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When Do Bull Markets End?
Hint: The Conditions Aren't There

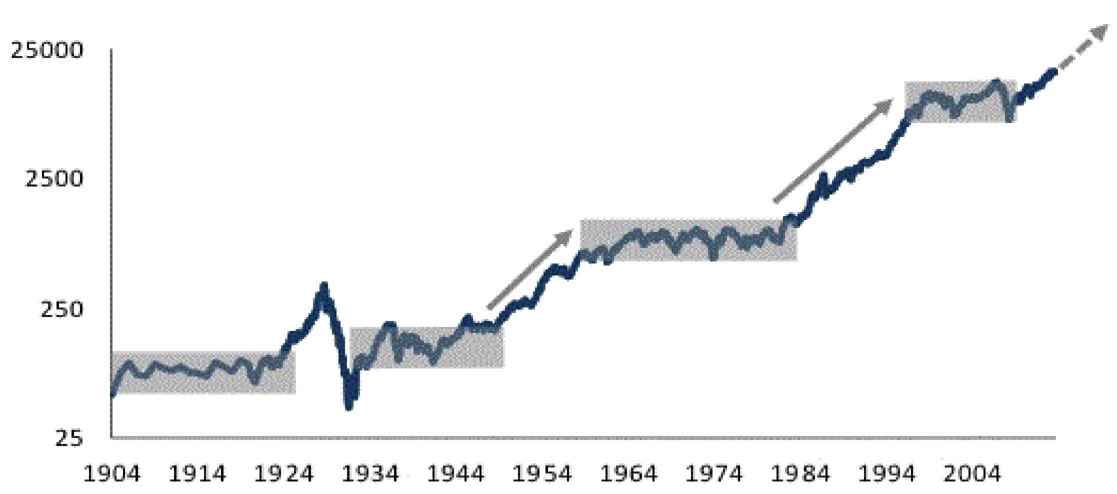
Persistent fear that stock prices are somehow being artificially inflated by either the Federal Reserve or stock buybacks, as well as turmoil in the Ukraine and the Middle East, have dominated public expectations. Dire warnings of imminent market corrections or crashes continue to float through the media. Nonetheless, stock prices have remained in a steady advance and the relevant economic indicators remain positive. We expect the upward trend in stock prices to continue despite the negative clamor.

Bull Markets don't end because valuations are high or because they have lasted too many months or years. Bull Markets end because of rising price pressure (inflation) and the risk of declining earnings because of looming recession. First, keep in mind that stock prices inevitably rise over time because of the unceasing march of human progress (see Chart 1 below). People everywhere are always building and finding new and better ways to live and produce. If you could only make one decision, buy or sell, BUY. There are, of course periods of stagnation or Bear Markets, but these reflect shorter-term constraints to growth, like insufficient labor, high factory utilization, tightness in commodity markets, and especially banking and financial reactions to those constraints and inflation. But, neither such constraints nor an inflation threat are presently an issue. Those who jump out of the market may find prices much higher before they ever get back in.

"The stock market serves as a relocation center at which money is moved from the active to the patient."
Warren Buffett, 1991 letter to shareholders

Chart 1

Super Cycle (Dow Jones Industrial Average)

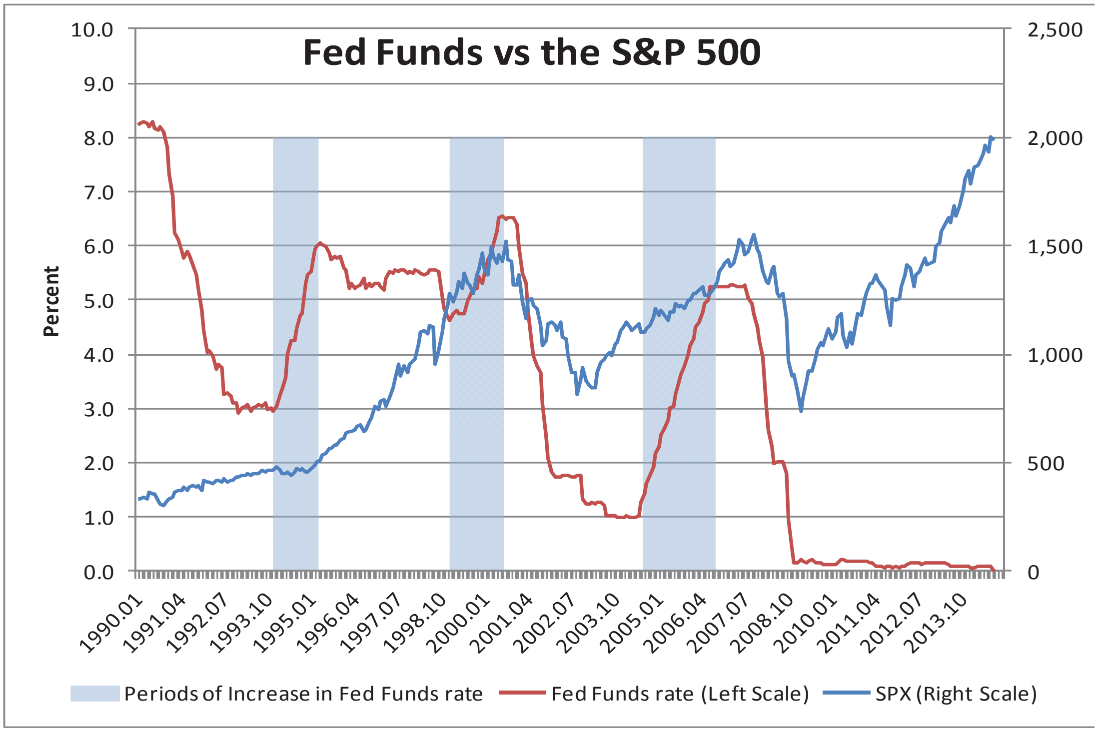


Note: Log Scale. Source: Dow Jones, Haver, and RBC Capital Markets

Another worry comes from people who fret about the uncertainties and risks from the actions of the Federal Reserve and the likelihood of rising interest rates. We are probably half way through the current economic cycle which began in 2009. Unemployment has fallen from more than 10% to about 6%, and capacity utilization is nearing normal levels. Accordingly, the Federal Reserve is expected to start raising the Fed Funds rate (the overnight bank lending rate) by about mid-2015. The reason this will be necessary is to normalize interest rates and prevent inflation from accelerating.

History has shown that rising interest rates will not interfere with a rising stock market as long as inflation remains contained. In Chart 2 below, we have highlighted three periods of rising Fed Funds rates. In all three periods stock prices continued to rise. Bull Markets are not killed by rising Fed Funds rates. They are killed by inflation and recession.

Chart 2

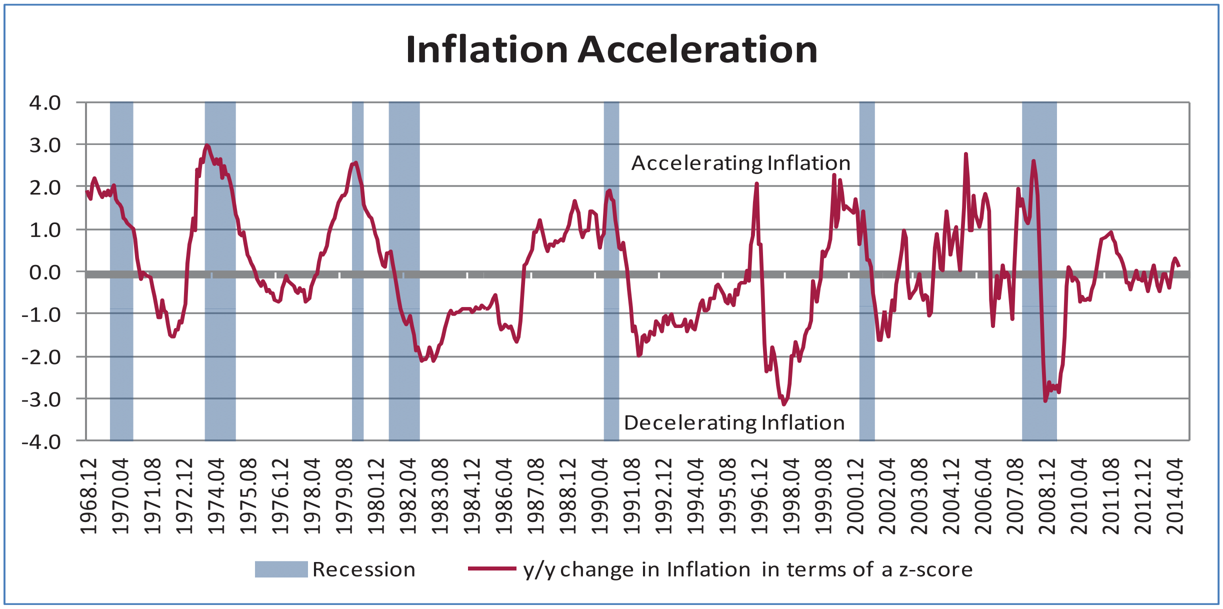


Source: Federal Reserve, Thompson Baseline, FVCM

The outlook for equity prices depends on a continuation of economic growth. The major indicators point towards continued expansion……..

Recessions are preceded by an acceleration in the inflation rate, which is the great poison of nations. Inflation is now low and stable.

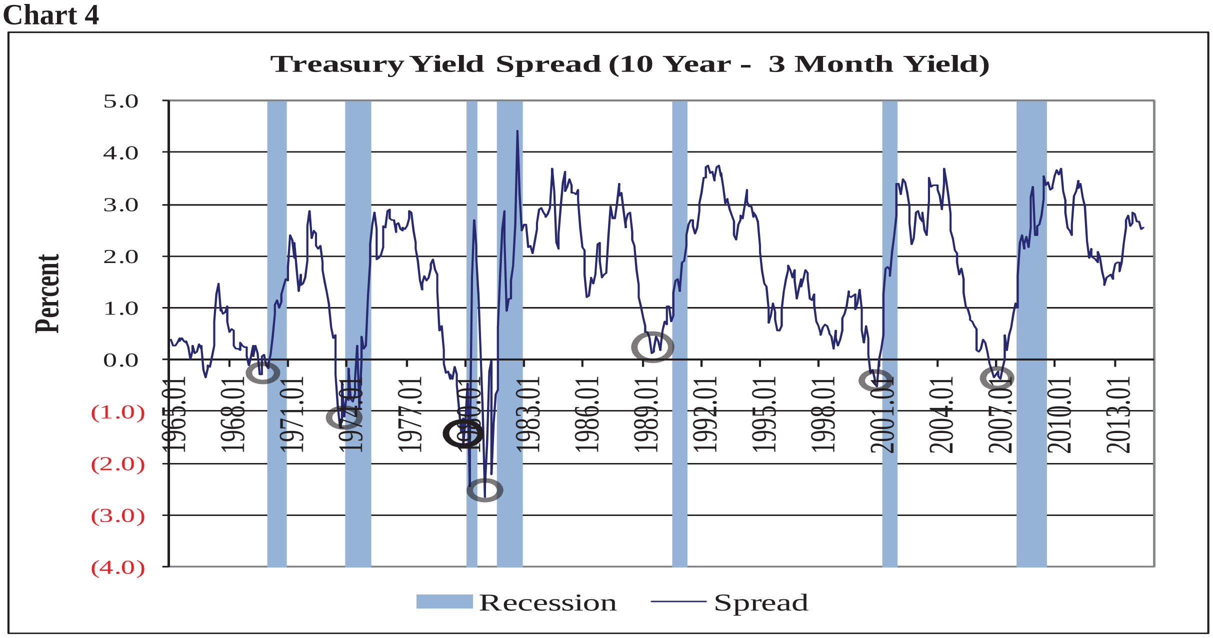
Chart 3



Source: Federal Reserve, FVCM

Before recessions, the Fed responds to the acceleration in inflation by sharply increasing short-term interest rates and causing the yield curve to turn negative (when short-term rates are higher than long-term rates). This is not the case now (see Chart 4).

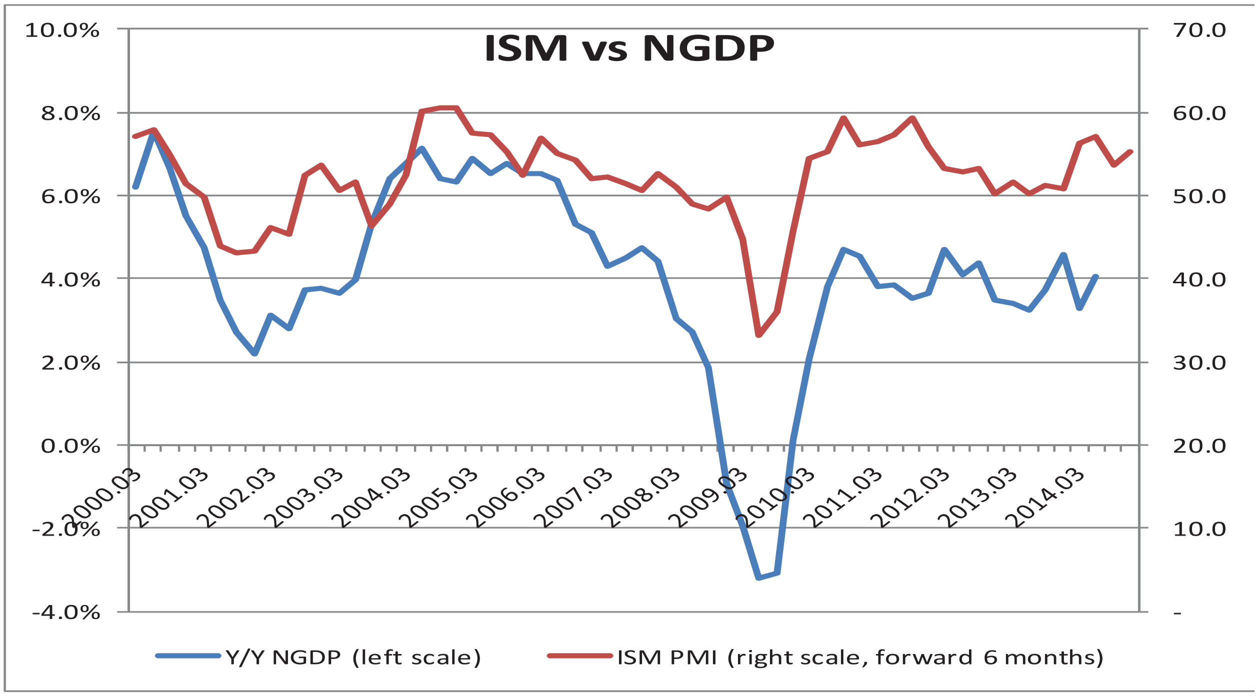
Chart 4



Source: Federal Reserve, FVCM

The ISM Manufacturing Purchasing Managers Index is a great leading indicator. In Chart 5 we have advanced the ISM data six months to show the leading effect: Business activity (nominal GDP) looks to improve further.

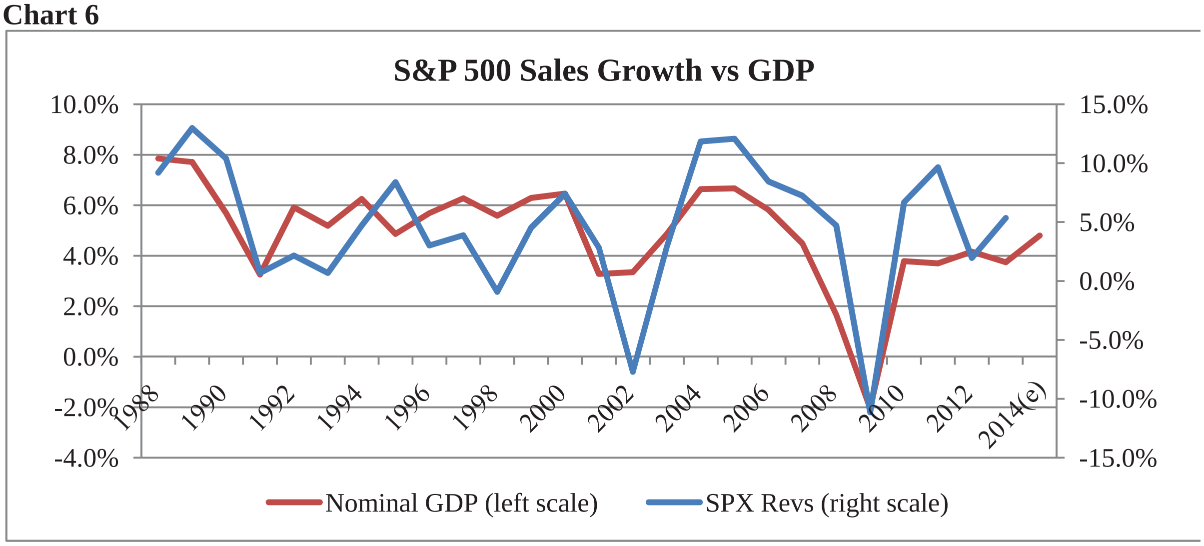
Chart 5



Source: Federal Reserve, Institute for Supply Management, FVCM

Corporate profitability, as measured by the S&P 500, is expected to increase in an upward trend of about 6% to 9% per annum. Corporate sales are more volatile than nominal GDP growth. Notice the difference between the scales on the left and right of Chart 6. Sales for the S&P 500 could increase some 5% to 8% both this year and in 2015.

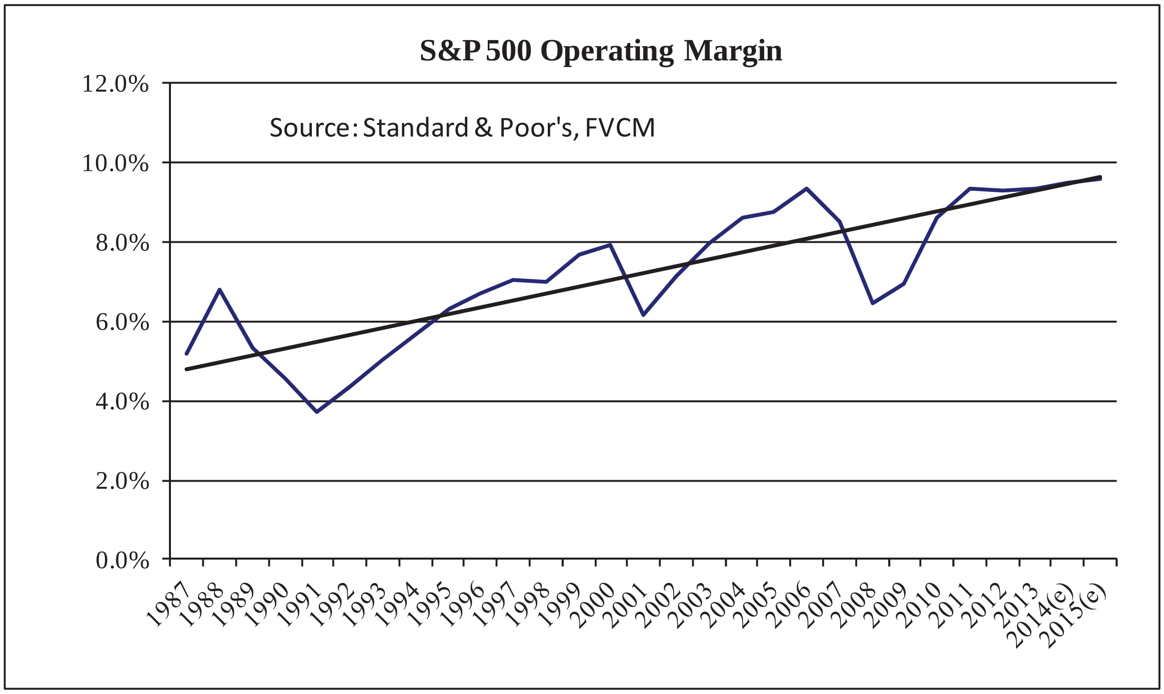
Chart 6



Source: Federal Reserve, Thomson Baseline, FVCM

Profit margins for the S&P 500 have been in a secular upward trend since the war, as labor has captured smaller amounts of national income relative to capital. Margins have also benefitted from declining interest rates and, now, margins are being helped by the cyclical expansion and rising capacity utilization. We are conservatively forecasting operating margins to rise from 9.3% in 2013, to 9.5% in 2014 and 9.6% in 2015, which would be right on the trendline. We think a surprise to the upside is more likely than a surprise to the downside.

Chart 7



Source: Federal Reserve, Thomson Baseline, FVCM

Our valuation model puts the 2014 fair value of the S&P 500 at 2200, or about 10% above the current level. That model uses trailing 10 year earnings (like the Schiller CAPE10 model) but adjusts fair value (P/E) for inflation. A "fair P/E" in today's environment would be a bit more than 18. Of course all such models are approximations of reality. From our perspective, stocks are now close enough to fair value as to no longer be a major issue. Our year-end 2014 target for the S&P 500 is 2,050, or 16 times expected earnings for 2015, and our target for year-end 2015 is 2,250 (see table 1). With inflation low, the economic expansion having plenty of room to go, valuations will be less of a driver for future gains and earnings growth will become more important.

Table 1 **S&P 500**	**2013**	**2014**	**2015(e)**	**2016(e)**
Index Price (Beginning of Year)	1,426.19	1,848.36	2,050.00	2,250.00
Index Earnings (forward)	110.66	119.57	127.50	137.00
P/E Ratio	12.9	15.5	16.1	16.4

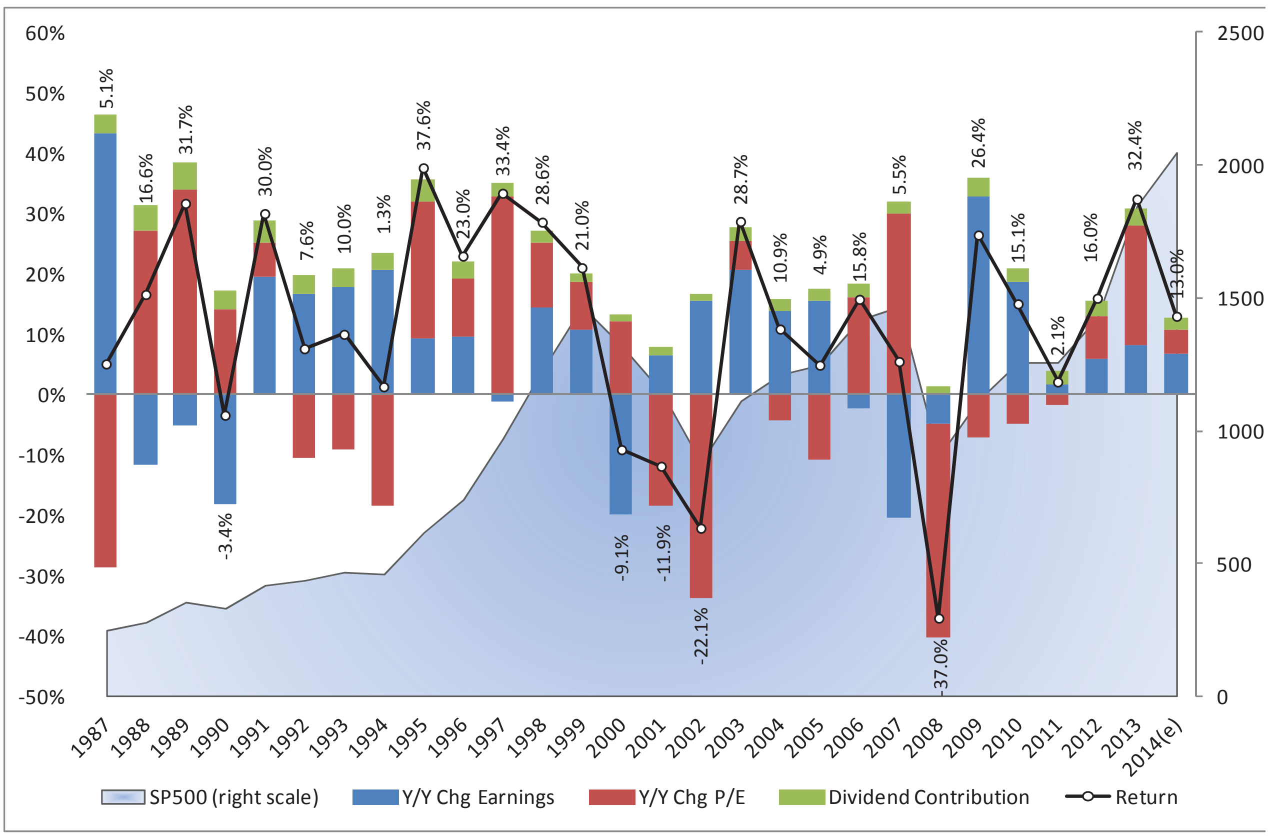
Source: Thomson Baseline, FVCM

We admit that Chart 8 below is rather complicated, but it contains lots of good information and is worth considering. For each year it shows the total return of the S&P 500 (the printed number), and it breaks down the contributions of that return between three components: 1) earnings growth/decline, 2) P/E expansion or contraction, and 3) the dividend contribution, including the return on reinvested dividends. So for example, in 2013 the total return for the S&P 500 was 32.4%. The drivers of that return were an 8.1% increase in earnings (the blue bar), a 19.9% increase in the P/E ratio (red bar) and 2.8% from dividends reinvested.

For 2014, considering our year-end price target of 2050, the total return for this year would be 13%, with 7% coming from earnings growth, 4% from P/E expansion, and 2% from dividends.

For 2015, our year-end target of 2,250 should be easily achievable and would imply a total return of 12%. In addition to the 8% from earnings growth, dividends should add another 2% to the S&P 500 return, and we are conservatively assuming only a 2% gain from P/E expansion. If P/E's were to expand fully to our model's fair value of more than 18, the S&P 500 would reach about 2,500 and the total return would exceed 20%.

Chart 8



Source: Standard & Poor's, FVCM

The Healthcare Sector has continued to lead the S&P 500 this year with a year-to-date total return of 16.8% (see table 2). Such sector data has to be considered with care. For example, in 2013, while the Healthcare sector return was 41.1%, you would have done poorly if you had invested in Edwards Lifesciences, which had a return of negative 27.1%. In contrast, you would have been quite happy with the return on Celgene, as our clients were, because that stock returned 115.3%. At the end of the day, it comes down to individual stock picking. Also note that last year's best performing sector, Consumer Discretion (+42.8%) is this year's worst performer (2.7%). Sometimes winners stay winners (Healthcare) and sometimes winners turn into losers (Consumer Discretionary). In business, the sand can sometimes quickly shift beneath your feet, but our strategy has been to focus on businesses that are experiencing positive developments in their operations and profitability, and picking only the stocks that are trading at good values. We also like to properly diversify and keep certain internal hedges in case conditions change in unforeseen ways. This has been a successful strategy over the years and we expect it to remain so.

Table 2

SECTOR	TTL RTRN % CHG YTD	TTL RTRN % CHG 2013	ERN %CHG 14 VS 13	ERN %CHG 15 VS 14	P/E 2015	DIVIDEND YIELD
HEALTH CARE	16.8%	41.1%	13%	12%	16.2	1.5%
INFORMATION TECH	14.4%	28.2%	3%	10%	16.1	1.4%
UTILITIES	14.0%	13.1%	8%	3%	15.7	3.5%
MATERIALS	9.0%	25.2%	8%	19%	15.8	2.0%
FINANCIALS	7.9%	35.3%	-4%	16%	13.0	1.6%
ENERGY	7.3%	24.8%	8%	8%	13.6	2.1%
CONSUMER STAPLES	7.0%	25.8%	4%	9%	17.6	2.5%
TELECOMMUNICATION	4.6%	11.4%	30%	7%	13.1	4.8%
INDUSTRIALS	4.0%	40.2%	9%	11%	15.5	1.9%
CONSUMER DISCRETION	2.7%	42.8%	9%	17%	17.2	1.4%

Source: Thomson Baseline, data as of 16 September 2014