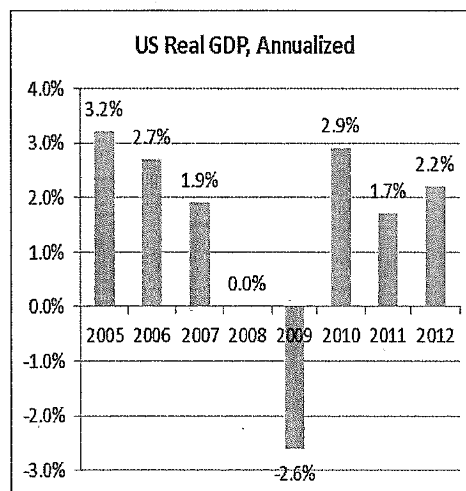
Investment Update
First Quarter 2013

Against a backdrop of slow growth in the US, deepening recession in Europe, and most of the same policy concerns that have dogged investors for the past three years, we are frequently asked why the stock market continues to do well. After all, most stock market indexes are at or near all-time highs, having fully regained the ground lost in the 2008-2009 bear market. To be sure, concerns about the sustainability of the current bull market are understandable given that we have already seen two major bear markets in this young century. Investors are clearly aware of the inflationary risks that follow the extraordinary efforts by the world's central banks to prop up economic growth by printing money. They are also justifiably skeptical of the ability of governments to adequately address the many economic and geopolitical challenges that remain unfixed.

To answer the question of how stocks have done so well, we would begin with a few macroeconomic factors.



First, growth in the US continues, defying repeated predictions of imminent recession. Real growth for all of 2012 was 2.2%, higher than in 2011 despite Hurricane Sandy and the much-anticipated fiscal cliff. Most of the areas of the economy that were weakest during the downturn are still improving steadily, particularly employment and housing, and we are continue to be in the early stages of a North American oil and gas production boom that is on balance very positive for the US economy. The fact that growth has continued despite all the negative headlines has helped to encourage many investors to again take on market risks, and stocks have benefitted.

Second, last summer's pronouncement by the European Central Bank that it is willing and able to take the steps necessary to prevent sovereign defaults and the collapse of the euro greatly reduced the likelihood of that worst-case scenario playing out. The reduction in this macro risk has also increased the attractiveness of riskier assets like stocks.

Third, though the process of policymaking in much of the developed world still seems dysfunctional and unnecessarily crisis-driven, the outcomes could have been much worse. In the US, the year-end fiscal cliff actually produced a few positives and sequestration has not yet been the calamity that some had warned about. Even in Europe, it is possible to be a bit more optimistic about the direction, if not the pace, of policymaking. At the margin, the conventional prescriptions for Europe's ailing economies (abrupt spending cuts and higher taxes) are being questioned more openly and this may eventually lead to more pro-growth policies that actually improve economic fundamentals. Though the process was messy, the recent Cyprus banking crisis solution seems to be an improvement on previous bailouts. The biggest losses are to be borne by shareholders, creditors, and those big depositors whose savings are above the guaranteed amount, while the governmental guarantee of smaller deposits will be honored.

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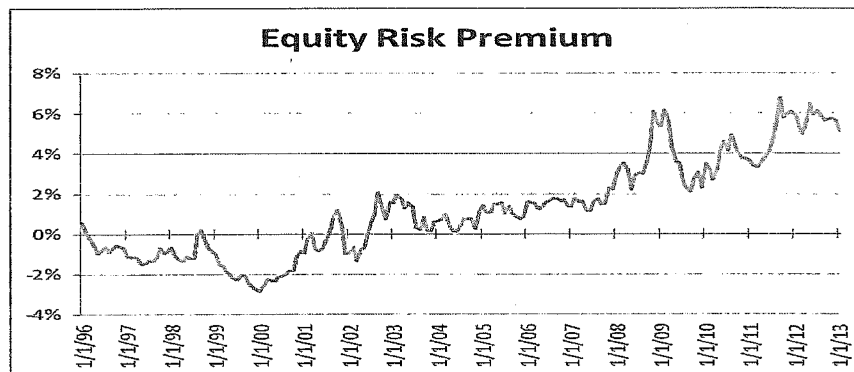
What these three sets of developments have in common is that in each case, the actual outcomes have been much better than the anticipated worst case scenarios, examples of what economist Dr. Ed Yardeni has referred to as "apocalypse postponed." However, we admit that there is room to argue about whether or not there has been enough improvement in terms of overall macroeconomic risk to, on its own, justify today's equity market levels.

A less disputable factor that we think explains much of the rebound in stock prices is that there has been an even greater rebound in corporate profits. Not only did corporate earnings hold up well during the recession, excluding the financial sector, but generally managements have done a very good job of increasing profitability in this relatively slow recovery. Total US corporate pre-tax profits in 2012 were $1.77 trillion, well above the previous peak of $1.52 trillion in 2006, while many major stock market indexes have just regained their 2007 peaks. Since earnings have increased even faster than stock prices, the current US stock market is attractively valued at about 15x trailing 12-months earnings. For comparison, when the S&P 500 was previously at today's levels, in August 2000 and October 2007, earnings were lower and the market traded at P/E multiples of 27x and 17x respectively.

We do not think that stock prices on the whole have been inflated artificially by central bank interventions. Rather, the passage of time and a general muddling through that has avoided the worst-case outcomes, together with strong corporate performance, do justify today's equity market levels. As an asset class, fixed income has probably been most affected by the huge amounts of liquidity created by central banks. Certainly in the US, given the recent level of economic growth, it is extremely unlikely that interest rates and yields would be as low as they are today absent these extraordinary monetary policies. Without the Fed's interventions, which will not be maintained forever, interest rates would be higher. Therefore fixed income valuations do not have the same fundamental underpinnings as equity valuations.

The following graph demonstrates the relative attractiveness of stocks versus bonds today. The equity risk premium (ERP) charted is the difference between the earnings yield on stocks (the inverse of the S&P 500's P/E ratio) and the yield on bonds (10-year US Treasuries). The long-term average is close to 2%. When the ERP is especially negative, as in early 2000, the implication is that stocks are expensive relative to bonds. When the ERP is unusually high, as in early 2009 and since early 2012, stocks appear inexpensive relative to bonds.



To us, stock valuations are fundamentally well-supported and inexpensive, while bonds are expensive and are being artificially supported. As allowed by each client's circumstances and risk tolerance, we would therefore prefer to increase exposure to stocks relative to bonds.

The information contained in this report has been taken from trade publications, statistical services and other sources, which we deem reliable. We do not represent that it is accurate or complete, and it should not be relied upon as such. Any opinions expressed herein reflect our judgment at this date and are subject to change.