Investment Viewpoint

April, 2014

Overview

In 2013, the S&P 500 Index recorded the sixth best gain since 1950, closing at a record high. During the first quarter of 2014, the markets seemed to be digesting these gains, fretting over cold weather and international events, holding their breath for earnings follow-through and signs of capital spending, and generally chopping around. This exercise in anticipation and consolidation resulted in flat performance. The S&P 500, S&P 600, S&P 1500, and Russell 2000 all closed the quarter within a percentage point range, up 1.81%, 1.13%, 1.88%, and 1.12%, respectively.

Much of the consolidation that took place appeared rotational in nature, with investors shifting money from leaders into laggards. For example, the utility index, which had lagged significantly since last May, advanced by more than 10% in the first quarter of 2014; the consumer discretionary sector – a star in 2013 – performed poorly. We view this passing of the torch as healthy.

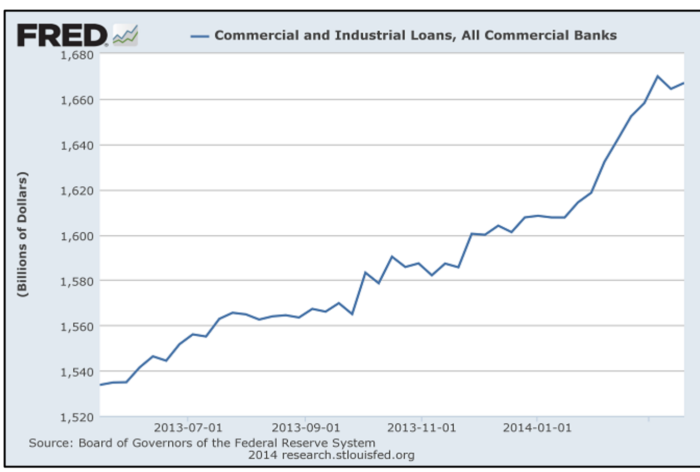
After successfully pulling out a less than remarkable, but better than feared, holiday retail sales season last year, the U.S. economy took a breather as a series of unusually heavy winter snows, accompanied by persistently cold weather, blanketed the nation. Consumers and business people stayed home, shipping backed up, and inventories stacked up. First quarter GDP expectations are being adjusted accordingly (into the 1.5% range +/-). Nevertheless, most economic indicators pointed toward growth at quarter-end, including measures related to jobs, wages, industrial production, capacity utilization, and capital spending. Thus far in the economic expansion that began in 2009, business confidence as reflected in capital spending had been the missing link. Overall, patterns typical of a mid-cycle expansion appear to be developing.

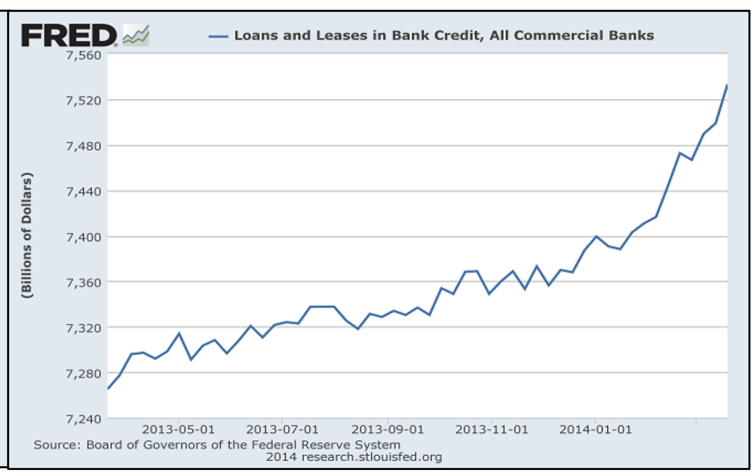
Recognizing that the past never repeats itself exactly, and that past performance is no guarantee of future results, we are encouraged to find that following each of the five best equity market years since 1950, the next year yielded decent results – let’s hope for a rhyme!

Economic Trends

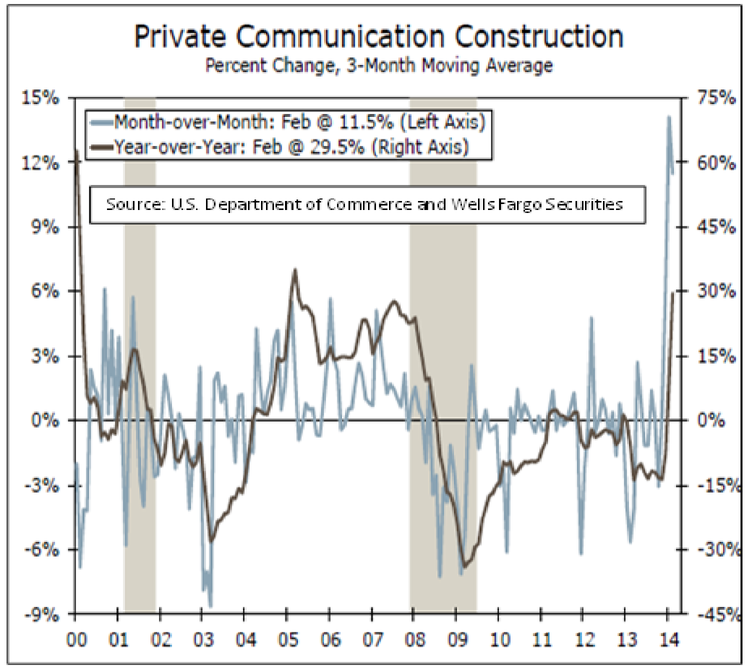
Indications of increased capital spending have appeared; other data appear supportive as well.

- According to the Business Roundtable, the CEO Outlook Index rose to the highest level in two years in the first quarter. The biggest improvement occurred in investment spending. Nearly half of the CEOs surveyed said that they plan to invest more in the next six months, up from 39% last quarter. Randall Stephenson, CEO of AT&T, attributed the better outlook to more stability and certainty surrounding tax and spending policies in Washington.
- As seen in the charts below, Commercial and Industrial Loans and Loans and Leases in Bank Credit took a sharp rise during the first quarter of 2014. These measures are typically barometers of capital spending plans.
- Private non-residential construction spending is up 12.5% Y/Y and has increased in 10 of the last 12 months.





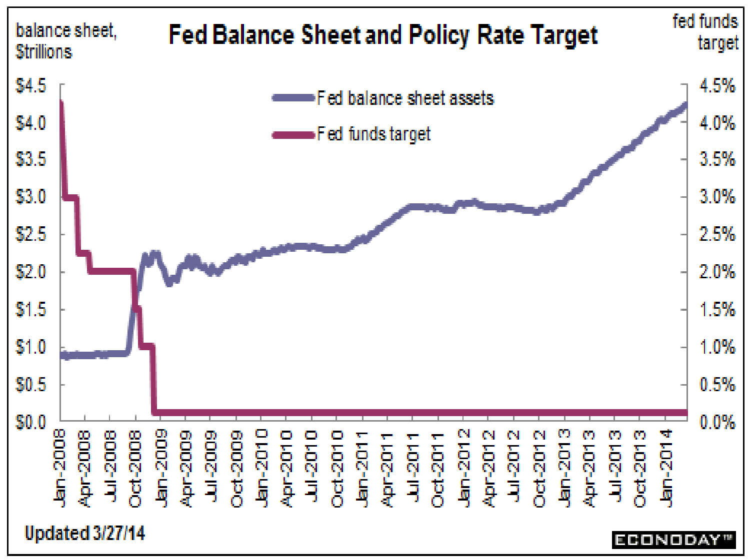
- Construction spending rose in February with private non-residential spending up 1.2%. Outlays for communications showed a significant turn.
- Factory orders bounced in February, following January's decline, with major lifts in commercial aircraft orders (+13.4%) and motor vehicle orders (+3%).
- Total motor vehicles sales recovered from weather-induced weakness with 16.4 million units sold (annualized) in North America in March.
- Manufacturing, as reflected in the March ISM purchasing manager's report, expanded; supplier delivery times improved; and production surged. New domestic and export orders also showed strength, with solid order backlogs.
- Generally, as of quarter-end, layoffs had declined, wages had risen, and consumer confidence and balance sheets were healthy. The outlook remained positive.



Financial Conditions/Monetary Trends

Tapering will result in less stimulus – but slowly.

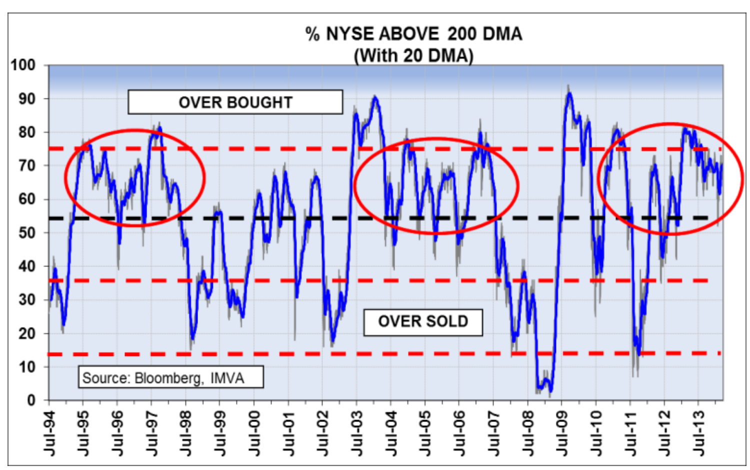
- According to Chairman Janet Yellen, the "scars from the Great Recession remain, and reaching our goals will take time."
- With respect to unemployment, the Federal Reserve believes that an "extraordinary commitment is still needed and will be for *some time*…" (Yellen)
- The Fed's specific goals include the commitment to a 2% inflation objective and the resolution of the "considerable slack in the economy and the labor market." (Yellen)
- During the first quarter of 2014, the yield curve flattened somewhat, in line with weakened economic reports. Even so, the curve retained an upward, positive slope.
- In time, and assuming the Fed is successful in achieving its goals, it will raise interest rates. The timing ("some time") is uncertain but likely not near-term.



Sentiment Indicators/Market Trends

Sentiment/Market Trends maintained a neutral stance.

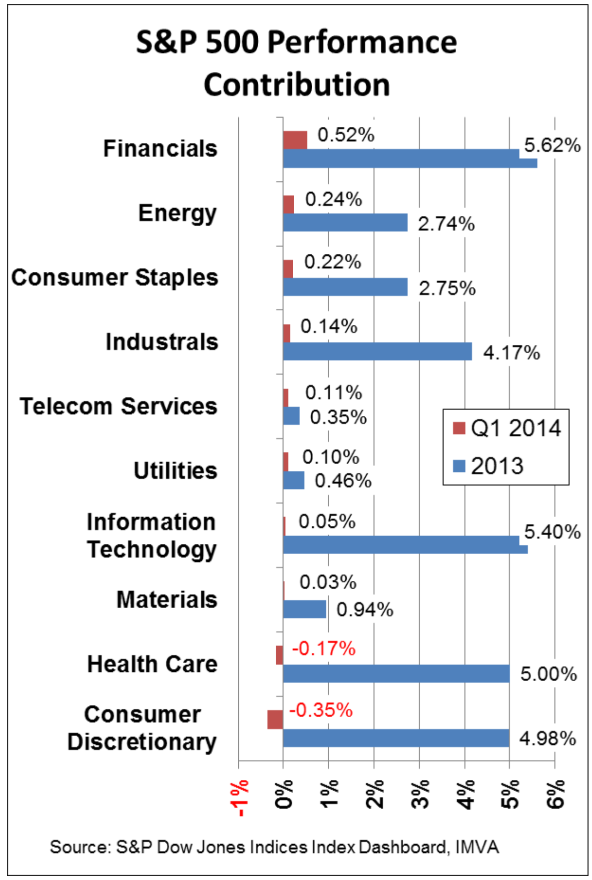
- The adjacent chart illustrates the percentage of NYSE stocks above their 200 day moving average over various time intervals.
- Neither over-bought, nor over-sold, the observation reflected a neutral position that could persist for an extended time period, albeit with increased volatility and more frequent rotation between leaders and laggards.
- The correlation between the direction of the equity markets and the direction of forward earnings has been approximately 95% in the past; presently, forward earnings expectations are expanding.



Equity Market Valuations & Earnings

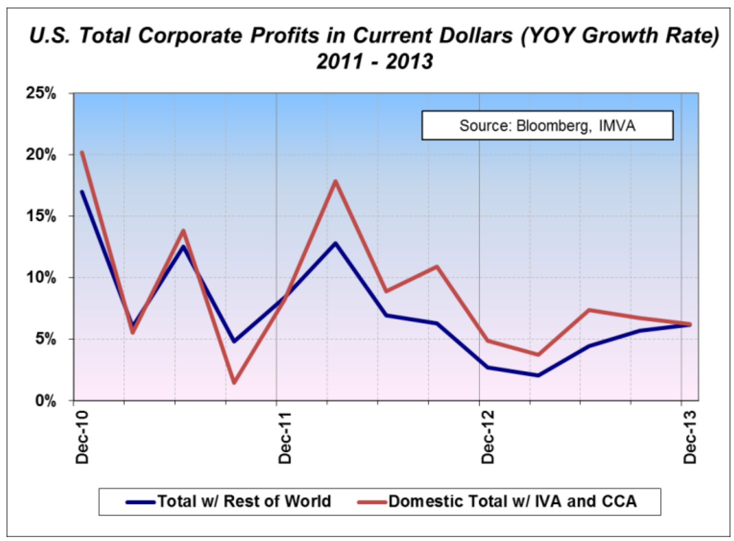
Valuations generally appeared fair, or full.

- Following a high-return year like 2013, it is not uncommon for the markets to pause for earnings to grow and shareholder value to build.
- Mid-cycle in 2004, the S&P 500 (SPX) stalled, following a near 30% advance the previous year. By November, the SPX had only gained 1.6%, fluctuating no more than 3% month-to-month along the way. Importantly, earnings continued to build throughout the year, and 2004 closed with a +10.9% return – and delivered another 28.2% over the next three years.
- Similarly, mid-cycle 1994 exhibited many of the same traits, albeit with greater volatility.
- The chart to the right illustrates the sector performance contribution during 2013 as compared to the sector performance contribution of Q1 2014. The most dramatic swings in leadership can be seen in the health care and consumer discretionary sectors. Rotation of investor emphasis among different capitalizations, styles, and sectors is normal, and perhaps healthy, during a market pause.
- Looking ahead, earnings must grow or the markets can become vulnerable.



International economies appeared to advance.

- Europe showed signs of stabilization and perhaps emergence from recession. Even Europe's southern countries (Greece, Italy, Portugal, Spain, along with France) reported improving purchasing manager data and bond yields that had declined to 2005 levels.
- Japan and the Asia Pacific region showed promise as well, with stabilizing currencies and the return of foreign investment inflows. China's outlook remained a material question-mark, but we believe that officials stand ready to infuse capital into the economy if necessary.
- As seen in the adjacent chart, U.S. corporate profits grew over the last three years and even accelerated throughout 2013. Interestingly, domestic profits decelerated somewhat in the back half of 2013; yet total profits, which include profits from the rest of the world, strongly accelerated. This trend supports our impression that international economies are mending.



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

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