Investment Management of Virginia

# *Investment Viewpoint*

October, 2014

## Overview

We noted in the second quarter's *Investment Viewpoint* that stock performance diverged markedly across different capitalization ranges. These trends continued into the third quarter, which also reflected greater variance in performance among industry sectors and heightened volatility in general. For the third quarter, the Dow Jones Industrials closed up 1.88% and the S&P 500 advanced 1.13%; both indices established record highs intra-quarter. Smaller capitalization indices, however, including the S&P 400, S&P 600, and Russell 2000 did not fare so well, declining -3.98%, -6.73%, and -7.36%, respectively.

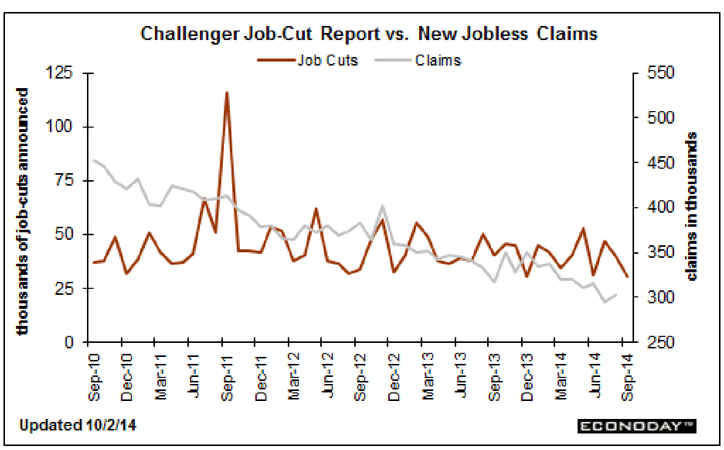
Year-to-date through September 30th, sample index returns were as follows: Dow Jones Industrial Average (+4.56%), S&P 500 (+8.34%), S&P 400 (+3.22%), S&P 600 (-3.72%), and Russell 2000 (-4.41%). With regard to sectors, Energy and Utilities, which had led through the first half of 2014, reversed course, falling -8.62% and -3.96%, respectively. Health Care (+5.46%) and Technology (+4.77%) took the leadership roles during the third quarter.

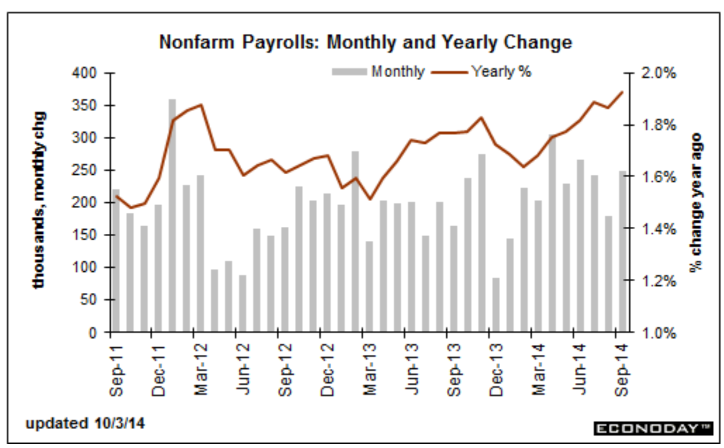
As of June 30th, improving economic fundamentals appeared to be gaining momentum over the weather-handicapped first quarter. In fact, we learned this quarter that U.S. second quarter GDP proved to be even stronger than expected, with annualized growth of +4.6%, the best quarterly gain since early 2006 – and a welcome relief from the 2.1% first quarter decline. Presently, most economists expect that U.S. third quarter GDP growth will prove to have been 2.5% to 3.0%, moderately slow, but near the top of this expansion's range and a bright spot versus other global economies, whose growth slowed into quarter-end. Global economies and markets generally suffered from the uncertainty created by events, including but not limited to, Russia's foray into Ukraine, Islamic extremism throughout the Middle East and Africa, riots in Hong Kong, Ebola's effects, and slower growth in Europe, Japan, and China.

This U.S. versus rest-of-the-world economic/psychological divergence generally favored U.S. assets – the dollar, U.S. Treasuries, and large capitalization stocks. We continue to believe that further advances in the markets are possible near-term, but they will depend heavily on continued earnings improvements. According to S&P Capital IQ, third quarter S&P 500 earnings are expected to post another 7% gain with a 4% expansion in revenues.

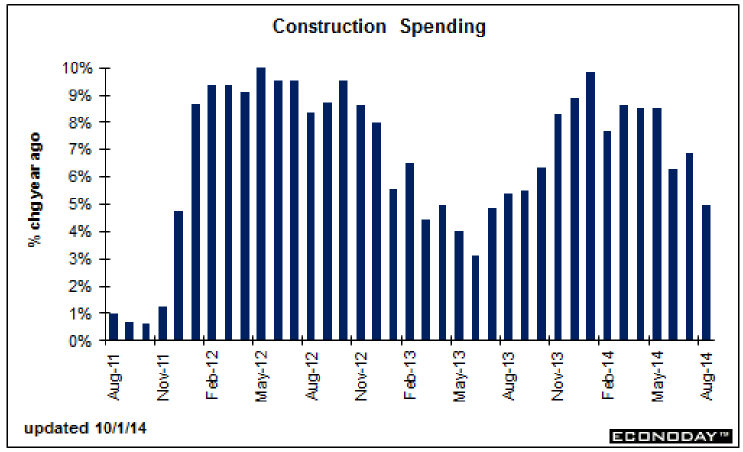
## Economic Trends

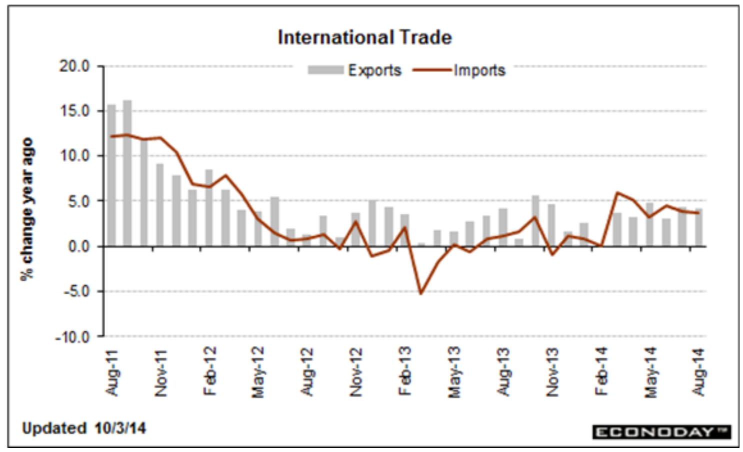
- Layoff announcements in September were the lowest since June of 2000 (per Challenger, see chart below). The U.S. jobless rate declined to a six-year low of 5.9%. The unemployment rate for insured workers remained at a recovery low of 1.8%. Continuing Jobless Claims for the September 20 week fell to a new recovery low, with the 4-week average down to a new recovery low as well.
- Employers added 248,000 in payrolls in September, following August's 180,000 advance. According to Gallup, the uptick in job creation came predominantly from the private sector. Hiring among government entities declined.



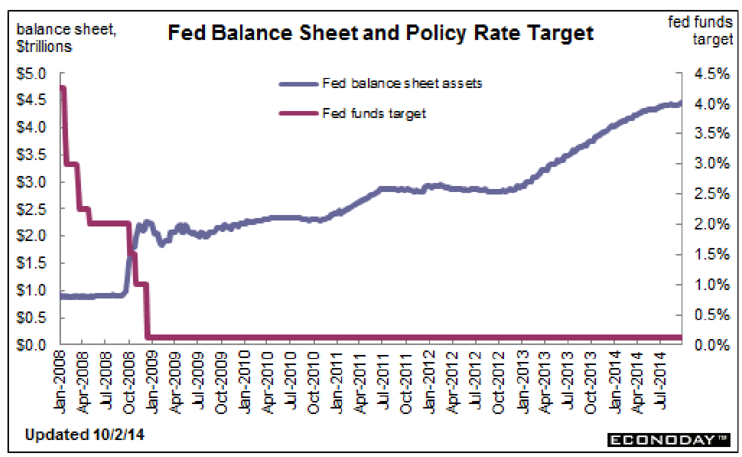
- The consumer sector showed much needed improvement in August for both incomes and spending. Personal income growth posted a 0.3% gain in August, following a 0.2% increase in July. Personal spending jumped 0.5% during the back-to-school season.
- September vehicle sales fell sharply (16.4 million units) compared to an extraordinarily strong 17.5 million unit annual rate in August. Auto sales are expected to remain healthy but face cycle headwinds (having rebounded from the lows of approximately 8 million units annualized).
- Housing continued to disappoint. Rising prices, low inventory, and few first time buyers were the headwinds. Constrained income growth among low-wage earners remained a hurdle as well.
- On a positive note for construction, demand for design services, as tracked in the latest Architecture Billings Index (ABI), were robust across all four sectors (multi-family residential, mixed practice, institutional, and commercial/industrial).
- Manufacturing and service purchasing indexes continued to show growth, though recent readings have eased from extremely high levels.
- International trade conditions were generally favorable in the U.S. The largest component of imports, crude oil/energy, fell in price, benefiting consumers and manufacturers. Healthy export orders provided strength to U.S. manufacturing.

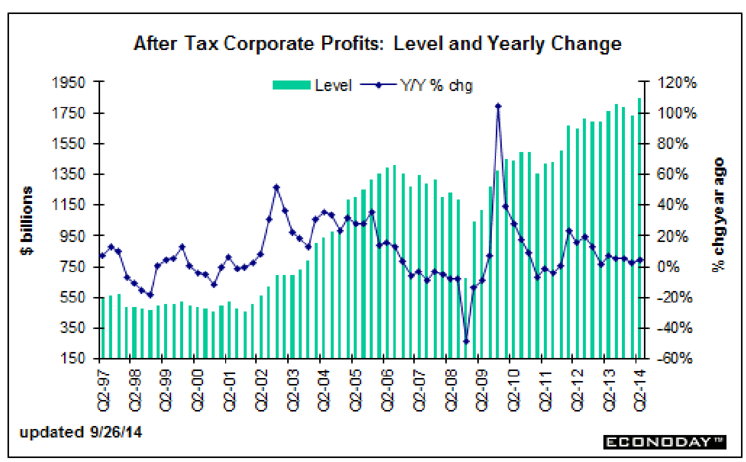


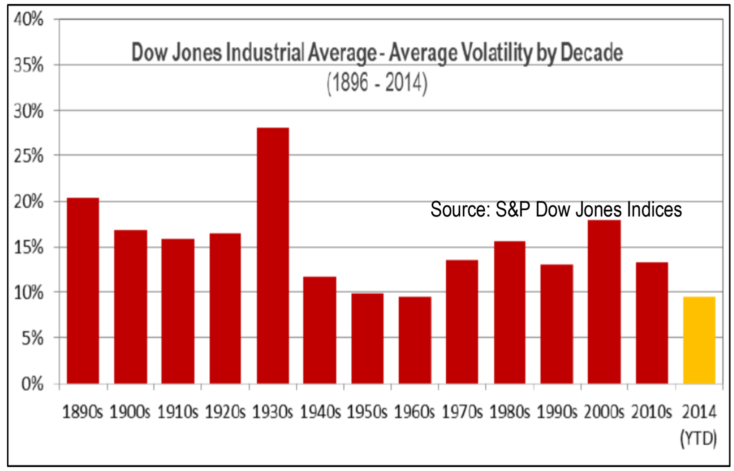

### Financial Conditions/Monetary Trends

- Since 2008, Quantitative Easing programs ("QE") by the Federal Reserve have sought to reflate assets and stimulate corporate profits, with the ultimate goal of passing the torch and responsibility for growth and capital formation to the private sector.
- Over this timeframe, as can be seen in the charts to the right, the Fed's balance sheet has swelled to ~$4.5 trillion.
- Over the same interval, corporate profits and tax payments by corporations and individuals rose substantially.
- Accordingly, QE3 Fed asset purchases are scheduled to end in October. Furthermore, the Fed is planning for the normalization of interest rates – they remain hazy on the timetable; changes in interest rates ultimately will depend on the strength of incoming data, especially those associated with jobs and employment.
- Central banks in Europe, Japan, and a number of emerging economies remain on the path of reflation as well, reducing interest rates and expanding balance sheets.



## Sentiment Indicators/Market Trends




- Thus far in 2014, investor sentiment has been complacent, hovering between neutral and bullish.
- Recently, the majority of our short-term market trend measures moved into over-bought territory, indicating a greater probability of a correction. We last experienced a minor correction in February; there have been no significant corrections since 2012.
- Generally, market strength has been rotating among capitalization ranges and industry sectors.
- As seen in the Dow Jones Volatility chart, volatility in 2014 has been the lowest since the 1950s and 1960s, the last time the economy and Fed fought deflation. It would not be surprising to see a rise in volatility, as we did last quarter. At some point, a modest correction would be healthy as well.

S&P500 (BTTM-UP EST) 10/02/14
(SPXB) 1946.17
Earnings Per Share - % change
Latest Qtr (Jun 14) ........up 12 %

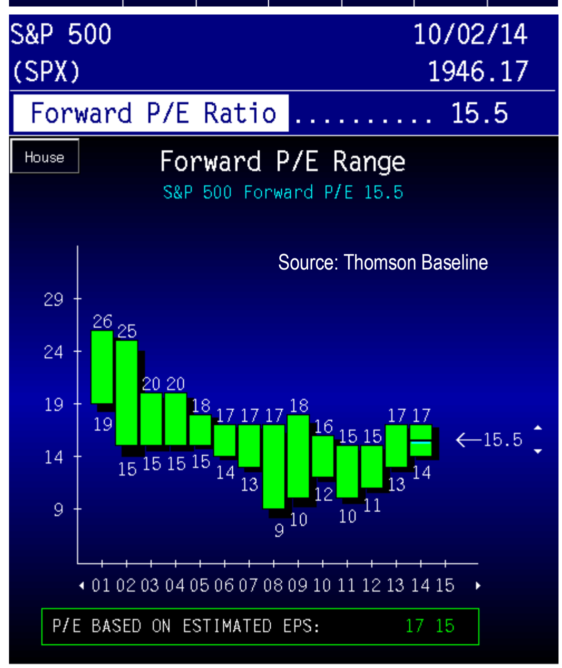
%Y Earnings Per Share
Next Expected EPS Date: Nov 13

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|
| Mar | 13.01 | 19.76 | 23.76 | 25.71 | 26.67 | 28.15 | 30.52 |
| Jun | 16.79 | 21.65 | 25.53 | 26.00 | 27.05 | 30.20 | 32.36 |
| Sep | 17.15 | 22.60 | 25.68 | 26.11 | 27.94 | 28.78 | 32.75 |
| Dec | 18.31 | 22.72 | 24.92 | 26.76 | 29.00 | 31.55 | 34.72 |
| Yr. | 65.27 | 86.74 | 99.88 | 104.58 | 110.67 | 116.79 | 130.42 |
| Yr. to Yr. | 33 % | 15 % | 5 % | 6 % | 6 % | 12 % | |

Source: Thomson Baseline

## Equity Market Valuations & Earnings

- As of quarter end, earnings expectations contemplated 6% growth in 2014 and acceleration in 2015 against a backdrop of improving economic conditions.
- In the third quarter, markets moved marginally, earnings increased, and the trailing price-to-earnings multiple dropped to 16.9 times earnings (as of October 2nd), down from 17.5 times at the end of last quarter.
- The forward looking price-to-earnings multiple (see chart to the right) dropped to 15.5 times forward twelve month earnings. If these earnings come through, that valuation appears reasonable.
- Generally, we are encouraged by Bloomberg, who recently opined that "the companies in the Standard & Poor's 500 Index are the healthiest in decades, with the lowest net debt-to-earnings ratio in at least 24 years, $3.59 trillion in cash and marketable securities, and record earnings per share."

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