FVCM

U.S. Market Report

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MARKET OUTLOOK

- Over the next months, anything can happen because of all the „tail risk"; Specifically, discussions over the U.S. debt ceiling are very contentious and markets could react negatively as they did under similar circumstances in the summer of 2011.
- Stocks are under-owned, un-loved, cheap and are moving higher after a decade of negative performance;
- Our Model, indicates that the S&P 500 is fairly valued at 1900, or some 30% above current levels;
- Growing liquidity from central bank easing will continue to spill into the equity markets;
- If perceptions of potential tail risk decline (from spending and debt agreement in Washington, etc), stocks could experience an explosive upward move;
- The greatest risk to stocks is inflation, which is a slow moving ship. We don't expect rising inflation to cause market declines for at least some 2-3 years.

POLITICAL SAUSAGE

Part of the "fiscal cliff" took place, part was averted and part was postponed. Under the law passed by Congress and signed by Obama, some taxes are rising but the automatic spending cuts, the so-called "sequestration," were postponed two months until March 1, 2013. Taxes are rising for nearly everyone. Half of the payroll tax used to fund social security, the government pension plan, is paid by businesses and the other half is paid by workers. The part paid by employees will rise back to the normal 6.2% tax on income, up from the temporary 4.2% rate put in effect because of the financial crisis of 2008. Second, the top income tax rate will rise to 39.6% from 35% for single people making more than $400,000 per year ($450,000 for married couples). Those same taxpayers will also face a capital gains tax of 20%, up from 15%, plus investors with adjusted incomes over $200,000 will have a 3.8% investment surtax because of the Obama healthcare plan. There were also numerous other changes in tax laws. Not changing are income tax rates for people earning less than $400,000/$450,000.

The part of the fiscal cliff related to government spending cuts ("sequestration") was delayed two months. Not coincidentally, a final decision will now coincide with the need to raise the "debt ceiling" again. Sequestration involves $1.2 trillion in spending cuts over ten years and about $109 billion in 2013. The debt ceiling is the arbitrary maximum amount of debt the Treasury can sell and additional approval from the US Congress is required in order for it to be raised. These two issues are closely tied together: Remember that the entire "fiscal cliff" drama came about because of the August 2011 political deal between Obama and the Republicans to raise the debt ceiling. Republicans wanted automatic spending cuts before they would agree to raise the debt ceiling. Democrats wanted tax hikes. Now we are coming back to the same place and the positions are hardening. The Republicans say additional tax increases are not an option and that substantial spending cuts should be approved before the debt ceiling is raised again. The Democrats and President Obama want to raise taxes further in addition to any spending cuts. An agreement over the debt ceiling would likely be combined with an agreement to further delay or modify sequestration. But it is very difficult to predict what kind of agreement can be reached and there remains the possibility that sequestration will take effect and that for a time the debt ceiling may not be increased. In that case, the federal government will not be able to sell additional treasury securities above the amounts that are maturing. Government employees, social security recipients and others may not get their monthly payments, but the 14th amendment of the U.S. Constitution indicates that Treasury bond holders would continue to collect their interest and principal.

In a sense, all the political posturing is like making sausage: We're better off if we turn away and don't watch how it is done. In the end, we believe some agreement will be reached. Unfortunately, the stock markets are watching and investors are unlikely to enjoy what they see. The S&P 500 experienced a sharp correction of more than 10% in 2011 starting about two weeks before the deadline for raising the debt ceiling. Fear that an agreement cannot be worked out could cause similar volatility this time around. But just as the market then went

on to regain those losses and move higher, we think the stock prices will be moving upward in the year ahead regardless of any short term setbacks.

DON'T FIGHT THE FED

Ongoing stimulative monetary policy is one of the biggest factors in helping stocks move higher, and an end to this policy is not yet in sight. The Fed essentially has two ongoing programs of purchasing fixed income securities—so called quantitative easing (QE). Last month the Federal Reserve said it "will purchase longer-term Treasury securities……at a pace of $45 billion per month." This is in addition to the purchase of agency mortgage-backed securities at a pace of $40 billion per month. Furthermore, the Fed said "the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6½%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored."

The first order effect of QE is to create liquidity (money) and drive interest rates lower. The second order effect is to push stock prices upward as incremental liquidity flows toward securities with a higher return potential then the paltry fixed income yields. It is true that investors, in general, remain highly risk adverse and are willing to hold very low yielding fixed income securities because of the fear of stock losses. However, bond yields are now so low that there is growing risk that fixed income investors could experience capital losses as yields move up. Why would yields move up? The labor market is growing at an average of 150,000 new jobs per month, which supports growth in income and spending. In comparison, the U.S. needs to only create 75,000 net new jobs per month in order to maintain a stable unemployment rate. So with new employment growing faster than 75,000 per month, the unemployment rate could be down near 6½% by late this year or early next year. And as the Fed announced, QE would not be necessary at that level of unemployment. Bond yields would likely start rising *before* we get to that point. And our thesis is that when bond investors start seeing losses on their monthly statements and, at the same time, they see the stock market continues to grind higher, there will at some point be a rush out of bonds and into stocks, which should continue to rise with business activity. As shown in Chart 1 below, cumulative 10-year returns for the S&P 500, including dividends, was near or below zero only three times in the last century. Only recently have those 10 year cumulative returns turned positive. It looks to us that there is plenty of room for equity returns to move upward.

Chart 1

Source: R. Schiller, Yale University, FVCM.

Valuations also support a bullish scenario and our model indicates that the S&P 500 is some 23% below a fair value of about 1900. From the other perspective, stocks would have to rise some 30% from current levels. Our model uses the trailing 10 year average earnings for the S&P 500, which is a conservative way of calculating the price-earnings ratio (P/E) of the index because it eliminates estimation bias: We're using actual historical data and not analyst estimates. Also, volatility from business cycles is eliminated because 10 years of data covers complete cycles. As seen in Chart 2, the 10 year trailing average of earnings for the S&P 500 has grown at a steady pace through recessions and wars and booms and busts. Furthermore, our model adjusts the P/E ratio for inflation because inflation causes stock values (P/E's) to contract for the same reason bond values decline when inflation rises—inflation reduces the present value of future cash flows. With inflation at or below 2%, stocks are significantly undervalued.

Chart 2

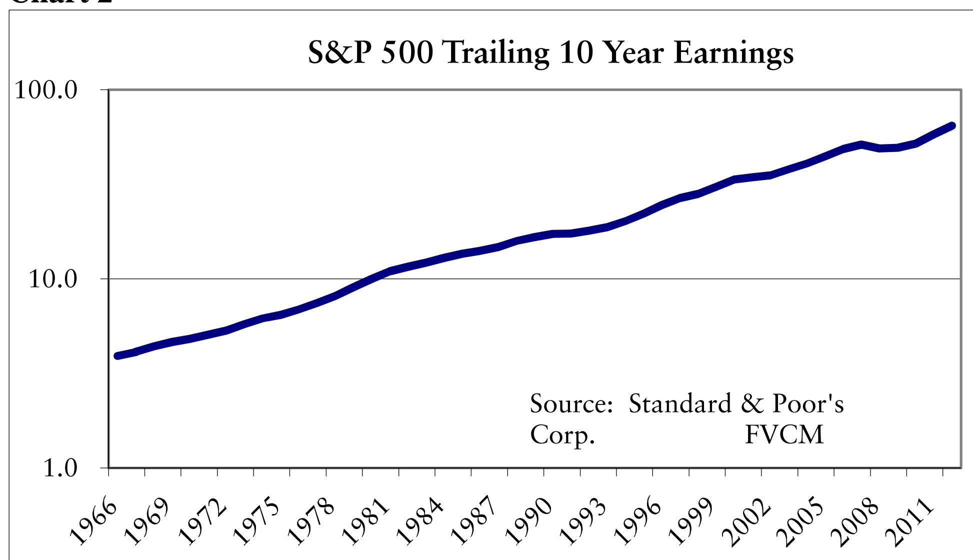
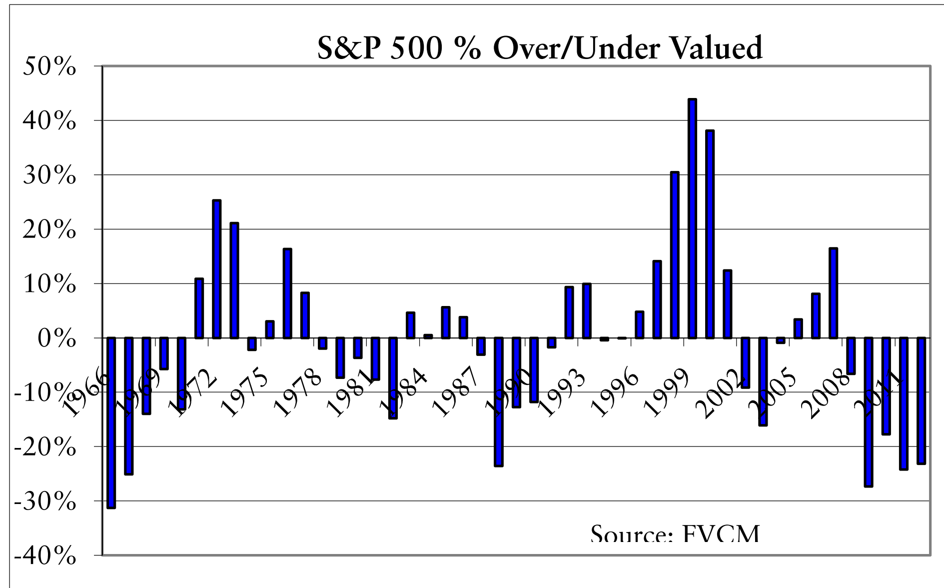
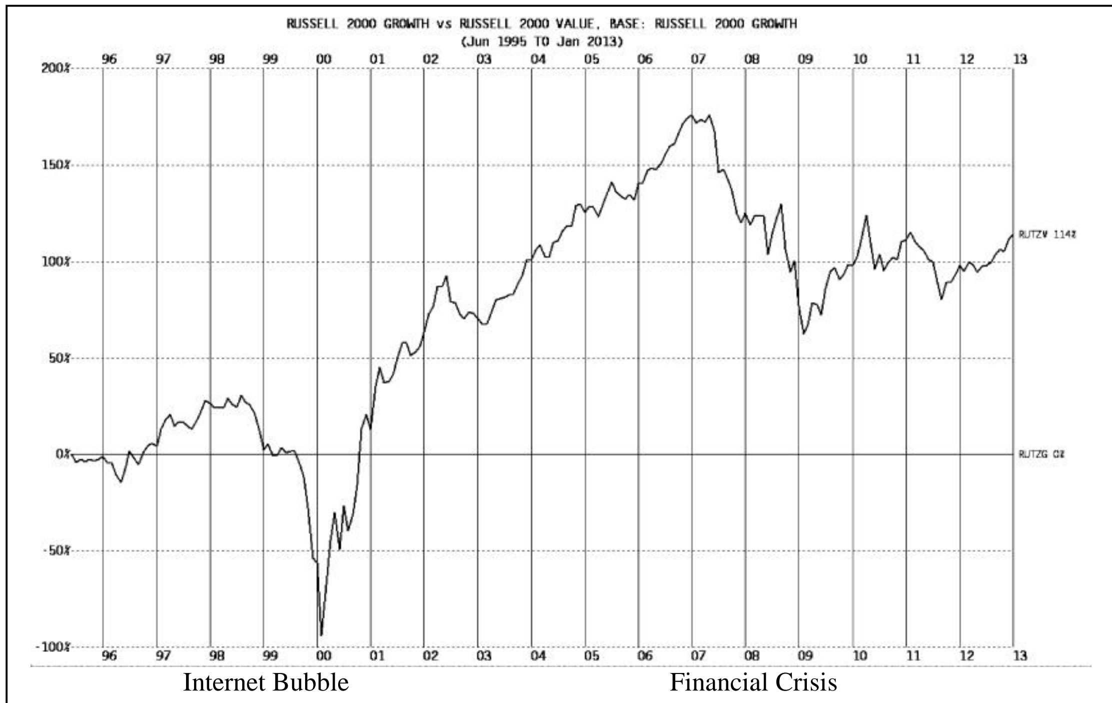


Chart 3



In summary, there is a risk that stocks will decline between now and the end of February as Congress and the President battle it out over the issues of sequestration and the "debt ceiling." However, stock valuations are attractive and a transition out of bonds into stocks could extend this Bull Market for years. We plan to use weakness over the next two months to buy more equities. Of course the scenario we have described here will not last forever. We could envision the economy growing at a modest pace of about 2% per year for a few years with the S&P 500 ultimately reaching 2000 or higher. However, inflation is very slow to get started and hard to stop once it gains momentum. By sometime in the 2015 to 2017 time frame the business cycle expansion will be extended and inflation is likely to be more of a problem. The Fed will have to be tightening monetary policy and, by that time, we'll be ready to reduce our equity exposure. But between now and then, conditions should be good for equity investors.

Value investing, as practiced by Benjamin Graham through Warren Buffet and others including ourselves, has been shown to be a successful strategy. While value has been out of favor since the financial crisis first took root in 2007, there are indications that value strategies are again outperforming. The Chart below shows the Russell 1000 Value index *relative* to the Russell 1000 Growth index. When the line is rising, value is outperforming growth and when the line is falling value is underperforming growth. Growth sometimes dominates value, as it did during the tech bubble in the late 1990s. And starting in 2007, because there was so much doubt about the outlook for the economy, investors shifted cash toward "growth" businesses with prospects more independent of general business conditions. Stocks like Amazon, Apple and Salesforce.com did well because they were perceived as businesses that would expand no matter what, and valuation was little considered. However, as the current economic expansion continues to persist, confidence is gradually growing and investors are increasingly willing to invest in businesses that have growth tied more to the general economy and are trading at good values. They are also taking a closer look at the high valuations of those growth stocks.



The recent outperformance of value is expected to persist for at least the remainder of the current Bull Market. We need to point out that the terms value and growth are somewhat nebulous. Some analysts define the terms according to price-to-book value (P/BV) ratios, others by Price/Earnings (P/E), and others by sales growth. Problems exist for all such methods of definition. For example, an auto manufacturer could for a period experience rapid sales growth as it emerges from the depths of a recession, but few people would characterize such companies as growth companies. Conversely, we do not believe investors will have a happy ending if they are now buying Salesforce.com, a fast growing company that trades at 110 times earnings and 8.5 times sales. Investment success will best be found in stocks that trade at low valuations but still have good growth prospects. For example, Amgen, a biotechnology company, is forecast to have a long term earnings growth rate of 10%, well above the long term historical average rate of 6% for the S&P 500. And yet Amgen trades at 13.8 times trailing earnings, below the S&P 500's 14.1 P/E. Companies that are "growth" and trade at discounts to the benchmarks are where we continue to see the best prospects.

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