Considerations

Ideas for Consideration in Managing Investments

The U.S. large cap stock market is headed for another record high. Is it over valued, fair, undervalued? The answer is Yes.

Market Review

Domestic U.S. Market— much of the world's market attention has been focused on the Mediterranean island of Cyprus. Even though it is small on an economic basis, investors and the general public were genuinely concerned the island could bring on a Euro Zone financial calamity. Additionally, it would be the first time since the Depression, developed world depositors felt the brunt of high risk banking. Two thoughts come to mind as a result of the European recommendation. First, it would be good for depositors to realize that going forward they will share the downside risk of failed banking actions, not just upside. (Maybe they will be more careful next time around in their selection of bankers.) Second, this would constitute a major change in the stability of global banking deposits and most likely result in fewer depositors willing to leave money in financial institutions when the economy gets shaky, commonly called a "run". Instability in deposits would contribute to lower economic growth and act as an downward accelerator in bad times.

Much of what is happening in the Euro Zone today could have major impact on markets going out for several decades, so why are we looking at a record market high in the U.S? Should not the potential uncertainty of deposits create concern?

Without a doubt the level of the DOW and S&P500 is at a record according to the raw number approaching 15,000 for the DOW. This level in the market was once thought unachievable. (So was 1,000 and 10,000) One good part about the record is that it is much broader based than previous records. There is only one sector significantly above fair value. Also, most individual stocks are participating at some level with fewer and fewer stocks in the undervalued range. The upward movement is broad based.

Currently, the percentage of the market that is in fair value range is at 65% and has dropped from the beginning of the year when it represented 72% of the market. Undervalued stocks have dropped from 12% to 6%. The buy opportunities are so slim that some sectors do not have a single undervalued stocks available. Stocks in the overvalued range now represent 27% of the market, up from 16% just three months earlier. Every day new stocks reach both trim and sell categories.

Surprisingly, none of the individual sectors

have reached a complete overvalued position where the sector would need to be trimmed or sold, but one is getting closer by the day, Consumer Discretion. This sector has reached a level of 112.8%; the highest in relative value of any sector in the market. The chart to the right shows the sector position.

Most of the other sectors are close to the fair value line such as Industrials shown in the chart below at 97% of Fair Value. This is the case with most sectors, they are close to the Fair Value level without showing a overvalued or undervalued position. This is what is providing stability in the overall gain and movement above Fair Value for the market.

Is there a concern the market has reached a point of correction? It is moving in the direction to eventually reach extreme overvalue, but it is not there yet. Given that 27% of the market is already in a general overvalue and extreme overvalue range, the pressure for a return to fair value, or below, is building. Many stocks are reaching the overvalue range and above.

Overall, we still have room to the upside, but it is getting thinner even with generally good economic news.

When the market approaches these levels of overvaluation the impact of a negative event are magnified. Currently, if North Korea becomes unstable and a conflict develops, the downward pressure on the market is greater at such over fair value levels than if the market were in an under valued position. It is almost skittish. (Technical term)

The risk matrix on the next page shows the likelihood of both positive and negative events impacting the market in each of the next three years. The table shows eight major events that could significantly move the markets either positively or negatively. At the moment the events are divided equally between positive and negative outcomes. The number in each of the cells shows the probability of the event occurring in the year. The color of the cell indicates as to whether the event would be positive or negative to the markets. A green color is positive, yellow neutral and red, negative impact. The events are primarily thematic rather than fundamental and therefore are strategic in nature.

Moving from top to bottom the events are: **1. U.S. Energy Exploration and Independence—**the country is moving rapidly to a position not seen since the 1940's when America was the world's energy provider. If the current rate of exploration continues, the country will be energy independent by 2017 and a net exporter by 2020. This will significantly alter the productive opportunity of the country in a positive manner.

2. U.S. Production Costs Favorable on a Global Basis— domestic labor costs are currently running significantly lower than Europe and well below Japan. This places America in an excellent, potential, position for manufacturing with reliable energy sources close at hand. **3. U.S. Earnings Favorable—**this is more than just having favorable earnings, but continued earnings above expectations. **4. Economic Growth @ 2%+ -** domestic GDP must continue to perform at above 2% within an environment that expects less. The 1st quarter is showing 2.5%. **5. European Debt Default—**has a negative influence with the potential of drastic devaluation of the Euro or potentially the demise of the currency. **6. North Korean Confrontation Spreading or Prolonged—**the threat of nuclear attack grows with threats from the North. Traditionally, these have been idle threats in order to obtain negotiating favors. Unfortunately, with new leadership the threats may be posturing followed by illogical actions. The fear of a nuclear cloud spreading across the globe and the loss of South Korea in the global economy could be significant on a short term basis. **7. Cyber Threat Event such as Fire Sale—**denial of service has been impacting financial institutions, utilities and government facilities for the past year. A **Fire Sale** is an organized massive attack on all areas. Total disruption of services and facilities are possible and would threaten the financial markets for a period of time. **8. U.S. Debt becomes a global problem—**while the level of U.S. debt is being discussed the real impact on financial markets is currently minimal. However, if the trend of imbalance between revenue and spending continues the impact will be subtle and indirect. The significant nature of the impact will be when foreign buyers of American debt start to balance or rebalance their debt positions by purchasing greater amounts of European, British and Pacific debt while reducing American debt purchases. This results in a lower demand, during higher interest rate conditions. The impact is the creation of higher expenses for debt service through higher interest payments without any benefit.

Because investments are not turned on and off like a light switch planning for the probability of events occurring must be done proactively over time and not after the fact on a catch up basis. The same is true when adjusting asset allocation as markets become over or under valued.

Currently, the positive themes presented in the Subjective Factors table, are outweighing the negative factors for 2013 and neutral in 2014. The negative impact builds as we move into 2015. Surprises can move any factor forward.

The greatest pressure on market performance for 2013 is in the over valued level of largecap domestic stocks. Expectations for future opportunity is reflected In the level of over value for each stock, sector and market overall. At the current level there is moderate pressure to return to fair value, but the overall positive economic and subjective themes continue to offer an upside opportunity. Now is the time to reduce positions in overvalued individual stocks and place the proceeds in stability producing investments. This is a selective move, not a wholesale move. None of the individual sectors are showing extreme over value positions so there is still room available to the upside on a broad basis. Consumer Discretion should be underweighted as it is the most overvalued, but not to an excess. Energy is undervalue and could be over weighted. As the sectors continue to move forward, they should be reduced and swapped for stability.

We are not to that level at this time, but could possibly reach such a level by mid-summer.

It will certainly be an interesting Spring as economic news will most likely be favorable and corporate earnings will support opportunities. We are more concerned that as such good news builds, investor expectations will become unrealistic. When reality sets in, market disappointment could be significant with a drop in values as they return to fair values or below.

Subjective Factors Impacting the American Stock Market

Factor	2013	2014	2015
U.S. Energy Exploration & Independence	10	15	30
U.S. Production Costs Favorable on a Global Basis	20	20	20
U.S. Earnings Favorable	55	45	30
Economic Growth @ 2%+	40	30	20
European Debt Default	-20	-32	-42
N Korean Confrontation Spreading or Prolonged	-10	-15	-15
Cyber Threat Event such as Fire Sale	-10	-30	-40
U.S. Debt becomes global problem	0	0	-5