SAPLING
WEALTH MANAGEMENT

Market Strategy 2014-2015

Capital Markets Outlook

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2014-2015 Executive Summary

We remain optimistic on equities. Opportunities will present themselves in areas that are unloved. EPS growth will be the main focus for investors this year. Political solutions to long term problems are being implemented and will diffuse near term investor anxiety about the future.

Equities Poised For Future Appreciation

Strong price appreciation is on tap, particularly if earnings come in near our estimates, which are up +11% for both 2014 & 2015. Valuations appear reasonable in light of this strong earnings growth and low yields available in the fixed income market. Select emerging markets will shine, while other remain dim. Ideal time for active management and fundamental research.

We Are Still Cautious On Fixed Income

Fixed income yields are historically quite low and monetary easing policies are ending, which puts a higher bias to interest rates. Generally, we believe this asset class offers an unattractive risk/reward returns for the next few years. With that said, opportunistic investors will have a chance to buy oversold securities that have fallen well below their intrinsic value. The most important role of this asset class comes in the form of portfolio diversification in 2014-2015.

The Key Is EPS Growth

2014 may be a year for positive economic surprises. Europe should stop putting a drag on the world economy, sales should accelerate and operating margins have room to increase. With all of these factors beginning to be baked into valuations, we see earnings disappointments as the single largest risk in the equity markets.

Table 1: Components of S&P 500 EPS Growth

Components Of Growth	Y/Y%
Sales Growth	4-5%
Share Count Reduction	0-1%
Sales Per Share Growth	4-6%
Margin Growth	5-7%
EPS Growth	9-13%

Source: Sapling Wealth Management [i]

Other Risks Are Relatively Low

The international scene has put several major crises to rest in the last few years and is in the process of working through the details of the proposed solutions. And while this process may not be perfect, we believe policy makers are much more on top of the issues than they have been in the last few years.

Equities Valuations Reasonable

We calculate the market's current valuation on forward 2015 EPS is 14.1X, up +11.0% from 12.6X at this time last year. While this multiple expansion reflects increased confidence in the economy, it is still below the historical average of 16.6X and leaves room for further multiple expansion.

High Probability Of Excellent Returns in 2014-2015

The odds of excellent returns outweigh the probability of problems. Tepid growth scenarios still offer returns well above many fixed income investment alternatives.

Figure 1: SWM S&P 500 Earnings Per Share (EPS) Estimates

	3/21/14	SWM S&P EPS			P/E Ratio			Trailing 12 Month	Trailing 12 Month
	S&P 500	2013A	2014E	2015E	2013A	2014E	2015E	Yield	Dividends
Prices & Ratios	1,867	$ 107.29	$119.09	$132.23	17.4	15.7	14.1	1.9%	$ 34.99
Y/Y %			11.0%	11.0%					

Source: S&P Indices, Sapling Wealth Management[ii]

Our Estimates Are Well Below Current Consensus

Our projected EPS remains below consensus EPS for the S&P 500. While we are not as ebullient as the consensus estimates, we believe many positive macroeconomic drivers are in place. Therefore, the consensus estimates cannot be dismissed completely.

Market Will Focus on EPS Growth

We remain optimistic on equities in the current capital market environment, as a steady increase in earnings per share will likely keep markets marching higher. Fixed income is tricky, as rising interest rates will depress bond values; however, opportunities will present themselves. Long term risks from massive fiscal deficits, unsustainable monetary policies, and international political tension remain in place, however we remain hopeful that investors will look past the negatives in the near term.

We Project Upbeat +9-13% EPS Growth 2014-2015

We have high confidence in a 9-13% EPS growth rate, tied to an accelerating world economy, corporate cash management (buybacks, mergers & acquisitions, increased leverage) and increasing operating margins.

Figure 2: SWM Projected S&P 500 Earnings Per Share (EPS)

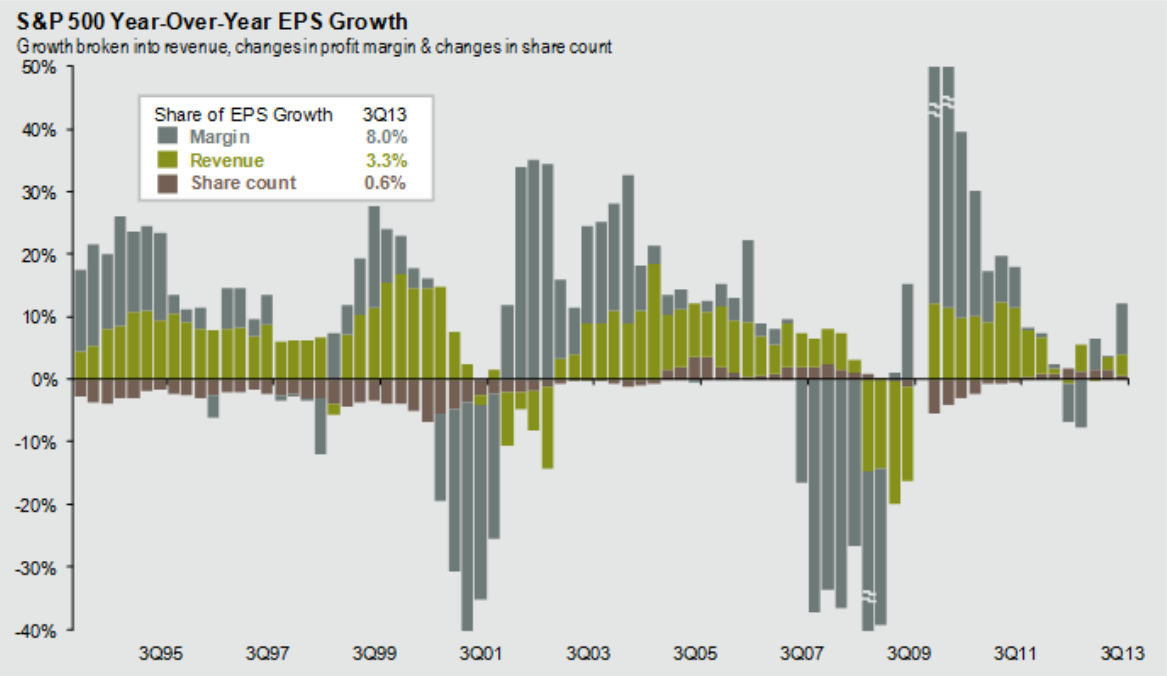
	2013A	2014E	2015E
Sales Per Share	$ 1,117	$ 1,174	$ 1,235
Baseline Sales Growth		4.60%	4.70%
Share Reduction		0.50%	0.50%
Total Y/Y % Growth		5.10%	5.20%
Operating Margin	9.61%	10.14%	10.71%
Y/Y % Growth		5.6%	5.5%
S&P Earnings	$ 107.29	$ 119.09	$ 132.23
Y/Y % Growth		11.0%	11.0%

Source: S&P Indices & Sapling Wealth Management [iii]

Sales Growth Will Boost EPS Gains

Our forecast looks for revenue to take a larger part of EPS growth in the 2014-2015 period. In Q3 2013, +11.9% EPS growth was comprised of: +8.0% margin expansion, +3.3% revenue growth and +0.6% share count reduction. We are looking for revenue to uptick to +4-5% Y/Y, operating margins +5-6% and share count reduction to contribute +0.5%.

Figure 3: Components of S&P 500 EPS Growth



Source: JP Morgan Asset Management[iv]

Our Estimates Are Well Below Current Consensus

Our projected EPS is $119.09 for 2014 and $132.23 for 2015, +11% in both years. Consensus EPS for the S&P 500 is projected to grow +14.1% in 2014 and accelerate to +17.2% in 2015. While the consensus estimates are notoriously rosy, they reflect the general positive macroeconomic outlook and strong long-term trends.

Figure 4: SWM vs. Consensus S&P 500 Earnings Per Share (EPS)

	2013A	2014E	2015E
SWM Estimate	$107.29	$119.09	$132.23
Y/Y %		11.0%	11.0%
Consensus		$ 122.42	$ 143.52
Y/Y %		14.1%	17.2%
SWM Discount To Consensus		-2.7%	-7.9%

Source: S&P Indices & Sapling Wealth Management [v]

Global GDP Growth Projected To Accelerate

The World Bank economic forecast sees worldwide growth accelerating from +2.4% in 2013 to 3.2%-3.4% in 2014-2015. Economic growth is anticipated in almost every major country and region in the world, with the exception of China, which is slowing to 7.5% growth in 2015 from 7.7% in 2014. The US growth rate is projected to uptick from +1-2% to +2-3%. Importantly, S&P 500 companies derive approximately 45-50% of sales from outside of the United States. Of this number, 30% represents European exposure with approximately 70% in the rest of the world. European GDP, which contracted in 2013, is estimated to be +1.1% in 2014, a positive +1.5% change.

Table 2: World Bank Forecast of Annual GDP Growth %, by Region

Region	2012	2013E	2014F	2015F	2016F
World	+2.5%	+2.4%	+3.2%	+3.4%	+3.5%
Euro Area	-0.6%	-0.4%	1.1%	1.4%	1.5%
United States	2.7%	1.8%	2.8%	2.9%	3.0%
Japan	1.9%	1.7%	1.4%	1.2%	1.3%
Non-OECD	3.5%	2.5%	3.3%	3.7%	3.8%
China	7.7%	7.7%	7.7%	7.5%	7.5%
Developing	4.8%	4.8%	5.3%	5.5%	5.7%

Source: World Bank [vi]

Baseline Sales of +2-4% Should Pick Up +3-5% in 2014-2015

When we weight S&P 500 sales by country/region, we calculate an estimated sales growth rate of +4.6% for 2014. This would represent a significant acceleration over the +2-4% rate of the past 12 months. In addition, share buybacks and other corporate balance sheet management tools will give a further boost to our estimated Sales Per Share figure.

Even Rosier EPS?

One of the oddest parts of the average $143.52 consensus earnings forecast this year is that "bottoms up" earnings of $137.38 (typically derived from sell side analysts that are notoriously optimistic) is lower than the $149.66 "top down" earnings estimate (created by traditionally dour economists as well as market strategists). Historically, "top down" estimates come down faster than "bottoms up" prior to a recession; "bottom's up" estimates rise faster than "top-down" prior to a recovery. In this case, the "top-down" is moving up faster than the "bottoms up". The statisticians at S&P Indices do not recall seeing this dynamic before. What this says to us that the ivory tower econometric analysis (economic models that stretch in some cases over 10-15 years) is projecting that the combination of low interest rates, muted labor & commodity market pricing and pent up demand will create a rising tide in the long term. The field is indicating they are not seeing it yet. For now, we will chose to be more conservative than both.

Figure 5: Last Twelve Months (LTM) Rolling Sales per Share, S&P 500

	Dec-13E	Sep-13	Jun-13	Mar-13	Dec-12	Sep-12
LTM Sales Per Share	$ 1,117	$ 1,115	$ 1,105	$ 1,096	$ 1,092	$ 1,077
Q/Q %	0.5%	3.8%	3.3%	1.3%	5.7%	1.1%
Y/Y%	2.2%	3.6%	2.9%	2.5%	3.8%	4.3%

Source: S&P Indices [vii]

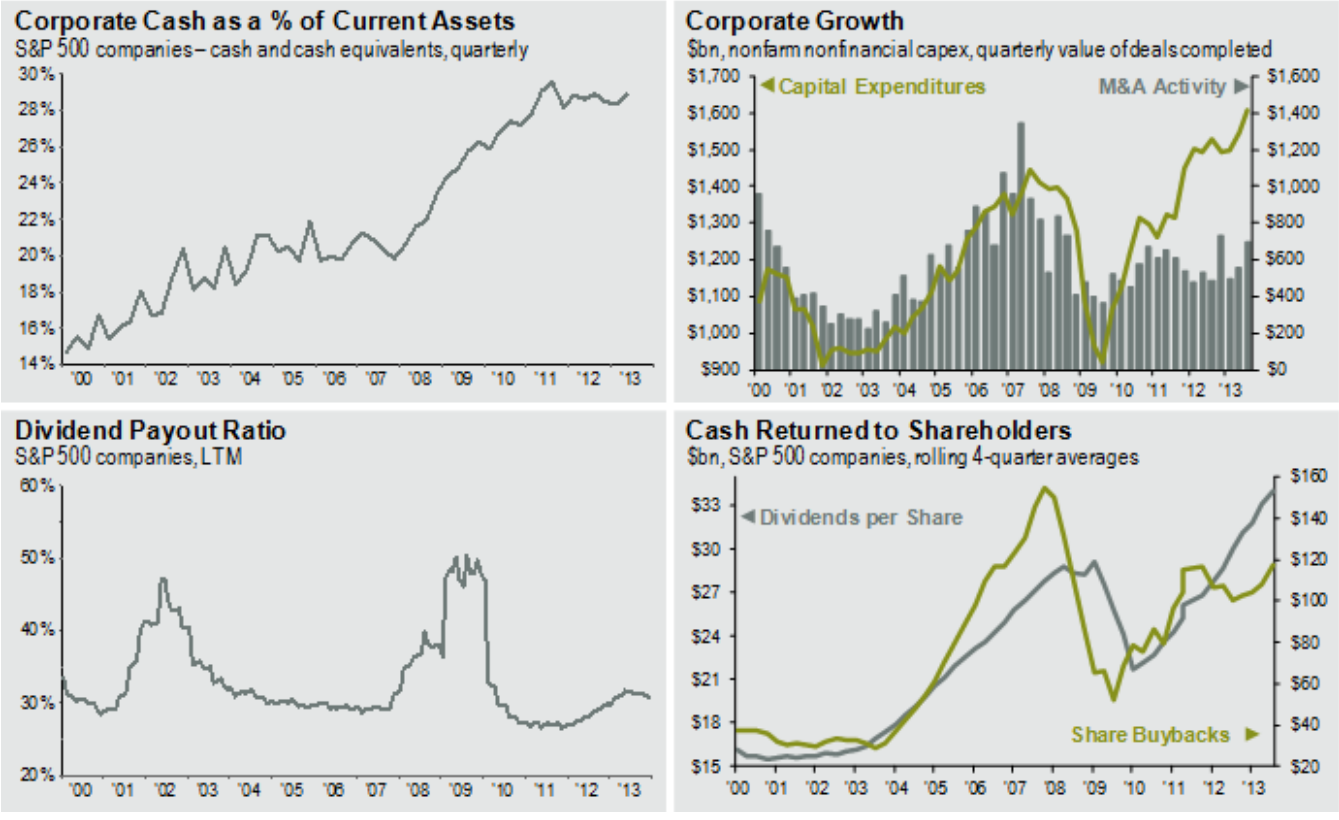
Share Count Reductions Help Boost Sales Per Share Growth

S&P Indices, the organization that tracks S&P 500 statistical data, has seen a decrease in the number of shares issued by corporations in the last few quarters, which stems from share buy backs, M&A, fewer option grants and other balance sheet mechanisms. Conversations with people tracking these figures suggest that 15-20% of companies in the S&P 500 are seeing 1% sequential reduction in shares outstanding per quarter, or 4% annualized. Over 20% of securities in the S&P 500 index now have EPS growth that is 15% higher than net income growth.

Cash Redeployment May Take Other Shapes & Forms

With equity markets +30% in 2013, 2014 share repurchases may start to look relatively less attractive than last year. However, corporations, which still have record amounts of cash as a percent of current assets, will likely consider using other tools & options - mergers & acquisitions, capital expenditures and dividends.

Figure 6: Cash Redeployment Opportunities for S&P 500 Companies



Source: JP Morgan Asset Management[viii]

Operating Margins Expanded During 2013, +8.1% Y/Y

Over the course of 2014, operating margins for the companies in the S&P 500 dramatically expanded, due to continued focus on cost cutting, balance sheet efficiency, declining commodity prices and relatively slack labor markets. Going forward, we believe the current operating leverage in a growing economy may provide additional upside.

Figure 7: S&P 500 Operating Margin Analysis, By Quarter

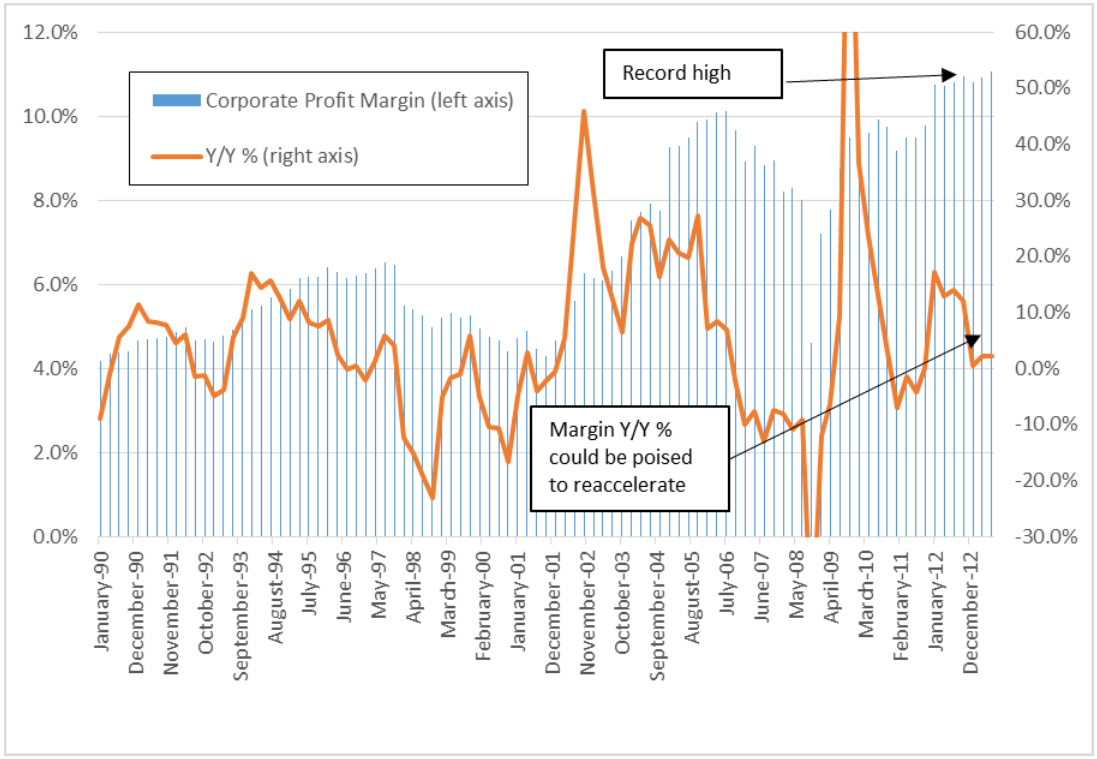
	Dec-13E	Sep-13	Jun-13	Mar-13	Dec-12	Sep-12
S&P 500 Operating Margin	9.76%	9.63%	9.51%	9.52%	8.04%	8.92%
LTM Average Margin	9.60%	9.17%	9.00%	8.99%	8.88%	9.05%
Y/Y % Change	+8.17%	+1.43%	(2.12%)	(2.06%)	(3.08%)	(1.19%)
Basis Point Change Y/Y	+0.73	+0.13	(0.19)	(0.19)	(0.28)	(0.11)

Source: S&P Indices[ix]

We Believe Margins May Have Room for Further Expansion

Our upbeat earnings forecast factors in operating margins that expand past the recent records. The Q4 2013 LTM operating margin of 9.60% was 73 basis points higher than the year ago figure of 8.88%, +8.1%. In 2013, the quarterly operating margin increased steadily on a sequential Q/Q basis, from 8.04% in Q4 2012 to 9.76% in Q4 2013. We believe this is due to three positive factors:

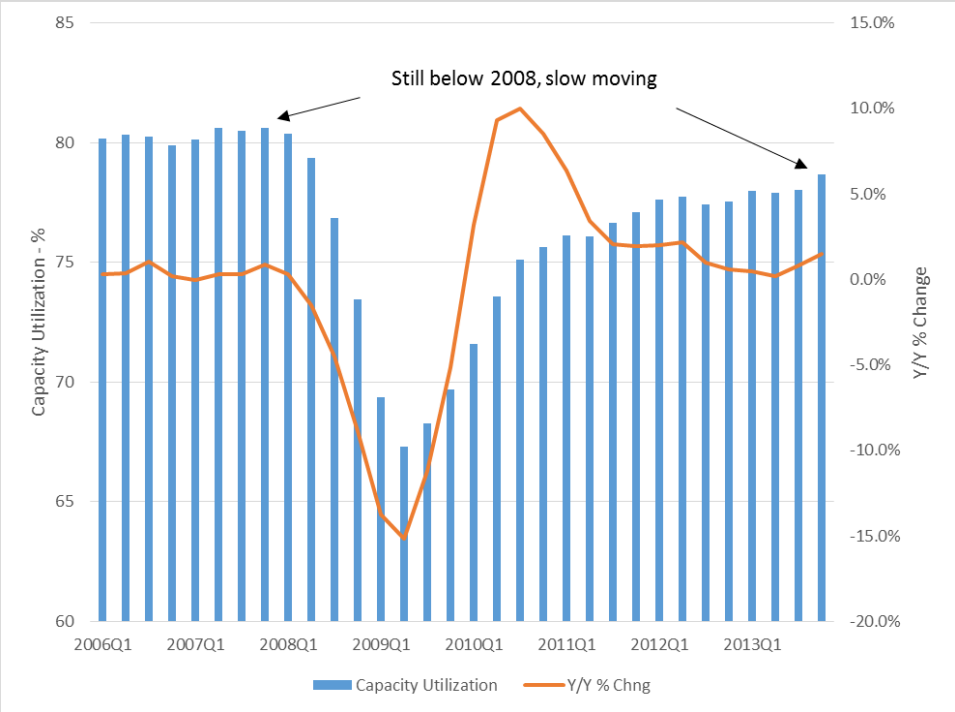
Figure 8: Historical Corporate Profit Margin & Y/Y % Growth



Source: Federal Reserve[x]

- **Operating Leverage in a Sweet Spot** – An accelerating economy (without large CAPEX spending to build new capacity) will drive operating asset efficiencies. The total industry capacity utilization ratio, now at 78%, has room to increase before there is pressure to build additional capacity. At the current rate of change, capacity utilization will be 80-81% by the end of 2014. At this time companies may choose to examine their capital spending plans. If corporations increase CAPEX spending in late 2014, we believe that the positive effect on GDP growth & confidence in the economy would outweigh potential margin inefficiencies & tightness in labor pricing.

Figure 9: Capacity Utilization Ratio Still Below Recent Peaks



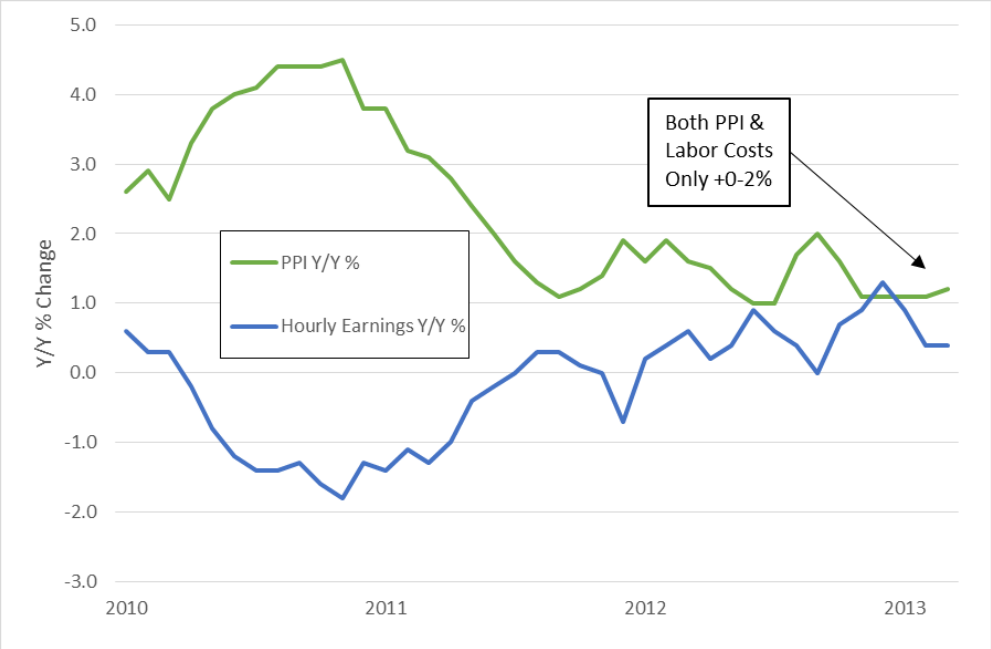
Source: Federal Reserve [xi]

- **Labor Costs +0-1% Y/Y**– Low new hiring, low labor participation rates, and international liquidity of labor service markets will keep overall labor pricing in check. The only segments of the labor market that are getting tight are in oil & gas, trucking and housing industries.

- **Producer Pricing +1-2% Y/Y** – New technology for energy extraction (fracking), a slowing Chinese economy, and less lax monetary policies in the U.S. all add up to a tame commodity environment. In addition, we believe that the Chinese demand for commodities is going through a long-term secular down shift, as this important economy moves away from

infrastructure investment and towards a less material intensive consumer goods & services.

Figure 10: Producer Price Index and Hourly Wages, Y/Y % Change



Source: Bureau of Labor Statistics [xii]

Risk from Rising Rates Is Muted

We are not terribly concerned about possible interest rate increases on profit margins. First, many companies have stretched out maturities by refinancing the entire corporate capital structure. Also, huge corporate cash balances will actually generate interest income if short term rates were to rise. Therefore, the profit margin of companies with pro-active financing strategies and large cash balances will have some buffer from rising interest rates.

Equity Valuations Still Attractive

Robust projected earnings growth make equities look relatively attractive to other financial investment options. However, we anticipate that the funds flow sector rotation to equities will create capital market disruptions and opportunities. This environment is an ideal for agile, active investment managers.

Equities Still Offer Best Risk/Reward In Our Eyes

We project that there are five scenarios that could occur in the next 12-24 months.

Figure 11: Five Scenarios 2014-2015 & SWM Estimated Capital Market Returns

	3/21/14	SWM S&P EPS			P/E Ratio			Trailing 12 Month	Trailing 12 Month
	S&P 500	2013A	2014E	2015E	2013A	2014E	2015E	Yield	Dividends
Prices & Ratios	1,867	$ 107.29	$119.09	$132.23	17.4	15.7	14.1	1.9%	$ 34.99
Y/Y %			11.0%	11.0%					

Projected Valuations	Probability	SWM EPS Estimate	2015/ 2014 Y/Y %	% of S&P Estimate	SWM Est P/E Multiple	Chg. 2014 Y/Y %	Target S&P Valuation	% Return S&P	+	% Yield	=	Total Return S&P
China Hard Landing & Financial Contagion	5%	$ 95.00	-20.2%	71.8%	12.0	-23.4%	1,140	-38.9%		1.9%		-37.0%
Mild Worldwide Recession	10%	$ 110.00	-7.6%	83.2%	14.0	-10.7%	1,540	-17.5%		1.9%		-15.6%
Tepid Growth, Europe Stable	30%	$ 125.00	5.0%	94.5%	15.7	0.0%	1,959	5.0%		1.9%		6.8%
Earnings Come In At Estimate	50%	$ 132.23	11.0%	100.0%	16.0	2.1%	2,116	13.3%		1.9%		15.2%
Economy Gains Traction & Inflation Signs	5%	$ 145.00	21.8%	109.7%	17.0	8.5%	2,465	32.1%		1.9%		33.9%
	100%											

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

Positive Scenarios a 85% Probability

Our top two scenarios (50% + 5% = 55% probability) generate returns in a +15.2-33.9% range. However, this optimism is somewhat offset by our two pessimistic scenarios (5% + 10% = 15% probability) of negative returns of (15.6%)-(37.0%). Overall, we favor equities, which we slate to have nearly an 85% chance of delivering a high single digit (or greater) returns by this time next year. We do not see many clouds on the horizon, with even our muted scenario offering decent returns for stock investors.

- **Two Bull Case Scenarios, S&P Total Return +15.2%-33.9%** – In these two cases where earnings come in close or above our EPS estimates. In this environment, a rush to equities could become a stampede, supporting P/E multiples in a 16.0-17.0X range (which is about average for the last 25

years). The main drivers to total return is capital appreciation via earnings growth, not P/E multiple expansion. Fixed income would be a place to avoid in this ebullient environment.

- **Muted Case, S&P Total Return +6.8%** – Ho-hum earnings growth would still command a P/E multiple of 15.7X current year earnings of $125 per share, which would be equal to the today's market valuation. Our calculations of +5.0% earnings growth + 1.9% yield = 6.8-7.0% total return is still a decent outcome for a below expectations earnings growth environment. Tepid economic growth would likely restart fiscal and monetary policy measures, providing downside support.
- **Bear Cases, S&P Total Return (15.6-37.0%)** – In these two cases, earnings disappointments turn into economic contractions of varying degrees, a major negative. Market risk assessments increase, causing P/E multiple contraction. High quality bonds would do well in these two scenarios that we ascribe only a 15% probability.

Valuations Look Reasonable Relative to EPS

We are looking for +11% growth for the S&P 500 in the 2014-2015 time frame. By historical standards, this would be (and has been) an exceptional period of earnings growth.

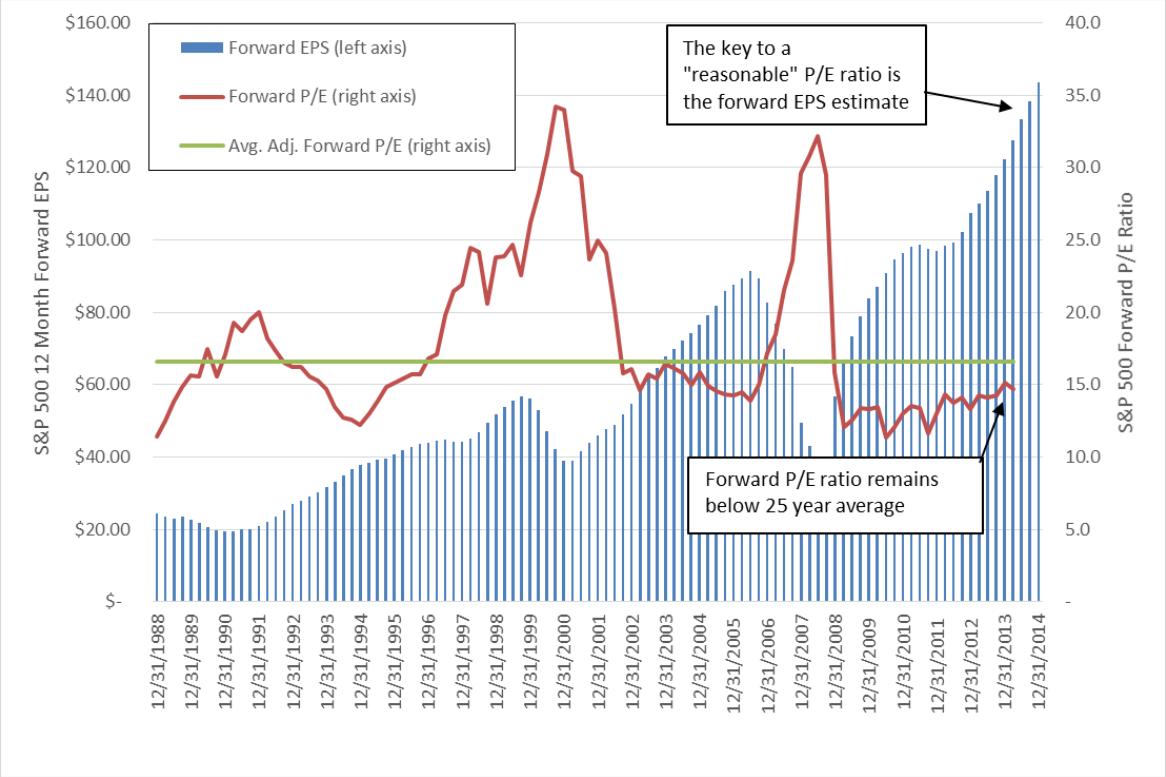
P/E Multiples Below Historical Averages, Room for Expansion

The market's current valuation on 2015 EPS is 14.1X, up +11.9% from 12.6X at this time last year. While this multiple expansion reflects increased confidence in the economy, it is still (15.0%) below our "adjusted" 25 year average of 16.6X. This suggests to us there is room for multiple expansion in 2014-2015. (We took the Jan-Dec 2000 and June 2007-Dec 2008 P/E multiples out of our calculation, as we believe those statistics are outliers).

Other Valuation Metrics In Line

Currently the market is selling for approximately 2.6X book value, 1.9% yield and 1.6X sales, all close to the historical averages. Therefore, while the markets have appreciated nicely in the prior year, it has mostly been to a normalizing of valuation ratios, rather than "over exuberant" investor interest.

Figure 12: S&P 500 Forward P/E Multiples & EPS (Actual and Estimated)



Source: S&P Indices [xiv]

International Equity Markets Poised to Play "Catch Up"

We are favoring developed international equities (+9.1% estimated total returns), as those economies will continue to benefit from the favorable economic environment of low interest rates, low commodity prices, modest labor pricing changes and improved fiscal policy management. Europe and Japan have the most to gain in the next 12-18 months.

Figure 13: Capital Market Asset Class Sub-Sector Total Return Estimates

		SWM EPS Est.		P/E Ratio		Bond Market		
	S&P 500	2014E	2015E	2014	2015	10 Year	HG Corp	HY Corp
Market Valuations (3/21/2014)	1,867	$119.09	$132.23	15.7X	14.1X	2.81%	3.19%	5.17%

		Equity			Debt		
Scenario	Probability	Int'l	Emerging	S&P 500	10 Yr	HG Corp	HY Corp
China Hard Landing & Financial Contagion	5%	-47.0%	-52.0%	-37.0%	16.7%	8.7%	-11.5%
Mild Worldwide Recession	10%	-20.6%	-25.6%	-15.6%	9.5%	4.3%	-4.9%
Tepid Growth, Europe Stable	30%	11.8%	1.8%	6.8%	0.6%	0.1%	2.4%
Earnings Come In At Estimate	50%	20.2%	20.2%	15.2%	-3.5%	-3.8%	-1.3%
Economy Gains Traction & Inflation Signs	5%	43.9%	48.9%	33.9%	-7.4%	-7.6%	-4.9%
	100%						
Wtd. Average		9.1%	7.6%	6.6%	-0.3%	-1.4%	-1.7%

Source: S&P Indices, Sapling Wealth Management[xv]

China A Wild Card For Emerging Markets

China is the only major economy in the world that the World Bank projects to decelerate in the 2014-2015 period. Part of the skepticism regarding the economy is the accuracy of the data reported. For instance last year, Chinese electrical consumption was up +5.5%, but the economy was reported to have grown +7.7%, a significant disconnect. In 2013, (see below) electrical consumption appears to have upticked to +7.5%, more in line with +7.7% projected GDP growth. However the bulk of the electrical consumption is occurring in the service sector, which is less capital (and commodity) intensive. Therefore, we believe several emerging markets are on the wrong side of this long-term secular shift away from commodities. Some countries – such as Brazil, Russia, and South Africa – that rely heavily on commodity demand will have a very tough row to hoe. Even commodity dependent developed countries, like Canada, may also have some exposure to this issue. However, other areas, such as Mexico, which are more strongly linked to industrial manufacturing and US GDP growth, look attractive. If investors shed index fund exposure – which sells all markets according to market capitalization – it will create an opportunity for active investment managers. Goldman Sachs estimates that emerging market companies are now selling for a 40% below developed markets P/E ratios, a valuation near the bottom of the historical range.

Figure 14: Chinese Economy Electricity Consumption, 2012-2013

	Trillion Kilowatt		Growth
	2013	2012	2013/2012
Industrial	3.90	3.64	7.0%
Services	0.67	0.61	10.3%
Other	0.73	0.68	7.7%
Total	5.30	4.93	7.5%

Source: Wall Street Journal [xvi]

Fixed Income Projected To Be Lackluster, or Worse

We don't think there will be much to cheer about in fixed income in 2014-2015. There will be select opportunities to enter into target markets (such as municipals) after broad sell-offs. The strongest argument going for this asset class in 2014-2015 is diversification in the case of earnings growth disappointments. In this case, higher quality credits with longer durations have value.

Risks Should Be Manageable

We believe the primary issue facing the capital markets next year will be the strength of the world economy. While there are still significant risks in the system, we do not think they will be the focus in 2014-2015.

Earnings Disappointment Risk Is Muted By Lack of Alternatives

The primary investment risk, in our view, is an earnings disappointment. However, even if earnings come in below expectations, other asset classes offer limited investment return appeal.

Mid-Term Elections In US to Focus on Solutions, Not Problems

The Republican Party has stepped away from their traditional hard line stance on debt ceilings and budget balancing to focus on the Affordable Care Act (Obamacare) as a winning issue in the 2014 mid-term elections. Confrontation on budget issues is now a losing issue for both sides of the isle.

Military Tensions Remain, But Little Appetite for Action

The Mideast process, international terrorism and exit issues from Afghanistan and Iraq will continue to dominate headlines, but are unlikely to derail the world economy. Recent annexing of Crimea by Russia will be dealt with by the EU and US with economic sanctions, but are unlikely to provoke a military conflict. Generally, we believe the world is tired of military action.

Currency Driven Economic Strategies Bear Watching

More worrisome, in our eyes, are the economic strategies that devalue local currencies to gain a competitive export edge. While small doses of this economic policy is healthy, too much is worrisome, and competitive devaluations are downright dangerous. Some export driven countries may be tempted to use this mechanism too much to resolve domestic economic issues.

Hard Landing In China Unlikely

The Chinese economy is slowing from its rapid 7.7% clip of the last few years. We believe that the country will go out of its way to maintain the growth needed to produce and maintain jobs in the country. This could take the form of additional stimulus, changing economic incentives to consumption growth (from infrastructure) or further loosening of economic restrictions. The country is well capitalized to take on this challenging transition.

Financial Shock Resistant Institutions Are In Place

The Federal Reserve recently deemed 29 of 30 of the nation's largest banks financially strong enough to withstand a severe economic downturn. Even with a major disaster somewhere else in the world, the odds of financial contagion are much lower due to the higher levels of bank capital and general regulatory awareness and preparedness.

Our Top Five Ideas

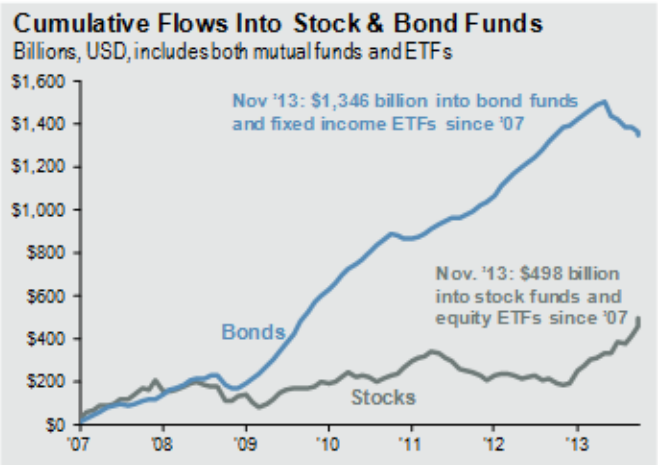
With a strong emphasis on the positive economic outlook, we are highlighting our best thematic ideas for 2014-2015.

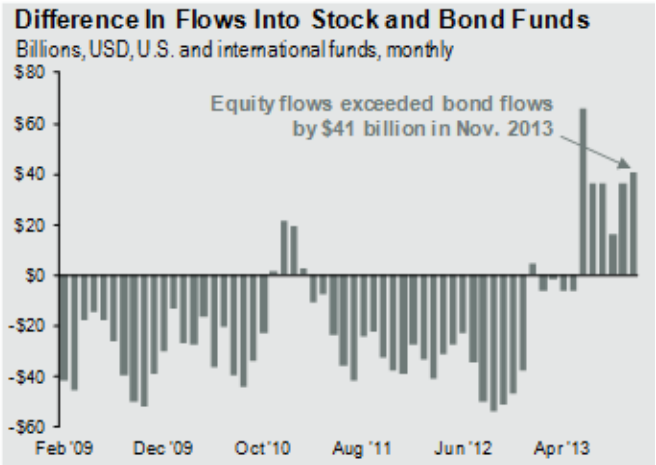
#1: Rotation From Bonds To Equities Continues

We continue to emphasize equities over fixed income investment options. Starting in 2005, investors built large cash positions, which peaked in the 2008 financial crisis. In 2009-2011, cash flowed largely into bond funds, to take advantage of higher yields and relative safety. We now believe that we are in the first innings of another large asset "reallocation" shift, this time from bonds into equities. Indeed, 2013 was the first year since 2005 where the US domestic equity mutual fund sector saw positive inflows, a statistic we find astounding. The amount of capital that could shift is so enormous that this process will likely occur over a several year period.

Figure 15: Funds Flow Analysis, by Asset Class

		Fund Flows															
Billions, USD	AUM	YTD 2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
Domestic Equity	5,026	15	(156)	(132)	(81)	(29)	(149)	(65)	(0)	18	101	120	(26)	55	261	176	149
World Equity	1,763	91	3	4	58	28	(80)	139	149	106	71	24	(3)	(22)	53	11	8
Taxable Bond	2,795	19	254	137	224	310	21	98	45	27	5	40	125	76	(36)	8	59
Tax-exempt Bond	515	(32)	50	(12)	11	69	8	11	15	5	(15)	(7)	17	11	(14)	(12)	15
Hybrid	1,126	59	46	29	29	12	(25)	41	18	37	48	38	8	9	(36)	(14)	10
Money Market	2,633	(68)	(0)	(124)	(525)	(539)	637	654	245	62	(157)	(263)	(46)	375	159	194	235



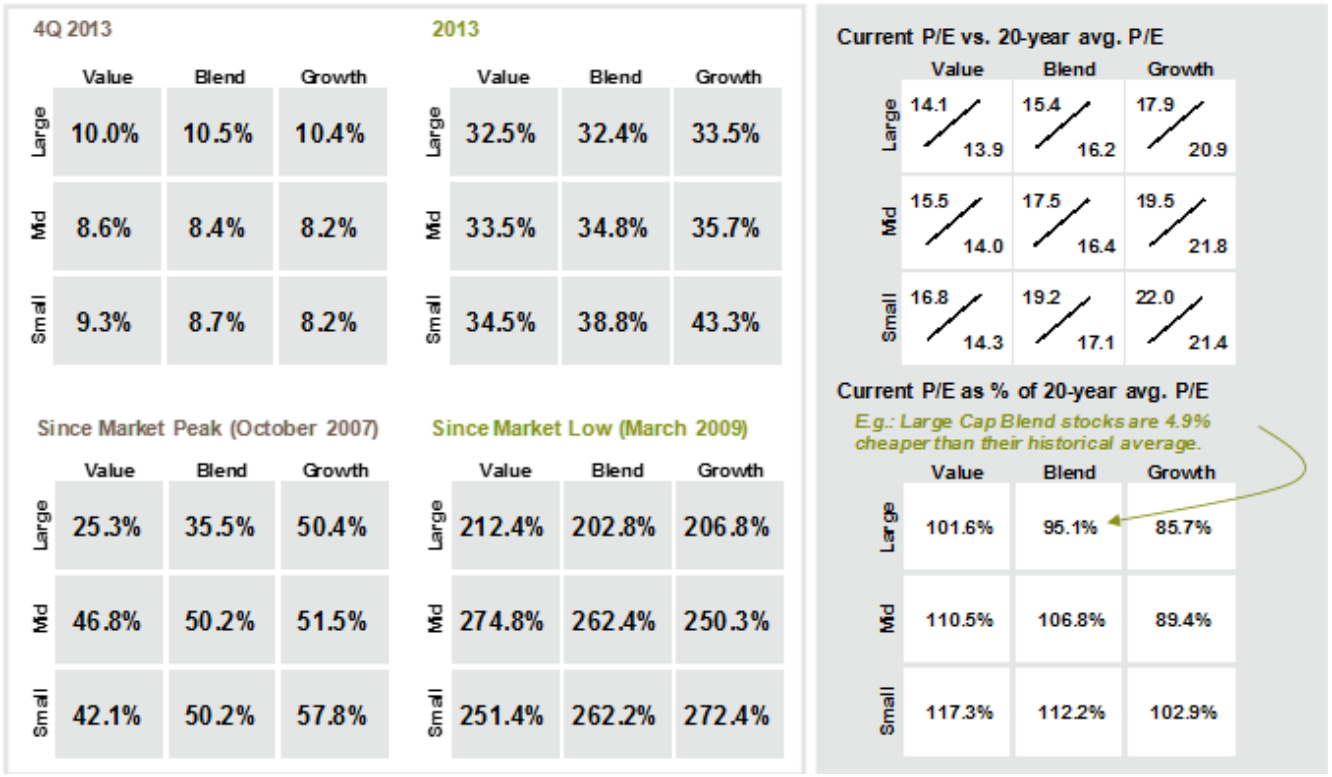


Source: JP Morgan Asset Management [xvii]

#2: Growth Companies Look Relatively Attractive

Growth companies appear to be more attractive than traditional value plays, in part due to the lack of conviction in achieving the earnings growth. We believe sales growth will accelerate in 2014-2015 and we find this area intriguing. Large and mid-cap growth stocks, which are now selling at a 10-15% discount to historical P/E multiples, have the potential for multiple expansion as well as earnings growth.

Figure 16: Valuation Of Growth Stocks Attractive

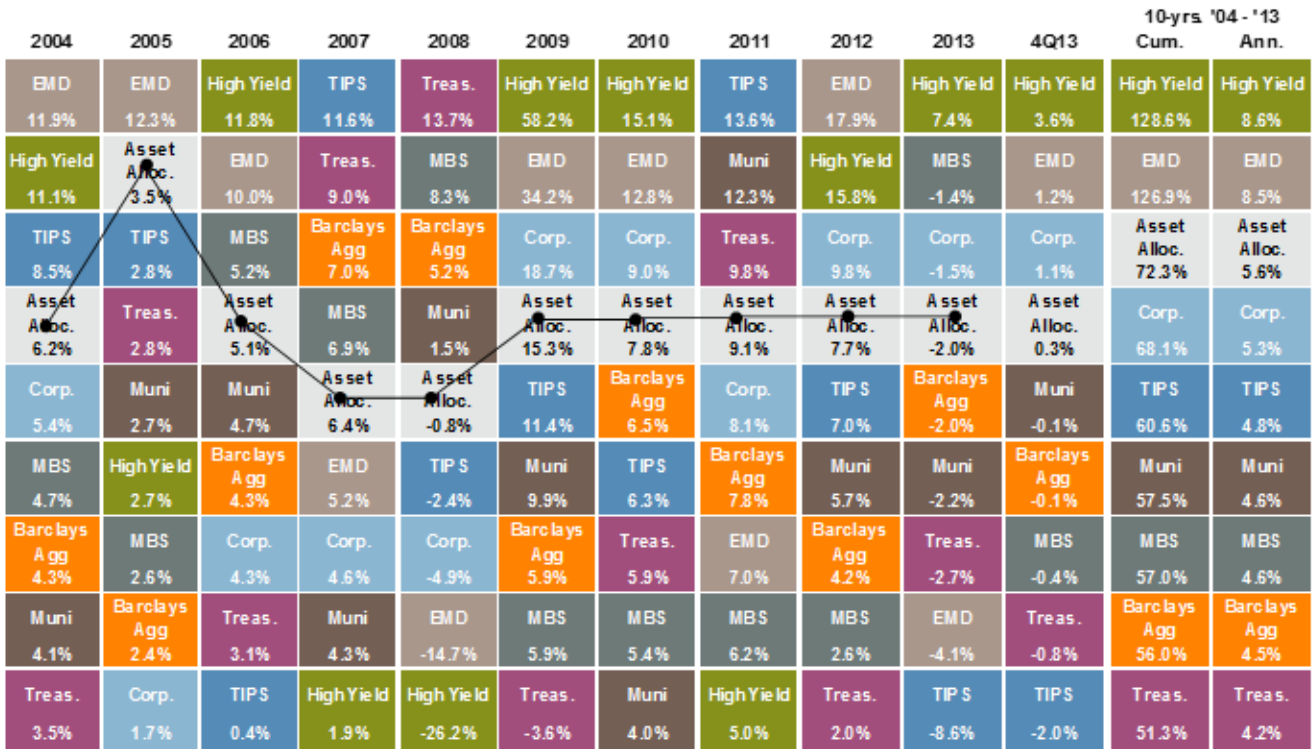


Source: JP Morgan Asset Management[xviii]

#3: Opportunistic Fixed Income Strategies May Work

While we remain cautious on fixed income, in general, we believe that there will be solid investment choices for investors that are opportunistic. For instance, many closed-end municipal bond funds declined 15-20% in 2013, as retail investors reallocated capital from fixed income to equities and realized losses for tax related reasons. This has left several closed-end funds selling at 10% discounts to net asset values and offering 6-7% tax free yield (9-10% tax effective yields). A relatively stable interest rate environment could result in 5% discount reduction + 6-7% yields = +11% total returns for investment grade credits – an appealing risk/reward in an generally unattractive asset class. Emerging market bonds are an interesting area, assuming currency issues are properly hedged.

Figure 17: Annual Fixed Income Investment Returns, by Sector

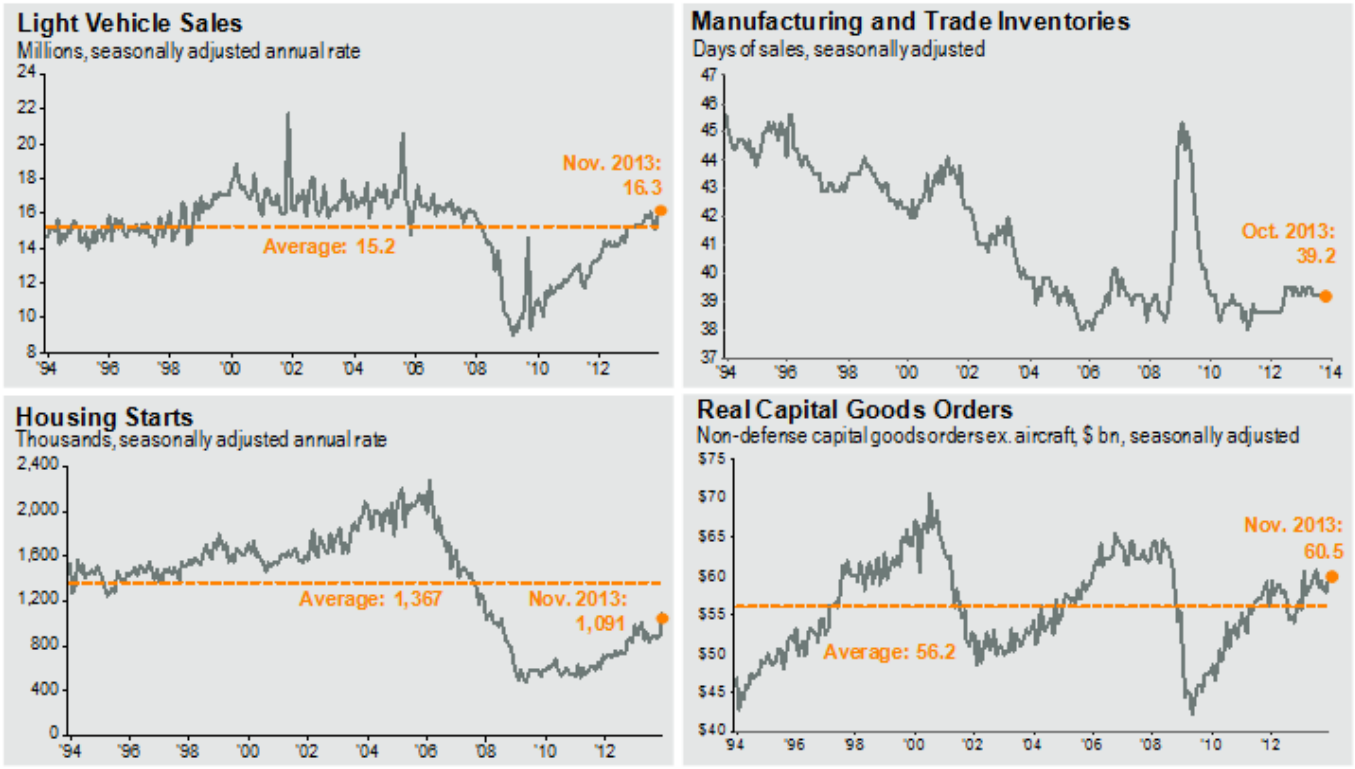


Source: JP Morgan Asset Management [xix]

#4: Cyclical Businesses Have The Wind At Their Backs

While many cyclical stocks have done very well in the last year (industrials were up +40.7% vs. S&P 500 index +32.4%), we believe there is still room to go. Light vehicle sales, housing starts and capital good orders are still playing catch up after the 2008 downdraft in demand. Slowing Chinese growth and importantly, mix of growth (from infrastructure to consumer spending) will see little pressure on commodity pricing. Decreased cost of inputs, accelerating sales and upside from potential increase in capital expenditures make this area look attractive to us. Yields in the industrial sector are 2.0%, which is higher than the 20 year average of 1.7% and market average of 1.9%. This segment, which posts a 1.2 beta, should outperform as we believe there is still too much pent up demand in this sector to ignore.

Figure 18: Business Conditions for Important Cyclical Sectors

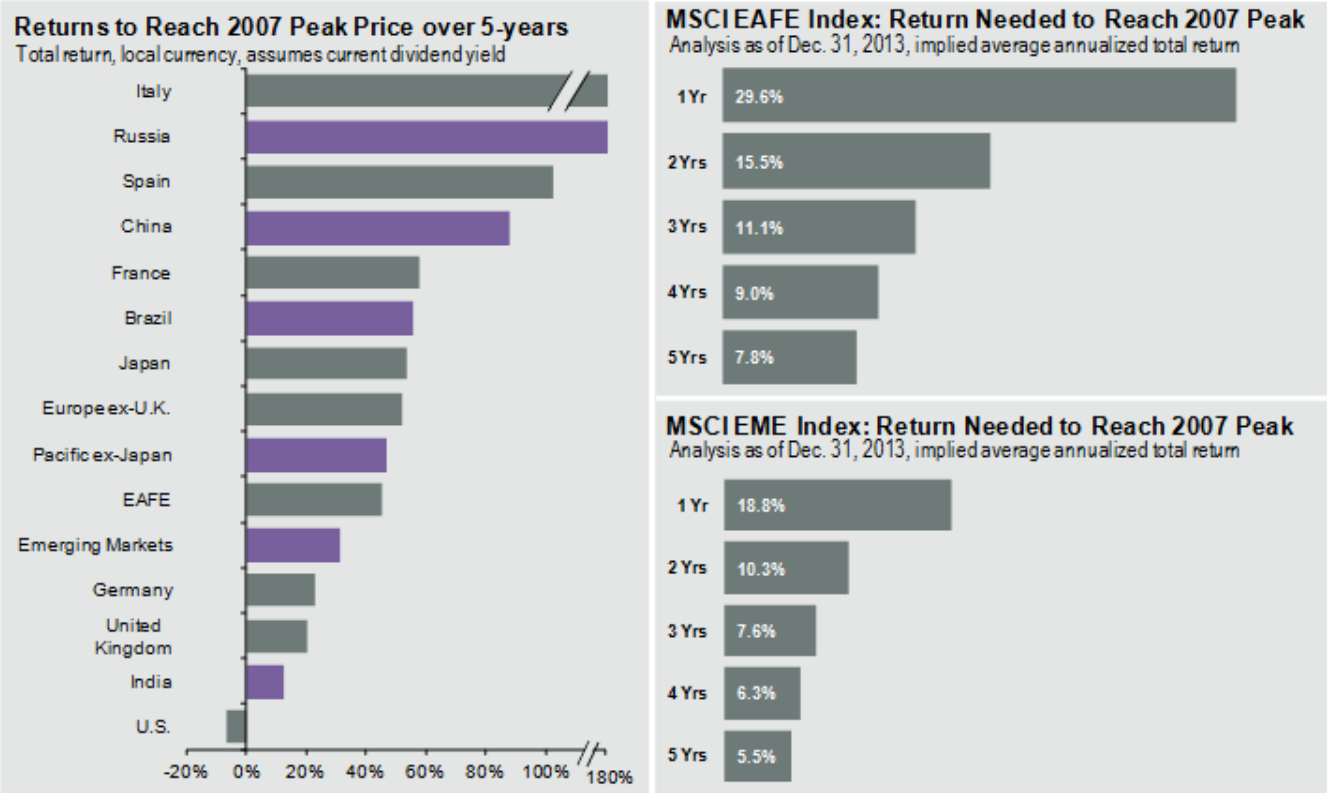


Source: JP Morgan Asset Management[xx]

#5: International Markets May Play "Catch-Up"

Many emerging and developed international markets are not even remotely close to their prior 2007 highs, whereas the US has surpassed its valuation peak. While some of these markets are still quite troubled, we believe that an expanding world economy will be a tide that lifts many of these boats. However, all boats will not float equally. Germany, Japan and the UK appear to be in better economic shape and the countries are generally better run. Italy, Spain, France and other European countries have much heavy lifting to do regarding regulatory, institutional and governance change – but they also offer very high potential. Brazil, Russia and select emerging markets dependent upon commodity demand have economic disappointment in store and should only be considered at very inexpensive valuations. Savvy money managers should be able to dart in-and-out of fundamentally attractive positions.

Figure 19: International Equity Markets Well Below 2007 Highs



Source: JP Morgan Asset Management [xxi]

ENDNOTES

[i] "EPS Estimates Bottoms Up", Sapling Wealth Management, Support 3-13-14.xlsx, (March 22, 2014).

[ii] Endnotes i & ii, ibid.

[iii] Endotes i & ii, ibid.

[iv] "Guide to the Markets: Market Insights 1Q:2014", JP Morgan Asset Management, page 9, 1Q 2014 GTM powerpoint.pptx, (January 2, 2014).

[v] Endnotes I & ii, ibid.

[vi] "The Global Outlook in Summary, 2012-2016: Table 1", The World Bank, http://www.worldbank.org/en/publication/global-economic-prospects/summary-table, GEP2014aTable1.xlsx (January 1, 2014).

[vii] Endnote ii, ibid.

[viii] Endnote v, ibid, page 13.

[ix] Endnote ii, ibid.

[x] "GDP & CP - FRED Graph Observations", Federal Reserve Economic Data, http://research.stlouisfed.org/fred2, (March 17, 2014).

[xi] "Industrial Production and Capacity Utilization – G.17", Federal Reserve, http://www.federalreserve.gov/releases/g17/current/ , (February 14, 2014).

[xii] "Producer Price Index-Commodities 12-month Percent Change – Series WPSFD4", Bureau of Labor Statistics, http://www.bls.gov/data/, (March 17th, 2014). "Employment, Hours, and Earnings from the Current Employment Statistics Survey (National), 12-Month Percent Change – CES0500000013", Bureau of Labor Statistics, http://www.bls.gov/data/, (March 17, 2014).

[xiii] Endnote i & ii, ibid.

[xiv] "S&P 500 Earnings and Estimate Report", SEP Dow Jones Indices, http://us.spindices.com/indices/equity/sp-500, sp-500-eps-est.xlsx, (March 7, 2014).

[xv] Endnote I & ii, ibid.

[xvi] "What China's Electricity Usage Says About Growth", Wall Street Journal, http://blogs.wsj.com/chinarealtime/2014/01/20/what-chinas-electricity-usage-says-about-growth/ , (January 20th, 2014).

[xvii] Endnote v, page 61, ibid.

[xviii] Endnote v, page 5, ibid.

[xix] Endnote v, page 29, ibid.

[xx] Endnote v, page 19, ibid.

[xxi] Endnote v, page 40, ibid.