2013 Year In Review and 2014 Investment Outlook

Talk To Me, Mr. Ed

Go right to the source and ask the horse
He'll give you the answer that you'll endorse
He's always on a steady course
Talk to Mr. Ed

- Theme Song for the Mr. Ed Show

2013 Year in Review

Before the early 1900's, horses were extremely valuable, as they provided both a means of faster transportation and were also an important part of agricultural production, the main engine of the U.S. economy at that time. Even though combustion engines eventually replaced horses, the power that engines generate is measured in horsepower, a respectful tip of hat to the horse. It is estimated there were 21 million horses in America in 1900 but by 1960 the equine population had declined to 3 million as they were only used mostly for recreational purposes by then. Given their importance and value, horses were sometimes given as gifts, much like cars are today. Due to their dietary habits of constantly chewing, a horse's gums recede with age, which makes their teeth look longer. If one received a horse as a gift, it was considered impolite to look closely at the horse's mouth, implying the owner making the gift was giving you an old horse. The phrases Long in the Tooth and Don't Look a Gift Horse in the Mouth originated during the time when horses had a more prominent role in society.

Interestingly, both phrases are particularly apt today given that 2014 is the Year of the Horse. The 33% return earned by U.S. stocks (as measured by the Russell 3000 Index) during 2013 was a gift (horse) and significantly above expectations set at the beginning of the year. The Fed's Quantitative Easing ("QE") policy was the biggest factor behind the outsized performance of U.S. stocks during 2013, no matter what most of the cheerleaders on CNBC are telling you. Over the past 50 years, there have only been four years this good: 1997, 1995, 1989, and 1975. Even though most investment professionals hugely underestimated (I'll take my bow here) how well U.S. stocks would perform during 2013, when you're wrong about the upside, no one cares. As is often said in investing, it's not whether you are right or wrong, it's whether you make money, and investors with stock exposure made nice gains during 2013. According to the World Federation of Exchanges, global stocks increased $6 trillion in value for the year, 50% of which is attributed to the gains in the U.S. stock market, which outperformed most other global stock markets by a wide margin. Any investor with stock exposure, especially to U.S. stocks, should be happy campers. Those investors heavily invested in bonds and cash did not fare well at all and summer camp pretty much sucked for them. The S&P 500 Index has now been positive for five straight years and has returned a cumulative 128%. The median bull market advance usually lasts for 50 months in duration. From that perspective, this rally is starting to get long in the tooth as it is now at month 58 starting from the March 2009 low.

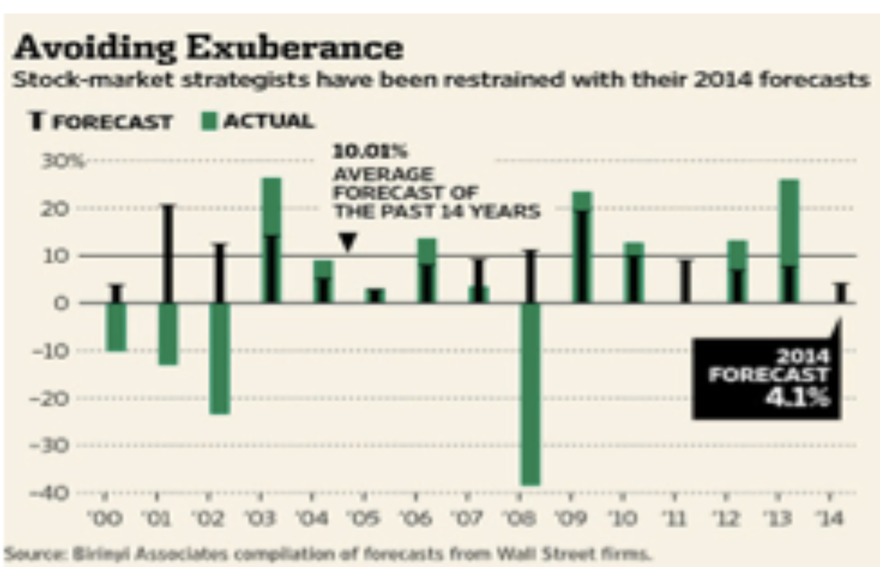
Thanks to extreme central bank policies, cash-like investments pay virtually nothing and the risk/reward setup in bonds looks terrible. Stocks have been big winners by default and seem ready to disappoint as they often do when everyone is falling in love with them. What to do? What to do? I've looked at all viable prognostication options to point me in the right direction. Tarot cards, Ouija board, finger in the wind, the Wizard of Oz, even Beeks. After careful consideration, I have settled on Mr. Ed. Mr. Ed is a horse. A horse is a horse, of course, of course. I get it. But, in light of how wrong everyone was about 2013, is it so outlandish to listen to a horse? Neigh. Besides, Mr. Ed will give me an answer that I can endorse for 2014, which is a steady course. So, for that reason, talking to Mr. Ed is a perfectly logical.

Mr. Ed has roamed the investment landscape and notes that 2013 was a Gift Horse in the Mouth kind of year. A totally unexpected gift, but don't look too close, and be happy with the gift you got. Mr. Ed also says this rally is long in the tooth and some indicators are flashing frothiness. If anyone can spot an old horse, well, it takes one to know one, and let's just leave it at that.

The spread in returns between stocks and other asset classes during 2013 was one of the widest on record. The performance of major asset classes during 2013, dominated by U.S. stocks, is shown in the next table.

Index	Return
S&P 500 Index (large cap U.S. stocks)	32.4%
Russell 2000 Index (small cap U.S. stocks)	38.8%
MSCI EAFE Index (developed int'l mkts)	22.8%
MSCI EM Index (emerging int'l mkts)	-2.6%
Barclays Aggregate Bond Index (invt. grade)	-2.0%
Barclays High Yield Bond Index (below invt. grade)	7.4%
Barclays Short-term Treasury bills (cash)	0.1%
Gold	-28.0%
Brent Crude Oil	-1.0%
Corn	-39.0%

As can be seen in the next chart, return expectations for the S&P 500 Index (black part of bar) for 2013 were below 10% according to stock strategists at the major Wall Street investment firms. As shown in the green (light) bar, actual returns significantly exceeded expectations. How did so many miss the mark by such a wide margin on how the U.S. stock market would perform in 2013?

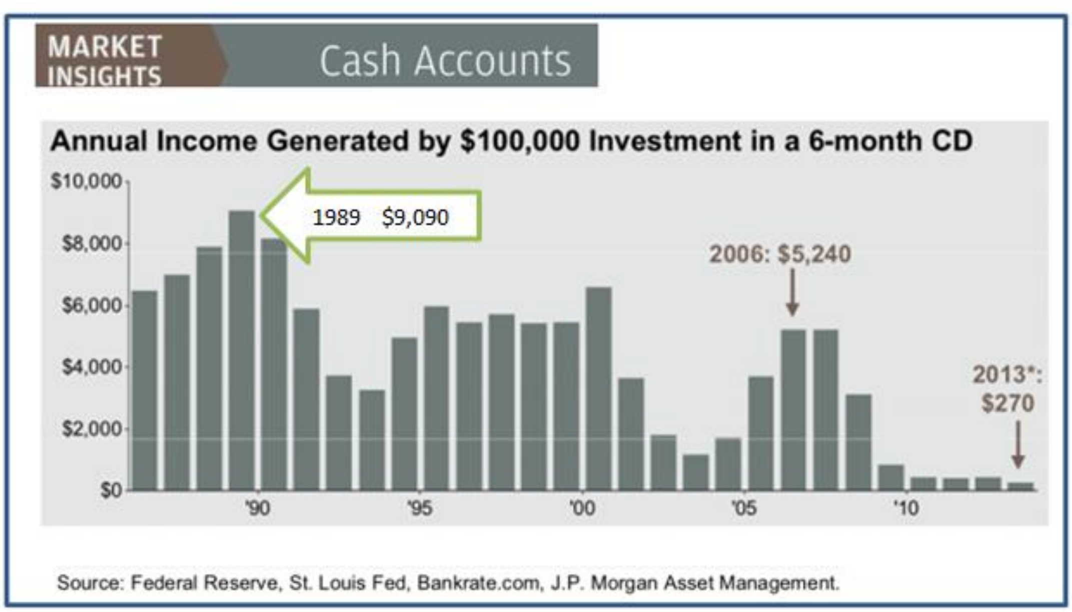


QE

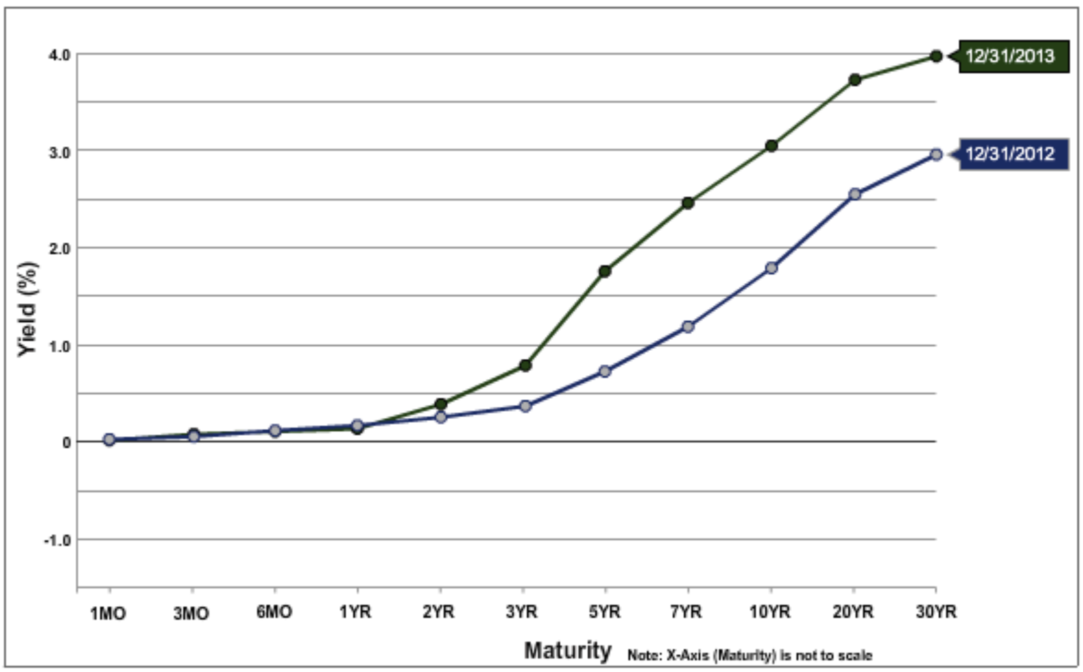
The hard reality is the world is in an era of unprecedented monetary policy actions lead by the Federal Reserve's QE program, which is the dominating factor influencing financial asset returns. Fundamentals have taken a back seat and parsing the language of Fed policy decisions and press conference comments is now what constitutes critical investment research in the QE Era. Given the size of the program (now over $4 trillion of bond purchases), QE is the elephant in the room. The Fed decided last month to begin tapering its bond buying in January, which will now be $75 billion a month, down from $85 billion previously. QE is still growing, just at a lesser rate and not much of a change in the grand scheme of things. Based on public comments made by Fed Chairman Ben Bernanke in early May, investors anticipated QE tapering would begin by September. However, that proved not to be the case as the U.S. government shutdown added uncertainty to the economic outlook and the Fed decided to wait. The decision to postpone tapering lead to a large stock market rally during the last four months of the year with the S&P 500 Index rallying 14% from September through year-end. Additionally, Janet Yellen was nominated (now confirmed) as the new Chairwoman of the Federal Reserve. It was clear from her confirmation process testimony that she is completely in the Ben Bernanke camp of not withdrawing QE until the economic data shows the economy is in a better state. Her comments emboldened stock investors and pushed stocks to new highs by year-end.

While QE has been a large positive for U.S. stock returns, the Fed's other major monetary policy action of keeping short-term interest rates near zero for over four years has served to punish risk averse investors. As shown in the next chart, income earned on bank CDs during this era of repressive Federal Reserve policies has all but eliminated any income potential from short maturity investments. Lower income streams from investments have forced many consumers on fixed incomes to either tighten their spending belts or to adopt a more aggressive investment approach in order to replace the income streams they were used to receiving from bonds or cash like investments prior to QE.

Income on Bank CDs: Down 97% since 1989

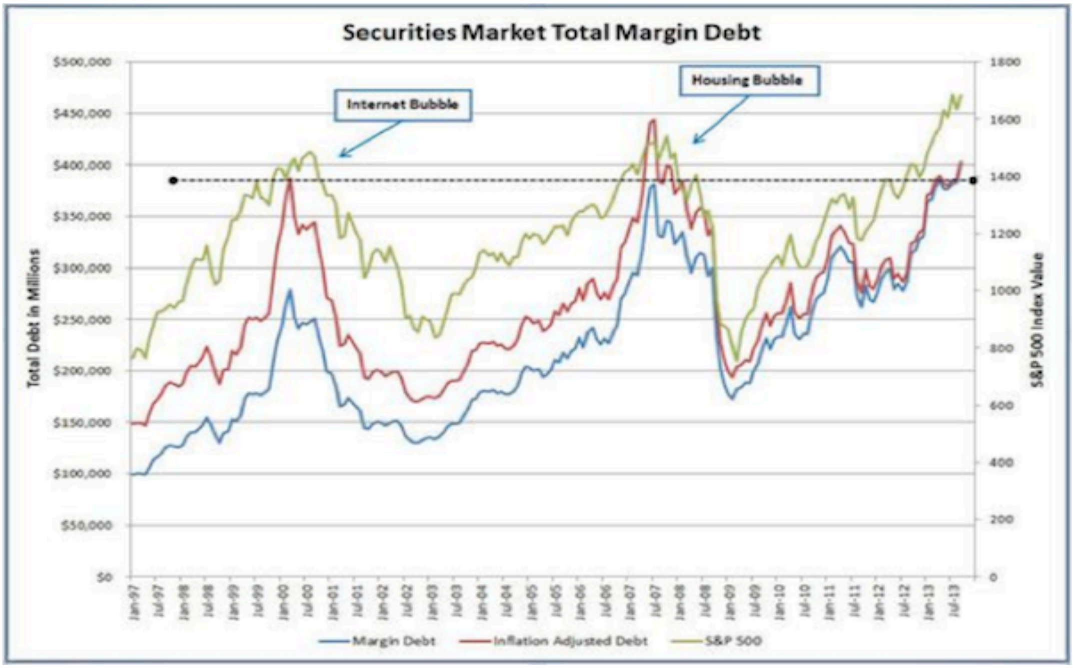


Since 2009, the Fed's QE policy has provided additional support for bonds. Its bond-buying program (under QE the Fed buys Treasuries and mortgage-backed bonds) has kept long-term interest rates artificially suppressed. That changed starting in May, when Ben Bernanke made his first public comments about the start of the tapering of bond purchases under the QE program. Although the Fed didn't formally decide to begin tapering until January, the genie was out of the bottle and bond yields moved aggressively higher starting in May. The following chart shows the change in the shape of the U.S. Treasury yield curve during 2013. Yields on maturities one year or less barely changed as the Fed's short-term interest rate policy kept those yields anchored in place at very low levels. However, the sharp rise in yields on longer maturity bonds lead to negative returns for most bond investors during 2013. Only high yield bonds, which benefited from the outperformance of riskier assets and the reach for yield by income-starved investors, managed to generate positive returns.



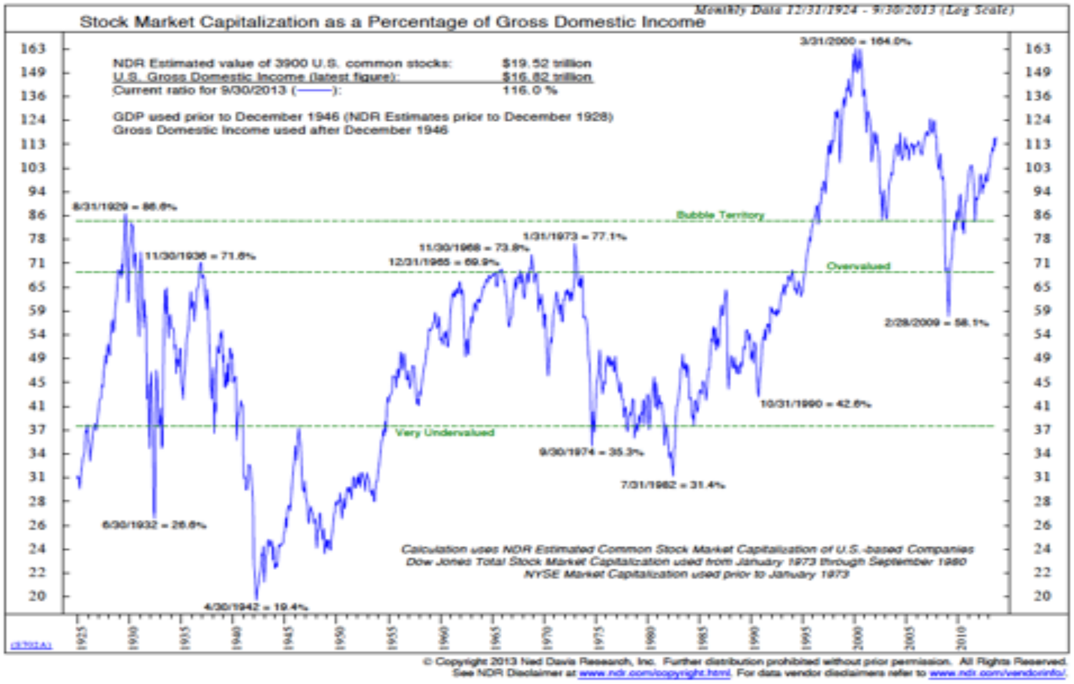
Source: U.S. Treasury

The Fed's extreme policy measure of keeping short-term interest rates at very low levels for an extended period of time has lead to other knock-on effects and unintended consequences. The next chart shows the level of margin debt in the securities market. Margin debt is debt that can be borrowed from brokers to invest in financial assets, mostly stocks. The stocks purchased are the collateral for the loan. With short-term interest rates near zero, borrowing is inexpensive. The blue (darker) line shows the explosive growth of margin debt since July 2012 and is clearly a result of the Fed's extended use of its zero interest rate policy. The current level of margin debt is now at the same level as during the Internet and Housing Bubble periods.

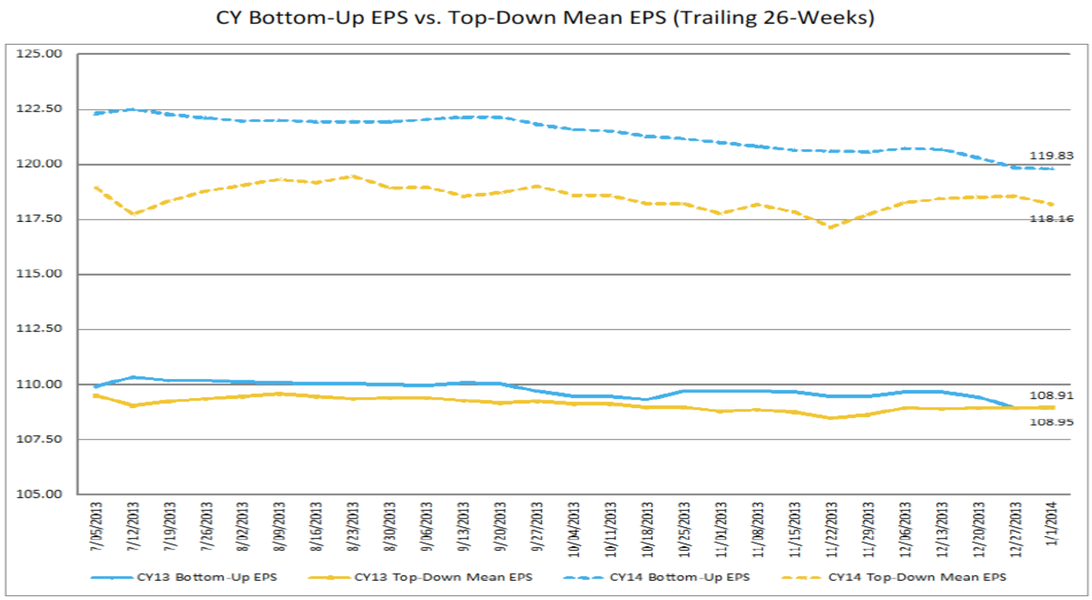


Source: motleyfool.com

The outsized performance of stocks relative to other financial assets during 2013 is extreme, particularly given the state of the U.S. economy. When Fed policies make it impossible to earn decent returns on any investments except stocks, it's not surprising these types of distortions can occur. As noted the following chart from Ned Davis Research, which shows the relationship since 1925 between stock market capitalization and U.S. Gross Domestic Income, the stock market's valuation relative to the growth of the U.S. economy is once again at extreme levels. This relationship is not as extreme as the Internet Bubble but is near the level of the Housing Bubble. Alan Greenspan ("the Fed was not a propagator of the housing bubble") and his protégé Ben Bernanke ("there is no national housing bubble") were the dynamic duo at the helm for the last two bubbles. Ben has bowed out and passed the baton to Janet Yellen, Vice Chair of the Fed the past three years, who gets to take over this monstrosity and figure out how to effectively exit from QE without blowing up the Mother Ship. Because the stock market's valuation is so high relative to GDI, any correction will have a negative impact on the entire system. Should GDI growth accelerate and the stock market returns remain low or flat, the current overextended nature of this relationship would ease.

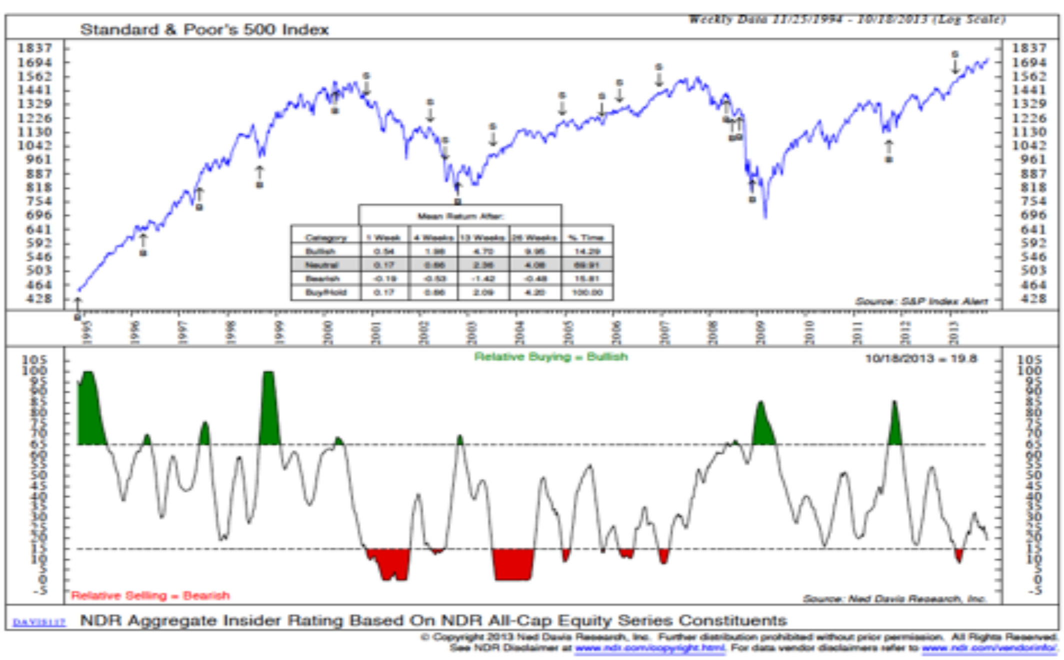


Many talking heads and cheerleaders on CNBC will have you believe that strong profit growth was a key factor on the outsized returns of stocks during 2013. If you check back to our 2013 Investment Outlook published in January 2013, the S&P 500 Index top-down (forecasts by Wall Street strategists) operating earnings estimate for 2013 was at $108/share at that time. The bottom-up (stock analysts) estimate was $113/share. If strong profit growth were the main factor for the >30% return of stocks in 2013, actual earnings for 2013 would be significantly above the estimates made at the start of the year. In fact, as shown in the next chart from Factset Research, the current 2013 S&P 500 operating earnings estimate (yellow line at bottom) is still near $108/share. This figure is three quarters of actual earnings plus the fourth quarter estimate, and represents only 6% profit growth from 2012 and no change from the start of 2013. The top two lines in the same chart show that the current top-down and bottom-up 2014 operating earnings estimates are around $119/share, which would represent year-over-year growth of 10%. The history of bottom-up estimates is that they start high and come down as the year progresses, such as happened in 2013. It remains to be seen if 10% earnings growth bar is too high.



Source: Factset Research

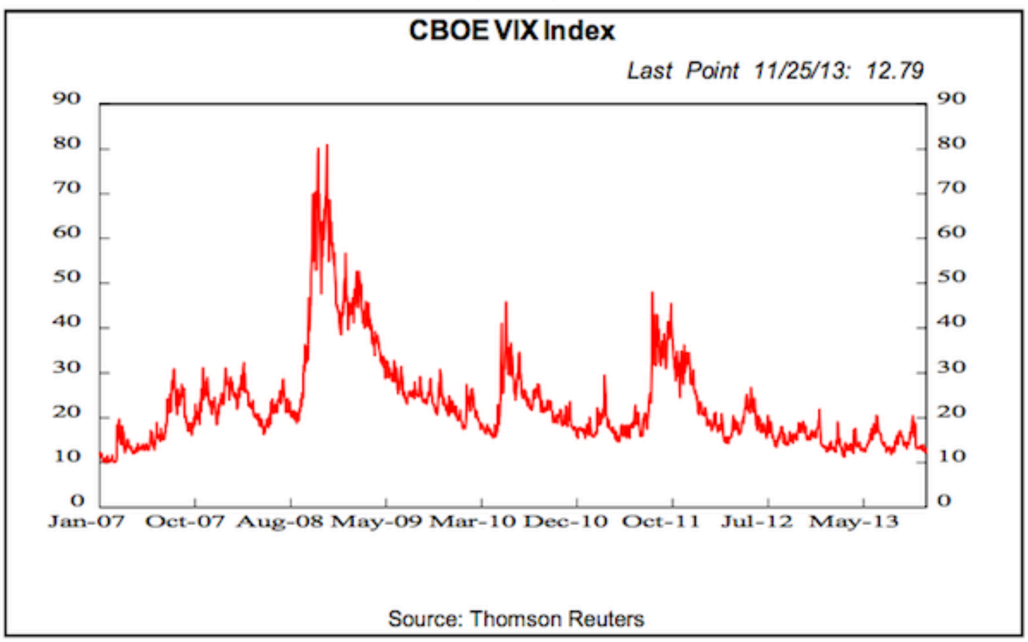
Insider selling is another internal market dynamic that is worth keeping an eye on for signs of market froth. Insiders are defined as senior corporate executives or Board members with meaningful share ownership in a publicly traded company. As the market continued to move higher during 2013, insiders were increasingly selling their shares. Although it is perfectly normal for insiders to book profits on stock gains over time, it is when the selling becomes extreme that one needs to become wary since insiders know the prospects of their company the best. As can be seen in the next chart from Ned Davis Research, as the market has rocketed to new highs, the insider-selling ratio is approaching the low end of extreme negative readings level.



Another indicator of high market valuations that is similar to insider selling is the number of Initial Public Offerings or IPOs coming to market. As with insider selling, where insiders are selling out of shares as prices head higher, owners of private companies want to take their companies public at a time of high stock prices and strong demand. The strong market advance lead a bang up year for IPOs in 2013. According to Renaissance Capital, a total of 222 companies went public during 2013, raising $55 billion, the highest level since the Internet bubble peaked in 2000, when 406 companies went public and raised $73 billion. The FTSE Renaissance U.S. IPO index, which measures the performance of IPOs once they are publicly traded, increased 63% during 2013. There is one major lesson learned from the Internet bubble era. While the returns earned during that period were extremely positive, the returns in the subsequent years (previous chart, 2000-2002) were not too pretty.

Another aspect of the Fed's extreme policy measures is its distortion of the natural order of things, particularly as it relates to market risk. The next chart plots the CBOE Volatility Index, which is a measure of the market's expectations of near-term stock market volatility. Since July 2012, when global stock markets last experienced a major hiccup brought on by a short-term European sovereign debt crisis, stock market volatility has been on a steady downward path and is now near all time lows. The knowledge that the Fed is implementing QE and has the back of risk investors, so to speak, has lead to artificially low levels of volatility. Now that the Fed has announced the start of QE tapering, market volatility may be more pronounced than it has been since mid-2012. This is not necessarily a bad thing as complacency levels are high and investors need to be reminded once again that there is a risk side to investing as well.

CHART 5

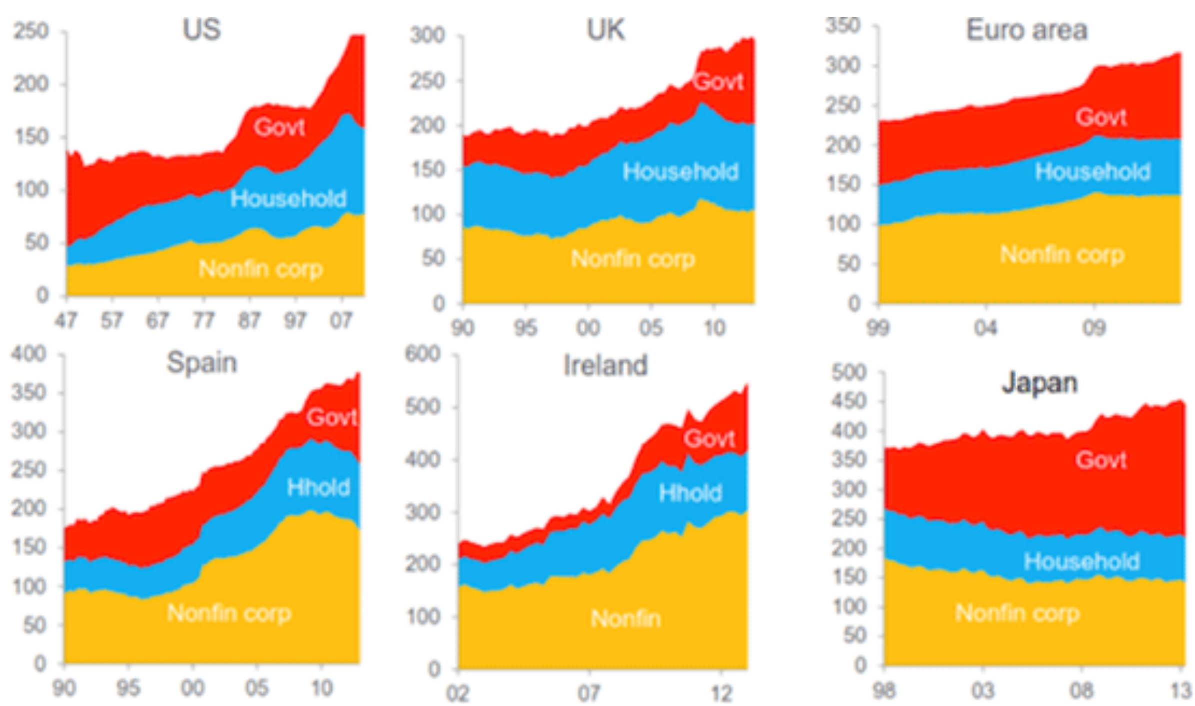


2014 Investment Outlook

As Mr. Ed and I sat down (okay, I was actually sitting on him), to discuss the current investment environment, the overriding (no pun intended) theme of our discussion was how the QE Era has been extremely beneficial to owners of risk assets. However, QE has not translated into meaningful improvements to the global economy or to the excessive debt problem that created the global financial crisis in the first place and brought us into the QE Era. Let's have a look at the current global debt picture.

The next chart shows a hysterical, oops, rather, a historical profile of economies with high levels of gross debt as a percentage of GDP.

Gross debt as % of GDP (excl. financial sectors)

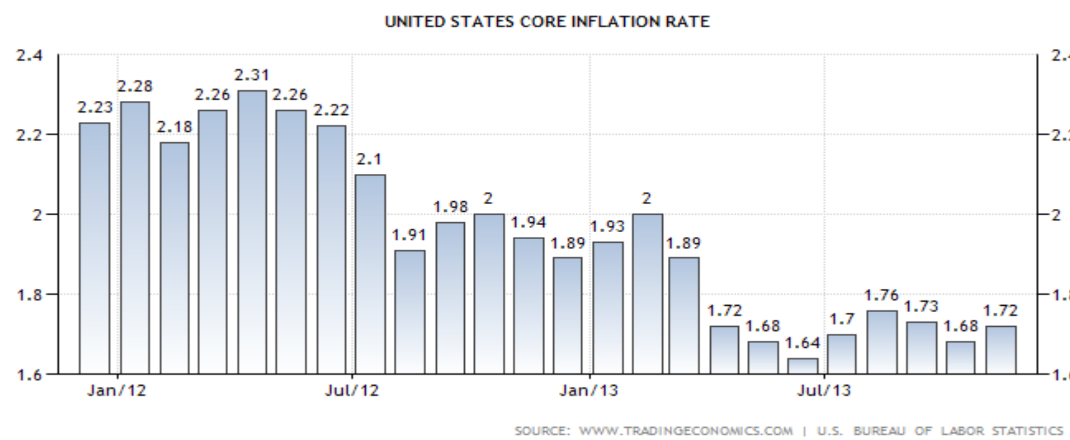


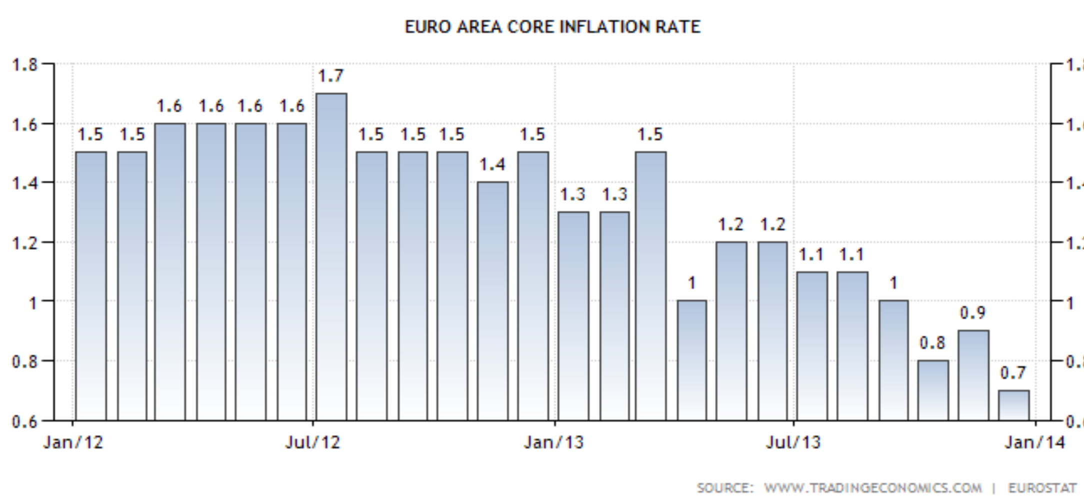
Source: Back to Black, Citi Research, October 2013.

While household and corporate debt (bottom 2 sections) as a percent of total debt is starting to flat line or in some cases decline in most major economies, total debt remains at very high levels. The main reason is that governments (top section) continue to increase their outstanding debt via deficit spending. Governments rely heavily on GDP growth and the resulting increase in tax revenues to fund spending. Despite massive monetary stimulus programs, most major developed economies are stuck at very low levels of real GDP growth. Taxes have not been able to recover sufficiently since the start of the global financial crisis to offset continued outsized government spending levels. In Europe, austerity programs to reduce government spending reached a tipping point where citizens started to push back against further cuts. The U.S. never bothered to implement any austerity programs (with the Fed doing all the heavy lifting, why bother?) during the financial crisis and the most recent budget passed by Congress (the first in four years) actually raised spending by a modest amount over the next two years. U.S. total debt outstanding now exceeds $17.3 trillion ($55,000 per person). Global QE programs have been able to keep a lid on the interest rates paid by governments on their debt, as central banks like the U.S. Federal Reserve have been large, unnatural buyers of sovereign debt. Despite a stock market roaring ahead and making some feel much better about their financial wealth, the underlying problem that started the global financial crisis in the first place has not gone away and remains a major macro risk. Additionally, excessive debt acts as a tether on GDP growth.

Deflationary Trends

Perhaps one of the most surprising aspects of the QE Era is that the extreme monetary policy measures being implemented by the Fed and other major global central banks has not yet lead to inflationary pressures. One major factor in the large decline in the price of gold and some other major commodities last year was the fact that global inflationary indicators came in below expectations. As shown in the next two charts, U.S. and Euro Area monthly core inflation rates moved lower during 2013 and remain at low levels. The fact that this is happening fours years into a global economic "recovery" is disturbing and is certainly a concern of central banks (as if they are not overly stressed out already).





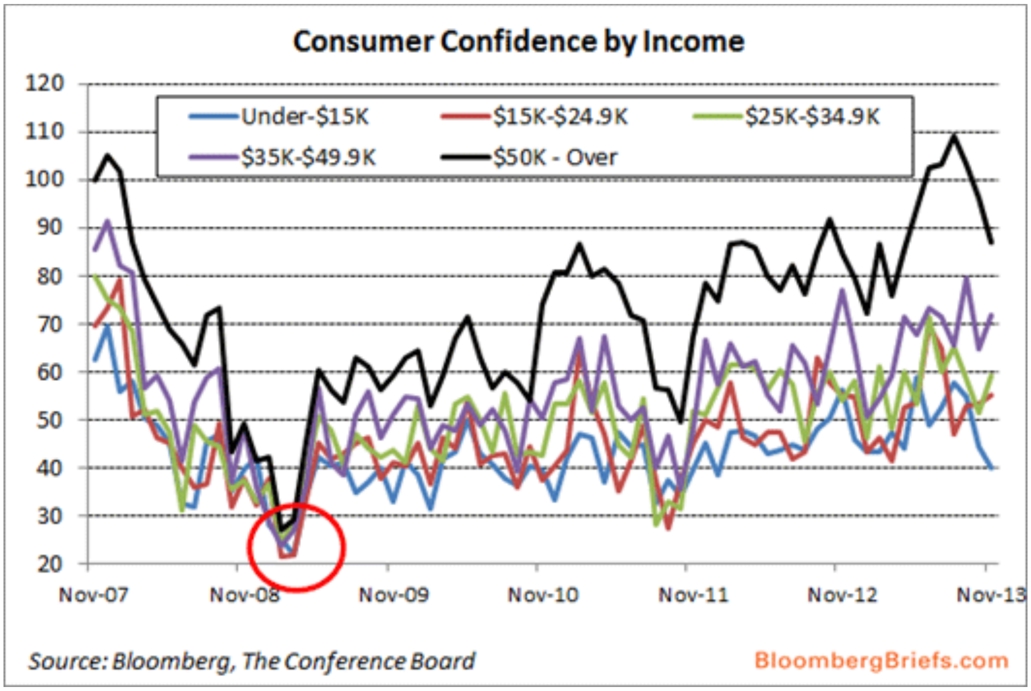
Perhaps it is not surprising that the two largest economic regions with excessive debt levels are seeing deflationary trends and despite the fact that their central banks are pumping massive amounts of liquidity into the financial system. One of the major goals of the Fed at the start of the global financial crisis was to shock the system and implement policies to ensure that deflation did not take hold a la the Great Depression. To date, QE has not been successful in this regard because debt levels remain too high and real GDP growth has been unable to reach the level of velocity to create natural inflationary pressures. Weak job growth has also played a part as well. Despite the infusion of liquidity by the Fed, many banks are keeping excess reserves parked at the Fed instead of moving them into the economy. There is nothing that scares a central banker more than deflation, and should these low inflation rates continue, it may impact the speed and timing of how the Fed implements its QE tapering during 2014.

All that being said, inflation expectations seem to be on the rise again since the December Fed meeting as noted in the next chart.

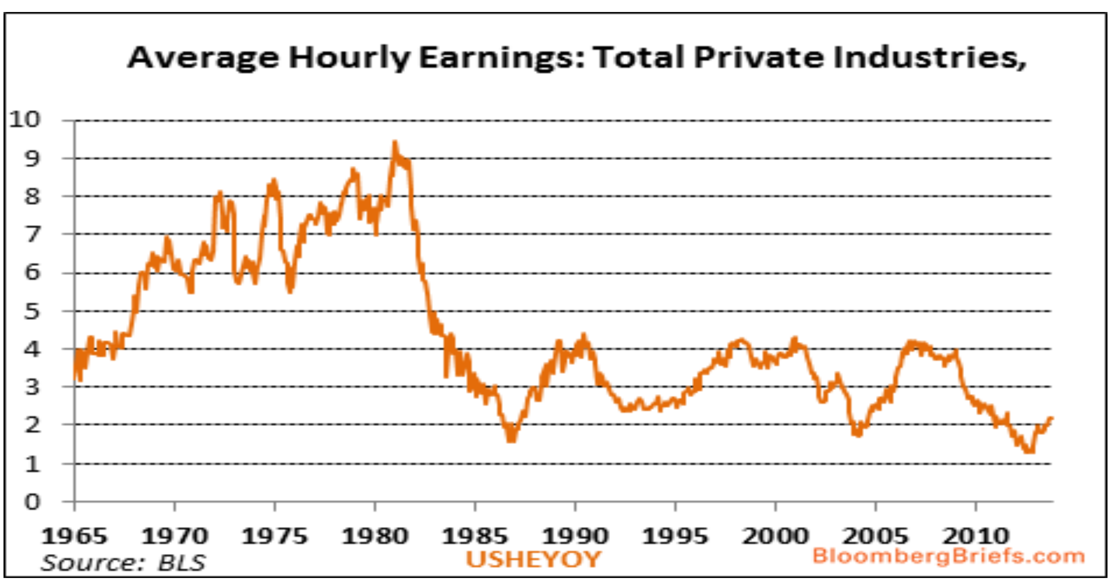
Source: Bloomberg

Consumer Confidence

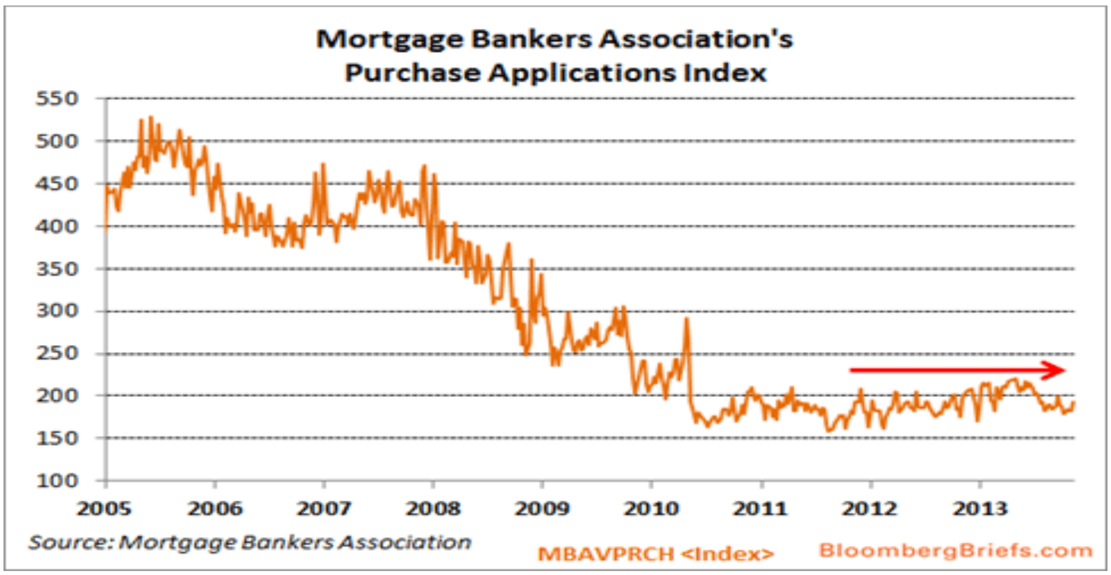
Mr. Ed astutely points out that anytime U.S. stocks make big gains like they did in 2013, it will naturally have a positive impact on investor and thus consumer confidence. High-income consumers benefit the most from the rise in the value of risk assets since they own a disproportionate amount of them. As shown in the next chart, as the stock market rocketed higher since the March 2009 lows, the confidence indicators for higher income Americans (black line) have also moved higher. However, for consumers in the lower income tiers, confidence remains sub-par and mired below levels before 2007 when the economy was on steadier ground. The two main reasons are 1) the stock market advance has meant little to them as they have little to no exposure to stocks, and 2) job growth and wage gains for consumers in these lower income tiers remain weak.



As shown in the next chart, average hourly earnings growth last peaked around 2007 and has moved steadily lower before the recent uptick to the 2% level. It is extremely difficult for real GDP growth to exceed 2.5% when the vast majority of Americans have had such low wage growth for an extended period of time. To have healthy economic growth, the consumer has to do its part since consumer spending is such a large part of the U.S. economy. For the vast majority of Americans, what matters more is jobs and wage gains, both of which have been tenuous during the QE Era.



A more important asset for most Americans is their homes. The news here was good for 2013 as the Case-Shiller National Home Price Index advanced 11% during 2013 and some of the more depressed real estate regions saw even bigger gains (i.e., Las Vegas). While home prices recovered nicely, purchase applications data shows that housing activity remains meaningfully below the bubble peak of 2006-2007. Even though Fed policies have kept mortgage rates at historically low levels, purchase applications have remained stuck in a fairly depressed range since mid-2010. News of QE tapering and the resulting 1% rise in mortgage rates had a negative impact on housing activity as new home purchase applications quickly headed lower (the far right end of the next chart). A strong housing market requires job growth, wage gains, and consumer confidence. To date, QE has failed to create positive momentum in any of these areas outside of the high-income tier. Unsurprisingly, the one segment of the housing market that is doing very well is high-end homes in major metropolitan areas.

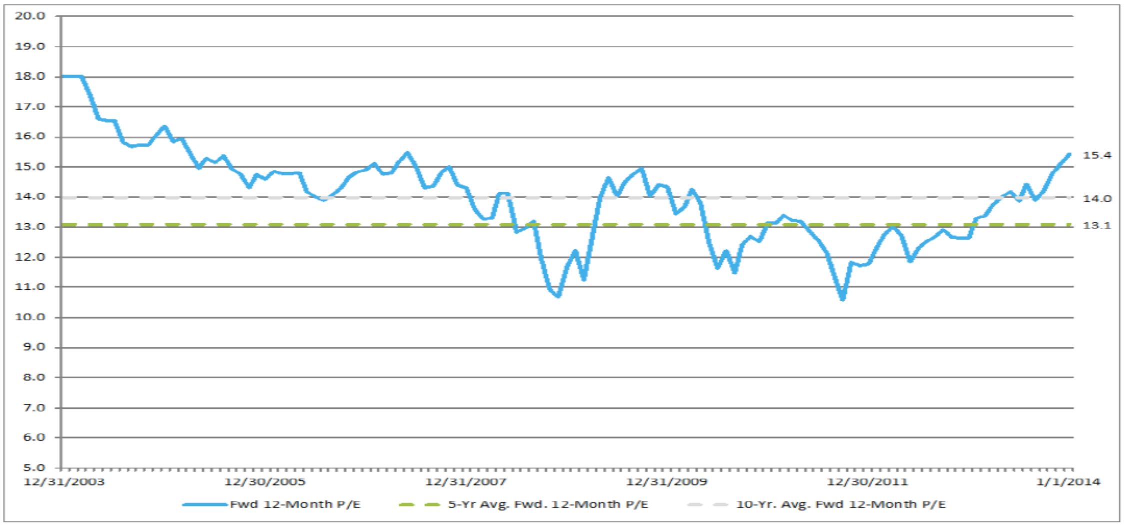


The Song Remains the Same

Based on the Fed's recent policy statement, short-term rates are likely to remain low until at least through 2015. Therefore, short-term investments will continue to offer investors little to no return potential in 2014. As soon as the Fed announced its intent to start the QE tapering process, longer maturity bond yields headed higher. If the economy continues to see gradual improvements as it did throughout 2013, the Fed will most likely continue with tapering and the pressure on yields should be to the upside. If the economy accelerates and inflation expectations move higher, it will be another ugly year for bond investors.

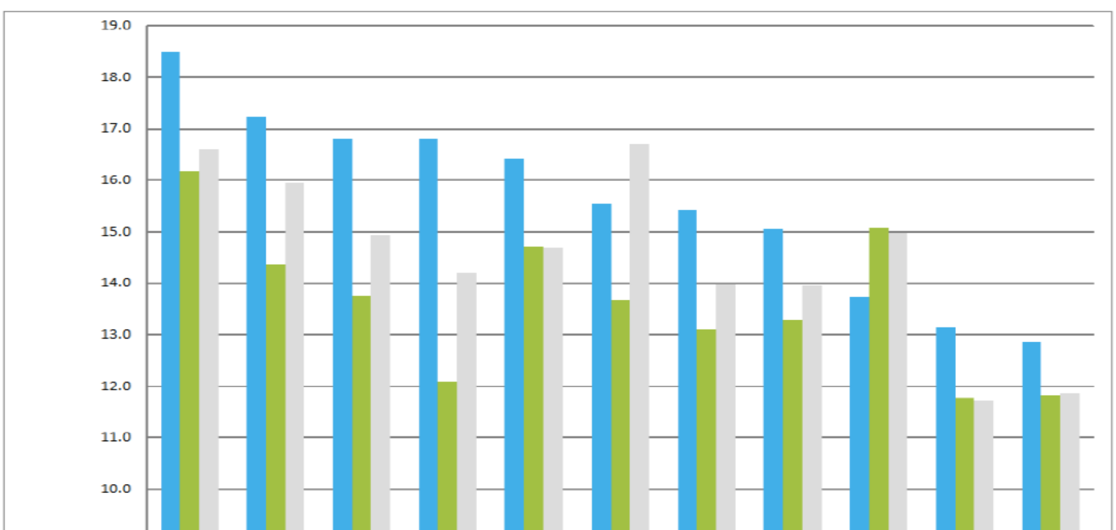
Under QE, stocks remain the only game in town where an investor has the chance to earn a decent return on investment. However, the 30+% advance for U.S. stocks during 2013 has pushed valuations much higher and the risk/reward profile for stocks is less attractive. For all the tailwinds that QE has provided to U.S. stocks over the past five years, the withdrawal of QE is likely to turn those tailwinds into headwinds or at least a dead wind. A potential offsetting factor could be the U.S. economy exceeding a 3% real GDP growth profile such that corporate revenues and earnings can exceed expectations. A better economic outlook in Europe would help as well. However, the stock market has already priced in a 10% profit growth outlook for 2014. In light of the market's valuation profile, Mr. Ed believes it is going to take an upside surprise in earnings growth for stocks to get more giddy-up and go.

Forward 12M P/E Ratio: 10-Year



Based on last year's large stock market advance, valuations for U.S. stocks are now more stretched. The above chart shows the S&P 500 Index has a 15.4X 12 month forward PE, towards the high end of its past 10-year average profile. The chart below shows that the only sector of the U.S. stock market trading below its 5 and 10 year forward 12 month average P/E is telecom services. Some of the more cyclical sectors such as Consumer Discretionary and Industrials are well above their averages of the past decade.

Sector-Level Forward 12-Month P/E Ratios



	Consumer Disc.	Consumer Staples	Industrials	Health Care	Materials	Info. Technology	S&P 500	Utilities	Telecom Services	Energy	Financials
Fwd 12M P/E	18.5	17.2	16.8	16.8	16.4	15.5	15.4	15.0	13.7	13.1	12.9
5-Yr Avg.	16.2	14.3	13.7	12.1	14.7	13.7	13.1	13.3	15.1	11.8	11.8
10-Yr Avg.	16.6	15.9	14.9	14.2	14.7	16.7	14.0	14.0	15.0	11.7	11.9

If the S&P 500 Index earnings forecast of $119/share turns out to be accurate, the stock market's multiple is going to have to expand even more for investors to earn decent returns from stocks in 2014. If global economic growth exceeds expectations, and earnings forecasts exceed current estimates, stocks can deliver positive returns. The table below provides a framework of potential return outcomes for U.S. stocks using a range of S&P 500 Index earnings and multiples and from a starting point of the January 10th S&P 500 Index close price of 1842. Note that the market multiple (now at 15.4X) will have to expand even more and earnings will also need to surprise current expectations for stocks to deliver double-digit returns during 2014. Wall Street stock strategists have an average return expectation of 4.1% for 2014 (see chart on page 2).

	$115	**$119**	**$125**
15X	-6.4%	-3.1%	+1.2%
16X	-0.1%	+3.4%	+8.6%
17X	+6.1%	+9.8%	+15.4%
18X	+12.4%	+16.3%	+22.1%

Summary

Who better than Mr. Ed would know that all good things must come to an end. His own show only lasted a little over four years when he was put out to pasture. He now spends most of his spare time on the riding circuit. The beginning of the end of QE is now upon us but QE, given the size of the program, will remain a key factor on financial asset returns during 2014. The pace and timing of the tapering process will be a very delicate matter for the Fed to manage as the U.S. economic recovery remains tentative. A faster pace of QE withdrawal and bond yields will most likely move higher. If rates rise too quickly, it could undermine stocks and hit interest rate sensitive areas of the economy such as autos, which have been bright spots in a dull landscape. The stock market is up dramatically during the QE Era, and it is reasonable to expect some level of payback as we head down the slippery slope on the other side of QE Mountain. Should the U.S. economy kick into gear and start growing consistently above 3% real GDP growth, and jobs gains move consistently above 200,000 per month, then Janet and the Fed Boys may be able to pull the rabbit out of the hat. There's always hope, right?

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January 12, 2014

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