



**Artemis**  
FINANCIAL ADVISORS LLC

# Market Outlook & Strategy

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Second Quarter of 2013

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### ***Executive Summary***

- Global markets became volatile during the quarter due to Federal Reserve Chairman Ben Bernanke's comment on May 22 that the Fed could start to taper its quantitative easing (QE) program in the near future. **The prospect of the Fed winding down its stimulus measures sparked a rise in global bond yields and put pressure on equity markets.**
- **Despite the increase in volatility, the overall U.S. equity market was still able to eke out a respectable gain of 2.8% during the quarter and is now up 14.2% YTD.** Equity returns in all other developed markets were more muted, declining by -0.9% during the quarter. In stark contrast, emerging-market equity posted a disappointing -8.1 % return overall as the rise in U.S. bond yields led to a reversal in emerging-market equity and debt inflows.
- **Fixed-income returns were negative across the board, with longer duration bonds and emerging market debt hit especially hard.** The quarter did end on a more positive note, however, as Fed officials started to emphasize that markets had overreacted to the possibility of a tapering of QE, and investors started to react to better economic data from the U.S.
- **In this issue, we examine some of the reasons why U.S. corporate earnings have been so high since the recession and assess the prospects going forward.** We conclude that earnings growth is going to slow down because most of the gains came from margin expansion and margins expanded largely due to one-time events, which have now ended. The implication is that earnings growth will be much more dependent on revenue growth going forward, which, in turn, depends on the pace of economic activity (long-run corporate revenue growth typically rises at the rate of nominal GDP growth).
- **While we see some scope for further increases in P/E ratios (multiples expansion), we conclude that equity prices are unlikely to rise by more than 7%-8% annually going forward, unless U.S. GDP growth accelerates.** While this rise warrants tilting balanced portfolios modestly toward more equity, we highlight the need to stay diversified.



### ***Markets in Review***

Global markets became volatile during the quarter due to Federal Reserve Chairman Ben Bernanke's comment on May 22 that the Fed could start to taper its quantitative easing (QE) program in the near future. The prospect of the Fed winding down its stimulus measures sparked a rise in global bond yields and put pressure on equity markets.

Despite the increased volatility, U.S. equities still managed to deliver positive returns over the quarter, gaining 2.8%. All size segments produced positive returns, and small growth companies led the pack at +3.7%.

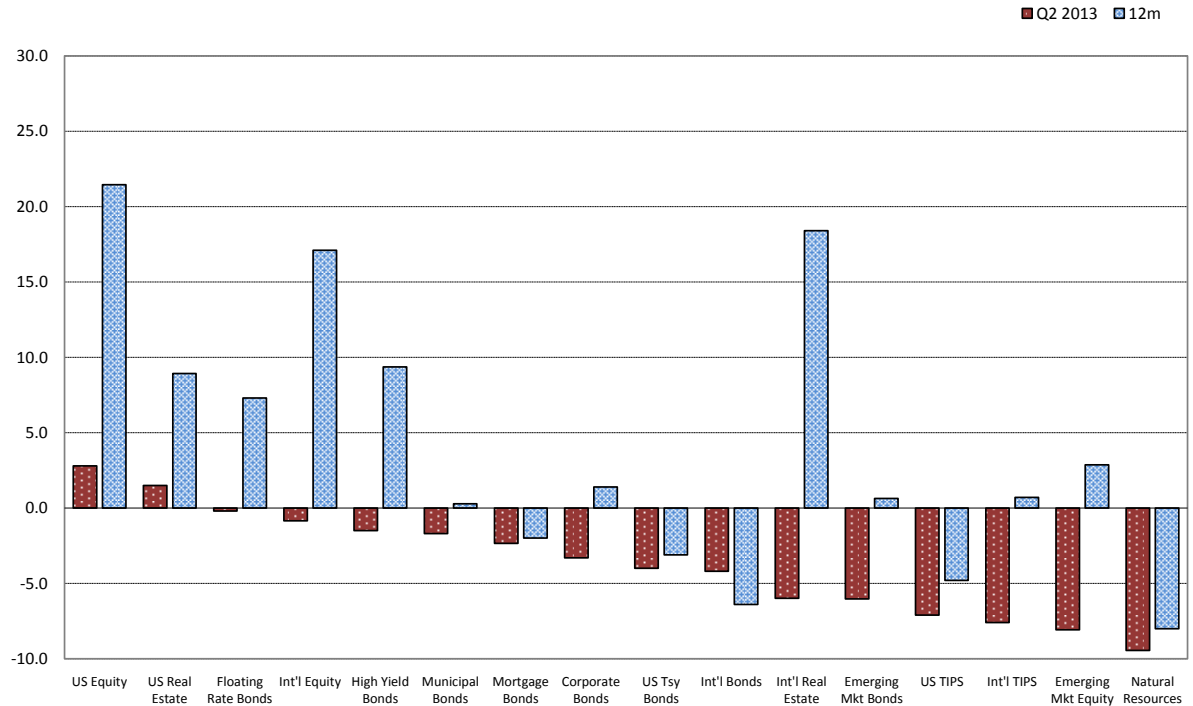
In contrast, international equity returns were slightly negative (-0.9%), primarily due to weakness in Asia. Most major European markets (excluding the United Kingdom) posted gains in the +2-3% range. Emerging-market equities performed particularly poorly over the quarter (-8.1%). Disappointing economic data from the larger BRIC (Brazil, Russia, India, China) markets weighed on sentiment, and the rise in U.S. bond yields led to a reversal in emerging-market equity and debt inflows.

It was also a dismal quarter for fixed income. Treasury returns were hard-hit, as the 10-year U.S. Treasury yield climbed as high as 2.61% on June 25 — 98 basis points higher than its low for the quarter of 1.63% at the beginning of May. (Remember that bond prices move in the opposite direction of yields.) By the end of June, the 10-year Treasury yield was 64 bps up for the quarter as a whole, at 2.49%. Corporate bond yields — both investment grade and high yield — were also spooked by the prospect of QE tapering and posted losses. Emerging-market debt was hit particularly hard, with local currency debt and emerging-market corporate bonds especially affected. (See Figure 1)

The quarter did end on a more positive note, however, as Fed officials started to emphasize that markets had overreacted to the possibility of a tapering of QE. The more positive mood was also supported by better news from China, where money market rates eased and calmed fears about a credit crisis in the country. Good economic data from the U.S. also helped investor sentiment late in the quarter.



Figure 1: Asset Class Performance in Q2 2013 (percentage points)



### Sources of Equity Returns

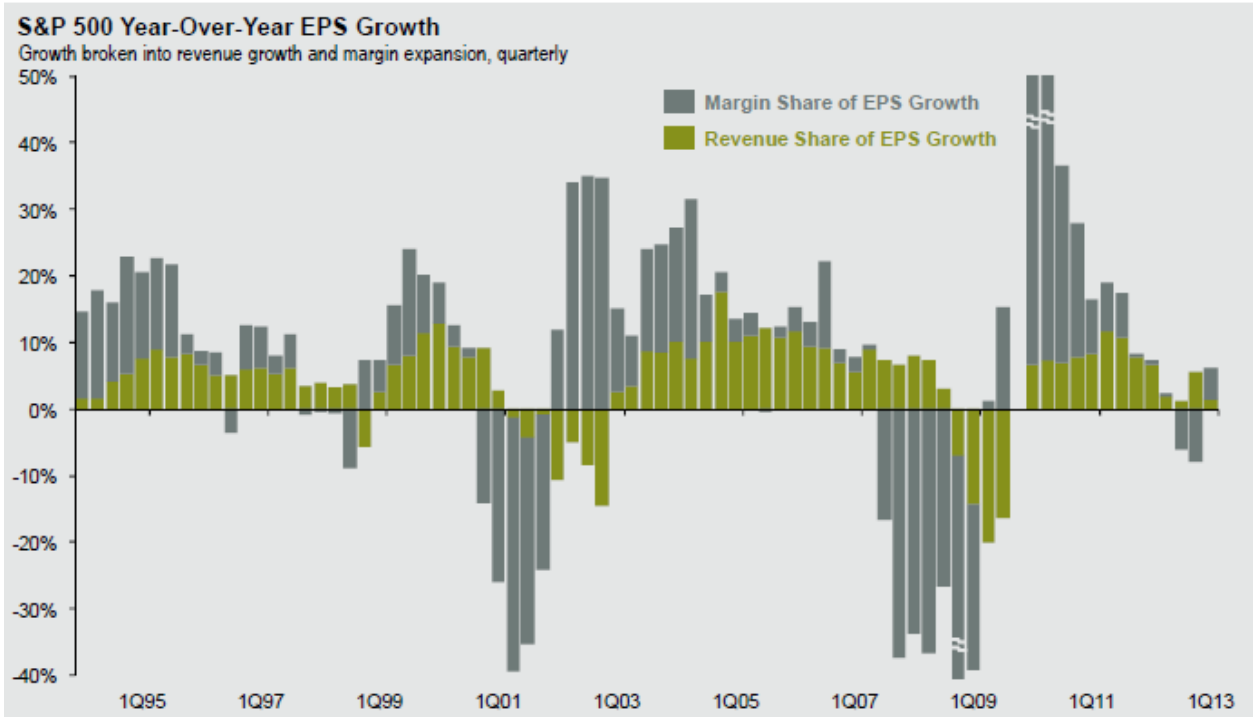
Investors who are now seeking to reduce their fixed income exposure are confronted with the choice of either holding more cash or holding more equities. Holding more cash comes at a price, as the Fed is signaling that it has no intention of even starting to increase short-term interest rates for another year or more. Thus, the questions become 1) Should such investors take on more equity risk now?, and 2) Is the risk worth taking? The answers depend, of course, on the assumed trajectory of equity returns in the next few years.

### Earnings Growth

It is worth recalling that equity prices go up for one of two reasons: earnings growth or multiples expansion. Until very recently, U.S. earnings growth has been on a tear, largely driven by margin expansion (Figure 2). The basic story behind this strong performance is well understood: companies have cut costs aggressively, productivity has improved, lower



Figure 2:



Source: Standard & Poor's, Compustat, J.P. Morgan Asset Management.

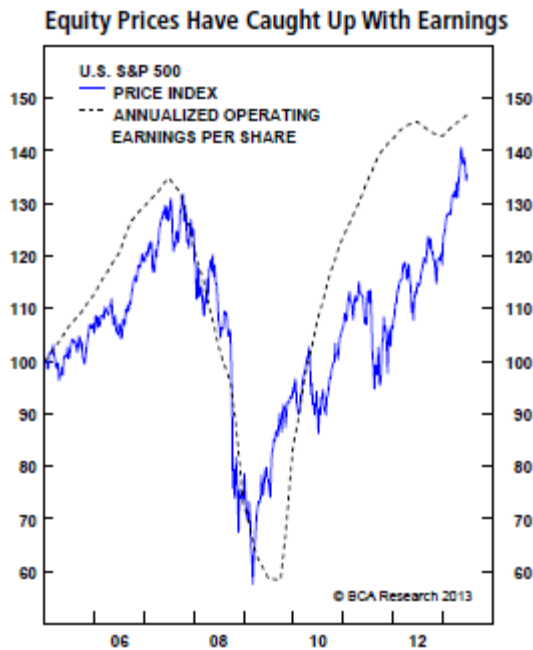
EPS levels are based on operating earnings per share. 4Q2008, 1Q2010 and 2Q2010 reflect -101%, 92%, and 51% growth in operating earnings, and are adjusted on the chart.

Data as of 6/30/2013.

interest rates have reduced debt-servicing burdens, wage increases have been non-existent, and a weaker dollar has boosted overseas earnings. In fact, as shown in Figure 3, while the Fed's easy money policies have certainly played a role in pushing up equity prices, most of the gains in equities over the past four years reflects higher earnings. Earnings growth that matches stock price growth is the key reason why U.S. stocks are not currently overvalued (Figure 3).



Figure 3:



Source: BCA Research Inc.

Unfortunately, there are many reasons to believe the big increases in margin growth are behind us – productivity growth has stalled primarily because the huge gains achieved early in the recovery were largely a one-off affair due to massive lay-offs. Profits are also ceasing to benefit from other early tailwinds, such as low interest rates, declining depreciation charges (due to the decline in capital stock and investment during the recession) and a weak dollar (which has been helping overseas profits). In summary, the ability of companies to boost their bottom line via cost-cutting is now much more limited because all the easy savings have already been made. The implication is that earnings growth will be much more dependent on revenue growth going forward, which, in turn, depends on the pace of economic activity.

Analysts who agree with this line of thinking are generally predicting earnings growth to plateau at about 4% per year over the medium run, assuming the U.S. economy can resume growing overall at around 2%-3%. Earnings growth of around 4% per year implies total returns of only around 6% per year for equities, assuming no change in valuation. While this looks attractive relative to current bond yields (and fantastic relative to current and prospective cash yields), 6% equity returns won't be very enticing once bond yields return to a more normal level. Thus, while the stock market can be expected to outperform fixed

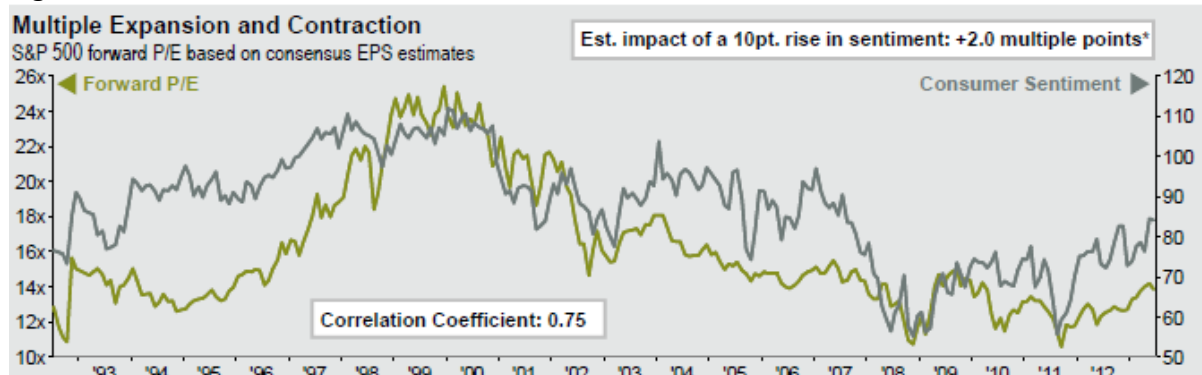


income for a while, stronger economic growth that eventually brings a normalization of interest rates might present a more difficult environment.

### ***Multiples Expansion***

But what about expansion of the "multiple," the other reason why stocks can go up? Multiples expansion happens when investors are willing to pay more for a given stock, for a given level of future earnings. Multiples expansions happen for a variety of reasons, but, unsurprisingly, they often track improvements in investor sentiment (Figure 4).

Figure 4: Consumer Sentiment and Forward P/E



Source: Standard & Poor's, FactSet. \*Estimated impact based on coefficients from regression analysis. Data as of 6/30/13.

Investor sentiment, as measured by the University of Michigan, has been increasing fairly steadily since the low in August 2011 during the debt ceiling crisis. The reasons for this rise include steady job growth, rising housing prices, the decline in international risks and further stabilization of the global financial system. Still, the current forward P/E on the S&P Index is only at 14, which is lower than the 15-year average of 16.2. This suggests that while the market is becoming fully valued, valuation is not a huge constraint against some additional price appreciation, even as earnings growth slows (Figure 5).

The upshot of all of this is that, in our view, equity returns over the next few years are unlikely to exceed 7%-8% on an annualized basis (unless GDP growth and corporate earnings really accelerate), which is far lower than what investors have experienced since early 2009. The road is also likely to be fairly bumpy, with the normalization of interest rates likely causing volatility along the way. We believe this is sufficient to warrant tilting balanced portfolios toward a little more equity to help offset what are likely to be low returns in fixed income.



Figure 5:

S&P 500 Index: Valuation Measures				Historical Averages			
Valuation Measure	Description	Latest*	1-year ago	3-year avg.	5-year avg.	10-year avg.	15-year avg.
P/E	Price to Earnings	13.9x	12.0x	12.6x	12.9x	14.1x	16.4x
P/B	Price to Book	2.4	2.1	2.2	2.1	2.5	2.9
P/CF	Price to Cash Flow	9.4	8.3	8.6	8.4	9.6	10.9
P/S	Price to Sales	1.4	1.2	1.2	1.1	1.3	1.5
PEG	Price/Earnings to Growth	1.4	1.1	1.1	2.0	1.7	1.6
Div. Yield	Dividend Yield	2.2%	2.4%	2.2%	2.3%	2.1%	1.9%

Source: Standard & Poor's, FactSet. Data as of 6/30/13

### Artemis Strategy

It has not been a secret that interest rates were going to move up at some point in the future, although almost everyone was taken by surprise at the sharp move in late May in light of still sluggish global growth, excess savings and nearly non-existent inflation. At Artemis, we had already started to position portfolios for higher interest rates by not holding any non-inflation-protected U.S. Treasuries. Even our holdings in TIPS, which are Treasuries that do adjust with inflation, were under our typical allocations in May. Nevertheless, the market's sharp reaction to Bernanke's comments prompted us in late May to reduce our emerging market debt allocation by half, exit all remaining TIPS holdings, and trim our international real estate allocation. We invested the proceeds principally in cash and floating-rate bonds. Through the spring, we also kept our municipal bond portfolios focused on shorter-term bonds (underweight duration), and we had an overweight position in equities.

More recently, we have been trimming our high-dividend paying equity fund in favor of growth-oriented stocks, as the latter appear to be of better value. Finally, we decided not to rebalance our emerging-market equity allocation. (Due to the steady decline in the value of emerging markets relative to other holdings in the last year or so, a rebalancing effort would have us purchasing emerging-market equity currently.) In fact, we have adjusted downward our emerging market-equity *targets* for all clients and will likely begin some trimming once the market stabilizes.

Are we throwing in the towel on emerging markets? Not completely, but we are increasingly cautious. One of best analysts I follow recently pointed out that in every decade one or two major themes tend to dominate financial markets, and these themes create massive outperformance in specific markets or asset classes. For example, you may remember that in the 1980s, the dominant story was the "Japan Miracle," which created a

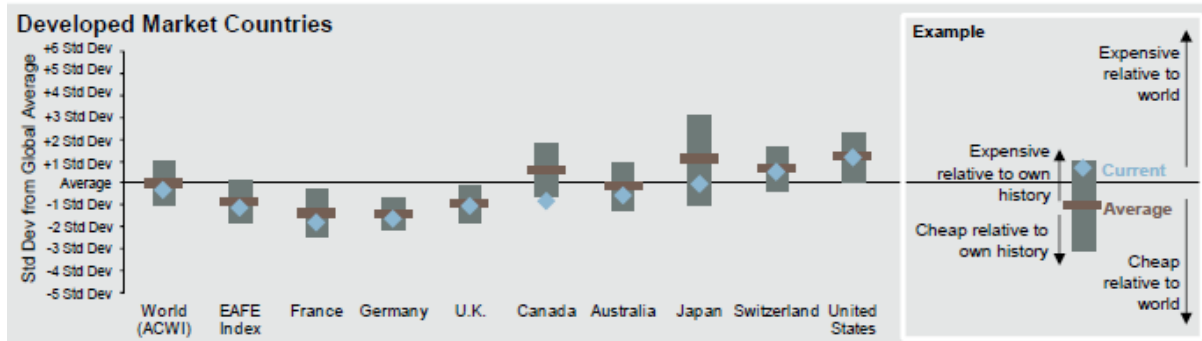




massive bull market in the Nikkei. In the 1990s, the big story was technology and the dot-com boom. The outperforming assets were U.S. stocks and the dollar, while Japan and emerging markets became the underdogs as they went through repeated crises. Last decade, the dominant story was a “rising China,” with emerging markets and commodities outperforming, while the U.S. stock market and the dollar became the underdogs. I am becoming increasingly convinced that this decade we may well see a rising dollar and developed-market equities outperforming emerging markets and commodities once again, and so we are increasingly willing to put more money behind this bet.

Consistent with this theme, we very recently moved to increase our allocation to international developed-market equities, particularly Germany. Germany’s export-intensive economy stands to benefit disproportionately from a weaker euro, which appears ever more likely now that the U.S. is going to start tapering soon and the European and Japanese central banks both announcing they have no intention of doing the same. Moreover, it also appears that the worst of austerity in Europe is over, and so we should see a resumption of some growth in the European market in the latter half of the year. Finally, German equity is just plain cheap (Figure 6). As a reminder, we also completely exited our commodities allocation last year and have no intention of re-entering. We will likely make some additional moves once the market stabilizes.

Figure 6: Global Equity Valuation



Source: MSCI, FactSet, J.P. Morgan Asset Management.

In summary, our current strategy is to modestly increase our overweight equity stance — with an increased tilt toward the U.S. and Europe —and underweight fixed income, focusing on credit over interest-rate sensitive instruments. We are also holding a bit more cash than usual.