U.S. Market Report

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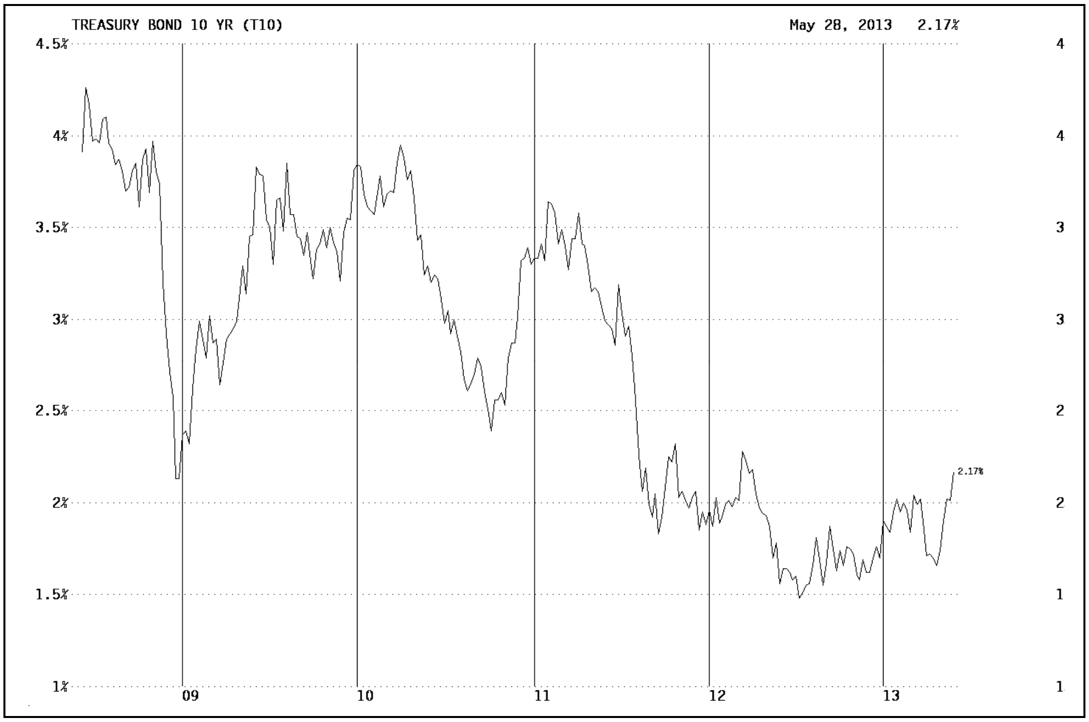
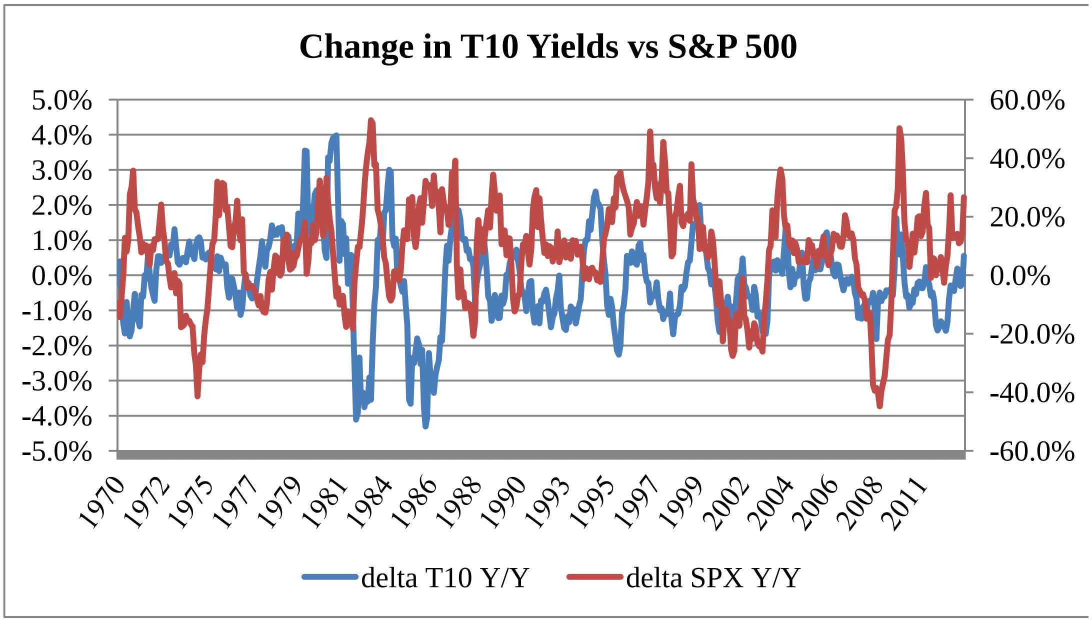


The 10 year US treasury yield increased a sharp 16 basis points from 2.01% to 2.17% on a single day, May 28th, and stirred fears that rising interest rates would hurt stock performance. For now, our only concern is for bond investors. The jump in bond yields in recent days has been tied to two related issues: The data for the US economy is showing signs of improvement and there are some recent estimates that growth could be about 3% (annualized) in the second half of the year. The consensus among the members of the Federal Reserve also seems to be that economic growth will be stronger than commonly expected and that the Fed's "quantitative easing (QE)" program will have to be reduced during the second half of 2013. If this is indeed the case, long bond investors are at risk of capital loss. Long term bond yields have been in a declining trend for 30 years and recently have been showing signs of bottoming out. At a minimum, the 10 year treasury yield looks to reach about 2.3% in the near term, and possibly get back to at least 3% in the months ahead. Higher bond yields mean that bond investors will start seeing declining values in their bond portfolios. Stock investors, as we will discuss below, should not be too concerned. If fact, we expect increasing flows out of bonds and into stocks to keep the market indexes moving higher this year.

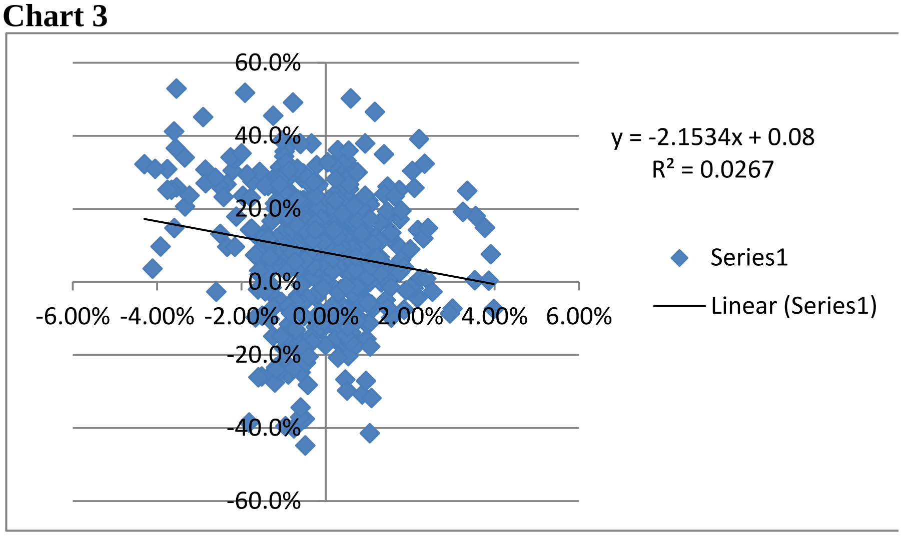
Chart 2



Sources: FVCM, Thomson Baseline

We looked at changes in 10 year treasury yields versus the percent change in the S&P 500 using data starting in late 1969 and found that the relationship is very weak. As can be seen in Chart 2, there have been many periods when bond yields (blue line, left scale) were moving up at the same time as the S&P 500 (redline, right scale) was rising. There were also many periods when they were moving in opposite directions. The lack of a clear relationship between bond yields (X, the independent variable) and the year-to-year percent change in the S&P 500 (Y, dependant) is made most clear in Chart 3—**the data looks like a shapeless blob!** True, every one percent rise in bond yields is associated with a 2.15% decline in stock prices, but the relationship is extraordinary weak. Bond yields explain only 2.67% of the change in stock prices. The bottom line is that even if bond yields move higher in the months ahead, as now looks to be the case, there is no immediate concern for stock investors.

Chart 3



Sources: FVCM, Thomson Baseline

At this juncture, we expect stocks to do well through the remainder of the year under both scenarios that we see as most likely:

1) If economic growth in the second half of 2013 is stronger than the current consensus of about 2.0% to 2.5%, stocks will benefit because it implies better than expected earnings performance. As we have detailed in previous reports, from a valuation basis the S&P 500 would not reach a fair price until it reaches our current target of about 1900 (up another 15% or so). Keep in mind that the fair target value moves higher as time passes and base earnings power (smoothed for the business cycle) of the corporations in the index moves higher. Furthermore, prices typically surpass fair value during Bull Markets before running out of steam, so this upward move could easily exceed 2000 for the S&P 500 before a substantial correction occurs. And, as we have briefly tried to argue here, a rise in bond yields will not have a material impact on stock performance. In fact, we can envision bond investors opening their monthly statements and seeing losses and deciding that it is time to shift more capital away from bonds and into stocks, helping push stock prices up even further.

2) If economic growth only matches current expectations of 2.0% to 2.5%, or even disappoints on the downside, then the fears about QE3 coming to a premature end will probably prove wrong. Keep in mind that as of the end of March, the Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE), index was up only 1.0% year over year, well below the 2.0% threshold that the Fed finds acceptable. Furthermore, with unemployment of 7.5% about a percentage point above the Fed's desired target before QE ends, we see little risk that monetary policy will become a headwind anytime soon.

The greatest future risk to the stock market is not interest rates, it is inflation. And because inflation is so low, and because it will likely take many quarters, if not years, of higher nominal spending before inflation accelerates, the stock market is really in a very sweet spot. Earnings should keep moving upward, even if the rate of growth is not spectacular. And, valuations are still low given the modest level of inflation. We think P/E ratios have further room to increase. But keep in mind, at some point out in the future, rising spending will start pushing inflation upward, which will only induce the Fed to tighten monetary policy and push interest rates further upward. When that time arrives, probably not for a couple years, we will be looking to reduce our exposure to equities.
