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August 6, 2013

Gleanings

A Monthly Chart Presentation and Discussion Pulling Together the Separate Disciplines of Economics, Fundamentals, Technical Analysis, and Quantitative Analysis

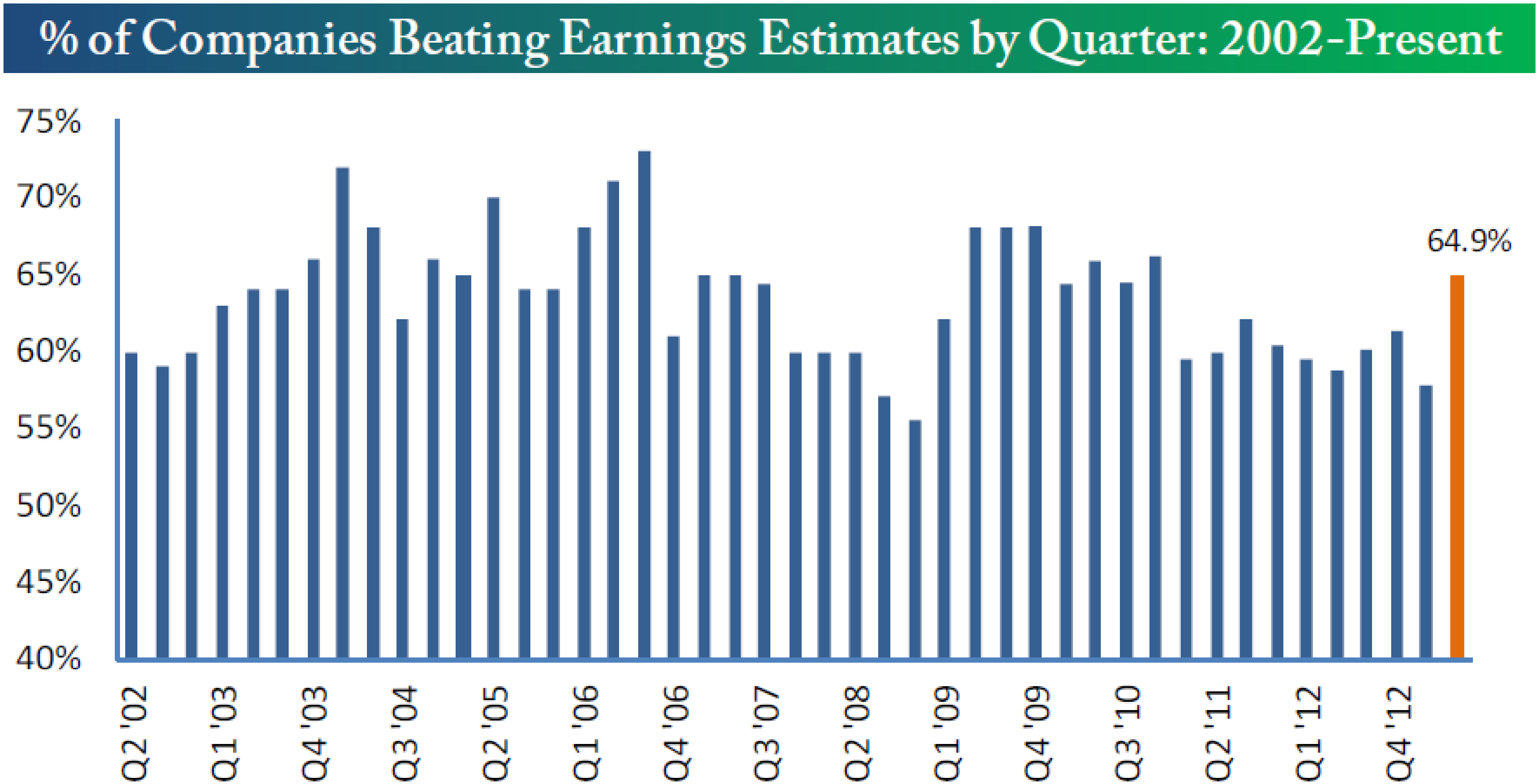
Earnings Season

- Not surprisingly, with 75% of companies having reported their 2Q13 earnings, some 64.9% of them have beaten consensus estimates. What is surprising is that 57.1% of those reporting companies have beaten respective revenue estimates.

- That makes the S&P 500's (bottom up) operating earnings estimates of $108.69 for 2013, and $122.43 for 2014, seem achievable. While using the S&P 500's (SPX) historic average P/E multiple of 15.3x leaves the SPX overvalued in the near term, it renders a price target of 1873 on 2014's estimate.
- However, using the Rule of 20, which states that the P/E plus the inflation rate should equal 20, actually implies a P/E ratio of 18x currently. Or a price target of 1956. Moreover, there is plenty of history suggesting that a P/E ratio of 18x is not an unrealistic objective for a bull market.
- As repeatedly stated, I have targeted mid-July to mid-August as the first window of time for a "meaningful decline" because of the seasonality and for a number of other reasons. However, so far that "call" has been wrong-footed.
- Yet, any meaningful decline is for buying (IMO) because confidence remains high that we are into a new secular bull market with yet another Dow Theory "buy signal" being registered last week. It is the sixth such "buy signal" since the March 2009 bottom.

Please read domestic and foreign disclosure/risk information and Analyst Certification beginning on slide 28.

Not surprisingly, with 75% of companies having reported their earnings, some 64.9% have beaten estimates



Source: Bespoke Investment Group.

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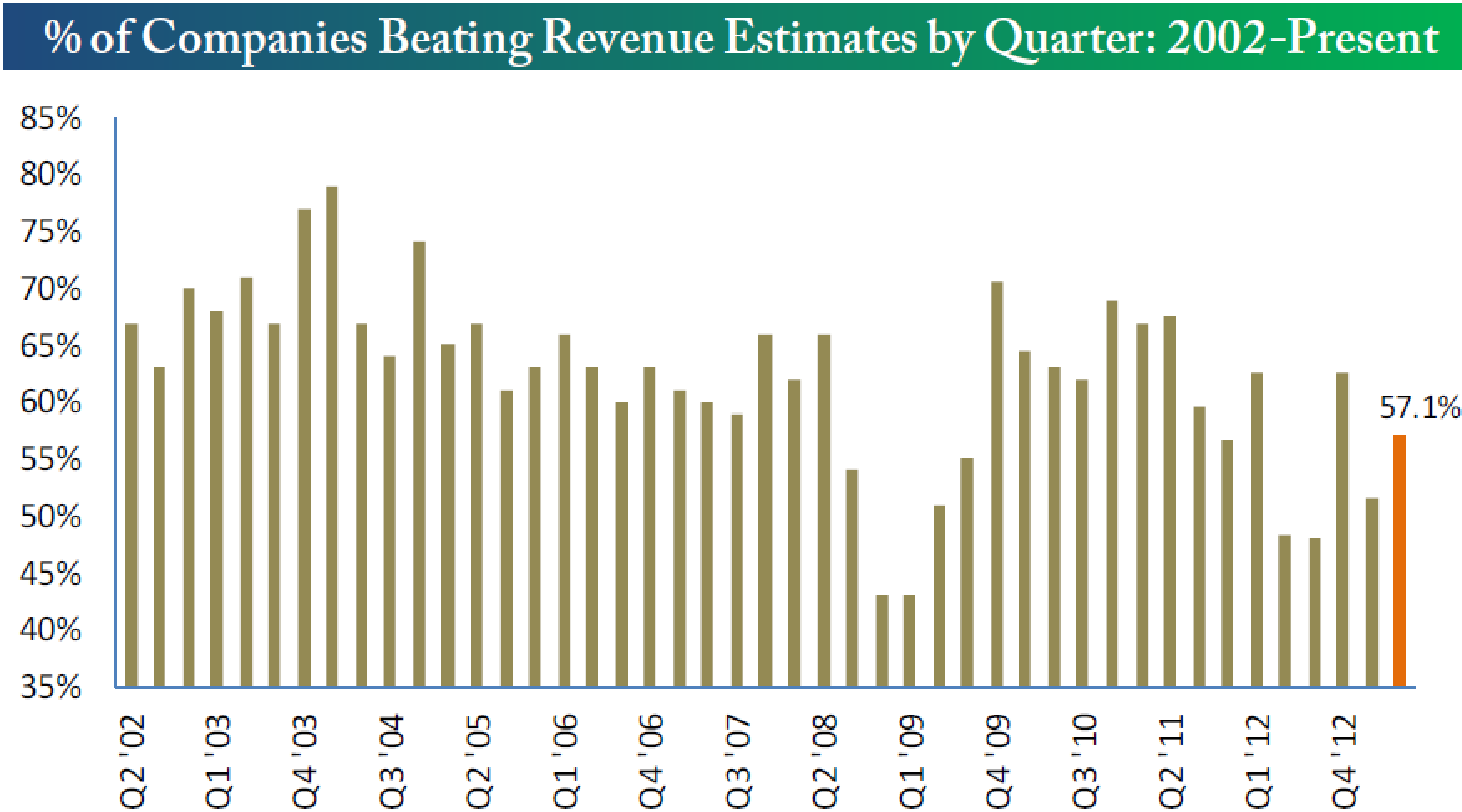


Source: Bespoke Investment Group.

That makes the S&P 500's (bottom up) operating earnings estimates of $108.69 for 2013, and $122.43 for 2014, seem achievable

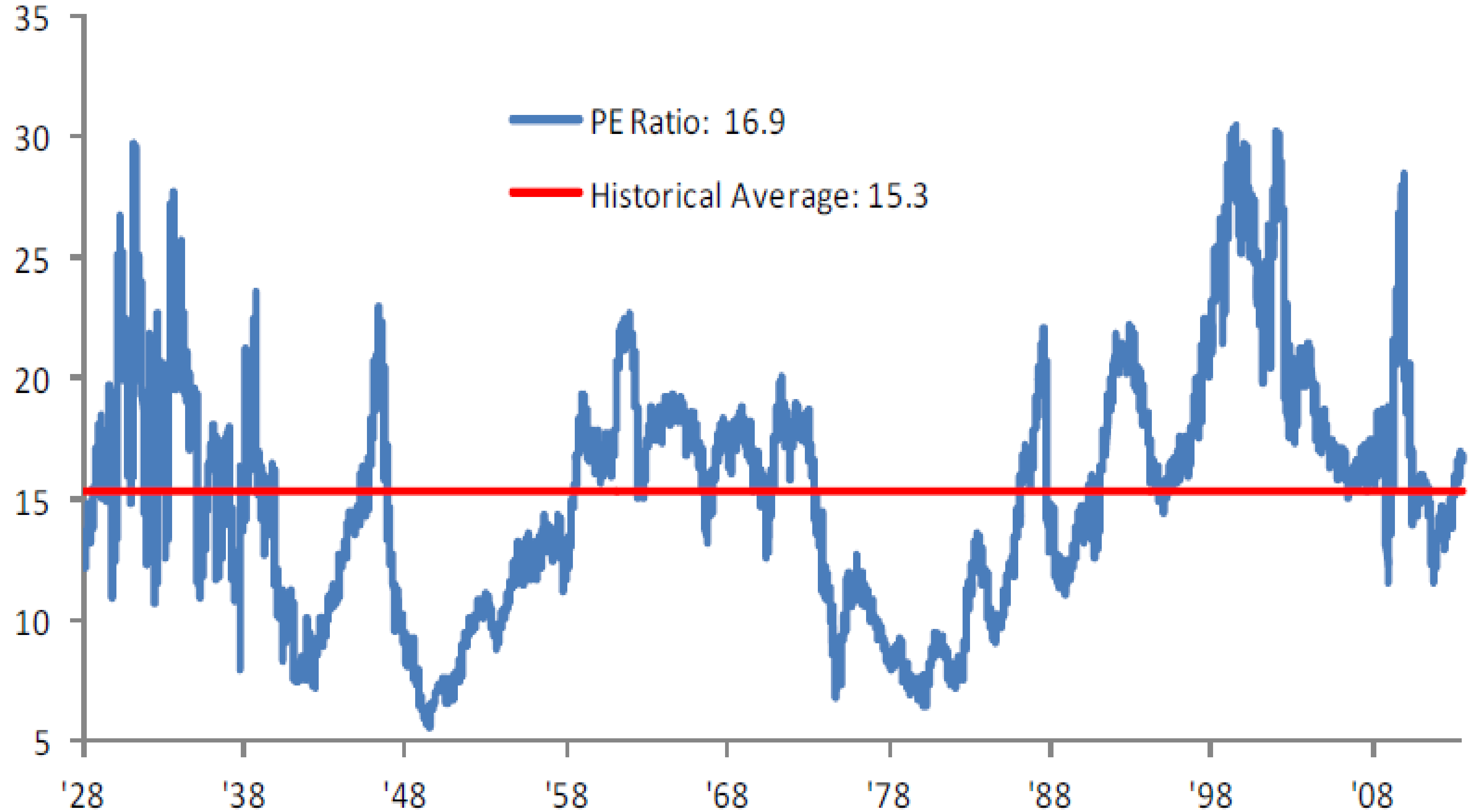
Data as of the close of: 7/31/2013
S&P 500 close of: 1685.73
Dividend yield (last 12 months: Jul,'13) 2.00%
Dividend yield (indicated rate) 2.10%

QUARTER END	PRICE	OPERATING EARNINGS PER SHR (ests are bottom up)	AS REPORTED EARNINGS PER SHR (ests are top down)	OPERATING EARNINGS PER SHR (ests are top down)	OPERATING EARNINGS P/E (ests are bottom up)	AS REPORTED EARNINGS P/E (ests are top down)	OPERATING EARNINGS P/E (ests are top down)		--- 12 MONTH EARNINGS PER SHARE --- OPERATING EARNINGS (ests are bottom up)	AS REPORTED EARNINGS (ests are top down)	OPERATING EARNINGS (ests are top down)
ESTIMATES											
12/31/2014		$32.68	$25.60	$28.03	13.77	15.11	14.72		$122.43	$111.53	$114.53
09/30/2014		$30.90	$28.48	$29.48	14.17	15.16	14.76		$118.93	$111.21	$114.24
06/30/2014		$30.08	$28.76	$29.02	14.61	15.45	15.00		$115.36	$109.09	$112.37
03/31/2014		$28.77	$28.69	$28.00	15.09	15.94	15.30		$111.69	$105.78	$110.19
12/31/2013		$29.18	$25.28	$27.74	15.51	16.64	15.61		$108.69	$101.31	$107.96
09/30/2013		$27.33	$26.36	$27.61	16.42	17.44	16.31		$102.66	$96.68	$103.37
06/30/2013 (72.3%)	1606.28	$26.41	$25.45	$26.84	16.97	18.42	16.90		$99.33	$91.53	$99.76
					16.17	17.55	16.10	(P/E on Jun,'13 price)			

Source: Standardandpoors.com

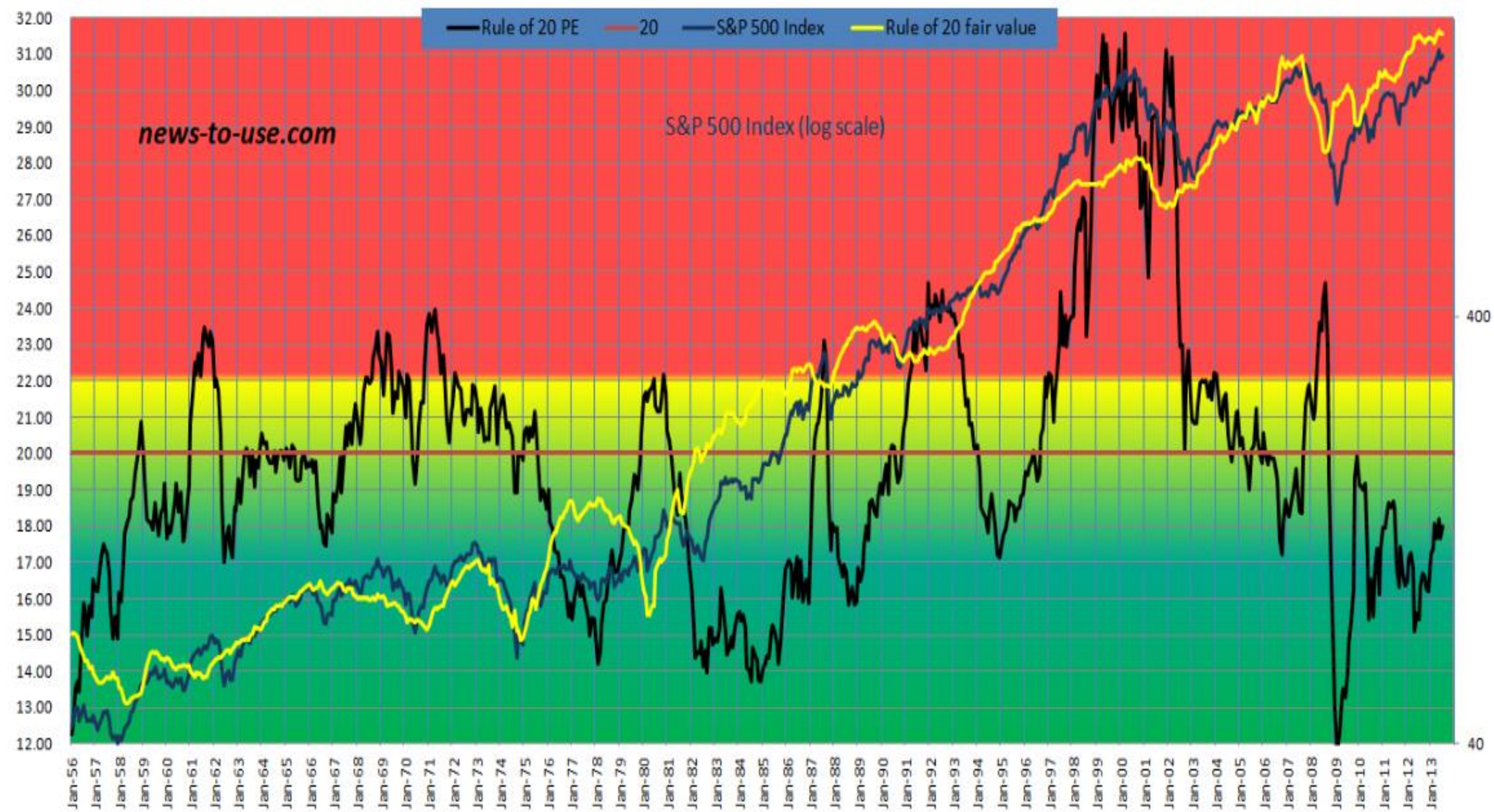
While using the S&P 500's (SPX) historic average P/E multiple of 15.3x leaves the SPX overvalued in the near term, it renders a price target of 1873 on 2014's estimate

S&P 500 P/E Ratio: 1928 - 2013



Source: Bespoke Investment Group.

However, using the Rule of 20, which states that the P/E plus the inflation rate should equal 20, implies a P/E ratio of 18x currently, or a price target of 1956



Source: News-to-use.com

Moreover, there is plenty of history suggesting that a P/E ratio of 18x is not an unrealistic objective for a bull market

S&P 500 P/E Ratios During Bull Markets (1 Year +): 1928 - 2013

		S&P 500	Duration	Trailing PE Ratio		
Start	End	Change (%)	(Calendar Days)	Start	End	% Change
1/2/28	9/16/29	80.41	623	12.8	19.8	54.6
3/14/35	3/10/37	131.64	727	11.0	14.6	32.1
4/28/42	5/29/46	157.70	1,492	7.2	22.9	219.1
5/19/47	6/15/48	23.89	393	9.6	9.2	-4.1
6/13/49	8/2/56	267.08	2,607	5.6	14.4	154.6
10/22/57	12/12/61	86.35	1,512	11.2	22.8	102.7
6/26/62	2/9/66	79.78	1,324	15.1	17.6	16.8
10/7/66	11/29/68	48.05	784	13.3	18.8	41.6
5/26/70	1/11/73	73.53	961	12.6	18.7	49.2
10/3/74	11/28/80	125.63	2,248	6.8	9.5	38.7
8/12/82	8/25/87	228.81	1,839	7.6	21.2	181.1
12/4/87	3/24/00	582.15	4,494	12.8	29.6	131.0
7/23/02	10/9/07	96.21	1,904	19.2	17.5	-8.6
3/9/09	7/22/13	150.50	1,596	13.7	16.9	23.6
Average (Ex Current Period)				**11.1**	**18.2**	**63.4**
Median (Ex Current Period)				**11.2**	**18.7**	**66.7**

Source: Bespoke Investment Group.

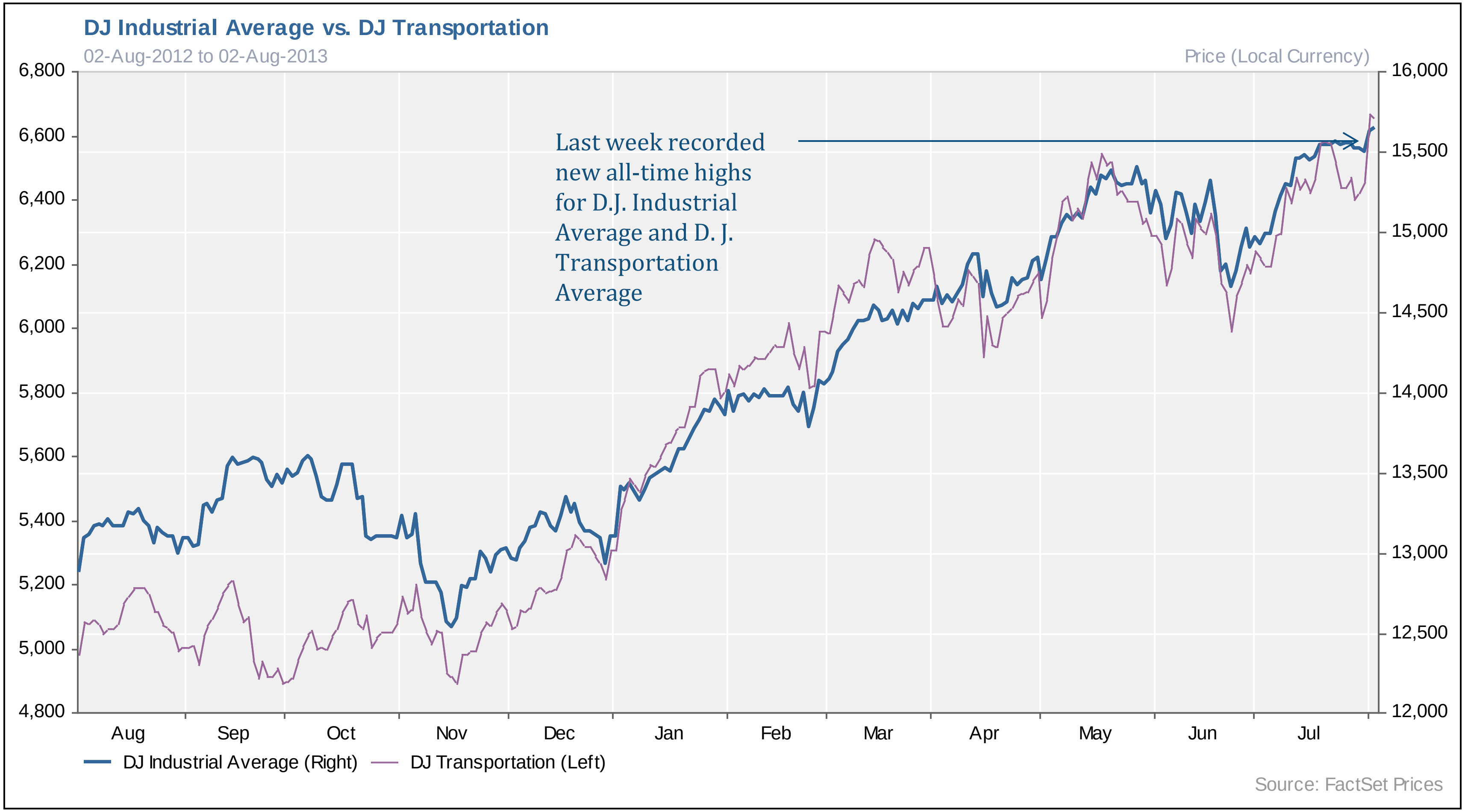
That said, I have targeted the mid-July through mid-August timeframe as the first "window" of the year for a meaningful decline because of the seasonality

S&P 500 and Average Sector Returns - Next Two Weeks (7/29 - 8/12)

	Average	Percent of Time		Last Ten Years - Percent Change (%)									
Sector	Change (%)	Positive	Outperforms S&P 500	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003
Con Staples	0.27	60	70	0.0	-3.9	-0.4	-1.2	4.7	2.4	0.6	-1.6	0.3	1.7
Cons Discret.	-0.26	40	50	0.8	-9.1	-0.4	5.4	7.6	-1.6	-0.8	-0.6	-4.8	0.9
Health Care	-0.51	30	60	-0.5	-7.4	2.4	-0.6	4.2	0.8	-1.6	-0.1	-1.3	-1.0
Utilities	-0.53	40	60	-1.6	-4.8	-0.3	0.3	-2.5	3.8	-0.6	-1.9	2.0	0.2
Energy	-0.71	50	50	2.6	-12.0	-0.8	1.7	-3.5	-1.4	1.3	5.0	-4.3	4.3
Materials	-0.79	40	60	2.8	-9.3	-1.3	7.0	-3.3	-0.4	-0.2	0.6	-4.0	0.2
S&P 500	-0.86	40	-	1.4	-8.8	-1.6	3.1	2.1	-0.4	-0.9	-0.3	-3.4	0.1
Telecom Svcs	-0.89	30	40	1.2	-4.8	2.3	-2.1	3.1	-2.2	-2.0	-2.2	-1.7	-0.4
Industrials	-0.96	40	40	1.6	-9.6	-2.8	7.2	2.2	-1.5	-2.6	-0.9	-4.2	0.9
Financials	-1.13	20	30	1.0	-13.8	-4.2	11.8	-1.2	-0.2	-1.8	-0.9	-1.8	-0.4
Technology	-1.33	30	40	3.7	-6.8	-4.0	1.0	5.6	-1.2	-0.5	-0.8	-8.7	-1.7

Source: Bespoke Investment Group.

Yet, any meaningful decline is for buying because confidence is high that we are into a new secular bull market with yet another Dow Theory "buy signal" last week



Source: Factset.

Scott Brown

Economic Indicator	Status	Comments
Growth		Real GDP rose at a lackluster pace in the first half of the year, restrained by the tightening in fiscal policy. Growth is expected to pick up somewhat in the second half of the year.
Employment		Job growth has trended at a moderately strong pace. Job destruction remains low. However, unemployment rates for teenagers and young adults remain elevated and long-term unemployment remains unacceptably high.
Consumer Spending		A mixed bag. Wealth gains from the stock market and housing are supporting spending at the high end. Stagnation in inflation-adjusted wages and lagged effects of the payroll tax increase are restraining spending growth at the lower end of the income scale .
Business Investment		Corporate profits have remained strong, providing fuel for business fixed investment. However, recent figures on capital spending have been mixed.
Manufacturing		Mixed across industries and uneven over time. Generally positive, but not especially strong. The ISM survey results surprised to the upside in July, but it's only one month and many supply managers commented that activity was "stable," "steady," or "slow."
Housing and Construction		Sales and construction activity should continue to improve. However, higher mortgage rates won't help. It will take some time before the supply chain in housing fully recovers.
Inflation		The PCE Price Index rose 1.3% over the 12 months ending in June (+1.2% ex-food & energy), well below the Fed's 2% target. The soft global economy has put downward pressure on commodity prices. Wage pressures remain mild. Inflation expectations are well-anchored.
Monetary Policy		The Fed will continue to purchase $85 billion per month in long-term Treasuries and mortgage-backed securities, but is expected to taper the pace in the months ahead. Short-term interest rates are expected to remain exceptionally low until mid-2015.
Long-Term Interest Rates		Long-term interest rates have risen and some of the increase may be due to misunderstanding of the Fed's policy intentions. The financial markets are putting too much emphasis on a possible tapering of Fed asset purchases.
Fiscal Policy		Sequester cuts are spread out over time (no cliff effect), but will subtract from overall economic growth this year and next. The outlook for the deficit has improved considerably in recent months. The federal debt ceiling will probably not be binding until October.
The Dollar		Likely range-bound in the near term. Some support vs. the euro and pound as foreign central bank policy appears a bit easier (and the Fed is perceived to be less easy).
Rest of the World		Global growth has been relatively soft, but is expected to improve in 2014. Europe remains weak, which won't help China's export engine.

Federal Reserve Policy – Extraordinary Measures

1. **Forward Guidance** on short-term interest rates
   The Committee anticipates that this exceptionally low range for the federal funds rate will be appropriate *at least as long as*:
   a) the unemployment rate remains above 6.5%,
   b) inflation one to two years ahead is projected to be no more than 2.5%,
   c) longer-term inflation expectations remain well anchored
2. **Large-Scale Asset Purchases** (LSAP or "QE3") – the Fed will purchase:
   $45 billion in long-term Treasuries and
   $40 billion in Mortgage-Backed Securities
   until the labor market *"improves substantially"*

Note that tapering is not tightening. The Fed would continue to add monetary policy accommodation even as it slows the rate of asset purchases. Low short-term interest rates would continue to provide support for the economy for some time after asset purchases end.

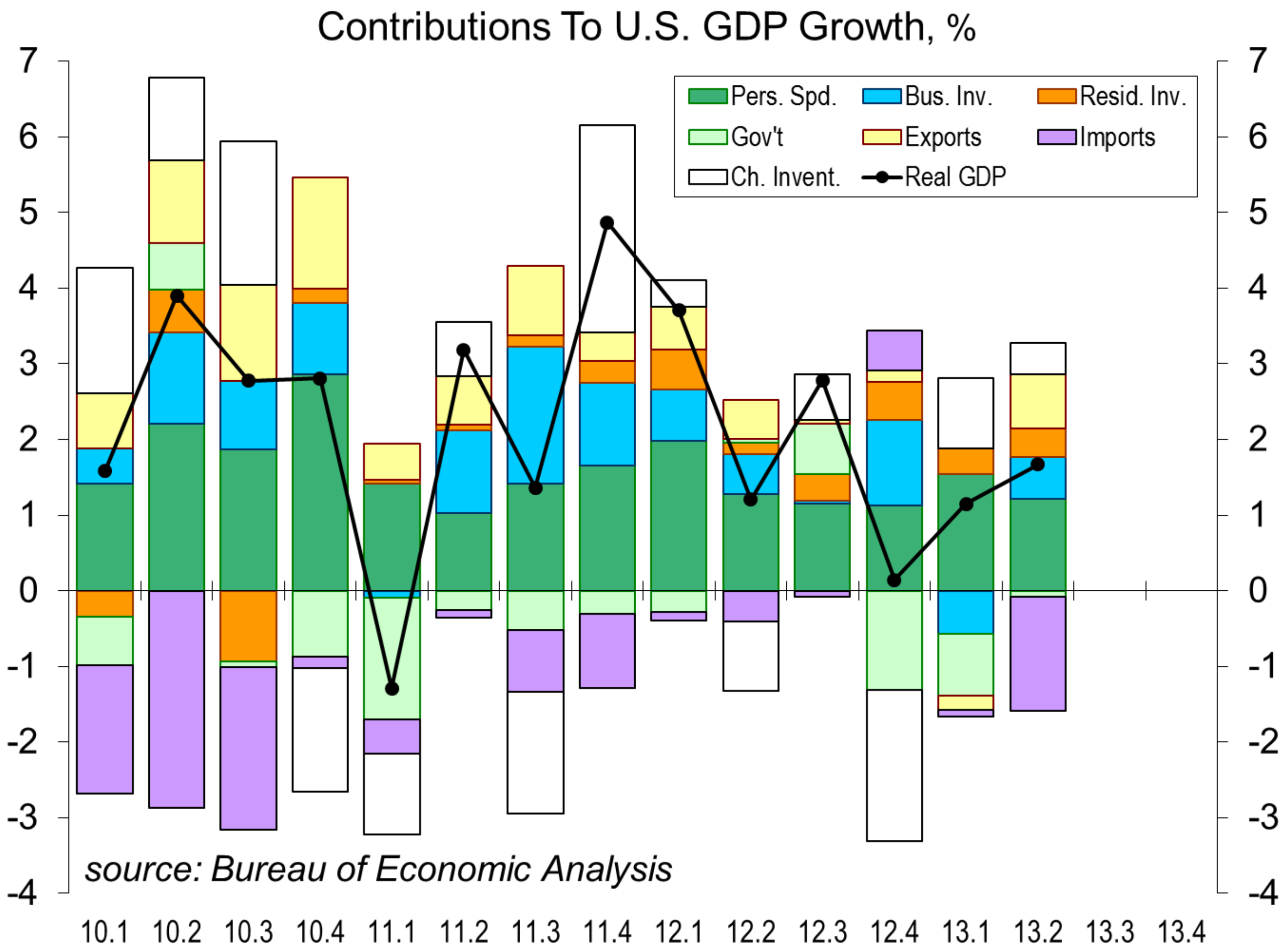
Fed officials were caught off guard by the market reaction to the talk of tapering. From the Fed's point of view, it doesn't matter much whether tapering begins in September, December, or in early 2014. Chairman Bernanke was clear in laying out the Fed's intentions, but the markets did not take it well.

Key Takeaways From the July 31 Fed Policy Statement

1. **No change in rates, no change in the forward guidance, no change in the rate of asset purchases**
   None of that is a surprise
2. **Information suggests that *"economic activity expanded at a modest pace during the first half of the year"***
   That implies no pressing need to taper the pace of asset purchases
3. **Housing has been strengthening, *"but mortgage rates have risen somewhat"***
   Higher long-term interest rates may dampen the pace of recovery
4. **The FOMC recognizes that *"inflation persistently below its 2 percent objective could pose risks to economic performance"***
   Inflation has trended low in recent months
   The Fed expects inflation to move gradually toward the 2% goal
   But a continued low trend would be a concern

Investors would be wrong to conclude that the Fed won't taper by the end of the year, but future policy decisions will remain data-dependent. The Fed would still be adding monetary accommodation as it slows asset purchases, but needs to communicate its intentions more clearly to the financial markets.

Real GDP: a 1.7% annual rate in the adv. est. for 2Q13



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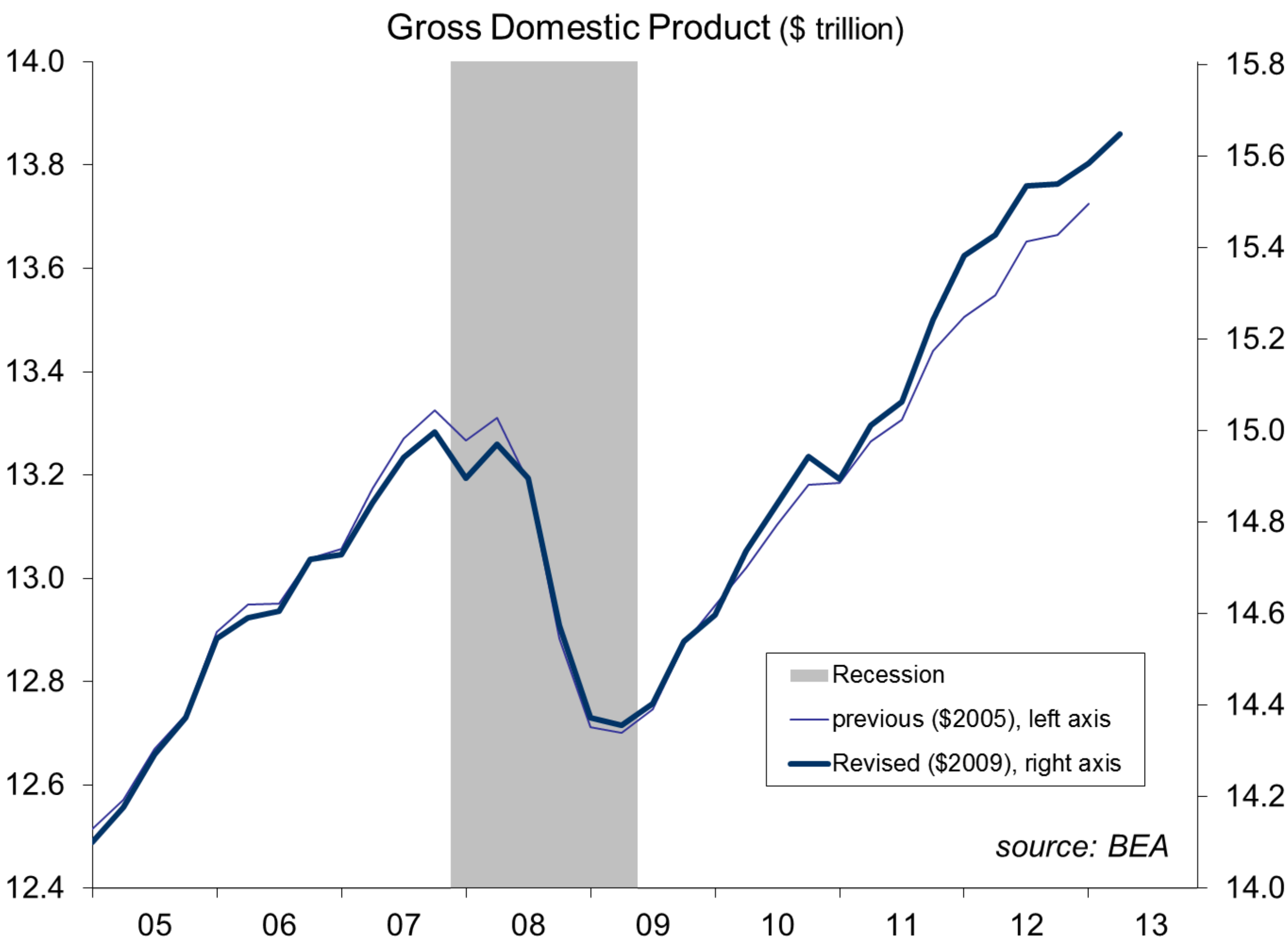
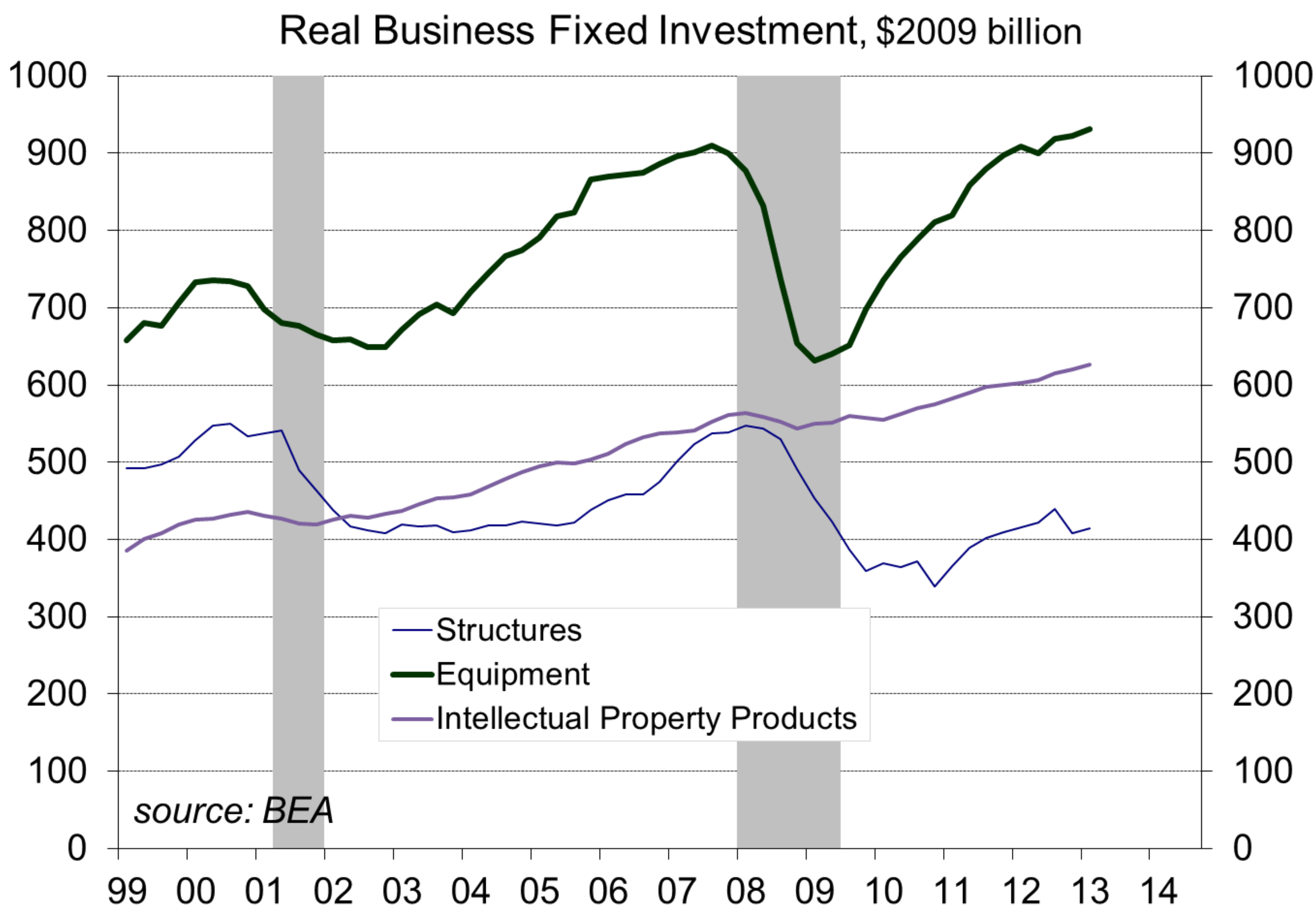
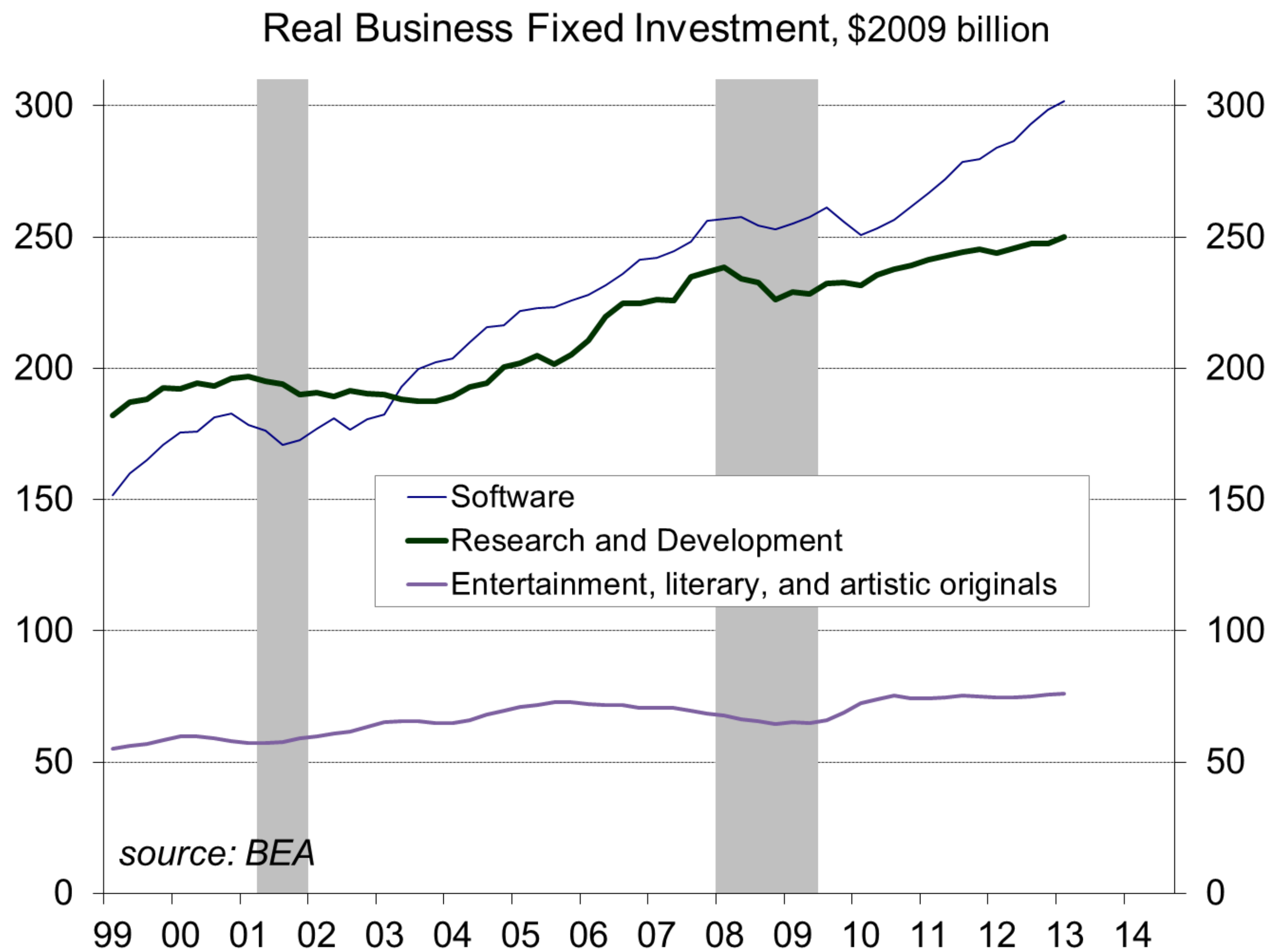
Comprehensive revisions did not alter the GDP growth picture by much



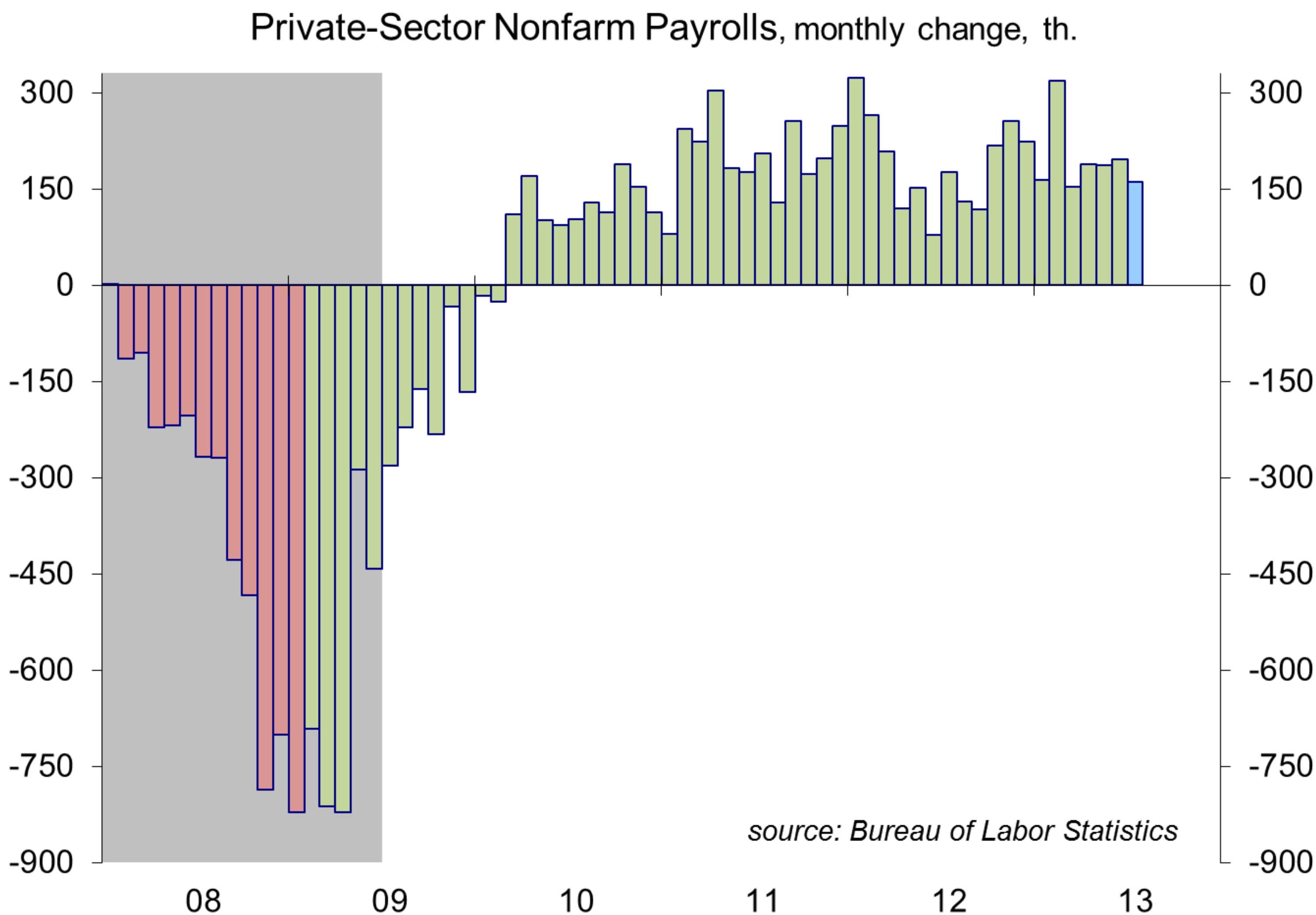
Intellectual Property Products were added to BFI



The categories within Intellectual Property Products

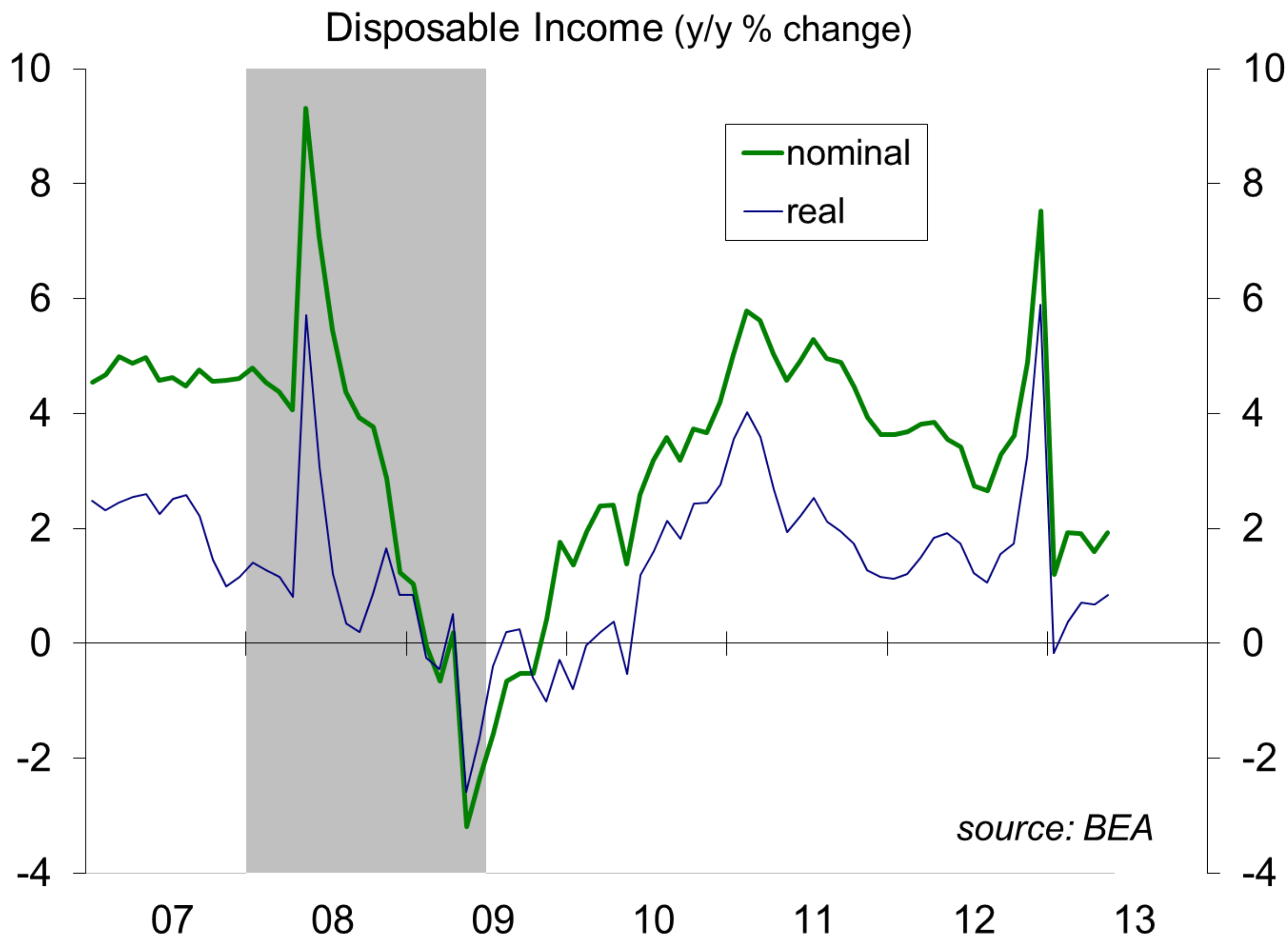


Nonfarm payrolls are on a moderately strong trend

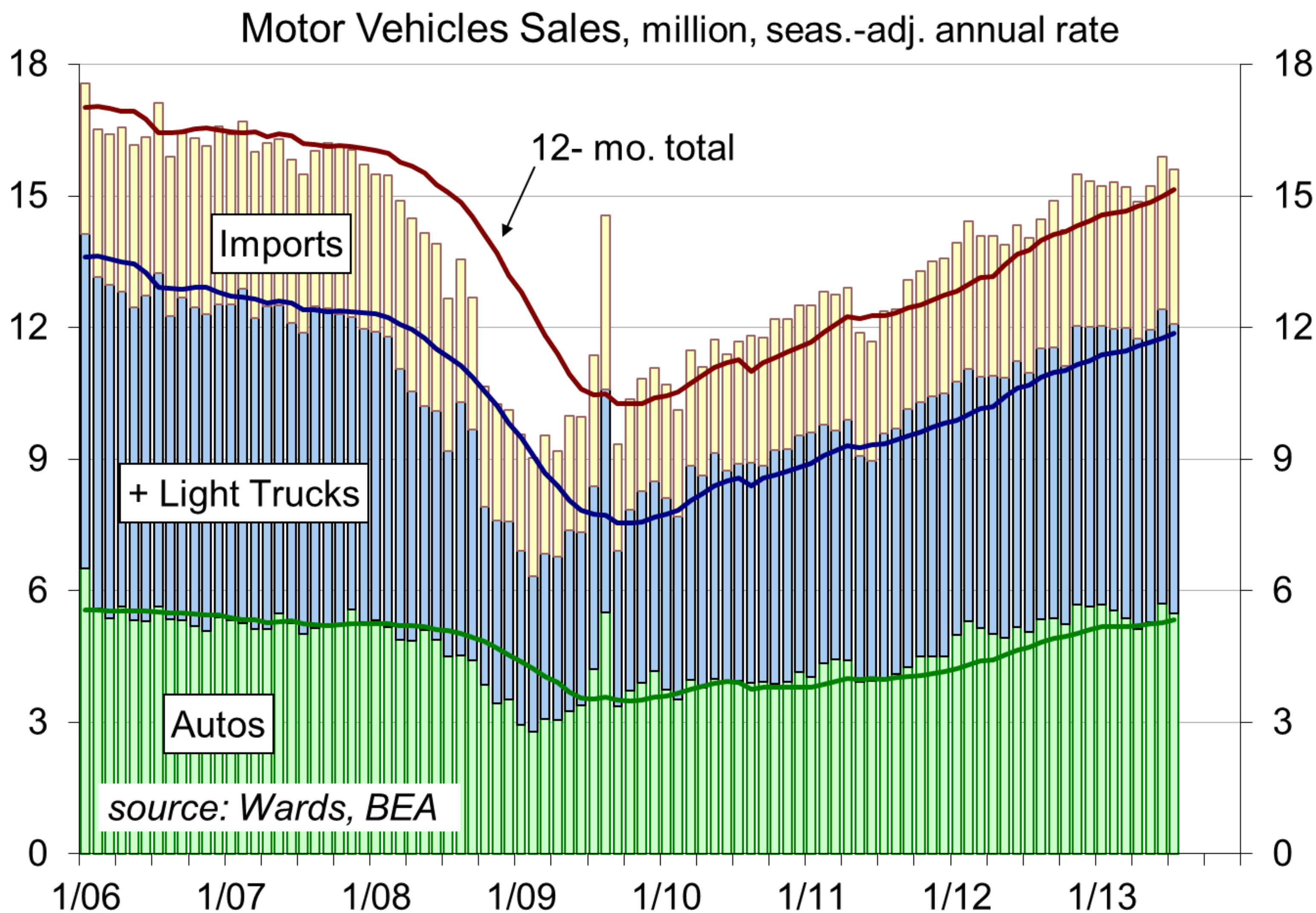


The unemployment rate has been trending lower, but the employment/population ratio is up only gradually

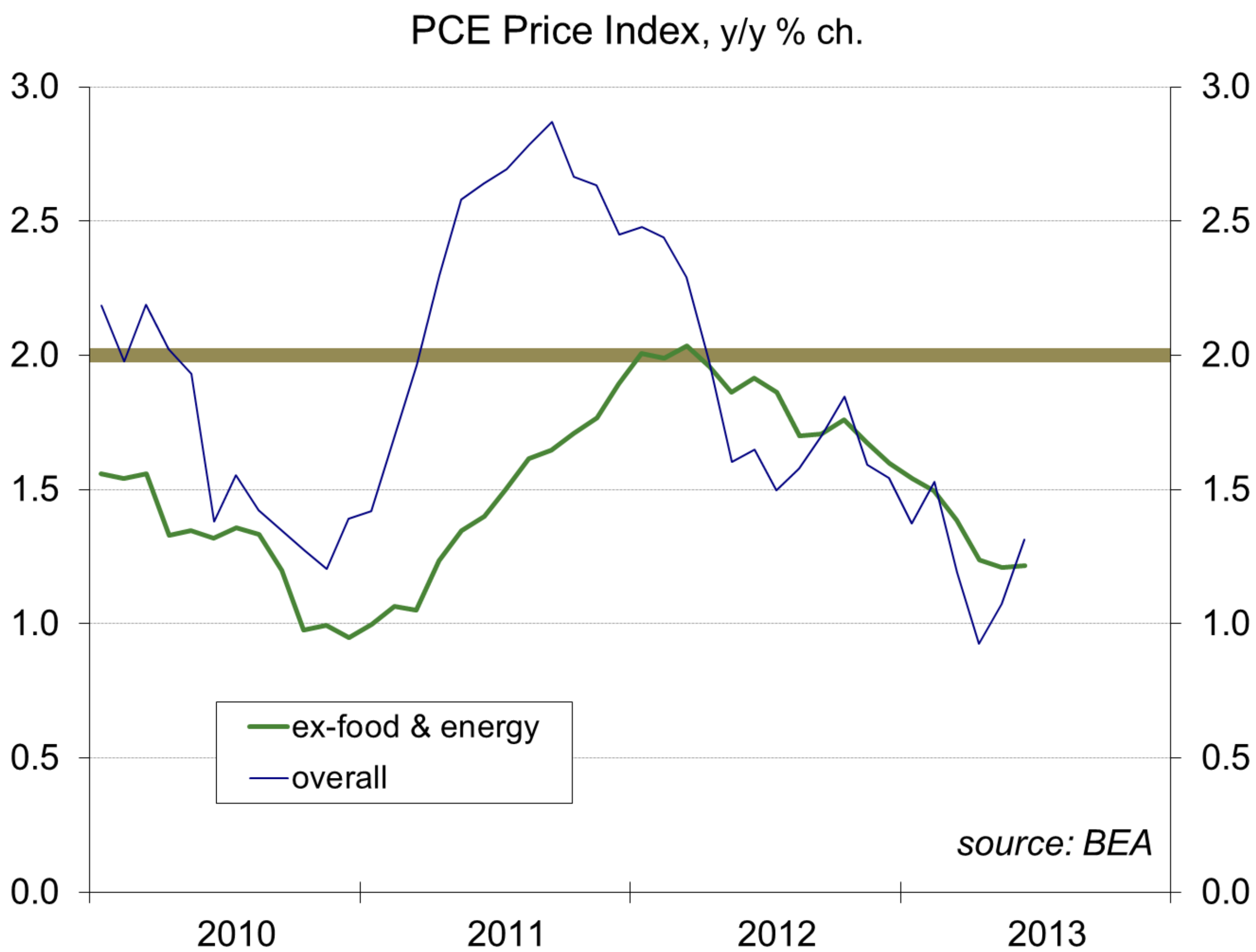
Real disposable income is up modestly y/y



Motor Vehicle Sales have remained strong



Inflation has been trending low



Fiscal Policy

- Fiscal policy is restraining economic growth
  - Payroll tax hike + sequester cuts: -1.5 ppts from GDP growth in 2013
    - Sequester impact is spread out over time (no cliff effect on economy)
- The debt ceiling went back into effect on May 19
  - Not likely to be binding until October or November
- Current Budget Authority expires on September 30
  - Will need a real budget or another Continuing Resolution
- Fiscal Cliff 2 – the sequel?
  - Congress will be back in session the second week of September
  - Expect a showdown (debt ceiling, budget authority)
  - There's more leeway in sequester cuts in FY14
    - A choice between cuts to defense and everything else (that actually makes it harder to reach a compromise)

Economic Outlook: Real GDP growth likely to pick up (2.0% to 2.5%) in the second half of 2013 – "more of the same" (that is, a gradual economic recovery with "glacial" improvement in the job market)

- Economic Headwinds
  - Payroll tax increase (has restrained disposable income in first half of 2013)
  - Federal government (sequester) spending cuts (spread out over time)
  - Global economic weakness
  - Tight credit for some borrowers (consumers, small business)
- Economic Tailwinds
  - Accommodative monetary policy
  - Homebuilding (support for GDP growth, but mortgage rates have risen)
  - Autos (driven by replacement needs, easier credit)
- Economic Wildcards
  - Gasoline prices
  - Long-term interest rates (market reaction to tapering)
- Economic Risks
  - Europe (signs of stabilization and much less fear than a year ago)
  - Fiscal policy (showdown over debt ceiling and 2014 budget)

Key Calendar Dates

- August 21 – FOMC Minutes (July 30-31)

  Any insights into the debate about tapering asset purchases?
  How does the Fed view the market reaction to tapering talk?
  How worried is the Fed about the low trend in inflation?

- August 29-31 – KC Fed Monetary Policy Symposium (Fed Camp)

  Bernanke will not participate

  Yellen will lead a panel

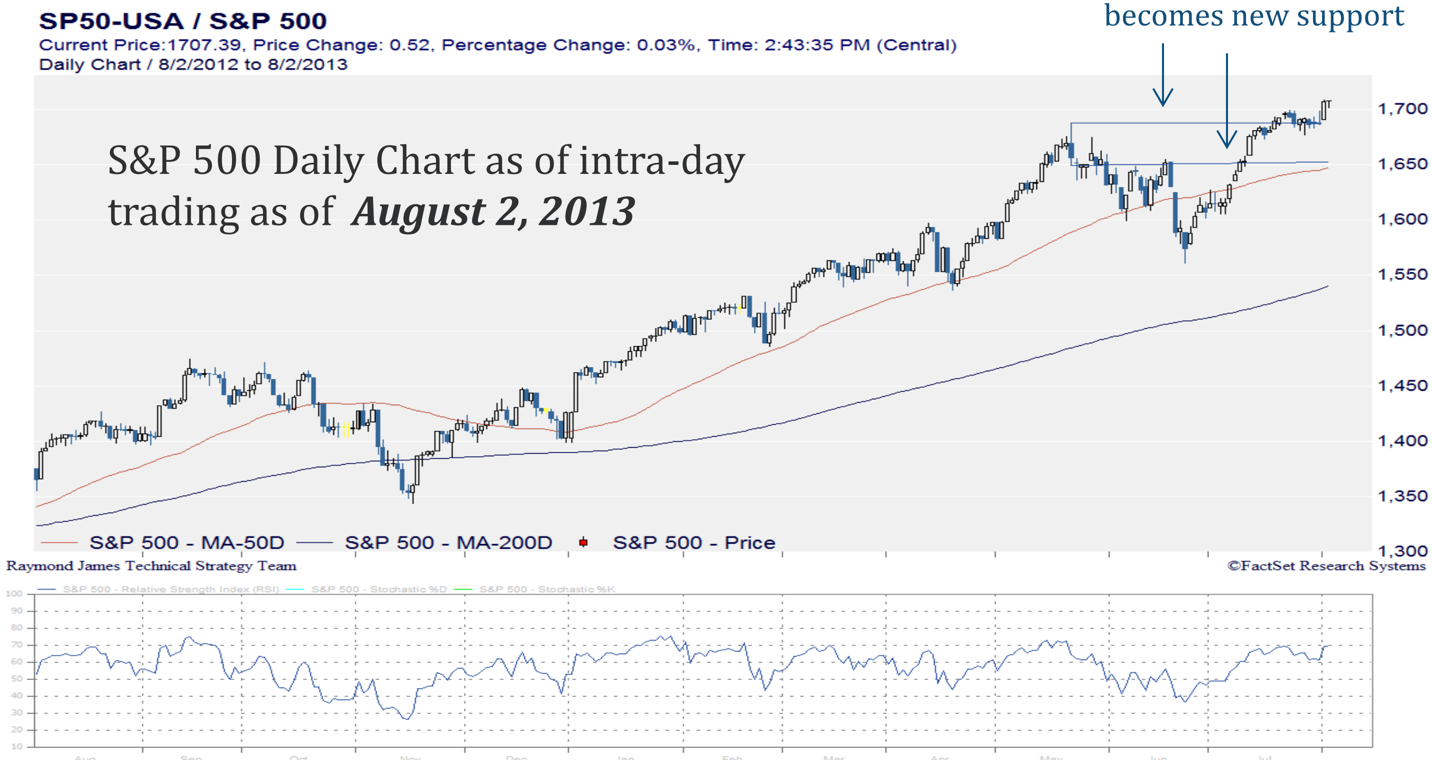
- September 6 – August Employment Report

- September 18 – FOMC Policy Decision

Taking the Pulse of the Short Term

In last month's *Gleanings* we showed a chart of the S&P 500 attempting to recover from a near 6% pullback. At the time, the rebuilding phase had begun as the index closed the month just above the 50-day moving average. The recovery extended into July as the index rallied 5% in price and pushed to a new all-time high. The move produced a technical breakout and repaired the technical damage done during the pullback. The technical price target generated by the breakout is near 1770. This price objective may be out of reach in the very near term, as the rally left the market slightly extended. Yet, the constructive recovery after the largest pullback over the past seven months suggests a good underlying tone to the equity market .

Former resistance becomes new support

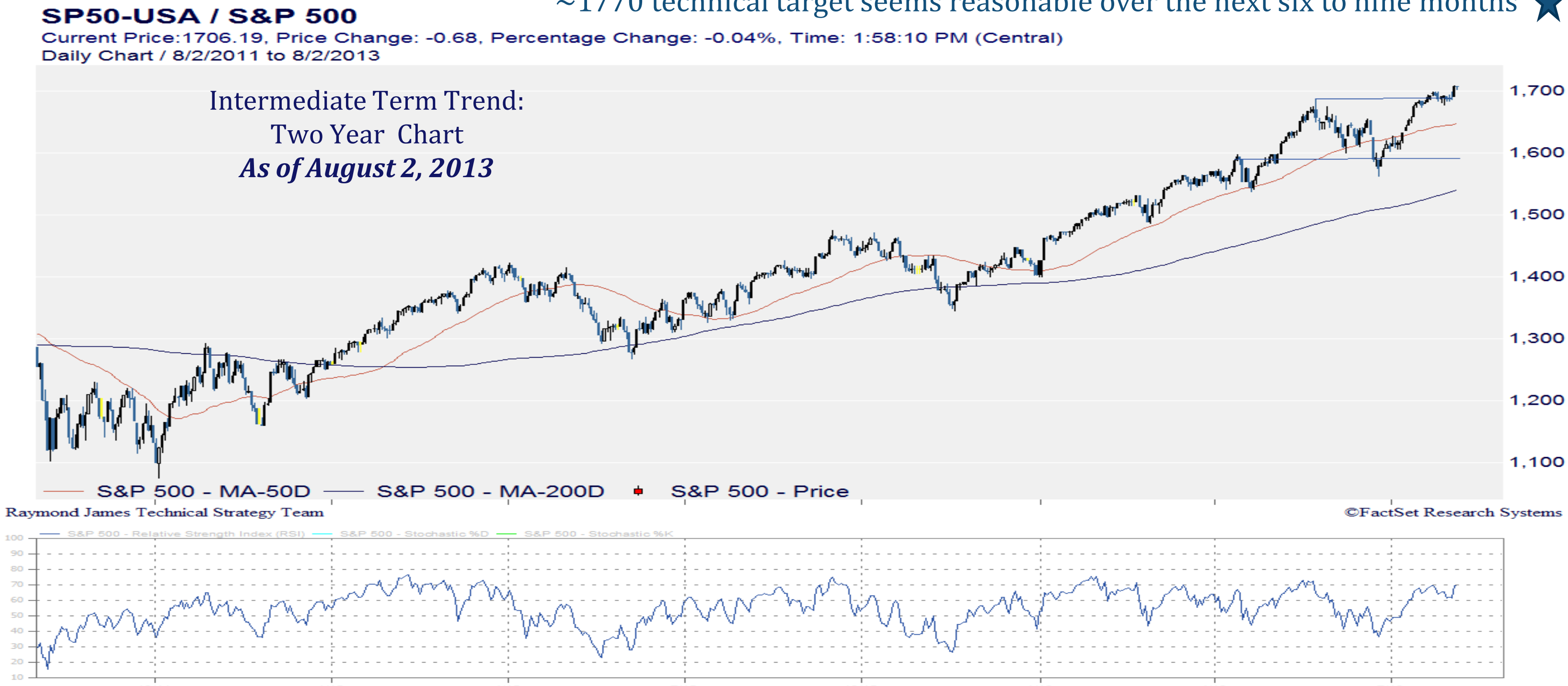


During the rally in July, the S&P 500 easily overcame technical resistance and rallied to a new all-time high. These former resistance levels now become technical support.

Intermediate-Term Trends are Still Intact

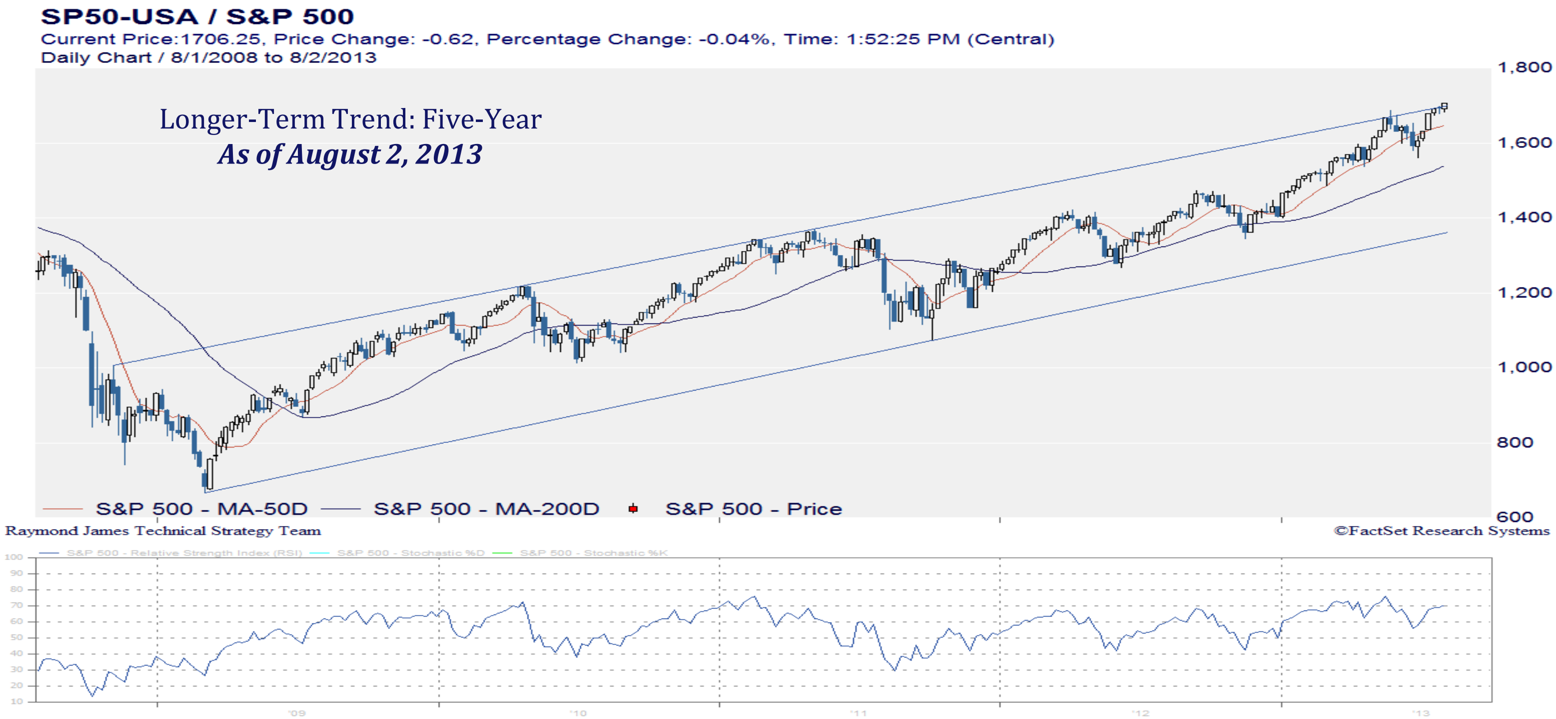
Intermediate -Term Trend: As previous highlighted, the S&P 500 technical price objective is 1770 after the index broke out of the base left in the wake of the May to June pullback. Although this price objective may not be realized in the next few months, it should be achievable with only a moderate expansion of the P/E multiple, if year-end earnings estimates reach current projections. Such an occurrence will require more of the same in terms of the economy (gradual improvement globally), no renewed battle in D.C. (over the debt ceiling), and no new surprises (unknown) to sway investor emotions. At the moment, all of the above requirements appear achievable and prices should be higher by year-end and into 2014.

~1770 technical target seems reasonable over the next six to nine months



Long-Term Trends are Still Intact

Longer-Term Trend: The rally in July pushed the S&P 500 to the top of the trend channel drawn off the credit crisis bottom. At the top of the channel valuations have also returned to levels equal to levels reached at the May peak. The market can obviously push well beyond the uptrend line but with the historically seasonal weak period (August and September) upon us, the odds of a massive push higher are low. Nonetheless, the weight of the evidence suggests the undertones are solid and, after a period of regrouping, the ascent can continue.



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Strong Buy (SB1) Expected to appreciate, produce a total return of at least 15%, and outperform the S&P 500 over the next six to 12 months. For higher yielding and more conservative equities, such as REITs and certain MLPs, a total return of at least 15% is expected to be realized over the next 12 months.
Outperform (MO2) Expected to appreciate and outperform the S&P 500 over the next 12-18 months. For higher yielding and more conservative equities, such as REITs and certain MLPs, an Outperform rating is used for securities where we are comfortable with the relative safety of the dividend and expect a total return modestly exceeding the dividend yield over the next 12-18 months.
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	Coverage Universe Rating Distribution				Investment Banking Distribution			
	RJA	RJL	RJ LatAm	RJEE	RJA	RJL	RJ LatAm	RJEE
Strong Buy and Outperform (Buy)	50%	62%	43%	45%	25%	31%	0%	0%
Market Perform (Hold)	44%	37%	57%	34%	9%	27%	0%	0%
Underperform (Sell)	7%	1%	0%	21%	3%	0%	0%	0%

Risk Factors

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