INVESTMENT STRATEGY UPDATE

December 27, 2013

2014 – THE YEAR AHEAD

As the investment years pass by, certain things remain constant. Short-term stock market fluctuations are a function of investor reactions to developing news events, while longer term they're all about the growth of corporate profits, dividends, and changes in valuation. What were the investment consequences of the crash of 1987, the tragedy of 9/11, or even the Great Recession of 2008 and 2009? Those events and others caused sharp stock market declines during the periods in which they occurred, but as painful as they were at the time, earnings growth returned to trend and there was very little lasting effect on the long-term rate of return.

From an investment standpoint, the year just ending was quite a bit better than we had originally forecast. While our outlook for earnings was generally on point, the broad expansion in valuations was well beyond our expectation. As a result, stocks have now moved from the significant undervaluation seen a few years ago to what is perhaps modest overvaluation currently. Historically, however, the longer-term swings in stock market valuation have seldom stopped at fair value.

Looking ahead, we find several topics of importance to investors. These include, of course, the outlook for corporate earnings and how those earnings will be valued by the market. From an economic standpoint there is a great wave of American innovation underway and a plethora of new profit opportunities. Yet there is also reason to believe that the overall rate of growth, while improving, will remain below trend for at least another year. Additionally, in this world of technology-driven productivity enhancement, profit growth has been flowing almost entirely to corporations and capital providers rather than to workers. Income inequality has been growing in this nation and we anticipate a growing chorus of demands for political and economic solutions.

So with those thoughts in mind, we present "2014 – The Year Ahead." We remind you, however, that while we are attempting to forecast the future, our continued investment success will largely depend on our ability to interpret and adjust to trends and events as they occur and as new information becomes available.

The Economy

U.S. economic growth, since the Great Recession, has trended well below that of most previous recoveries. This anemic growth has been a natural result of the after-effects of the bursting credit bubble and a number of other headwinds. These include an aging population, inadequate global demand, continued deleveraging, and the fiscal drag resulting from government downsizing, which the IMF estimates took a full percentage point off of 2013 U.S. real GDP growth.

Looking forward, there are reasons to believe that growth will pick up somewhat this coming year. For one thing, as we lap sequester and tax law changes, fiscal policy will provide less incremental drag in 2014. For another, following several years of restraint, improving business sentiment and the effects of normal wear and tear should result in increased capital spending. Also, monetary policy remains highly accommodative in the U.S. and globally, household and corporate balance sheets have strengthened noticeably, housing construction still has meaningful upside potential, and the global economy is on the mend – all of which should serve to bolster final demand.

Still, by historical standards U.S. growth is likely to remain subpar, but from an investor's point of view, that is not entirely a bad thing. Slow growth is still growth. And, the lack of excesses and imbalances that would likely accompany more rapid growth should enable our economy to grow for an extended period of time without triggering an inflationary scare or restrictive action by the Fed. There is still a lot of slack in the system.

Longer term, there are several significant positives for the U.S. economy, about some of which we have previously written. One is the hydrofracturing revolution and the prospect that we as a nation will more fully focus on harnessing our low-cost energy advantage. A second is the growing trend of re-shoring American manufacturing. Additionally, continuing U.S.-led advances in technology and medicine should help to further drive corporate profits.

On December 18, 2013 the Federal Open Market Committee (FOMC) announced that it would "modestly reduce" the pace of its asset purchases, to $75 billion per month from $85 billion. So, the tapering process has begun. Yet for the Fed, a balancing act remains. On the one hand, there is little evidence that the latest round of quantitative easing has meaningfully added to growth, and it is important to begin unwinding the sizeable and still growing Fed balance sheet – now more than $4 trillion, up from roughly $1 trillion in 2008. But on the other hand, core inflation remains well below the targeted 2% level, and there is still enough overall economic risk to keep Fed members cautious. The FOMC has indicated that, depending on the data, it is likely to expand the tapering process in 2014, but let's remember that tapering simply means slowing down the rate of stimulus. It does not mean tightening.

Inflation, Interest Rates, and the Bond Market

The battle continues between the forces of deflation, which currently pressure the global economy, and the intense reflationary efforts of the world's central bankers. It has been that way ever since the Great Recession. Milton Friedman once said that "inflation is always and everywhere a monetary phenomenon in that it is and can be produced only by a more rapid increase of quantity of money than in output." The problem with that concept in regard to our current situation is that the effectiveness of money added to our financial system is also a function of the rate at which that money is employed. Bank lending, and therefore monetary velocity, plummeted in 2008 and fell further during the Great Recession. It continues to trend lower currently.

While the Fed's efforts have successfully inflated asset prices, general price levels remain too low to declare victory over the forces of deflation. Going forward, fuel costs are likely to trend somewhat lower, while higher taxes and increasing healthcare costs will continue to suppress consumer demand for discretionary items. Also, inflation rarely rises very much in the absence of wage inflation, which is itself unlikely to heat up without tighter labor markets than we are experiencing today. Thus, our belief is that inflation will not become a problem for this country until faster growth leads to lower unemployment, rising wages, and increased capacity utilization. When that occurs, inflation will drift up and the Fed will have no choice but to react, however we don't think this likely in the immediate future.

Given this outlook, the Fed will likely continue its mission to maintain short-term interest rates at close to the zero level for at least another year or two. As for the rise in long-term rates seen during the second half of 2013, this increase was largely a function of tapering comments by the Fed Chairman and the fact that bond yields were simply too low in the light of improving economic conditions.

Artificially low interest rates cannot continue forever, and it is our own strong belief that the thirty-year bull market in bonds is over. Still, our expectation is that a 3½% ten-year Treasury yield might just be the ceiling for 2014. In the absence of exogenous events, any sustained rise in rates beyond that level seems further down the road. Nonetheless, our economy will continue to grow over the next few years, capacity utilization will tighten, inflationary pressure will rise, and eventually and inevitably, interest rates will grind higher.

This being the case, and with current rates so low, the risk/reward tradeoff in long-maturity bonds seems quite unfavorable. Our strong inclination is to maintain our short-duration bias and continue looking for special situations that will prudently add some additional fixed-income return beyond the standard curve. An opportunity to extend maturities lies ahead, albeit not in the near future.

The Stock Market

As we said at the outset, stock market returns over time are a function of earnings growth, dividend yield, and changes in valuation. We also said that stocks are somewhat overvalued currently, that earnings growth will continue at a less than normal pace, and that the Fed will begin to taper its expansionary policy. So what is the case for stocks?

While the stock market could pull back at any time, there are a number of reasons why equities remain highly attractive investments. First, taper or not, the Fed will remain highly stimulative, which should continue to benefit investment assets. Second, while it may be at a slower than normal rate, corporate profit growth will continue. And third, investor cash reserves remain historically high and there is a continuing lack of attractive investment alternatives. Investor returns on cash and savings are actually negative after factoring in inflation, while projected fixed-income returns are minimal. The bond market, particularly bond funds, remains at risk if interest rates continue to rise. And for the average investor, real estate remains a very difficult asset class in which to achieve adequate diversification. This all suggests that the longer the stock market continues to rise, the greater will be the pressure to put underinvested pools of capital to work. And, as stated earlier, the history of bull and bear markets shows that the underlying trend of stock prices seldom reverses course at fair value.

Regarding Fed tapering, investor concerns were misplaced, in our opinion. First, as we said earlier, tapering is not the same as tightening. Second, to our way of thinking, good news really is good news. The fact that the Fed is willing to begin the tapering process is a reflection of favorable economic traction and an improving labor market.

Stock market breadth was astounding in 2013. Close to 90% of U.S. stocks were up on the year. Bull markets do not tend to end until leadership narrows substantially. And most commonly, years with strong stock market breadth are followed by continuing gains in the next year. Thus, we anticipate positive, primarily earnings-driven, stock market returns in the year ahead. However, we are also due for a pause, in our opinion, as we have now been some eighteen months without a 10% correction. Historically, it is the periodic cleansings that have enabled bull markets to endure, and the healthiest outcome in the long term would be if the current trend of rising valuations takes a breather. While a continuing buildup of speculative excess would no doubt add to 2014 returns, it would also likely bring a premature end to the current bull market. We hope for moderation.

Longer-Term Issues

In early December, President Obama addressed the nation regarding income inequality. This is an issue to which we had already been paying attention. In the U.S., the labor-force participation rate is currently the lowest it has been in 35 years. And the share of income accruing to the top 10% of earners in this nation is at an all-time high.

In this regard, it is important to understand that the rising trend of income inequality has not been a result of the fat cats taking advantage of the less fortunate. Rather, it has been the inevitable result of the rapid pace of innovation, productivity enhancement, and changes in the way things are made. Simply put, the manufacturing process now requires fewer workers, and that will continue to be the case even as we move to improve work force education. Manufacturing is the foundation of America's middle class. The question is how we as a nation will balance the needs of our workers with the equally important need to incent the innovators and entrepreneurs who will drive us forward. It is a significant dilemma, and one for which we see few simple solutions. When and how income inequality is eventually addressed could have significant implications for our economy.

In addition to income inequality, this nation must eventually come to terms with some of its other looming problems, such as excessive government debt, the growing cost of our entitlement programs, and a badly deteriorating infrastructure. For the most part, these problems are solvable, whether by proactive government initiatives or driven by financial crisis. One effort to create jobs and address income equality might be to redirect some of the nation's resources toward long-term projects to upgrade and maintain our infrastructure. Nonetheless, with constrained government spending and continuing economic growth, the critical need to resolve some of these problems has been pushed back in time.

Conclusion

So let's try to put it all together. The U.S. and global economies will grow slowly this coming year. But grow they will, and currently there are virtually none of the inflation or capacity constraints that typically bring economic expansions to an end. Yes, the Fed will begin the tapering process, but logic suggests this will have limited impact. Longer term, this nation's economy is fighting the continuing headwinds of excessive debt and a still unwinding credit bubble. One result is that interest rates should remain contained for the foreseeable future.

In the meantime, the economic and policy environment remains supportive of further stock market gains. Corporate America is healthy and earnings continue to grow. While stocks are not cheap by historical standards, neither are they so stretched as to be a constraint. And as indicated, there is a dearth of attractive investment alternatives. We believe that a secular bull market in stocks is underway, with still a long way to go, but we would not be surprised to see, and would even welcome, a pause in the advance. A healthy stock market correction along the way would serve to bolster the longevity of the advance.

In today's world of near instant communication investors are barraged with news, most of which is negative because that is what seems to garner the greatest attention. But if we are truly "investors" in the company shares that we own, it is the developing fundamentals over the next two to three years, or even longer, that will really impact our well-being – meaning that we must look beyond the current noise. There are a number of very positive long-term trends for this nation. The development of new technologies and advances in productivity seem to be accelerating, and the U.S. remains the global powerhouse of innovation. America, for instance, makes up 75% of the global venture capital industry.

As we enter the New Year, we are optimistic about our future. Our strategy is to maintain discipline, take profits on further gains, and use any corrections to buy quality companies at favorable prices. Additionally, buying and selling partial positions seems a prudent way to move forward.

We wish all of our friends and clients, peace, joy, health, and prosperity in this New Year, and for many years to come. As a final note, we invite you to visit our recently redesigned website – www.btrcap.com.

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