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THE HEADINVEST QUARTERLY

MarketComment.

After a slight pause in April, the U.S. stock market resumed its upward march in the second quarter. Indeed, major stock markets throughout the world, with the exception of Japan, have posted solid advances so far this year. In general, the gains can be attributed to continued economic recovery, higher corporate earnings and accommodative monetary policies—the same drivers that have sustained the rally since the fall of 2011.

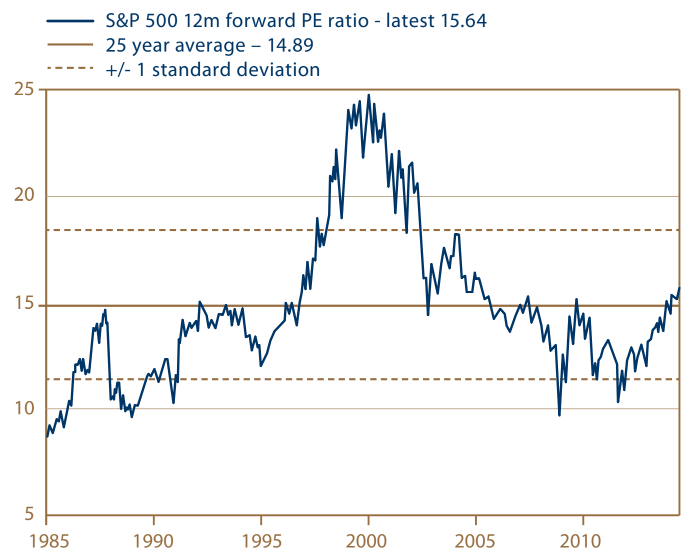
THE GAINS CAN BE ATTRIBUTED TO CONTINUED ECONOMIC RECOVERY, HIGHER CORPORATE EARNINGS AND ACCOMMODATIVE MONETARY POLICIES.

It has been almost two years since the S&P 500 suffered a decline of more than 5%, something that happens on average about 3 times a year. It has been three years since a decline of more than 10%, while such a decline averages once per year. While it would be tempting to predict a decline of either magnitude—history supports such a prediction—the same history also suggests it would be extremely difficult to be accurate with such a prediction. The prospect of a decline of either magnitude, however, should not deter long-term investors.

This market behavior has apparently drawn the interest of Fed officials. In an interview in June, the President of the NY Fed, William Dudley, said "I am a little bit nervous that people are taking too much comfort in this low-volatility period. As a consequence, they'll take more risk than is really appropriate." It is a conundrum that if the Fed succeeds in achieving financial stability—or, at least, market confidence—investors may be tempted to take too much risk, which in turn risks undermining that stability. More recently, Fed Chair Janet Yellen warned investors that valuations seem extended in certain sectors of the market, notably biotech and social media stocks. It is unprecedented for a Fed official to make such a specific statement.

If the Federal Reserve's own policies have contributed to complacency, they are now engaged in a delicate unwinding process that seeks to avoid undermining it too much. Minutes of their June 2014 meeting indicate that the Fed will end its purchases of long-term bonds by October. From Yellen's statement, it also appears the Fed has assumed responsibility for mitigating the risk of irrational exuberance—a duty that previous Fed Chairs have been unwilling to undertake. We further discuss below some of the challenges of unwinding the Fed's unprecedented policies.

S&P 500 12M FORWARD P/E RATIO



Source: *Thomson Reuters Datastream* Reuters graphic/Scott Barber 7/18/2014

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VALUATION That investors have regained confidence can be seen in the higher value now placed on each dollar of corporate earnings, as measured by the price /earnings ratio. Since late 2011, stocks have risen faster than earnings, leading to an increase in the ratio, as shown in the chart on the first page. Note that the market also advanced from 2009 to 2011 while PE ratios declined. This was the result of the extraordinarily high rate of profit growth coming out of the recession.

The chart shows that readings above the thirty-year average ratio of 14.9 have occurred, most notably during the tech bubble of 1997-2000. It would be foolish to predict another such over-heated episode, though bull markets do overshoot. Instead, it seems prudent to expect that continued advance in stock prices will be driven more by earnings growth than by further increase in the valuation of those earnings.

CORPORATE PROFITS So, let's examine the prospect for profits. In the first quarter, profit growth was about 6%. Last year, profits rose 11% and are expected to show a similar gain this year. Since 2007, profits have expanded about 30%, while GDP has risen only half that much.

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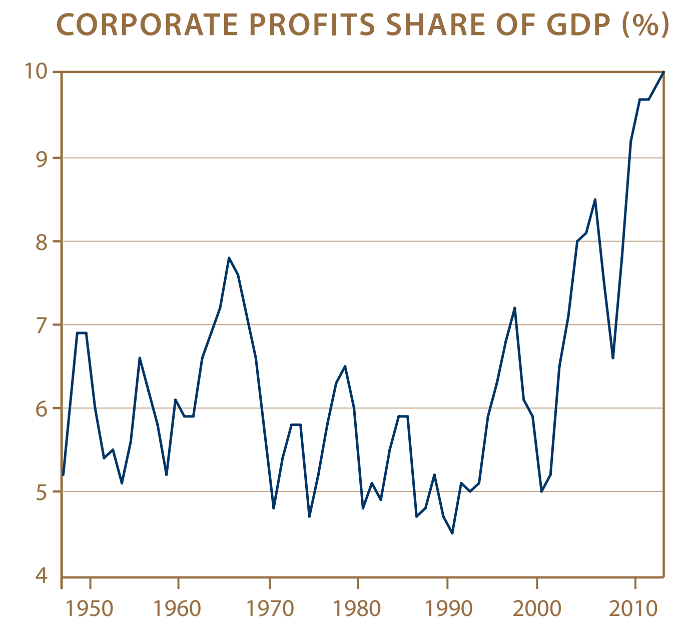
As a result, corporate profits are not only at their highest level ever in absolute terms but also as a percentage of GDP, as shown in the chart at right. Corporate profit margins have benefitted from restrained wage growth, low interest rates and lower taxes. Wage growth has been restrained by the global labor cost arbitrage enabled by information technology and by the free flow of capital. Since 2000, effective corporate tax rates have declined from 35% to 20%.

With the exception of interest rates, none of these factors is likely to reverse any time soon. The national rate of union membership has fallen to 11% from 20% thirty years ago and is only 6.5% in the private sector. The decline in unions and their power shows no sign of reversing. To reverse globalization would mean a resurgence of nationalism and trade wars. There is very little public support for tariffs, which were discredited by our negative experience with the Smoot-Hawley Tariff during the Depression. Some have cited competitive currency devaluation as a form of trade war. The intended effect is much the same as tariffs: to boost exports relative to imports. In practice, currency interventions have seldom had lasting effects. Accommodative monetary policy can have an effect on currencies, but all major currencies are currently engaged in some form of quantitative easing. So, competitive currency devaluations are unlikely to be effective or have lasting harm. And despite the decline of effective tax rates, the U.S., by taxing the global income of multinational corporations, already taxes corporations more than most other developed nations.



Source: *Federal Reserve Economic Data*

THE ECONOMY Though economic growth has been anemic compared to previous recoveries, it has been strong enough, coupled with self-help, to support corporate profit growth. There are some issues, however, that bear watching.

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Estimates of U.S. economic growth in the first quarter of the year were revised downward substantially in June. Government economists concluded that GDP contracted by nearly 3% in the quarter. This represents the worst quarterly result since the depths of the recent recession in 2009.

This decline in economic activity, though, does not seem to have affected financial markets. Why not? The most likely explanation is that unusually severe winter weather and other one-off factors were a temporary restraint on economic activity. More recent indicators of economic activity have already rebounded. The Conference Board's index of leading economic indicators showed four consecutive monthly gains through May. Employment gains have also continued, strengthening during the first quarter and accelerating since then. So far this year, the economy has added 1.4 million jobs. These reports have led most economists to conclude that growth in the second quarter will rebound to 3-4%. For the full year, the consensus is now that growth will be 2-2.5%. While this rate is lower than earlier estimates, it would mark acceleration from last year's sequester-restrained rate of 1.9%.

EMPLOYMENT GAINS HAVE ALSO CONTINUED, STRENGTHENING DURING THE FIRST QUARTER AND ACCELERATING SINCE THEN.

A growth rate of 2-2.5% is still anemic and clearly does not reach the threshold of "escape velocity" that most hope for. Neither is it assured. Among the risks cited by Fed Chair Yellen is housing. Existing home sales fell 15% or so over the winter, and some fear this was a permanent effect of higher prices and mortgage rates. Figures announced subsequently offered some comfort. Existing home sales in May rose nearly 5% to seasonally-adjusted annual rate of 4.9 million, though they are still below the level of a year ago. To put these figures in context, at their nadir in 2010, existing home sales fell to an annual rate of under 3.5 million units from over 7 million homes in 2005. But more recently, new home starts have slumped, especially in the South. Should this slump continue, it could further weaken the prospects for growth.

In Europe, the recovery lags behind that of the US. After recording growth of 0.3% in the first quarter, growth in Europe is expected to be 1.6% this year. There is a risk that full-year results will be weaker than expected, as second quarter activity in Germany appears to have slowed, not strengthened. The European Central Bank has already announced further monetary accommodation, including lower benchmark lending rates and even negative interest rates for bank deposits at the ECB. Some expect the ECB to be forced to announce even more support by year-end.

Increasing geopolitical tensions have the capacity to undermine the economy or confidence or both. Because of the inroads made by ISIS in Syria and Iraq, oil prices rose by 15% or so, though they have since backed off earlier highs. Rebel blockages in Libya have been released and Iraq has not yet suffered from production cuts. Obviously, the risk to oil prices remains.

THE FED Despite some uncertainty about the economic outlook, the Fed has announced its intention to wind down its monthly purchases of bonds by October. When former Fed Chair Ben Bernanke first broached this topic in the summer of 2013, the yield on ten-year Treasury notes promptly doubled, rising from 1.5% to 3.0% at year-end—a market reaction that was quickly termed the "taper tantrum." In contrast, the Fed's announcement this time has been greeted with yawns. The ten-year yield now stands at 2.5%, a decline in yields from last year end that most did not expect. Indeed, within the context of a stable, albeit slow economic recovery and an

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impending end to Fed purchases, the decline in interest rates must be seen as a positive surprise—one that is likely to have contributed to the continued advance of stock markets this year.

WHILE MANAGING AN EXIT FROM ITS POLICIES, THE LAST THING THE FED WOULD WANT TO DO IS TO SIGNAL AN ACTUAL INCREASE IN RATES.

While managing an exit from its policies, the last thing the Fed would want to do is to signal an actual increase in rates. To this end, they have testified to emphasize their intentions, reiterated their "forward guidance" and assured investors they will not act if the economy cannot support it. As noted above, they have also begun to "talk down" the market so as to reduce complacency without raising rates. This has helped to create an apparent consensus that rates will stay "lower for longer" than many expected a year ago.

However, the downside of extraordinary monetary policy is that both in managing it and withdrawing from it, the Fed is in uncharted territory. What if it is appropriate to tighten monetary conditions and actually raise rates? A recent uptick in inflation and in wages suggests the idea to some. If it were, the Fed may be reluctant to back off of its previous "guidance", which it had encouraged investors to rely upon, in fear of losing credibility. On the other hand, not doing so creates the risk that inflation could take root before the Fed acts, a position they have historically been loath to be in.

BECAUSE WE HAVE NOT EXPERIENCED IT BEFORE, THE IMPACT OF THE TAPER AND FUTURE FED ACTIONS TO REDUCE ITS EXTRAORDINARY ACCOMMODATION IS HIGHLY UNCERTAIN.

Because we have not experienced it before, the impact of the taper and future Fed actions to reduce its extraordinary accommodation is highly uncertain. This uncertainty is one reason many believe it might be best for the Fed not to have assumed greater responsibilities after the financial crisis. So far, investors are sanguine, but it could turn out that the most important "bubble" out there is faith that the Fed will get things right.

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