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Great to Good – The Transition of a Bull Market

It is hard to speak anything other than superlatives about the market's performance in 2013. Not only was it the best year registered in nearly fifteen years (1997), but the climb to all-time highs was relatively calm and sedate. The largest correction for the year happened in late May, where the Bears were convinced that one should sell in May and go away. By late June, the market had bottomed with a roughly 7.5 percent drop and the market once again began to meander back to a series of new highs. And despite Washington's best efforts to derail the economy with the budget standoff in the fall and the clumsy rollout of the Affordable Care Act, economic conditions continued to improve, albeit gradually, inflation remained in check and the Federal Reserve maintained its extremely accommodative stance. As the market climbed this wall of worry, the largest contributor to its gain was a growing confidence among investors that assuming additional market risk was a prudent thing to do, especially in light of historically attractive valuation multiples. As Table 1 illustrates, much of the market's overall gain for 2013 (nearly 75 percent) is attributable to Price\Earnings multiple expansion in contrast to other performance drivers such as earnings growth or dividend reinvestment. By yearend, much of the discount to long-term valuation multiples had disappeared and now we are pretty much back in line with historical averages. The message here is simple, in 2014, we are going to need a resurgence in corporate earnings growth to enable market prices to move higher and maintain reasonable valuation multiples.

Table 1

Drivers of Market Performance

	12/31/2012	12/31/2013	% Change
P/E Multiple	13.64	16.95	**24.29%**
Earnings	$104.58	$109.05	4.27%
Price	1426.19	1848.36	29.60%
Dividends Reinvested			2.15%
% Total Rate of Return			32.39%

Source: Thompson Baseline as of 12.31.2013

Investing at the All-Time High

Back in 2001, business consultant and author Jim Collins wrote a very successful book, *Good to Great* trying to answer the thoughtful question, "Can a good company become a great company?" After the financial market's performance in 2013, I am inclined to ask the inverse question, "Can a great stock market successfully transition to a good stock market without a severe hiccup along the way?" Market history would suggest that more often times than not, the answer is, "yes." S&P Capital IQ recently performed research on the S&P 500 Index back to 1945 on this subject

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U.S. Energy Independence and What It Means For Investors

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In November, the International Energy Agency (IEA) stated that the United States will surpass Russia and Saudi Arabia as the world's top oil producer by 2015 and be close to energy self-sufficiency in the next two decades. The IEA, a Paris based adviser to 28 energy consuming nations, projects U.S. oil production will rise to 11.6 million barrels a day in 2020 from 9.2 million barrels per day in 2012.

Booming output of both oil and natural gas from shale formations has driven proved reserves, defined as estimates of oil and natural gas that may be reasonably recovered from known reservoirs in future years, to record levels. U.S. crude oil reserves are now at their highest levels since 1991 while natural gas reserves are at their highest levels since the U.S. Energy Information Administration began measuring in 1977. In 1980, the U.S. had proved reserves of little more than 29 billion barrels of oil. From 1980 to 2010, the U.S. produced more than 77 billion barrels of oil, over two-and-a-half times the proved reserves. In the Canadian oil sands, ExxonMobil estimates they will recover 170 billion barrels of oil, enough to power the North American passenger vehicle fleet for 45 years. The transformation underway in North America is possible because sources that were once dismissed as uneconomic or inaccessible are now becoming reliable thanks to advances in technologies pioneered by the oil and natural gas industry.

We believe this energy independence in the U.S. has the potential to drive a significant positive shift in long-term economic fundamentals for the country. Lower energy costs are likely to drive a renaissance in U.S. manufacturing as well as lead foreign domiciled corporations to relocate manufacturing facilities from Europe and Asia to the U.S. The price of natural gas in Europe is nearly triple the price in the U.S. while prices in Asia are nearly five times as much. The German company BASF recently announced that because of significant energy cost savings it was relocating its research and development and chemicals divisions to the U.S. Petro-chemical companies are rapidly expanding facilities to produce natural gas liquids like propylene and ethylene seeking cost advantages over foreign competitors. Dow Chemical, Bayer Corp, Royal Dutch Shell, and Formosa Plastics are among the first companies to recently announce expansion of manufacturing operations in the U.S. to take advantage of opportunities presented by incremental energy resources.

Additional transformations in manufacturing processes, power generation, and energy transportation are also occurring. Nucor, the largest steel producer in the U.S., has plans to invest more than a $1 billion in direct reduced iron facilities. These facilities will use natural gas, rather than traditional coal, to create a gas of hydrogen and carbon monoxide then used to reduce iron ore in solid form to create iron. The conventional route for making steel in a traditional integrated plant requires high capital expenses, raw materials of stringent specifications, and generates significant pollutants.

Utility companies across the country are actively converting coal fired power plants to being natural gas fired. As environmental standards for power plant emissions have become more stringent, utility companies are aggressively seeking alternative energy sources. Converting existing facilities to natural gas can often cost less than installing the emissions control systems required to keep an antiquated coal plant running. The additional infrastructure needed to transport natural gas from existing pipelines to the converted power plants offers attractive investment opportunities.

Historically, the U.S. has been a liquefied natural gas (LNG) importer as domestic supplies were limited. The trend now has reversed. Given the natural gas price differentials between

Global Natural Gas Prices

Source: Federal Energy Regulatory Commission the U.S., Europe and Asia described previously, existing LNG import terminals in the U.S. are now converting to export facilities. Despite the expense of liquefaction, transporting and then regasification, the end cost to Asian and European companies is still less than buying locally.

Potentially the most significant economic boost to the U.S. in becoming energy independent is job creation. Price Waterhouse Coopers estimates that manufacturing employment could increase by approximately 1 million workers in an environment where natural gas recovery rates from the new found shale formations remain high. The expansion within the chemical industry as they ramp up production of ethylene and polypropylene will create meaningful new jobs. TransCanada Corporation continues to promote the economic benefits from infrastructure projects such as Keystone XL Pipeline and the Gulf Coast Pipeline. The U.S. State Department estimates that Keystone XL will create 42,000 direct and indirect jobs and inject $20 billion dollars into the U.S. economy. Further, the spinoff activity from Canadian oil sands projects is expected to reach $45 billion dollars per year while supporting nearly 465,000 jobs in the United States by 2035.

The transition from being a net importer to a net exporter of oil and natural gas has the potential to be one of the most significant economic developments in decades. If the U.S. is successful in achieving energy independence, we believe it will be a game changer with lasting benefits to U.S. manufacturing, the economy, and perhaps even our nation's defense policies.

Key Numbers for 2014

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As we usher in the New Year, it's that time of year again when we like to re-visit contribution limits for retirement savers, as well as confirm annual estate and gift tax figures for planning purposes. Every year, the IRS uses the Consumer Price Index for Urban Consumers (CPI-U) September year over year performance to determine whether or not to make cost of living adjustments to these key figures. The CPI-U, rate of inflation, was relatively flat at 1.2 percent from September 2012 to September 2013. This figure is great news for those filling gas tanks and grocery carts but not so great news for those who were hoping to boost their contributions to an IRA, 401(k) or other tax advantaged retirement savings account.

Limits remain largely unchanged in 2014 and here is what you need to know as you begin to think about your cash flow and financial planning this year:

Defined Contribution plans: The maximum allowable contribution to 401(k), 403(b) and 457 plans remains unchanged at $17,500. If you are over age 50 or turning 50 this year, you can make an additional $5,500 in catch up contributions (also unchanged). The annual limit for combined employee and employer contributions did increase this year, however, by $1,000 to $52,000.

IRA Contribution Limits: Contribution limits for 2014 remain at the same level that they were in 2013. Investors under age 50 can contribute up to $5,500 (Roth or traditional IRAs) and individuals over age 50 can contribute $6,500.

While the contribution limits remain the same, income limits for deducting traditional IRA contributions on your federal return have bumped up a bit:

- If you are covered by an employer plan and are single or head of household, the tax deduction phases out for AGI between $60,000 and $70,000 (up from $59,000 to $69,000)
- If married and filing jointly, the phase out range is $96,000 to $116,000 (up from $95,000 and $115,000)
- If you're married and aren't covered by an employer plan but your spouse is, the IRA deduction is phased out if your combined AGI is between $181,000 and $191,000 (up from $178,000 to $188,000)

Roth IRA income limits have also increased:

- Individuals filing singly and making less than $129,000 will be able to make at least a partial ROTH IRA contribution in 2014. (The amount you can contribute is phased out for single filers who make between $114,000 and $129,000)
- Married couples filing jointly can make at least a partial contribution if their incomes are less then $191,000 in 2014. (Contributions for joint filers are phased out between $181,000 and $191,000).

Defined Benefit Plan Limits: The limit on the maximum annual benefit you can receive from a defined benefit plan increases by $5,000 to $210,000.

Contributions to Health Spending Accounts (HSA): The 2014 annual contribution limit to an HSA for individuals with single medical coverage is $3,300 and the annual contribution limit for individuals covered under qualifying family medical plans is $6,550 (plus an additional $1,000 if age 55 or older).

Estate and Gift Tax: The federal estate tax exemption for estates of those who die in 2014 increases to $5.34 million, up from $5.25 million in 2013 and the gift tax exemption remains the same at $14,000.

Great to Good

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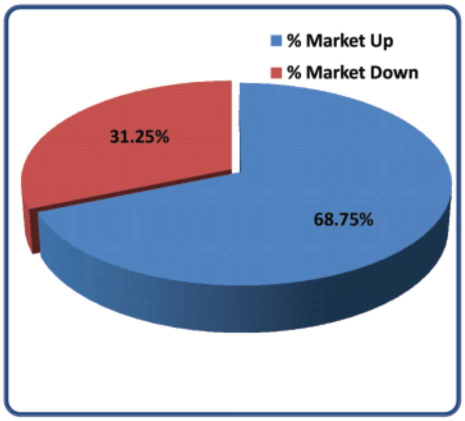
matter; we expanded the time frame back to 1926. After examining the years in which the market had achieved total rate of return performance greater than 20 percent, what type of performance did we experience in the years following? As the data table below depicts, roughly 69 percent of the time we have experienced an up market with an average rate of return of nearly 11.50 percent. On the downside, we have suffered through ten declines, some more severe than others, with an average loss of nearly 8.50 percent. In many instances within these down moves, we experienced intra-year Bear Markets, in which the index declined from high to low greater than 15 percent before an eventual recovery. In general, one take away from this research is simply the market tends to be a bit more volatile than normal after years of big gains, which would seem to be a normal course of events. But one cannot come to the conclusion that after such a large rally a decline is inevitable: the statistics will simply not support this outcome. More likely is a year of modest gains, supported by both earnings and dividend growth. I am hoping for a good year in 2014.

The History of Great Equity Markets

	Year	> 20% Gains	Subsequent Year	% Total Rate of Return
1	1927	37.49	1928	43.61
2	1928	43.61	1929	-8.42
3	1933	53.99	1934	-1.44
4	1935	47.67	1936	33.92
5	1936	33.92	1937	-35.03
6	1938	31.12	1939	-0.41
7	1942	20.34	1943	25.90
8	1943	25.90	1944	19.75
9	1945	36.44	1946	-8.07
10	1950	31.71	1951	24.02
11	1951	24.02	1952	18.37
12	1954	52.62	1955	31.56
13	1955	31.56	1956	6.56
14	1958	43.36	1959	11.96
15	1961	26.89	1962	-8.73
16	1963	22.80	1964	16.48
17	1967	23.98	1968	11.06
18	1975	37.23	1976	23.93
19	1976	23.93	1977	-7.16
20	1980	32.50	1981	-4.92
21	1982	21.55	1983	22.56
22	1983	22.56	1984	6.27
23	1985	31.73	1986	18.67
24	1989	31.69	1990	-3.10
25	1991	30.47	1992	7.62
26	1995	37.58	1996	22.96
27	1996	22.96	1997	33.36
28	1997	33.36	1998	28.58
29	1998	28.58	1999	21.04
30	1999	21.04	2000	-9.10
31	2003	28.69	2004	10.88
32	2009	26.46	2010	15.06
33	2013	32.39	2014	?
			Average Gain	11.49

Source: Morningstar Encorr



Despite modest negative rates of return in those years that the S&P 500 Index declined, intra -year price only declines from high to low can be substantially more extreme. For instance, after the technology bubble burst in March of 2000, the market fell over 17 percent as it reached its low in December. In a more extreme example, the 1962 Bear Market that preceeded the Cuban Missile Crisis registered a decline of nearly 27% prior to its recovery later in that year.

(Source: Federal Reserve Bank of St. Louis.)

The Fed Taper

If there is a fly in the ointment, it continues to be the unprecedented involvement by the Federal Reserve in the management of long-term interest rates. The Fed's Long Term Asset Purchase program or Quantitative Easing is now in its third iteration and the Fed's balance sheet is nearing $ 4 trillion dollars. Since 2008, the Federal Reserve's balance sheet has nearly quadrupled in size. Recently, the Fed has announced that they will begin to modestly reduce their monthly purchases from $ 85 to $ 75 billion. This is not a tightening move, simply less accommodative. Under a tightening environment, the Fed would actually need to begin to reduce their balance sheet. If all of the securities that are being held were short-term in nature, simply allowing these securities to mature would resolve this issue. However, much of the balance sheet is now comprised of longer dated mortgage back and U.S. Treasury securities. Looking at the recent Federal Reserve consolidated balance sheet, nearly $ 2 trillion dollars are held in securities with maturities greater than ten years. With the Fed comprising such a large percentage of total issuance, especially in mortgage backed securities, selling securities is really not an option. It is likely that the Fed will have to maintain and manage this larger balance sheet for many years to come. It will be a godsend when the Fed is back simply targeting the appropriate level of short-term interest rates for our nation's economy, which is frankly hard enough.

Resting on One's Laurels

After a year like 2013, it would be very easy to come to the conclusion that the financial markets are a bit more manageable and well behaved, the future is bright and the path of least resistance is up, up and away. After nearly thirty years of riding the roller coaster of markets and investor sentiment, I know that you are only as good as yesterday and in this business no one has time to rest on their laurels. Despite DVI's history of success, from very modest beginnings, we know we have much to do and much to accomplish as we enter into 2014. Once again, problems will need to be solved, new ideas vetted, temptations held in check and unemotional decision making will have to rule the day. The unwavering commitment to our clients' best interests will guide us as we embark upon this never ending journey to meet the financial needs of our valued clients.

Will Williams
President

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