2013: A GROWTH ODYSSEY

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The stock market remains attractive while bond yields reside in record low territory. Ben Bernanke and his crew are on a bold mission: economic growth. The economy is indeed growing but not to its potential. Inflation, by most reasonable methods of measurement, remains mild. Despite these factors, a high degree of hesitation towards risk haunts many professionals and individual investors.

The Economy Remains Tilted Towards Growth

On the monetary side of the equation, the Federal Reserve is spending money to buy bonds at a stunning rate of $1 trillion per year. On the fiscal side of the equation, via sequestration, the federal government is *reducing* spending at a rate of $1 trillion over *10 years*. While not a perfect apples-to-apples equation, this 10-to-1 relationship demonstrates who is carrying the biggest economic policy stick. Right now, that would be Mr. Bernanke and crew.

There are practically an infinite number of ways to interpret monetary and fiscal policy, and all are fraught with contention. However, when the history books are written, it cannot be said about this current era that the United States was hamstrung by excessively tight governmental policies. Making that argument would have to contend with the facts:

- a zero-interest rate policy
- a very aggressive asset purchasing program
- historically high government-spending absolutely and relative to the economy

Essentially, our economic policy accelerators are near full-throttle.

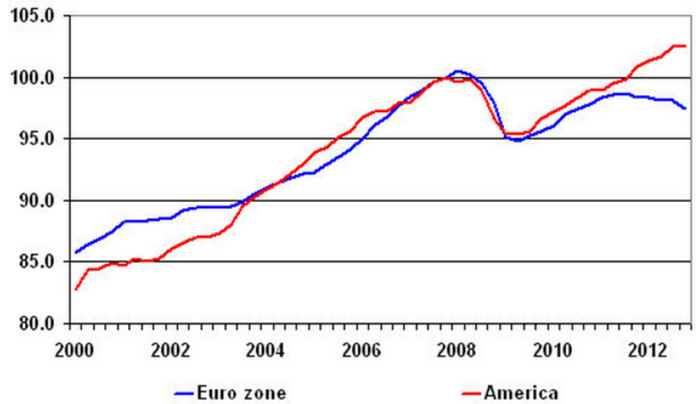
However, for those of a budget-minded nature, now is a particularly uncomfortable period. After all, how are we taxpayers going to pay for these policies? This is a difficult question that only the future will reveal. What most economists seem to agree on is that growth cures many ills. Strong economic growth improves employment, expands the tax base, reduces the reliance on government spending, and eliminates the need for accommodative monetary policies.

While many can't imagine removing the "anemic" descriptor from the economy's growth rate, the sails of this big ole boat will fill at some point. This will happen when factories approach full-utilization, bank lending accelerates, and companies compete over their next employee. The ultimate sign, of course, will be robust growth itself.

We are not there yet. Though, it can be argued that these aggressive policies are beginning to work. When we compare U.S. growth to that of Europe, stark differences are beginning to emerge. As a possible result of the currency union, Europe's policies, on a whole, are arguably much less accommodative than ours – and it shows.

Gross Domestic Product "GDP" Growth

(adjusted for inflation)



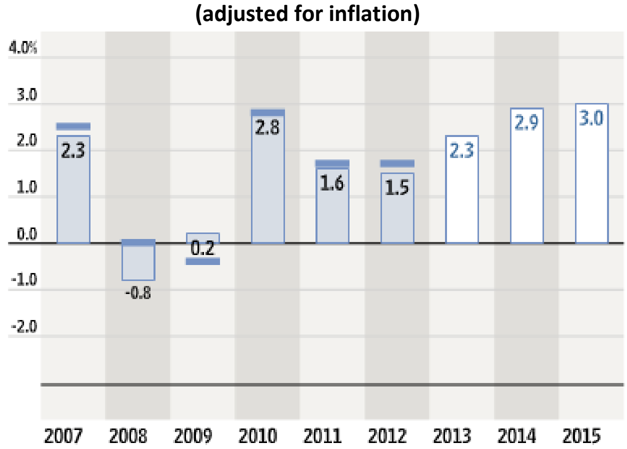
Source: The Economist.

There are indeed headwinds in the U.S. For example, short-term hiring decisions will likely be negatively impacted by the recent payroll tax-hike, and yes, sequestration will dampen the growth rate of some economic indicators. As stated in our prior letter, we expect the market to pull-back as news of various headwinds reaches the economic data banks. These pullbacks are part of the reality of equity investing, and 2013 will be no different. In the end however, market downturns, even those that result from much stronger gale-force winds of recessions, prove temporary and opportunistic.

Despite the possible headwinds, there is still consensus that this year and beyond will be economically productive:

Historic and Consensus Estimated GDP Growth

(adjusted for inflation)



Source: Wall Street Journal.

Three Measures of Market Valuation Remain Attractive

Aside from economic factors (and equally important), we can study market valuation. For this, we focus on the S&P 500. Based on its market capitalization, the S&P 500 represents approximately 75% of publicly traded American companies.

The S&P 500 price level is now above 1550. Recall that we've seen this movie twice before - in 2000 and 2008. In both cases, however, the companies themselves (that comprise the S&P 500) were significantly smaller in terms of revenues, cash flows, and earnings. For example, S&P earnings stood at $48 (net) by early 2000 vs. $89 (net) at current levels despite a similar price level. Therefore, today's higher market price is much more palatable.

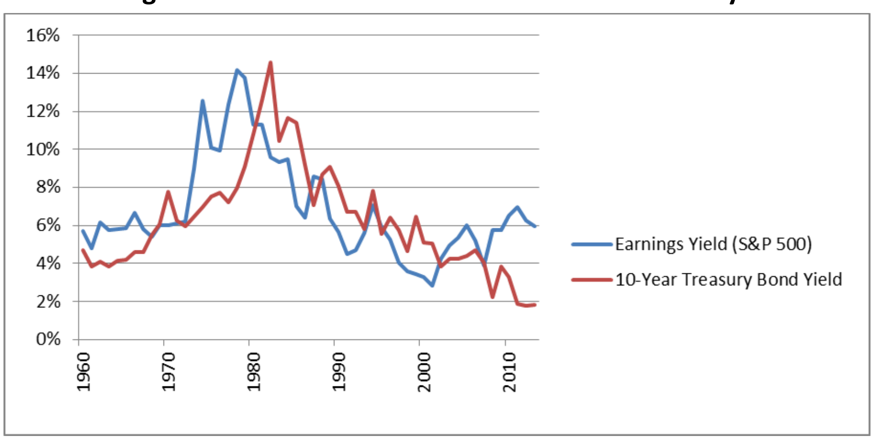
1) **Estimated Long Run Returns**

Over the long run, the total return on stocks tends to be in line with company growth plus dividends. Companies grow earnings at a rate of approximately 5% each year on average or roughly the same rate at the economy (nominal GDP growth). At current price levels, the S&P is paying a dividend yield of 2%. In this light, one could estimate that an investment in the market would generate long-run average returns of 7%.

2) **Stocks versus Bonds**

In another light, consider that the relative attractiveness of stocks to bonds remains rather strong. A simple comparison of bond yields (the 10-Year Treasury in our case) versus the earnings-yield on stocks (earnings as a percentage of price – or – one divided by the price-to-earnings ratio). Stocks are still delivering a near 4% advantage which is historically high.

Earnings Yields on the S&P 500 vs. the 10-Year Treasury Yield



Source: Standard & Poor's.

3) **Discounted Market Model**

Perhaps a more sophisticated form of market valuation analysis would include a discounting mechanism, if you will. Consider that the risk of the stock market is significantly higher than that of the bond market. As a result, investors tend to demand higher returns on stocks.

Historically, stocks have bested Treasury bonds by over 5% on average. So imagine if you demanded 5% in extra returns from stocks over bonds. To satisfy that demand, the market would have to be sufficiently cheap enough relative to its earnings (and your estimated growth of those earnings) in order for you to proceed. This approach is typically associated with using a discounting model, such as a "Discounted Cash Flow" or "Dividend Discount Model". To satisfy your demand of 5% extra returns, the answer would sound something like "I calculate the market has a fair value of XYZ and therefore needs to be trading below this fair-value level in order for it to be a good deal." It is important to note these models, like most, require a lot of assuming.

To get around the risks that go along with making assumptions, we input a range of best and worst case scenarios. When we calculate the market's current fair value based on our discounting model, we find it to remain rather attractive under a range of growth and discounting assumptions (worth anywhere from 1600 to 1800 on the S&P). However, as the yields on bonds increase, the discounting rate increases, and the market's fair value decreases. This happens because higher yields on bonds makes them more attractive relative to stocks. As a result, we view the Federal Reserve's current commitment to lower rates as particularly relevant to recent market action.

Conclusion

Given the range of factors that go into studying the current investment environment, we believe stocks remain attractive. The current monetary policies are delivering potent medicine that result in: 1) exceptionally low bond yields, 2) incentives to take risk (via the stock market among other areas), and 3) lower discounting rates which help justify current market valuations.

The two biggest risks relate to 1) the short-term nervousness of market participants as they respond to head-winds in the economic news cycle, and 2) a change in Fed Policy from accommodative to tightening. In terms of the short-term nervousness of market participants, we intend to exploit these opportunities by finding bargains. In terms of the second and perhaps larger risk, we believe the earliest this could become a reality is 2014. A likely precursor to monetary tightening will be strong economic growth. As a result, this second risk is not certain to be problematic to the market and depends much on valuation levels.

It is important for investors to remain committed to their long-term asset allocation policies. Finding this suitable mix between various asset classes remains a circumstantial endeavor, depending on a myriad of personal factors and market conditions. Investors seeking a tactical view of the markets should remain modestly tilted towards equities and alternative forms of income-production.