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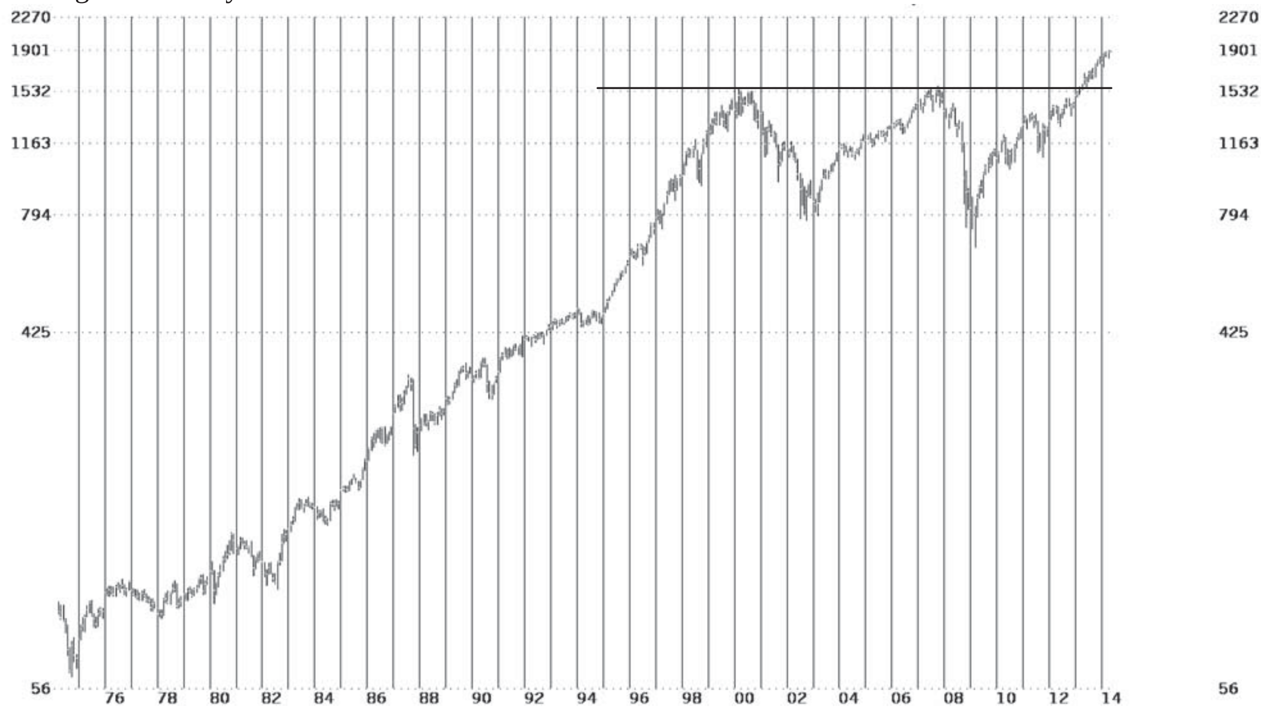
S&P 500
Closing Price 2 May 2014: 1881.14

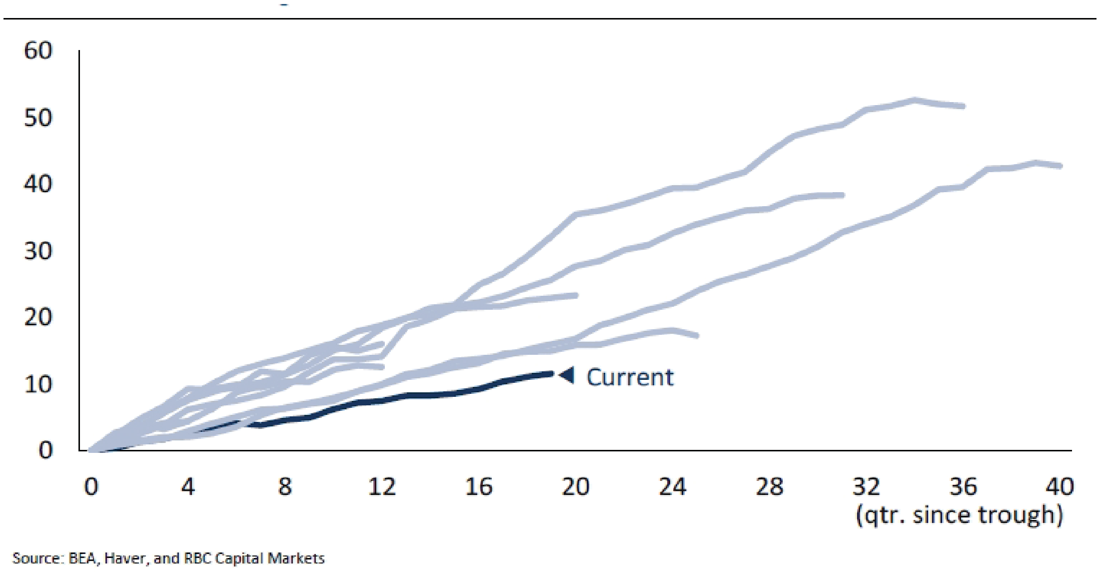


S&P 500 UPTREND REESTABLISHED: DON'T FIGHT THE TREND

- The current recovery has been the slowest recovery of the post-war period;
- The recovery in the housing market is modest, as is the recovery in business capital investment;
- The private sector has no appetite for debt or excessive spending;
- Slow growth means none of the excesses that precede recessions are in place;
- The Federal Reserve may continue to taper QE3, but interest rates likely to remain low until bank loan growth and spending accelerates, which is not foreseen;
- The expansion in the economy and corporate profitability should continue for years more, albeit at a moderate pace;
- There is no upward pressure in inflation, and stock valuations can continue to expand;
- The S&P 500 has broken through the old double top and the Bull Market likely has much further to go.

Our bullish call on the U.S. equity markets over the past five years has paid off well, and we think this strong upward trend still has a long way to go. We recommend investors stay overweight equities. The conditions that cause an end to Bull Markets are not in sight and, in fact, equities are benefitting from nearly perfect conditions. Greater detail will be provided below, but the fuel for rising stock prices is higher corporate profitability and stable or rising valuations thanks to low inflation. This we have. Corporate America has been through the wash during the decade following the Bear Markets starting in March 2000 and then again in October 2007 (see chart on previous page). Many excesses have been purged and there is significant capacity to expand: labor is available, capacity utilization is low, cash levels are high/corporate balance sheets are strong, and there is significant potential to expand capital expenditures as demand grows. Production and profitability have a long way to increase before constrains are reached. Only last year did the S&P 500 finally break out above the high first set back in the year 2000 and the trend should continue until new excesses are created. We think this will not occur until perhaps 2017 or beyond.

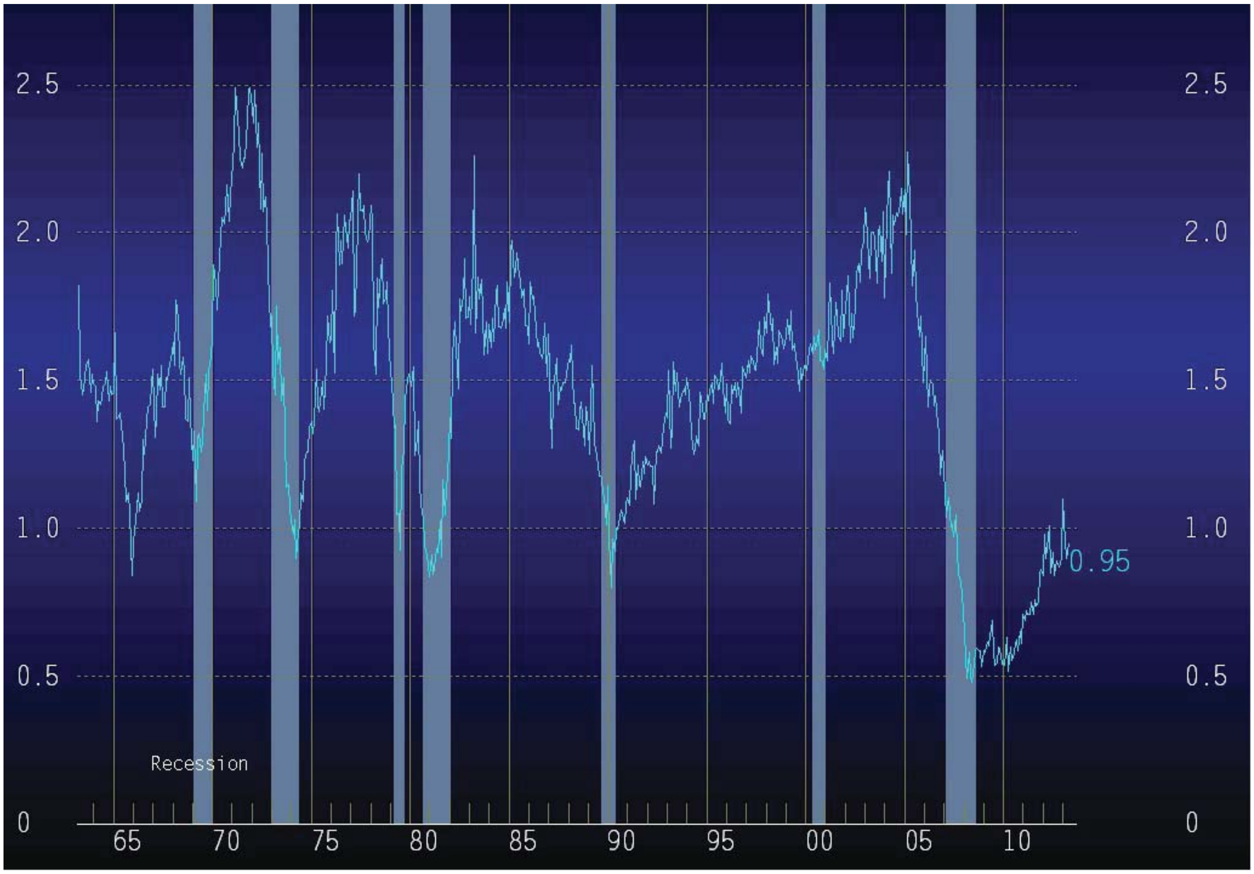
Chart 1: Cumulative GDP Growth Following Recessions



The current recovery is nearing its 5th anniversary and has been the slowest in the post-war era (see Chart 1 above), because loan growth is not providing the fuel for spending like past expansions. Much has been made of the fact that during past expansions, debt grew faster than GDP. However, during this expansion bank loans and leases have grown at only a 2.1% rate, while nominal GDP has grown at a 3.9% annual rate. The good news is that growth with little addition to debt is healthy and sustainable. The bad news is that the expansion is less robust compared to past periods which were fueled by high borrowing.

Interest rates are not low because of the Fed. Interest rates are low because there is no demand for loans. Fed policy has historically been reactionary. They lower rates in response to declining economic activity, and they raise rates when activity accelerates. Right now, both individuals and businesses are unwilling to borrow at all except at the very lowest rates of interest. Even a rise in mortgage rates from 3.4% to 4.4% over the past year has caused a fairly rapid effect as sales of existing homes dropped from a 4.8 million annual rate to a 4.0 million annual rate. People are unwilling to increase debt even at modestly higher rates of interest.

Chart 2: Housing Starts
Millions of units at seasonally adjusted annual rates
Recessions are highlighted by the vertical bars

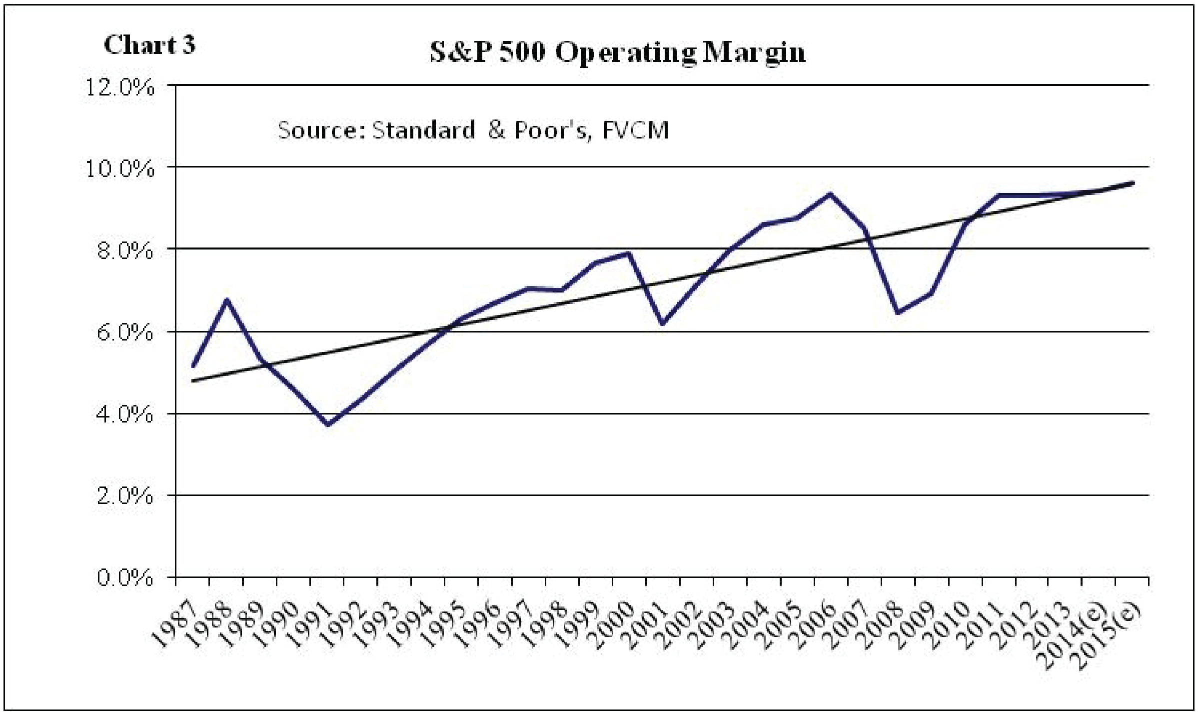


Source: Thomson Baseline

Historically, big drivers of economic recoveries have been strong increases in new housing construction and, with a slight lag, growth in business capital investment. These sectors are experiencing muted growth this time. There are about 118 million "households" in the U.S. In a normal recovery, about 1.5 million new households are created due to population growth. During this recovery, new housing starts have bounced off the recessionary low of fewer than 500,000 new homes, but have recently only gotten back to a rate of only about 1.0 million units despite five years of growth. This slow growth reflects, as already discussed, the unwillingness of people to take on debt unless at very low interest rates. But as we have suggested, this recovery likely has a long way to go because of pent-up demand and the absence of excesses. More houses need to be built in order to meet the demands of a growing population.

STOCK MARKET FUNDAMENTALS

Profit margins for the S&P 500 have been rising for years due primarily to a decline in wages as a percent of corporate costs. This has been a long term secular trend, not a short or medium term cyclical event. Earnings for the S&P 500 are forecast to rise 7% in 2014 to 118.50, and 8% in 2015 to 128.00, based on a conservative estimation of a continuation of the trend. It is not clearly understood why wage rates have been declining in a relative sense, but it likely has to do with declining transportation costs and more trade, better and cheaper means of global communications, and wage competition on a global scale. Trying to predict a reversal in such long term trends usually end up being a fool's game. Expecting a gradual continuation of the trend is likely more sensible. Furthermore, when the day comes that wage pressures begin to build from a secular standpoint, it will also most likely mean that corporate revenue growth will strengthen as workers have more money to spend. At that time, corporate profits will likely continue to grow due to rising sales even as margins come under pressure from wage costs. The bottom line is corporate profits have a natural tendency to grow. Recessions cause profitability to decline and, with plenty of real resources (labor, materials, etc) available, inflation low, and monetary policy being easy, there is no recession on the horizon.



The stock market valuation (P/E ratio), like bond market valuation (yield), is determined primarily by inflation. Inflation in the U.S. is low, there is no upward pressure, and it would likely take at least a couple years of rising spending before inflation accelerates. Inflation is the most dangerous and corrosive factor for the financial markets—especially bonds, but also stocks. When inflation increases, investors know that future interest or dividend payments will be less valuable in real terms, and thus bond yields rise and P/E ratios decline. The good news is that the current inflation rate is only 1.4% (using the GDP deflator, the broadest measure of inflation) and there is no upward pressure. It takes years of high spending before inflation accelerates and, most painfully, it also takes years for inflation to decelerate even when spending declines. In this way inflation is like a large and slow moving ship. Nominal spending growth has been a very steady average of 4%. According to our model, a 4% rate of growth in spending will produce inflation of 1.4%, which is exactly where it's now.

With inflation at 1.4%, the S&P 500 remains about 15% undervalued despite the recent gains and 10 year treasury yields are priced about right (see Chart 2 below). We estimate that the S&P 500 would be fully valued at a level of about 2200, or 18.5 times our earnings estimate of 118.50 for 2014 and 17.2 times the 2015 estimate of 128.00. These relatively high P/E ratios are "fair" for the same reason that 10 year treasury yields are "fair" at only 2.6%. Low rates of nominal spending mean low inflation, and low inflation means high P/E ratios and low bond yields. There is a lot of history going on in the 50 year chart on the next page, but a key takeaway is that bond yields follow spending growth because inflation follows spending growth. As previously mentioned, nominal spending (total GDP) has been averaging a very steady 4% in recent years. We expect bond yields to eventually rise, but we'll first have to see a lengthy acceleration in spending first. Similarly, P/E ratios will decline someday, but we'll first have to see spending accelerate, which would imply rising inflation. This will take time measured in quarters, if not years. In the meantime, high valuations should be expected.

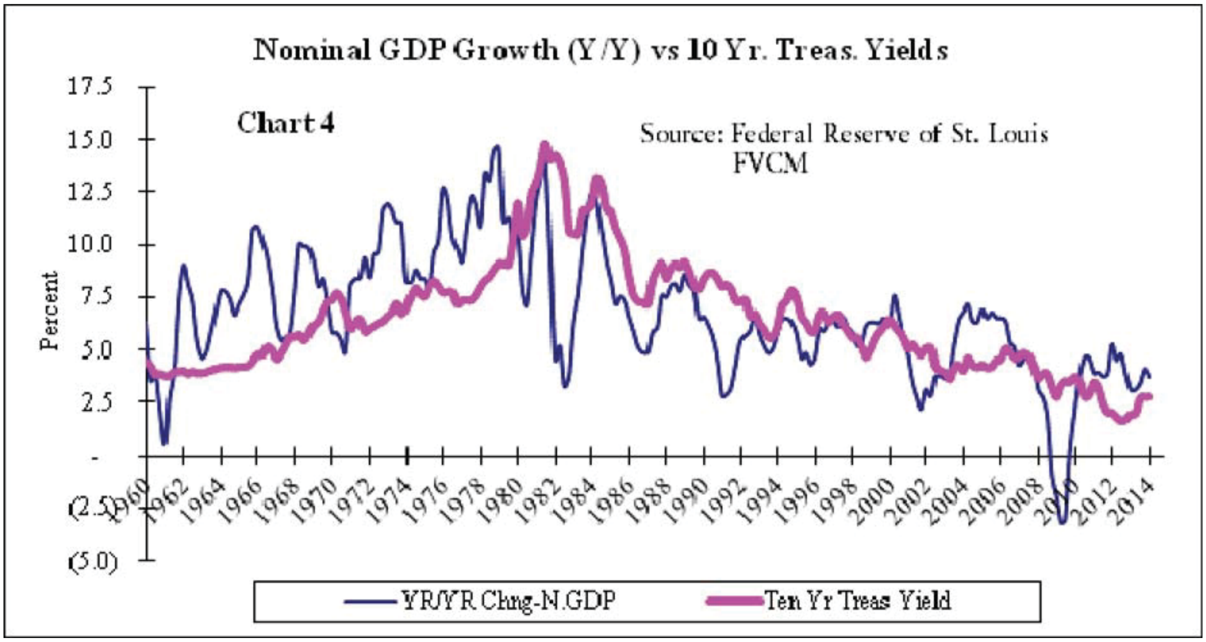


Table 1

Bull Markets

Trough	Peak	Return	# Mo.
Oct-66	Nov-68	48%	26
May-70	Jan-73	74%	32
Oct-74	Feb-80	90%	65
Mar-80	Nov-80	43%	8
Aug-82	Aug-87	229%	61
Dec-87	Jul-90	65%	32
Oct-90	Mar-00	417%	115
Oct-02	Oct-07	101%	61
Mar-09	Apr-14	175%	61

Source: RBC Capital Markets

Table 2

Bear Markets*

Peak	Trough	Return	# Mo.
Nov-68	May-70	-36%	18
Jan-73	Oct-74	-48%	21
Feb-80	Mar-80	-17%	1
Nov-80	Aug-82	-27%	21
Aug-87	Dec-87	-34%	3
Jul-90	Oct-90	-20%	3
Mar-00	Oct-02	-49%	31
Oct-07	Mar-09	-57%	17

Source: RBC Capital Markets

STOCK MARKET DYNAMICS

There are frequent stories in the press or calls by "market gurus" predicting a market crash or a new Bear Market. It's a good way to sell newspapers or a chance in the spotlight. But we think the evidence goes the other way. As shown in the Table 1, the current Bull Market is 61 months old, which is long but still far short of the Bull Market during the 1990s. Furthermore, the current Bull Market follows the deepest Bear Market in modern times (see Table 2). Given the depths of the last market decline, a long Bull Run would be normal. Furthermore, as we have argued in this report, the current recovery is slow but being propelled without a return to rapid debt growth and should be much more sustainable. As long as the recovery continues, we can expect rising corporate profitability and gradually increasing stock prices.

Events in the Ukraine or elsewhere always have the potential to create stock market volatility, but are unlikely to flip the switch from Bull Market to Bear Market. We are the first to admit that the events in the Ukraine, as well as Syria, the Sea of China, North Africa and elsewhere are disturbing. At any time, unpredictable world events can alter investor psychology and prompt a decline in prices. However, throughout history there have been negative geopolitical events in the background, and yet stock prices continued to be driven by market fundamentals such as corporate profitability and inflation. For sure the events in the Ukraine are negatively impacting that nation itself, as well as Russia. To a lesser degree, the events in the Ukraine pose a risk to Western Europe because of the close trading ties with Russia. In contrast, the U.S. is well insulated and it is difficult to see how the U.S. economy would be directly affected. In fact, there is growing discussion in the U.S. about the need to increase energy exports to Europe. Of course, such business opportunities would be slow in developing. Risk to the U.S. would obviously escalate if it gets to the point that Russia invades one of the Baltic States, which are NATO members. However, that does not appear to be a likely outcome.

Some short-term technical indicators, like a 56 reading for the RSI, suggest that the S&P 500 is a bit "over-bought" and a minor pull-back in prices is possible. But we're not too confident about that. Only recently have cash flows into equity funds turned net positive. There are large cash balances still being held and equities as an asset class continue to appear to be under-owned by individuals as well as institutions like pension funds and university endowment funds. It has become a practice for investors looking to raise their equity exposure to "buy on the dips." The problem for such buyers is that the dips never develop very far because as soon as prices begin to swoon, the cash starts to come in and cut the dip short. Instead of trying to buy on the dips, we think a more successful strategy would be to simply add capital to equity positions on regular intervals. Unfortunately, sometimes the dips only come after prices have already risen.
