# Quarterly Commentary

Investment Management of Virginia

October, 2013

**Summary**
Through the end of the third quarter, 2013 delivered expansion in corporate profits, jobs, consumer confidence and spending, and the equity markets (record highs). During the three-month period, the S&P 500 Index rose 5.24%, while the smaller capitalization Russell 2000 Index advanced 10.21%. Year-to-date, the indices had returned 19.79% and 27.69%, respectively.

Second quarter U.S. gross domestic product (GDP) surprised to the upside, growing 2.5%, a marked improvement over first quarter growth of 1.1%. Looking ahead, most forecasts reflect a continued push toward 2.0%-2.5% GDP, with accelerating growth in 2014. Recent reports show that retail sales may now be moderating. Consumers are still working down their debts, even as household net worth has been rising. With global economies improving and capital spending increasing, U.S. trade, manufacturing, and export orders have rebounded recently.

As of September 30, 2013, the forward price-to-earnings multiples for the Dow Jones Index and S&P 500 Index were 13.0x and 14.7x, respectively – a far cry from 2009 valuations of 9-10 times earnings. When current multiples are compared to those of longer data series, they appear reasonable. On the other hand, price-to-sales valuation metrics appear high. Some justification for these high readings can be found in corporate profit margins, which are healthy – and at record highs by some gauges. For further earnings and market advances, these margins must hold, and revenues must rise. S&P 500 Index earnings grew 2% in 2012; they are trending toward 4% growth in 2013; and 11% growth is expected for 2014.[2]

Presently, the yield curve is steepening, and the Federal Reserve remains accommodative but seeks an opportunity to normalize rates. Also, the four largest world economies (U.S., Eurozone, Japan, and China) show early signs of a possible synchronized expansion. Although fluid, these observations would tend to support continued expansion, not a recession. Recessions normally end equity bull markets.

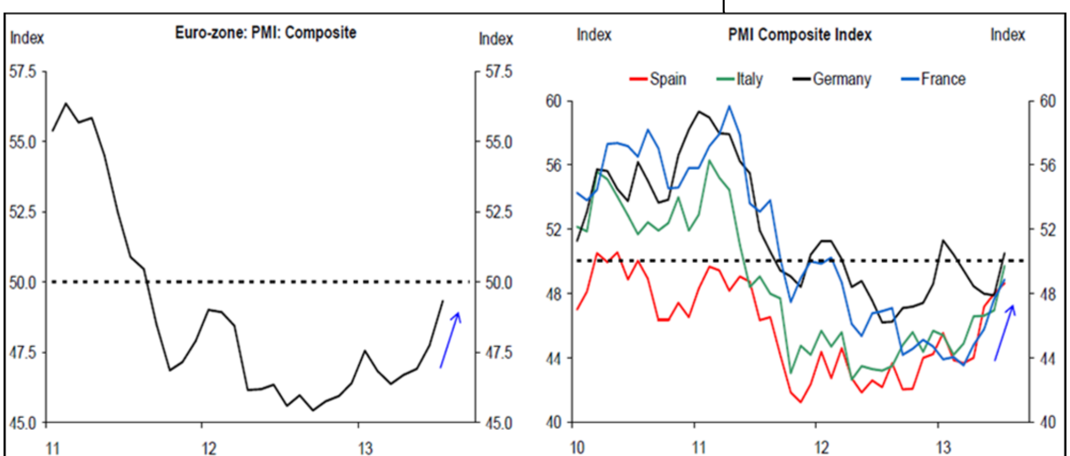
## Seeking Sustainable Growth

Through the end of the third quarter, 2013 delivered expansion in corporate profits, jobs, consumer confidence and spending, and the equity markets (record highs). During the three-month period, the S&P 500 Index rose 5.24%, while the smaller capitalization Russell 2000 Index advanced 10.21%. Year-to-date, the indices had returned 19.79% and 27.69%, respectively.

Outside of the U.S., the data and markets brightened as well. After several years of contraction, developed economies around the globe began to show signs of positive growth. The Euro area LEI (leading economic indicator index) was up three months in a row, and PMIs (purchasing manager indices) appear to be turning up in Europe (with particular strength in the UK), Japan, and China. Equity markets have taken notice in these regions. These economies, combined with the U.S., account for 65% of world GDP, which helps drive the remaining 35% of world growth. For the first time since 2007, the opportunity for synchronized global growth is in view.

Even as these advances have occurred, investors have had much to worry about, including stubbornly high unemployment, war in Syria, growing unease across the rest of the Middle East and Africa, and dysfunction in Washington. These concerns notwithstanding, history – including the most recent 4.5 years – reminds us that slow economic growth and expansionary monetary policy can be bullish for the markets. In fact, The Fed's decision to continue its current level of support, announced September 18, prompted record market highs.

Presently, the Federal Reserve needs to see better economic data and more rational activity in Washington before it reduces/"tapers", and ultimately ends, its intervention in the form of monthly bond purchases ("quantitative easing"). This co-dependent dynamic between market advances and Fed intervention is unsustainable, and we would not be surprised to see more volatility in the near future. Nonetheless, recessions normally end bull markets, and we don't see one occurring imminently – unless our government participants manufacture one.




Source: Markit, Haver Analytics, DB Global Market Research

As we write this commentary, a government shutdown, due to the lack of appropriations legislation, has been enacted. Of greater potential significance is the upcoming national debt limitation. The Treasury Department reports that the U.S. government, absent new legislation, will run out of additional borrowing authority on October 17th. According to the Congressional Budget Office, the government will then have a cash balance that will last until the last week of October. We have seen much of this movie before. Hopefully, as in 2011 and 2012, rational heads will prevail soon.

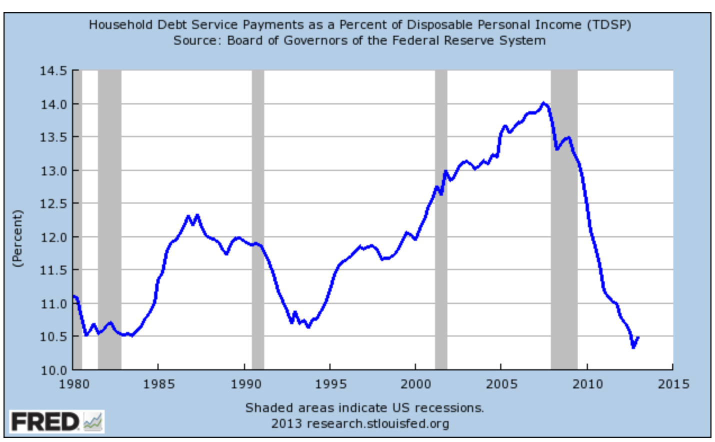
**Economic Trends**

Second quarter U.S. GDP surprised to the upside, growing 2.5%, a marked improvement over the initial estimate of 1.7% and first quarter growth of 1.1%. The latter was notably weak, owing to "fiscal cliff" and sequestration concerns – hopefully, this fact has not been lost on our politicians. Looking ahead, most forecasts reflect a continued push toward 2.0%-2.5% GDP, with accelerating growth in 2014.

Since 2009, the U.S. recovery has relied upon different drivers. In the first few years, U.S. growth was concentrated in international trade and manufacturing export orders. These


trends favored corporate interests but were sparsely felt by the general population. Beginning in late 2011, pent-up consumer demand picked up the torch, generating a strong resurgence in the auto, housing, and retail sales markets. Meanwhile, international economies weakened, pressuring U.S. trade and exports.

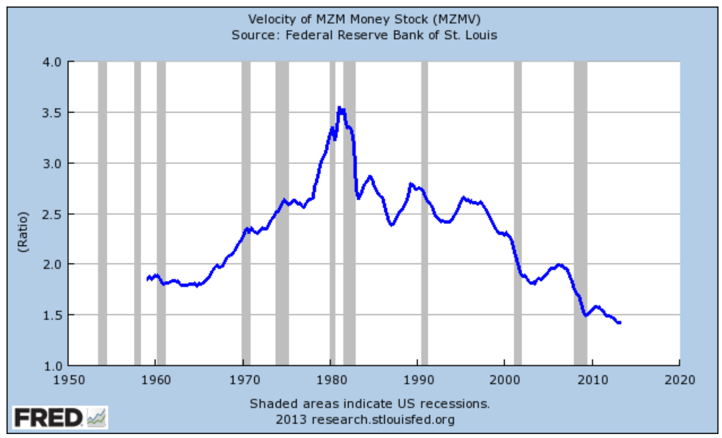
Recent reports show that retail sales may now be moderating. Consumers are still spending, but autos and housing growth cannot compound at recent rates indefinitely. Additionally, consumers are still working down their debts, even as




household net worth has been rising. In fact, household debt service payments, as a percent of disposable personal income, are now the lowest in more than thirty years. With global economies improving and capital spending increasing, U.S. trade, manufacturing, and export orders have rebounded recently.

**Financial Conditions/Monetary Trends**

While the Federal Reserve, through quantitative easing and other measures, has made available unprecedented amounts of capital, much of the money has migrated back to the Federal Reserve Bank in the form of excess bank reserves. The world is awash with dollars ($12 trillion in Money of Zero Maturity, or "MZM") that could be used to finance growth, but these dollars are not making their way into the economy. In fact, nominal GDP growth is tracking at 3.2%, half the long-term average. Put another way, money's velocity – the measure of product output for each one dollar of available currency – is extremely low. In fact, money's velocity is the lowest in more than fifty years. With consumers, corporations, and countries around the globe deleveraging, the effort to entice growth through borrowing and spending is like "pushing on a string."




With below trend growth, accompanied by increased fiscal risks, the Federal Reserve delayed the inevitable act of withdrawing or "normalizing" monetary policy. The central banks of Europe, Japan, and China, also remain accommodative. As for now, yield curves are steepening, historically a favorable indicator for economic growth and the markets. By comparison, flattening or inverted yield curves generally indicate high odds for recession. Assuming that forecasts of accelerating economic growth do materialize, tapering will be a subject to be revisited.

**Sentiment Indicators/Market Trends**

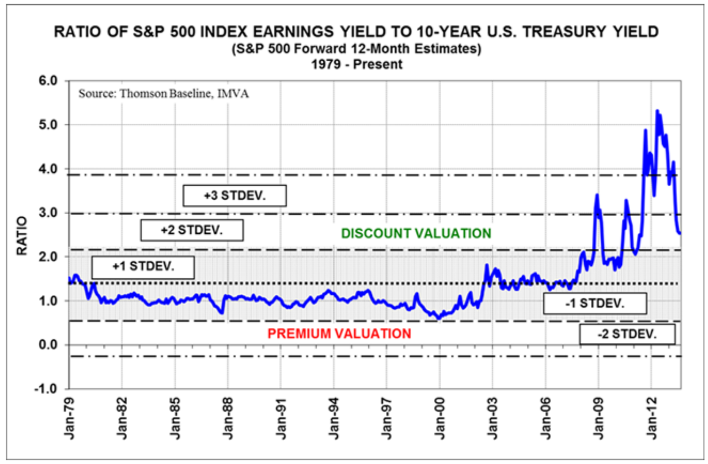
Sentiment and market trend indicators are mixed, perhaps reflecting "over-bought" near-term but "neutral" on a longer term basis. From these levels, we might expect a correction, consolidation, or continuing rotation. Most of 2013 has been characterized by the latter. Through mid-May, yield oriented and defensive positions tended to lead market performance. On the mention of Fed tapering, these positions began correcting (valuations had been pushing the high end), and growth oriented stocks began to advance. From May 21st (the day before taper talk) through September 30th, the S&P 500 Index advanced only 0.7%, yet the smaller capitalization Russell 2000 Index rose 7.5%. Internal rotation of market leadership may be a healthy sign, demonstrating the desire for money to stay in stocks. Generally, with expectations of rising interest rates at some point, money continues to migrate from bonds, and particularly bond funds, into stocks – which, judging from mutual fund data, had previously experienced years of outflows. We are encouraged by Deutsche Bank's recent suggestion that the implied retail equity allocation to stock mutual funds is still near a 17-year low.

**Equity Market Valuations & Earnings**

Since 1920, the average of the yearly high price-to-earnings multiple for the Dow Jones Industrial Index is 16.7x; the average of the yearly low price-to-earnings multiple is 12.3x.[1] As of September 30, 2013, the forward price-to-earnings multiples for the Dow Jones Index and S&P 500 Index were 13.0x and 14.7x, respectively.[2] When compared to 2009 valuations of 9-10 times earnings, current multiples appear rich, prompting some to fear that the market has run too far. When compared to longer data series, valuations appear reasonable. In 2009, valuations were at twenty-year lows.

On the other hand, price-to-sales valuation metrics appear high. Some justification for these high readings can be found in corporate profit margins, which are healthy – and at record highs by some gauges. In an era of growth (however slow), low interest expense, deleveraging, tight cost controls, and measured hiring, we would expect margins to be high. But, some of the associated numbers are in fact stunning. According to a Bloomberg report, the "combination of near-zero rate policy and more than $3 trillion of bond purchases by the Fed since December 2008 means that the collective interest savings enjoyed by Apple, Verizon and more than 2,000 other corporate borrowers exceeds Switzerland's $632 billion economy."

For further earnings and market advances, these margins must hold, and revenues must rise. S&P 500 Index earnings grew 2% in 2012; they are trending toward 4% growth in 2013; and presently, 11% growth is expected for 2014. History demonstrates an extremely high correlation (93%) between the S&P 500 Index and forward earnings. Additionally, we remain encouraged by the equity market's earnings yield (earnings/price), particularly when we compare it to that of alternative investments. As of the end of September, the S&P 500's forward earnings yield was 6.84%, compared to the 10-year U.S. Treasury yield of 2.61%.




**Conclusion**

Setting aside all the noise, and looking ahead, we believe that company-specific earnings data will drive investment returns. Future equity market advances will require continued earnings growth. Presently, the yield curve is steepening, and the Federal Reserve remains accommodative but seeks an opportunity to normalize rates. Also, the four largest world economies (U.S., Eurozone, Japan, and China) show early signs of a possible synchronized expansion. We understand that these dynamics will not last forever or may never fully develop, but in our view, these observations support continued expansion, not a recession. Recessions normally end equity bull markets. As for Washington, our request is simply "do no harm!"

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

[1]Source: Bloomberg LP, Thomson Baseline, Value Line, and IMVA.
[2]Source: Thomson Baseline.



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