August 5th, 2013

Dear clients and colleagues:

July was a very strong month for equity markets in the US. The Dow, S&P and Russell US indices are all at all-time highs. Yet, we are in the midst of earnings season, and again, revenues and earnings growth is disappointing. Q2 sales and earnings growth for the S&P500 is less than 2%.

In the past 12 months, the S&P 500 is up 27% with earnings up 2%. ***What drives these markets higher?***

Multiple expansion

Multiple expansion is one reason; the market current forward P/E ratio is now 14.6x up from 12.7 at the beginning of the year, yet only slightly above the 10-year average (14.1). Analysts are now expecting record level earnings in the next 12 months.

Given the mostly positive economic news around the world in the past few weeks, it is possible.

The great rotation

Money moving into stocks is another reason. $80 billion was withdrawn from bond funds in June 2013, the largest single-month withdrawal in history. Stock funds have had strong inflows for the last six months. Could this be the great rotation so much talked about?

Certainly, investors fear that the recent upswing in interest costs is just the beginning of a permanent rise in borrowing costs.

Despite these positive news, **WE ARE TURNING CAUTIOUS ON THE MARKET** for the next few months, especially on the U.S. market. ***WHY?***

Oil Price

Oil prices are now solidly above $100. A level that hurts the consumer and the economy. Many restaurants chains are already talking about a marked slowdown in the last few weeks.

F/X rates

A number of U.S. companies have commented on the negative impact of F/X rates in the second quarter and the U.S. dollar continues to strengthen.

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Interest rates

Interest rates are increasing. The yield on the 10-year Treasury bonds increased from 1.85% on March 29 to 2.60% on July 31st. A number of banks talked about the negative impact of higher rates on mortgage revenues. Home resale numbers seem to suggest a slowdown in the housing sector.

Growth in the capacity to borrow has replaced income growth over the last 30 years. Only possible because interest rates have fallen continuously since the early 1980's, making it feasible to borrow more and more with less income.

What happens if interest rates rise? Purchasing power will be significantly curtailed even if income rises.

Fiscal policy

Obama Care, increase in payroll tax, sequestration and the upcoming fiscal battle will all come back to the news in the fall.

Europe

Europe is on vacation at the moment. Although some economic numbers seem to suggest a bottoming, conditions are still weak. The fall will bring back Greece, Portugal and Spain to the forefront but especially elections in Germany which no doubt will spell uncertainty.

For all these reasons, we are turning cautious on the markets in the short term. A healthy correction is needed. The market is overbought and a correction could take place. Riskier companies will be most affected.

We are still optimistic in the mid to long term. We believe that the U.S. will continue its slow recovery, Europe is bottoming and Emerging markets will still be the global growth drivers. 2014 should see the Global economy come back to trend growth with 2015 possibly surprising.

Our portfolio has high-quality companies. We emphasize on superior sales growth: 6.3% vs. 4.8% for the index; better gross margins: 50.1% vs. 43.5% for the index, less debt. Our portfolio in aggregate has no long term debt.

Have a good week.

The Global Alpha Team

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