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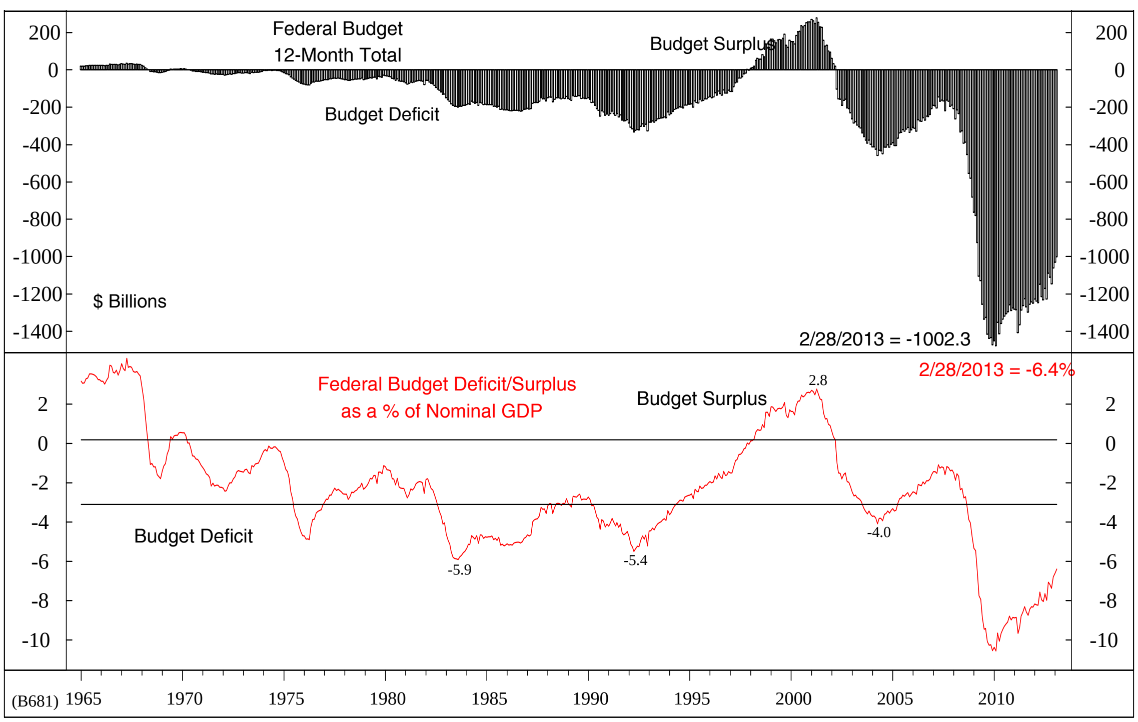
A New Chapter in the Bull Market

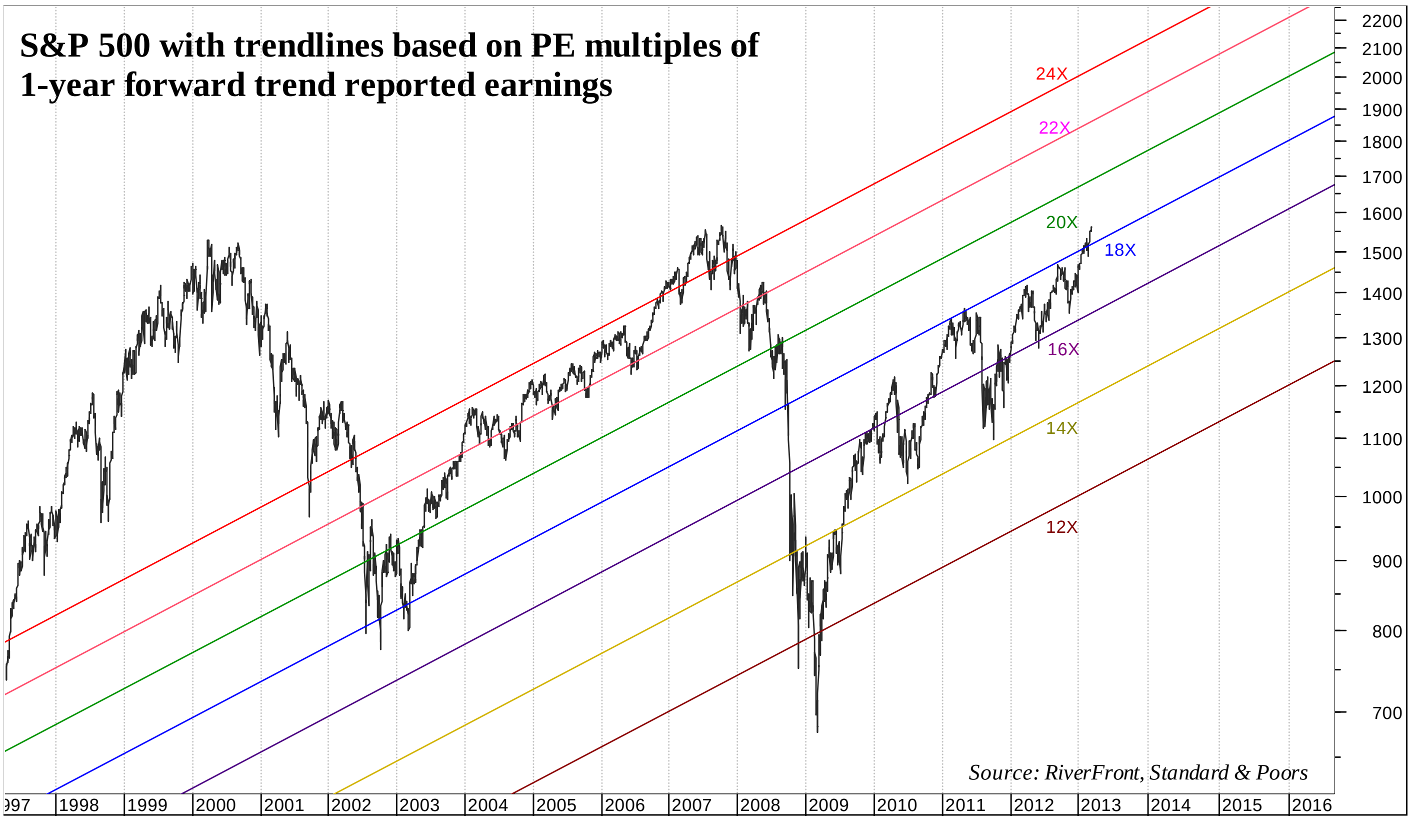
An easing of investor fears has pushed stocks up into a higher valuation range, marking a new chapter in the current bull market (see Weekly Chart). Despite recent events in Cyprus, detailed on page 2, we think this move is justified and reflects investors' recognition that the risks to the US economy have diminished. Nonetheless, our clients have had a hard time reconciling new stock market highs with the dysfunction in Washington. We see a logical explanation: stocks are driven by earnings, which are growing, and interest rates, which are near record lows. Additionally, stocks are moved by changes in news at the margin, i.e., when bad conditions get less bad, it tends to be good for stocks. Last summer, investors were worried about a recession in 2013 when the US fell over the fiscal cliff. Since then, US economic growth has remained positive and has recently accelerated enough to improve retail spending and job creation. Furthermore, the US budget deficit — many investors' number one concern — is improving.

The US budget deficit is getting 'less bad' — it has improved by $475 billion from early 2010, when it was more than -10% of GDP, to -6.4% of GDP currently (see chart below). This improvement is due to a combination of flat spending and increasing revenues. Federal outlays have stopped rising since their peak in the first half of 2011, and US Federal government employment, which peaked around the same time, has since declined by about 2%. US Federal receipts are now back to 2007 levels, up roughly 25% from their lows at the beginning of 2010. Goldman Sachs chief economist Jan Hatzius expects the federal deficit to be down to $500 billion, or just under 3% of GDP By 2015. We think the best cure for the deficit is growth (earnings and employment) because tax revenues (capital gains, income, sales) increase and spending on 'automatic stabilizers' (like unemployment benefits and food stamps) decrease.



Perceived risks to the Eurozone ramped up over the weekend when Cyprus' newly elected government agreed to raise €5.8 billion from a one-time tax on bank deposits, including individuals with small amounts in their accounts, to help pay for a bailout of the country's two largest banks. The ECB had threatened to send these banks into liquidation, which would cripple the nation's financial system and potentially lead to an exit from the Eurozone. The near-term resolution to this tax is clouded — Cyprus' parliament has delayed the vote to pass the legislation until Tuesday, and the banks — which were closed for a holiday on Monday — will remain closed on Tuesday. The concern raised by this package is the precedent set for depositors (even small ones) to absorb losses, potentially sparking a run on weaker banking systems such as Spain and Italy. We believe Cyprus' small size and reputation for money laundering is the reason for the hardline stance by Eurozone policymakers and that this bailout is not a precedent that will be applied to other countries.

THE WEEKLY CHART: VALUATIONS BREAK OUT AS FEARS RECEDE



Past performance is no guarantee of future results

With the S&P 500 back at all-time highs first made in early 2000 and then again late in 2007, we want to stress that earnings have more than doubled in the last 13 years (the PE [price-to-earnings ratio] on trend earnings in March 2000 was 41). For us, this means that stocks are attractively valued today, where they were expensive in both 2000 and 2007. Our chart shows the S&P 500 movement in relation to its 'trend' earnings. Trend earnings are represented by a best fit line through the S&P 500's actual earnings starting in 1935. The line has an annual run rate of 6.1%. We regard trend earnings as a good proxy for the S&P 500's core earnings power because it reduces the impact of the business cycle, thus making it useful for longer-term valuation purposes. We note that actual reported earnings are currently 12% above trend and operating earnings are 24% above, so the PE often quoted in the media is lower. Having derived trend earnings, we then multiply each year's number to show various price-to-earnings ratios (PE) based on trend earnings (the different colored lines in the chart). We think the message of this chart is twofold. First, stocks have broken out from the 14 to 18 PE range that had confined them since 2010. With greater certainty of sustained economic expansion, we anticipate a new trading range centered around 18 times trend earnings and so are not reducing stock weightings. Second, while an 18 PE is high by 'post-Lehman' standards, it is not unusual in a low interest rate environment; indeed stocks bottomed at an 18 PE in 2002/03.