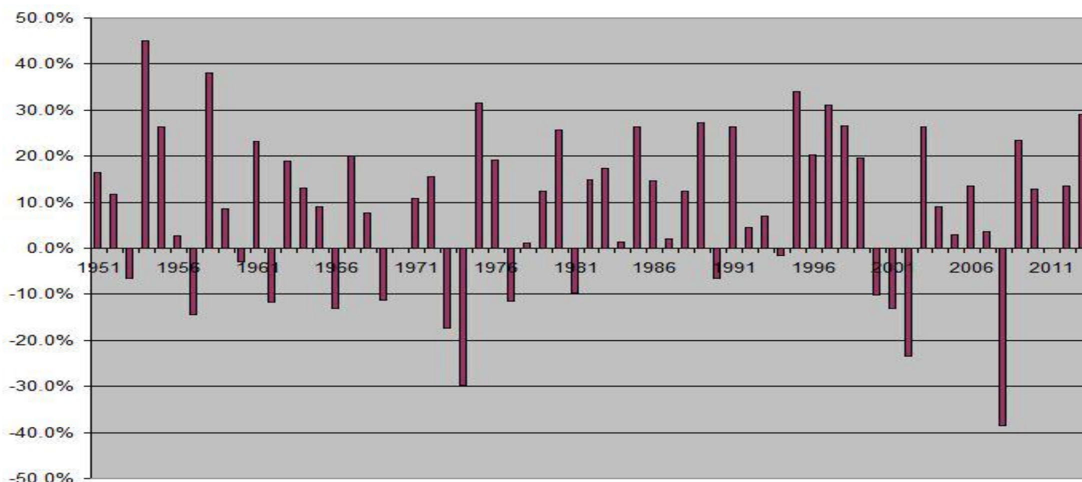
New Albany
Investment Management

January 2, 2014

Market Insight: 2014
Valuation Assessment and Prediction

2013 was the best year for the S&P 500 since 1997. With a return of over 32%, this performance was nothing short of amazing considering earnings only grew about 7-8%. Even the most bullish stock analysis was surprised by the magnitude of change. To put this in perspective, there have been only 5 years in the last 63 years where the S&P 500 exceeded 30%. Now that's impressive! What can be gleaned from this remarkable performance? Can 2014 be another stellar year for stocks or are we at risk to give it all back? Let's take a look at a few charts and stats…

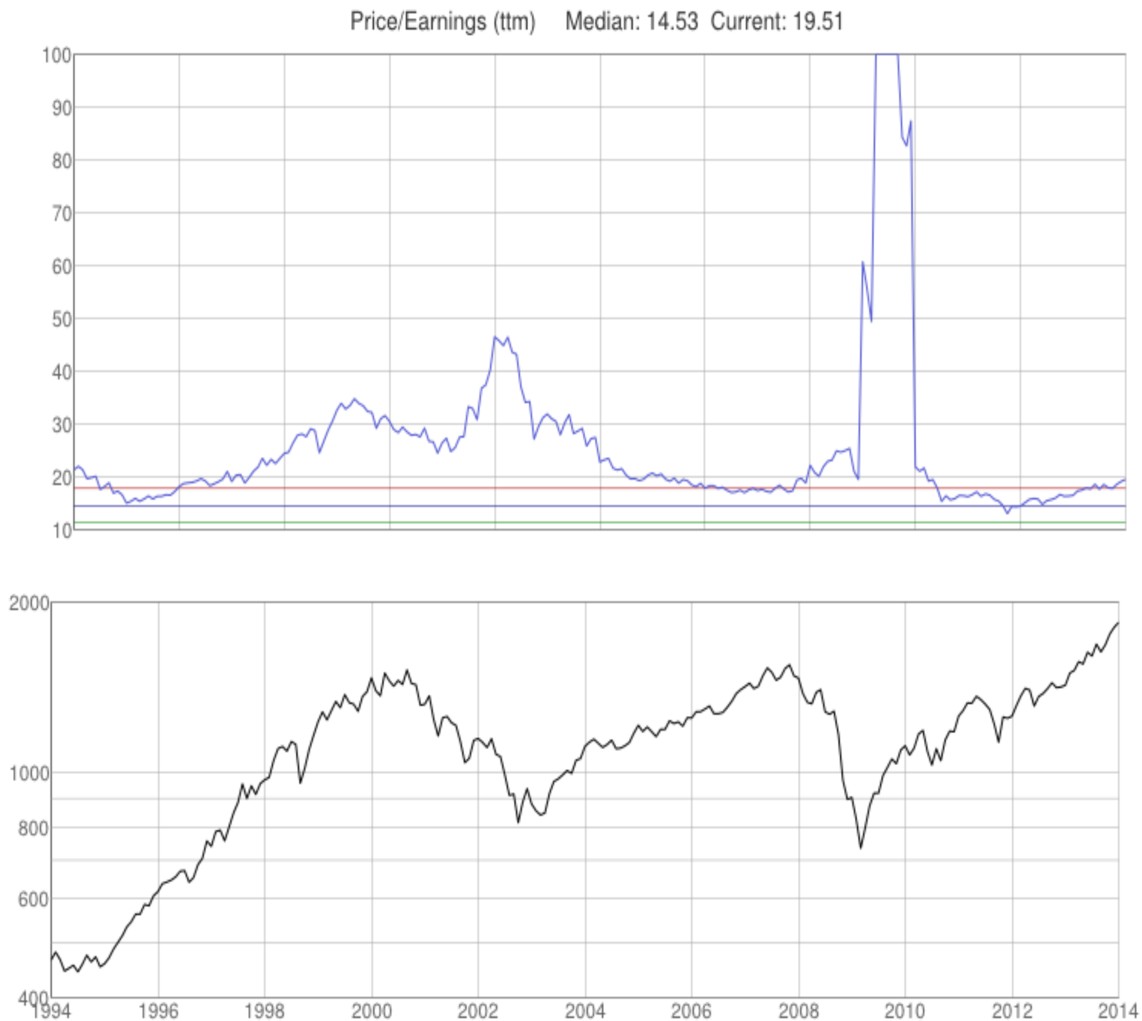
Past may predict the future: The chart below shows the annual return of the S&P 500 since 1951. As mentioned above, there have only been 5 years during this time frame when the return exceeded 30% and each time, the following year also produced positive returns ranging from 17- 25%. Thus history alone would suggest 2014 will be another positive year.



Quality of the Rally: It is essential to understand the catalyst driving prices higher. Is it due to earnings growth or is merely Price/Earnings (P/E) expansion? In 2012, the S&P finished the year with a trailing P/E of 17, as compared to a P/E of 19 at year-end 2013. Thus, the rise in prices was predominately due to P/E expansion or P/E inflation, and it is continuing a trend that has been in place since the downturn ended in 2009. Keep in mind however, P/E expansion is not necessarily bad, as it is normal and actually healthy in an improving economic cycle. It shows confidence in future growth, which is essential for economic growth to accelerate. So an expanding P/E could be construed as a positive leading indictor for both the economy and the markets.

Valuation and Relative Valuation: Is the market cheap or expensive? There are many measures of valuation but for this exercise we will focus on just two: the P/E Ratio and the E/P ratio otherwise called the Earnings Yield. The P/E ratio can be used as a relative valuation measurement of stocks; whereas the Earnings Yield can be used as a relative measure between stocks and bonds.

P/E Ratio Perspective: Below are two charts showing the S&P 500 P/E ratio and price since 1994. Over this period the P/E has ranged from 13-48 and the current P/E is near 20. It is difficult to draw any definite conclusion other than the current price level is in the neutral zone and that given the gradual increase in the P/E, investors and prices have not reached an 'irrational' status.



Earnings/Price or Earnings Yield Perspective: What is Earnings Yield and why is it helpful? The Earnings Yield is the inverse of the P/E ratio and can be viewed as measure of relative risk of holding a stock verse another investment. It is calculated as: Earnings / Stock Price where the higher the yield, the cheaper the stock. For example, a P/E of 15 translates into a 6.7% earnings yield verses a P/E of 20 equals a 5.0% yield. The Earnings Yield measurement is also a critical component of the Fed's model, which evaluates whether stocks are over or under valued. With a current P/E of 19, the S&P 500 has an earnings yield of 5.26%. Now let's compare this to Corporate Bond Yields.

Below is a chart of the S&P earnings yield (green line) verses the Moody's BAA Corporate Bond Yield (red line) since 1986. Three points to take note:

1) Bond yields (red line) have been dropping since 1987 and are still near the lows.
2) Earnings yield (green line) is more near the middle of the range over the past 27 years.
3) In 2004, stocks became expensive relative to bonds (green line overlapping red line). Then when the market crashed in 2008, a "new normal" investing environment of low valuation and risk tolerance evolved (green line crossed the red). Stocks are now 'cheaper' than bonds reflecting investors' reluctance to return to stocks. Since 2011, the spread is narrowing but <u>still indicates a relatively cheap stock market.</u>

Forecast for 2014: Of course valuation alone cannot make a market move but it does set the stage for a positive performance. **The direction of both the economy and interest rates will be the lead actors. I expect both to go higher, that is, economic growth will continue to gradually accelerate but rates will rise too. The tension of these two elements will bring volatility but ultimately, it is likely a stronger economy will steal the show.** Thus I will go out on a limb and **<u>predict stock prices will move modestly higher, barring any exogenous factors.</u>**

Investment Strategy: The US stocks should continue to lead global markets; but at the same time, emerging markets, bonds and precious metals will struggle. For now, positions remain near the high end of risk bands with exposure primarily to US and European stocks; Small and Mid Cap sectors. Income focus will remain in floating rate bank loans and High Yield bonds.

Please contact me with any questions or concerns. And if you like this letter, pass it on to another keen investor.

Happy Trails and a very Blessed New Year!

Barbara

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139 ~ www.newalbanyinvestment.com