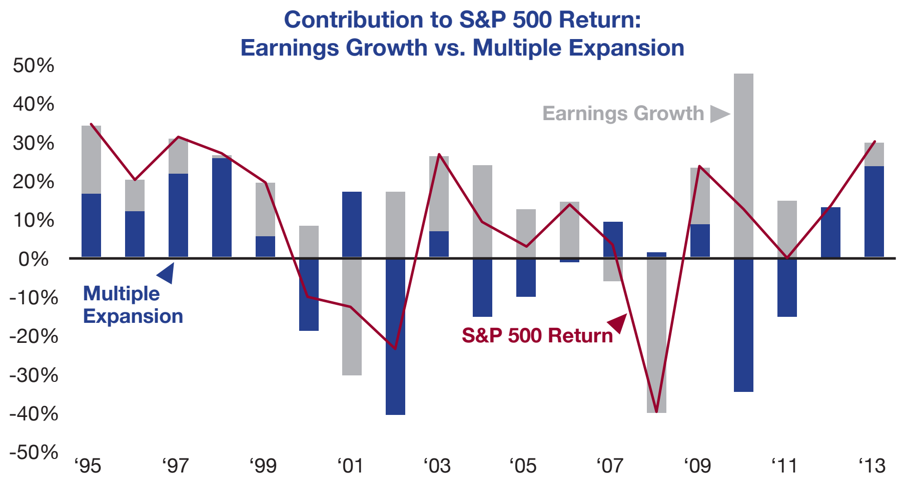

For a number of years we have maintained our exposure to international markets, and for the most part this effort has been rewarding. However, this has not been the case over the past few years but in 2013 those markets also performed very well – actually extremely well. The optimism on display in U.S. markets was felt across those international markets. Even in some of the most troubled countries in the euro zone market returns were surprising, to say the least. In Greece stocks advanced over 26% and the same for Ireland – stocks there up over 33%. While strength in economic activity across the region was in evidence, growth initiatives have not been quite the same in each country. Still the region undoubtedly benefitted greatly by the simulative policies of the European Central Bank under Mario Draghi. Mr. Draghi has been successful in convincing investors that the euro zone would survive and across the region stabilization has become more and more evident. In Japan last year the experience was similar – the Nikkei 225 experienced its best gains in over 40 years – rising over 56% for the year. Investors seemed to applaud the efforts of Prime Minister Shinzo Abe in putting in place very aggressive and simulative monetary policies to pull that country out of its longer term poor growth.

Much as we suggested a few months ago, returns for the coming year should resemble long-term trend levels, reflecting we believe, earnings growth for the next 12 months, near 8% to 9%. We expect markets to reward investors as worldwide growth continues, producing earnings growth, with interest rates still stable and very low. Again, valuations for stocks have been stretched some over the past year, but still not extreme and investors should continue to accumulate equities. ■

Allan Keyes