

Keep your eye on the ball...

OK, the side show in Washington is at it again and investors are angsting over the outcome of the current argument. We would remind everyone that this episode looks kind of like home movies from last year, and you should “keep your eye on the ball” i.e. what is happening with the real worldwide economy.

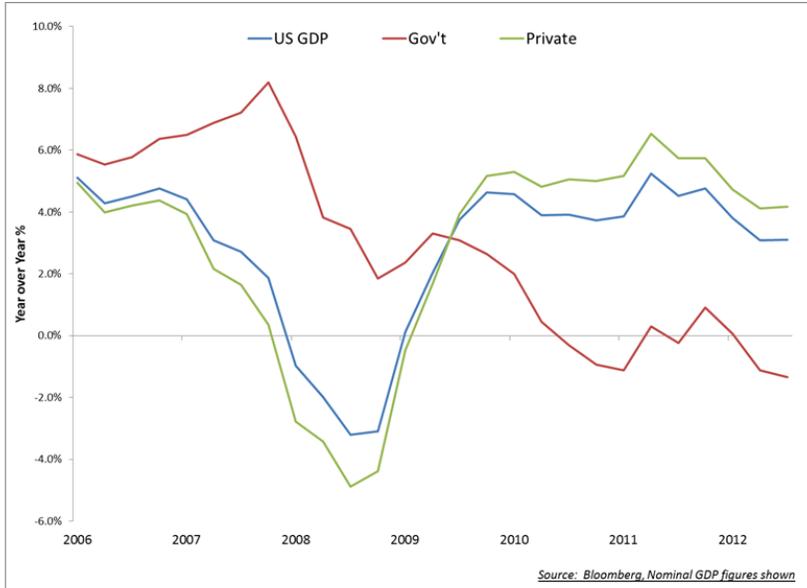
At this writing, the politicians are arguing, the discretionary portion of the government is shut down, and most observers are yawning. Investors really don’t seem to mind that there is a government shutdown. Many analysts and news anchors expected it to last until the debt ceiling discussions are concluded. This deadline is October 17 on paper, but anything can happen. This entire episode feels more like a frustrating posturing exercise by both sides, but there may be a silver lining to it. At some point, it will be over and the markets will get a relief rally. Take a look at the following list and think about what they have in common:

- Fiscal Cliff
- The *last* debt ceiling debate
- The Presidential Election
- The Affordable Care Act
- The European Financial Crisis
- The Sequester
- Arab Spring
- Emerging Market Slowdown
- The Fukushima Reactor Meltdown
- Libya, Egypt and Syria
- Larry Summers
- The Taper

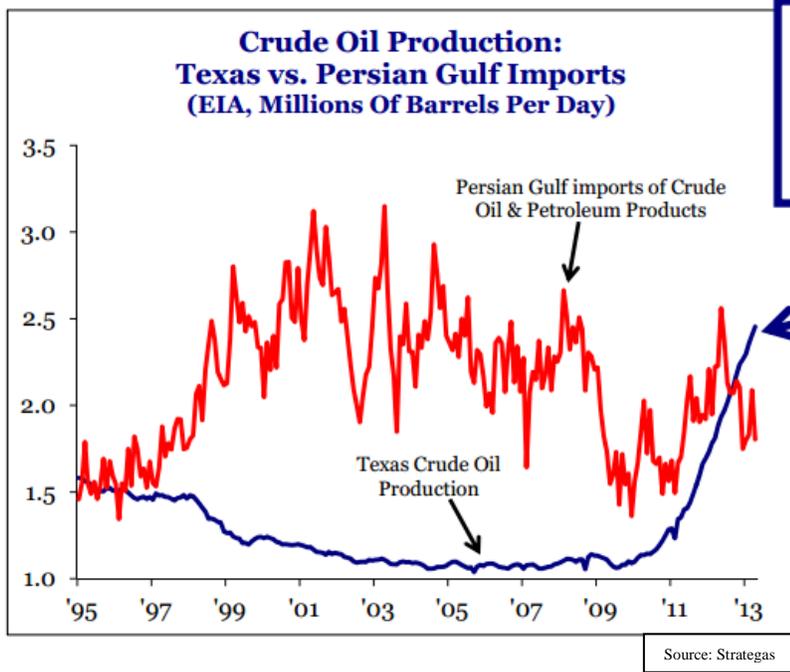
What do they have in common? All of these have been used at one point or another over the past few years as an excuse why investors should stay out of equities. All have proven to be temporary impediments to the market marching higher. We think the current setup in DC is just another excuse for the newscycle to produce worries and hysteria... and be wrong. Economies seem to be poised to recover worldwide and history shows bear markets usually do not start until short rates move to equal or exceed long term interest rates. Other useful forward indicators for the stock market in the past have been when inflation spikes or industrial production craters. None of these elements are in place now. This remains the most hated stock market rally on record. Until we see the precursors to a bear market in place, we view any politically inspired weakness in the market as just another pullback (not the end) in this bull market.

Interesting Charts We Saw This Quarter

Nominal GDP Growth has recovered for the Private Sector



The chart to the left shows the nominal US GDP growth for the overall economy, the private and the government sectors. The private sector has staged a recovery from the depths of the Great Recession, where government spending is actually declining since then. As this is nominal, you need to subtract the inflation rate to get real growth. In that instance, the government real spending is now declining almost 4% per year. The fact we are not in recession again speaks volumes about the strength of the private sector.

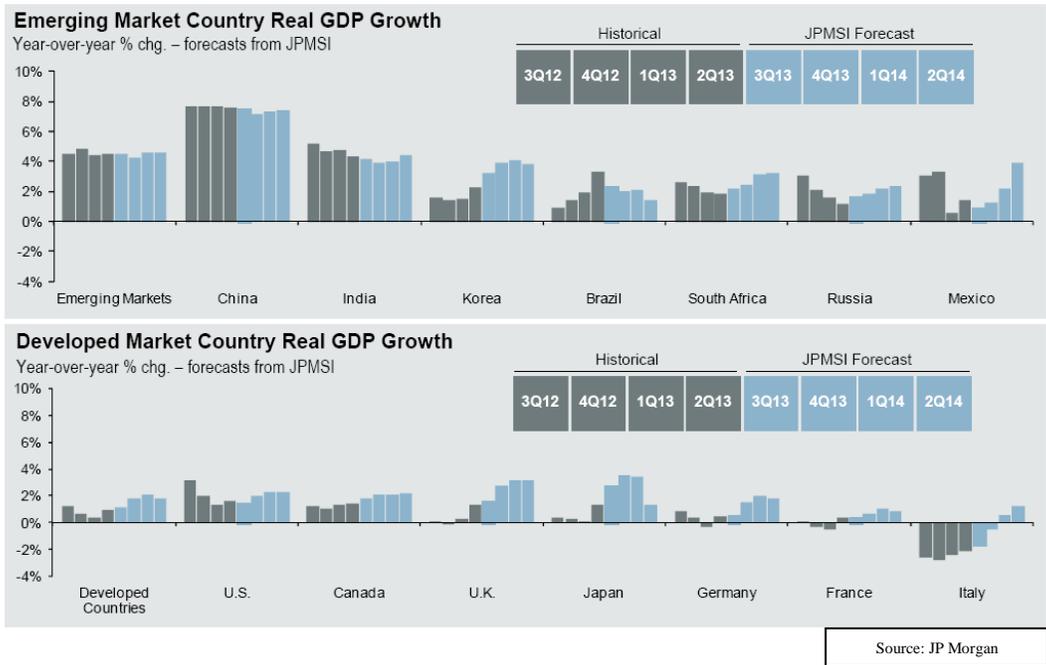


Texas Is Producing More Crude Oil Than The US Is Importing From The Middle East

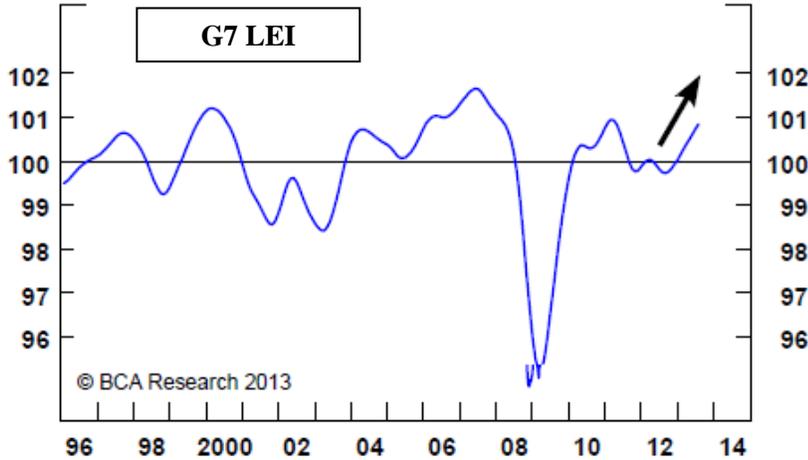
If you have read our overviews for some time, this chart should not be a surprise. We believe the new production technologies for domestic oil are a game changer, with positive knock on effects for employment, national security and the trade balance.



If there is any question about where Global growth is likely to come from, the picture above may be instructive. The chart below offers some idea of growth rate differentials between China, India and Korea, and the rest of the emerging markets and developed markets.

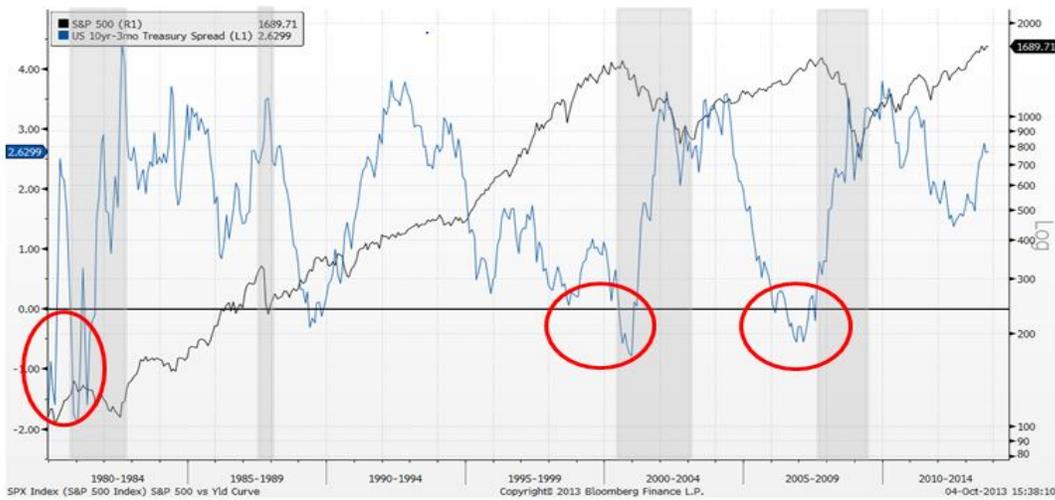


Leading Indicators are Strengthening for Developed Economies



Worldwide conditions seem to be improving. The leading economic indicators for developed economies have turned up and look decidedly better since Europe began solving their Financial Crisis last year, and Japan adopted very stimulative policies.

Inverted Yield Curves Preceded 3 of the past 4 Bear Markets



Source: Bloomberg and TAM

For those that are worried about a bear market, we would point out that a reliable indicator that it is time to be cautious is when the yield curve becomes inverted. The chart above illustrates that in three of the four bear markets (shaded areas) since 1980; yield curves were inverted (red circles). Usually, this was a result of higher short term interest rates. We do not see evidence of this currently.



We've been accused of being Pollyanna-ish in the past for being optimistic about market prospects in the US. We would point out we were very concerned in the run up to the Fiscal Cliff on the US outlook, and that turned out to be the wrong position. Also, in prior years we have noted that European markets have had a recession to deal with and Emerging markets were slowing, so we are not always positive on all markets. With International markets emerging from recessions or slowdowns, they probably have more upside over the coming year than the US does. Also, we would point out that being bullish on the US has been the appropriate stance since 2009.

Where could we be wrong in our outlook? The drama in Washington is continuing; though some hopeful headlines seem to be crossing the tape. If the politicians do allow the unthinkable to occur, a default of some sort on our national debt, the markets should decline. If the current Washington standoff leads to default, short rates are likely to increase pretty dramatically as investors demand higher returns for the risk of delayed payments, which would tie in with our final chart above. That is the indicator we are watching for. Across the ocean, Europe is exiting the recession and should be recovering. They will probably be in a sub-par recovery like the US has experienced as worldwide developed market deleveraging provides a headwind to growth provided by pent up demand. We expect the governments of Northern Europe may try to adopt more pro-growth policies. If they decide to pursue renewed austerity, the outlook could weaken and markets could decline. Emerging markets are pursuing pro-growth policies as they have started some modest fiscal stimulus policies again in China. If a modest recovery continues in the rest of the world, export markets for China and other emerging markets should recover as well. If efforts within China to rein in unregulated lending severely crimp loan availability, that could cause expectations for the recovery to fade.

Still, in our opinion, the most likely course of action that we see is for world economies to continue firming up.

As always, we are here to serve you. If you would like any additional information on any of these trends, please feel free to call us.

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