PARAGON
CAPITAL MANAGEMENT

JANUARY 2014
ECONOMIC OUTLOOK

We expect growth to increase in 2014 simply because government tax increases, spending cuts, and lay-offs will abate. Last year's tax increase and sequester, which cut some government programs by 10%, reduced economic growth by at least 1%. In fact, budget policy will be accommodative with a 2.4% increase in discretionary spending. Thus, GDP growth may rise to 2.5% or higher in 2014 after posting an estimated 1.7% in 2013. Cautious hiring trends and muted pay increases continue to limit income and, therefore, spending growth.

Inflation should remain low given slack in the labor market, modest capacity utilization, and falling commodity prices. The consumer price index decelerated to 1.5% last year, and is only expected to pick up to 1.7% in 2014. This level is concerning to Federal Reserve officials who are targeting a 2% inflation rate. Low inflation rates could represent deflationary forces; thus continued low inflation suggests that monetary policy will remain very accommodative.

Better than expected economic reports have pushed the economic surprise index to highs. In recent years, we have seen a similar pattern with surprises hitting highs at the turn of the year, followed by reversals. The surprise index, thus, tells us that expectations are ahead of themselves. Furthermore, while confidence has increased in most surveys, small business and consumer confidence remains mired at relatively low levels from an historical perspective.

STOCK MARKET OUTLOOK

We expect limited market upside against a potential for significant downside. The U.S. stock market is over-valued by all indicators that have predictive power. Goldman Sachs recently indicated that stocks were over-valued based on forward looking operating earnings which are consistently overly optimistic, and Citgroup's strategist suggested the market was in the euphoria zone of their panic-euphoria model.

It is useful to consider stock returns as the sum of valuation change, earnings growth and the dividend yield. Earnings grew an estimated 5% in 2013. The dividend yield for the U.S. stock market is about 2%. So with no valuation change the return would be the sum of earnings growth and dividend yield, or about 7%. Increased valuations added about 24 percentage points to the U.S. stock market return in 2013 and 15 percentage points in 2012. Therefore, any return of valuations to normal levels would overwhelm the low earnings growth and low dividend yields.

While fundamentals are worrisome, U.S. and European stocks remain in uptrends, although momentum is waning. Volatility has also remained low, supporting a "risk on" environment for stocks. Investors favor U.S. markets, and expectations have increased significantly over the last year.

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BOND MARKET OUTLOOK

We expect rates to remain in a range over the next year, while bond market expectations are for rate increases across all maturities. How much rates rise or fall depends on expectations about the pace at which the Federal Reserve policy is reversed over the coming years. Since the Federal Reserve has explicitly tied policy to employment, the rate of economic growth and improvement in unemployment will drive interest rate changes along with Federal Reserve communications.

We expect that the Federal Reserve will maintain a very accommodative stance and inflation will remain contained; these factors will keep rates from rising on shorter maturities. While we expect economic growth to accelerate, current expectations are high enough that we do not expect economic growth to surprise on the upside. Thus, the year began with 10 year Treasury rates at 3%, consistent with a high level of positive economic surprises; however, over the course of the year, inevitable downside surprises will tend to push rates back down towards 2.5%.

Bonds remain somewhat over-valued. Compared to average interest rates, historically, bonds are quite over-valued. However, compared to inflation and expected inflation, bonds are less over-valued. Since last year was the worst year for bonds since 1994, we have a rough idea of the downside, which was 2% for the total bond market index. By contrast, stable rates could provide upside in the 2% to 3% range. Thus, over the short-term we are neutral on bonds, while we are defensive over the intermediate term.