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Jan. 17, 2014

OBSERVATIONS ON THE MARKET

No. 271

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The market finished 2013 at an all time high, and recorded a 31% gain. If you were told that earnings would advance by 9% for the year, the odds that anybody would predict the market advancing by 30% is probably close to 0. However, we live in a world where not everything is rational. The *Wall Street Journal* ran a story on January 2nd titled: Flipping the Coin on the Value of Stocks. It sort of implied that you are wasting your time listening to any short-term prediction. Since we are all hard wired to try and predict the future, even though we can't, here is a prediction for 2014.

First, it is always good to score last year's results. There were three predictions last year, with a self-graded result. 1) "This leaves us set up to at least hit new highs this year, another 5% in addition to the 5% the first three weeks of January has already given us." A 10% gain vs. the market's actual 31% is a C+ since the direction was right and the number of digits was correct. 2) "It is really ditto for the emerging equity markets also." Oops, they lagged horribly last year, down 5% for the year: D-. 3) "The best approach now is to shorten maturities and just resign yourself that there is a time to make money, and a time to protect you capital. This is the latter." The 10-year Treasury bond was down 7%: A. So goes the world of fortune telling.

If you are going to attempt to predict the future, it is good to study the past. Examining the returns of the last 90 years reveals that the S&P 500 has achieved a compounded return of 9.3% per year. This correlates with corporate earnings growing by 6%, plus a dividend yield of 3%. An interesting observation is that in those 90 years, the market produced a return that fell in the range of 8.3% to 10.3% one time. If you expand the range by plus or minus 2% (7.3% to 11.3%), the stock market had four results in this range. This seems to suggest two outcomes: 1) The market is not a rational being, it is emotional, 2) Don't guess the norm, guess high or low. This leaves us with another interesting observation; most gurus are predicting a 10% return for this year. Proof they don't know anything. (Hopefully you missed the fact that I picked 10% last year)

This year analysts are estimating that earnings will grow by 13%, leaving the market trading at a projected P/E of 15. If we assume that the economy is picking up a little momentum, 13% earnings growth seems reasonable. Knowing that returns tend to over or under shoot what the economy and earnings are doing, I am picking 7% for this year's market performance. The 10-year treasury will have another negative year, but not quite as bad as last year, it will finish 2014 down 2%.

To paraphrase Chris Davis: *There is no predictive value in short-term forecasts, but everyone wants one anyway. I really can't tell where the price will be tomorrow, but I can tell you where I perceive there is value today.* The value is in emerging markets. They are trading at valuations that are around 10 times earnings, this 50% cheaper than the US market. They lagged the S&P 500 by 35% last year, and history proves that they play catch-up at some point. However, history also shows they can lag another year or two. You must realize that you cannot predict the short-term, but if you want to make a lot of money, being early is the price you pay.