COMMENTARY

PRIVATE CAPITAL MANAGEMENT
A Subsidiary of GUARANTY BANK AND TRUST

P: 303.370.0055
F: 303.370.0066

pcm-inc.com

250 Steele Street | Suite 350 | Denver, CO 80206

First Quarter 2013

"There is no sadder sight than a young pessimist."
-Mark Twain

There is a strong sense of déjà vu for investors right now. After falling 57% from the October 2007 peak to the March 2009 low, it has taken four years for the S&P 500 to recover. Interestingly, in percentage terms, the recovery (+131%) is more than *twice* the decline (-57%). This is an important concept to understand about investing. In a pattern similar to the last two years and, despite the US budget sequester and problems in Europe, the S&P 500 was up 10.6% during first quarter, a return that would normally be considered a pretty good year. By contrast, the NASDAQ Index was up only 8.5% (Apple -16%) and the MSCI EAFE international index was up 5%, while the Barclays Aggregate Bond Index was down slightly. In this quarter's commentary we hope to shed some light on the recent market rally and the current market valuation.

Economic Update

We have seen a decent amount of improvement in the economic data in the United States over the last twelve months. Namely, the Federal Reserve's efforts to kick start the housing market by driving mortgage rates to historical lows is finally working. As the graph here shows, the lack of home inventory is currently one of the biggest headwinds to a continued recovery in housing. New home construction declined dramatically during the recession. In order to meet the recent rise in demand, we expect the pace of new home construction to increase, which should help create more jobs. Additionally, the 8.1% year-over-year increase in homes prices in January and strong stock market returns have pushed household net worth to a new all-time high. The household debt-to-service ratio (debt payments as a % of disposable income) is only 10.4%, a level not seen for 30+ years. Surprisingly, retail sales reached a new all-time high in February, despite the increase in payroll taxes. More recently, non-farm payrolls rose by only 88,000 in March, missing the 193,000 increase expected by economists. The March ISM Manufacturing Composite fell to 51.3 from 54.2 last month. A reading above 50 indicates expansion, but this was below the 54 level analysts expected. This likely means the Federal Reserve will maintain its stimulative policies for the foreseeable future.

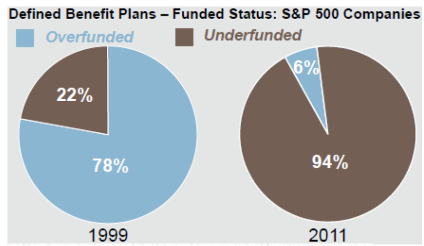
Source: J.P. Morgan Asset Management 3/31/13

Cyprus… Why do we care?

As you have probably heard, the European financial crisis claimed its latest victim–Cyprus. Formerly a wealthy country of less than one million people, the Cypriot banking system is near collapse. As the Cypriot banking system grew rapidly after joining the Euro zone, it sought places to invest excess capital–enter Greece. Cypriot banks began investing excess reserves into Greek debt and now their banking system is in need of rescue from the European Union. The world is watching this situation to see if the European Union will bailout depositors or force them to accept some losses. It is believed that the resolution in Cyprus could set a precedent for other Euro zone countries. A run on Cypriot banks could be contained, but a run on Spanish or Italian banks would be difficult to control. The situation in Europe is far from over; we continue to monitor events closely and make investment adjustments as necessary.

Bondholders vs. Retirees

There has been an interesting development in the nation's largest municipal bankruptcy filing: Stockton, California. A federal judge decided to allow Stockton to proceed with bankruptcy but he also opened the debate about whether it should cut pension benefits for retirees as part of the bankruptcy process. If the courts allow pension benefits to be reduced in the bankruptcy process, bondholders might not have to bear the full brunt of the bankruptcy and it could make bankruptcy more appealing for other cities burdened by bloated pensions. In an odd twist, CalPERS is Stockton's pension provider and also its largest creditor.[1] Pension funding has become a hotly debated topic as plan providers continue to struggle under the financial weight of funding pension obligations. In addition to public pensions, as the chart above shows, the recent financial crisis and growing number of retirees has led to staggering underfunding problems for the defined benefit plans of public companies as well. The Stockton bankruptcy has been making headlines since last June and municipal bondholders will continue to watch this case closely as it could set a precedent for future bankruptcies.



Source: J.P. Morgan Asset Management 3/31/13

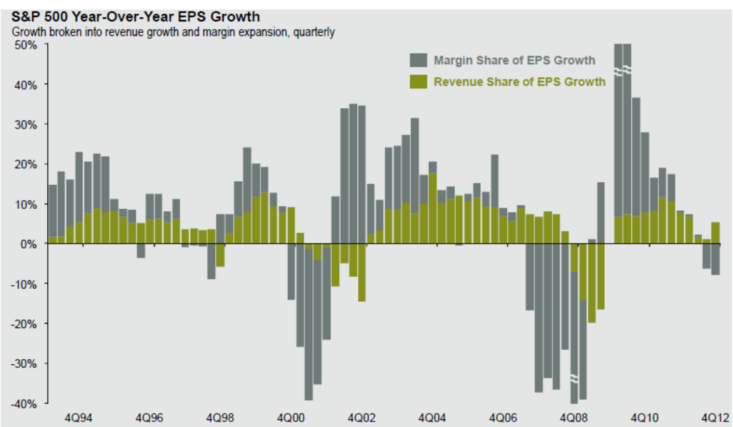
Market Fundamentals

Now that the S&P 500 is bouncing around its all time high, many investors are wondering if we should expect another major market downturn. While we cannot predict where the market is headed in the short term, we would like to note an interesting point on valuations. During the past decade, the market has been essentially flat but with some major ups and downs. Interestingly, when the market hit these levels in 2000, it was trading at an unsustainable 25.6x forward price-to-earnings multiple (P/E) with a 1.1% yield.[2] At the 2007 peak, it was trading at 15.2x earnings with a 1.8%

yield.[2] Now, the market is trading at only 13.8x earnings and the yield has increased to 2%.[2] This compares with a 10 year average forward P/E of 14.2x and a 10 year Treasury yield of only 1.9%.[2] Importantly, corporate earnings are now higher today than they were in either 2000 or 2007, hence the lower P/E multiple. Over longer time periods, corporate earnings drive the markets. We believe the market has been catching up to the earnings growth of the last few years, but not necessarily getting ahead of itself. That said, future earnings growth will be key to keeping the engine running on the current rally and the Q1 earnings season starts in April.

Earnings Growth… What's next?

In an update to a chart we have shown in the past, earnings growth following the recent recession has been driven primarily by cost cutting at companies (profit margin expansion [grey areas]), and to a lesser extent, revenue growth [green areas]. Margin expansion has a finite life because companies can only cut costs so far and still deliver the same level of goods and services. During the last two quarters, profit margins have had a negative impact on earnings growth. During the fourth quarter, this was partially offset by revenue growth, which is a good sign. In an environment where the US economy is only growing 2-3%, and parts of Europe are slipping into recession, growing revenues at a rate much higher than that could be challenging.



Source: Standard & Poor's, Compustat, J.P. Morgan Asset Management.

Inflation can help revenue growth (think of paying a few cents more for a gallon of milk this year versus last year). But, despite all of the Federal Reserve's expansionary policy efforts, inflation is still only running at about 2%. In a slow growth world with profit margins near historic highs, we believe some caution is warranted as earnings season gets underway in April. In summary, market valuations look reasonable because earnings growth has outpaced the market rally, but future earnings growth will be increasingly difficult unless the economy continues to improve. Investors should be prepared for some potential volatility if Q1 earnings and 2013 revenue and earnings guidance fail to meet Wall Street expectations.

Technically Speaking

Over the past six weeks there have been a record number of common stock buybacks announced and *The Chartist* newsletter notes that, at the current pace, they will exceed $900 billion this year versus just $248 billion last year.[3] When a company re-purchases its shares, the earnings per share goes up simply because there are fewer shares outstanding. Additionally, *The Chartist* editors point out that while the market was overbought in January, it is not overbought now. They remind us that in 2007 very few people were looking for a collapse in the market while today a large percentage of investors are concerned about the markets.

Shrinkage

USA Today published an interesting article in which they explained that the Wilshire 5000 index, which is designed to cover most all of the U.S.-based companies that are publically-traded, only has 3,678 companies left in the index, a level near the 1971 low of 3,069.[4] Quoting CFO Magazine, Monness, Crespi, Hardt & Co. strategist Sydney Williams stated that the number of publically-traded companies in the U.S. declined from 8,823 in 1997 to 5,091 in 2011, while the annual number of IPOs shrank from an average of 311 between 1980 and 2000 to just 102 from 2001 to 2011.[5] Meanwhile, merger and buyout activity has directly reduced the value of publically available shares to $12 trillion from $17 trillion.[4] This is an interesting dilemma given growing population.

Thank You

We would like to take this opportunity to thank all of our clients for placing their trust and confidence in Private Capital Management. We remain dedicated to our research process and to finding investments that we believe will offer good risk adjusted results in this market environment.

By the numbers…

Index	Close	1st Quarter	Year to Date
S&P 500	1569	+10.6%	+10.6%
Dow Jones Industrial Average	14,578	+11.9%	+11.9%
MSCI EAFE	1674	+5.1%	+5.1%
MSCI Emerging Markets	1034	-1.6%	-1.6%
Barclay's US Aggregate Bond	-	-0.1%	-0.1%
DJ|UBS Commodity	137	-1.1%	-1.1%

Data provided by Morningstar as of 3/31/2013

1 Brooks, M. (2013, April 5). [Web log message]. Retrieved from http://blog.alliancebernstein.com
2 J.P. Morgan. (2013, March 31). Guide to the Markets 2Q|2013. Retrieved from www.jpmorganfunds.com
3 Sullivan, D., & Mais, S. (n.d.). March 27, 2013. (2013). *The Chartist*, Retrieved from www.thechartist.com
4 Krantz, M. (2013, March 17). Investors face a shrinking stock supply. *USA Today*. Retrieved from www.usatoday.com
5 Williams, Sydney. "Thought of the Day - "Are Stocks Still Relevant"." Message to Justin Apt. 08 Apr 2013. E-mail.