FVCM

U.S. Market Report

F&V Capital Management, LLC
805 Third Avenue, #1203
New York, NY 10022

H. Terrence Riley III, CFA
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Contact: Karin Mueller
+1(212) 326 9533 [***kmm@fvcm.us***](mailto:kmm@fvcm.us)

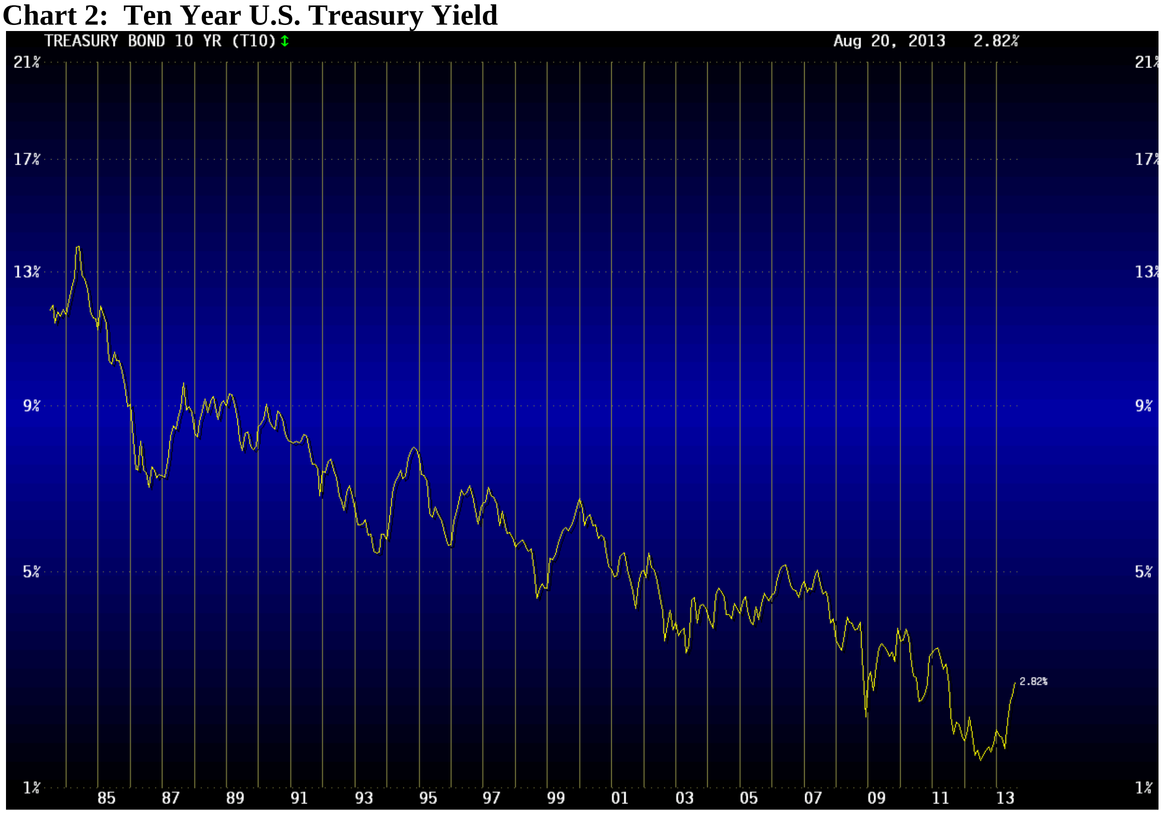
S&P 500

The current market environment is a good reminder of how there often is almost as much fear and trepidation during Bull Markets as during Bear Markets. Stock prices have been in a fairly steady upward march for several years now and all along the way, almost like "prophets" predicting the end of the world, there have been repeated forecasts that the stock market is about to collapse. Every 5% downward move is filled with warnings of imminent disaster. This most recent pull-back in stock prices has been accompanied by concerns regarding some meaningful issues, like Federal Reserve policy and rising bond yields, as well as some very silly warnings such as the appearance of the frightening sounding "Hindenburg Omen." The big picture is this: Bull Markets end in excess. Bull Markets end when economic growth is strong, spending is high, asset prices excessive and the Fed is trying to cool things off. Today, there is still surplus labor, surplus factory capacity, low inflation and lots of room for future growth. US government deficits have declined from 10% of GDP to 4% and are still declining. Household debt is down and debt service payments as a percentage of income are now at the lowest level in 30 years, and employment and income is rising. Under these circumstances, it seems likely that any decline in stock prices will be relatively modest in magnitude and short in duration.

The Federal Reserve is the culprit in the latest softness in stock prices because of warnings that "Quantitative Easing (QE)" will be scaled back starting this year. Specifically, on June 19th Fed Chairman Bernanke said that the Fed could start reducing the amount of bonds the Fed purchases beginning in September, and that the whole program could end by mid-2014. Currently the Fed is buying $40 billion of mortgage securities and $45 billion of U.S. treasury securities per month. The current consensus is that the Fed will reduce bond purchases from $85 billion per month to $75 billion per month as of the September 17-18 Fed meeting. Two points are important: $75 billion per month is still highly simulative and, second, Bernanke has often stated that the tapering is data dependant. If the data continues to show moderate growth in the economy and unemployment continues to fall, then a reduction in QE is appropriate. If growth were to weaken for any reason, then QE will continue. Either direction, it seems to us, supports an ongoing Bull Market in equities. Our worries for equities will really begin when unemployment is low and inflation is accelerating. A lack of capacity and inflation are sure Bull Market killers. But we're not there yet so we consider each retreat in stock prices as a buying opportunity.

In our May 2013 report, we warned that that the 10 year US treasury yield could get back to at least 3% in the months ahead. We have just about reached that point and bonds are now looking more attractive. The yield on 10 year treasuries has been in a declining trend for three decades (see Chart 2 below). The recent increase has brought 10 year treasury yields near the top of the long term downward channel. And fundamentally, bonds look priced about right. With nominal yields at 2.8%, the real yield is somewhere in the 1.3% to 1.8% range. Real yields historically have been driven by real growth rates, so that range looks reasonable. While there could be some additional upward movement in yields as we near the September Fed meeting, bonds are generally looking over-sold at this point and some investment in this area may not be a bad move.

Chart 2: Ten Year U.S. Treasury Yield



Equity returns are determined by earnings growth and changes in valuation, such as P/E ratios. We see these factors pushing stocks higher. While the outlook for earnings growth remains unexciting, valuations have still not recovered to a fair level following the deep selloff during the financial panic of 2008-2009. For example, instead of looking at the market valuation in terms of the P/E ratio, we can consider the reciprocal ratio, E/P. The E/P ratio is the earnings yield of the stock market in much the same way the annual interest payment over price is a measure of bond yields. As shown in Chart 3, the earnings yield on the S&P 500 went from less than 2% to more than 6% during the financial panic as prices fell. Even after the recent gains in stock prices, the earnings yield is still about 5.6%, significantly more than the 2.8% yield on 10 year treasury bonds. The market estimates that earnings for the four quarters ahead will rise 4%-to-8%, a range that is consistent with our outlook. Even if valuation levels remain unchanged, and using the mid-point of that range, 6%, this would imply a total return of about 8% for the S&P 500 (6% in price gains plus dividends of about 2%). However, we think that it is reasonable to expect valuations to improve further as lingering fears are overcome and capital continues to return to the equity markets. A return of 10% to 20% in the year ahead is possible. In fact, if earnings grow 6% and the earnings yield falls to only 5.1%, the S&P 500 would reach 1900, a gain of 15%. Add to that dividends and it's easy to see the possibility of strong returns ahead.

Chart 3