

MARKET COMMENTARY

Year End 2013

2013 has been a great year in the markets and this has fueled some skepticism and uneasiness among investors. The Great Recession affected many investor's view of risk tolerance and their sense of normalcy within the markets. Investors have come to expect a dramatic fall after any rise without any consideration of value or economic growth. In 2007 corporate debt levels were much higher (2008-S&P 500 avg. 215% of equity) and valuations were higher but today corporate balance-sheets are stronger and valuations are down. 2013 has been a year of new highs but at lower valuations. (We are getting a better bargain per dollar invested.) The market as a whole is still trading at an attractive valuation yet rumors of a bubble stay in the news.

Valuation Measure	Description	Latest 12/31/2013	1-year	3 year average	15 year average
P/E	Price to Earnings	15.4x	12.6x	13x	16.2x
P/B	Price to Book	2.7	2.1	2.2	2.9
P/CF	Price to Cash Flow	10.6	8.7	8.9	10.8
P/S	Price to Sales	1.6	1.2	1.3	1.5
PEG	Price/Earnings Growth	1.5	1.3	1.2	1.6

*Data as of 12/31/2013 - Current price divided by consensus analyst estimates of earnings, book, cash flow, sales and earnings growth for the next 12 months.

Equity

The table above shows the current market metrics and compares them to their 1, 3, & 15 year respective averages. The first thing that should come to your attention is that the markets are slightly above their 1 year and 3 year averages. This is the foundation of the current "bubble" argument. Everyday market pundits square off on television and argue over the valuation of the market and if we are too high, too low or just right. When people make the argument that the market is in a bubble, they are measuring from the wrong point. They tend to point to valuations that immediately followed The Great Recession and not the long-term averages. When we look at current market levels and compare them to their long-term averages it is easier to see that there

is still room to move to the upside. The US economy continues to show signs of improvement and S&P 500 companies should be able to grow their 2014 earnings by 13%-15% over 2013 levels. Good years tend to follow great years and 2014 is set to be a good year. I fully expect that some of the skepticism concerning the domestic recovery will subside and allow continued growth in our markets and the Federal Reserve tapering should keep us from becoming over-valued.

Fixed Income

The fixed income markets are coming to the end of a 30 plus year bull market. Many investors assume that a company or government not repaying a bond is the only risk that they need to be concerned with when investing in bonds and bond funds but that isn't the case. Even if you are receiving your interest payments the price volatility can be surprising to many investors. Today, a change in the 10 year treasury's yield from 3.04% to 4.04% would most likely result in a -8.9% loss in the principal value. If you hold the bond until maturity then you will receive the full par value but most bond portfolios are not structured to hold all issues until maturity. If you own a bond fund you have no control over the holding period and the manager may be forced to liquidate depending upon cash needs. This can result in heavy losses passing through to you. The same move in yields with a 30 year bond would result in an approximate -15% loss. Many investors should have many types of bonds as part of their long-term allocation but now is not the time to jump into the fixed income market. Buying a long-term bond at these prices is no different than buying a stock at extremely high valuations. The equity markets present a better value with better visibility. Look into making larger investments in fixed-income when the Federal Reserve has completed tapering and the fixed-income market get back to more reasonable valuations.

Economic Overview

It looks like 2013 annual Gross Domestic Product growth will be a little under 2%. It is currently about 1.7% and will most likely be restated in the coming weeks. 2014 is forecasted to grow about 2.5%. This is a nice move up but it is still well below the long-term average Gross Domestic Product growth rate.. Unemployment is still an issue but it is segmented and that is why so many people still feel that the recession is as bad as 2009 while others feel that we have made a full recovery. Unemployment among those that hold a college degree is at 3.4% while unemployment among those that hold less than a high school degree is still at 10.8%. Housing prices continue to recover but this is a regional event and may not be felt by many Whitenor Capital Management customers. The recovery is real but it is amplified in areas that are experiencing strong economic growth and muted in areas that are just getting back to normal. We are averaging out to a nice recovery but there are many of us that just don't see it and may not for a long time.

Summary

Despite averaging an intra-year drop of more than 14% over the last 35 years, the S&P 500 has finished with positive returns 27 out of 35 years. The markets will always have volatility but by focusing on a company's fundamentals we can build portfolios that withstand the next pullback and recession. As Warren Buffett once said, "Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it." We will experience pull-backs, corrections and bear markets. Knowing that you own quality and a value makes the rough markets easier to bear.

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FINANCIAL PLANNING CORNER
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Last summer Forbes magazine published an article describing the repeal of North Carolina's state income tax. I received a call about it because the caller has aging parents in a state (Pennsylvania) that still maintains an inheritance tax. Most people do not even realize that states often have their own inheritance or estate tax system, so this quarter's column is devoted to that subject.

The Federal government maintains a 5.25 million dollar estate tax exemption which means an individual who dies with an estate in excess of that amount will probably owe Federal estate taxes. There are 19 states plus Washington DC that maintain their own estate or inheritance tax system. Usually these states use an estate tax rate of 16% on assets in excess of \$1,000,000. New Jersey has the lowest threshold with an exemption amount of only \$675,000.

Most of Whitener Capital's clients are residents of NC, so why cover this subject? A NC resident can be impacted mainly in two different ways:

- 1) He or she has a parent in a state with an estate tax. Suppose a resident of Raleigh has a parent in New York. When that parent dies, the estate is subject to NY estate taxes if the estate's value exceeds \$1,000,000. This reduces the size of the inheritance regardless of where the heirs live.
- 2) He or she owns property in another state. Estate planning attorneys say this shocks their clients but a NC resident who owns a second home in a state with an estate tax can find their property is subject to the estate taxes of that state! Minnesota is one state that not only has this rule but is aggressive in their collection of the tax.

A number of our clients have parents or own property in South Carolina, Florida, Virginia and Georgia. None of these states have their own estate taxes. If you have parents or property in Tennessee, Maryland, Washington DC or anywhere in the Northeast you should explore this topic and make sure you are aware of how it will affect you. Please call Rick or me if you wish to discuss this further. We can refer an estate planning attorney if we feel it would be helpful.

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