Archer 2014

Annual Outlook

By The Archer Funds

Family Values. Focused Investing.

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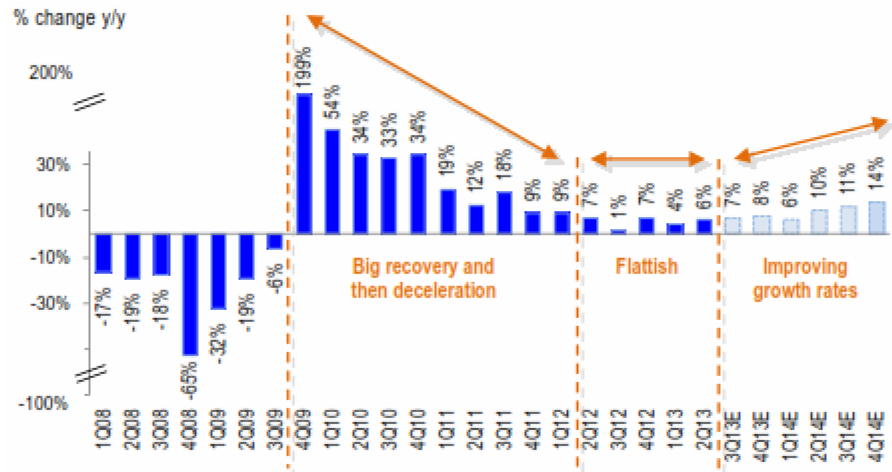
Archer 2014 Annual Outlook:

As we look back at 2013, with the market at its all-time highs, it is easy to say it was a great year. Stocks moved higher by 30%, balanced funds, just short of 20% returns. All is great in wonderland! However, as we predicted, fixed income turned in a negative return. Let's review the catalysts that are driving this market to new highs. The main reason is the stock market was relatively inexpensive compared to bonds. In fact, we have been in this camp for some time. Even today, the stock market compared to the P/E multiple of High Yield bonds is still undervalued by 10-15%. The easy monetary policy by the Fed sure helped the stock market move to new highs. In addition, the profits of companies, coupled with the stock buybacks as I will explain later is moving the market to new highs and will continue to do so in 2014. Three key themes will ring in 2014. The global macro landscape will come together to be more like-kind. This means all countries from Emerging Markets to Industrialized Nations will be working on most cylinders. We expect Europe as well to gain ground and come out of the slump they are in as they have started easing lending standards. The continued economic restructuring of Asia, China, and Japan will also help to move our markets higher as easy monetary policy finds its way outside of their borders. Lastly, according to most government agencies, inflation will remain low or in some cases be falling as price pressures in certain goods and wages find its way to keeping margins steady or above the average.

What can the market do for an encore after a year like 2013? Chances are, the stock market turns in a positive year, but surely not a repeat of 2013. If history is any guide, the stock market rarely has a repeat performance of the year like 2013, but does turn in a positive return for 2014 when stocks have climbed so quickly. We also believe this will lead to margin expansion which will add to the returns in the stock market and the High Yield P/E and the Stock Market P/E become better aligned. The way they do this is multiple expansion in the stock market, not lower rates on bonds….

Let's take a closer look at the stock market and discuss why we believe the market will turn higher in 2014. One item we talk about when managing money is what is the "reversion to the mean"? Or what is the average market look like. When looking at the averages or mean first, we have a frame of reference to find the equilibrium point of what the market should be trading at. Since 1999, the average P/E multiple (Price to Earnings, if a company earns $1 and they trade at a 15 P/E then the stock will trade at $15) is 15.3x. However, the stock market rarely looks in the rear view mirror except during downturns. If the S&P (stocks making up the S&P 500) in 2014 earns $120, then the market would trade at 1836. We think this is the fair number as the stock market looks forward to 2014. So with the S&P currently trading today at 1845, the market appears fully valued. As we turn our attention in 2014 to what may happen in the quarters following 2014 and look at 2015, we see expansion. In fact, as the first calendar quarter of 2014 transpires, we will begin looking at the earnings and see if they are moving higher and then start to replace the first quarter of 2015 with what happened in 2014. In 2014, estimates are close to the $120 mark, for 2015, they are closer to $132. This implies a market as we close out the 2014 calendar of 2019 (15.3 x $132). This would imply a 9.5% return in the stock market.

In the graph below, it appears looking at the estimates according to Bloomberg, that growth rates may pick up for the reasons we discussed earlier. In fact, there is still room to run for profits even though they are high currently.

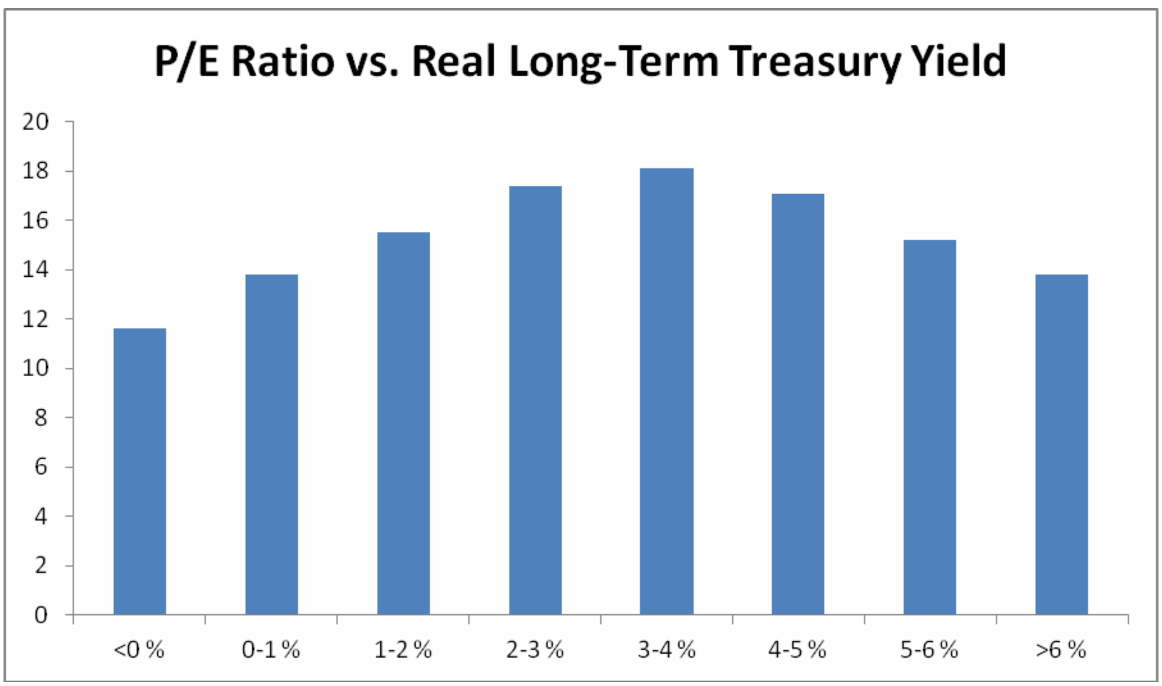


This rise or improvement in the growth rate may help us to expand the average P/E multiple. This could lead to an even greater return in 2014 beyond our estimated 9.5%. Remember the average means just that, an average. Sometimes it is larger and sometimes it is smaller. In the case of an improving profit outlook, we would argue it means a larger multiple. A simple one point move to 16.3x could imply a 2150 target on the S&P which means a 16.5% return on the S&P. We would all welcome this move.

What could derail this growth? We need to be optimistic, but realists as well. It is possible, Washington gets in the way of this growth with more detrimental wrangling of the debt ceiling and budget. We saw this over the last two years and hopefully they are beginning to learn their lesson. Second, the Fed's keeping interest rates low was the reason for higher profits and balance sheets of companies to improve dramatically. We think this helped but was not the only reason. The rise in interest rates of the ten year to near 4% will put the fork in real estate. There are other items which could play a part as well, but we think they are less likely. For instance the consumer is getting overextended, stocks and profits are actually in a bubble, etc.

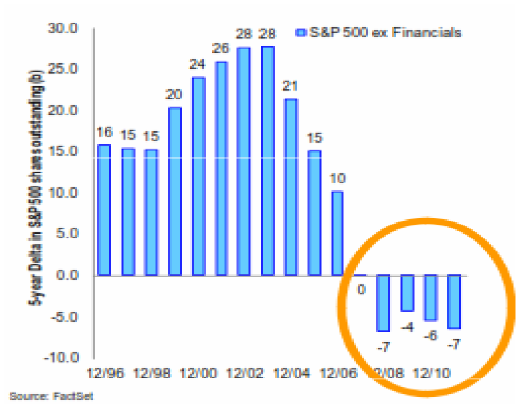
Let's address the Fed and tapering as most folks think this is bad for the economy. We know this is the consensus, but are not convinced this is actually the case. When interest rates (real interest rates measured by the difference between the 10yr Treasury less CPI) are normal or find their reversion to the mean, it implies multiple expansion as there is less interference by the powers that be, namely the Fed. The table below (the same one I have put in last year in the 2013 outlook and the 2013 mid-year outlook) tell the tale of the multiple expansion. Obviously, we do not want a rise in interest rates to the 5% level on the 10yr, but a more gradual move in interest rates higher supports the conclusion the economy can operate on its own two feet. This is how the multiple we have been discussing can move to the 16x levels.

The reason for the expansion in multiple can be seen on this graph. Yields will generally rise as the economy is doing better, thus there are less buyers of debt and more of equities.

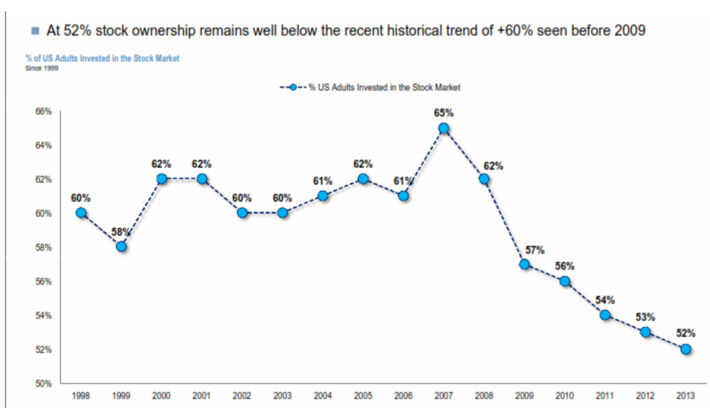


(This excerpt was posted in the last mid-year update, but still relevant) [Again, we believe the rise in interest rates in June is a bit overdone with all the selling, but remember, rates have been artificially low for quite a while and should not stay that low forever. The low rates have given corporations the ability to retool their business balance sheets and put more profits to the bottom line. This has and will translate into more hiring, more consumer spending, and (we can all hope but not hold our breath) more responsible Washington spending.]

Let's discuss buybacks. This has been one theme, we have supported for some time. Although there were many more IPO's in 2013 (Initial Public Offerings), we believe the stock buybacks are helping to push the market higher. Stock's balance sheets are amazingly strong and the corporations and boards are putting this cash to work by buying back their own stock as a way to return equity to shareholders. As you can see by the chart over the last several years, the change in shares from the average continues to decline. This tell-tale of stock buybacks says insiders believe their stocks to be inexpensive and the best use of their capital is to buy back stock. This sends a positive message to consumers, investors, and the markets in general.



Last item on the stock front to discuss is the percentage of ownership of stocks. Many baby boomers have not returned to the market since getting see-sawed in the 2000-2002 era and again in 2007-2009. Ultimately, we believe they will return as they see another tough year in the bond market and everyone wants to be in the campground that has running water and electricity (or you could say positive returns). The graph below tells the story of stock ownership and if the masses come back to the stock market, this again may push the multiple higher in the stock market.



As you can guess, we are bullish in 2014 on stocks. Let's turn our attention to the bond market. As you can imagine with a near zero return in 2013, one would expect a positive return in 2014. Not so fast.

We may once again have the same scenario in 2014 as we did in 2013. However, this time the Fed slimming down the QE will again support the rise in interest rates to a more normal level. If we speak of reversion to the mean or averages, the real rate of the 10yr Treasury, may be closer to 4% or 4.5%. This move would dictate another tough year of sledding for bond holders. If you are in the bond market, one should expect to buy and hold bonds and as they mature, you should be able to lock in higher rates than you did in 2013 and 2012. Once the bond market gets back to normalcy, it will once again be a good place to invest, but those who own a well-balanced portfolio should continue to stay shorter in duration on their bonds. With this said, the bond market can be its own animal. A signal in lower rates may lead the stock market lower if there are any hiccups in the global economy or here at home.

We will continue to keep you up to date on our posts at www.thearcherfunds.com. Remember to invest in a manner you are content with and focus on long-term investing. Although we speak about short-term gyrations in the market, it is difficult to trade the market with any kind of long-term accuracy if you are focused only on the short-term.

Regards,

The Archer Team

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