Review & Outlook

THIRD QUARTER 2013

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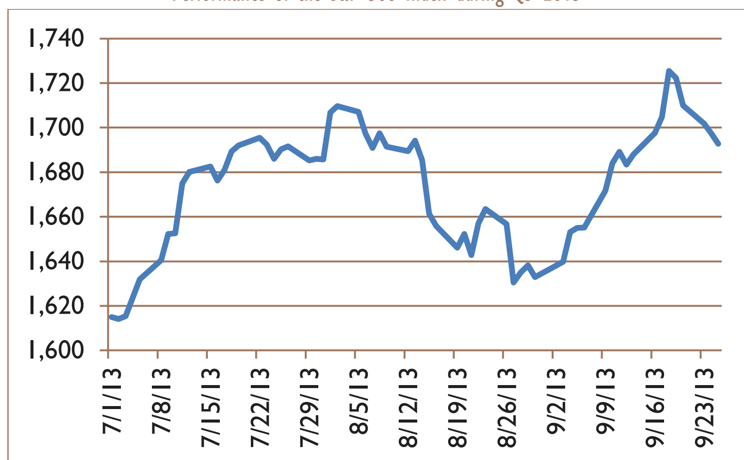
Review

The S&P 500 Index rose in July, fell in August, then rose again in September. Ultimately, the S&P 500 increased 5.2% during the quarter, including dividends. The total return for that index year-to-date is 19.8%.

Performance of the S&P 500 Index during Q3 2013[1]



Historically, September has been a rough month for the stock market. This September was quite good by historical standards, primarily due to somewhat encouraging news about the US economy, and the surprise announcement from the Federal Reserve that they will continue their stimulus program for at least another month.

Research suggests that US GDP and the S&P 500 index are not highly correlated. Corporate profits do more to drive stock returns. Still, we think changes in the labor market and the uneven distribution of winners and losers is something to watch particularly as they impact consumer spending.

We often reflect on prior quarters because events are easier to understand in hindsight. Curiously, it is still difficult to know what to make of recent economic news and data relative to the stock market. The housing market has clearly improved, and the unemployment rate has declined. But the number of families with negative or no equity in their homes is still high. In addition, wages have not increased for many people in this business cycle, if one considers the effects of inflation. Negative equity limits the inventory for sale in the housing market, thereby allowing for sharper price increases. The sluggish job market invites concerns about consumer spending in the future. So there is good news, but there are also potential concerns. The Federal Reserve clearly worried enough about the problems that they decided to continue with the bond purchase program.

Outlook

Looking ahead, we expect the economy in the U.S. to continue its slow progress. We are comfortable with the consensus forecast from the National Association of Business Economists (NABE) calling for GDP growth of 2%-2.5% in 2013, increasing to 3% in 2014. NABE economists also anticipate low inflation numbers and continued, though modest, improvements in the housing market through 2014. These forecasts hinge at least partly on the Federal Reserve's promise to keep interest rates low through 2014. We also expect continued improvement in Europe, which provides opportunity for expanded portfolio diversification.

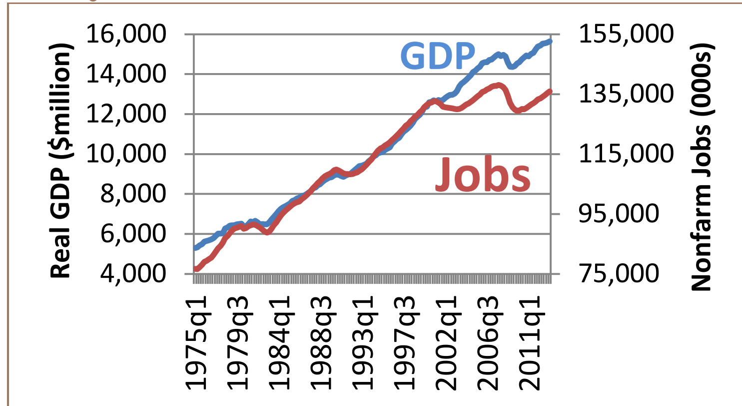
On October 1st, stock prices moved higher following the partial shutdown of federal government operations at midnight the night before. While initially surprising it is apparent that investors may be collectively anticipating a short shut down. If correct, the shutdown may have little impact on corporate profits. However, an extended shutdown would probably result in a market pull back. In addition, the Congressional debate later in October over the debt ceiling may result in further volatility during the final quarter of 2013.

In Focus

In our effort to identify emerging trends, and understand their potential impact on financial markets, our attention is drawn to the weak labor market. While there has been considerable commentary about the weak recovery in the job

market since the 2008-2009 recession, we believe pronounced changes in the labor market started well before the last recession.

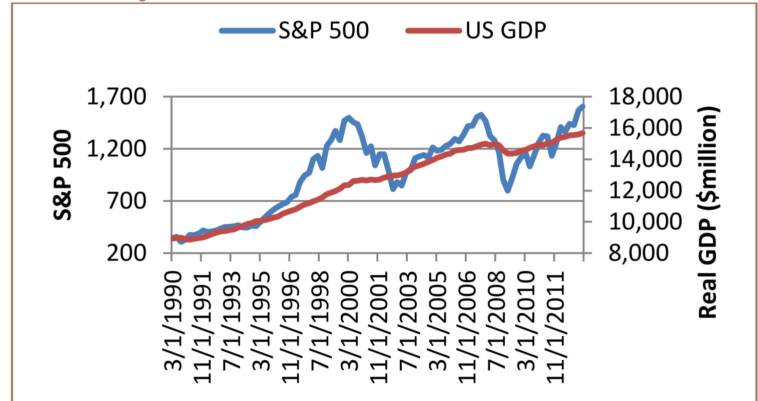
Figure 1: Weakness in the Labor Market Preceded the 2008-2009 Recession[2]



It appears that the total nonfarm jobs have been relatively stagnant since 2000 while GDP has continued to improve. Part of the story behind the disappearing middle class is a reduced need for workers performing routine jobs. Another facet, in regards to increasing concentrations in wealth, is the ability for certain individuals or companies to leverage technology or enjoy scale economies. Productivity has increased, along with the need for workers to interact with 'intelligent' machines. Some workers are able to benefit from these conditions; others are not. Many who do not benefit are leaving the labor force, resulting in declining labor force participation rates. Ultimately, this will likely mean lower GDP growth. As such, we do not see GDP growth returning to historic norms in the near term. We think potential real GDP growth may be in the 2.5%-3% range for quite a while.

This lower rate of growth may or may not affect stock market returns. Research suggests that US GDP and the S&P 500 index are not highly correlated. Corporate profits do more to drive stock returns. Still, we think changes in the labor market are something to watch particularly as they impact consumer spending. There are times when broad economic factors exert influence on stock prices, perhaps through consumer sentiment and spending.

Figure 2: Poor Correlation between GDP and the S&P 500 Index[3]



Given the importance of corporate profits in determining stock market performance, we are paying close attention to price to earnings ratios (earnings multiples). Stock prices have continued to rise as earnings growth has stalled. Broad market prices are getting to the upper end of our comfort level relative to earnings. Because of this, the next earnings season will be particularly important to us.

Getting more technical, the S&P 500 had a price-to-earnings ratio (P/E) of 19.28 as of October 1st. That number is based on the past 12 months of reported earnings. The long-term average is 15.5, and the long-term median value is 14.51. An alternative P/E ratio presented in a classic text[4], uses adjusted real earnings rather than the trailing 12 months reported earnings. While this ratio does not get as much attention, it has a higher correlation with the S&P 500's performance over time. Its current value is 23, well above its historic average of 16.5. So both indicators are suggesting that prices are a bit high relative to earnings. If earnings do not increase, prices could correct.

Corporate earnings could rise again with efficiencies made possible by technology and innovation. But, again, we think of the tension between corporate earnings and stagnation in the labor market.

1. Chart Source: Yahoo! Finance (finance.yahoo.com) and the Bureau of Economic Analysis (bea.gov).
2. Chart Source: Bureau of Labor Statistics (bls.gov) and the Bureau of Economic Analysis (bea.gov).
3. Chart Source: Bureau of Labor Statistics (bls.gov) and Yahoo! Finance (finance.yahoo.com).
4. Benjamin Graham and David Dodd, *Security Analysis: Principals and Techniques*, 2008.

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