SAPLING
WEALTH MANAGEMENT

Market Strategy 2013-2014

Capital Markets Outlook

Prepared by

William G. Hicks
Managing Director

March 18, 2013

SAPLING
WEALTH MANAGEMENT

Table of Contents

2013-2014 Executive Summary 1
- For 2013-2014 We Are Very Positive For Equities 1
  - Corporations Are Starting To Redeploy Capital More Efficiently 1
  - Fiscal Policies Will Likely Be More Sensible 2
  - Monetary Easing To Continue In Short-Term 2
  - Economy Is Coming 'Round the Bend 2
- Equity Valuations Reasonable Vs. Historical Norms 2
  - +10-15% Annual EPS Growth For Next Two Years 2
- Risks Have Been Kicked Down Road A Few Years 2

Slow Train Coming 3
- 4 Key Factors Lead Us To Be Positive For Equities 3
- Cash Redeployment Provides A Big Boost 3
  - S&P 500 2.1% Yield Slated to Increase +6.38% in 2013 3
  - Buyback Authorizations At All-Time High In February 4
  - "Buy Outs" Yet Another Catalyst 4
- We Expect A Big, Positive Fiscal Policy Surprise 5
  - Republican Policy Positions Already Beginning To Moderate 5
  - Democrats Beginning To Reach Out 5
- Monetary Easing To Continue 6
  - Employment Picture Improving, But Slowly 6
- Economy Beginning To Chug Along 7
  - +3.0-3.5% Global Economic Growth 2014-2015 7

Favorable Outlook For Equities 9
- Likely Range of +7.4-16.0% for Equity Returns in 2013 9
  - We Think Odds of Major Financial Crisis Are Only 5% 9
  - 15% Chance of An "Historic" Stock Market Return 9
- Plenty of Support For Our Positive Thesis 10
  - Revenue Growth + Low Cost Pressure = High & Stable Margins 10
- Additional Positives to Our Bull Market Thesis 11
  - Increased Conviction in EPS Likely In 2013 11
  - Multiple Expansion Would Cause A Powerful Move Up 12
  - Flow of Funds Analysis Suggests Much Room For Change 12
  - EPS Estimates Narrow, Indicating Higher Predictability 13
- Fixed Income Market Risks Are Foreboding 14
  - Capital Flowed To Fixed Income In Last Few Years 14
  - Spreads Have Tightened 15

Commodities Prices Likely To Stay In Line 15
Long-Term Risks Lurk 16
International Scene 16
US Domestic Concerns 16
Our Top Ideas 17
Security Selection Is Driving Performance 17
We Prefer Active Money Managers vs. Closet Indexers 18
Fixed Income 18
Equities 18

Tables

Table 1: World Bank Forecast of Annual GDP Growth %, by Region 7
Table 2: Consensus S&P Earnings & Valuation Ratios, (3-18-2013) 12
Table 3: S&P Performance, by Sector (2/28/2013 except where noted) 17
Table 4: Themes, Strategies and Investment Ideas 19

Figures

Figure 1: Sapling Wealth Management – Summary Market Forecast 1
Figure 2: Corporate Dividend Policies Beginning To Shift 4
Figure 3: Employment Picture Slowly Brightens 6
Figure 4: Financial Lending & Borrowing Picking Up After Election 8
Figure 5: Housing Permits Recovering, Still Well Below Average 8
Figure 6: Historical Valuations & Components of SWM Forecast (3-18-13) 9
Figure 7: Y/Y % Change Producer Price Index and Commodities 10
Figure 8: Corporate Profit Margin & Wage Growth 11
Figure 9: Quarterly Funds Flow, Credit & Equity Net Investments 12
Figure 10: Bottoms Up and Tops Down Estimates Getting Closer Together 13
Figure 11: Annual Flow of Funds, Credit & Equity Net Investments 14
Figure 12: Credit Market Spreads Have Tightened Significantly in Last Year 15
Figure 13: Commodity ETFs Not Indicating Inflation 15

Contact us at:

2212 Queen Anne Ave.
Seattle, WA 98109

main (206) 281-4055
fax (206) 283-0791

www.saplingwealth.com

Disclaimer: The opinions in this document are for informational and educational purposes only and should not be construed as a recommendation to buy or sell the financial assets mentioned. Past performance of the companies and asset classes discussed may not continue and the companies may not achieve the earnings growth as predicted. The information in this document is believed to be accurate, but under no circumstances should a person act upon the information contained within. We do not recommend that anyone act upon any investment information without first consulting an investment advisor as to the suitability of such investments for his specific situation.

2013-2014 Executive Summary

We remain very optimistic on equities due to improving fundamentals, attractive valuations and compelling risk/return profiles. For many of the same reasons, we believe fixed income securities will underperform. Long-term risks still lurk around the bend, but not a big concern for now.

For 2013-2014 We Are Very Positive For Equities

For this investment outlook, our weighted average of equity returns resulted in an expected +14.0% total return for the 2013 – a measure we view quite positively. The high return is partially due to low odds of a large negative event. Out of our four main likely economic scenarios, we project only one (5% probability) that results in a negative equity return. The expected return is significantly boosted by a 15% chance of an "historic" market total return of +44.4%. Therefore the primary investment risk is being caught with insufficient exposure to the equity markets and playing catch up later on.

Figure 1: Sapling Wealth Management – Summary Market Forecast

		Consensus EPS Est.		P/E Ratio		Bond Market		
	S&P 500	2013E	2014E	2013	2014	10 Year	HG Corp	HY Corp
Current Market Valuations (3/18/2012)	1552	$112.04	$123.65	13.9X	12.6X	1.90%	2.76%	4.97%

		Equity			Debt		
Scenario	Probability	Int'l	Emerging	S&P 500	10 Yr	HG Corp	HY Corp
#1: European Bond Market Crisis & Collateral Damage	5%	-50.0%	-55.0%	-40.0%	8.0%	9.6%	-9.3%
#2: Mild Recession Europe, Slow Growth US & Asia	40%	2.4%	7.4%	7.4%	1.0%	2.8%	4.7%
#3: Slow Growth Developed Mkts, No Recession	40%	16.0%	16.0%	16.0%	-7.5%	-5.4%	2.8%
#4: Growth + Confidence + Moderate Inflation	15%	54.4%	59.4%	44.4%	-13.3%	-12.8%	-6.1%
	100%						
Wtd. Average		13.0%	15.5%	14.0%	-4.2%	-2.4%	1.6%

Source: Sapling Wealth Management, S&P IQ[i]

Corporations Are Starting To Redeploy Capital More Efficiently

With 10% of corporate net worth stashed in cash, shareholders can expect a more efficient use of capital in the face of improving economic fundamentals. This may take the shape of dividend increases, share buybacks and strategic acquisitions. For those corporations not employing these techniques, private equity firms may offer investors an attractive buy-out alternative.

Fiscal Policies Will Likely Be More Sensible

Our most contrarian call this year is that Washington D.C. lawmakers can pass a budget that has substantive measures to control spending and raise revenues. A general election loss by the Republicans is starting to cause a moderation in policy positions and hold out legislators may feel the pressure to compromise.

Monetary Easing To Continue In Short-Term

The heroic efforts by the Federal Reserve to stimulate the economy are most likely to continue for the next 24 months. Any changes may be considered in the face of increased employment or higher inflation. However, even then, we would not anticipate any change unless the economy is clearly on the mend.

Economy Is Coming 'Round the Bend

Slowly and surely, the US economy is recovering. Europe is projected to be less of a drag in the 2014-2015 time periods. Japan and the Eurozone monetary authorities are opting to pursue easy policies to support weak economies. We see little, outside of a major financial mishap or international political event, which will derail this process.

Equity Valuations Reasonable Vs. Historical Norms

Tempered economic risks and reasonable valuations bode well for equity prices.

+10-15% Annual EPS Growth For Next Two Years

Solid revenue growth, sustained margins and cash redeployment all add up to excellent earnings growth in the next few years. At a P/E ratio of 13.9X consensus EPS of $112.04 for the S&P 500, the equity markets are valued well below historical P/E ratios and we believe stocks are attractive at this valuation.

Lots of Reasons To Be Bullish

P/E multiple expansion, higher than expected earnings, capital asset rotation into equities from cash & fixed income, and higher earnings quality all are additional factors that support our positive thesis.

Risks Have Been Kicked Down Road A Few Years

We continue to believe there are serious long-term fiscal issues – entitlement and federal spending (including defense) – that must be addressed to avoid severe future financial hardship. While we do not believe these issues will be resolved in the next few years, we do believe they will be easier to manage with a healthier economic back drop. Only a major financial crisis in a sovereign debt market or international political event would temper our view.

Fixed Income Has Little Appeal

For many of the same reasons that cause us to be positive on equities, we are negative on fixed income securities. We believe that the 2013-2014 time frame may be the period where investors become disenchanted with this asset class and materially change their investment risk preferences.

- **Positive Returns?** – We believe the probability for negative returns for Treasuries and HG Corporates are likely for 2013. HY Corporate bonds have only modest attractiveness at this juncture.

Slow Train Coming

We believe that the economy is now beginning to chug down the track. Necessity is pressuring politicians to get on board and address fiscal policy matters earnestly. We believe the outcome will be positive for the equity capital markets. With the exception of dire scenarios, attractive fixed income returns are a bygone era.

4 Key Factors Lead Us To Be Positive For Equities

We draw our optimism on the equity markets from four major fundamental changes: corporate cash redeployment, positive fiscal initiatives, continued easy monetary policy and a recovering economy. We are mindful of the risks of sovereign debt and long-term fiscal issues. However, policy makers that still have several levers to pull *plus* full support from nearly all monetary policy makers worldwide adds up to an attractive environment for equity markets. Many of the elements that are bullish for equities are negative (and possibly very negative) for fixed income securities.

Cash Redeployment Provides A Big Boost

Corporations have nearly 10% of their net worth stashed in cash, which is an incredibly inefficient use of corporate resources. The justification for the overcapitalized position is to be prepared for a major financial crisis. As the economy stabilizes, this primary rationale is likely to fade into the background. Corporate executives will begin to feel the pressure from shareholders to redeploy capital in more thoughtful ways. The three primary areas to look for change are: dividends, stock buybacks and acquisitions.

S&P 500 2.1% Yield Slated to Increase +6.38% in 2013

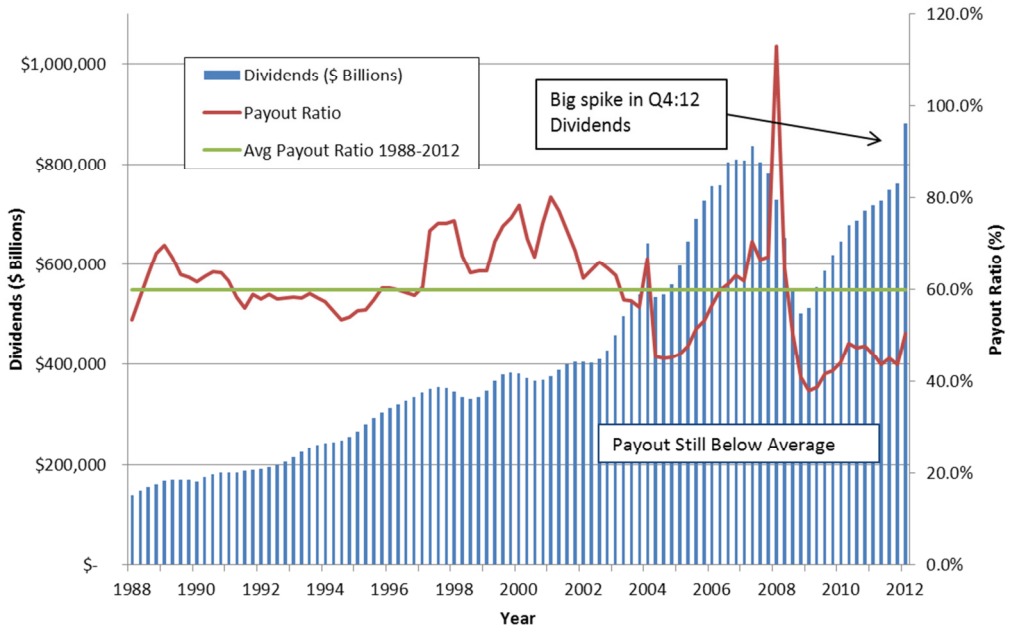
The Wall Street Journal reported that S&P 500 companies are expected to pay at least $300 billion in dividends in 2013, +6.38% from 2012 levels. Three companies – Apple, Exxon & AT&T – are slated to pay out $10 billion each.

More Room For Additional Dividend Growth

The Federal Reserve statistics that track all corporate dividends (public & private) indicate that the current payout ratio (dividends divided by after tax profits) of 50.5% is well below the 1988-2012 average payout ratio of 60.0%. However, with recent approval for large banks to increase payouts, we believe this will change meaningfully in the next 12-18 months. Given the current level of

corporate profitability, there is the potential for a re-acceleration in dividend growth without compromising conservative balance sheet cash positions.

Figure 2: Corporate Dividend Policies Beginning To Shift



Source: Federal Reserve[ii]

Buyback Authorizations At All-Time High In February

According to Birinyi Associates, February 2013 represented the largest monthly authorizations for equity stock buybacks since 1999.[iii] The monthly buyback authorization of nearly $120Billion in stock value is approximately 50% higher than *any* of the next 9 largest monthly buyback authorizations in the last 14 years. Authorizations are a leading indicator for repurchases which, in turn, can provide a positive push to equity prices.

"Buy Outs" Yet Another Catalyst

Public companies are also choosing to go private (Dell - $23B, H.J. Heinz $28B) and take advantage of accommodating debt markets and a benign economic outlook. While these are two of the largest examples, additional capital provided by private equity funds and eager debt markets can also take additional stock out of the equity markets. Public corporations that make targeted strategic acquisitions will likely do so with cash, which will bolster top-line revenue without share count dilution, effectively converting 0% yielding assets into positive revenue and income streams.

We Expect A Big, Positive Fiscal Policy Surprise

After losing the general election in November, we believe that there will be a race to the center for the Republicans & Democrats before the midterm elections. If this occurs, it enables substantive movement in fiscal policies that take steps to balance the budget through decreased spending, higher taxes, or both.

Republican Policy Positions Already Beginning To Moderate

Mitt Romney, who we believe was an electable candidate, was defeated in the November general election, despite taking approximately 60% of largest voting demographic (white voters represent almost 70% of voters). This is astounding, as it suggest that the Republicans gleaned less than 20% of all remaining voters (Blacks, Hispanics, Asians, Other). Since non-white voting groups are the fastest growing in the United States, it caused post-election Republican Party soul searching and is likely to lead to substantive policy re-positioning.

Democrats Starting To Reach Out

President Obama has stepped up his efforts in early March to reach out to Republican lawmakers – both the leadership and rank & file – to secure support for a large budget compromise. We expect the Democratic controlled Senate to produce a budget this year (the first since 2009). Whether this is due to political positioning or statesmanship does not concern us; we are enthusiastic about the direction and increased substance of the discussions.

Just One Fiscal Policy Success Will Change Investor's Perceptions

Expectations are so low for budget compromise that it will take only one intelligent piece of public policy legislation to change perceptions that nothing can be done on the Federal level. In addition, some compromises are simply not difficult to make, particularly if you target long-term funding commitments (such as future entitlement changes) that do not affect the pocket book of any voting constituency in the near term.

Republican Tweaks Just Aren't That Hard To Make

In order to appeal to non-white voters, we believe that Republicans will moderate positions on social issues, defense, immigration and "no tax pledges". The party may find advantages in positioning itself as a financially responsible and inclusive party. What to expect:

- **Moderate Spending Growth –** Clearly articulated policies that cut spending growth, not total spending.
- **Concede On Core Issues –** We expect Republicans will consider additional tax revenue sources and rationalized defense spending levels.
- **Immigration–** This is already happening.
- **Focus On Reforms –** Republican Party can leverage its base of State Governors to project an image of managerial reformers that focus on making the system more efficient and less encumbered with ineffective regulation and tax loopholes.

Monetary Easing To Continue

The Federal Reserve is unlikely to pull back on its easy-money programs that have been implemented to increase employment and GDP growth. Only if the Consumer Price Index (CPI) kicks up above +2.5% or unemployment dips below 6.5% would the Federal Reserve would even consider a shift in policy. We do not think this is a significant risk in the next 18-24 months. In addition, if Chairman Bernanke is not re-appointed as head of the Federal Reserve, his most likely successor will be Janet Yellen, who is also an easy money policy advocate.

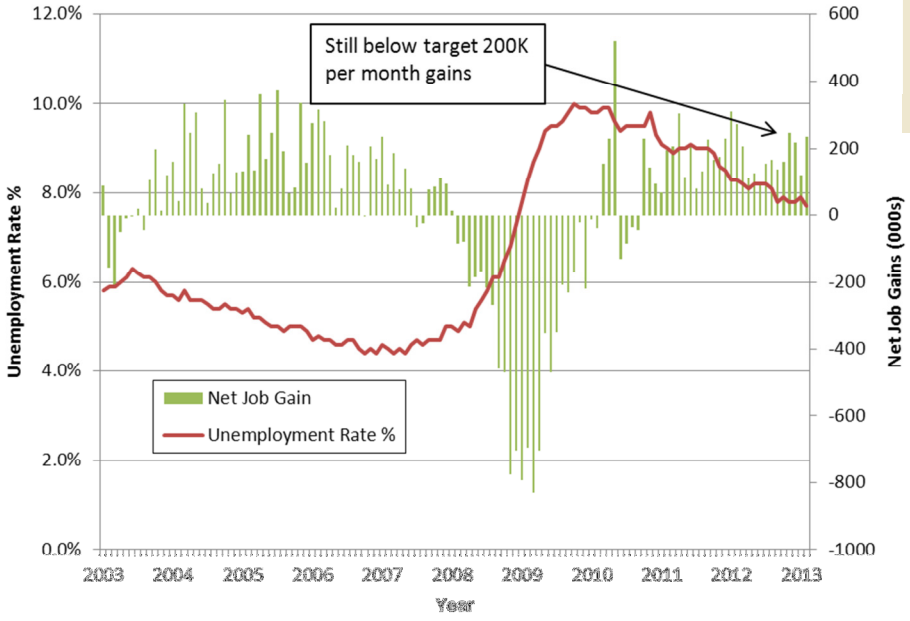
Employment Picture Improving, But Slowly

Despite extraordinary efforts on the part of the Federal Reserve and fiscal policy makers, the employment growth in the United States has been meager. Monetary policy makers will need to see consistent monthly employment gains of +200,000 in order to view the economy as healthy. Even at that point, easy money policies would likely tail off slowly.

Are Monetary Policies Less Effective?

Market observers have noticed that the past few Federal Reserve interventions have had a less positive effect on the stock market returns. Chairman Bernanke has stated that monetary measures cannot fix the economic problems alone, and there must be thoughtful steps taken on the fiscal policy side. In fact, we believe that the perception that the Federal Reserve is becoming less effective will drive fiscal policy negotiations forward in Washington, D.C.

Figure 3: Employment Picture Slowly Brightens



Source: Bureau of Labor Statistics[iv]

Economy Beginning To Chug Along

After heroic efforts, particularly on the part of the Federal Reserve, the economy is showing results. Investors are apt to be encouraged by the increase in employment, consumer spending, lending/borrowing and improvements in large cyclical markets (autos, housing). However, in most of our scenarios, growth is projected to be stable, but moderate.

+3.0-3.5% Global Economic Growth 2014-2015

For 2014-2015, the World Bank projects +3.0-3.5% worldwide economic expansion. Importantly, Europe will turn modestly positive during this time and developing countries will post 5-6% growth.

Table 1: World Bank Forecast of Annual GDP Growth %, by Region

Region	2011	2012E	2013F	2014F	2015F
World	+2.7%	+2.3%	+2.4%	+3.1%	+3.5%
Euro Area	1.5%	-0.4%	-0.1%	0.9%	1.4%
United States	1.8%	2.2%	1.9%	2.8%	3.0%
Japan	-0.7%	1.9%	0.8%	1.2%	1.5%
Non-OECD	5.0%	2.9%	3.5%	3.8%	3.8%
China	9.3%	7.9%	8.4%	8.0%	7.9%
Developing	5.9%	5.1%	5.5%	5.7%	5.8%

Source: World Bank[v]

Employment Trends

As noted earlier (Figure 4), employment trends have been improving, albeit slowly. The recent February 2013 net gain in employment of 236,000 was a solid reading and above expectations. Consistent growth in the 200,000-300,000 range will be considered a success.

Consumer Spending & Sentiment Slated To Rise

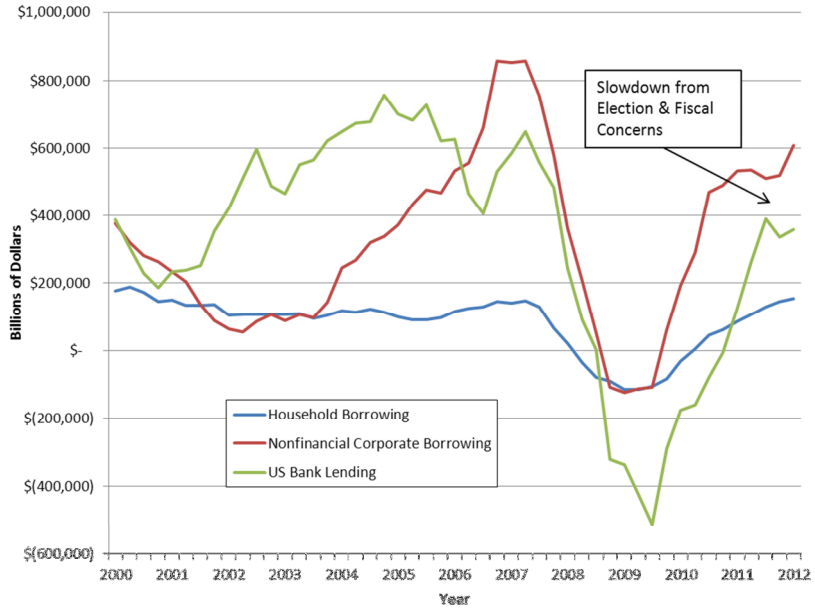
Consumer spending, which represents 70% of the US economy, is increasing steadily, due to pent-up demand for goods and services, greater confidence in the economy and improved employment trends. Improving consumer confidence, which is in part boosted by stable-to-up housing prices and financial market strength, will help support the economy to chug along.

Lending & Borrowing Activity Picks Up After Concerns Abate

Uncertainty around the general election and European sovereign debt issues caused a pause in borrowing from non-financial corporations and a decrease in

US bank lending. However, both are back on track as these issues have been worked through.

Figure 4: Financial Lending & Borrowing Picking Up After Election

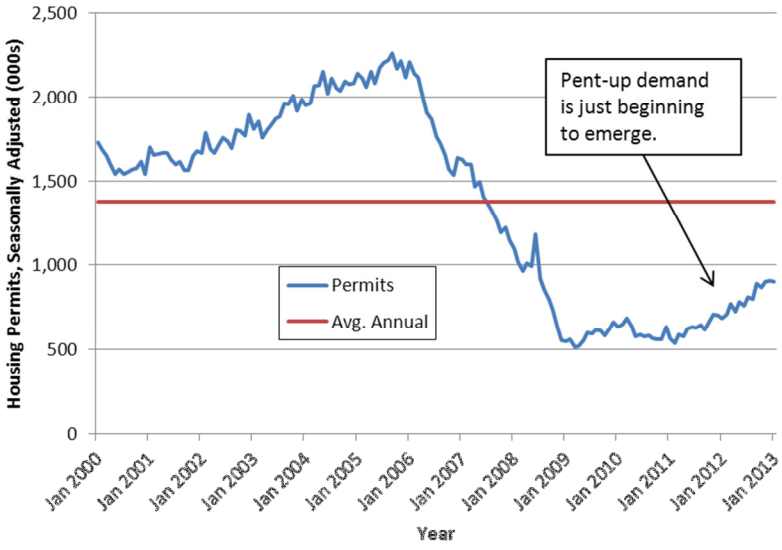


Source: Federal Reserve[vi]

Housing Permits Showing Strength, Yet Still Way Below Averages

After a painful downdraft from 2006-2009 housing permits are beginning to show strength, powered by pent-up demand, low mortgage rates and greater economic confidence.

Figure 5: Housing Permits Recovering, Still Well Below Average



Source: US Census Bureau[vii]

Favorable Outlook For Equities

The main tenant to Sapling Wealth Management's investing strategy is assessing the probabilities of likely economic scenarios, forecasting investment returns and implementing thoughtful asset allocations and security selection accordingly. This year, equities look particularly attractive on both an absolute and relative perspective.

Likely Range of +7.4-16.0% for Equity Returns in 2013

Our two most likely scenarios peg S&P 500 earnings estimates in a 118-122 range, below the current consensus of 123. Even with more conservative earnings projections, we project investment returns that exceed all other capital market alternatives. Our estimated total return scenario is comprised of: +5-9% EPS growth, +0-5% P/E multiple expansion and +2% dividend yield.

Figure 6: Historical Valuations & Components of SWM Forecast (3-18-13)

		Consensus EPS			P/E Ratio			Trailing 12 Month	Trailing 12 Month
	S&P 500	2012E	2013E	2014E	2012E	2013E	2014E	Yield	Dividends
Prices & Ratios	1552	$ 96.81	$ 112.04	$ 123.65	16.0	13.9	12.6	2.1%	$ 31.96

Projected Valuations	Probability	2014 EPS Estimate	2014/ 2013 Y/Y %	% of Concensus Estimate	SWM Est, P/E Multiple	Chg. 2013 Y/Y %	Target S&P Valuation	% Return S&P	+	% Yield	=	Total Return S&P
#1 Scenario	5%	$ 75.00	-33%	60.1%	12.0	-13%	900	-42.0%		2.1%		-40.0%
#2 Scenario	40%	$ 118.00	5%	94.6%	13.9	0%	1,635	5.3%		2.1%		7.4%
#3 Scenario	40%	$ 122.00	9%	97.8%	14.5	5%	1,769	14.0%		2.1%		16.0%
#4 Scenario	15%	$ 130.00	16%	104.2%	17.0	23%	2,210	42.4%		2.1%		44.4%
	100%											

Source: S&P IQ, Sapling Wealth Management[viii]

We Think Odds of Major Financial Crisis Are Only 5%

Valuations in this market appear to be putting a higher probability on a crisis than our estimates. We are sticking with our 5% probability (the same as last year) in part due to the amount of credible policy levers put in place in the last 18-24 months. We believe that factoring in a high probability of a major financial crisis is not valid. Risk preferences may increase as others discount this event.

15% Chance of An "Historic" Stock Market Return

We project that there is a reasonable chance for a very robust stock market return, which could be as high as +44.4%. This scenario is comprised a combination of higher than projected earnings (130 vs. 123 consensus) and P/E multiple expansion to reflect a rosier than expected economic situation.

Plenty of Support For Our Positive Thesis

There is much tangible evidence that the economic recovery is on its way. Historically, equity market valuations have increased along with higher conviction in the economy and future earnings growth. Valuations also may get an additional boost due to increased appetite for risk taking and funds flow out of low return alternatives.

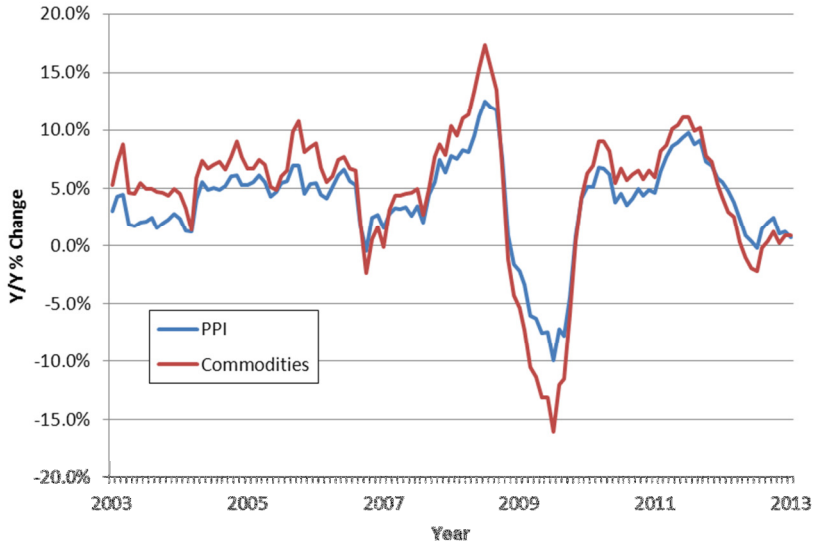
+3.0-3.5% Worldwide GDP Growth Will Be Reflected In Revenues

Stable and increasing worldwide GDP growth (see prior Table 1) will support solid revenue trends for both domestic and international segments.

Little Cost Pressure From Producer or Commodity Prices

We expect cost pressures on corporations to remain in check. We estimate that a +0-3% in price pressure is in store for the foreseeable future, and that the peak price growth in 2009-2011 was due to a rebound from 2009 rather than core inflationary pressures. We are bearish on commodity energy prices in the United States, due to inexpensive natural gas & oil coming from fracking technology in several areas of the country. Increased production is resulting in lower energy prices and decreased energy imports, both of which are major positives for the United States economy.

Figure 7: Y/Y % Change Producer Price Index and Commodities

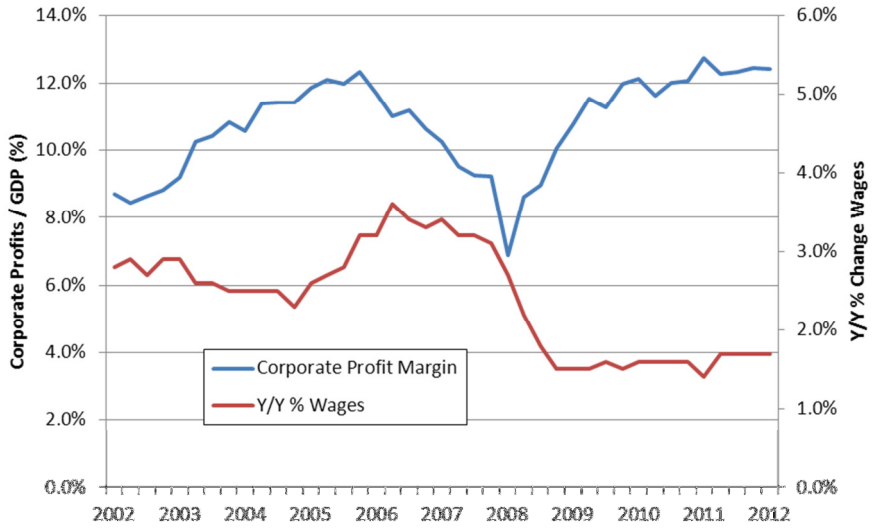


Source: Bureau of Labor Statistics and Sapling Wealth Management[ix]

Revenue Growth + Low Cost Pressure = High & Stable Margins

Margins are likely to remain at historic highs, due to absence of a major economic crisis, moderate labor and commodity prices.

Figure 8: Corporate Profit Margin & Wage Growth



Source: Federal Reserve, Bureau of Labor Statistics, Sapling Wealth Management[x]

Additional Positives to Our Bull Market Thesis

Investors should consider increasing their exposure to the equity markets relative to their current weightings, due to reasonable valuations, earnings growth and potential for P/E multiple expansion. Unless there is a major debt crisis in Europe, we believe that the +30 year long bull market for bonds is over. Monetary easing, generous fiscal policy measures and an economy prepared for growth all add up to an economic revitalization.

Increased Conviction in EPS Likely In 2013

The average P/E ratio for the S&P 500 on trailing 12 month operating earnings is 19.1X since 1988. Currently the market is trading at a 16.0X ratio, which represents a 15-20% discount from historical averages. More interestingly, consensus earnings growth is projected to be up +15.7% and +10.4% for 2013 & 2014, respectively. Therefore, if earnings estimates come in as projected, investors are looking at 10-15% returns without any increase in valuation multiples. In the Q4:2012, nearly 65% of companies beat earnings expectations and 25% missed expectations. With more companies exceeding expectations, we believe conviction in earnings will increase.

Table 2: Consensus S&P Earnings & Valuation Ratios, (3-18-2013)

	Price	2012E	2013E	2014E
S&P 500	1552	$96.81	$112.04	$123.65
Y/Y %			+15.7%	+10.4%
P/E Ratio		16.0X	13.9X	12.6X

Source: S&P Dow Jones Indices[xi]

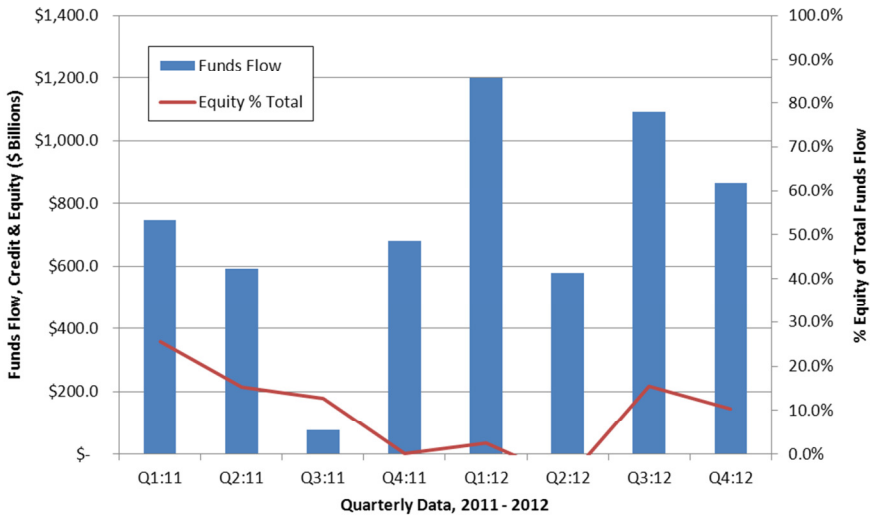
Multiple Expansion Would Cause A Powerful Move Up

If the discount to the historical market multiple of 19.1X was 10%, instead of the current 15-20%, it would place a P/E of 17.1X on consensus 2013 earnings of 112.04 to produce a year end 2013 price target of 1915, +23% from current levels. While the elements of the financial crisis are still with us – too much leverage, sovereign debt credit – they are manageable in a confident, growing economy.

Flow of Funds Analysis Suggests Much Room For Change

A security's price is set by the last incremental dollar to trade that security. Therefore, what is most important in anticipating risk preferences is analyzing where incremental dollars are being invested. We believe an asset allocation shift from cash & bonds to equities is just beginning to occur. In the past two years investors have put their money overwhelmingly into fixed income investments. Equity investment, as a percent of total net investment, has been below 10% in the last 6 quarters. There is significant room for this to change.

Figure 9: Quarterly Funds Flow, Credit & Equity Net Investments



Source: Federal Reserve[xii]

EPS Estimates Narrow, Indicating Higher Predictability

"Bottoms up" consensus 2014 estimate (a notoriously optimistic figure) for S&P 500 earnings is 124.8; "Tops down" forecast is 122.6. However, the spread between the two estimates is only 1.8%. Last year at this time, 2013 "bottoms up" earnings projection of 118.9 was 8.3%% higher than the "tops down" forecast of 109.8. Currently the "tops down" estimate for 2013 is 1.4% *higher* than the "bottoms up" forecast. A greater alignment in forecast estimates indicates to us ebbing fears of large macro-economic risks (such as a financial crisis) and higher predictability of estimates. A "tops down" 2013 forecast which has become higher than the "bottoms up" estimate suggests to us that macro-economist are changing their perceptions faster than security analysts.

Figure 10: Bottoms Up and Tops Down Estimates Getting Closer Together

		Year Ahead S&P EPS Est.		
		Bottoms	Tops	Bottoms/
Date	Year	Up	Down	Top Down
07-Apr-12	2013	118.9	109.8	8.3%
14-Mar-13	2013	111.3	112.8	-1.4%
14-Mar-13	2014	124.7	122.6	1.7%

Source: S&P IQ, Sapling Wealth Management[xiii]

As Macro Views Get Rosier, Estimates May Actually Surprise

"Bottoms up" forecasts can be slower than "top down" estimates in anticipating a change, such as a better-than-expected economy. As such, there is a viable scenario for an increase in "bottoms up" earnings projections from current levels. If this were to occur, it would be a powerful positive catalyst for stock market valuations.

Fixed Income Market Risks Are Foreboding

Many of the factors that we believe may buoy the equity markets in 2013 – accelerating economy, increased risk tolerance - are factors that have significant downside risk for fixed income markets. Decreased fear of a financial apocalypse may be replaced by inflation fears; while we view neither as probable, increased inflation fears would negatively affect bond market valuations. Any increased risk preference increases the probability of a sector rotation out of bonds and fixed income instruments into equities. In this environment, we believe fixed income asset categories offer an extremely unattractive risk/reward profile.

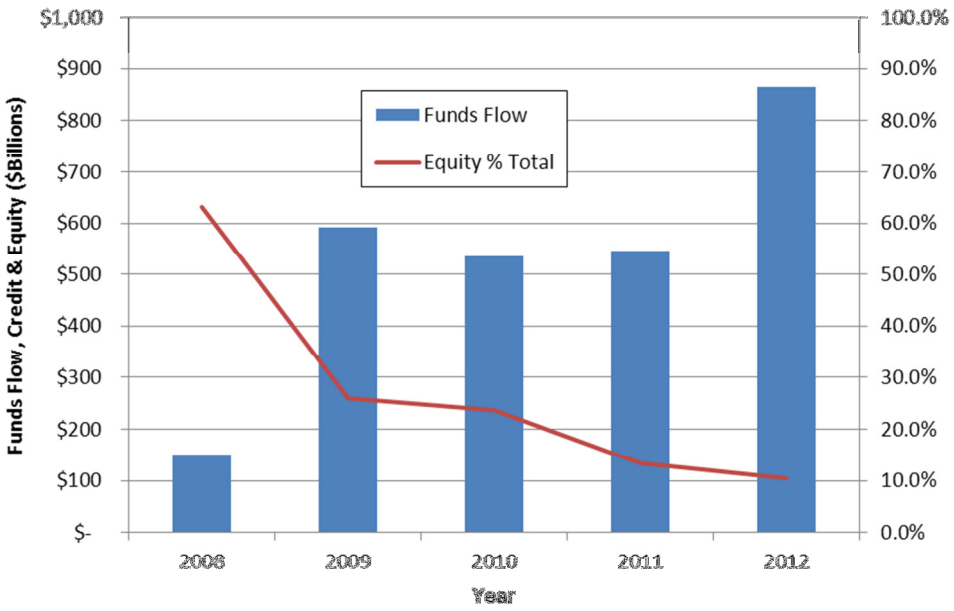
Capital Flowed To Fixed Income In Last Few Years

One of our favorite charts (which this time is stated in annual rather than quarterly statistics) shows how much capital fixed income markets have attracted in the past 4 years. The chart suggests several things to us. First, fixed income markets are taking an unusually high percent of the incremental net investment dollar. Second, there is lots of room for perceptions and risk preferences to change. Finally, if and when investor preferences do change, the asset class rotation wave will be tsunami sized.

Ask Yourself, How Can It Get Better Than This?

With massive Federal Monetary Policy bond purchases, fears of financial Armageddon, negative real short term interest rates, tightening spreads, insatiable investor demand for bonds and sovereign debt credit issues – it is hard to believe it gets better than this for US fixed income bond investors. We recommend investors thoughtfully examine their asset allocation exposure in the fixed income markets, paying close attention to duration, credit and currency issues.

Figure 11: Annual Flow of Funds, Credit & Equity Net Investments



Source: Federal Reserve[xiv]

Spreads Have Tightened

While 10-year Treasury Bonds have been relatively flat compared to last year, the investment grade and high yield bond markets have been extraordinary performers. While easy money policies and massive capital flows into fixed income show no sign of abating in the near term, we do not believe investors are being paid appropriately to take capital risk in these areas.

Figure 12: Credit Market Spreads Have Tightened Significantly in Last Year

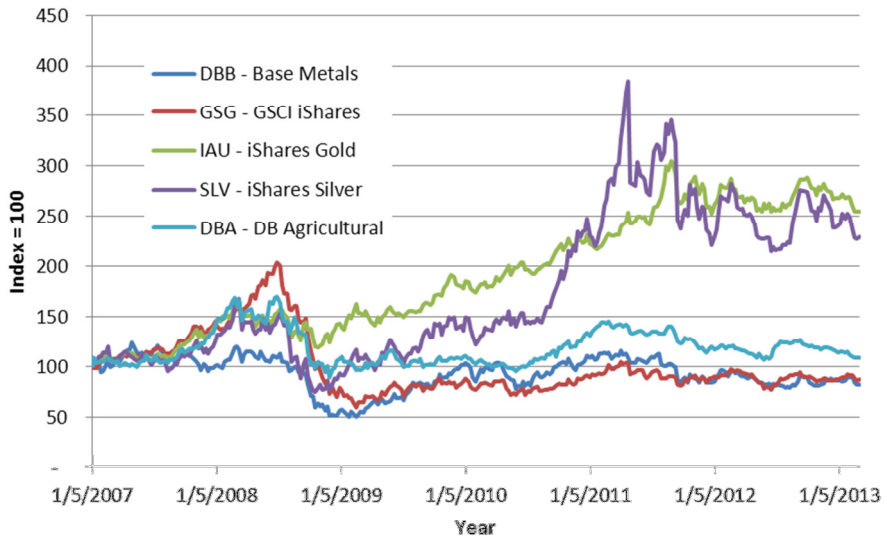
			Basis Pt.	% Chng.	Spread to 10 Yr. T-Bond	
	4/7/2012	3/7/2013	Change	Yield	4/7/2012	3/7/2013
US Treasury 10 Year	1.99%	1.90%	0.09	4.5%	0.00%	0.00%
Investment Grade Corporate	3.37%	2.76%	0.61	18.1%	1.38%	0.86%
High Yield	6.80%	4.97%	1.83	26.9%	4.81%	3.07%

Source: Wall Street Journal[xv]

Commodities Prices Likely To Stay In Line

The performance of commodity ETFs has been lackluster since the beginning of 2011. We believe that 2009-2011 performance was boosted by the fear that monetary expansion would produce significantly higher inflation. In fact, this has not been the case and speculators have been leaving the market. Commodities may continue to disappoint as an attractive asset class, due to slowly expanding economies and monetary policies that will eventually moderate in the face of improving economic and fiscal environments. Gold prices, which are distinct from economically sensitive commodities, have recently been soft as speculators have been exiting large positions.

Figure 13: Commodity ETFs Not Indicating Inflation



Source: Yahoo! Finance & Sapling Wealth Management[xvi]

Long-Term Risks Lurk

We believe that the primary risks in the market come from the international and domestic fiscal issues. We believe both risks are manageable, with international risk being the more concerning of the two.

International Scene

Eurozone Will Take Leadership & Persistence

We believe that both the Eurozone will begin more expansive monetary policy expansion to combat 12% unemployment. It will take much leadership to navigate the structural and political issues necessary to deliver lower Eurozone interest rates and stimulate local economies. European sovereign debt issues are the single biggest risk to our capital markets thesis.

China

This economy does not appear to be having a hard landing and the recent political leadership transition has occurred without disruption. Policies of the new administration will encourage growth. Chinese military assertiveness is an issue.

Japan

Monetary policy measures are looking to jump start this flailing economy. While demographics in this country are extremely negative, the next 18-24 months will likely look better than the last. The risk of the emergence of "beggar-thy-neighbor" currency devaluations bears watching.

Emerging Markets

Commodity driven markets are expanding to embrace middle class values and lifestyles. Solid growth prospects depend on formative political systems.

Middle East

Tinderbox issues continue to emerge – nuclear arms in Iran, etc. – and it will take active involvement to derail risks before they take on greater importance.

US Domestic Concerns

Most of our concerns in the United States are longer term in nature.

Dysfunction on Budget Matters

Even if our call for intelligent fiscal compromise doesn't happen, expectations are so low that we don't believe it will affect the market meaningfully.

Healthcare Execution Issues

The Affordable Health Care Act gets implemented in earnest in 2014. Execution risks are high. Healthcare delivery, cost overruns and the ability to control them could cause market pessimism.

Our Top Ideas

This will be a stock picker's market and security selection *within* asset allocations will drive performance. Passive index strategies will deliver benchmark returns (less associated fees). Intelligent risk taking should be amply rewarded in the capital markets in the next 18-24 months.

Security Selection Is Driving Performance

Conservative equity industry sectors (health care, consumer staples) have been boosted by investors seeking a combination of safety and return. Economically cyclical sectors (industrials, consumer discretionary, financials, telecom) have gotten a lift from higher than expected earnings performance. Future performance will be driven by macro-economic themes, security selection and investor risk preferences.

Table 3: S&P Performance, by Sector (2/28/2013 except where noted)

	Index Level	YTD (3/8/2013)	1 Year	3 Year	5 Year
S&P Total Return		9.2%	13.5%	13.5%	4.9%
S&P Price Only	1,551	8.8%	10.9%	11.1%	2.6%
Outperforming Sectors					
Health Care	515	11.2%	20.2%	11.3%	5.8%
Financials	245	10.9%	19.3%	6.2%	-7.3%
Telecom Services	157	7.2%	18.3%	14.3%	2.2%
Consumer Discretionary	416	10.7%	17.5%	18.6%	10.3%
Consumer Staples	398	10.4%	15.1%	12.2%	6.8%
Industrials	361	9.9%	10.8%	12.2%	1.6%
Under Performing Sectors					
Energy	579	8.7%	2.9%	11.1%	0.0%
Materials	249	4.9%	3.6%	8.4%	-0.9%
Technology	482	3.9%	-0.2%	10.2%	6.5%
Utilities	192	7.9%	7.2%	8.7%	-0.2%

Source: S&P IQ[xvii]

We Prefer Active Money Managers vs. Closet Indexers

We tend to favor actively managed mutual funds with managers with historical track records for consistent performance and thoughtful strategies. Recent academic research supports this view, which suggests that actively managed funds outperform the peer group by 1-2% annually.[xviii] "Closet Index Funds" essentially mimic the benchmark index, but charge fees from 0.50-1.00%, essentially guaranteeing below benchmark returns.

Fixed Income

Investors need to thoughtfully examine their strategies for fixed income and carefully define goals that match short and long term objectives.

Shorten Duration

Shorter duration bonds offer less volatility, but often come with much lower yields or higher credit exposure.

Currency Exposure Important

Low yields around the globe increase the importance of investing in bonds denominated in currencies that will not depreciate.

Credit Quality

Credit quality is tricky, as investors are not being well compensated to take additional risk in credit.

Equities

There is considerable room for security selection that outperforms the averages.

Flat & Falling Commodity Prices

While energy producers largely do not benefit from falling commodity prices, energy refiners and transport companies do. Therefore, even if an industry sector performs poorly, securities within the sector may deliver extraordinary results.

Economically Cyclical Investments

Businesses that benefit from late stage economic growth – consumer durables, industrials, financial services – will all benefit disproportionately in a rebound.

Capital Redeployment

Fundamental and cash flow analysis will drive results in this area.

Convincing Growth Areas

Novel, value added technologies and products will always be in demand. During low economic growth times, valuations on these companies rocket skywards.

Table 4: Themes, Strategies and Investment Ideas

Themes	Strategy	Investment Ideas
Cash Redeployment	Identify those companies with high cash balances, active management & and business models with low current CAPEX needs	Large technology stocks, mature capital intensive industries, consumer staples (buyouts)
Fiscal Policy Changes	Invest in areas benefitting from fiscal policy; some major areas to avoid	Invest: Healthcare services; Avoid: Defense
Monetary Policy Easing & Low Interest Rates	Look for businesses that will continue to benefit from low interest rates	Housing, Building Materials, Autos
Commodities	Examine sectors that will benefit from stable to lower commodity prices	Industrials, Midstream Energy, Select Utilities, Manufacturing
Improving Economic Conditions	Analyze opportunities for changing expectations and reduced risk profile	Select high yield debt, industrials, capital goods, consumer durables
Technology Driven Products and Services	Identify companies with defensible, game changing technologies	Biotech, Medical Devices, Technology
Pent Up Demand	Distressed industry contrarian ideas	Housing, Autos, Financials

Source: Sapling Wealth Management

For our analysis we select indexes and securities that represent the most widely regarded gauges to track capital markets. Those indexes are: S&P 500 & Sector Indexes as a proxy for large capitalization US Equity market & sectors; 10 Year US Treasury Bond for US Government borrowing cost; HG Corporate for investment grade US Corporate borrowing costs; HY Corporate for US non-investment grade borrowing costs; DBB, GSG, SLV, IAU, DBA for varied commodity markets.

ENDNOTES

[i] "S&P 500 Basic Earnings & Estimates (EPSEST)", S&P Dow Jones Indices, http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--, sp-500-eps.xls, (March 14, 2013).

[ii] "Flow of Funds Accounts of the United States (z.1)", Federal Reserve, http://www.federalreserve.gov/releases/z1/Current/, (March 7th, 2013).

[iii] Garci, Cardiff, "February the strongest month ever for US Buybacks", FT Alphaville – Financial Times, http://ftalphaville.ft.com/2013/03/06/1412962, (March 6, 2013).

[iv] "Labor Force Statistics from the Current Population Survey – Unemployment Rate (Series LNS14000000) & Net Job Gain (Series CES0000000001), Bureau of Labor Statistics, http://www.bls.gov/data/, (March 7, 2013).

[v] "Table 1.1 The global outlook in summary, January 2013", The World Bank,http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGBLPROSPECTS/0,,menuPK:615470~pagePK:64218926~piPK:64218953~theSitePK:612501,00.html, (March 1, 2013).

[vi] Endnote ii, ibid.

[vii] "Building Permits Survey: US and Census Regions", US Census Bureau, http://www.census.gov/construction/bps/uspermits.html, (March 8th, 2012).

[viii] Endnote i, ibid.

[ix] "Producer Price Index", Bureau of Labor Statistics, http://www.bls.gov/ppi/, March 8th, 2013).

[x] Endnote ii, ibid. & "Employment Cost Index – Series CIU1020000000000A", Bureau of Labor Statistics, http://www.bls.gov/data/, (March 8th, 2013).

[xi] Endnote i, ibid.

[xii] :"Flow of Funds Accounts of the United States – Table F120-121", Federal Reserve, http://www.federalreserve.gov/releases/z1/Current/, (March 7th, 2013).

[xiii] Endnote i, ibid.

[xiv] Endnote ii, ibid.

[xv] "Tracking Bond Benchmarks – Market Data", Wall Street Journal, http://online.wsj.com/mdc/public/page/2_3022-bondbnchmrk.html?mod=mdc_bnd_pglnk, (March 11, 2013).

[xvi] "Historical Prices – DBB, GSG, IAU, SLV, DBA", Yahoo! Finance, http://finance.yahoo.com/q?s=iau&ql=1, (March 7th, 2013).

[xvii] Endnote i, ibid.

[xviii] Max, Sarah, "Is Your Fund Manager Active Enough?" Barron's, January 14, 2013.