Investment Management of Virginia

Investment Viewpoint

January, 2014

Overview

The U.S. equity markets wrapped up 2013 with a stellar final quarter, with most indices recording double-digit gains. The Dow Jones Industrial Average, S&P 500, S&P 1500, and Russell 2000 finished the fourth quarter with returns of 10.2%, 10.5%, 10.3%, and 8.7%, respectively.

The major averages also set new highs, each concluding the year with a gain greater than 29.0%. For example, the S&P 500 finished 2013 at 1848.36 with a total return of 32.4%, representing a fresh all-time high (the first at year-end since 1999) and the Index's best annual performance since 1997. The Dow Jones Industrial Average enjoyed its best year since 1995, returning 29.6% and reaching a new high at year-end. The S&P 1500 and Russell 2000 finished 2013 with total returns of 32.8% and 38.8%, respectively, as smaller cap companies fared best of all in 2013. The industry groups that lagged were those whose performance tends to be inversely correlated to rising interest rates, e.g., utilities and REITs.

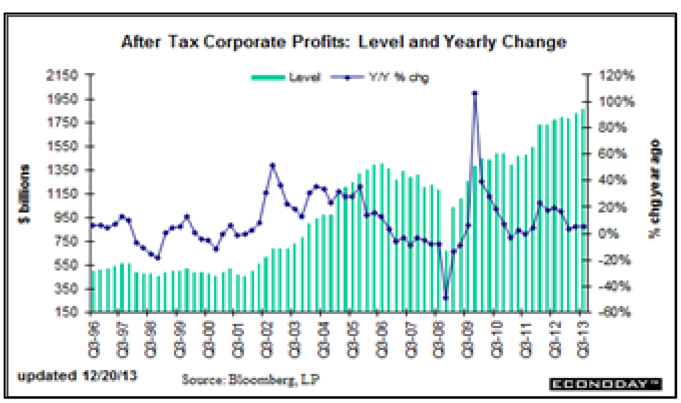
Ten-year U.S. Treasury yields started the year at 1.76% and finished at 3.03%, reflecting a decline in price. The spread between the 2-year and 10-year U.S. Treasury yields widened considerably, from 1.51% to 2.65%. With respect to corporate bonds, the S&P U.S. Issued Investment Grade Corporate Bond Index lost 1.59% for the year; the S&P U.S. Issued High Yield Corporate Bond Index gained 6.43%.[1] Historically, environments characterized by a steepening yield curve and low quality bonds' outperforming high quality bonds often foreshadow improvements in the economy and equity markets.

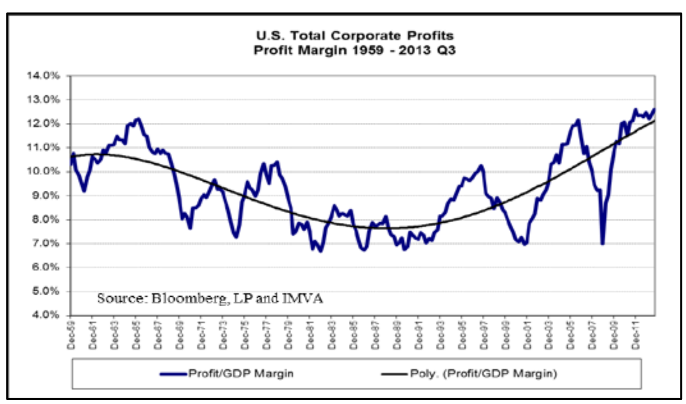
The sequential rate of real U.S. GDP growth has averaged an annualized figure of only 2.3% since we exited the recession in the third quarter of 2009, according to Wells Fargo Economic Group. Real GDP growth, which had been 1.1% in the first quarter of 2013, accelerated with gains of 2.5% and 4.1% (annualized) in the second and third quarters, respectively. With global economies improving and capital spending increasing, U.S. trade, manufacturing, and export orders have rebounded. Further acceleration in GDP growth appears promising for 2014, given recent economic data.

Quantitative Easing or Fundamentally Driven?

Some argue that equity gains in 2013 were driven by the Fed's QE (Quantitative Easing), not by fundamentals, yet…

- Recent year-end reports suggest that economic strength improved in Europe, with notable acceleration in the UK.
- In the Asia Pacific region, Japan's upturn was solid, and China continued to target 7%-8% annual growth.
- The largest global economies, including the U.S.'s, delivered signs of synchronized growth not seen since 2006-07.
- U.S. corporate profits rose to new highs along with profit margins (see charts below).
- S&P 500 Index company earnings achieved new record highs
- According to J.P. Morgan, a "wealth effect" of $8.8 trillion occurred in 2013, due largely to rising equity market and home values.
- Net worth for households and non-profit groups rose by $1.92 trillion in the third quarter alone.
- Consumer and small business confidence rose; personal income and spending rose; and job growth expanded.
- The missing link remained business confidence (as reflected in capital spending), but improvements were noted.





Economic Trends

Business investment in equipment appeared to advance.

- Though leadership changed hands, housing, autos, retail, and manufacturing all demonstrated strength in 2013.
- As seen in the top chart, industrial production surged, following the resolution of the government shutdown; manufacturing, having lagged early in the year, improved as well.
- Capacity utilization leaped to a post-recovery high, indicating that slack in production had diminished (second chart from top).
- In the November durable goods orders report, nondefense capital goods orders excluding aircraft expanded by 4.5%; shipments jumped 2.8%.
- U.S. demand for petroleum products increased to more than 19 million barrels per day (YTD cumulative daily average), the highest level of demand since 2010 (still ~2 MBPD below peak demand).

Financial Conditions/Monetary Trends

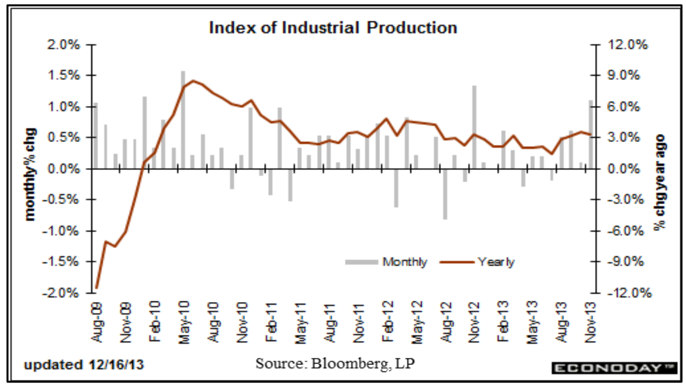
The first steps toward "normalization" were taken.

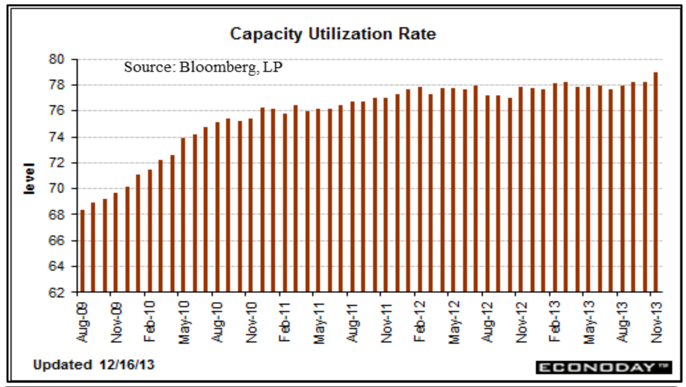
- The Federal Reserve's path to drawing down Quantitative Easing was announced; beginning in the first quarter of 2014, stimulus will be reduced to $75 billion per month instead of $85 billion.
- Noting that the yield curve had steepened and that longer term interest rates had risen, the FOMC's December assessment suggested that short-term rates would remain low, perhaps until late 2015 or early 2016.
- As seen in the adjacent chart, past periods of a steep yield curve and wide T-Bill/10-yr. UST spreads have tended to reflect periods of economic expansion.
- According to PIMCO, the U.S. fiscal drag detracted ~1.3% from U.S. GDP in 2013; looking ahead, the reduction in fiscal drag for 2014 could boost growth by ~0.7%.

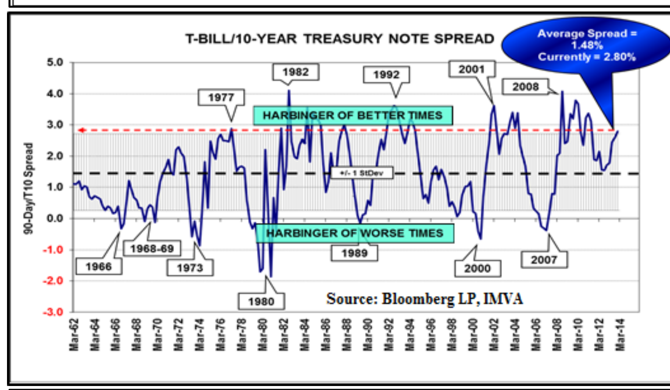
Sentiment Indicators/Market Trends

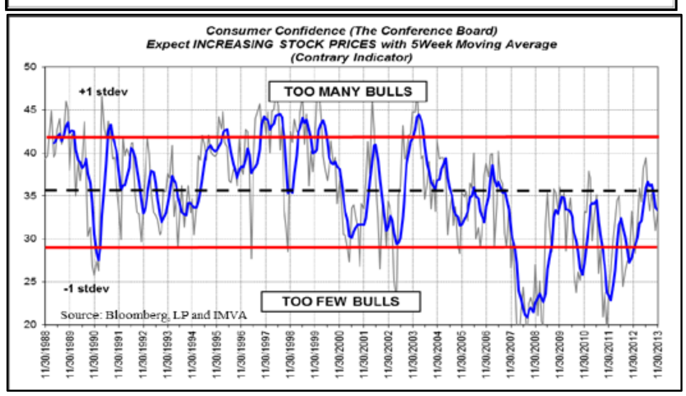
Sentiment and Market Trends appeared neutral.

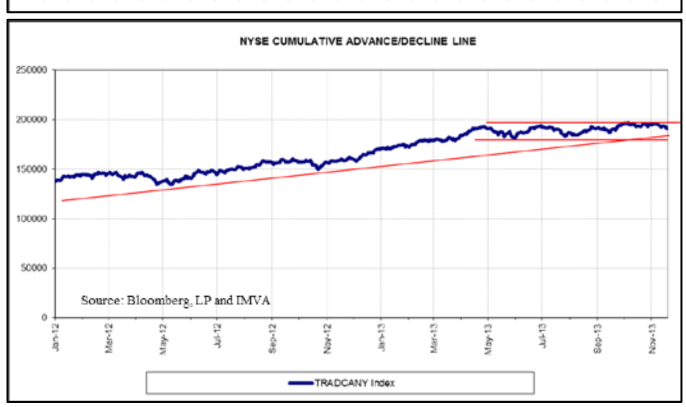
- According to the Conference Board, investors expecting stock prices to rise (a contrary indicator) had a neutral reading at year-end.
- Underlying 2013's banner equity market gains were a series of healthy rotational corrections; various sector and industry groups participated at different times, respectively.
- The NYSE cumulative advance/decline line chart reflected investor caution into year-end; the net cumulative total of advancing stocks moved sideways, beginning in May, even as market indices moved higher.











Equity Market Valuations & Earnings

What drives valuation?

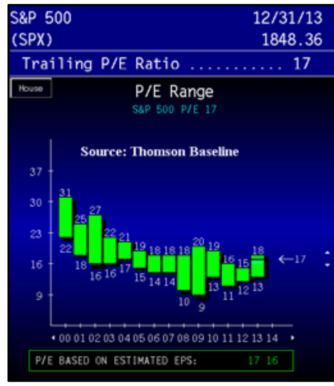
- In 2009, stock valuations were at twenty-year lows. As fears of an economic depression receded, animal spirits returned; and stock prices moved up toward actual intrinsic values.
- Earnings growth turned positive in late 2009 and has since expanded to new record highs; stocks advanced to record levels as earnings expanded.
- As of year-end, valuations appeared full or fair near-term but not expensive on a longer term basis.
- During this stage in the market cycle, and looking ahead, valuations are typically driven by forward earnings, revenue, and cash flow growth.
- The middle two charts at the right show acceleration of forward-looking growth measures.
- We remain mindful that optimism can drive returns over short-term timeframes, but underlying earnings results and potential drive them over the long-term.

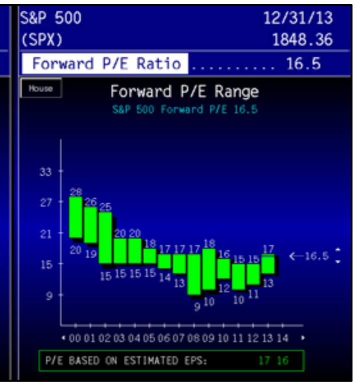
Several catalysts could accelerate earnings in 2014.

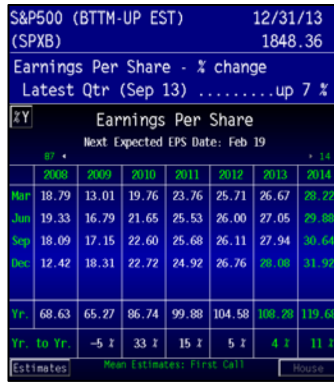
- Simultaneous if uneven expansions among the largest global economies (US, Eurozone, UK, Japan, and China) bode well for stronger nominal GDP readings.
- Nominal GDP growth and corporate sales growth appear to be highly correlated.
- Improving industrial production and higher capacity utilization could lead to improved productivity, particularly as wage and unit labor cost inflation remain low.
- The value of U.S. corporate pensions soared this past year (biggest improvement in ~25 years), and pensions now cover approximately 96% of future obligations (versus a reading of below 80% as of the end of 2012); this could relieve an enormous drag against earnings – and according to *The Wall Street Journal*, "The news could get even better in 2014 if bond yields rise."
- As profits earned by U.S. Corporations abroad are repatriated in an increasingly healthy global economy, strength among foreign currencies (Euro, Pound, and Yuan; possibly less Yen weakness) versus the U.S. dollar could have a favorable impact on foreign currency translation adjustments and earnings.

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

[1]Source: S&P Dow Jones Indices' Market Attributes: Index Dashboard U.S, December, 2013.

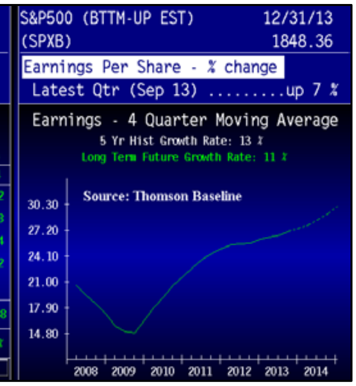


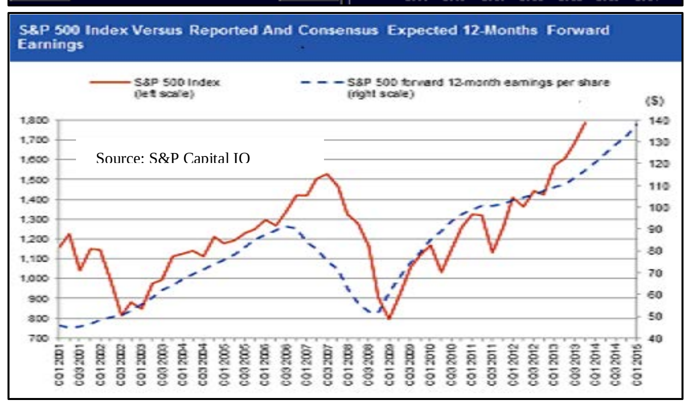


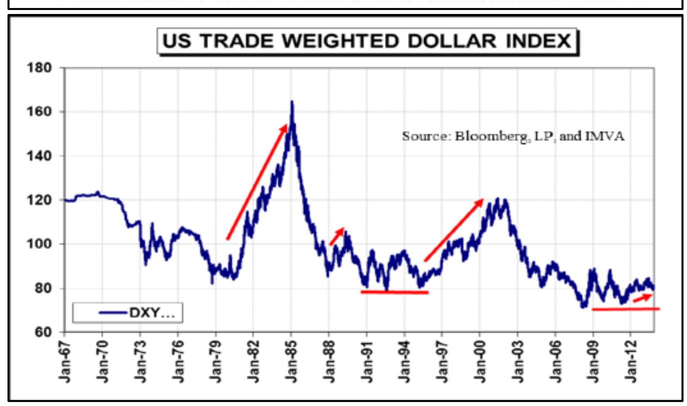

S&P500 (BTTM-UP EST) 12/31/13
(SPXB) 1848.36
Earnings Per Share - % change
Latest Qtr (Sep 13) ....up 7 %
Earnings Per Share
Next Expected EPS Date: Feb 19

	2008	2009	2010	2011	2012	2013	2014
Mar	18.79	13.01	19.76	23.76	25.71	26.67	28.22
Jun	19.33	16.79	21.65	25.53	26.00	27.05	29.88
Sep	18.09	17.15	22.60	25.68	26.11	27.94	30.64
Dec	12.42	18.31	22.72	24.92	26.76	28.08	31.92
Yr.	68.63	65.27	86.74	99.88	104.58	108.28	119.68
Yr. to Yr.		-5 %	33 %	15 %	5 %	4 %	11 %

Mean Estimates: First Call







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