OVERVIEW

Economic Analysis and Market Review

Q4—2013

A LOOK AT Q4

- Jobs and the Recovery
- The velocity of money
- Peak corporate profits

To paraphrase an old English rhyme, for want of some jobs the recovery was lost, for want of a recovery, the economy was lost. The fuel this sluggish recovery needs is more jobs. The latest count for the month of December was only 74,000 jobs created when most economists expected something in the neighborhood of 200,000. After all, 163,000 jobs were created in September followed by a monthly gain of 204,000 jobs; 200,000 seemed like a very possible scenario. Even so, as the number of new jobs fell short in December, the unemployment figure dropped to 6.7%. This was attributed however to a decline in the number of people looking for work. The Fed believes that the actual unemployment figure is closer to 10% if you count those who have left the job pool. Recovery? Yes and no. GDP was revised upward to 3.6% from 2.6%. Finally a number we can live with. But one economic indicator that still looks very sick is M2 ($11 trillion, all the money in bank checking and savings accounts and money market mutual funds) velocity of money or how fast a dollar moves through the economy in transactions involving goods and services in the U.S. Data going back to 1959 shows that money has never moved this slowly. People are reluctant to spend their money and with such low velocity, this may explain why all the Fed's easing, or printing of money, has not produced higher inflation and may allow the new Federal Reserve chairman, Janet Yellen, to continue with QE3 for quite a while longer. She's considered a more aggressive interventionist than Bernanke and could even lower the unemployment target from 6.5% and even raise the inflation target from 2.5% before any further tapering of the stimulus program takes place. The Fed has kept the short rate near zero and has had quantitative easing in place for five years. What else can it do?

If we're in a recovery, it's strictly in the corporate sector where record profits are being made. Corporate profits have never been as large a percentage of our GDP in history. They're now at 10.8% of GDP. Conversely, labor wages have never been as small a percentage of our GDP. Normally around 49 – 50%, they now are slightly above 43% of GDP. Corporations have become more profitable due to productivity gains from automation and globalization. Robotics have changed the way factories, warehouses and even libraries are run. Tesla's plant in Fremont, CA once had over 3000 workers when it was NUMMI, a joint venture between Toyota and GM and now has only 1000 or so assembling Tesla's Model S. Amazon's warehouses are almost

LOOKING AHEAD

- Stock market juggernaut
- Bonds in jeopardy
- Emerging markets a buy?

completely automated as stacks on robots move around the floor bringing goods to the shipping department. The University of Chicago's new library uses robots to fetch books from 50 foot stacks underground. Globalization has helped corporate profitability significantly by lowering labor costs — as well as sheltering billions in profits from U.S. taxation by keeping them off-shore in low tax countries. Looking forward, corporate earnings have grown primarily due to cutting costs, but what's been missing is revenue growth. So far that hasn't happened. Maybe this year.

And as corporate profits hit record highs, so did the stock market as it continued its march from March 2009. The stock market as measured by the Dow Jones Average gained 32% for the year as stocks beat all other asset classes. Somehow, beyond any expectations, the market continued its climb to new all time highs in the face of strong headwinds — a tax hike, a sequestration that dragged on GDP, Congressional dysfunctional arguing about the fiscal cliff and risking default on our debt service, boots-on-the-ground in Syria and finally a 16-day government shutdown. 2014 also has head winds to shake investors' confidence — mid-term elections, debt ceiling negotiations, likely more tapering of the Fed's stimulus program, Iranian nuclear program talks and uncertain growth in Europe. These are just the known events. Any one of these concerns could provide enough reason to sell stocks and take some profits.

With the stock market hitting all-time highs, where does one look for value or will the value come when the much-anticipated correction comes? A correction is most probably due anytime as several indicators are signaling a market top: the percent of bullish investors, according to Barron's was at 75% at the end of the year, a level considered "overbought" and to such an extreme level that they consider it at a level of "potential market reversals". Additionally, Investors Intelligence Sentiment Index is at 59.6% bulls and 14.1% bears. With a spread of 45.5, it is at the 96th percentile of its highest historical readings. Still another factor to consider is the low level of money market fund assets. The Rydex fund family was designed to attract market timers by allowing frequent trading. The Rydex Government Money Market Fund has a very low level of assets meaning that investors have pulled money out to put it to work in the stock markets. This, historically, is a sign of extreme bullish sentiment and often signals important market tops. That being said, there are places where investors can find attractive targets. The energy boom in the U.S. will continue unabated and those serving the drillers will find all the business they can handle. Fracturing or fracking has opened up oil fields thought to be dry decades ago — Spindletop, the well that put Texas on the oil map in the early 1900s is now producing oil due to fracking. The Permian basin or Eagle Ford field is more active now than in many decades due to the new technologies of horizontal drilling and fracking. The Marcellus field in Pennsylvania, where John D. Rockefeller got his start, is now back in full production and the Bakken field in North Dakota/Montana is making cities in that part of the country look like gold rush days.
The lowest unemployment in the country is in N. Dakota and Texas at 3.4%

In the bond market, the prospect of tapering the Fed's quantitative easing program gave warning. Investors pulled over $62 billion from intermediate term bond funds and added $46 billion to short term bond funds with maturities under 3 years. It's very likely that as the tapering continues and the economic recovery gains traction, interest rates will rise causing bond investors more problems. The only bond funds to show positive returns in 2013 were those with 1-3 year maturities (+0.37%) and high yield funds (+7.44%).

Overseas, the outlook for value is better as Europe is experiencing anemic but improving growth, Japan is only just emerging from a two-decade slump with the help of a quantitative easing program like ours and emerging markets are the cheapest and fastest growing in the world. After falling more than 20% at one point, emerging markets are in the basement. JP Morgan recently published a paper recommending that when the price-to-book ratio in emerging markets is below 1.5% investors should "buy aggressively". Today that number is at 1.4%. In developed markets, that ratio is at two times book value.

All things considered, the one factor that gives me confidence that 2014 will be another year in the plus column is rising confidence. Car manufacturers sold over 15 million cars in 2013. That's up from 14 million the year before. A car is a big purchase that requires a lot of confidence in one's future income. Things must be looking better for a lot of people. The housing recovery is gaining momentum and that's another key purchase for the consumer. I'll leave the forecasting to the experts and wait and see how this all plays out in 2014.

Market Indexes
Fourth Quarter, 2013

INDEX	Q4'13	YTD	3 YEAR RET.	10 YEAR RET.
S&P 500	10.51%	32.39%	16.18%	7.40%
Russell 2000	8.72%	38.82%	15.67%	9.07%
Europe, Aust., Far East	5.71%	22.78%	8.16%	6.91%
Barclays Agg. Bond	-0.14%	-2.02%	3.26%	4.55%
Dow Jones Real Estate	-1.09%	1.22%	9.04%	8.22%
3-Month Treasury Bills	0.02%	0.07%	0.10%	1.67%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Dow Jones Real Estate Index is an index of commercial real estate properties