Market Comments

April 11, 2014

What are the most important things to know about the U.S. capital markets right now?

1. Corporate earnings surprised on the upside in 2013, and we believe earnings will be surprisingly good in 2014 – we estimate $120 per share earnings for the S&P 500; at 16x P/E, fair value for the S&P 500 is 1950-2000.

2. Valuations for stocks remain attractive despite the fact that the S&P 500 is up 173% from the March 9, 2009 low. Stock valuations improved in 2013 as the market's P/E expanded, so stocks are not as cheap as they were 12-18 months ago, but they are still attractive long-term: we expect average annual returns for stocks of 6-9% over the next 3-5 years; not spectacular, but much better than the returns we expect for cash and bonds. Equity returns will be more dependent on earnings growth than valuation expansion going forward.

3. A meaningful correction in stock prices is more likely than not in 2014. The S&P 500 corrected 5% in January-February but has since moved to new all-time highs. We expect volatility will increase in 2014 over 2013 and there will be periodic sharp downdrafts in the market – but we expect the market will grind higher in 2014 on balance. We anticipate using periods of broad equity market weakness as opportunities to upgrade our portfolio holdings in terms of long-term earnings growth and balance sheet quality.

4. Considerable buying power for stocks still exists. Equity mutual fund flows turned positive in 2013 for the first time since 2006, and we believe that we are still in the early innings of a secular move of capital away from bonds and toward stocks (reversing the capital flows from stocks to bonds that occurred between 2000-2012); ongoing capital flows out of bonds and into stocks remains a core aspect of our constructive longer-term view on stocks. Rising interest rates over the next several years should continue to drive bond investors toward equities.

5. Small and midcap stocks have significantly outperformed large-cap stocks since the bear market low of March 9, 2009 (S&P 500 +173%, S&P Midcap Index +220%, S&P Small Cap Index +238%). While we remain constructive on the outlook for small and midcap stocks, we believe high quality large capitalization stocks offer the best value to investors at present.

6. Balance sheets for U.S. companies are in extremely strong financial shape. Balance sheet strength, and the ability to deliver free cash flow, are highly desirable attributes in the current environment (sluggish global growth). We

continue to emphasize companies that can create and grow shareholder value by 1) investing in their businesses where returns on capital are attractive, 2) repurchasing stock, and 3) increasing dividends.

7. Trailing annualized 10-year returns for stocks are 7.26% versus 4.26% for bonds. We expect returns of 6-9% for stocks over the next 5 years (versus a 1.68% yield on the 5-year Treasury and a 2.70% on the 10-year Treasury). Stock returns will be driven by aggregate corporate earnings growth of 4-5%, dividends of 1-2%, and a slight increase in equity valuations. Based on current valuations, stocks remain far more attractive than bonds.

8. The seven most valuable brands in the world and 15 of the top 20 brands are owned by U.S. companies -- The U.S. remains a vibrant source of innovation, economic production, and wealth creation. We believe that over the next decade, U.S. equity returns will reflect the strong underlying vibrancy of the U.S. economy.

9. Interest rates fell during the first quarter, interrupting a rising interest rate trend that has been in place since July 2012. The yield on the 10-year Treasury declined from 3.02% to 2.72% during the quarter, which drove a 1.84% total return for the Barclays U.S. Aggregate Bond Index. Bonds remain unattractive in our view because 1) interest rates remain well below historic levels and are currently priced to provide very small returns, and 2) we believe interest rates are likely to rise on balance in coming years; rising interest rates depress bond prices and bond returns. Further, bond credit spreads remain tight. We believe there will be better opportunities in the future to increase our allocation to fixed income; at present, we believe equities are priced more attractively than bonds for investors that have multi-year time horizons.

Edson L. Bridges III, CFA
President