

VOLUME 17, NUMBER 1, JANUARY 2014

CAPITAL IDEAS



INSIDE:
CROSSROADS
AND
WORDS WITH FRIENDS
IN EVERY ISSUE:
QUARTERLY REVIEW

CROSSROADS

by Charlie Smith



Last year at this time, we were moderately bullish. Our base case for the U.S. economy included economic growth again averaging less than 3% for 2013, as consumer deleveraging continued and government deleveraging got started. We thought corporate earnings (as measured by the S&P 500) could rise 4% for the year, reaching \$105. Home prices would plateau, and bank lending would rise about 5%. We also said long-term U.S. interest rates would end a 30-year decline, marking the end of a long bull market for bonds. We put fair value on the S&P 500 at 1500, estimating about a 7% total return for the year.

Fast forward 12 months, and our biggest miss turned out to be housing. Prices for the average U.S. home increased nearly 15% during the year, double the rate of our most bullish forecast. Corporate earnings came in better than we thought as well, with S&P 500 profits rising into the neighborhood of \$109, depending on upcoming fourth quarter results. Thanks to all the “taper” talk from Federal Reserve Chairman Ben Bernanke during the summer, our bearish outlook on interest rates worked as well; bonds had their worst year since the early 1990s. Our guess on the magnitude of the rise in stock prices was not nearly as good. U.S. stocks jumped 30% during the year, well ahead of our 7% estimate.

So should we be in a celebratory mood after a 30% year for U.S. stocks? Certainly. Should we be anticipating a repeat performance in 2014? Not hardly. The booming stock market appears to be discounting a better economy, but at the same time reflects ongoing money printing by the Federal Reserve. Our task in the New Year will be to tease out what is “real” from the massive inflationary efforts emanating from Washington. With this in mind, here are our thoughts on the various conflicting signals as we enter 2014.

Road to Health?

U.S. economic surprises were generally positive in the second half of 2013, so much so that accelerating growth was a top theme among investment strategists at year end. Most are looking for growth above 3% at an annual rate during the fourth quarter. After a 4.1% gain in the third quarter, it would be the best back-to-back quarterly performance in two years, and it would put the gain for the year at about 2.7%, the best since 2007. The assumption is that the Fed recognizes this improvement, and therefore has room to ever-so-slightly reduce monetary accommodation via reducing bond purchases. Thus the \$10 billion monthly “taper”, formally announced on December 18th.

“Our task in the New Year will be to tease out what is “real” from the massive inflationary efforts emanating from Washington.”

The second positive signal comes from the fiscal side of the house. After seemingly endless hand-wringing over the deficit and the fiscal cliff at the end of 2012, Congress defaulted to the “sequester” in January of last year. When combined with a tax increase on high earners, it worked. It really worked. The federal deficit fell from over \$1 trillion in fiscal 2012 to \$660 billion in 2013, a 40% decline. And after 3 months of fiscal 2014, another

40% decline appears to be in the works. Extrapolation is a dangerous game any time D.C. politics are involved, but pro-rating the first quarter deficit numbers over the rest of fiscal 2014 yields an estimated deficit of \$400 billion, just over 2% of Gross Domestic Product (GDP). In retrospect the fear mongering over a collapse in the economy due to fiscal drag was obviously way overdone. Economic growth has remained sluggish, but positive, and now appears to be accelerating, despite the vast decline in the Federal deficit. Maybe all the Keynesian economists who've been pounding the table for more spending and greater deficits simply had their signs crossed? Who knows?

One of the keys to a stronger 2014 could be how corporate managements react to the improving fiscal situation. Executives have been complaining about economic and fiscal "uncertainty" since the recovery began nearly 5 years ago, and capital spending remains weak. One would think that an improvement in the deficit of this magnitude would be greeted in the C-suite with open wallets. There is little sign of it, however. For whatever reason, capital spending remains at multi-decade lows relative to the size of the economy. Perhaps a still-deleveraging consumer can't pump up sales growth enough to justify new capacity? Maybe technology has advanced to the point where a dollar of capital buys a much bigger boost in capacity than it did 10 or 20 years ago? Maybe the introduction of cheap foreign manufacturing capacity has permanently reduced the need for domestic projects? Whatever the cause, there has yet to be a revival of real investment spending in the U.S., the plunging Federal deficit notwithstanding.

The final indicator that 2014 might be better is Europe. After GDP declined steadily across most of the Continent for the better part of 5 years, 2013 brought a hint of economic stability to the Eurozone. Europe is "better" in the way that a man who has been hit by a truck is "better" after being dragged to the berm, but at least the risk of runaway bank failures has passed. European Central Bank President Mario Draghi vowed to do whatever he could to save the financial system in July of 2012, and thus far he has succeeded without having to crank the printing presses at anywhere near the rate of his U.S. counterparts. Perhaps nearly \$4 trillion in money creation on the part of the U.S. Federal Reserve is enough to save both economies!

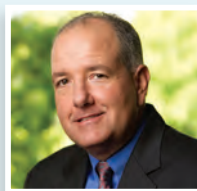
Or Road to Perdition?

The best (and most immediate) counter to the "better economy" meme was the ugly December employment report. On January 3rd, 2014 the Labor Department reported that only 74 thousand net new jobs were created in December. This against a consensus estimate of over 200 thousand. One month obviously does not a trend make (as market pundits have repeated ad nauseam since the announcement), but this report, combined with mixed holiday results from a string of retailers, has caused some questioning of the bull thesis. Ongoing weakness in labor force participation (a new 36-year low!) remains a concern as well, as millions of couch potatoes watch their remaining job skills fade into the cushions like so much loose change. The unemployment rate has fallen to 6.7%, but only because people are leaving the labor market in droves. Again, a single weak month can be explained away by bad weather, faulty seasonal adjustments or a myriad of other factors. Retail sales for December (ex autos and gas) were actually up a modest 0.6%, better than expected. Both these key indicators of consumer health bear watching in the New Year.

Another red flag is China. The Chinese economy is downshifting to a 7% growth rate—and may go even lower if authorities are forced to rein in the "shadow" banking system. In the final week of 2013, for the second time in six months, Chinese interbank lending rates spiked above 10 percent, prompting fears of a credit crunch that could cripple the world's second-largest economy. The People's Bank of China quickly injected \$50 billion into the system, just as they did last summer when the same thing happened. These rumblings within China's financial system are symptomatic of the bad debts building up after a 5-year investment boom. Total debt has risen from 125 percent of GDP in 2008, to 215 percent in 2012. An additional \$15 trillion of new credit has been provided during this period—an amount equaling the size of the entire U.S. banking sector. Much of this money has gone into projects with nebulous return prospects, designed more to pump up GDP statistics than generate profits. Bad debts are rising, and policy-makers face the Hobson's choice of slowing the economy now via tighter money, or letting it crash later of its own dead weight. The implications are real for global investors. China's growth has fueled worldwide demand for metals and machinery. China is also the world's largest automobile market, the largest oil importer, and the largest buyer of gold. Any sustained weakness in these demand vectors would send tremors through world markets.

Finally, there are a couple other nagging "issues" with the U.S. economy. Housing is doing better, but to some extent has become a victim of its own success. Home prices rebounded far faster than many thought possible in 2012 and 2013. Mortgage rates are also a full point higher than a year ago. This combination has made home affordability a problem, particularly for first-time buyers. Unless income growth picks up, or mortgage credit is made more freely available (we know how that ends!), the "echo" housing boom may not last. Also, the economic recovery itself is getting long in the tooth. The average U.S. postwar recovery has lasted 45 months. This recovery is now 52 months old. Talk of "green shoots" was fine when economic growth was first emerging from the tundra of the financial crisis, but today the statistics are working against us.

On balance, we're thinking real economic growth might accelerate moderately in 2014. Perhaps a 3% year is finally in the cards, particularly if capital spending revives. Corporate earnings should continue to rise moderately as well. Perhaps instead of doing more with less, as has been the case throughout the recovery, corporate managers will find a way to do "more with more", benefitting labor as well. Our estimate is the S&P 500 can earn about \$114 per share in this environment. Put a 17 multiple (quite reasonable given 2% annual inflation) on this number, and you get a target of 1938, 90 points higher than the 2013 close. Happy New Year!



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WORDS WITH FRIENDS

by Jay Sommariva



With the 2013 Time Magazine Person of the Year award going to Pope Francis, we wondered what the economic “word” of the year might be if there were such a thing. If we had a vote, it would be “tapering”. Although you won’t find it in any economics text, tapering is proving a strong successor to last year’s winner: Quantitative Easing (QE). More importantly from the market’s perspective, tapering may have just as great an effect on how we view 2014 as QE did on 2013.

Similar to ex Fed Chairman Alan Greenspan’s 1996 “irrational exuberance” comments, current Fed Chairman Ben Bernanke’s tapering remarks on May 22, 2013 were a big market mover. Tapering, effectively a reduction in the Fed’s \$85 billion monthly bond purchases, was initially viewed as snatching the punch bowl away from the party, and deflated both stock and bond prices. Six months of backtracking on the part of various Fed governors has since put the process in better perspective, however, and tapering has come to be not only accepted, but embraced. This is because Bernanke and friends have generally done a good job with regard to describing both how tapering might play out, and the conditions necessary to initiate the process. By continuously reminding markets that the punch bowl is still there (albeit a little less full), the Fed has reassured investors, allowing bond prices to stabilize and stocks to continue to rise.

By the time it was formally announced on December 18th, tapering was nearly fully priced into the bond market. On the date of the announcement, for example, ten-year and thirty-year U.S. Treasury yields were both about a full percentage point higher than they were in May, before the taper talk began (see Exhibit 1). After the announcement that the Fed would reduce its purchases by \$10 billion per month, yields across the spectrum continued to drift upward, with the benchmark 10-year Treasury breaking the 3% threshold.

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(Continued on back page)

12-MONTH YIELD INCREASES

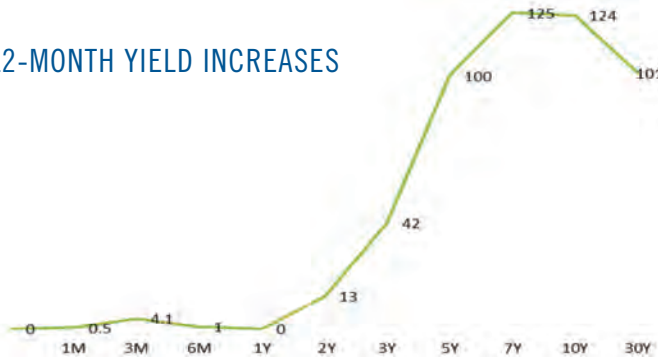


Exhibit 1 | Source: Bloomberg

YIELD CURVE

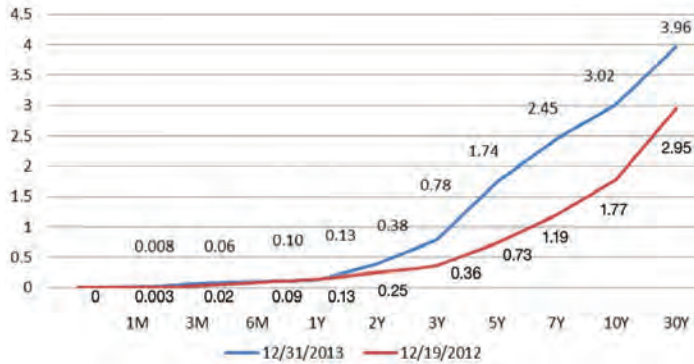


Exhibit 2 | Source: Bloomberg

Better Fed communication since the summer has dampened bond market volatility, allowing the actual announcement to be pretty much a non event. Bond prices fell just prior to the official announcement, but at a much more controlled pace than earlier in the year (see Exhibit 2). In fact, the Fed has managed to not only price in a \$10 billion reduction in QE, but also initiate a conversation about future reductions, as well as hint about cutting the interest on excess reserves (IOER) which the Fed pays to banks. Reducing IOER would cause a major shakeup in money markets, similar to the turmoil which hit the bond market last summer, so we see it as unlikely until the economy is on much stronger footing.

As for the economy, a consensus was gradually forming at year end that the Fed wanted to taper Quantitative Easing because domestic economic growth was accelerating. The jury is still out on this topic, however, as the December employment report was quite weak. If the data remains weak, prevailing opinion could spin just as quickly as it did in September, when everyone knew the Fed would taper, yet nothing happened. Two weeks ago the major surprise for the markets would've been if the Fed failed to follow through with tapering. Now there is talk that another bad month of data could cause QE to continue, or even increase!

Remember though, that no matter when it begins, tapering is NOT tightening. If the Fed decides to begin cutting back its bond purchases in January of 2014, this should not be interpreted as tightening monetary policy. A \$10 billion per month pullback in bond purchases is symbolic at best, and has minimal bearing on economic activity. The discount rate, which officially is the only rate the Fed controls, and the Fed funds rate, which has a current target of 0-.25%, remain at historic lows. Until the Fed raises these rates, the official tightening of monetary policy has yet to begin. Futures markets indicate that the Fed funds rate will remain where it is for all of 2014, with a 50% chance of an increase in the first half of 2015. Tapering could start tomorrow, but markets believe the Fed will remain accommodative with regard to the cost of short-term money for at least the next 12 months.

The bottom line is that recent economic and financial crosscurrents are as severe as any we've seen since the 2008 financial crisis. Meanwhile the economic "word" for 2014 has yet to be spoken. Chances are good that when it arrives it will emanate from the lips of one Janet Yellen, the new Chair of the Federal Reserve Board. Maybe she can take a lesson from the Pope and start with "humility", and work her way up from there.



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QUARTERLY REVIEW

By Denny Baish

All major equity indices rallied in the fourth quarter, capping a year of strong gains for 2013. Domestic stocks led the way, with gains across all market capitalizations and styles. The S&P 500 Index, a proxy for large-cap domestic stocks, posted a quarterly gain of almost 11%, and returned over 32% for the year. Investors have to go back to 1997 to see a yearly gain greater than that for the S&P 500. International stocks posted positive results, but weren't able to keep up with the U.S. market. International developed markets, represented by the MSCI EAFE, gained more than 5% for the quarter, and posted an impressive 23% rise for the year.

The Federal Reserve once again topped the headlines in the fourth quarter. The Fed announced at its December meeting that they would begin to reduce bond purchases (Quantitative Easing). Beginning in January, purchases will fall to \$75 billion per month, down from \$85 billion. The Fed cited the improving labor market as a reason for the reduction, as the unemployment rate dropped below 7% for the first time since December 2008. As expected, the Fed continued to leave very short-term interest rates near zero. The yield on the 10-year U.S. Treasury continued to rise during the quarter, finishing the year just shy of 3%.

Strong gains were seen across all major stock categories in the final quarter of the year. Large-caps led the way, gaining more than 10%. Mid-caps and small-caps posted returns of 9% each. Both value and growth styles saw gains nearing double digits in the quarter. Large growth and large value each gained 10%. Small growth added 9%, surpassing small cap value's 8% return, and both mid growth and mid value returned 8% each.

International developed stocks lagged the major domestic indices during the quarter, but still posted satisfactory results. As mentioned above, the MSCI EAFE rose more than 5% for the quarter, and 23% for the year. Emerging markets, represented by the S&P/IFCI Emerging Composite, gained 2% in the quarter, falling far shy of the gains seen across developed markets. For the year, emerging markets failed to keep up, with the S&P/IFCI Emerging Composite dropping 1%.

BENCHMARK INDEXES

INDEX	4 TH QUARTER RETURN	2013 RETURN
DJIA	+10.22%	+29.65%
S&P 500	+10.51%	+32.39%
S&P Mid Cap 400	+8.33%	+33.50%
Russell 2000	+8.72%	+38.82%
MSCI EAFE	+5.71%	+22.78%
BarCap Agg. Bond	-0.14%	-2.02%

Much like the prior quarter, fixed income markets were mixed. Prices of long-term bonds continued to decline, as interest rates rose during the quarter. Long-term Treasuries, represented by the Barclays Capital Long Government Index, dropped 3% and slid more than 12% for the year. Barclays Capital Long Municipal Index, a proxy for the long-term municipal bond market, finished unchanged for the quarter, but fell 6% for the year. Intermediate-term government, corporate, and municipal bonds were little changed during the quarter, and posted slight losses for the year. International bonds reversed the positive third quarter results, and fell 1%. The Citigroup World Government Bond Index finished with a loss of 5% for the year. High yield bonds followed the equity markets higher for both the quarter and year, posting gains of 3% and 7%, respectively. The Barclays Capital Aggregate Bond Index, a proxy for the overall investment grade US fixed income market, fell slightly for the quarter and finished down 2% for the year.



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