FVCM

U.S. Market Report

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

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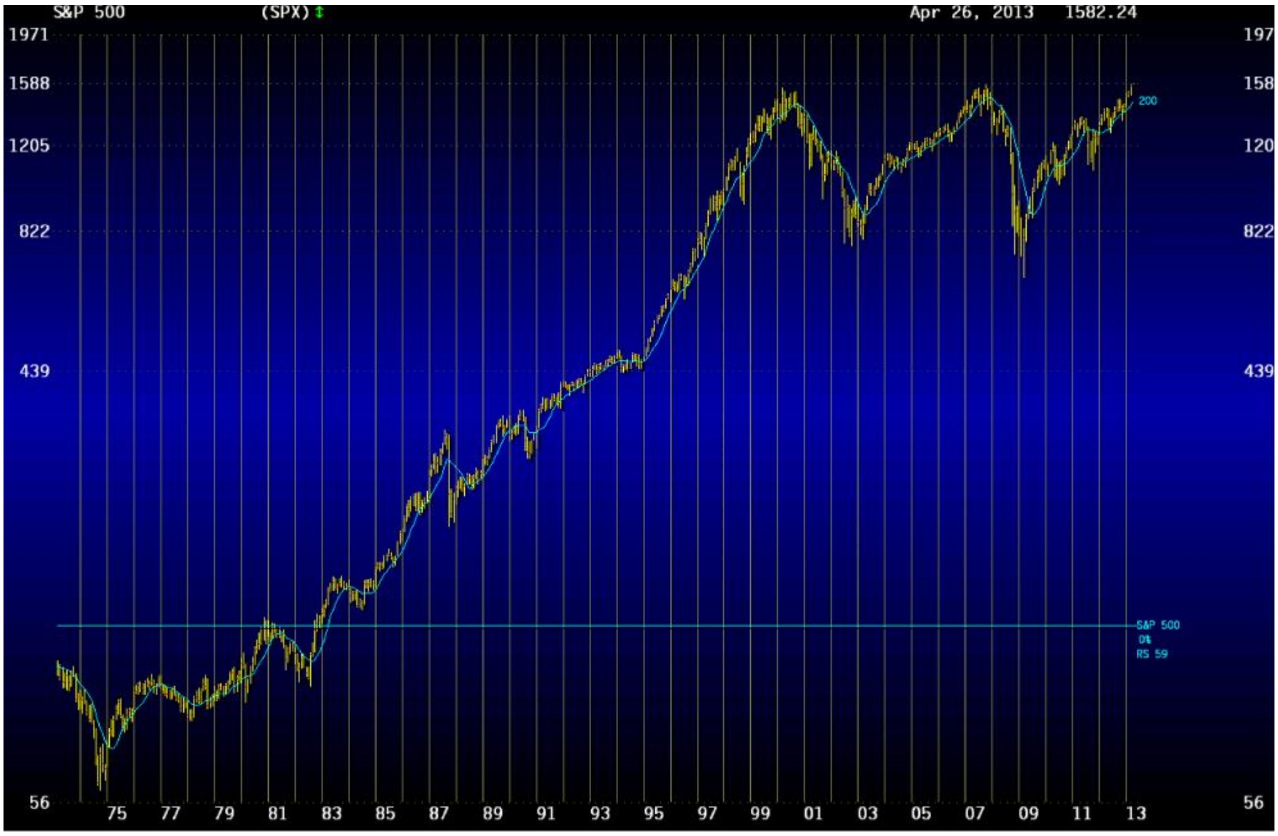
Contact: Karin Mueller
+1(212) 326 9533 ***kmm@fvcm.us***



Trends nearly always last much longer than people expect. The trend now in place is private deleveraging, easy monetary policy to offset the deflationary forces from deleveraging, and rising equity prices. Listen to the markets: Market volatility is low and back to where it was prior to the start of the financial crisis in 2007. Gold and other commodities have been declining in price. Bond yields remain at extremely low levels. And equity prices have passed the old highs set in 2000 and 2007 and show no signs of material weakness despite many predictions that a major correction is forthcoming. For sure, debt levels are still too high, but progress has been made since the 2007-2009 turmoil. Old warnings that the Fed's monetary policy would create high inflation have not come true. Instead, the Fed's policies have been sufficiently successful that the Japanese have now decided to implement an even more extreme version of quantitative easing (QE) in an attempt to end deflation in that country. And, if deflationary forces strengthen in Europe, we suspect that even the ECB will eventually move even more aggressively. These global conditions are favorable to equities and we expect markets to go higher.

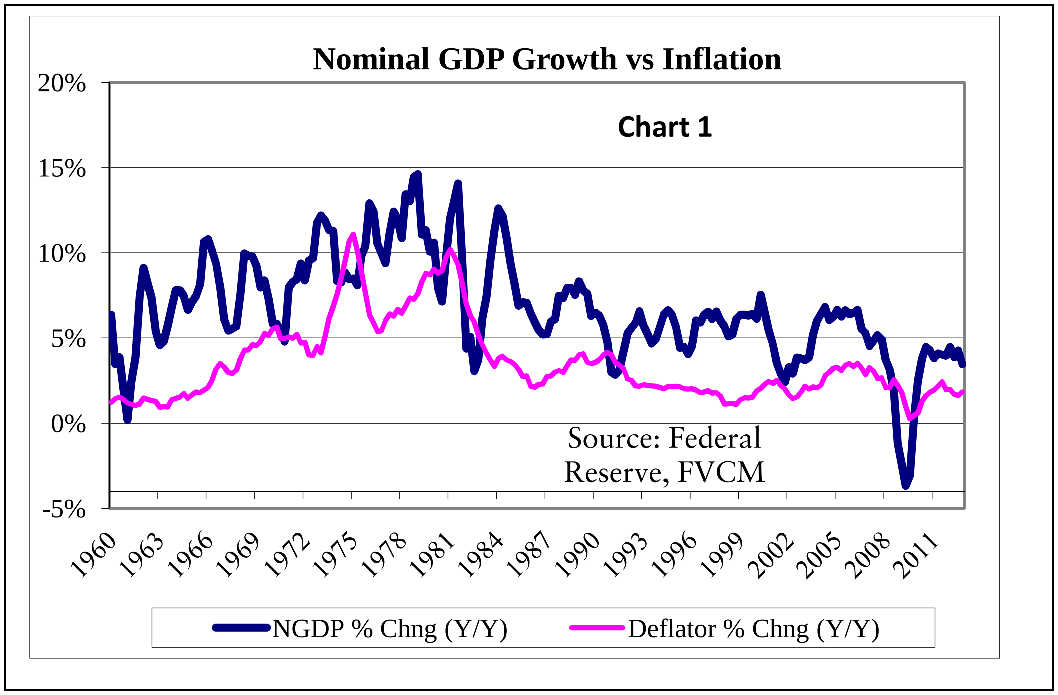
Gold & Commodities

We think that the secular Bull Market in gold that began after the tech bubble burst in 2001 is not over yet, but the next couple years may not be rewarding for the holders of the metal (although the miners should do ok). Let's be clear: there are no good ways to model or value gold. Despite assertions to the contrary, the price of gold does not correlate with the price level (inflation) or income except perhaps when the time period is measured in terms of generations. Nor are gold prices driven by economic growth or any other variable we can find. The most that can be said is that people buy gold as insurance in times of crisis. Many of the disaster scenarios that floated about over the past few years are starting to fade: talk about a collapse in the dollar or a breakup of the Euro are looking stale; inflation hasn't broken out despite loud howls of doom in response the Fed's quantitative easing (QE), and civil war hasn't erupted in Europe despite very high unemployment in places like Greece and Spain. On the contrary, some countries like Germany and the U.S. look like they are going to grow at a moderate pace. And while China may look softer, Japan is looking up and growth in the emerging markets is moving along. Because the perception of crisis conditions have been easing, gold has recently traded as low as $1,380, versus the peak of $1,895 per once back in September 2011. We would not be surprised to see gold move sideways in between a range of perhaps $1,400 and $1,600 as the global economy continues to heal. When the current cycle ends and a new crisis comes along, which may not be for another 2-4 years or more, gold will likely start to move higher again. In the meantime, investors wanting exposure to the metal should consider the mining companies like Newmont Mining, which should generate enough cash flow to keep paying very satisfying dividends to their shareholders.

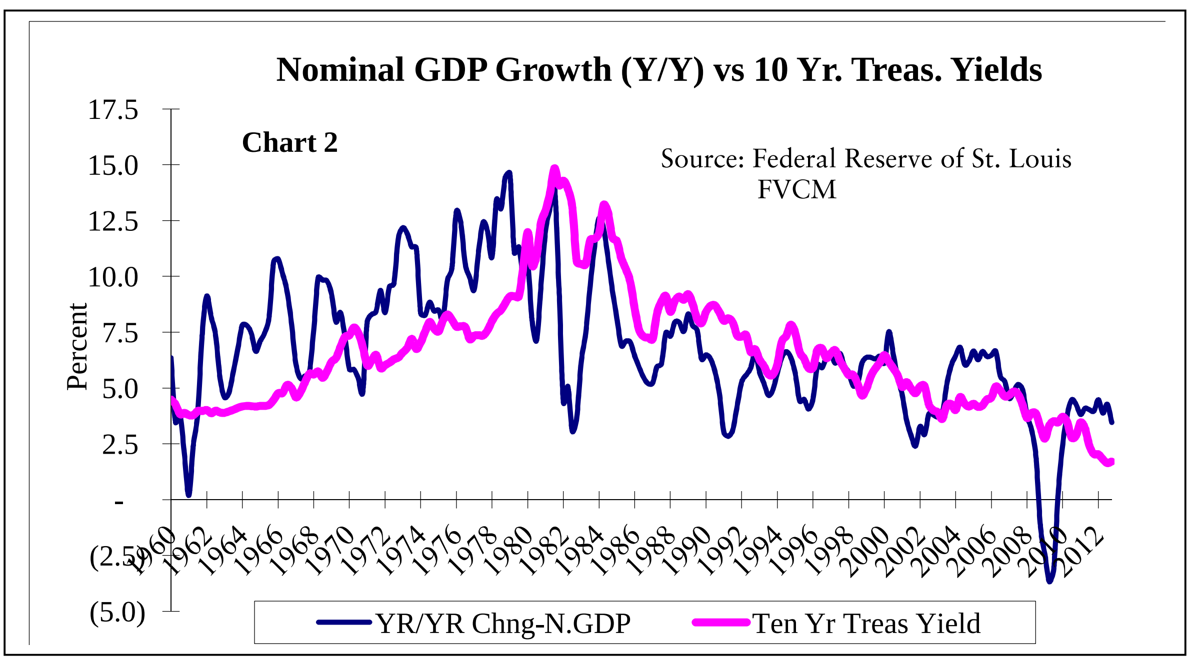
Basic and industrial commodities, particularly the metals, have also been weak during the past year. A huge rise in commodity prices is probably unlikely anytime soon, but at least some stability can be expected going forward. The questions about these commodities in some ways parallel the questions about gold. From our perspective, the central cause of the recent weakness is that commodities are coming off a speculative period when investors wanted "real things" and nothing to do with "financial paper." Of course this was a natural reaction to the financial crisis which was partly due to the collapse in markets for paper like CDOs, CMOs, CDSs, and other esoteric financial products that most people don't understand. The problem is that commodities are inert substances of little or no intrinsic value if not used in the production process of a value creating enterprise like a butcher, a baker or a multinational corporation. Speculators, perhaps even the Chinese government itself, artificially bid up the price of commodities and now the air is coming out of the balloon as excess inventories get worked off. The good news is that global economic growth continues and demand will rise in the years ahead. Therefore, we see not much further downside to most commodity prices.

Inflation & Bond Yields

There is little pressure in the economy that could produce a significant rise in either inflation or bond yields. A little background: Money has two primary purposes. First, money is used as a medium for transactions—you spend it. Second, it serves as a store of value—you feel good and safe because you have money in the bank and cash in your wallet. It is true that, ultimately, inflation comes from growth in the money supply. However, if expansion in the money supply is being used only to meet growing demand for cash balances, and not for spending, it is not inflationary. Money has to be spent in order to produce inflation. In fact, money has to be spent at rising rates for a sustained period in order for inflation to accelerate. As shown in Chart 1, inflation, as measured by the broad GDP deflator, rises and falls with growth in nominal GDP, which is the broadest measure of spending. Inflation lags spending growth by about two years. With the nominal GDP recently growing 3.5%, year-over-year, there simply isn't enough money being used for transactions to push inflation upward.



Spending growth determines trends in long term interest rates as well as inflation. And because spending growth has been soft, we may be more than a few quarters away before interest rates increase in any kind of a meaningful way. As shown in Chart 2, the yield on 10 year US treasuries has been in a declining trend for thirty years. Spending growth has rebounded from the negative rates of 2009, but yields seem unlikely to rise much until spending growth is sustained at a better pace than the recent rate of 3.5%. In the meantime, the money is flowing through the financial system like water seeking wider and deeper reaches, a phenomenon that largely explains the strength in the stock market. And when conditions accelerate and bond yield begin to rise, we would expect capital to flow strongly out of bonds and into stocks.



Currencies

One Euro will purchase goods that would cost about $1.25 in the U.S. according to data provided by the OECD. So based on this measure, known as purchasing power parity (PPP), the Euro is slightly overvalued. Nonetheless, while PPP is very good at determining foreign exchange rates over long periods of time, it is not useful for forecasting short run fluctuations. In periods measured in months, currencies are more closely tied to changes in relative interest rates as well as changes in perceived growth opportunities. Because the dollar and the Euro are very close to their fundamental fair values based on purchasing power, and because we don't see any big changes in the relative outlook of the Eurozone and the U.S., we would not expect any extreme movements in f/x rates. However, the Fed is already at a very highly accommodative level with QE and additional easing is not expected. In contrast, the very weak conditions in much of Europe suggest that there could be cuts in interest rates and possibly other actions by the ECB to combat deflation and contraction in the periphery countries. Therefore, while a large change in f/x rates may not occur, the gradual decline in the Euro that has been in place since 2008 is likely to continue (see Chart 3 below).

Chart 3

The U.S. Stock Market

On a nearly daily basis there are forecasters predicting a significant correction in stock prices. We think such forecasters are engaging in wishful thinking. The problem that many investment managers have is that they have been too bearish and they are underinvested in equities, which have been outperforming bonds and other asset classes. U.S. pension funds and other large investment pools, most notably the big university endowments, moved substantial amounts out of public equities over the past decade and towards real estate, hedge funds, private equities and other illiquid investments. Portfolio managers look bad when equities are strong and they own low yielding bonds or illiquid investments of unknown duration. It has been very notable that when the stock market experiences small pull-backs of even only 2%-to-3%, there seems to be an inflow of buyers to push prices back up again. It seems there are simply too many investors who have been on the sidelines and every pull-back is used as an opportunity to increase exposure to equities. These are bullish signs.

The recent earnings data has been mixed, but we still think that the S&P 500 could reach at least 1900 – 2000 (up more than 20%) before this Bull run hits a wall. The 2013 first quarter earnings reporting period is almost done. While sales have generally been weaker than expected, earnings have mostly been on target thanks to cost cutting, slow wage growth and operational efficiencies. Alcoa, the big aluminum manufacturer for example, boosted its first quarter earnings about 10% despite a 3% decline in sales. Many of the big U.S. companies have been blaming the sales weakness on the poor conditions in Europe. We expect sales growth for the S&P 500 to be in the low single digit range (1% to 4%) in 2013 but that earnings growth will be more like 3% to 6%. Earnings growth of only 4% or so may not be particularly strong fuel for equity prices; nonetheless, we expect the stock market to perform very well as liquidity flows into equities and valuations, e.g., price-to-earnings and price-to-book value, increase. Given the low rate of inflation and low interest rates, our model puts the fair value of the S&P 500 at about 1900, or about 20% above the current level. The combination of easy monetary policy, low valuations, and underexposure to equities by many investment managers and funds provides a very strong wind to the back. We do not anticipate a serious threat to stock prices until inflation starts to move higher, and that is unlikely for at least a couple years due to the deleveraging/soft spending growth issues discussed above.
