CAUBLE & HARRE WEALTH MANAGEMENT

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January 2, 2014

Happy New Year! As I begin to write this note on January 2, I wonder if I should discuss the impressive markets of 2013, or if I should discuss that fact that the first trading day of this year is the worst since 2008? The two subjects would result in quite different tones. 2013 was impressive, both on the positive and the negative. With this note, I will try to put 2013 in context, describe where the markets are now, and where we might head as 2014 continues.

In the fourth quarter alone, the S&P500 index appreciated 9.9% excluding dividends. That is a good average year. Not all assets appreciated during the year. Barclays Long-Term Treasury Index was down 12.7%, Gold and Silver were down 28.6% and 36.6% respectively. Barclays Intermediate Term Treasury Index fell 1.34% and the Barclays Municipal Bond Index was down 2.55%. Bonds and Gold were not pleasant places to be during 2013.

The equity markets performed better, but not across the board. Emerging Markets were challenged. Morningstar's Diversified Emerging Markets benchmark fell 3.25%. Developed International Markets fared better with a 22.8% gain (MSCI EAFE), but the crown belonged to the domestic equity market putting in gains of 32.4% as measured by the S&P500. Dividend stocks lagged the broader market.

Stock market gains are a function of earnings gains and the Price/Earnings multiple, or how much the market is willing to pay for $1 in earnings. If you know where these two variables are headed (the earnings and the multiple) you will know precisely where the markets are headed.

Back in 2011, the stock market was close to flat. The P/E of the market that year declined by about 13%, but corporate operating earnings (per share) increased about 13%. The result was a flat market despite earnings gains. This is the year that gold peaked along with inflation expectations. While the economy began to gain some traction, inflation concerns stemming from Federal Reserve actions and continued high levels of government spending were supporting gold prices in addition to causing some angst. This is also the year that the U.S. debt was downgraded.

Earnings growth stalled in 2012, increasing only slightly. However, as the concerns over immediate inflation fell during 2012, the P/E began to expand. During 2012, the P/E increased about 13% and operating earnings increased only slightly. The S&P500 increased 16% that year.

2013 was a year that saw both earnings increases and a P/E multiple expansion. The P/E multiple increased about 17% and earnings per share increased about 11%. Along with dividends, this resulted in returns over 30%. One question is whether the P/E ratio is sustainable at current levels? I think at best, it will remain flat. Continued gains in the equity markets will be reliant on continued earnings gains from corporations. I do think this is likely.

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Note that if the P/E declines this year, in order for equity market returns to be positive, operating earnings per share will have to increase more. Is the economy strong enough to accomplish this? I think that it is.

Our economy is made up of individuals, corporations and the government. Individuals are in better financial shape than they have been for years. Progress has been slow, and there needs to be more, but they continue to contribute to higher levels of spending and have decreased their debt. Household Net Worth is hitting new highs.

Corporations are also in good shape. They have the capacity to spend more on investment, and I believe they will do so this year. The Institute for Supply Management's monthly index averaged 51.5 for the first half of 2013 (a level over 50 suggests expansion). During the last half of 2013 the index averaged 56.3.

The sequester last year in Government spending did negatively impact Gross Domestic Product (economic growth), but this will not be a negative this year. In summary, these three levers of economic growth will be neutral to positive. GDP growth should be higher this year than last. I think that higher earnings expectations are reasonable.

Of course, there are risk factors. Will enough people be subject to higher medical costs to actually impact consumer spending? Will the Federal Reserve's reduction in asset purchases continue to go smoothly under a new Chairman? This is a process that has never been tried before. A screw up here could materially reduce the P/E of the market. Will Iran, North Korea and China behave? Will the growing claims of economic inequality result in policies that will harm us all?

Later this month, our plan is to send out a more detailed performance report covering longer periods of time. We will also include a discussion of the current investment policy being implemented for your relationship. Please call with any questions.

Sincerely,

Peter B. Harre, CFA