



**Presentation to Economic Outlook and Revenue
Assessment Committee**

CAPITAL MARKET OUTLOOK

**Robert Maynard
Chief Investment Officer**

January 2, 2014

GURU PREDICTIONS VS MARKET

- **Bill Gross (PIMCO): “Fearless 2013 Forecast” (12/30/2012):**
 - **Stocks return less than 5% (actual return 31%+, best since 1998)**
 - **5 year treasuries yield 0.70% at end of year (actual 1.7%)**
 - **Gold goes up (actual loss of -28%, worst since 1981)**
 - **Unemployment 7.5% or higher (actual 7.4%)**

 - **Followed 2012 prediction of 5% or less returns for 2012 in stocks vs 16% actual returns and that the “cult of equities was dead”**

 - **<http://www.cnbc.com/id/100345518>**
-

OUTLINE OF PRESENTATION

- **ECONOMIC CONDITIONS EXPECTED TO BE BETTER BUT STILL MEDIOCRE**
 - Consensus has been generally correct past few years
 - **CAPITAL MARKETS MIXED**
 - Bond Markets Still “Dead Money” (Flat to Negative)
 - Expected Continued Good Equity Markets (8% -12%)
 - **MACRO THEMES TO WATCH**
 - Easy Financial Conditions
 - High Corporate Profitability
 - Future use of Potential Cash from Central Banks
 - Money isn’t printed until it is lent and spent
 - Hasn’t yet been either lent or spent – will it be inflation or reasonable growth?
 - No Bubbles (Yet)
-

2013 Economy and 2014 Expectations

- **World Economies “Muddled Through” generally as expected**
 - Slightly slower than expected, but mildly so
 - Europe mild recession, avoided fiscal collapse
 - China cooled inflation, avoided hard landing
 - US kept on slow, stumbling growth path

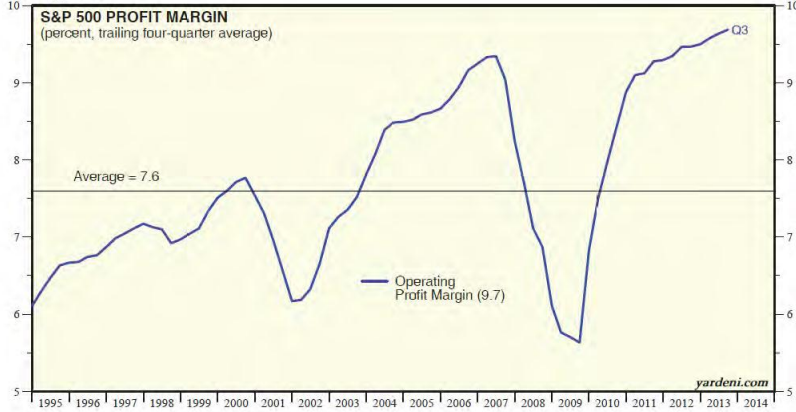
 - **Next year expected to be better, but only OK**
 - Real GDP 2.6%
 - Inflation 1.7%
 - Unemployment 6.8%

 - **MOST INTERESTING ISSUE: BUSINESS SPENDING**
 - Corporations very profitable
 - Sitting on big piles of cash
-

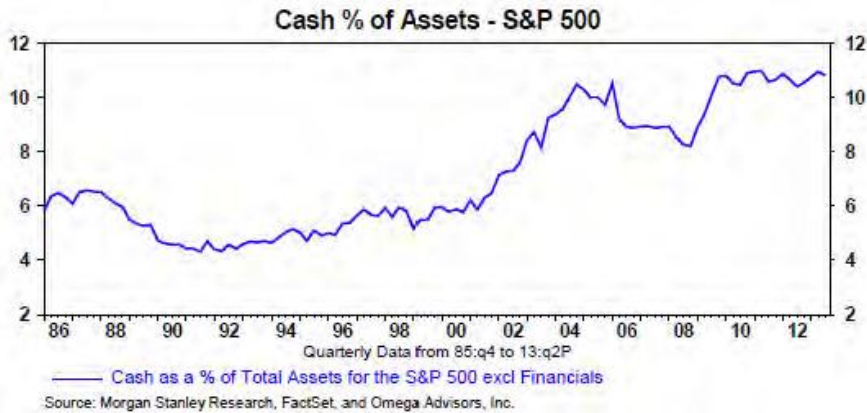
ECONOMIC EXPECTATIONS

	Projected 2013	Actual 2013	Projected 2014
Real GDP	2.0%	1.7%	2.6%
Nominal GDP	3.9%	3.2%	4.2%
Real Consumption	1.8%	1.9%	2.5%
Real Business Spending	3.1%	2.4%	4.6%
Real Ind. Product	1.9%	2.4%	3.0%
Unemployment	7.7%	7.4%	6.8%
Housing Starts	980,000	920,000	1,120,000
Core CPI Inflation	1.9%	1.5%	1.7%
Europe Real GDP	-0.1%	-0.4%	1.0%
Europe Inflation	1.9%	1.4%	1.1%
China Real GDP	8.1%	7.7%	7.5%
China Inflation	3.2%	2.7%	3.1%

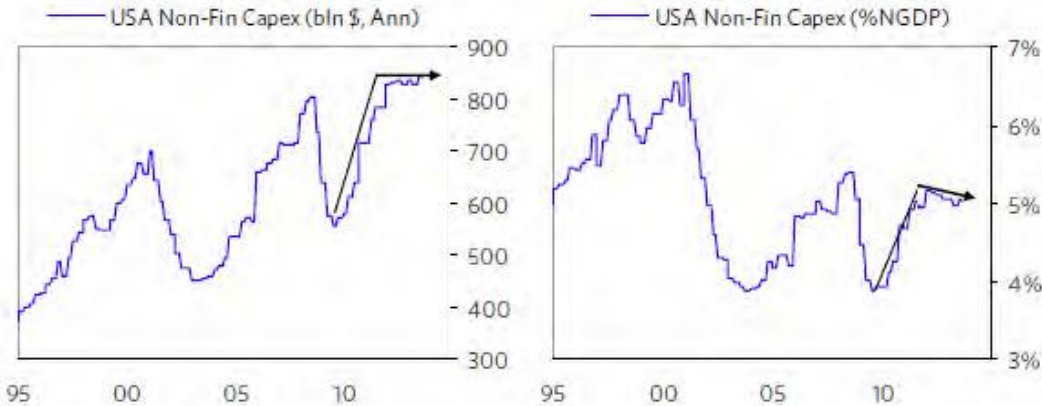
Figure 5.



HIGH PROFITS



RECORD LEVELS OF CASH



LOW AND STAGNANT CAPITAL SPENDING

2013 CAPITAL MARKETS AND 2014 EXPECTATIONS

- **Capital Markets Very Good for US and Developed Market Equities, Poor elsewhere**
 - **S&P 500 +31% vs expected +13%**
 - Increase in PE ratio from 14 to 16.5 (+18%) accounts for difference (consensus earnings + dividends as expected)
 - R2500 +36% EAFE +21%,
 - Emerging -3%, REITs -1%, Commodities -1% (Gold -28%)
 - **Investment Grade bonds down -1% as somewhat expected (“dead money”)**
 - Yields stayed low, but TIPs got crushed (-8%) as real yields rose
 - **Markets again expect around 8 - 12% equity markets, flat bond markets**
-

BASIC CAPITAL MARKET CONCEPTS

■ EXPECTATIONS

- Not Current Conditions
- Current Economic Expectations Moderate

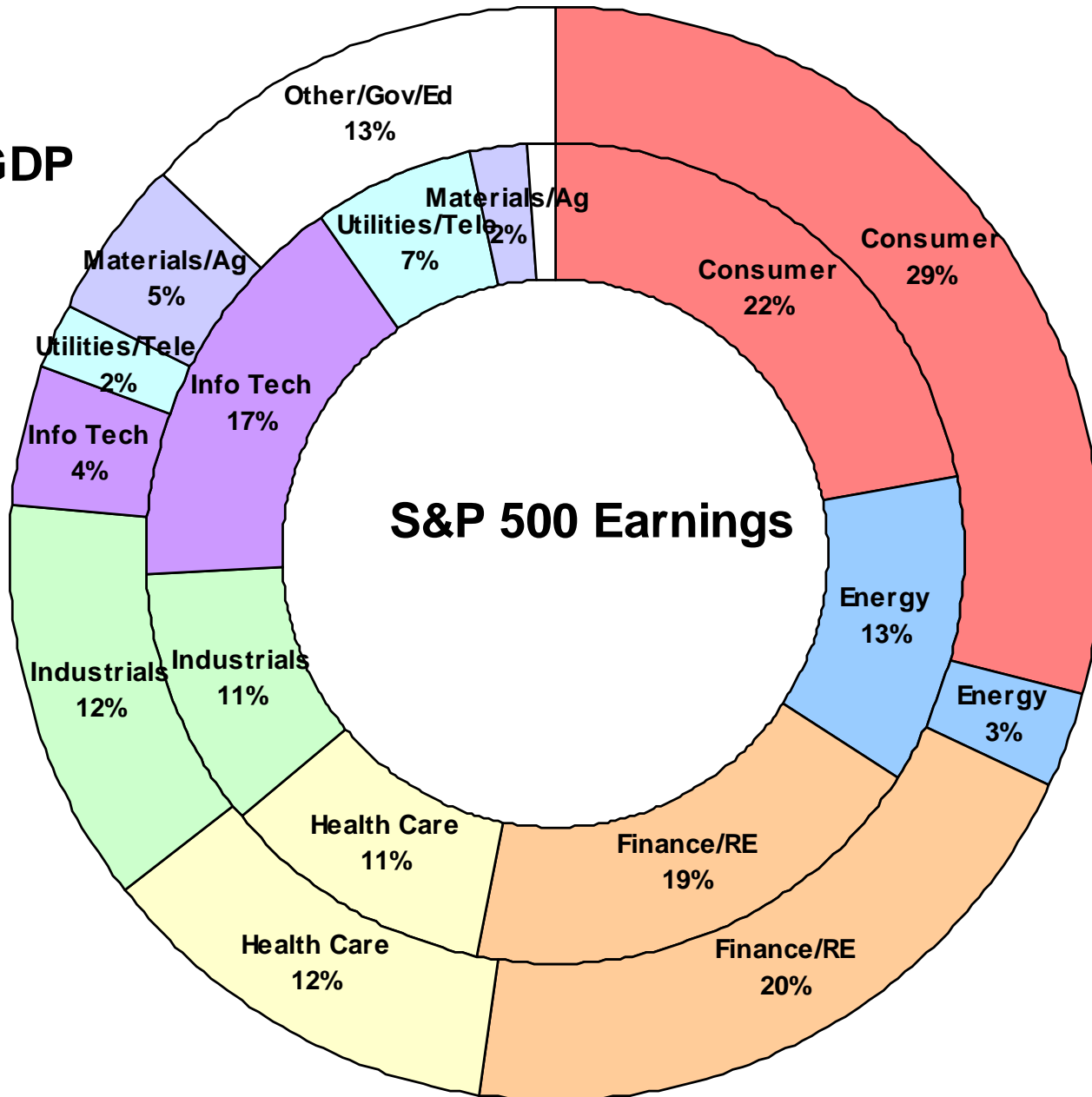
■ RELATIVE VALUE

- Not absolute value in itself
- What are people willing to pay for expected earnings
- Current alternative – bonds – unattractive

■ PROFITS

- Not general economy
 - Good balance sheets, lean operating conditions, growth overseas, little pressure on labor costs
-

US GDP



S&P 500 Earnings

Information Technology, Utilities and Energy 37% of Stock Market vs. 9% of GDP

Expectations : Bonds Will Continue to be “Dead Money”

- ❑ **Cash: Yields will rise from 0.2% to 0.3% for a +0.3% return**
- ❑ **TIPS: Yields will rise from a 0.7% real yield to a 1.0% yield for a 0.14% return**
 - **Will get 1.7% for CPI Inflation**
- ❑ **10Y Treasury: 3.0% Yield will go to 3.5%, for a negative -1.6% return**
- ❑ **10Y Corporate “A”: Yields from 3.8% to 4.3%, for a negative -0.1% return**

Expectations : Another Double Digit Equity Year

- **US Equities: +8% to +12%**
 - **Dividend at 1.9%**
 - **Expected Earnings Per Share Increase: 10.1%**
 - **Earnings increase : 8.4%**
 - **Above Historic Average of 7.5% (twice expected total U.S. Corp profit growth of 4.6%)**
 - **Net Share Repurchase: 1.7%**
 - **Assumes Current P/E stays around 16.5**

 - **EQUITY MARKETS WERE BEING DRIVEN BY RELATIVE VALUES AND FINANCIAL CONDITIONS, TURNING TO PROFIT GROWTH POTENTIAL**
-

KEY CONDITIONS

- Easy Financial Conditions
 - Corporate Profitability
 - World Liquidity and Potential Cash
 - No Apparent “Bubbles”
-

BLOOMBERG FINANCIAL CONDITIONS INDICES – UNITED STATES

33% MONEY MARKET

TED Spread
Commercial Paper/TBill
Libor/OIS

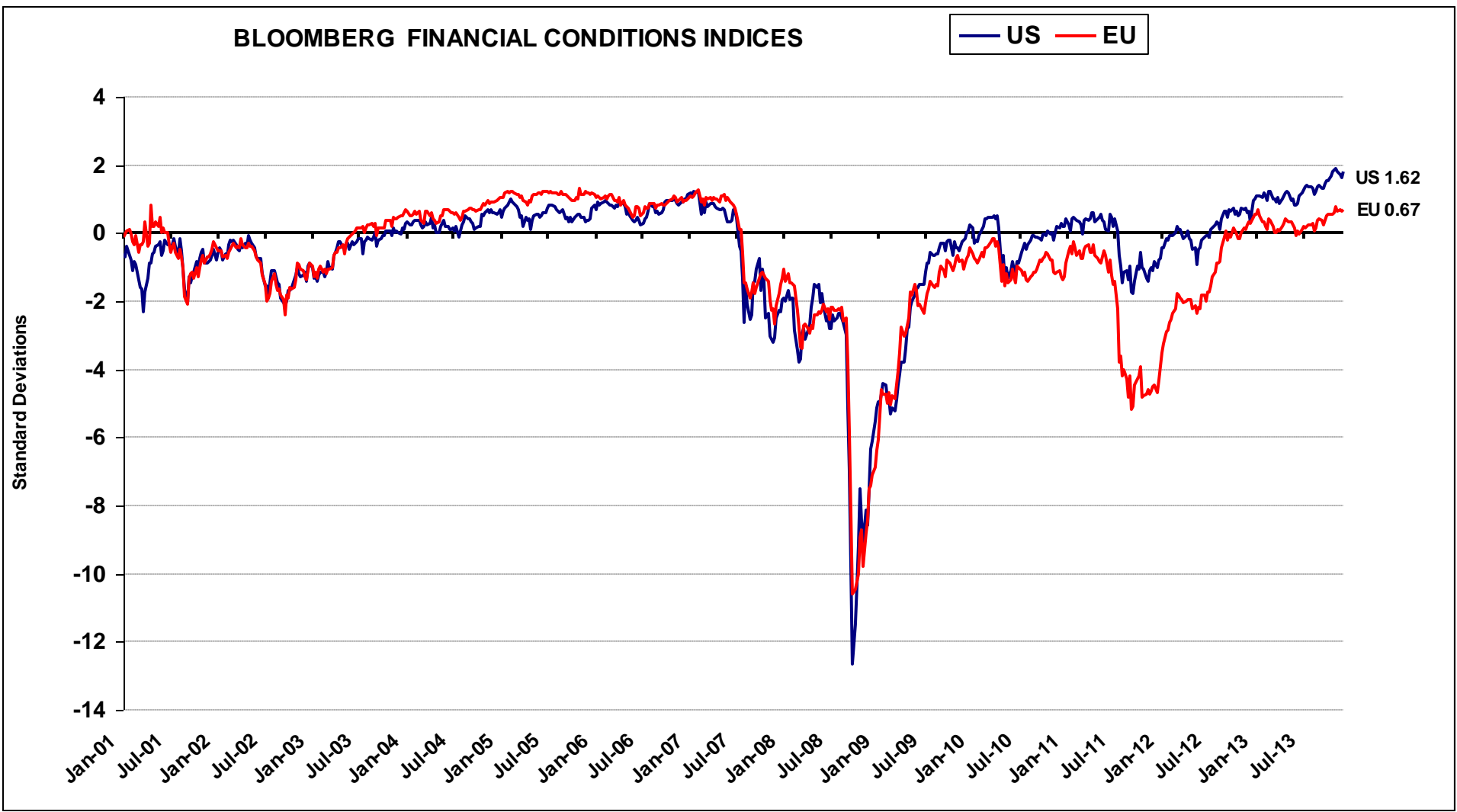
33% BOND MARKET

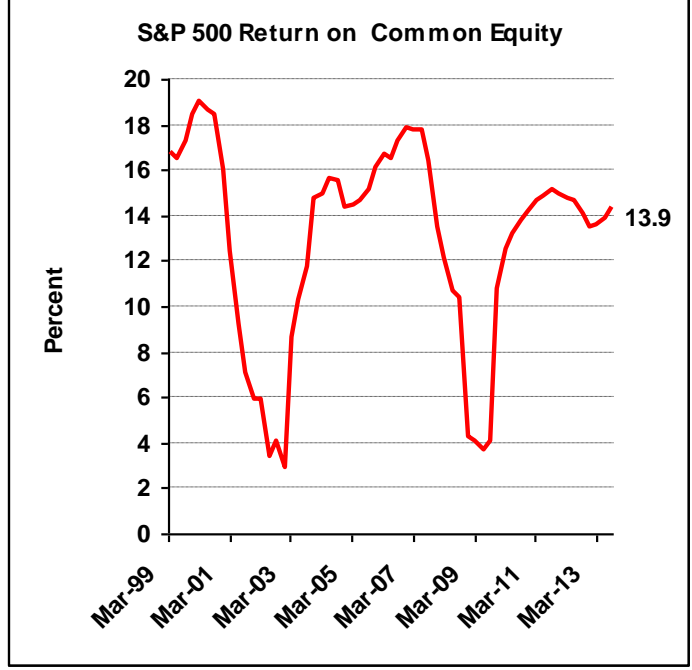
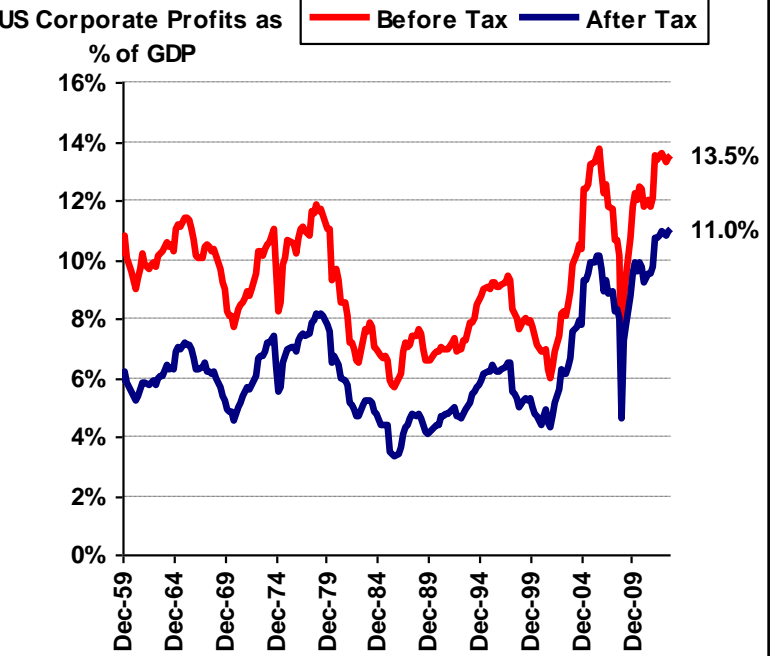
Corporate/Treasury
Muni/Treasury
Swaps/Treasury
High Yield/Treasury
Agency/Treasury

33% EQUITY MARKET

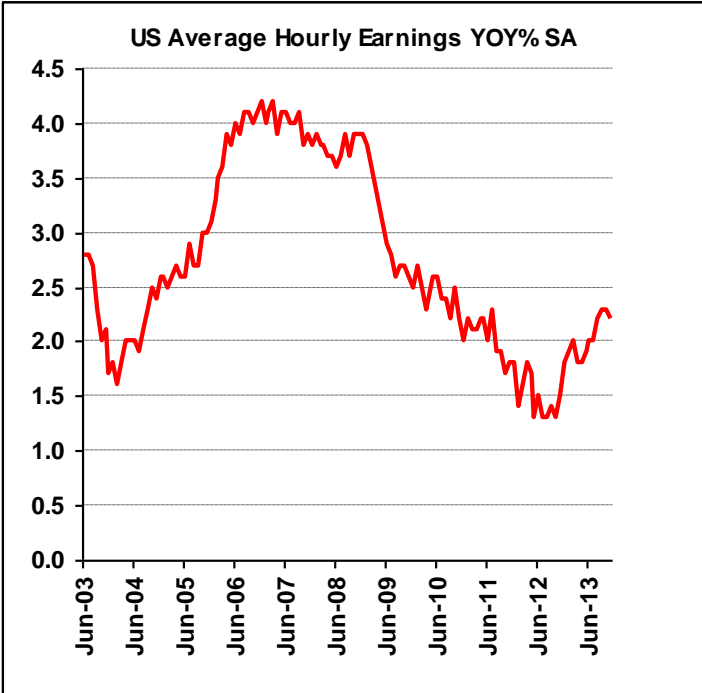
S&P 500 Prices
VIX Index

Z-Scores 1992- July 2008 Average





Corporate Profits and Return High

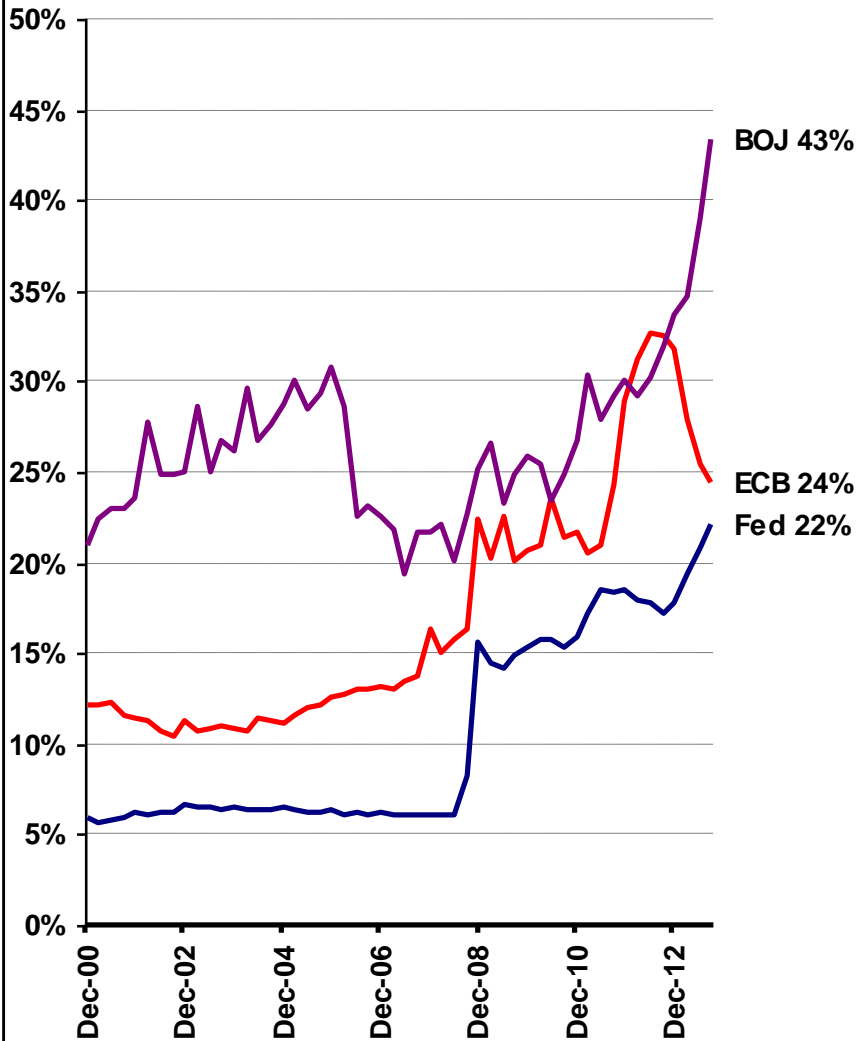


Labor Costs Are Low

Cash High Debt Low

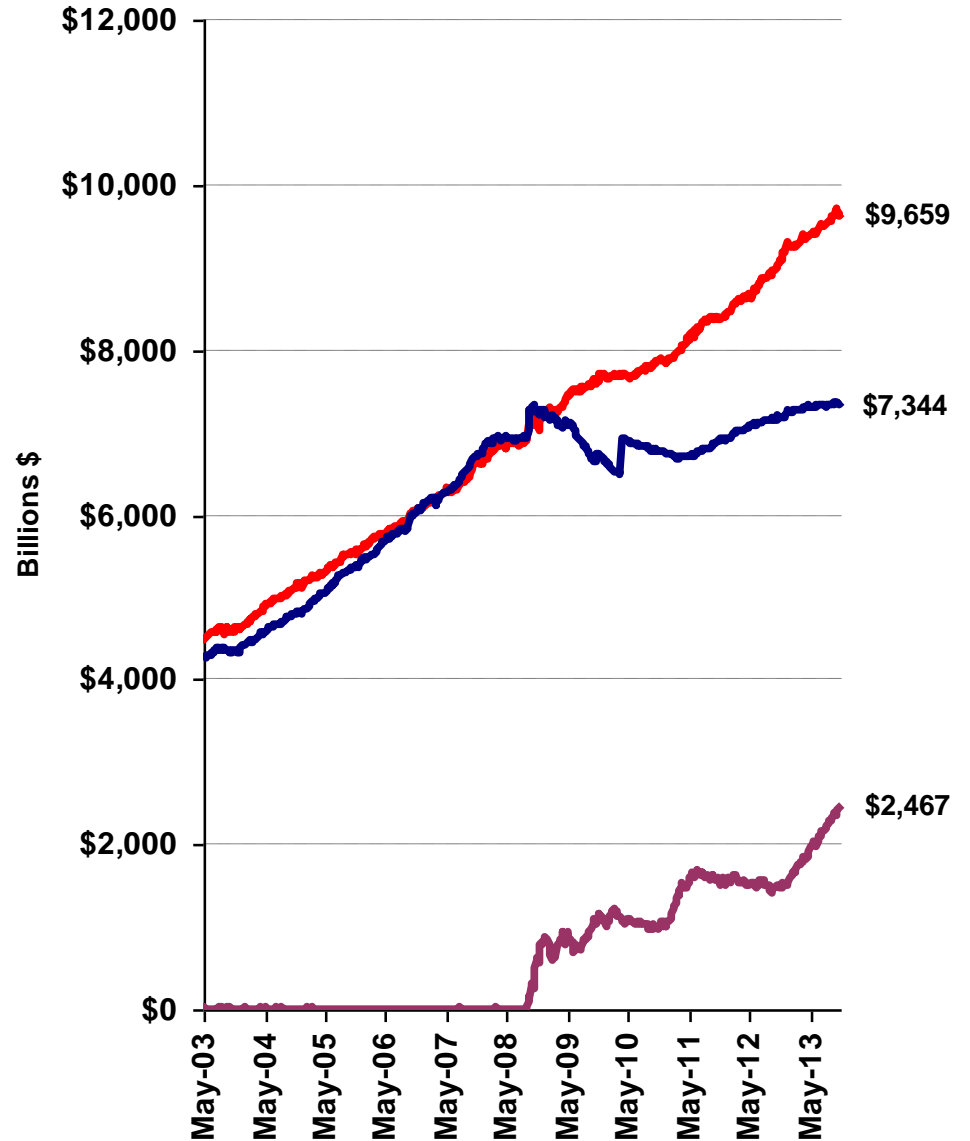
CENTRAL BANK BALANCE SHEETS as % of GDP

Fed ECB BOJ



US Bank Deposits and Loans

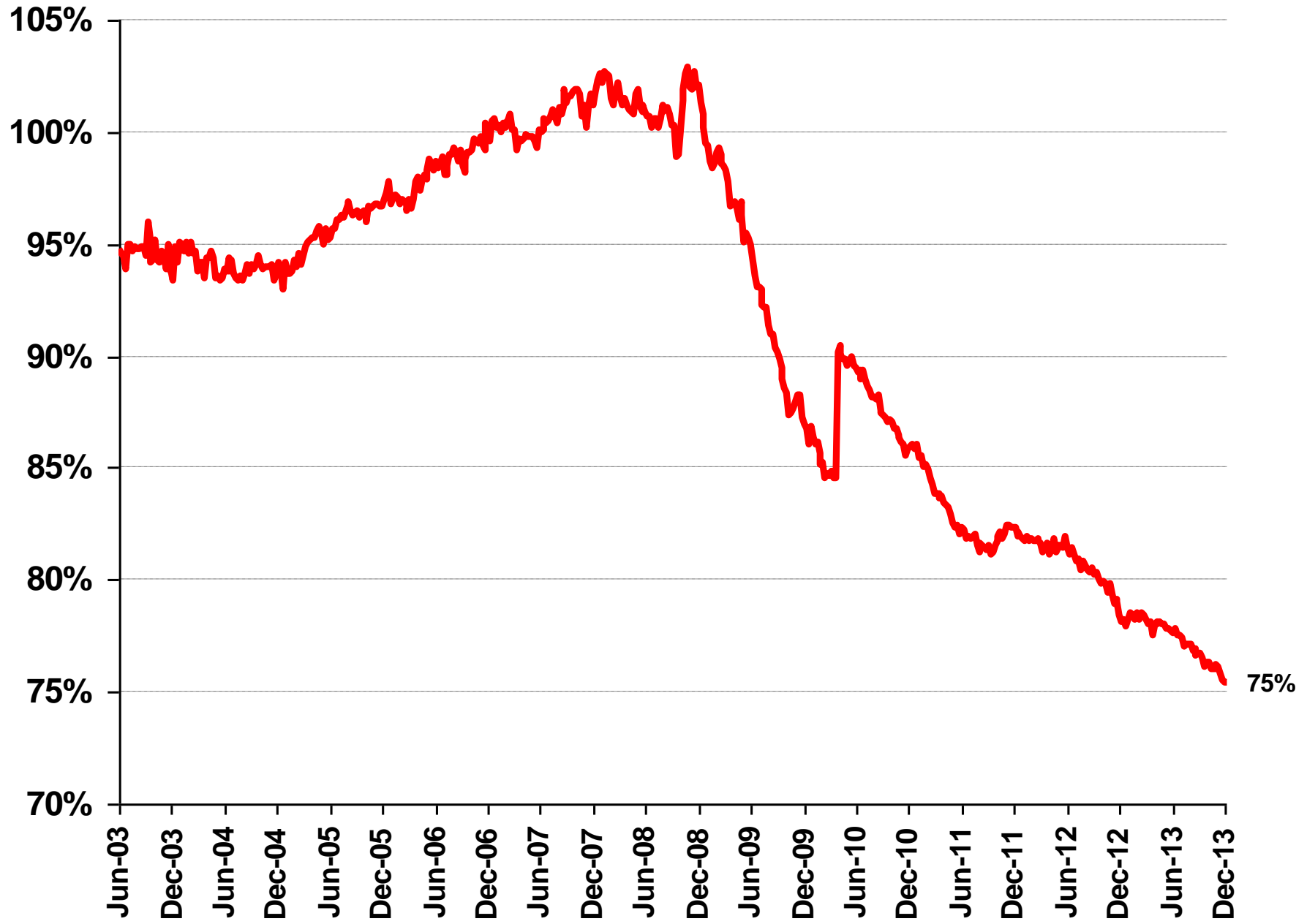
US Bank Deposits US Bank Loans Bank Reserves



MONEY ISN'T PRINTED UNTIL IT IS LENT AND SPENT

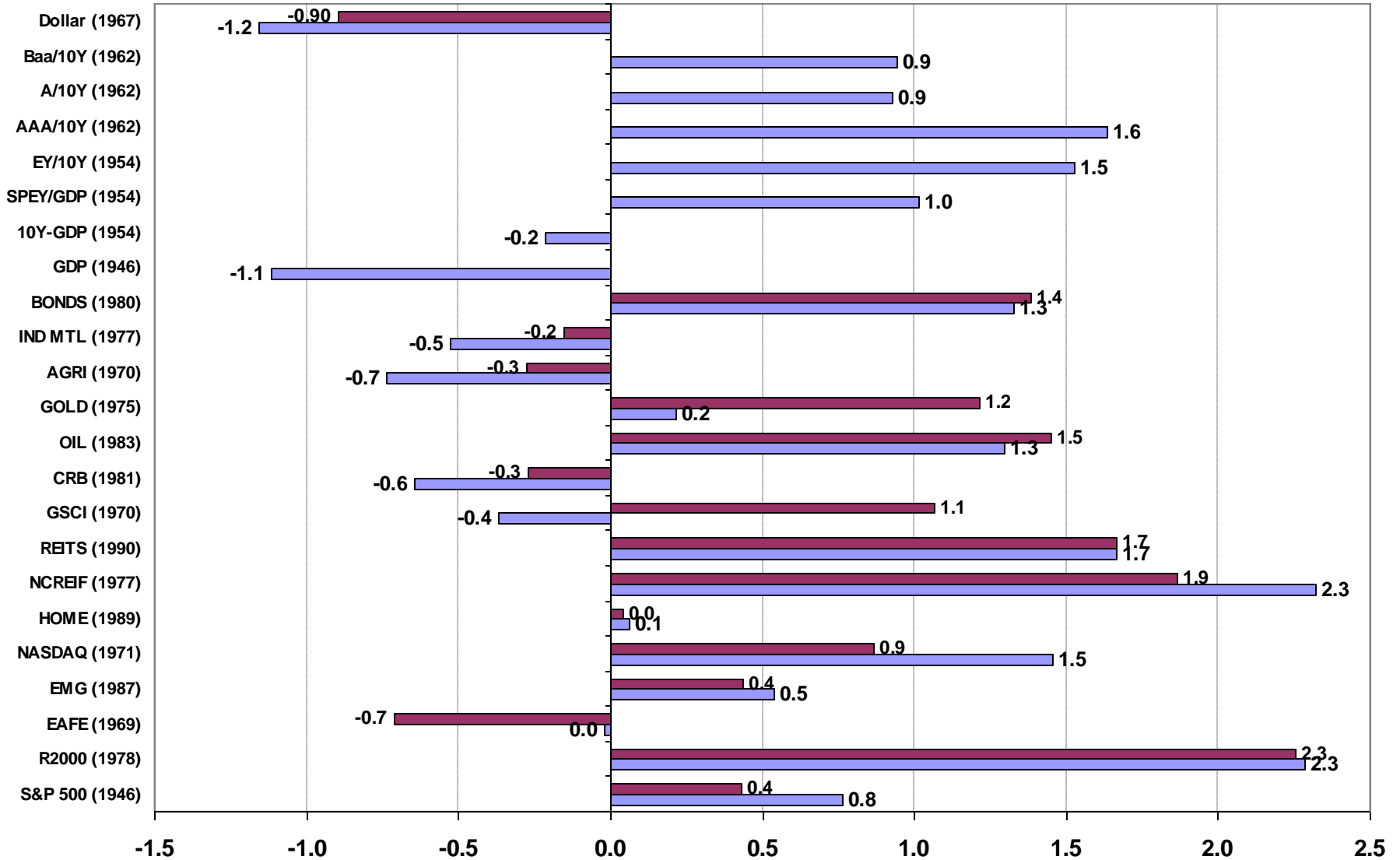
US Bank Deposits and Loans

— Loan/Deposit Ratio



Z SCORES INDEX

■ Since Inception ■ Since 1990



ZSCORES VS US GDP SINCE 1990

