THE BUTTONWOOD

On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

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FIRST QUARTER 2013

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Going On Record

The first quarter of 2013 is in the books and all major US stock indices posted positive returns for the period. Interestingly, of the 19 stock and commodity indices that are published each day in the Wall Street Journal, all were in positive territory for the quarter except the Philadelphia Stock Exchange Gold/Silver Index. This outstanding performance included record high closes for the Dow Jones Industrial Average and the S&P 500 Index on March 28, the last trading day of the quarter.

How strong has this bull market been? Going back further, each of the aforementioned indices has posted positive annualized returns for the last 3 years except of the Philadelphia Stock Exchange Gold/Silver Index. And finally, as measured by the 2009 closing lows, the chart below illustrates the average annualized gain for five of the most widely followed US stock indices. So, a very logical question is: can this market, as measured by the various US stock indices, keep going up? Our answer is a qualified yes.

US Stock Index	2009 Lows (3/9/09 Close)	3/28/13 Close	Point Gain	% Gain	Annualized Gain (3/9/09-3/28/13)
DJIA	6,547.05	14,578.54	8,031.49	122.67%	21.83%
S&P 500	676.53	1,569.19	892.66	131.95%	23.06%
S&P 400 Mid Cap	404.62	1,153.68	749.06	185.13%	29.49%
S&P 600 Small	181.79	531.38	349.59	192.30%	30.28%
NASDAQ	1,268.64	3,267.52	1,998.88	157.56%	26.28%

As we stated in the 2012 year-end issue of ***The Buttonwood*** we believe we went off the fiscal cliff in 2008. As this process played out, the major US stock indices all made benchmark lows in March of 2009. Since that time, stocks have moved higher as a result of two significant components in the investment equation.

The first is the Federal Reserve stimulus program (quantitative easing, QE) which has pushed interest rates to the lowest levels seen in the past 60 years. The old Wall Street adage "Don't fight the Fed" is a tried and true tenet of investing. Usually we hear this phrase when rates are being raised by the Federal Reserve in an attempt to cool down the economy. The logic follows that if the Fed wants to cool the economy it will raise rates until it has achieved the desired effect. The opposite has been in place for the past several years. The Fed has lowered rates in an attempt to jump start the economy. Slowly but surely, there is evidence that this policy is working. Those investors who have fought the Fed have missed out on this latest stock rise.

An improving economy is the second component of the aforementioned investment equation. The fact that this economic improvement has been slow is perhaps working in our favor. With no signs of an overheating economy there is little likelihood of rising interest rates any time soon. And when rates do go up, the consensus seems to be that they will rise slowly.

But is the US economy improving? There is evidence to suggest that it is. Fourth quarter 2012 economic output was recently revised slightly higher, putting 2012 domestic growth at 2.2%. Last week the Organization for Economic Cooperation and Development (OECD) published a new forecast for US growth pegged

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at 3.5% in the first quarter of 2013. OECD also said "monetary easing (QE) seems to be feeding through to the real economy as household consumption has picked up and the housing sector has begun to rebound." Recently the Commerce Department reported that consumer spending grew in February at a surprising pace, led by demand for autos and building materials. As we work our way through the final stages of the real estate deleveraging process, personal balance sheets have improved, home prices show signs of improvement, and rising stock prices have all contributed to a modest increase in consumer confidence. Finally, the Business Roundtable (BRT), an association of chief executive officers of leading US corporations, reported that 72% (up from 58%) of BRT members expected sales to increase in the next six months and 4 out of 10 (up from 30%) expect to increase capital investment.

Even with this evidence of slow but steady economic growth, investors might still be inclined to ask if it is reasonable to expect the market to continue to go up, given the large gains as shown in the chart on page 1. A look at some market statistics suggest that it can. The last time the S&P 500 traded at today's levels was 10/9/2007 when it closed at 1,565.15. In 2007 the index earned $82.50 per share which produced a price to earnings ratio (P/E ratio) of about 19. Recently earnings estimates for 2013 include Thomson Reuters' earnings analyst Gregory Harrison's estimate of $111.87. Deutsche Bank has forecast $109.00. There seems to be a consensus estimate of $112.49, according to Seeking Alpha, a US based stock market analysis website founded in 2004.

Assuming consensus earnings of $112.49/share, average P/E of 15, S&P would be valued at 1,687											
P/E ratio	10	11	12	13	14	15	16	17	18	19	20
S&P 500 Value	1125	1237	1350	1462	1575	1687	1800	1912	2025	2137	2250

If the S&P were to trade at its historic average P/E of 15, it would be valued at 1,665 or about 6% higher than it is today. If earnings were to continue to grow and we experienced a reasonable level of multiple expansion, the index could trade even higher. It is worth noting that if the bull market were to end today, it would mark the lowest multiple of earnings at a market peak since World War II. In addition, with many S&P components coming off of recession lows, the odds favor increased earnings growth over the next several years as the economy continues to improve. In mid-March Goldman Sachs' Abby Joseph Cohen was interviewed on CNBC.com. Joseph Cohen mentioned that she does think that this rally is real because "it is supported at the end of the day by improving fundamentals in the U.S. economy and, very importantly, valuations."

It's also interesting that she agrees with our long held contention that "it will be a long time before the Fed assertively raises short-term interest rates…it would take a dramatic and sudden upward shift in interest rates for there to be a real problem." Another important point to consider is that reasonably valued stocks do very well during a period in which interest rates are going up. Says Joseph Cohen, "a rise in interest rates is the flip side of the coin that says that the economy and profits are also doing well."

While we remain very positive regarding the long term outlook, we conclude with a word of caution. As the chart on page 1 shows, stocks have risen substantially from the 2009 lows and a correction at some point is inevitable. However, a correction might be viewed as a positive for the patient long term investor. Remember that we believe that the markets made benchmark lows in 2009 and that this recovery has a long ways to go. Remember also that markets that rise sharply with no correction are usually a sign of bull market tops. Therefore, for the investor that wants to *get rich slow*, a correction would be healthy.

As always please call, email or text us with questions, concerns or comments.

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