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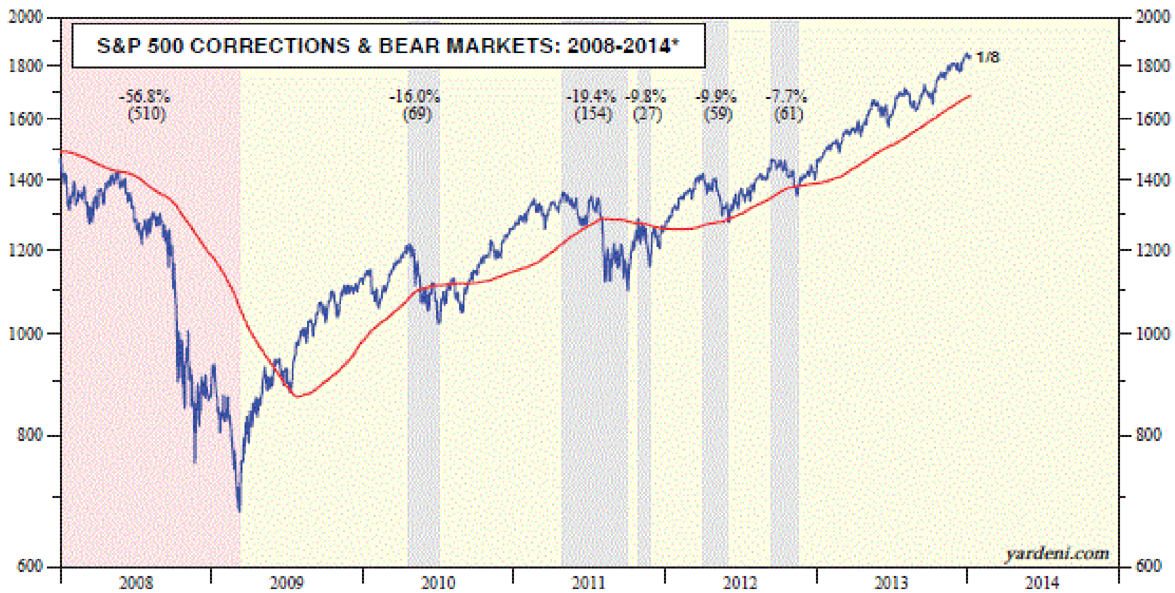
The past year was one that certainly exceeded most expectations and was capped with a fourth quarter that was the best quarter of the year in both the US and Canadian equity markets; a great end to a great year in which Padlock's portfolios fared even better than the market. I remain constructive heading into 2014 and am expecting positive equity returns for the year.

In the last chapter of Ben Bernanke's incredible tenure as the Chairman of the United States Federal Reserve, he began the process of gradually tapering the Quantitative Easing (QE) program that was necessitated by the financial crisis of 2008. The stimulus created by QE was certainly a huge factor in the US economic recovery and the outstanding performance of North American equity markets (especially in the US), but with the beginning of tapering, conditions remain in a sweet spot for equity investors.

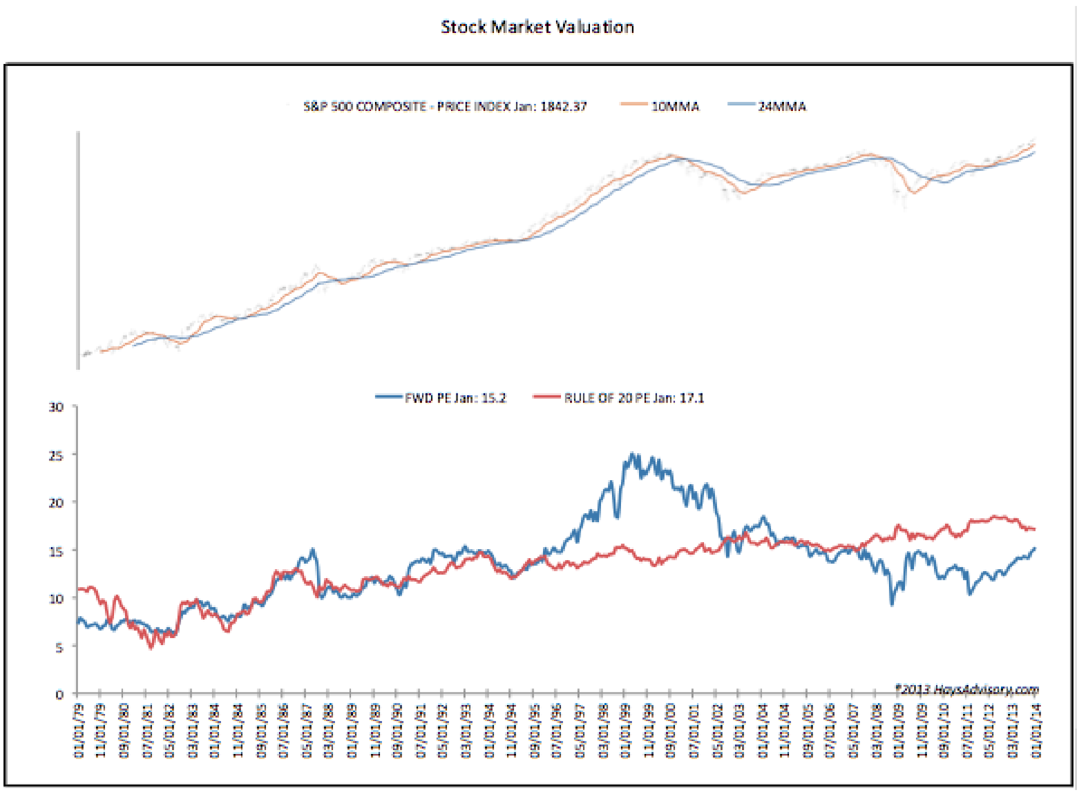
Tapering thus far has been minimal and I expect that the incoming Fed Chairperson, Janet Yellen, will be very cautious in accelerating the tapering process without signs of continued economic improvement. With a continued economic recovery, earnings growth should also continue which helps to justify the expansion in the Price/Earnings multiple that helped drive markets last year. Since the market bottomed almost five years ago, as shown in this chart, we have had corrections following significant changes to QE, particularly after the end of QE1 in 2010 and QE2 in 2011 but the equity market has ultimately proved to be quite resilient. The bottom line of the recent Fed action is that, in spite of the beginning of tapering, monetary conditions in this low interest rate environment remain very favourable for equity markets.



* Ratio scale. Corrections are declines of 10% or more (in blues shades). Bear markets are declines of 20% or more (in red shades). Number of days in parentheses.
Source: Standard & Poor's Corporation.

Another important factor for Padlock's continued positive stance is that equity market valuations also continue to remain positive. An old standby valuation measure is the "Rule of 20" P/E which suggests that the forward P/E Multiple of the S&P 500 Index plus the expected rate of inflation should equal 20. Although the gap has narrowed over the last year, given the continued low inflation expectations, as shown in the following chart, there is still room for P/E multiple expansion.

Markets benefitted in 2013 from both earnings growth and multiple expansion and although multiple expansion may be more muted in 2014, forecasted earnings growth combined with a slight expansion in the P/E multiple could lead to rising market levels, but only back to fair valuation levels.



Although there are some short term market indicators on the psychology side that suggest investors might be slightly too optimistic, on a long term secular basis, investors have only recently begun to forget about the devastating markets of 2008 and early 2009 and are coming out of their shell. This thought is verified by the fact that from 2009 to 2012, US investors added over one "trillion with a T" dollars to bond mutual funds and only $75 billion to equity funds. That trend reversed in the first 11 months of 2013 with $16 billion going into bond funds and $193 billion into equity funds.

That increase in equity fund inflows fueled equity markets in 2013 and although it was a record year of inflows, Padlock believes that we are still not near the 9th inning of this game. I have shown the chart below before but it bears repeating.

Source: Raymond James

With the "fear", leading to the "panic" and "capitulation" of a lifetime for many investors in 2008, "opportunity" definitely presented itself in March 2009. The flow of funds into equity funds last year was the first sign of "hope" by investors in almost 5 years. Having been rewarded for their hope with very good returns last year, investors are now "relieved" but still remembering 2008 clearly enough not to be "optimistic" and are certainly far from "thrilled" or "euphoric."

With trillions of investment dollars continuing to remain in cash or cash equivalents, any progress toward optimism will serve as the fuel to continue this bull market toward the 9th inning.

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