Bull & Bear Bulletin

Volume 5, Issue 1

February 2014

Celebrating 30 Years 1984-2014

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An on-line publication by The Investment Committee

The New Year Ushers in Renewed Volatility:

After a year filled with resiliency and minimal market volatility, stock investors were greeted with a 5% decline to start 2014. Instability among emerging markets was the designated catalyst for the New Year's sell off, but concerns over market valuations were certainly on the minds of many investors.

Traditionally, investors purchase stocks to gain ownership in a portion of a company's future earnings potential. While corporate earnings did improve approximately 10% in 2013, the market appreciated 30%. The 20% difference can be attributed to investors' desire to pay more for the respective earnings of the companies that make up the market, called a price-to-earnings (P/E) multiple. During periods of economic crisis, investors discount lower earnings potential by putting downward pressure on the stock price and are willing to bid the price of a stock higher when they anticipate a brighter future for a company. Over the long run, the market has traded at an average of 16 times the market's aggregate corporate earnings. In 2013, the S&P 500 Index P/E multiple expanded from 14.2 to 17.3 (Chart 1).

While the stock market ended 2013 slightly above its long-term average P/E value, the significant divergence between the growth of corporate earnings and the expansion in the market P/E left many investors cautious heading into 2014. As money started to vacate emerging market economies in response to the increase in U.S. interest rates, investors appear to have used this as justification for reducing their stock market exposure. This dynamic appears to have reversed course at the beginning of February, as we now see investors selling Treasuries (read through: higher interest rates) and adding back equity exposure both in the U.S. and abroad (Chart 2).

As the stock market declined 5% in January, we simultaneously received the latest quarterly earnings reports from corporate America. Most companies reported improvements from a year prior with aggregate earnings up over 12% versus the fourth quarter of 2012. In conjunction with analysts' expectations for corporate earnings to grow 10% this year to $118.50 per share, the strong fourth quarter earnings growth and the percent of market decline should have eased some of investors anxiety over the price they are paying for stock ownership. At the recent low of 1,740 on the S&P 500 Index, investors were paying 14.7 times the anticipated $118.50 per share in earnings projected for the companies that make up the Index.

As we look out at the remainder of the year, it is probable that we will continue to see earnings growth play catch up with the significant valuation expansion from 2013, leaving the market range bound. However, if the economy were to accelerate throughout the year and we see a strengthening between consumer optimism and spending, the U.S. stock market could experience an additional expansion as investors become more comfortable with the prospects of paying a higher P/E multiple in advance of better earnings growth. Our task is to determine those sectors and individual stocks that investors have mispriced in an effort to take advantage of either an oversold condition or the prospects of better than expected earnings growth.

Chart 1

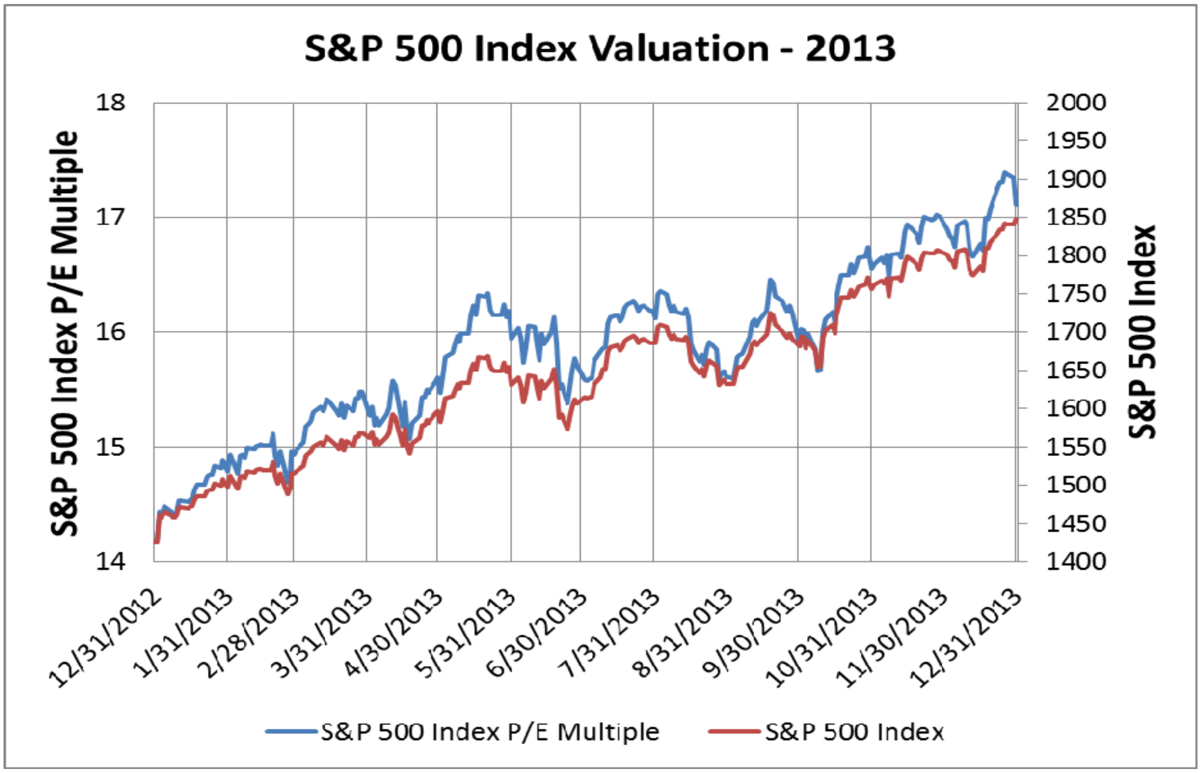

Chart 2