TODD
ASSET MANAGEMENT LLC

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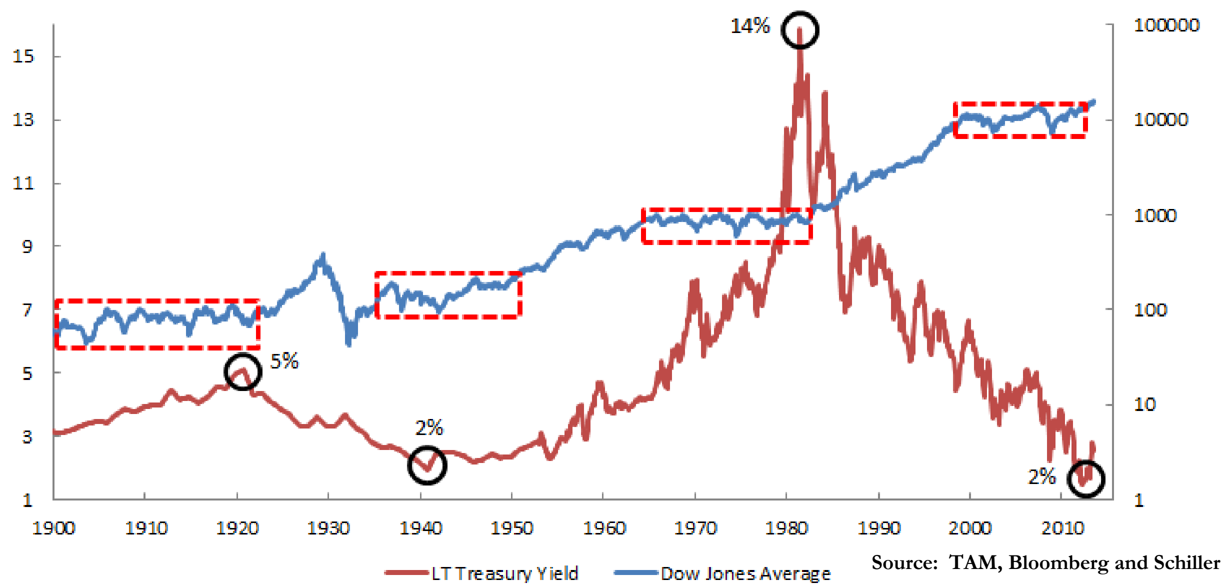
The Case for S&P 2500

This current bull market run remains the most hated rally we've ever seen. Our meetings with consultants and observations from the media confirm this. In July 2009, at 900 on the S&P, our quarterly letter stated "over the next several years, we could reasonably expect a move back towards 1400 or more on the S&P 500." In October 2009 at 1069 on the S&P, our quarterly letter stated "We think over the course of the next several years, it could move back towards the 2007 highs of 1550 or so." With those targets surpassed, we want to point out that the odds are the market is in a secular bull trend and the longer term direction of the market has shifted from sideways to upward with the recent breakout. Most market participants are not positioned for such a move, which makes it even more likely in our opinion.

Something extraordinary just happened, and most market participants have missed it. It's never happened in my investing career and has only happened once in the past 50 years. It has nothing to do with the government shutdown, wrangling in Washington or the gloomy predictions you hear from the TV pundits. The market decisively broke out of a 14 year trading range! That's big news, because we think the market may be forecasting a better decade to come, as has occurred after other breakouts like this. The chart below notes the four periods since 1900 where stocks traded sideways for extended periods.

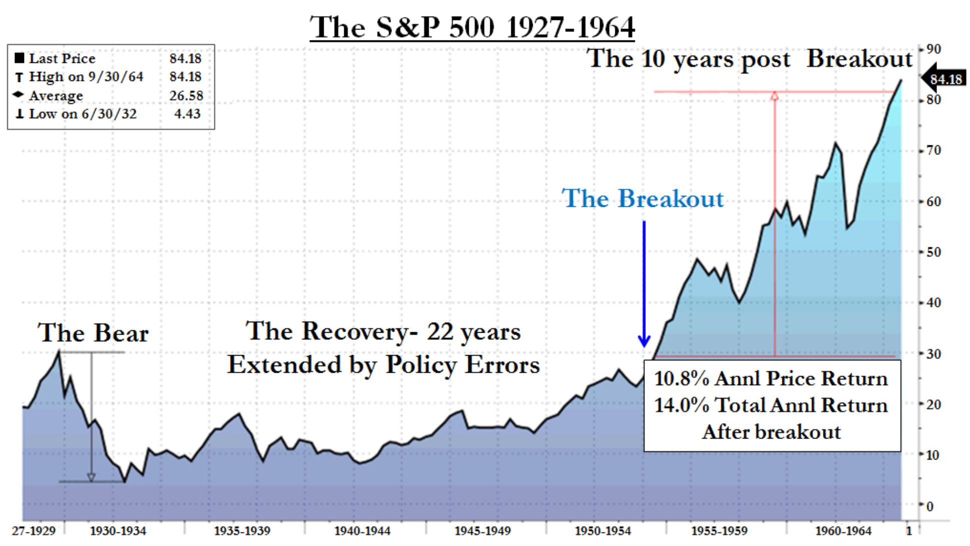
Dow Jones Industrial Average Versus 10 year Treasury Yield



Source: TAM, Bloomberg and Schiller

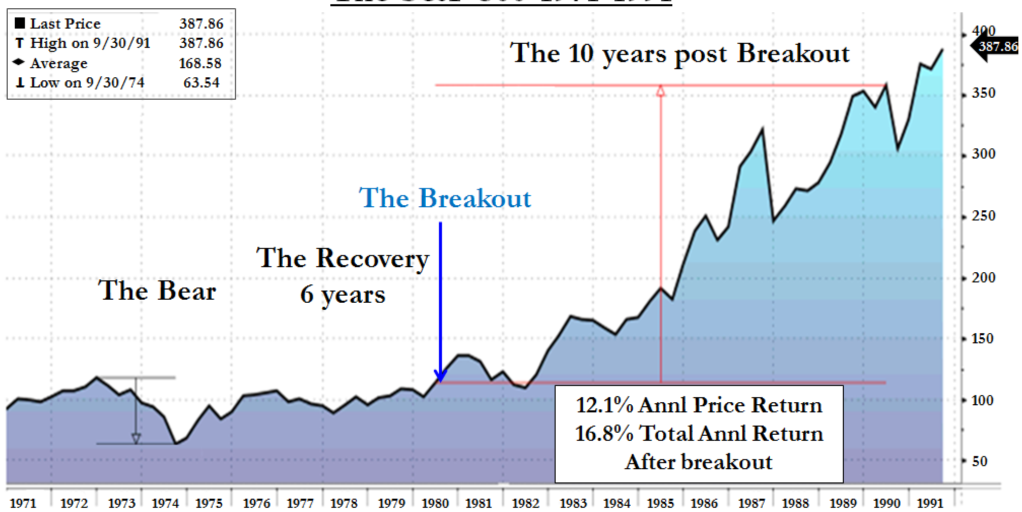
After the market broke out the last two times in 1980 and 1954, it was the prelude to at least ten good years in the market with annual percentage returns averaging in the mid-teens. The current market rally is not being treated as a potential new secular bull, and investors seem to be avoiding stocks, particularly US stocks. We believe the "Great Rotation" back to stocks is beginning, and may accelerate as interest rates are likely to rise from here. Markets can always correct, or even decline 20% or more in a year, but our sense is the market just signaled that the secular sideways market is over and a rising trend is back in place. If this is the case, S&P 2500 could be a conservative goal over the next several years.

Let's take a look at some prior instances where markets broke out and review what could potentially occur. In the chart below, we present the market action during and after the Great Depression. The market peaked out in 1929, and traded in a range for the 22 years between 1932 and 1954. During that time frame, policy errors aggravated the situation and extended the depression as money supply decreased, trade between nations was discouraged and frequent changes in Washington Policies left business leaders unwilling to invest. After the Depression and World War II, investors were simply worn out. In 1954, the US was just a year removed from the Korean War and the Cold War was just getting started. Despite these headwinds, the market broke out in 1954 and went on to achieve 14% annual returns over the next ten years as the economies of Europe and Japan rebuilt from the destruction of the war.



The other modern instance of the US market breaking out from a long term trading range occurred after the weakness of the 1970's made way for the optimism of the 1980s. The next chart illustrates this period. Following the 1973 OPEC oil embargo, the market bottomed in 1974 and traded sideways until 1980. During this period, the US economy suffered inflation, recession (producing stagflation) and another oil crisis in 1979. Those were only the economic issues, as political and social issues from the period included Watergate, a general decline in US stature overseas and the Iranian hostage crisis. Despite these concerns the stock market broke out in 1980. Regardless of enduring the 1982 recession, the market went on over the ten years from 1980 to 1990 to achieve nearly 17% annual returns.

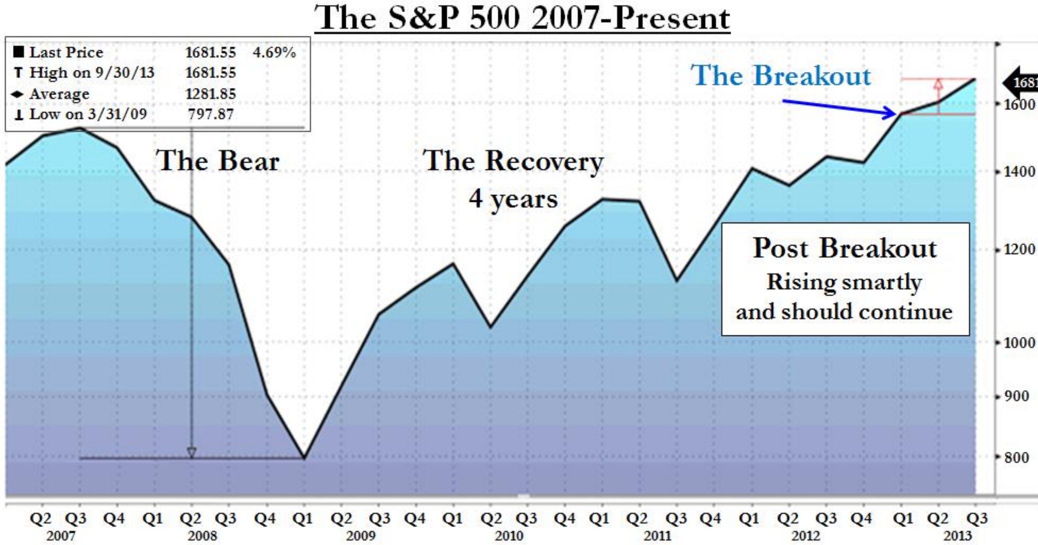
The S&P 500 1971-1991



Sources: TAM, Bloomberg

All of this brings us to the current situation, presented in the chart below. We endured a second bear market in ten years with the financial crisis of 2008 and the Great Recession of 2009. The recovery took 4 years, aided by extraordinary fiscal and monetary stimulus. Now, we've seen a fairly decisive breakout and most observers are not yet willing to say that it could be a confirmation that the bull market we have seen since the end of the financial crisis is likely to continue.

The S&P 500 2007-Present



Sources: TAM, Bloomberg

Nobody knew why markets were going to improve in 1954 or in 1980, but the market indicated something was going to change. This market is indicating a potential improvement from here. There may be catalysts emerging that would explain this, and several we are thinking about are presented below.

<u>Economically, several catalysts could be emerging, including:</u>

- **A Globally synchronized recovery.**
- **Emerging market growth could continue for years.**

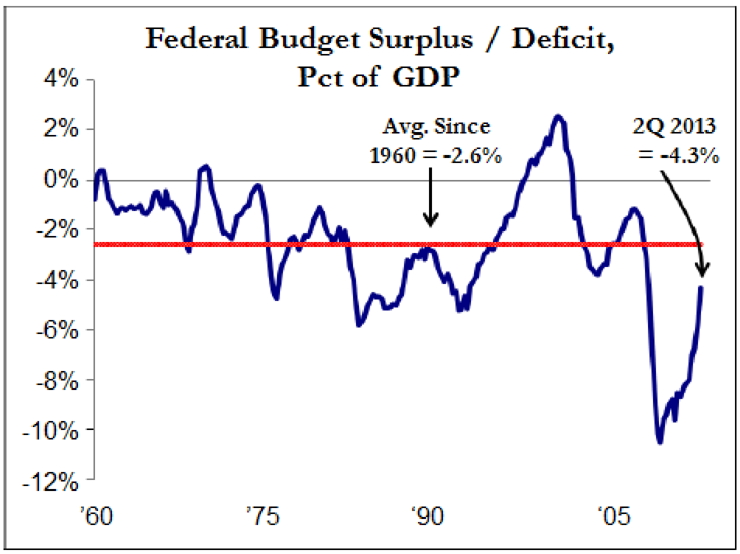
<u>Financially, several catalysts could be emerging, including:</u>

- **Easy money with deflationary pressures leaves few alternatives to stocks.**
- **Low rates force investors to seek higher returns. Modest rate backups probably force investors out of bonds and into stocks.**

<u>Politically, catalysts could be emerging, including:</u>

- **The Federal Government's deficit has been shrinking lately.**
- **Who knows what the future holds for grand bargains, entitlement reform or business policies after future elections.**

Investors voice many concerns about this scenario, with the largest being "the market has run for almost 5 years now without a bear market, aren't we due for one?" That is a very reasonable question. To answer this, we ask two questions. First, what are the excesses in the economy that would lead to a dislocation that could drive a bear market? Second, has the yield curve inverted or flattened out yet? Responding to the first question, the largest dislocation within the economy currently is the size and scope of the Federal Government post the 2008 financial crisis. As you will note from the attached chart, the Federal deficit as a percent of GDP ballooned to over 10% of GDP after the stimulus of the financial crisis. In the wake of a

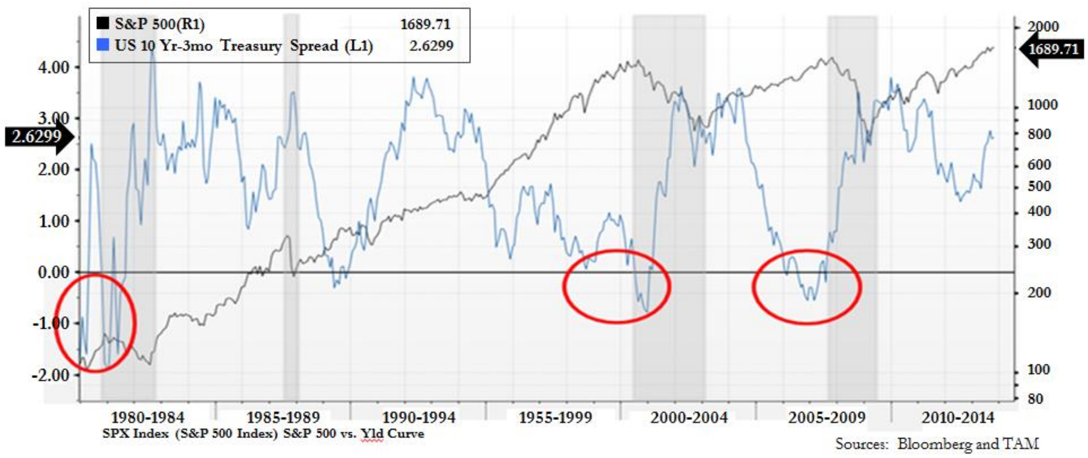


Source: ISI Group

modest economic recovery and reinstatement of payroll taxes, that has contracted to less than -4.5% and is projected by the CBO to decline to -2.4% in 2015.

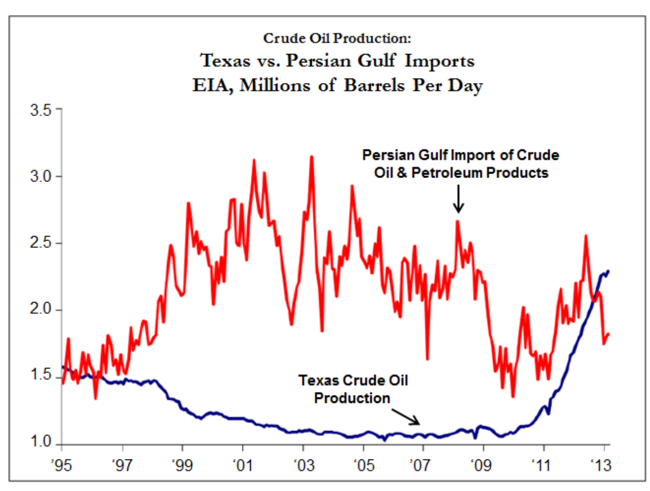
Investor concerns about a potential bear market may be misplaced as well. We reviewed the history of bear markets since 1980 and found a strong correlation between inverted yield curves and bear markets as noted in the chart below.

Inverted Yield Curves Preceded 3 of the past 4 Bear Markets
3 Mo to 10 year spread versus S&P 500 Performance



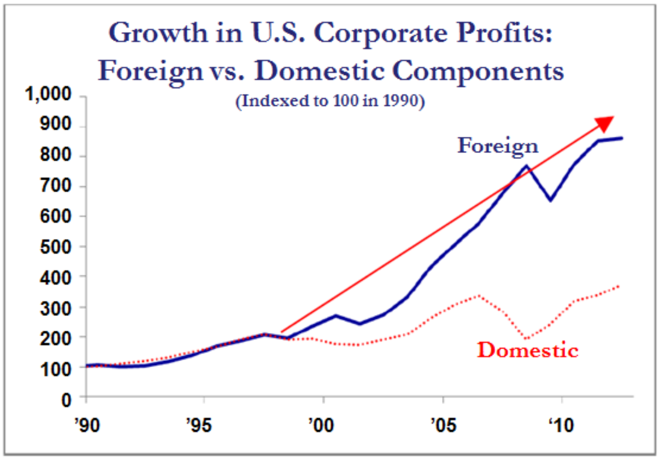
The worst three bear markets of the past 30 years were preceded by short term rates rising above long term rates. This makes sense, as normally bear markets are caused by Fed Action designed to slow the economy and ease inflation concerns. We do not see the likelihood of this happening for quite some time to come. There is the legitimate concern that as the Fed tapers their bond purchases that long term rates rise, which could disrupt the market. While that could happen, unless it is the precursor for a recession, we do not think a bear market is likely.

So, what could go right to make 2500 on the S&P a possibility? We see several potential catalysts playing out both domestically and internationally. The first trend we would point to is the availability of cheap energy from the US. The chart to the right illustrates the production of crude from Texas has surpassed Persian Gulf Imports recently. The availability of new energy sources in the US is a game changer, in our opinion. It may change the geopolitical landscape if North America becomes self-sufficient in energy resources. Between



discoveries in Texas, North Dakota and the development of the Canadian Tar Sands, we might accomplish this.

The second item we would point to is the potential for a synchronized global economic recovery. Europe has emerged from recession, and we are not seeing signs of financial stress in their markets. While most observers are skeptical, we would point out they were skeptical of the US potential for recovery in 2009 as well. Since then, we have seen a steady, albeit slow, economic recovery and excellent market performance. The chart to the left shows the growth of foreign versus domestic profits for S&P 500 companies. With foreign sales approaching 40% of the total, we think this growth could continue especially if you see an uptick in growth from Europe and the emerging markets. Our sense is this is underappreciated as most pundits seem to focus on negative aspects of the global economy and conveniently ignore that the European recession is over, Japan is stimulating and Emerging Markets are still growing.



Source: Strategas

We believe there is pent up demand both in the US and overseas for consumer durables. Autos and housing have been stronger performers in the US than many other industries. We are starting to see signs of improved demand in Europe for autos. In the UK, the housing market is strong. In the Emerging Markets, China has recently become the largest auto market worldwide, and growth in other consumer products and infrastructure continues.

Source: The Economist

As Emerging Markets gain clout, they are working to improve living standards for their citizens. The graphs to the left from The Economist shows EMs have over 80% of global population, most international foreign exchange reserves, yet only about 30% of global consumer spending. They should produce more GDP than the developed markets within the decade. Improving living standards in EMs could play a role in a better outlook over the coming decade.

Undoubtedly, there are concerns to be addressed. Many investors worry about US government debt levels and how sustainable they are at current levels. The Federal Reserve's bond purchases have changed the dynamics of the bond market. Investors are worried that ending these purchases over the next few years could disrupt the economy and financial markets. Additionally, the implementation of the Affordable Care Act will have unforeseen and unintended consequences. The labor market is improving, but many question whether that is because of an underlying improvement or simply fewer people participating in it. We are not trying to dismiss these concerns, but simply saying the market is inferring that some solution is likely to address these issues over the next few years. How these play out is anyone's guess.

Still, we think the S&P 500 is telling us something better than the consensus expectations is likely to occur. Many concerns we note are being discussed in detail in the media, which should mean that they are discounted in the markets valuation. What if something goes right? We can and will experience cyclical bear markets in the next 10 years, but they should be seen as buying opportunities within a market that is trending upward over that time. Time will tell, but we think the long secular bear market has ended, and worldwide markets are on a better footing for the next decade to come.

Jack White, CFA Curt Scott, CFA Jack Holden, CFA

12-5-13
Todd Asset Management LLC
S&P 500 – 1787
10 Year Treasury Yield- 2.85%