Independence Asset Advisors

Memorandum

To: Client Memo

From: Scott Renninger

Date: July 31, 2014

Re: Stock Market Outlook – No Bubble… Stay the course

Attribution: I owe credit to Byron Wien of Blackstone, Jeremy Grantham of GMO and J.P. Morgan for the ideas and data that led to this memo. "GMO'S Jeremy Grantham Doesn't See a Bubble Just Yet" and Byron Wien's Outlook articles inspired this summary of their conclusions with additional supporting data from J.P. Morgan's mid-year outlook.

My conclusions:

- Second half of 2014 should be positive for both world economies and equity markets.
- At current valuations, high quality stocks are fairly valued, not overvalued.
- U.S. equities provide 7% potential annual earnings growth over the next two years.
- U.S. stocks have the potential to return in excess of 15% over the next 18 months.
- Stay the course and maintain or overweight your target equity allocation.

Summary of Articles

Almost every indicator is showing a better tone to the economy:

1. Vehicle production is running at 17 million units;
2. Consumer confidence and retail sales are improving;
3. Bank loans, which indicate a willingness by businesses to borrow for inventories or new projects, are strong; capital spending is picking up; new plants are being planned or built;
4. Unemployment rate is down to 6.1%; the number of jobs created in June was impressive and initial unemployment claims are down;
5. Small business hiring plans are positive and there are signs of wage increases in the service sector.
6. Inflation is under control. Based on historical trends, we will not have to worry about wage acceleration until the unemployment rate hits 5.5%, which will probably not happen before sometime next year.

On the other hand, the indicators are not universally positive. Warnings and risks are abundant and should temper our optimism.

1. Housing starts, which had been running above one million units, dropped to 893,000 in June, and building permits also declined. For the economy to maintain 3% real growth and for unemployment to continue heading lower, housing has to be strong. Recent data on housing

has been mixed and the drop in starts is troubling, but there are enough other positive signs. However, if housing remains weak, a 3% growth assumption may be revised lower.

2. Disappointing revenue growth, up only 3% in the second quarter, could restrain earnings growth. At this point in the cycle, revenue should be growing 4%–5%.
3. Sentiment - most investors are optimistic or complacent. The Ned Davis Research Crowd Sentiment Poll is extremely positive, and we all know that the best time to buy stocks is when most investors are negative. This doesn't mean the market cannot rise further, but it is a warning sign that a correction could occur. ***In contrast,*** a Bloomberg poll found 47% of respondents think the market is close to a bubble, with 14% saying we are already in one. This level of caution among Bloomberg subscribers (mostly investment professionals) is encouraging as a contrary indicator.
4. The average bull market usually lasts 57 months according to Strategas Research and appreciates 160%. The S&P 500 has risen 186% in the 61 months since the March 2009 low.
5. It has also been a long time since we have had a meaningful correction: about two years since a decline of 10% and almost twice as long since a drop of 20%. ***This is not unprecedented.*** In the 1990s the S&P 500 rose over 4 1/2 years before a 10% pullback and over eight years before a 20% correction. The rise prior to the 2008 decline extended for over three years.
6. The International Monetary Fund has reduced its estimate for World GDP real growth to a little more than 2%. It was 4% in 2010 and has remained comfortably above 2% until recently. There is a general perception that growth around the world is slowing.
7. Geopolitical turmoil tends to increase short-term market volatility and can raises oil prices depending on the countries involved. Persistently higher oil prices would be a drag on global growth.
    a. High risk - Iraq will eventually be divided into three tribal regions. This has the potential to cause a long-term disruption of Iraqi oil exports. It may be a risk with a relatively low probability, but the highest potential negative impact.
    b. Medium Risk - Ukraine. While Putin wants conditions in the region to remain unstable, sanctions against Russia will be intensified. Sanctions will certainly impact some multi-national companies and emerging stocks in targeted sectors.
    c. Low Risk - Gaza. Israel will continue to make every effort to locate and destroy the missiles and tunnels used by Hamas. Let’s hope the missile launches and the counter offensive ends soon, but without a long-term political resolution, future flare- ups will continue.
    d. Low Risk - Iran will agree to reduce its nuclear weapons development program, under pressure from the younger population there to have the sanctions lifted.
    e. Low Risk - In Asia, it is in China’s interest to settle disputes in the South China Sea peacefully. China’s leaders are pragmatic.

Any of these trouble spots could erupt into something more serious at any time, resulting in a challenge to the present world order that could unsettle financial markets.

The market cannot go up forever, but that doesn't mean it must go down any time soon

Expansive Federal Reserve policy has helped the recovery, but now the Fed is tapering and investors are worried about an increase in short-term interest rates sometime next year. Many investors are worried about a shift in Federal Reserve policy triggering a serious correction in the market. Based on Chairman Yellen's comments on the economy, few economists or market strategists think an increase in short-term rates is imminent. However, if real GDP growth looks like it will exceed 3% sometime in the second half, a rate hike is possible. The consensus view is that we won't see a rise in rates until mid-2015, but beware of consensus forecasts; they have not been reliable.

Ned Davis Research has done a study of market responses to the first increase in interest rates by the Fed. It shows that the S&P 500 does, indeed, have a sharp negative reaction, usually about 5%, but then continues to move higher, on average, within three to six months. The danger of a change in the inflation outlook could be one reason the Fed would consider raising rates, but that doesn't seem about to happen. Not only are wages increasing modestly, but commodity prices have softened. It looks like inflation will remain reasonably tame for some time to come.

One of the problems limiting investor enthusiasm may be valuations. If the S&P 500 earns $115 in 2014, it is selling at 17.1x earnings. Market peaks have occurred historically at 25x–30x times earnings. On that basis, the market is fairly valued, but not exceedingly expensive.

Consider this base-case scenario – it's simple math.

- The average trailing 12-month price-earnings ratio when the inflation rate is 0%–4% is 17.
- If the economy grows at a rate of 3% real during the remainder of the year and inflation is 2%, then nominal growth should be 5%. With productivity increases continuing and share buybacks, the S&P 500 should be able to show improvement of 7% over the $108 in 2013 operating earnings, putting 2014 earnings at $115.
- If earnings repeat a 7% growth rate in 2015, the S&P 500 reaches 2,100 without an increase in the 17 times EPS market multiple.
- Very few investors see that as a possibility because the market did so well in 2012 and 2013 and strong previous performance breeds caution about the future. Actually, strong market performance in a given year should not discourage investors about the outlook for the following year. When the S&P 500 has been up 20% or more, the next year is usually positive and has been positive in every such year since 1990.
- If earnings reach my target and the S&P 500 sells at 20x, we could reach 2300 even sooner, which is 16% above the present level of 1,980.

Finally, taking a look at the economies around the world is probably useful. The United States is growing at 2% to 3% after adjusting for inflation, Europe at 1% and Japan at 1.5%. The U.S. market is large, liquid, transparent and (in my opinion) fairly valued. Europe appears past crisis mode as it gradually recovers from its double-dip recession. Its banking system is gaining strength and the ECB is continuing to provide support. Emerging nations are growing faster, but their equity markets have

generally not responded, creating some pockets of value there. This is not a bad macro environment for equities.

In Summary

Based on many sources, I believe that real economic growth in the United States will move toward 3% and S&P 500 profits (EPS) will be up roughly 7% in 2014, with a similar increase likely next year. As a result, I believe the S&P 500 will appreciate in the mid-teens (or more) over the next 18 months. If I'm wrong, I suspect it will be on the timing, not the direction, of market gains.

Stocks are attractive compared to bonds. Interest rates are likely to remain low for longer than most people believe, but they will eventually rise. Equities may perform well for longer as well, although with occasional setbacks (higher volatility) and maybe a correction.

The question is not really if, but when a correction will take place. No one knows. But that should not deter long-term investors and may provide a welcome rebalancing opportunity. Market pullbacks are a normal part of market pricing and one of the short-term hazards we must manage to earn the risk premium (higher reward) accorded to equity investing.

Despite many risk factors, positive economic indicators and fair equity valuations support the conclusion that the market is not in a bubble. With neither a recession nor a bear market in sight five years into the economic and market recovery; let's hope geopolitical turbulence doesn't upset that outlook.