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Archer 2014 Mid Year Outlook:

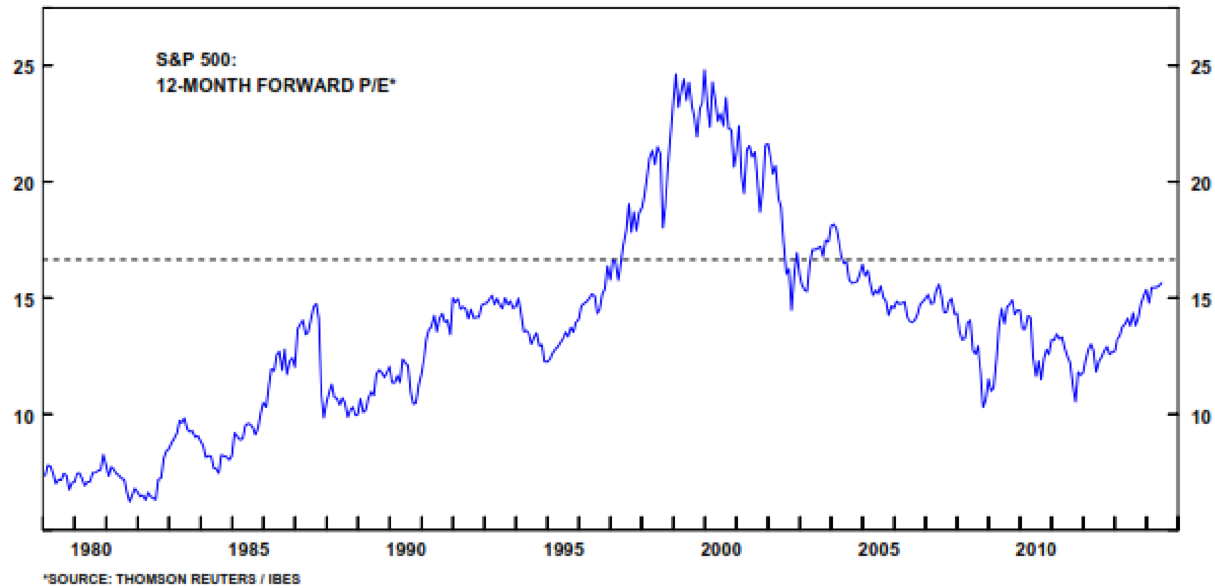
2014 is off to another rip as we are finishing the first half of the year with the S&P 500 up 7.14%, while the volatility index of the market is down 33%. Everything appears to be running on all cylinders except the GDP in the 1st Quarter of 2014. With this kind of anomaly (negative GDP) meandering in negative territory, we find it interesting the market has improved this much, this fast in a mid-term election year. Let's take a look at not only what has happened but what is in store for the remainder of 2014 and beyond.

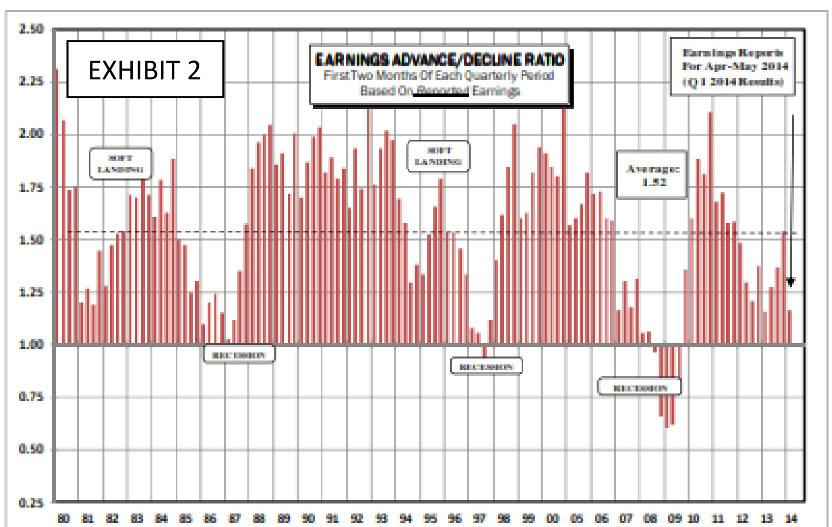
The first quarter of 2014, was setting up to be a classic mid-term election year where the old sell in May and go away until Labor Day may have worked. However, the market took a different turn. Bonds did rally only to give up some of the gains and the stock market followed in the 2nd Quarter to put the gains right back on. This happened amid concerns of an overall slowdown in the economy. Many are blaming the severe winter weather in the first quarter for this shortfall. Ultimately, the GDP revisions were negative for the first quarter showing the economy not just slowed but grinded to a halt. Although this is concerning, it has happened before without putting the economy into a recession. Time will tell if weather was to blame.

Moving forward, the stock market is still undervalued when looking at the earnings expectations for the next 12 months (SEE EXHIBIT 1). With a still easy monetary policy by the Fed and low inflation, the P/E multiples will probably remain somewhat subdued until we see some real GDP growth. (P/E is the Earnings of the stock times a multiple, for example $1 of earnings at 15x the stock would trade at $15 per share.) If the P/E multiple for the S&P 500 were to escalate to 17 times a forward multiple, the S&P would trade close to 2,050. We would see that as a sign the market is fully valued.

We believe the current multiple is a fair measure of the market. In light of the weakness of the first quarter GDP, many estimates for the S&P 500 companies were reduced to reflect this weakness. In fact, the Earnings Advance/Decline Ratio has shown a weaker than average number of companies reporting higher earnings than declining earnings. If you look at the graph (EXHIBIT 2) you can see we have seen this movie play out a few times and it often does not signal a recession, but merely we orchestrate a soft landing. It is possible the Fed would taper the taper (reduce the amount they are anticipated to reduce), or continue to buy debt for a longer period of time to keep the economy moving forward. (As most of you know our economy continues to be inflated by our government printing dollars. It used to be $80 billion a month and now it has been reduced to near half that amount. However, until it goes away completely, we will not be sure the economy can stand on its own two feet. This is why we believe the market will remain bullish through 2017.)

Exhibit 1





We have continually discussed this reversion to the mean theory and the expansion of the P/E multiple, however, we will surely not see any expansion in the P/E multiple until we see earnings move back to an average level in the Advance/Decline Earnings ratio. We would need 3 companies on average report higher earnings for every 2 reporting earnings lower. If we exceed this, it would surely be a positive sign for not just the economy but the stock market. In our view this could lead to a justified multiple expansion for the S&P 500 as well the overall stock market.

What is left in the tank for 2014? Our first estimate for 2014 was a 9.5% increase in the S&P 500. However, in the 2014 outlook we said it could rise as much as 16.5%. We are certain this latter scenario could play out if the GDP rises and erases the losses in the first quarter of this year. We would all welcome another 7-9% return in the markets for 2014.

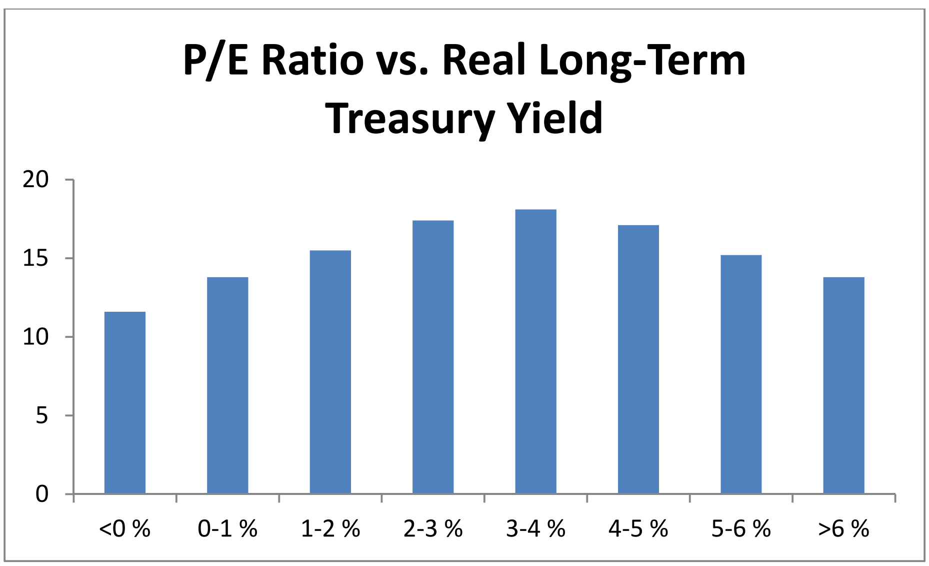
What Red Flags should we be looking for if we think the market could turn worse. I would pinpoint the following:

1. 17 times a forward multiple
2. Reversal of Manufacturing Recovery
3. Fading Employment or Negative Announcements
4. Significant Dollar Strength
5. Stalled Housing Recovery

We will be watching these attributes for any signs of economic weakness.

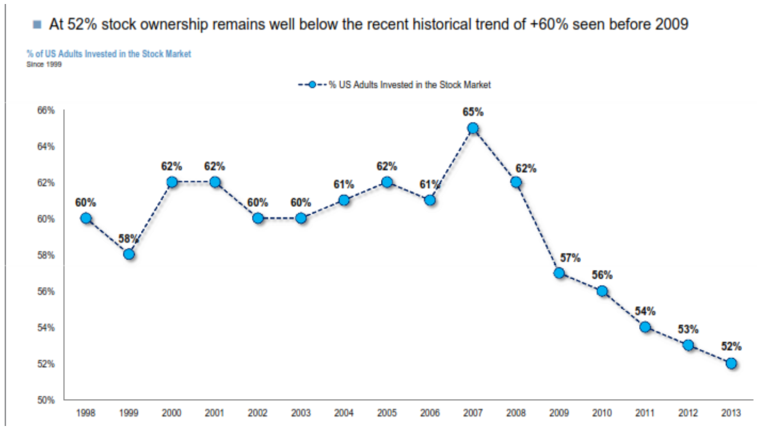
The table below (the same one I have used last year in the 2013 outlook and the 2013 mid-year outlook) tells the tale of the multiple expansion. Obviously, we do not want a rise in interest rates to the 5% level on the 10yr, but a more gradual move in interest rates higher supports the conclusion the 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.



One theme which continues to ring quite loudly is the number of corporate buybacks and dividends. The latest quarter of 2014 showed signs of huge buybacks. In fact, the number of buybacks and dividends was the largest on record. I think this is a positive sign for the stock market as executives are confident about the future of the economy and their respective companies. One company we own in a mutual fund we manage issued 50 year bonds at less than 5% interest to use $6 billion to buy back stock in the company. (Monsanto) They plan to reduce share count close to 10% overall. This is a very positive sign in our opinion.

Reprinted from 2014 Outlook…. 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.



We continue to believe equities will outperform bonds in the long-term and exposure to the stock market is a positive for most accounts. Overall we continue to believe rates will rise in the bond market. However, we believe low interest rates may continue for some time with the government intervention and a sluggish but steadily recovering economy.

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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