# WOODSTOCK

## QUARTERLY NEWSLETTER

Winter, 2014

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Who do you know who missed a 5 year run up in the value of their investments of over 15% each year? Some very smart money has missed this experience. Although the runup has happened to our clients, this return has not been our goal. I wish I could say it had been. Our goal has been to fulfill the investment objectives of our clients by picking the best high quality US stocks at the best prices we can find. We expect a reasonable return compared to the S&P 500, knowing that in boom times the lower quality stocks sometimes do better than our style. But we are very proud that our clients have had such success.

Adrian follows this letter with a look at what we expect for 2014. Of course there are plenty of caveats. This is a confusing time. A prominent investment consultant puts it this way: asset prices may remain supported if government continues to reduce deficits at a measured pace and interest rates remain low; however, if government decides to accelerate the end of quantitative easing this may depress growth and in turn put pressure on earnings and share prices; however, it could have the opposite effect by boosting confidence. Say, again?[1] OK, "we just don't know".

At the end of last year the Wall Street Journal published an article subtitled, "the best financial advice I ever got".[2] One of the "big names" quoted said: I was taught that the strategy to get rich – take concentrated risk, typically with your labor/capital/business – is entirely different than the strategy to stay rich, which is to minimize the risks we take, diversify the risks we take as much as possible, keep costs low, tax efficiency high and don't spend too much. Woodstock is designed to help with those parts of the above advice that an advisor can help manage. Knowing that some risk must be taken to keep up with reasonable spending and inflation, we try to provide the three legs of the stool of financial advice: sound investment management, low cost custody and accounting, and efficient tax advice.

As we in the U.S. stumble about trying to create enough stability to tackle the reforms in taxation, expanded trade and immigration that are needed to create the environment for robust economic growth[3], who believes that European and Asian governments will not eat their seed corn through regulation and taxation? Diversification through internationally oriented, high quality US stocks seems like a good strategy for 2014, too.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

Please feel free to call or email either of us with questions, comments or concerns regarding Woodstock.

*William H. Darling, Chairman*
*Adrian G. Davies, Executive Vice-President & CIO*

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1 *Please contact your IM for the reference*
2 *WSJ, 12/28/13*
3 *WSJ, 1/15/14*

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## S&P 500 Returns Will Also Taper in 2014!

Adrian G. Davies

Gazing across the return spectrum for all asset classes and particularly all equity markets the S&P 500's +32% return including dividends in 2013 was nothing short of stunning. The U.S. about equaled the best performing market Germany (32% vs. 33%). It trounced International stocks (+15%), Emerging Markets (-3%), Intermediate bonds (-13%), Long bonds (-14%) and Commodities (except for oil and gas most were down). Diversifying away from U.S. equities significantly diluted overall portfolio return performance.

2013's strong market performance is puzzling to many investors. Earnings growth was a pedestrian 4%-5% yet the stock market appreciated 30%. For many there is a close link between earnings growth and stock market rate of return prospects. But 2013 teaches us that there are times when small earnings changes can produce large stock market returns. 85% of the S&P 500's return in 2013 was generated from P/E expansion (~3.5 multiple points). While 2014 is unlikely to be as strong for US stocks, we believe the market can make further upward progress. Our expectations are based on healthy economic growth, very easy monetary conditions, and still reasonable stock valuations.

The US economy has begun the year with significant momentum. Real GDP grew a surprising 4.1% in the third quarter of 2013 and 3.2% in the fourth. Much of the Federal Government's austerity measures are behind us and indicators of future growth such as the ISM survey of purchasing managers suggest continued growth. This year GDP growth could be in the 3% range. The US economy created an average of 172,000 net new jobs per month during the fourth quarter. Average hours worked and average hourly wages have been increasing too.

US home construction grew at a 10.3% year-on-year in the third quarter and new housing starts climbed at a 22.7% rate in November, its highest in five years. Home prices rose 13.7% y/y in November according to the S&P/Case-Shiller index of 20 US cities, boosting household wealth. Home prices seem poised to rise by a mid-single digit number this year driven by healthy employment gains, offset in part by higher mortgage rates.

The global economic backdrop also appears favorable. China seems to have stabilized at around a 7.5% real GDP growth rate, while Japan's economy grew an estimated 1.8% as Prime Minister Abe's economic and monetary policies were implemented. Although there are reasonable questions to ask about the economic policies of Japan and China, austerity seems to be on the wane. Europe appears to have emerged from its multi-year recession. No one is expecting spectacular growth out of Europe, but even modest growth is an improvement over the estimated 0.4% decline the region saw in 2013. Stabilization will help global confidence tremendously.

On December 18th, the Federal Reserve announced its long-awaited plan to taper its third quantitative easing (QE3) program. From January, the Fed started buying $75 billion of Treasuries and mortgage securities per month, down $10 billion per month from the rate in effect for all of 2013. After witnessing the market turbulence last May when Fed Chairman Bernanke first discussed the idea of tapering, many had feared the act of tapering would lead to a market sell-off. In fact, the stock market rallied on the day of the announcement and continued to rally into year end. The market rallied in part because the Fed extended the time it expects to raise short term rates until "well after" unemployment falls below 6.5%, but also because market participants view tapering as an endorsement that the US economy is now healthy enough to withstand a reduction in monetary easing.

Despite reducing the amount of bonds it is buying, the Fed's monetary policy is still incredibly easy by historical standards. QE3 is still effectively creating $75 billion of new bank reserves every month. If the Fed continues to reduce its QE purchases by $10 billion at each of its Federal Open Market Committee meetings, scheduled every six weeks, it will end the QE program in December. The Federal Funds rate is still very close to zero, and most economists expect it to stay there through at least mid-2015. We don't foresee any significant changes to policy under incoming Fed Chairwoman Janet Yellen. The Fed is likely to adjust the pace of bond purchases and adjust expectations for the Federal Funds rate based on the strength of the economy and inflation.

We expect that inflation will remain modest. The Consumer Price Index, up 1.5% y/y in December, suggests inflation is not a threat. That inflation has remained low since the Fed's first QE program was initiated in 2008 has surprised many. Why hasn't quantitative easing produced more inflation?

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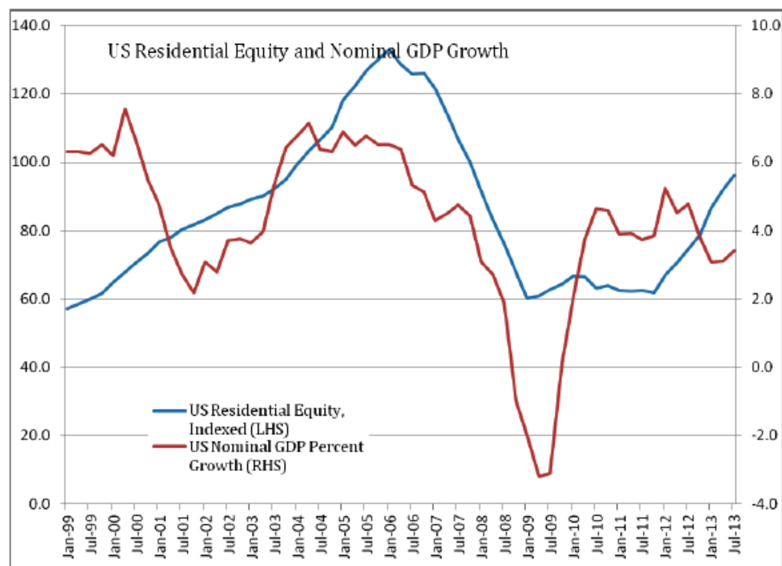


***Source: St. Louis Fed***

The Great Recession, with the accompanying bursting of a housing price bubble, had dramatic deflationary implications and the economy is still operating well below its potential. The economy's excess capacity, in the form of production capacity, but more importantly and more unfortunately, high unemployment, have meant that there has been little upward pressure on wages. Looked at another way, the Fed's aggressive policy hasn't translated into strong money supply growth because there has been little demand from businesses or consumers facing more restrictive lending standards. Loan demand finally started to pick up in 2013. Employment and capacity utilization are improving, but they do not appear to be improving at a rate fast enough to cause a rapid rise in inflation. Furthermore, with the Fed already reducing its bond buying, any evidence of inflation is likely to be met with higher interest rates.

Looking at stock valuations, current consensus estimates call for the S&P 500 Index constituents to earn $120 this year in aggregate, up about 10% y/y after having climbed about 4%-5% in 2013. On that basis, despite rising by 3.5 multiple points, the index finished 2013 trading at 15.4x forward earnings, in-line with its historical average over the past 15 years (15.4x). The median P/E over this period has been 14.7x. Analysts' earnings estimates should be treated with some skepticism, but if they are in the right ballpark, the stock market is not measurably over-valued relative to its history.

Stocks continue to look attractive in comparison to bonds. The 10-year Treasury finished 2013 yielding 3.03%. In comparison, the S&P 500 generates a dividend yield of 1.9%. When combined with potential earnings growth of 8%-10%, the S&P 500 remains a more attractive investment for those who can stomach the volatility.

After a 31 year bull market for bonds which saw the yield on the 10 year US Treasury fall from 15.8% in September 1981 to a low of 1.42% in July 2012, interest rates appear to be on the rise. While rates are more attractive to investors than they were in 2012, the broader historical context suggests rates could rise more, meaning bond prices could fall more. In our Fall Quarterly Newsletter, Tom Stakem pointed out that over the last 17 years higher interest rates have been correlated with higher P/E multiples. In 2013 the 10-year Treasury yield increased by 1.25 percentage points and the S&P 500 P/E multiple still expanded by 3.5 P/E points. So much for higher interest rates clobbering P/E ratios. The same phenomenon could occur should another 2% rise in Treasury yields occur in the next few years.

Two factors seem to be driving long term interest rates higher presently: faster economic growth and the anticipated reduction of quantitative easing. The Federal Reserve is currently the largest purchaser of US Treasuries

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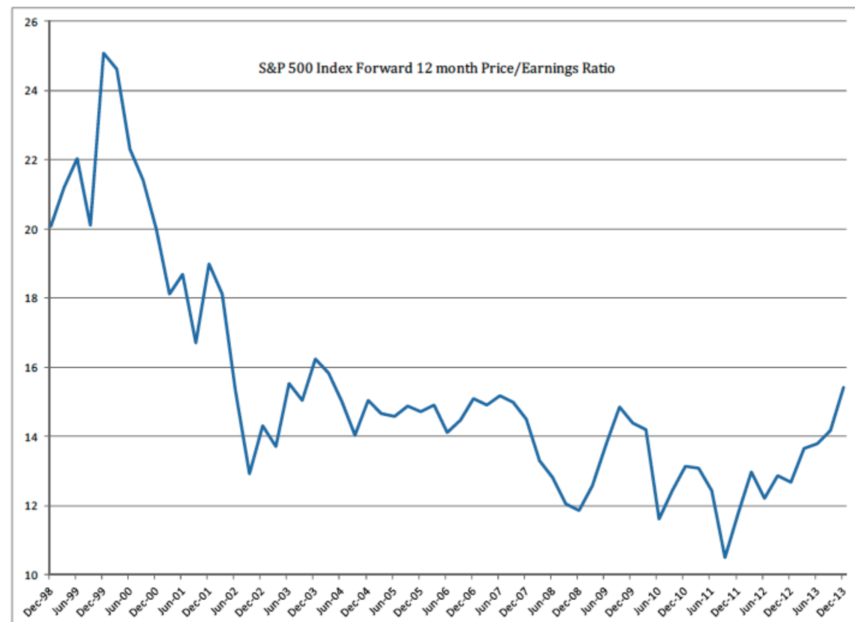

*Source: Bloomberg*

and mortgage debt. Through December, the Fed had purchased $1.4 trillion of US Treasuries and $1.5 trillion of mortgages as part of its quantitative easing programs. As the Fed pulls back from these markets, the price of bonds may fall and interest rates may rise. With the 10 year Treasury rate having already risen from 1.61% in May 2013 to 3.03% by year end, it's difficult to judge how much further rates may rise. It's worth mentioning that after QE1 and QE2 ended (in March 2010 and June 2011 respectively), long term interest rates fell each time. One interpretation of the rate declines is that the economy was not ready to grow without additional stimulus. Stronger GDP growth, the stock market's rise and higher interest rates since December 18th all suggest that investors think the economy is now ready for the withdrawal of QE3.

The market rarely goes up in a straight line. On average, the stock market has a pullback of at least 10% every two years. 2013 was unusual not only for its big gains, but for the steadiness of those gains. The largest pull back was 5.8% from May into June. 2014 could see a return to more historic volatility levels. Rarely if ever has the Fed's reduction in monetary easing resulted in a steady glide path for stocks. The Fed is performing a balancing act. If inflation persists above 2.5%, the Fed might end QE3 more abruptly. Alternatively, if economic growth comes in below expectations, the Fed would probably extend or even increase QE. Slower economic growth might disappoint stock investors, but in so far as the Fed's quantitative easing programs have been good for stocks, the stock market might view an extension of QE3 favorably.

We are confident that 2014 will bring the right balance of economic growth and low inflation that will enable stocks to advance. There are always concerns. Europe is continually at risk of slowing, China's centrally planned economy could always stumble, and there is always tension in the Middle East. In 2013, the US economy endured tax increases, fiscal spending cuts, the Federal Reserve taper, and even a Government shut-down to see stocks climb 30%. We enter 2014 with increased economic momentum, in part because these policy concerns are largely behind us, and in part because a wealth effect from rising stock and real estate prices is boosting confidence. Many balance sheets have been repaired and are ready to expand. Around the world economies are on the mend. With faster economic growth, the Federal Reserve will likely end its quantitative easing program and allow long term interest rates to rise. Rather than hurting stock prices however, rising rates would be consistent with greater confidence and risk taking. Earnings growth should reflect the economic acceleration, and this environment could see P/E multiples rise higher still. We are optimistic that 2014 will be another prosperous year. ◆

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