MIRACLE MILE ADVISORS

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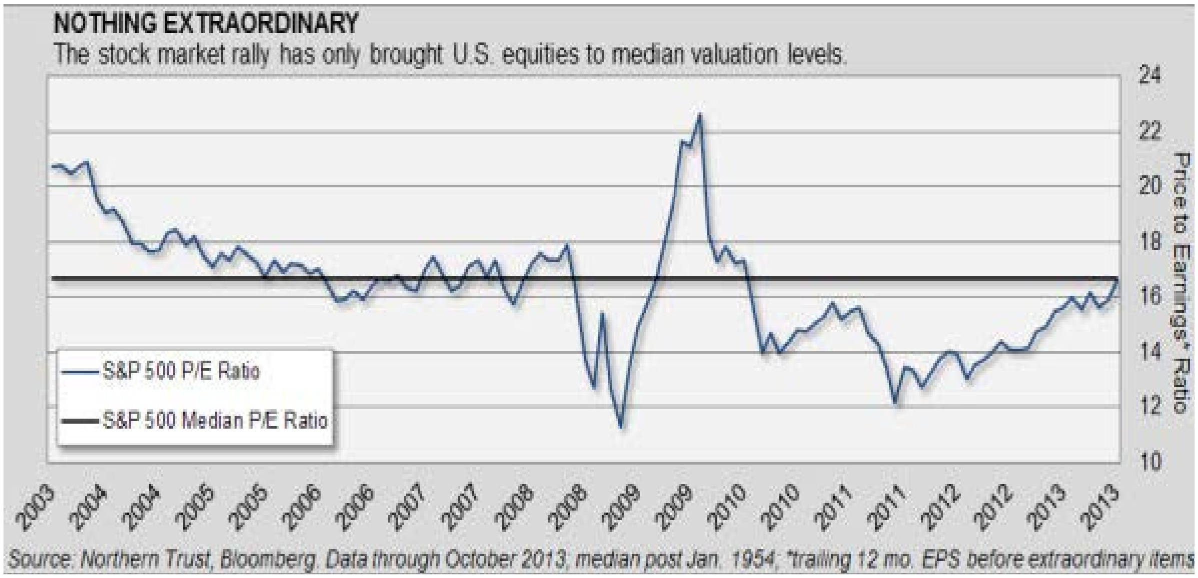
THE EQUITIES RALLY, DOES IT STILL HAVE LEGS?

Over the last several months, the investment community has written extensively about the effects of rising interest rates on the value of bond portfolios. In the face of limitless Fed tapering talk and moments of interest rate spikes, most investors understand that a rising interest rate environment can and will damper returns on traditional fixed income investments. However, what many investors do not understand is the ultimate effect of rising interest rates on equities. In this research report, we take a closer look at the historical performance of equities in rising interest rate environments and we present the historical framework for continued strength in equities in 2014.

Can stocks rally in the face of rising rates?

The simple answer is yes. Contrary to the limitless pundits touting an overvalued US equity market, history seems to paint a slightly different valuation picture. ***Currently at 15.9x 2013 earnings, we are seeing the US equity market trading at relatively fair valuation levels (see chart below).*** While in the past, markets trading at fair valuations with subdued earnings strength would present pause, we believe that today's improving economic data (see key economic indicators below) is building momentum for companies to experience stronger earnings. Improved earnings would justify both higher stock market prices and higher multiples.



Key Economic Indicators:

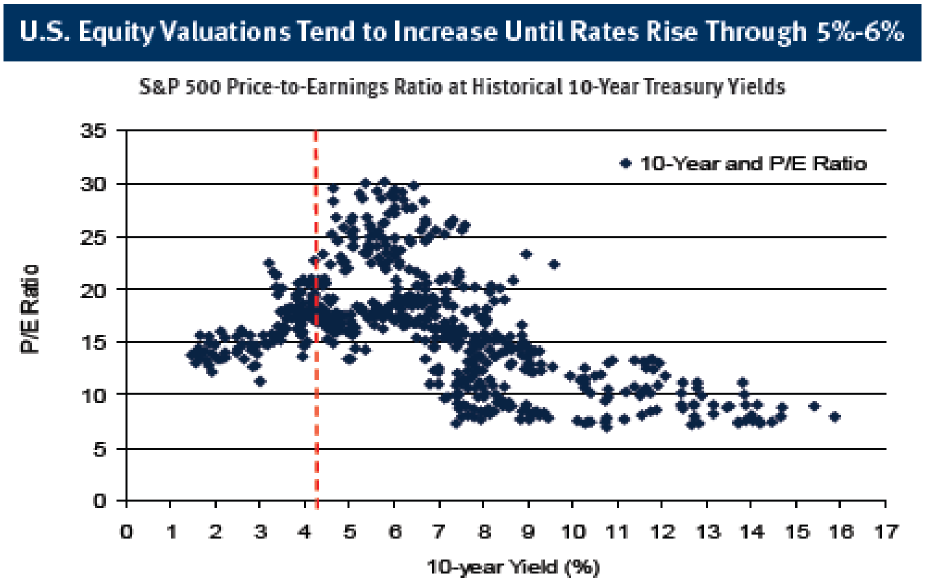
- November: Jobs growth of 203,000; unemployment rate dropped from 7.3% to 7.0%
- ISM Manufacturing Index increased to 57.3 in November, easily beating consensus of 55.2
- This ISM number is consistent with real annual GDP growth of 4.7% - In 2014, growth won't be anywhere near that pace, but should be stronger
- University of Michigan preliminary reading on consumer sentiment came in at 82.5 in December, which is up from a final reading of 75.1 in November; the consensus was for a reading of 76

Rising Rates and the Fed Taper

Interest rates surged in May when Fed Chairman Bernanke indicated that the Fed might begin tapering its bond buying program sometime in the fall. Although the tapering never materialized, the sudden spike in yields clearly spooked bondholders and equity holders alike. Rates have steadily come back down in recent months, but the bias towards higher rates in the coming months or even years has been established.

So, the central question that investors need to answer is at what point do higher rates truly effect equity valuations?

Historically, equity valuations have increased until interest rates (on 10-Year Treasury notes) rise to between 5% and 6%. While the Fed might taper within the next few months, the Fed Funds Rate (25 basis points) is not expected to increase until late 2015. Janet Yellen's nomination has only served to further embolden investors' view that she will continue on a similar path as Bernanke. The chart below shows that when the 10-Year Treasury trades between 3%-4% (a strong possibility in 2014), the S&P 500 P/E has typically stood between 15-20x. Given that we are at the lower end of that multiple range, we can conclude that there is room for multiple expansions as rates continue to rise.



Source - RBC Wealth Management, Bloomberg; data from January 1962 to September 2013.

The Fed taper has been a topic of hot debate over the last several months, especially because its announcement has the potential to trigger a pullback. The increased talk of a tapering at the upcoming Fed meeting drove the market down over 2% in the past couple of weeks. As we have said before, market pullbacks can be healthy for equities and can create a technical base for higher highs. If you examine this year's S&P 500 performance, a step-up pattern of small corrections consistently followed by higher highs in subsequent trading months is visible. Although many analysts have been calling for a correction (defined as a downward move of more than 10%) in the markets for some time, the fact remains that we have not seen one in over 500 days. This only intensifies the expectation of a correction in coming days or months and provides a contrarian backdrop for the equity markets to continue to climb a wall of worry.

This brings us to our next important question - Will the tapering of QE be the catalyst for the expected correction? While we believe that the announcement could create a pullback, we are not convinced that this news would necessarily lead to a correction. More importantly, we believe that there are a lot of misperceptions about QE and that QE itself is not as important as many investors may think***. Limiting QE is a signal of the Fed's commitment to keep short-term rates near zero; however, it is not a direct driver of rates.*** We saw market forces take hold in May when Bernanke first mentioned tapering. However, interest rates are low because of the low Fed funds rate policy, not because of QE. It is equally important to note that despite the trillions in Fed Treasury debt purchases driven by QE policies, the share of Treasury debt held by the Federal Reserve is not out of line with history. *The Fed has not cornered the Treasury market by any means and currently owns 18% of marketable Treasury debt.* The most recent peak was 20% in 2002.

How Have Markets Performed in Years following 20% returns?

Markets have historically performed well following years of 20%+ returns. 2013 is the first time the S&P 500 has managed to go an entire year without breaching the 200-day moving average. Since 1975, the average annual return following a 20%+ return is 12.8%. The last year the market had a negative year following a 20%+ return was in 1989, when the market went down 6.6%.

The historical returns of the S&P 500 indicate that there is a greater likelihood of next year being positive versus negative. If you go back even farther, in the last 85 years there have been 31 years of returns greater than 20% and in 22 of those instances, the following year showed a positive return. We do not expect the US Equity market to be nearly as strong as it was this past year, however a higher single-digit return or a lower double-digit return is certainly a good possibility.

S&P 500 Since 1975

	After a Year of 20% +	Other Years
No. of Years	11	27
Average Return	12.84%	8.10%
Median Return	14.62%	12.31%
Percent Positive	82%	74%

S&P 500 Up 20%+ & Following Year

Year	Return	Next Year Return
1975	31.5%	19.1%
1980	25.8%	-9.7%
1985	26.3%	14.6%
1989	27.3%	-6.6%
1991	26.3%	4.5%
1995	34.1%	20.3%
1996	20.3%	31.0%
1997	31.0%	26.7%
1998	26.7%	19.5%
2003	26.4%	9.0%
2009	23.5%	12.8%
2013	**25.4%**	**?**

What to Invest in in 2014

- **Stay the course and remained allocated to US Equities**
- **Remain overweight Developed International Equities (specifically Europe and Japan)**
- **Look for beaten down asset classes that still have an attractive value (pockets within emerging markets and frontier markets)**
- **Remain underweight to core fixed income**
- **Remain overweight to opportunistic yield (Bank/Floating rate Loans, Short term high yield, MLP's)**
- **Remain underweight commodities as inflationary pressures are not present**

2013 has been a challenge for a well-diversified investor who is allocated to a variety of asset classes. However, by no means should one abandon the strategy of being broadly diversified. While there are clearly bumps ahead in the road, such as the debt ceiling debates in the spring, smart beta ETFs, such as USMV (MSCI USA Minimum Volatility Index), will help dampen the rough patches when we hit them.

On the bright side, 2014 is a congressional election year so the House and Senate members have more incentive to resolve issues swiftly so they can focus on the campaign trail. In the last week we have seen a fractious Congress compromise to pass a 2-year budget plan - a clear sign that they recognize the importance of altering their dismal public perception heading into the election year.

Beyond the obvious political risks, there remain a number of potential economic risks that could also serve as headwinds to growth. Most importantly, we are continuously watching for signs of slowing GDP growth, decelerating earnings growth, or long term rates rising faster than anticipated - any of which could create significant problems in the housing market and mortgage markets. Managing risk is more important than ever, and being nimble and tactical allows us to avoid large drawdowns and be able to deliver consistent results. The landscape has shifted and what was thought to be your "sleep well at night money" (fixed income) is no longer. In a year when the Barclays Aggregate Bond Index (AGG) posted its first yearly loss since 2000 (down -2.15%), we are spending a considerable amount of time managing duration risk and credit quality risk in order to avoid potential losses and secure solid income.

Given the historical framework presented, we feel that the current rally has the potential for further strength in 2014. As we review the fundamentals, we think next year can be another solid one for equity returns. Other asset classes such as fixed income will continue to struggle as sensitivity to interest rates remain a concern. We will continue to actively manage clients' portfolios to balance return goals with appropriate risk profiles.

As we close out the year, we wish all of our readers and their families a healthy and happy holiday season!

Best regards,

The Miracle Mile Advisors Team

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