ClarkCapital MANAGEMENT GROUP

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navigator® REPORT

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Record Highs
Is a Hangover Next?

It took the Dow Jones Industrial Average six and one half years to finally eclipse the high of October 2007. This, by the way, was only slightly ahead of the prior high of October 2000 (see chart). The Dow has been posting new highs regularly for the past three weeks thereby making my comment on CNBC's "Squawk on the Street" on March 12 a truism! I had said that "new highs beget new highs." I wanted to add "until they don't" but I left that unsaid. However I did say that a correction was inevitable. This is explained in greater detail later in this Report.

Based on earnings, sales, dividends, and book value, we believe stocks are a much better value than at either prior peak.

The Dow's new high was accomplished in great style by posting the best first quarter since the first quarter of 1987. Uh oh! Could this be an omen of things to come? I am referring to the crash of October 19, 1987 when the Dow Jones lost 23% in one day. This is still the largest single day loss ever.

The S&P 500 finally eclipsed its high on the last day of the quarter, March 28th, after several days of back and fourth teasing of the old high. The last two times that the S&P 500 reached new highs were on March 24, 2000 at 1527 and on October 9, 2007 at 1565. The 2000 high was followed by a 49% decline and the 2007 high with a 57% decline. They were the second and forth worst Bear Markets since the 86% decline of 1929. Will it happen again?

This past quarter was the thirteenth time since 1926 that the S&P 500 has posted a double digit return. In this case it was 10.61% including dividends. **In the twelve previous occasions the S&P 500 return was mixed during the second quarter but in ten of the twelve cases it closed positive for the year with a median return of 5.8%.** This return would put the year end slightly higher than the prediction we made in January. **This does not mean that we cannot have a correction at any time. The**

IS THE GENIE OUT OF THE BOTTLE?

The "Genie" is the ability of a Central Bank to tax bank deposits in the country's banks. We are speaking of Cyprus and the "confiscation" of wealth that is taking place there at this moment. The European Union so called "Troika," consisting of the EU, the International Monetary Fund, and the European Central Bank, demanded that the Cypriot government tax all bank accounts as a condition to giving the country a 10 billion euro loan. On March 16th, the start of a three day holiday when the banks were closed, the Cypriot government announced plans to tax bank deposits of under 130,000 euro 6.75% and accounts over that amount at 9.9%. That tax would have raised 5.8 billion euro. The announcement shocked the banks' customers, of course, but also the entire global financial system because, up to then, bank deposits had been considered sacred ground. This violated an international banking principle from 1930 and the world was stunned. As it turned out, the government honored the insured accounts of up to 130,000 euro but then passed a tax on accounts over that amount of up to 40%.

Who cares about Cyprus, you might ask? It accounts for only 0.2% of the Euro Zone economy. As in many small tax-haven countries, the financial sector dwarfs the real economy and in Cyprus it was over seven times the country's GDP. Cyprus had become an offshore banking center for, among others, wealthy Russian clients. The important thing here is that this was even proposed by the European Financial Authorities.

Jeroen Dijsselbloem, head of the Euro Finance Ministries, said that this "solution" could become a "template" for future bailouts in the EU. He stated, "If a bank can't recapitalize itself, then we will talk to the shareholders, bond holders, and uninsured depositors." Now bank depositors around the world are on alert! Could this, Cyprus, be the first domino to fall? Is Slovenia or Malta next? How about Portugal, Italy and Spain? Bank customers in the EU can no longer believe that the European Central Bank will bail out banks and depositors. David R. Kotok, Chairman and CIO of Cumberland Advisors, (a fellow member of the Global Interdependence Council) describes the actions as "an unprecedented attack on bank depositors, banks, central banks, and the banking system of the entire euro zone."

The situation is far different in the U.S. where U.S. banks depend on bonds and other securities for capital to facilitate lending. European banks depend, to a great extent, on deposits to fund lending.

market has peaked in April for the past three years before a decent correction appeared.

Even though the Dow Jones and the S&P 500 reached new highs along with the Russell 2000 (small cap stocks) and Russell Mid-cap stock index, there are *still many indices that have not recouped losses from the 2007-09 or even the 2000-02 bear markets.* Many very large-cap indices are still below the 2000 high such as the OEX Mega-cap index, which is 15% below the 2000 high, the Russell Top 200 index is 12% below the 2000 high and the Russell 1000 growth index is 23% below 2000. **The most notable laggard is the NASDAQ index which is still 35% below the March 2000 peak.** The gold market was particularly hard hit over the past two quarters and declined by 10.1% for the worst loss over two quarters in over fifteen years.

Our prediction for 2013, which we made in our year-end Report in January, was for the S&P 500 to reach a high of 1700 during this summer and then to decline to 1625 to close out the year. That would give this year a very respectable return of 14%. We had mentioned in the earlier report that the market (S&P 500) in 2012 never closed below the close of 2011 on any day. This has only happened eight other times since 1928. The market was positive seven out of eight of those years with an average return of 10.52%. This bodes well for returns this year to at least be positive. Another good omen for this year is that since 1980, the second year of the Presidential Cycle (this year) has averaged a return of 14%.

Yes, this Bull Market is getting up in age at 48 months but these statistics auger for it to continue through, at least, mid-year as shown in the blueprint of the market for this year on page 3.

Since the bottom of the last Bear Market in March 2009, the S&P has increased 132%. This puts this rally, at the moment, as the second best Bear Market rally (is it a Bear rally or a new secular Bull?) behind the rally from June 1932 to April 1935 which moved 155%. This move has been much more orderly as the 1932-35 rally moved 121% from the low in the first twelve months. Interestingly, 1933 was the very best year for equity returns while the unemployment rate stood at 25%! And 1932 was the most volatile on record. If we reach our high target for this year at 1700 on the S&P 500 we will then have moved 151% from the March low which is very close to the record of 155%. Stay tuned!

It is interesting to compare economic and market conditions between 2007 when the market was last at these levels with today.

Economic Metric	Oct 2007	March 2013
Gasoline Prices	$2.75	$3.70
GDP Growth	2.5%	1.7%
Unemployed	6.7 M	12.9 M
Unemployment Rate	4.7%	7.8%
People on Food Stamps	26.9 M	47.69 M
Fed Balance Sheet	$0.89 T	$3.11 T
Debt as % of GDP	38.8%	74.7%
Outstanding Debt	$9.1 T	$16.7 T
Household Debt	$13.5 T	$12.9 T
Consumer Confidence	99.5	69.6
S&P Debt Rating	AAA	AA+
VIX	17.5	11.4
10-Year Treasury Yield	4.64%	1.89%
S&P Earnings ($111 estimate for 2013)	$82.54	$111
Gold	$748	$1,576
Silver	$14.50	$28.75
NYSE Volume	1300 M	545 M

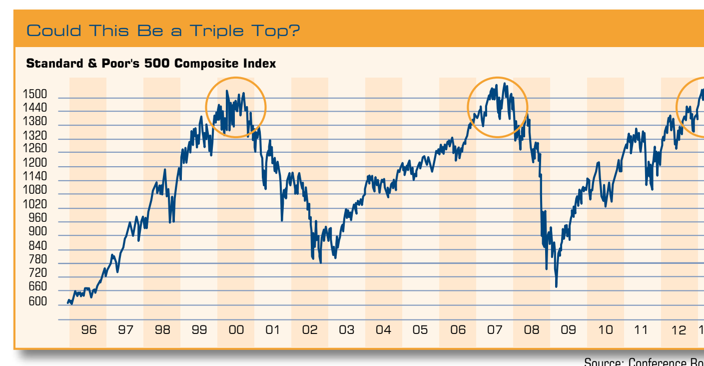
Source: OptionInvestor.com

S&P 500 earnings estimates at $111 for 2013, as shown above, give us a forward P/E (price/earnings) ratio of 13.9 compared to 2007 at 16.1. That means that unless earnings start to decelerate this current market move may have more legs to stand on and hence to move higher. In addition, we feel the S&P 500 is in a much stronger place than at either prior top. Earnings per share (trailing 4Q, operating) are up 79% from the 2000 peak and 9% from the 2007 peak. Forward earnings to the end of 2013 would be up 34.5%. **Based on earnings, sales, dividends, and book value, we believe stocks are a much better value than at either prior peak.**

An interesting comparison between 2007 and now involves flows into mutual funds during the four years preceding the tops. Before this record, stock mutual funds had a net outflow of $171 billion while bond funds have seen more than $1 trillion in inflows. Compare this to the four years prior to the 2007 top where stock funds had inflows of $585 billion while bond funds only had $177 billion of inflows. What this could mean is that there is a potential for a massive outflow from bond funds into stock funds going forward that could propel this market much much higher. While we do not expect interest rates to rise substantially or suddenly we feel there could still be a substantial flow from bonds to stocks as the public realizes that the inevitable rise in rates will hurt the bond market.

COULD THIS BE A TRIPLE TOP?

This is the question on most investor's minds and probably why the public, while still pouring record inflows into stock funds this quarter, is still way underinvested in this market. You can see from the chart that the stock market has essentially moved sideways since the peak in 2000 or for 13 years. And most investors are still underwater on assets they have held over these years even though we have seen the recent records. But as mentioned above, we believe there is likely to be massive movement from bonds to



Source: Conference Board

stocks when the public perceives that the stock market offers better risk adjusted returns than do bonds.

In technical speak, there really is no such thing. It is very rare to have a triple top. You can see the double top on the chart but the market should go through the 2007 top *eventually*. And by *eventually* I do not mean in the distant future. Another way to say this is that "failed breakouts" after new highs are rare. There have been eleven times since the mid 50s that the market has made a new high following a bear market. The time from the date of that high to the eventual high of that bull market has averaged 435 days and a gain of 23.3%. This is based on a Ned Davis research study. I excluded the rally from 2/13/1991 to 7/17/1998 which produced a huge gain of 221% over 2711 days because I felt that it skewed the data. So by this metric the current run has more to go.

Another way to determine how close we are to a major top is to look at the number of weekly new highs on the NYSE (New York Stock Exchange). Going back to 1966 (including 14 Ned Davis defined bull market peaks), new highs peaked every time prior to the eventual stock market high. The average time from the peak of new weekly highs to the eventual top was forty-eight weeks (336 days) and a gain of 14.5%. These numbers are not quite as good as those above but still they indicate that, potentially, the current market could move substantially higher.

Does this mean that we can relax our guard against a decline? Absolutely not!! All market rallies have corrections along the way. There are usually three 5% corrections per year: one 10% correction per year; one 15% plus correction every two years; and one 20% plus correction every three years.

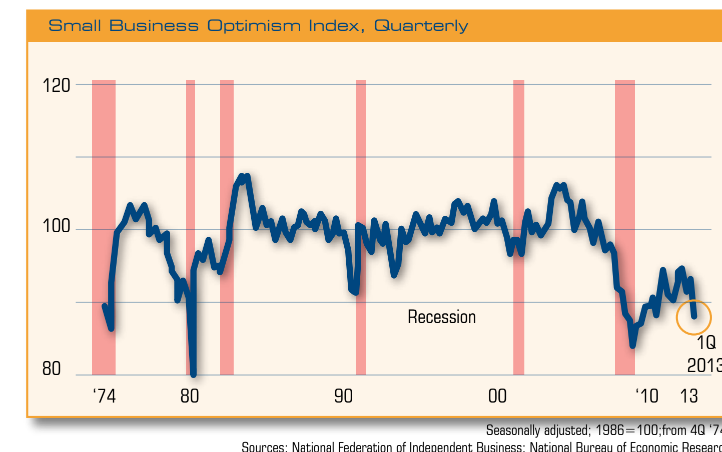
As mentioned earlier, there has been a correction in this ongoing "cyclical" bull market in each of the last three Aprils.

Below is the date that the market peaked each April, the amount of the correction, and the bottom date of the correction.

4/23/2010	-15.99%	7/2/2010
4/29/2011	-19.39%	10/3/2011
4/2/2012	-9.93%	6/4/2012

THE ECONOMY

So far this year the economy is perking along at a steady, albeit slow, pace. There are those that have lowered estimates for this year's GDP to 1.7% but others are raising the level to 2.5%. To see a 3% growth rate the country has to get small business growing again. The problem is that small business optimism is in the tank as shown by the chart below. According to William Dunkelberg (another fellow member of the Global Interdependence Council) and Chief Economist for the National Federation of Independent Business, while small business was in a depression it has only recovered to the level of a recession. This is because so many small businesses are in the housing sector.



Seasonally adjusted; 1986=100,from 4Q '74.
Sources: National Federation of Independent Business; National Bureau of Economic Research

Even given the above, the U.S. Leading Economic Index (LEI) is still recording new highs as shown below. James Stack of Investech Research says, "not a single recession in the past 50 years has begun without the LEI peaking first and turning down. The minimum lead time has been four months and since 1970 no recessions have begun without a lead time of at least nine months.

Source: Ned Davis Research

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SUMMARY

By historic standards the equity markets, even at the record highs we have just seen, are cheap. They are about as cheap as they ever get compared to bonds. One way to compare the value of equities to bonds is called the "earnings yield" of stocks. This compares the earnings of the S&P 500 to the share price. The earnings yield stands at 6.5% today which is about 4.5% above the yield on the 10-year Treasury note. The average spread over the past ten years has been about 2.5%. So far this year through February, investors have added $20 billion to stock mutual funds. But they still put $44 billion into bond mutual funds. The $20 billion is only 3.5% of the amount withdrawn from stock funds since 2007. The public is still not buying because they are continuing to smart from both of the prior bear markets of the past thirteen years. Can you imagine the volume and the surge that is possible when the investing public finally embraces equities?

Does this mean to throw caution to the wind? Definitely not!!

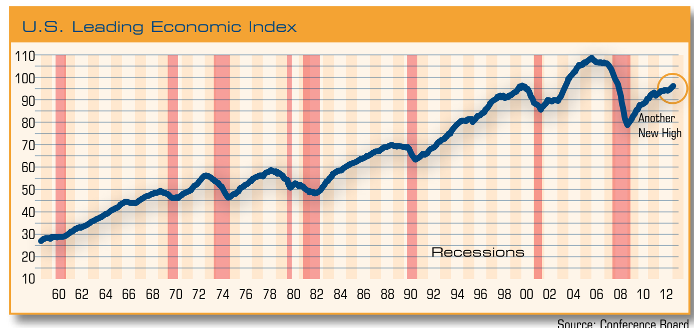
We are due for a correction. Look at the corrections mentioned earlier that all began in April. It seems as if the press and most advisors are expecting a mild correction of about 5% to 7%. We believe this will not happen. The market never accommodates the consensus. The correction will either be very mild at 3% to 5% or very aggressive at over 10%. You cannot tell before hand. The indicators that we use will tell us when and how much the market will correct. At present, all of our intermediate cycle indicators are turning down which indicates that we will have a one to two month correction. If this is wrong then the cycle will turn upward and tell us that the correction is over.

In any case, look at the stock market road map which shows a bigger top in mid-summer. Our projection is for a top in July at 1700 and a close at year-end of 1625 on the S&P 500.

A question that I am struggling with at the moment is whether this rally is a cyclical bull, i.e. a bear market rally, or have we begun a new secular long term bull market? We have been saying since late in 2000 that in our opinion we had entered a secular bear market. Secular bear markets typically last from thirteen to eighteen years in duration. Have we entered a new secular bull market?

The other side of the coin (there always is one) is that the market may peak this summer and gradually decline into mid-year 2014. If this is the case then I believe that would mark the end of the secular bear market and the beginning of the new secular bull market. The average gain from the bottom of a pre-election year (next year) to the top of the following year (2015) has been 51%. Now that would be a fun bull market. Only time will tell!

In the next Report for the second quarter, we will look at the Fed and what we expect them to do going forward. We will also take a close look at Europe and the Emerging Markets. And we will have a better handle on the secular bull market case. For now we believe the place to be is in the U.S. markets.



Source: Conference Board

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