

The Year They Got It Right

Last year will probably be remembered as “The Year They Got It Right”. Now for the natural question, who are “They” and what is “It”. “They” are the collection of groups that participate in our global economy; governments, private sector and consumers. “It” refers to the markets and the economies of the world.

Entering 2013, there were many moving parts in the investment landscape that could have gone wrong. We still struggled with lackluster US economic growth, and the potential for Washington to devolve into some form of US debt default because of politics. Most US market participants were petrified of that, and then tapering as the year wore on. International investors were not in much better shape. Europe was still in recession, though fears of a financial meltdown were lessening. Emerging markets were also grappling with the uncertainty of a political change expected in China and challenges created from weakening demand for many commodities that other emerging markets are noted for producing.

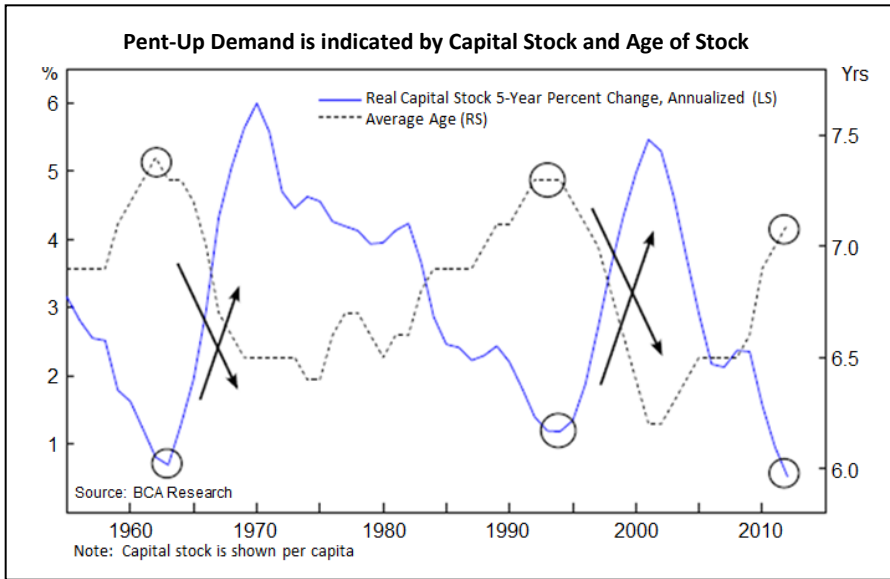
As 2013 progressed consumer spending in the US continued to grow, private investment started to pick up and investors started discounting a durable economic expansion. Trying moments did occur, like the mismanagement of the Fed’s tapering announcements and the government shutdown. In the end though, we saw a surge in job creation to end the year and economic growth that surprised to the upside. In international markets, Europe exited recession and we heard more pro-growth rhetoric out of local governments, notably Germany. Emerging Markets did as expected on the economic front, as China appears to be successfully managing their economy towards consumption growth and away from export growth.

“They” got it right, and the US market rose over 30% while EAFE gained 23% and the MSCI ACWI ex-US rose almost 16%. US bond investors suffered losses, while European bond investors benefitted. Many commodities declined during the year. Emerging Markets posted equity losses last year because many of their local short term rates increased as investors pulled back credit in anticipation of the Fed Tapering their bond purchases. As we look at it, it seems we are entering 2014 on the rocky road to “normal” times.

What does 2014 hold in store for investors? Our guess is much of the same we have seen in the past year. Importantly, market action in the US leads us to believe the market is in a secular bull phase that may carry on for years to come. Our December report entitled [“The Case for S&P 2500”](#) details this thought. It is available by clicking the link provided or by visiting our website (www.toddasset.com). We see pent up demand, contained inflation and a general absence of economic excesses in most developed markets and an emerging market middle class driving demand growth. That leads us to expect a continued self-sustaining recovery, which should translate into higher stock markets worldwide. Can markets decline from here? Sure, but it would probably take a geopolitical surprise to cause such a decline. We believe that if such an event were to occur, a US recovery to new highs would not be too far behind it. After all, last year US investors suffered a doubling in 10 year interest rates (from the bottom in July 2012), a government shutdown, and a mid-year economic slowdown. Despite that, the market still punched to new highs. We think the equity market is sending us a positive message on economic growth, and the synchronized global recovery is likely to continue.

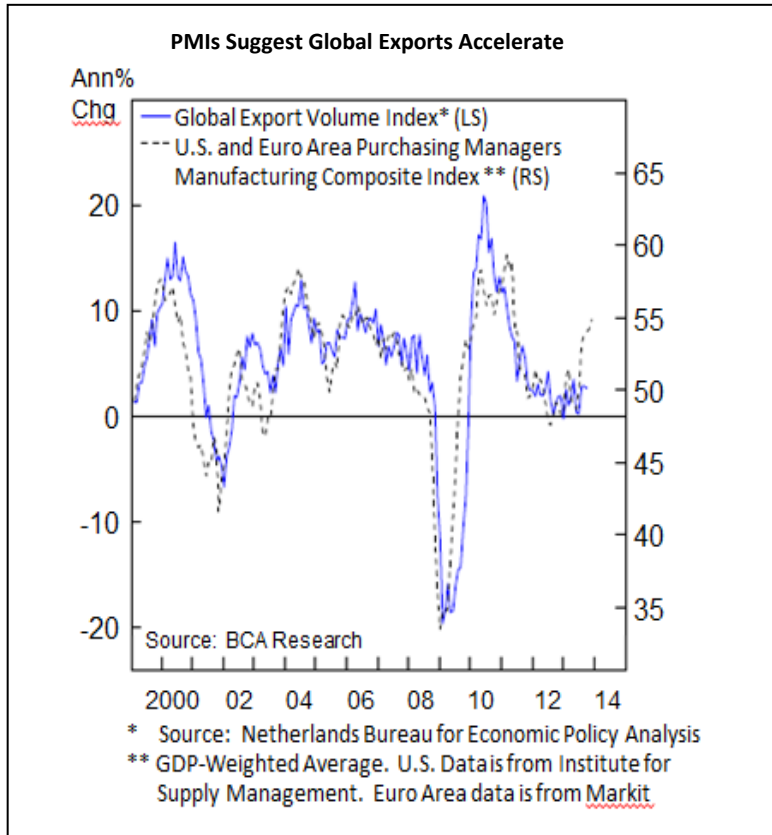
Interesting Charts We Saw During the Quarter

Capital and Consumer Spending

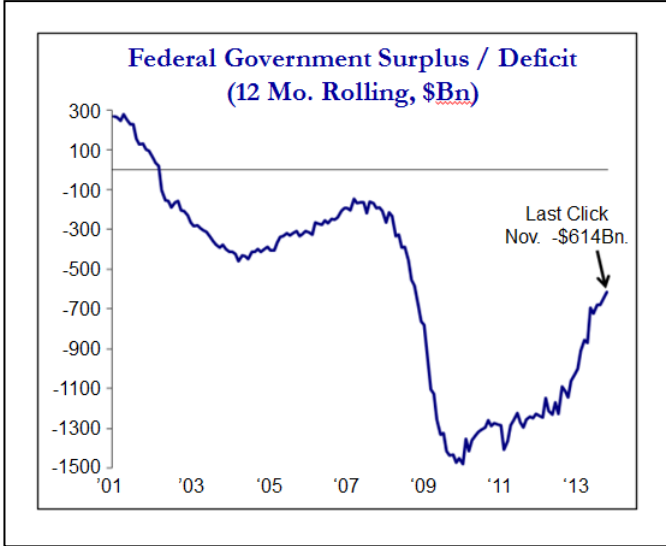


Capital spending has been lackluster since 2000 in the aftermath of the overspending of the late 1990s as can be seen in the chart to the left. With both the underinvestment in capital stock and the average age of plant and equipment being at extremes only seen twice since the 1950's, we expect a pickup in capital spending to unfold.

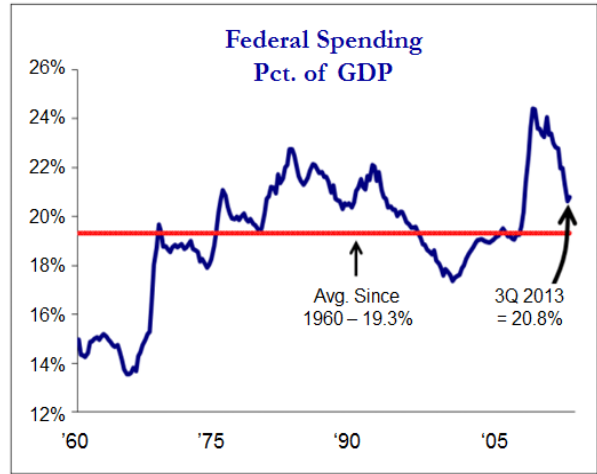
Purchasing Manager Index surveys (PMIs) indicate that production growth is occurring. Global export growth is somewhat depressed. PMI's generally lead export growth by a quarter or two, so trade between nations should pick up over the near term if this relationship holds true. We would expect this to lead to better visibility for manufacturers, which should lead to a reversal of the capital spending weakness we noted above.



The US Government Spending is Being Reined In

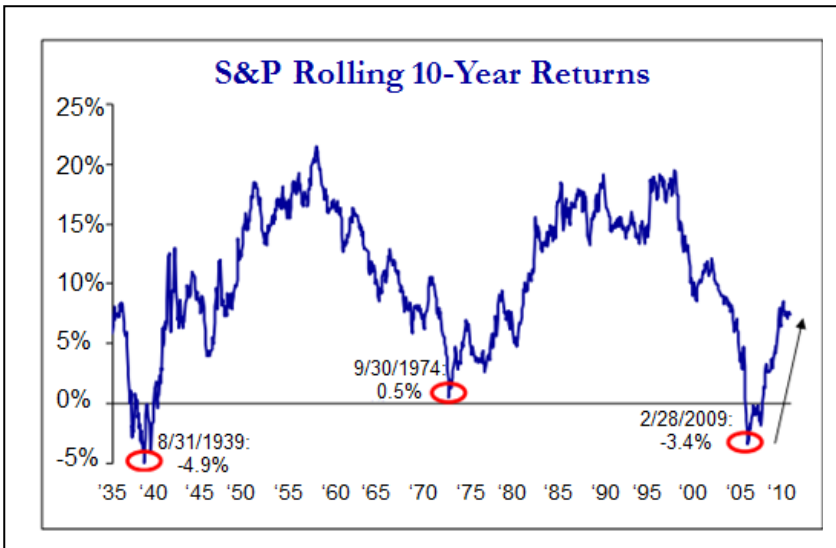


Source: Strategas



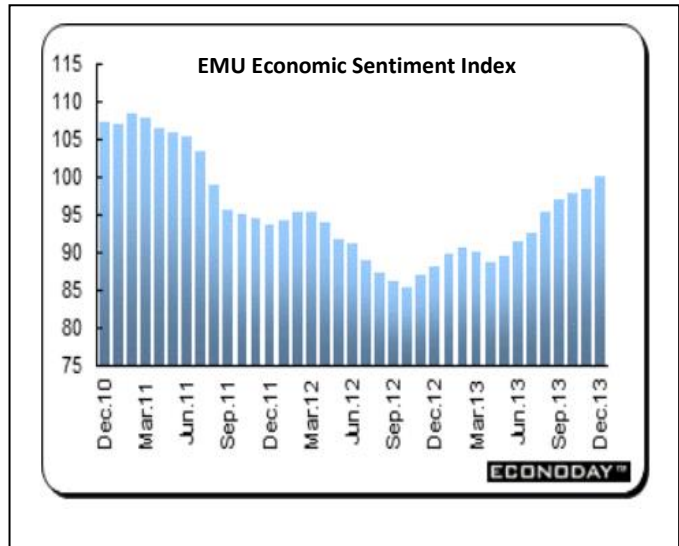
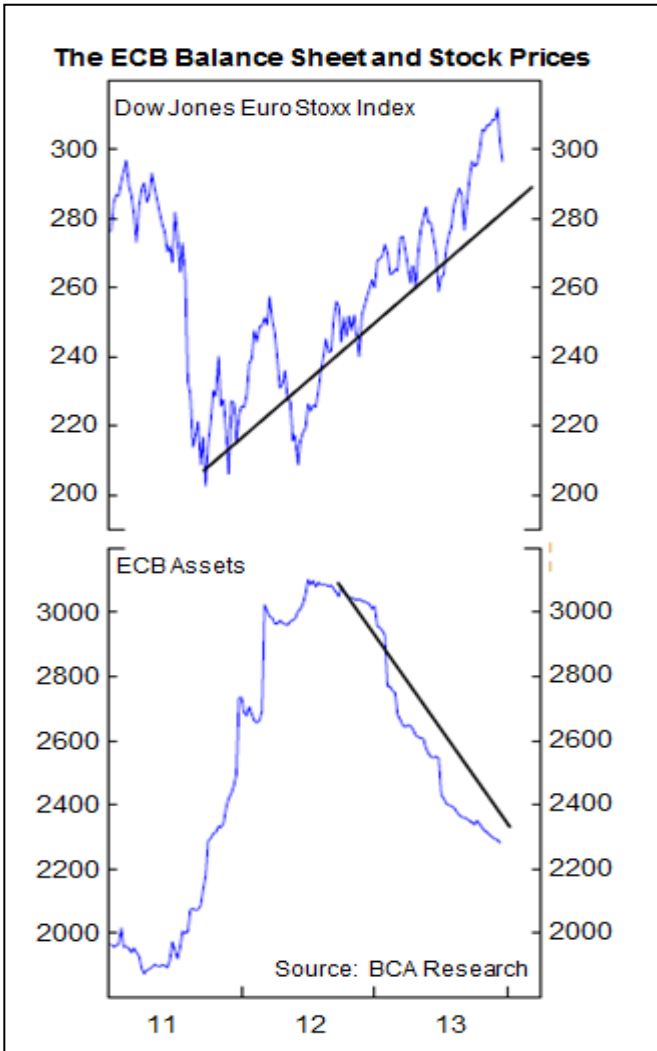
Source: Strategas

Everybody loves to hate the government, but if you take a harder look at the numbers some encouraging trends are in place. The two charts above illustrate the government deficit and the amount of federal spending as a percent of GDP. Trends in each of these suggest that since the extraordinary actions of 2010, government spending is declining as a percent of GDP and the deficit is working its way back towards a more normal level. The spending sequester, higher payroll taxes and expiration of some of the fiscal stimulus programs have gotten us to this point. If the economy accelerates over the next few years, further improvement is likely.



Source: Strategas

Equity markets have healed and are probably in position to continue advancing for some time to come as indicated by the recovery in the trailing ten year returns for the S&P. History suggests this cycle has a decade or more further to run, and trailing ten year returns should advance to over 15% over that time frame. Look for our December report [“The Case for S&P 2500”](#) for more on this theory. It is available by clicking the link provided or by visiting our website (www.toddasset.com).



The European Equity Markets have moved significantly higher despite the reduction in the size of the European Central Banks balance sheets, as illustrated by the chart to the left. Tracing sentiment back to 2012 in the chart above, we can see that the upswing in sentiment coincided with the downsizing of the balance sheet. This illustrates that economic sentiment can drive markets higher even if central banks are not buying bonds. This could be a pre-cursor to what we should expect from the Fed's tapering of bond purchases.

As always, we are here to serve you. If you would like any additional information on any of these trends, please feel free to call us.

Jack White, CFA
Todd Asset Management LLC

Curt Scott, CFA

Jack Holden, CFA

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