Investment Management of Virginia

Quarterly Commentary

April, 2013

Summary
While the status of the recovery remains mixed, fragile, and sub-par in many respects, we are generally encouraged by the recent data, especially the "Wealth Index", an informal measure of the creation of household wealth through rising stock and home values. Wealth Index readings are among the highest since 2007.

We will be more optimistic when we see self-sustaining growth (as opposed to government generated), capable of promoting new capital formation. At present, financial conditions and monetary trends remain uncommonly "easy" and accommodative.

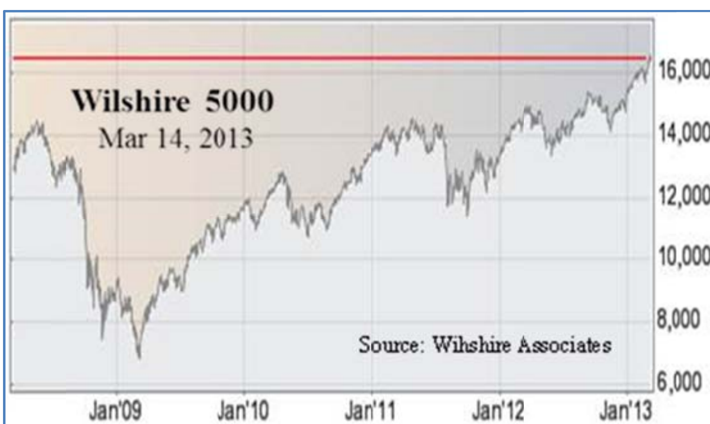
Market data originating from 1920 reveal a median low P/E multiple of 12.4 times earnings and a median high P/E multiple of 16.9 times earnings. Presently, the S&P 500's P/E of 14.9 times earnings appears to be positioned squarely mid-range, making advances in earnings more critical. On a positive note, the S&P 500 Index reflects an earnings yield (earnings/stock price) of 6.7%, far exceeding the paltry yields of high quality fixed income instruments.

In spite of the many worrisome knowns and unknowns that could have paralyzed the economy and markets with fear, the first quarter of 2013 delivered good economic data and excellent market returns. Looking ahead, we would not be surprised to see consolidation or a correction near-term. Common stocks remain relatively attractive on a long-term basis and versus other asset classes.

The Wealth Index – Wealth Effect

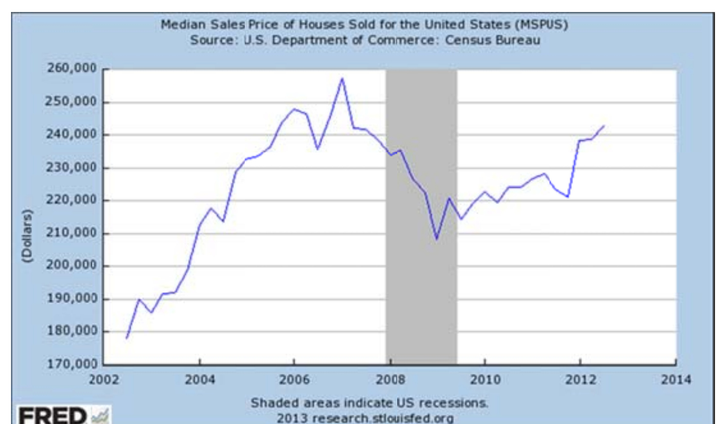
"Fear" remains a fascinating and appropriate topic on this fourth anniversary of the U.S. equity market's trough of March, 2009. Between then and now, investors have endured an exceptionally challenging series of crises and upheavals, ranging from a deep recession and the near-collapse of the global financial system, to threats of sovereign default in Europe, to various self-inflicted calamities that could only occur in Washington. Fear has been high over these four years – and yet, the S&P 500 Index still has managed to rise 132%. The S&P Midcap 400 and S&P Smallcap 600 have fared even better, up 185% and 192%, respectively.

Heading into year-end 2012, worries surrounding the "fiscal cliff" dominated investor psychology. This issue's resolution in early 2013, however imperfect and inadequate, proved sufficient to launch an S&P 500 Index total return of 10.6% during the first quarter.



Given what individuals and corporations have had to digest in order to heal – namely, unprecedented balance sheet repair (and in the case of numerous financial institutions, recapitalization), deleveraging, re-pricing of risks, etc. – it is not surprising that the economic advance since 2009 has been sub-par. It is also important to note that healing and growth among individuals and corporations has come at the expense of government balance sheets.

Looking ahead and before signaling "all clear", we need to see self-sustaining household and corporate capital creation. True growth would enable the Federal Reserve to withdraw its easy-money policies. Nevertheless, we are encouraged by recent trends in the "Wealth Index", an informal measure of the creation of household wealth through rising stock and home values. As seen in the charts below (Wilshire 5000 Index, the broadest measure of total U.S. equity market capitalization; and median price of U.S.



homes), Wealth Index readings are among the highest since 2007.

According to Dr. Ed Yardeni, an economist whose opinion we value, the Fed's flow of funds data show that the value of all stocks in the U.S. has increased by $12 trillion from the first quarter of 2009 through the third quarter of 2012. The value of stocks directly held by individuals is up $4.7 trillion to $9.8 trillion over the same period; the aggregate value of equity mutual funds is up an additional $2.3 trillion. In tandem with stock values, home values have appreciated. As illustrated by the Federal Housing Finance Agency (FHFA) House Price Index, year-on-year valuations have risen 6.5% through January, 2013.

These types of indications generally bode well for confidence, spending, and investment – the very things we need for the recovery to become self-sustaining.

Current Economic Trends

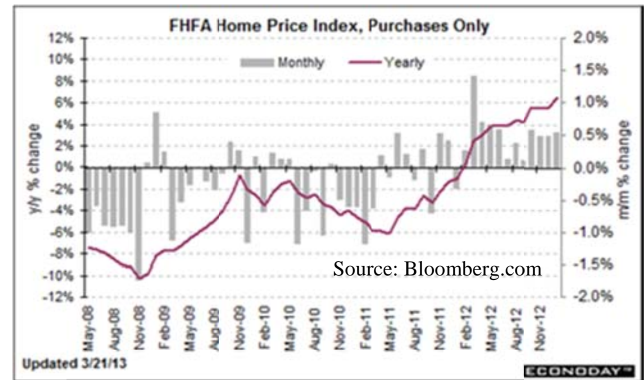
The rising Wealth Index appears to be having the desired effects on corporate activity. In fact, after-tax corporate profits reached record levels in the fourth quarter of 2012. And, as a result of better than expected business performance in the first quarter of 2013, primarily domestic, expectations for full-year GDP growth have advanced from 1% to 2%. While 2% growth remains below normal versus long-term trends, the threats of dramatically weakening economic conditions and zero-to-negative growth (deflation) seem to have diminished.

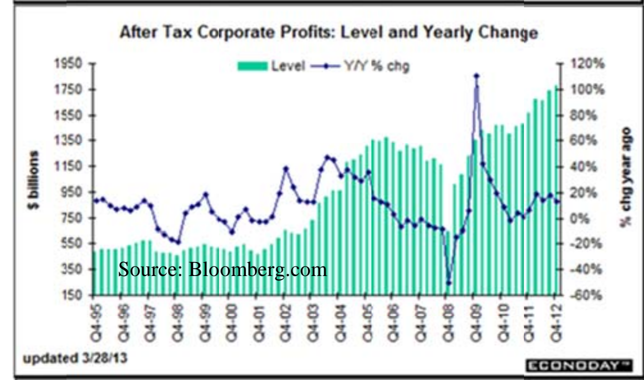
Retail, auto, and home sales have each improved thus far in 2013. Construction spending, housing starts, and even non-residential construction also appear to be on the rise. The NFIB Small Business Optimism Index rose in February, as did the American Institute of Architects' (AIA) new projects inquiry index, which advanced to its highest mark since January of 2007. Additionally, personal incomes have increased; average workweek hours have risen; and, jobless claims have diminished. Hints of increased hiring have surfaced throughout the U.S. economy as well.

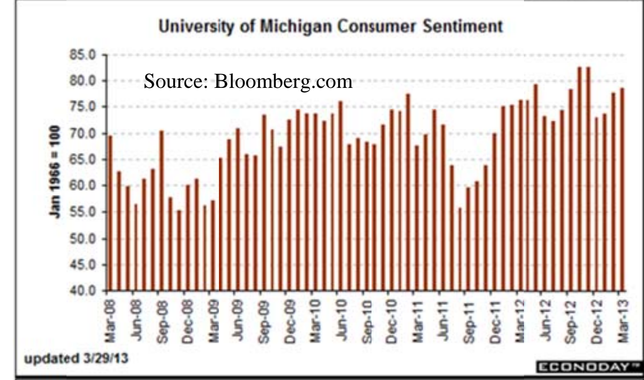
While the status of the recovery remains mixed, fragile, and sub-par in many respects, we are generally encouraged by the data. We will be more optimistic when we see self-sustaining growth (as opposed to government generated), capable of promoting new capital formation.

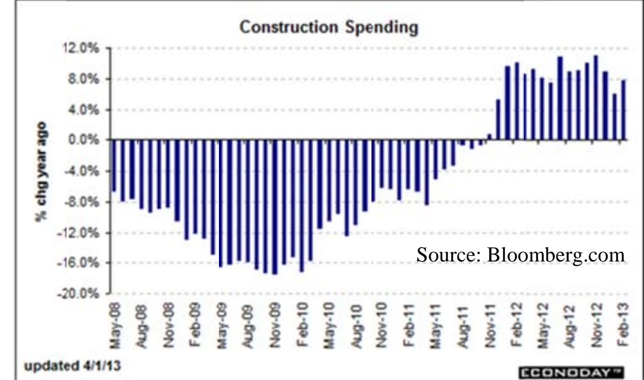
Financial Conditions/Monetary Trends

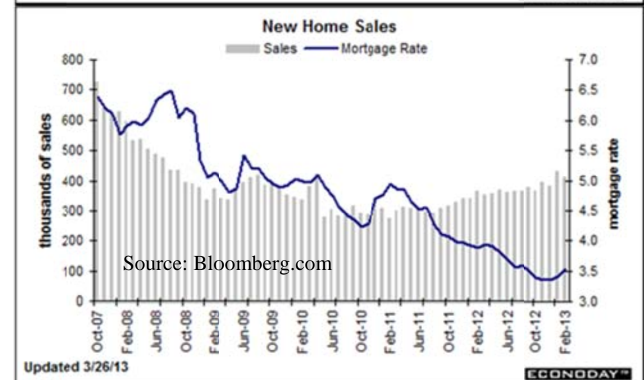
At present, financial conditions and monetary trends remain uncommonly "easy" and accommodative. In the back half of 2012, expectations of decelerating growth led the Federal Reserve to its third round of unconventional monetary policy, also known as quantitative easing (QE3). While the economy is showing signs of improvement thus far in 2013, Core PCE (Personal Consumption Expenditures) Inflation measures were reported at a mere 1.3% annual rate through February, meaningfully below the Fed's 2% longer-run goal. And with unemployment at











7.7%, the Fed's target of 6.5% remains distant. These data points imply little threat of the Fed's reversing course and raising interest rates anytime soon. Then again, we turn to Chairman Bernanke's comments from his recent March 20, 2013, FOMC press conference:

"It bears emphasizing that the Committee has described this program (QE3) in terms of a monthly pace of purchases, rather than as a total amount of expected purchases, and has tied the evolution of the program to economic criteria—specifically, to the achievement of a substantial improvement in the outlook for the labor market in a context of price stability. Within this framework, the Committee could vary the pace of purchases as progress is made toward its economic objectives or if its assessment of the efficacy and costs of the program changes. At this meeting, the Committee judged that no adjustment was warranted."

Sentiment Indicators/Market Trends

Since our last quarterly review, we've seen a downgrade in both our sentiment and market trends conditions. Sentiment appears more neutral, and the preponderance of our short-term market trend metrics indicate over-bought conditions. Traditionally, these readings would imply higher risk and higher probability of corrective market action. Given recent economic strength, along with highly accommodative financial and monetary trends, we hesitate to take extreme defensive actions. In fact, history reveals similar data series where periods of rotation or sideways market action remedied such conditions – ahead of a longer-term advance.

Equity Market Valuations & Earnings

Equity Market Valuation has also seen a downgrade, to a more neutral position. Typically a market move of 10.6% in a single quarter requires some period of consolidation thereafter. To be sure, the market is no longer obviously "cheap" from our perspective.

Market data originating from 1920 reveal a median low P/E multiple of 12.4 times earnings and a median high P/E multiple of 16.9 times earnings. Presently, the S&P 500's P/E of 14.9 times earnings appears to be positioned squarely mid-range, making advances in earnings more critical. Nevertheless, with the S&P 500 Index reflecting an earnings yield (earnings/stock price) of 6.7%, far exceeding the paltry yields of high quality fixed income instruments, common stocks remain relatively attractive on a long-term basis and versus other asset classes.

Record S&P 500 Index profits of $104.58 per share were earned in 2012, up 2% over 2011; this year's expectation for earnings improvement is currently penciled in at 6%. Should economic trends continue to improve, consensus earnings may prove to be too low. Furthermore, we note that corporate CEO's apparently (and understandably) have been providing very conservative guidance. In a similar vein, analysts have been stingy with their forecasts. Ultimately, confidence in the economy will tell the tale and drive earnings.

Conclusion

In spite of the many worrisome knowns and unknowns that could have paralyzed the economy and markets with fear, the first quarter of 2013 delivered good economic data and excellent market returns. Looking ahead, we would not be surprised to see consolidation or a correction near-term. Longer-term, common stocks appear attractive, especially when compared to alternative investment opportunities.

For an in depth review of our Market Pillars and Charts, visit: http://www.imva.net/market-pillars/.

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