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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FOURTH QUARTER 2013

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2013 Banner Year…2014 Some Caution

As most investors are aware, 2013 saw all major US stock indices post substantial gains. The Dow Jones, Standard & Poor's 500, and the NASADQ weighed in with some of the best returns we have seen in a very long time. The positive results were further evidence of a secular bull market for US stocks that began with the benchmark lows we saw in March of 2009. Last year's gains were driven by several key variables that we'll discuss in this issue of the ***Buttonwood***. Each of these variables will also have an impact on the direction of stock prices in 2014.

The first key variable was that Federal Reserve policy over the last several years came sharply into focus in 2013 from two perspectives. The first was the Fed's policy itself, which kept interest rates at historic lows and bond returns at or below the breakeven point. This enticed investors to look elsewhere for reasonable valuations. An obvious choice was the US stock market. Relative to bond valuations stock market values were attractive. This, in part, led to the markets advance which was the Fed's intended result.

The second key to Federal Reserve direction is how it will unbundle its policy of easy money (low rates) going forward. The evidence points to as gradual a process as possible, with the key variable being inflation. If inflation remains within a reasonable range, then the Fed will be able to raise rates slowly over a long period of time. A December 17th article in the Wall Street Journal stated that "inflation is slowing across the developed world despite ultralow interest rates…US consumer prices rose 1.2% in November from a year earlier". Annual inflation in Europe was 0.9% in November and several euro zone central banks lowered rates recently. Further inflation in China has fallen to 3.5% from 8% five years ago. Evidence of how low inflation is worldwide is the talk amongst the world's central bankers of how they might deal with deflation. In our opinion, this tells us that inflation is not going to be a problem for several years. What this means for the stock market is that as long as stocks remain reasonably valued (more on that later) we can expect gains in the major US stock indices.

The second key variable relative to last year's gains was the economy. The current economic recovery that began over four years ago has been frustrating in its pace and scope. A recent article in ***Barron's*** by Gene Epstein summed up this recovery in a very succinct way. In part the article pointed out that in the 10 previous expansion/recovery's since 1949 that lasted at least 2 years, there was at least one year to year period where Gross Domestic Product growth hit or exceeded 4%. In fact growth of 5% to 6% was common. In this current expansion/recovery growth has yet to reach 3%.

Epstein points to data from the ***Census Bureau's*** November report on construction spending that signaled strength in residential and non-residential investment, which are two key components to GDP growth. In addition, higher home prices and the rising stock market have resulted in increased consumer spending and boosted consumer confidence. These are critical components to the economic growth equation. Further evidence of a slowly improving economy is the

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recent reduction in jobless claims. The unemployment rate of 7% is the lowest since November of 2008. Also, October's and November's gains of 200,000 jobs were strong.

Slow economic expansion and low interest rates tend to go hand-in-hand. As we have stated previously the slow economic expansion has kept inflation in check, which has allowed the Fed to keep rates low. While this hurts bond investors, it greatly helps an economy that has been struggling gain traction as it recovers from the lows of 2008 – 2009. We believe that the US economy will continue to improve at the current slower than usual pace and that should augur well for stock prices.

The third key variable is the most important – stock valuations. You may recall that we have said the historical average P/E ratio for the S&P 500 is 15 times earnings. In the December 16, 2013 issue of ***Barron's***, 10 panelists estimated 2014 earnings for the S&P 500 at $118.11. The S&P closed December 31st, 2013 at 1,848.36 giving the index a P/E ratio of 15.65. The graph below shows S&P 500 values based on a range of multiples assuming earnings of $118.11. Based on this data we would classify the S&P 500 as fairly valued at this point.

Assuming consensus earnings of $118.11/share

P/E Ratio	10	11	12	13	14	15	16	17	18	19	20
S&P 500 Value	1181	1299	1417	1535	1654	1772	1890	2008	2126	2244	2362

If one agrees, as we do, that the Federal Reserve will raise rates slowly and that inflation will remain benign then the key to stock price appreciation from current levels is earnings growth, which is dependent on economic growth. It helps to examine some current trends, in concert with earnings and economic growth, to determine where stock prices might go in 2014. ISI Research, located in New York City, recently provided some interesting perspective on stock market direction in years following gains of 25% or more. Since 1950 there have been 11 years of 25% plus gains in the S&P 500. With the exception of 1981 and 1990, each year following gains of this magnitude the S&P 500 was up an average of 16%. It should be noted that 1981 and 1990 were recession years and the likelihood of a recession in 2014 seems remote. Positive years that follow big up years make sense to us. In order for stocks to rise 25% plus in a year economic conditions must be very favorable. While change can occur quickly on Wall Street the odds favor a continued promising investment climate after a big up year.

With so many favorable variables pointing to an up year in 2014 one might be inclined to ask which is the most important. The answer is earnings growth and price/earnings (P/E) ratio expansion. We believe that earnings will grow at a continued slow pace which is arguably a good thing. If we get that, and the economy continues its slow growth we could see some P/E multiple expansion. That is to say that the S&P 500 could rise to values that are above the average P/E of 15. We would not be surprised to see minor P/E expansion in the near future.

Please keep in mind that a correction is overdue and could occur at any time. We believe that this would be healthy in the long run for the markets. We don't recommend taking profits here as any correction is likely to be modest and the long term outlook for stocks remains excellent. Please know that we are constantly reviewing portfolios and remember that lack of activity does not mean lack of management. We will make changes as needed, but never make a change just for the sake of making a change.

As always please call, text or email us with questions, comments or concerns. And remember ***"Get Rich Slow"***.

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