Views From The Heartland
Investment Perspective of Buena Vista Investment Management

Volume 11 Issue 4
December 2013

AFTER A STRONG 2013 FOR THE S&P 500, WE SEE BETTER OPPORTUNITIES OVERSEAS

2013 was a fabulous year for the US stock market. The S&P 500 returned over 29% which is the 4th highest annual return over the past 50 years and has now produced price appreciation of 160% over the last 58 months. According to The Leuthold Group, this bull market (using the Dow Jones Industrial Index as a benchmark) now ranks #7 historically in terms of total gain and #6 in terms of longevity, when compared to all bull markets since 1900.

While that data does give us cause for concern, we are still not ready to call the end to the bull market here in the United States. However, given the strong price appreciation of the US market and the current higher valuation for US equities, we feel it makes sense to look at adjusting our portfolio allocations to other global markets that may offer better relative value. After looking at a number of factors this fall, we raised the allocation to international equities within the Total Return and many of our Custom Investment Service (CIS) portfolios.

The first thing we looked at was relative performance. In 2013, the US equity market outperformed Latin American by 45%, Asia ex Japan by 25%, and Europe by 9%. From a longer-term perspective, the US equity market (S&P 500) has reached and exceeded its 2007 peak level, while the rest of the world, as represented by the MSCI EAFE index, is still 37% below its 2007 peak.

The second and most important reason relates to valuations. At this time the US equity market is more expensive than other areas around the globe and in relation to emerging markets (EM), the US is significantly more expensive. So while we take the position that the European markets will continue their slow continued improvement, we see real investment opportunity in the emerging markets.

For example, a fundamental metric that has been very useful in evaluating the appropriate time to invest in the emerging markets is the price to book ratio. Historically when the price to book ratio is 1.5 or lower, it has been an excellent time to invest. We are currently at that level. Additionally, the consensus forecast indicates that the emerging markets gross domestic product (GDP) is expected to grow at double the rate of US GDP next year. Finally, most emerging market countries have attractive levels of debt to GDP when compared to the US and Europe.

When talking about emerging markets we must look at China. Chinese markets were up less than 1% in 2013, as the stock market was responding to the fact that the Chinese economy has been going through an adjustment from very strong growth of over 10% per year to a more modest growth of 6-7%. As economic growth has slowed, investors have been less bullish on Chinese stocks.

But recently the economic news from China has been very good. For example, China recently reported that exports grew 12.7% year over year for November and their trade surplus was $33.8 billion, which was the highest level since January, 2009.

(OVER)

Although we don't expect a return to 10% growth, these are just two out of a number of positive reports that may be giving us an early indication of more stable and sustainable growth in the Chinese economy. Consequently, we have positioned our portfolios with an allocation to China.

So while we believe that it is a good time to invest in the emerging markets, Europe also looks attractive for several reasons, including the fact that the European Central Bank (ECB) is continuing their stimulative monetary policies. At the November meeting the ECB lowered the interest rate on the main refinancing operations of the Eurosystem by 25 basis points to 0.25%. ECB President Mario Draghi also stated that they decided to keep the main refinancing operations (MRO) at full allotment "for as long as necessary, and at least until July, 2015". This policy stance should provide a nice tailwind for the European economy and markets within Europe.

While we believe monetary policy will be a tailwind for Europe, the situation in the US is different. Our recovery has been stronger than Europe's and this has caused the US Federal Reserve to reduce their $85 billion in monthly bond purchases. They recently announced a reduction for January and the impact of this is likely to be marginally higher interest rates in 2014. Already the yield on the 10 year Treasury has risen from 2.72% in November to 3.02% in December. Higher interest rates could present at least mild headwinds to the US stock market, which is another reason we like international stocks.

As many of our readers understand, we have always maintained an exposure to global equities over the years. Our portfolio allocation has ranged anywhere between 15-30% over the years. Recently, we felt that it was appropriate, based on the reasons stated above, to raise our allocation to international investments to the high end of the range. To put this allocation in perspective, the United States makes up less that 50% of the world economy. So technically, a 70-75% allocation to the US equity market is still an overweight position. All things considered, based on our evaluation, we believe there is good value in overseas markets and we want to be positioned accordingly.

As we look forward to 2014 we see further gains in the US and global markets, with outperformance by international markets relative to the US. Next year is likely to be a little bumpier ride than this year as we have not had a 10% correction since 2011. Following such a strong year we would expect US equity market returns to be in the single digits for 2014, with increased volatility. The primary negative surprise to our forecast would be significantly higher interest rates, which could slow the economy.

BUENA VISTA INVESTMENT MANAGEMENT LLC

LONG-TERM MARKET INDICATORS

Buena Vista Conservative Buy/Sell Discipline:	Bullish (turned positive 1-2012)
Leuthold Major Trend Index	Bullish (turned positive in 7-2013)
InvesTech Negative Leadership Composite:	Bullish (turned positive in 11-2013)
S&P 500 Stock Index:	1,848 (29.53% thru 12-31-13)
Dow Jones Total Market Index	19,053 (30.86% thru 12-31-13)

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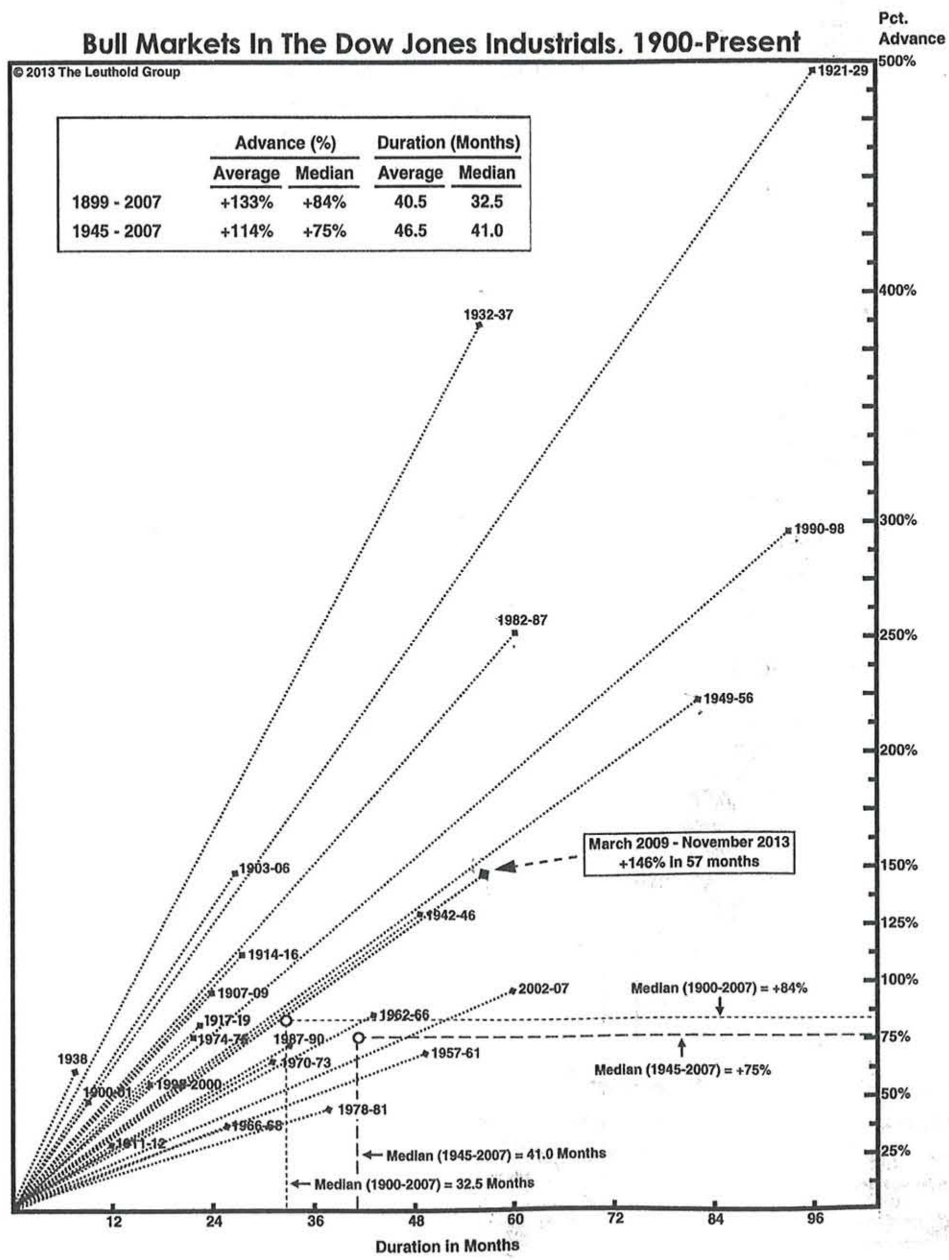
The cyclical bull market is approaching its fifth birthday. Should you be nervous? Yes, but not so much because of its age. Dow Theorist Robert Rhea warned that neither the duration nor the extent of a primary bull market could be a forecast in advance—an especially astute observation, considering it was made decades before the age of the megalomaniacal central banker.

The scatterplot below bears out Rhea's observation, with huge dispersion in the duration and extent of the 23 cyclical bull markets occurring since 1900. The current one, by the way, has moved up to the #7 spot historically, based on the DJIA's price gain (currently +146%). In doing so, it's eclipsed the 1942-1946 cyclical bull market—one that is considered to have kicked off a new secular bull market. Interestingly, four years and almost 150% later, the same "secular kick-off" theory is now widely attached to the current bull...

Bull Markets In The Dow Jones Industrials, 1900-Present



Year	Change in Index	Total Annual Return Including Dividends	Value of $1.00 Invested on 1/1/1970	5 Year Annualized Return	10 Year Annualized Return	15 Year Annualized Return	20 Year Annualized Return	25 Year Annualized Return
1970	0.01%	4.01%	$1.04	-	-	-	-	-
1971	10.79%	14.31%	$1.19	-	-	-	-	-
1972	15.63%	18.98%	$1.41	-	-	-	-	-
1973	−17.37%	−14.66%	$1.21	-	-	-	-	-
1974	−28.72%	−26.47%	$0.89	−2.35%	-	-	-	-
1975	31.55%	37.20%	$1.22	3.21%	-	-	-	-
1976	19.15%	23.84%	$1.51	4.87%	-	-	-	-
1977	−11.50%	−7.18%	$1.40	−0.21%	-	-	-	-
1978	1.06%	6.56%	$1.49	4.32%	-	-	-	-
1979	12.31%	18.44%	$1.77	14.76%	5.86%	-	-	-
1980	25.77%	32.50%	$2.34	13.96%	8.45%	-	-	-
1981	−9.73%	−4.92%	$2.23	8.10%	6.47%	-	-	-
1982	14.76%	21.55%	$2.71	14.09%	6.70%	-	-	-
1983	17.26%	22.56%	$3.32	17.32%	10.63%	-	-	-
1984	1.40%	6.27%	$3.52	14.81%	14.78%	8.76%	-	-
1985	26.36%	31.73%	$4.64	14.67%	14.32%	10.49%	-	-
1986	14.62%	18.67%	$5.51	19.87%	13.83%	10.76%	-	-
1987	2.03%	5.25%	$5.80	16.47%	15.27%	9.86%	-	-
1988	12.40%	16.61%	$6.76	15.31%	16.31%	12.17%	-	-
1989	27.25%	31.69%	$8.90	20.37%	17.55%	16.61%	11.55%	-
1990	−6.56%	−3.10%	$8.63	13.20%	13.93%	13.94%	11.16%	-
1991	26.31%	30.47%	$11.26	15.36%	17.59%	14.34%	11.90%	-
1992	4.46%	7.62%	$12.11	15.88%	16.17%	15.47%	11.34%	-
1993	7.06%	10.08%	$13.33	14.55%	14.93%	15.72%	12.76%	-
1994	−1.54%	1.32%	$13.51	8.70%	14.38%	14.52%	14.58%	10.98%
1995	34.11%	37.58%	$18.59	16.59%	14.88%	14.81%	14.60%	12.22%
1996	20.26%	22.96%	$22.86	15.22%	15.29%	16.80%	14.56%	12.55%
1997	31.01%	33.36%	$30.48	20.27%	18.05%	17.52%	16.65%	13.07%
1998	26.67%	28.58%	$39.19	24.06%	19.21%	17.90%	17.75%	14.94%
1999	19.53%	21.04%	$47.44	28.56%	18.21%	18.93%	17.88%	17.25%
2000	−10.14%	−9.10%	$43.12	18.33%	17.46%	16.02%	15.68%	15.34%
2001	−13.04%	−11.89%	$37.99	10.70%	12.94%	13.74%	15.24%	13.78%
2002	−23.37%	−22.10%	$29.60	−0.59%	9.34%	11.48%	12.71%	12.98%
2003	26.38%	28.68%	$38.09	−0.57%	11.07%	12.22%	12.98%	13.84%
2004	8.99%	10.88%	$42.23	−2.30%	12.07%	10.94%	13.22%	13.54%
2005	3.00%	4.91%	$44.30	0.54%	9.07%	11.52%	11.94%	12.48%
High	**34.11%**	**37.58%**		**28.56%**	**19.21%**	**18.93%**	**17.88%**	**17.25%**
Low	**−38.47%**	**−37.00%**		**−2.35%**	**−1.38%**	**4.47%**	**7.81%**	**9.28%**
CAGR		**9.94%**						
Median	**12.40%**	**15.06%**		**13.20%**	**13.38%**	**12.17%**	**12.32%**	**12.73%**

Year	Change in Index	Total Annual Return Including Dividends	Value of $1.00 Invested on 1/1/1970	5 Year Annualized Return	10 Year Annualized Return	15 Year Annualized Return	20 Year Annualized Return	25 Year Annualized Return
2006	13.62%	15.79%	$51.30	6.19%	8.42%	10.64%	11.80%	13.37%
2007	3.55%	5.49%	$54.12	12.83%	5.91%	10.49%	11.82%	12.73%
2008	−38.47%	−37.00%	$34.09	−2.19%	−1.38%	6.46%	8.43%	9.77%
2009	23.49%	26.46%	$43.11	0.42%	−0.95%	8.04%	8.21%	10.54%
2010	12.64%	15.06%	$49.61	2.29%	1.41%	6.76%	9.14%	9.94%
2011	0.00%	2.11%	$50.65	−0.25%	2.92%	5.45%	7.81%	9.28%
2012	13.29%	16.00%	$58.76	1.66%	7.10%	4.47%	8.22%	9.71%
High	**34.11%**	**37.58%**		**28.56%**	**19.21%**	**18.93%**	**17.88%**	**17.25%**
Low	**−38.47%**	**−37.00%**		**−2.35%**	**−1.38%**	**4.47%**	**7.81%**	**9.28%**
CAGR		**9.94%**						
Median	**12.40%**	**15.06%**		**13.20%**	**13.38%**	**12.17%**	**12.32%**	**12.73%**

See also

- Conference Board Leading Economic Index
- Dow Jones Industrial Average
- List of S&P 500 companies
- E-mini S&P
- Exchange-traded fund
- Fortune 500
- FTSE 100
- Index fund
- S&P 100
- S&P 400
- S&P 600
- S&P 1500
- Standard & Poor's

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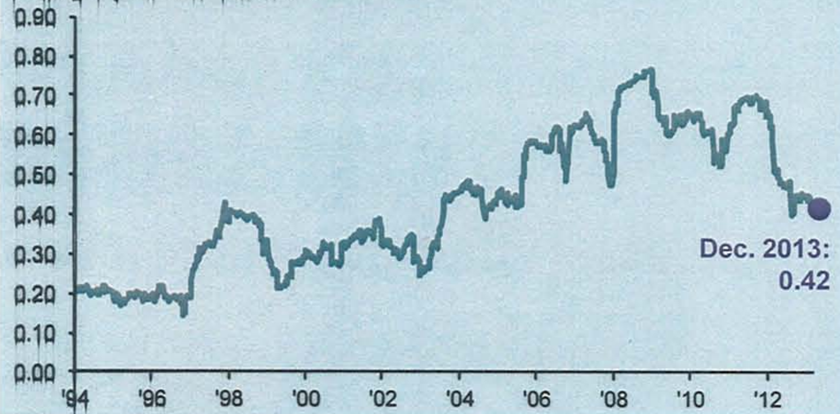
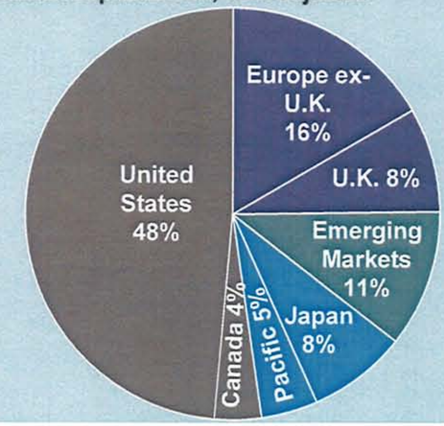
Global Equity Markets

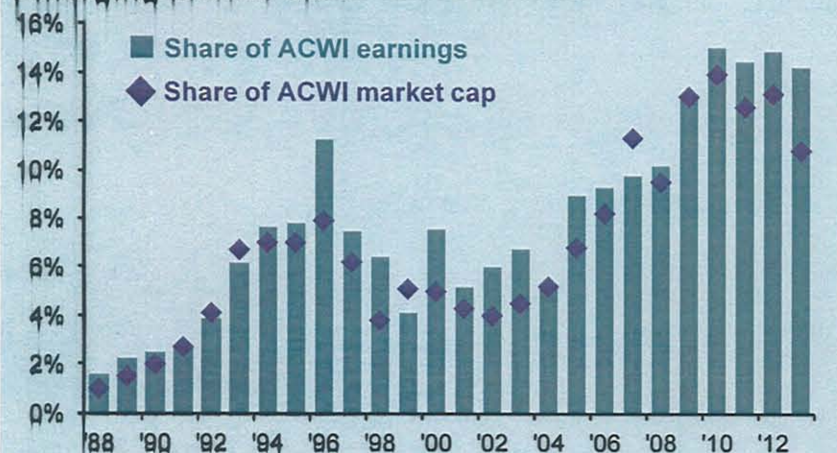
Global Equity Market Correlations
Rolling 1-year correlations, 30 countries



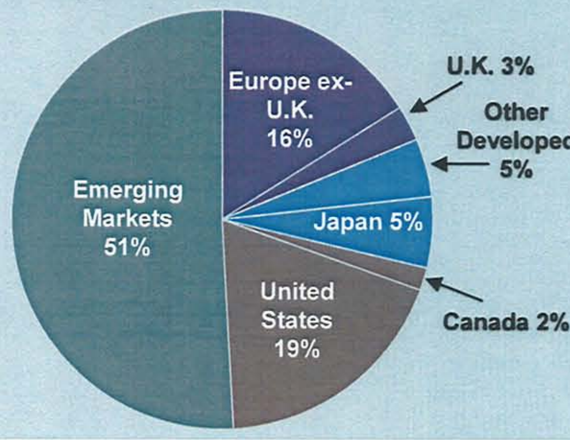
Weights in MSCI All Country World Index
% global market capitalization, float adjusted



Emerging Market Share of MSCI ACWI



Share of Global GDP
Based on purchasing power parity

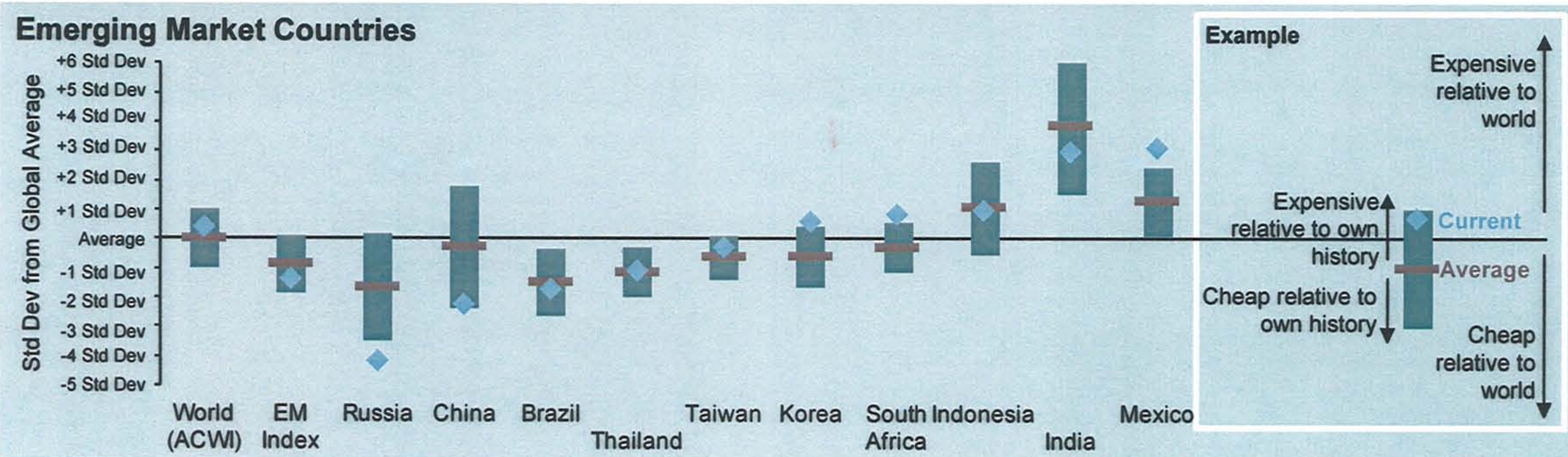


Source: MSCI, IMF, FactSet, J.P. Morgan Asset Management.

Share of global market capitalization is based on float adjusted MSCI data. Share of global GDP based on purchasing power parity (PPP) as calculated by the IMF for 2013. Definition of emerging markets is based on MSCI and IMF data sources.
Percentages may not sum to 100% due to rounding. Guide to the Markets – U.S.
Data as of 12/31/13.

J.P.Morgan
Asset Management

Global Equity Valuations – Emerging Markets



	Current Composite Index	Current				10-year avg.			
		Fwd. P/E	P/B	P/CF	Div. Yld.	Fwd. P/E	P/B	P/CF	Div. Yld.
World (ACWI)	**0.39**	13.8	2.0	8.6	2.5%	13.1	2.0	7.4	2.5%
EM Index	**-1.38**	10.2	1.5	6.0	2.7%	11.1	1.9	6.2	2.7%
Russia	**-4.16**	4.8	0.7	3.0	4.2%	7.9	1.4	4.9	2.1%
China	**-2.24**	9.0	1.5	4.6	3.3%	12.0	2.1	7.2	2.6%
Brazil	**-1.72**	10.0	1.4	6.8	3.6%	9.9	1.9	5.5	3.2%
Thailand	**-1.10**	11.3	1.9	6.6	3.5%	10.7	2.0	6.7	3.6%
Taiwan	**-0.30**	14.2	1.8	7.1	3.0%	14.0	1.9	6.8	3.6%
Korea	**0.59**	8.6	1.1	5.1	1.0%	9.4	1.5	4.8	1.6%
South Africa	**0.84**	13.5	2.5	11.1	3.1%	11.2	2.4	8.5	3.2%
Indonesia	**0.98**	12.4	3.0	10.3	2.8%	12.2	3.4	9.7	2.8%
India	**2.98**	14.1	2.7	12.5	1.5%	15.3	3.2	12.7	1.3%
Mexico	**3.10**	17.8	2.8	9.5	1.5%	14.1	2.8	7.4	1.8%

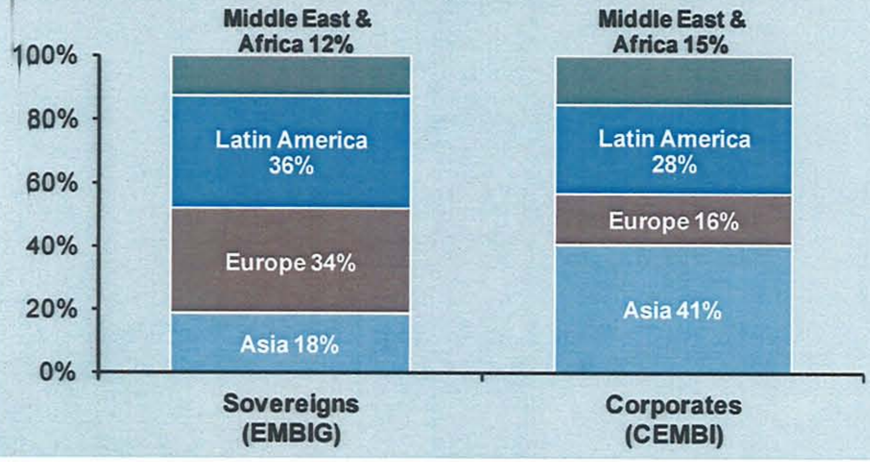
Source: MSCI, FactSet, J.P. Morgan Asset Management.
Note: Each valuation index shows an equally weighted composite of four metrics: price to forward earnings (Fwd. P/E), price to current book (P/B), price to last 12 months' cash flow (P/CF) and price to last 12 months' dividends. Results are then normalized using means and average variability over the last 10 years. The grey bars represent valuation index variability relative to that of the MSCI All Country World Index (ACWI). See disclosures page at the end for metric definitions. Guide to the Markets – U.S.
Data are as of 12/31/13.

International

J.P.Morgan Asset Management

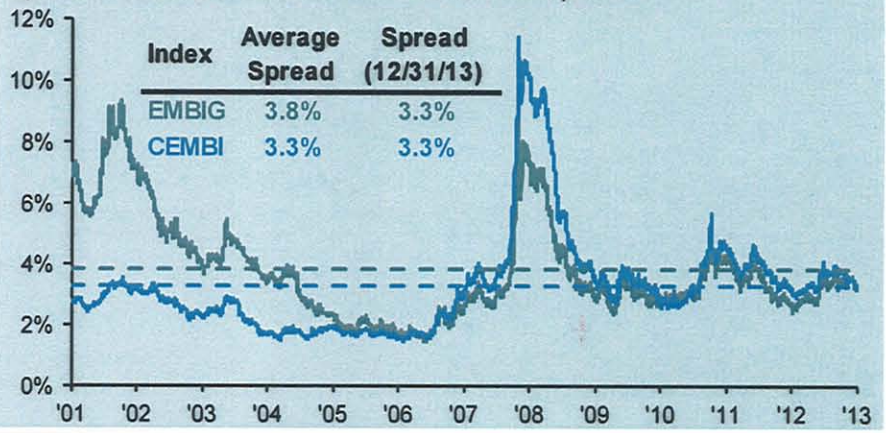
Emerging Market Debt

Index Breakdown – USD Denominated EMD



Emerging Markets Debt Spreads

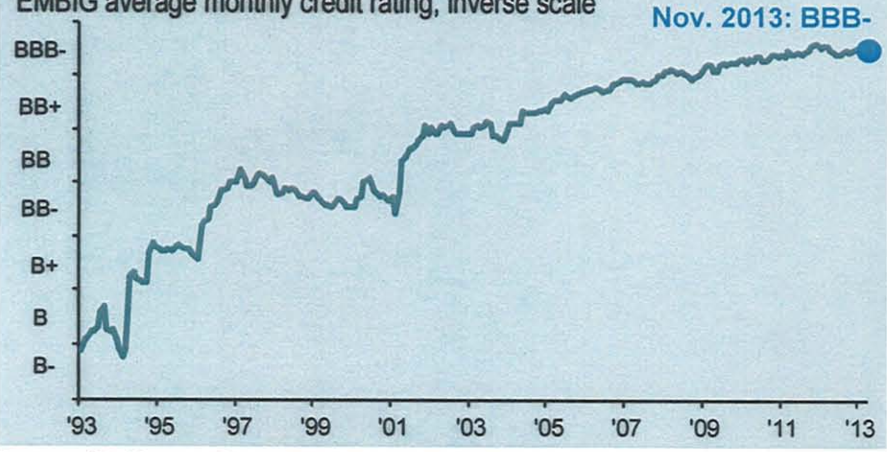
Spread to Treasuries of USD-denominated debt, percent



Index	Average Spread	Spread (12/31/13)
EMBIG	3.8%	3.3%
CEMBI	3.3%	3.3%

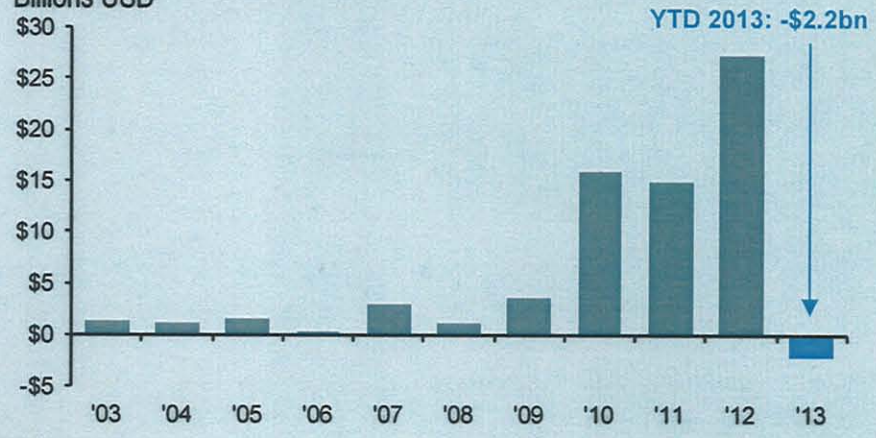
Emerging Market Debt Credit Rating

EMBIG average monthly credit rating, inverse scale

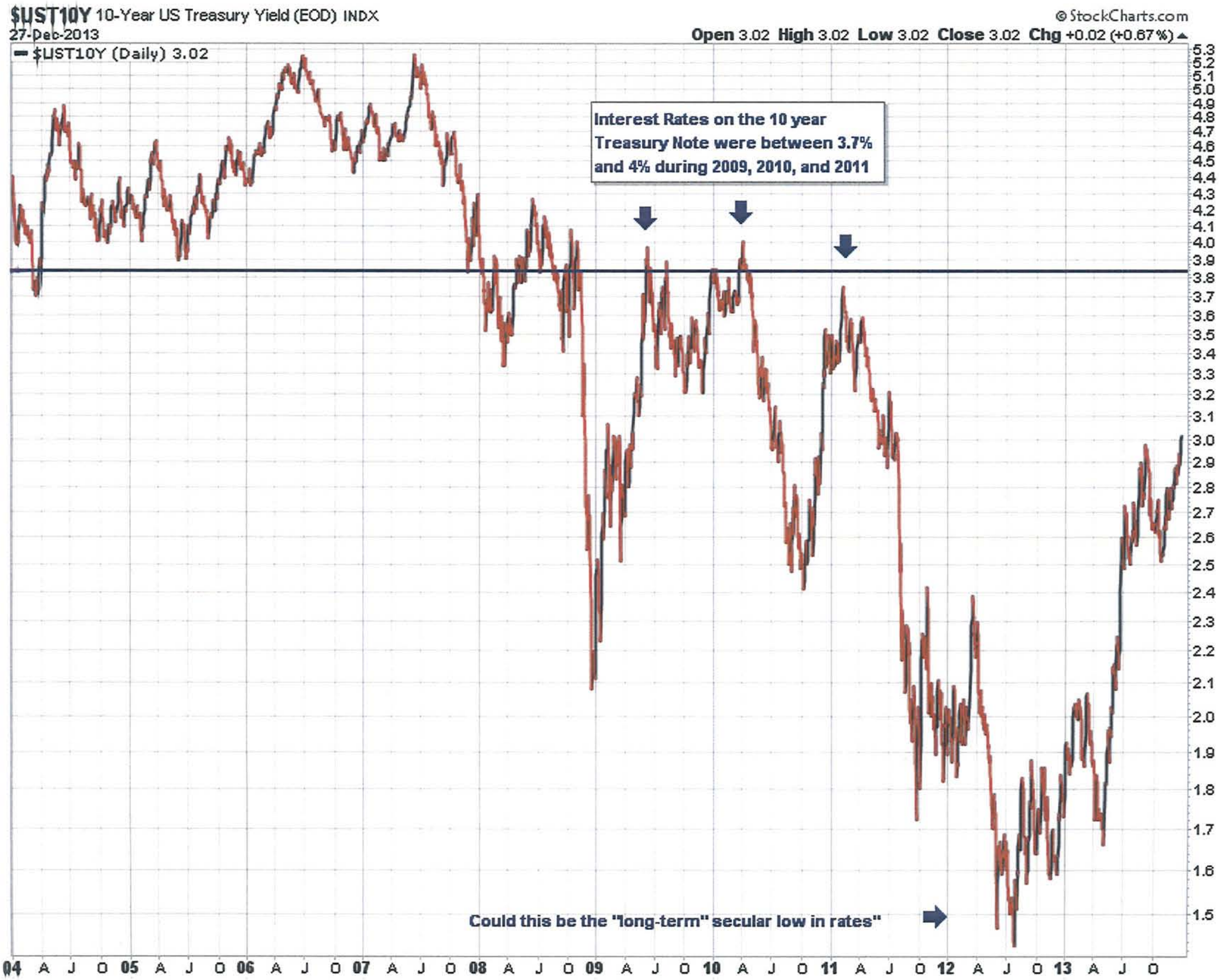


Annual Flows into EMD Mutual Funds & ETFs

Billions USD



Source: J.P. Morgan, MorganMarkets, FactSet, Strategic Insight, J.P. Morgan Asset Management.
Spreads measure the credit risk premium over comparable maturity U.S. Treasury bonds. The J.P. Morgan EMBI Global (EMBIG) Index is a USD-denominated external debt index tracking bonds issued by sovereigns and quasi-sovereigns in developing nations. The J.P. Morgan Corporate Emerging Bond Index (CEMBI) is a USD-denominated external debt index tracking bonds issued by corporations in developing nations. Flow data is as of November 2013. Past performance is not indicative of comparable future results. Index breakdown may not equate to 100% due to rounding.


$UST10Y 10-Year US Treasury Yield (EOD) INDX
© StockCharts.com
27-Dec-2013
Open 3.02 High 3.02 Low 3.02 Close 3.02 Chg +0.02 (+0.67%)
$UST10Y (Daily) 3.02
Interest Rates on the 10 year Treasury Note were between 3.7% and 4% during 2009, 2010, and 2011
Could this be the "long-term" secular low in rates"
04 A J O 05 A J O 06 A J O 07 A J O 08 A J O 09 A J O 10 A J O 11 A J O 12 A J O 13 A J O
5.3 5.2 5.1 5.0 4.9 4.8 4.7 4.6 4.5 4.4 4.3 4.2 4.1 4.0 3.9 3.8 3.7 3.6 3.5 3.4 3.3 3.2 3.1 3.0 2.9 2.8 2.7 2.6 2.5 2.4 2.3 2.2 2.1 2.0 1.9 1.8 1.7 1.6 1.5


$UST10Y 10-Year US Treasury Yield (EOD) INDX
27-Dec-2013
© StockCharts.com
Open 3.02 High 3.02 Low 3.02 Close 3.02 Chg +0.02 (+0.67%)
$UST10Y (Daily) 3.02
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