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THE WEEKLYVIEW

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Market Dip Presents Opportunity

We are encouraged that stocks rallied after last Friday's disappointing employment report and that our technical support levels held. January nonfarm payrolls were up only 113,000 versus consensus expectations for around 180,000 job gains. Despite the miss, the S&P 500 rose 1.3% for the day, closing the week just under 1800. We believe the stock market was able to look through the poor employment report (due in part to January's weather) because of better earnings and the possibility that the Federal Reserve could delay tapering if the weakness in the economy becomes more persistent. For now, we expect the Fed to continue reducing quantitative easing asset purchases by $10 billion per meeting; especially with the unemployment rate down to 6.6% and other indicators, such as the ISM employment indexes, suggesting ongoing job growth in manufacturing and services. Since our technical support level for the S&P 500 at around 1730 was successfully tested (see *Weekly View*, 1/27/14) and short-term investor sentiment hit extreme pessimism last week (see Weekly Chart), we think investors with cash or bonds are being presented with an opportunity to add to stock exposure.

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With about 64% of companies reporting fourth-quarter results, earnings and sales have been better than expected. Based on our comparison of actual results with estimates from six months ago, 51% of companies beat their earnings and sales estimates, the best results in more than two years. This 'beat rate' is especially noteworthy for sales as the majority of companies have missed their sales estimates in previous quarters, as shown below.

S&P 500 Sales Surprise

Actual Q Sales vs estimate 6 months prior to report date

	2Q2012	3Q2012	4Q2012	1Q2013*	2Q2013*	3Q2013*	4Q2013*
% Above Estimates	28.7%	29.1%	34.3%	36.6%	40.4%	35.0%	**50.9%**
Median Positive Surprise	5.5%	3.6%	7.3%	3.2%	3.3%	2.6%	2.7%
Median Negative Surprise	-6.3%	-5.2%	-8.0%	-3.2%	-3.0%	-3.0%	-2.6%

Source: RiverFront, Factset Research Systems

The pickup in US productivity (output per hour) and the corresponding decline in unit labor costs ('ULC', labor compensation per unit of output) is perhaps the best evidence for sustainable economic growth, in our view. Fourth-quarter labor productivity accelerated to 1.7% year over year from just 0.5% the prior quarter. Meanwhile ULC have fallen 1.3% from a year ago. In short, US businesses are producing more and paying less for labor, meaning that inflation isn't a problem, and any eventual Fed tightening is likely still years away.

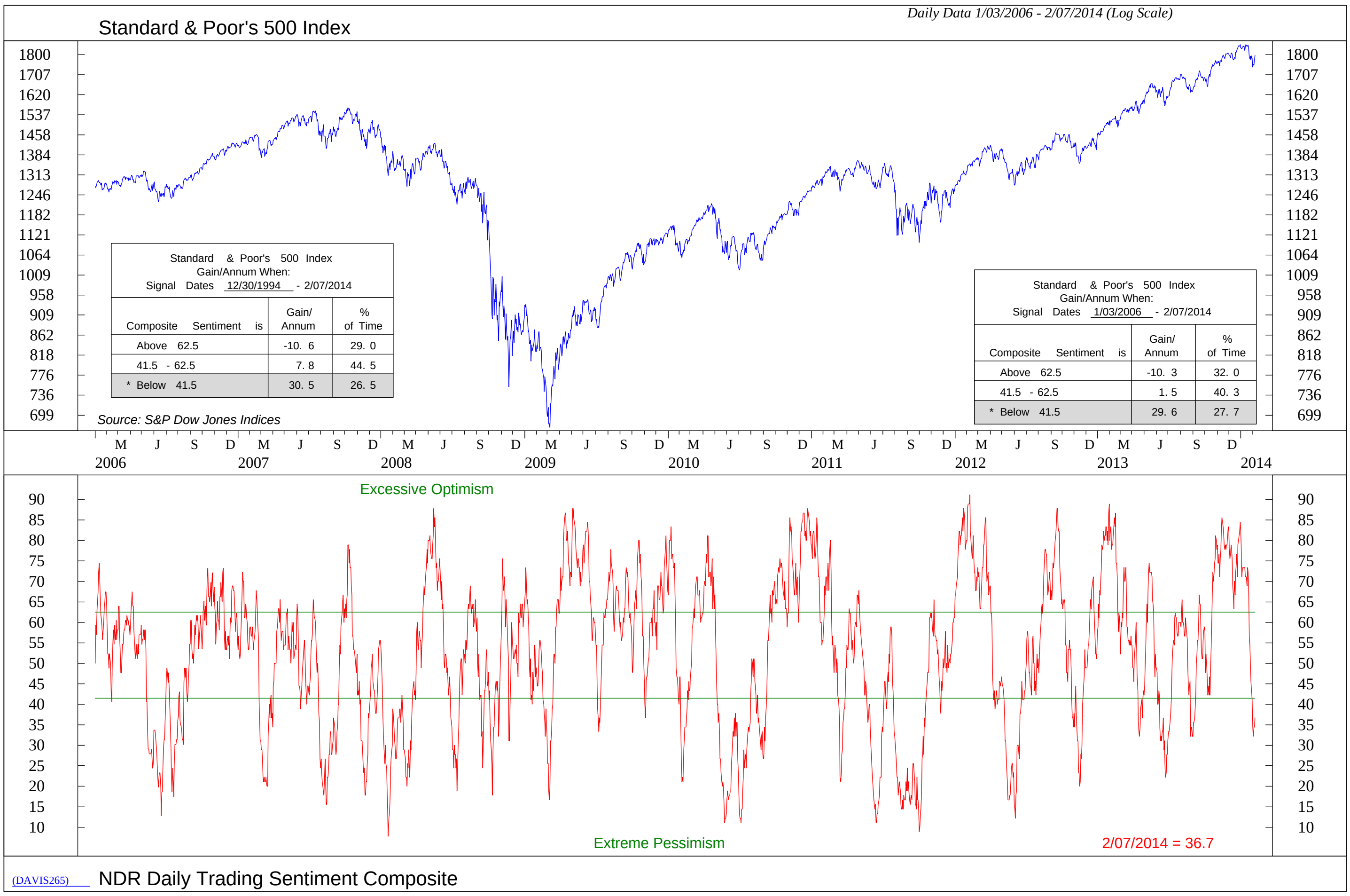
Some investors are concerned that corporate profit margins will fall, but we think margins can remain near their historic highs. Falling unemployment has historically improved workers' bargaining power. However, with the low cost of capital from the Fed, businesses are increasingly investing in automation and substituting capital for labor. From a recent review of 'The Second Machine Age' by MIT professors Erik Brynjolfsson and Andrew McAfee in the *Washington Post*:

"To illustrate the point, Brynjolfsson and McAfee cite the example of Instagram and Kodak. Instagram is a simple app that has allowed more than 130 million people to share some 16 billion photos. Within 15 months of its founding, Instagram was sold to Facebook — a company with 1 billion users

— for $1 billion. It was only a few months later that Kodak, the Instagram of its day, declared bankruptcy. Such is the 'bounty' of the second machine age…it has created a new class of super-rich entrepreneurs and investors, but it has done so with a company that employs only 4,600 workers. Compare that with Kodak, which at its peak employed 145,000 workers in mostly middle-class jobs."

This is just one example among many, and not just in the US or other developed markets. Even in China, as employment costs have risen, factory workers are being replaced by robots, forcing a structural transition toward higher-skilled jobs that complement the new 'machine age.' Just as in the past, when workers left the farm for the factory, workers today have to adapt to a new competitive landscape, especially now as technology and globalization advanced to the office. We think that we are in the early stages of business process automation and productivity improvements, and that corporations leading the change will continue to benefit at the expense of labor.

THE WEEKLY CHART: THE CROWD HITS A PESSIMISTIC EXTREME



Standard & Poor's 500 Index Gain/Annum When: Signal Dates 12/30/1994 - 2/07/2014

Composite Sentiment is	Gain/ Annum	% of Time
Above 62.5	-10.6	29.0
41.5 - 62.5	7.8	44.5
* Below 41.5	30.5	26.5

Standard & Poor's 500 Index Gain/Annum When: Signal Dates 1/03/2006 - 2/07/2014

Composite Sentiment is	Gain/ Annum	% of Time
Above 62.5	-10.3	32.0
41.5 - 62.5	1.5	40.3
* Below 41.5	29.6	27.7

Stock sentiment reached a pessimistic extreme of 32% bullish last week before rebounding slightly. The tables in the top panel of the chart show that the S&P 500's annualized gains have been the best when crowd sentiment was below 41.5. We have done our own analysis of Ned Davis Research's Daily Sentiment Composite for times that the S&P 500's primary trend was rising. In this environment, our review shows that following a sentiment extreme of 32, the odds of the S&P 500 rising over the next three and six months have been about ten percentage points better than average and the average return over the subsequent six months was around 8%.