Goldman SMALL CAP RESEARCH

The Goldman Guide

VOLUME 4 | ISSUE 4 | MAY 27, 2013

INSIDE THIS ISSUE:

KEY TAKEAWAYS

⇒ *Headwinds are here but for how long?*

⇒ *Global economy and domestic economy could curtail stock movement*

⇒ *Good Q for EPS and higher estimates ahead*

⇒ *Small stocks better than big and valuations fair not great or bad*

⇒ *Weather could hurt May #'s and lower EPS estimates damage 2H13*

⇒ *Buy on dips, don't chase stocks*

KEY STATISTICS

Index	Close	2013
DJIA	15303	16.8%
S&P 500	1650	15.7%
NASDAQ	3459	14.5%
Russell 2K	984	15.9%

(figures are rounded)

Is the Party Over?

From all of us here at Goldman Small Cap Research we hope you and your family had a meaningful and an enjoyable Memorial Day weekend. Moreover, we have in our hearts all those who have fallen in battle.

The Memorial Day holiday actually traces its roots back about 145 years to the end of the Civil War although it was not officially a national and federal holiday until 1971. It is an interesting story and if you have time I recommend you look it up along with its predecessor Decoration Day.

As an aside, please do not forget to help out when you can. At GSCR we often try to help out in the community and worked in a mission to feed homeless veterans ahead of Memorial Day. Just yesterday we found out a young woman with 3 young kids has been living in a storage locker for 30 days just a few miles from our HQ. Even when we make money when stocks rise, there are people out there who could use stocks of food clothing and shelter. Now back to our regularly scheduled program...

Last week we sounded the alarm that we could have some headwinds in the market and it actually hit us big time mid-week. In fact, the NASDAQ and Russell 2000 Index both retreated 2% and 2.5% respectively from their intra-week highs to their closes on Friday.

We expect continued headwinds and would use rallies as an opportunity to take a little off the table, and dips to buy, as we alluded too last week. These headwinds are more a function of macro issues and the fact that the market seems set to be mired in a conflict as to which direction it wishes to move.

Looking out beyond this week and early next week, we do see daylight in general for stocks and we are favorably disposed toward equities. In the meantime, in order to properly play this market, you must get a handle on how the following topics will affect stocks: Global economy, earnings, weather, valuation, domestic politics. (cont'd)

Is the Party Over? (cont'd)

So, let's look first at what could derail this market, followed by why it will continue to rise this year, and end it with what to expect and how to play it.

For investors holding on to a lot of bonds or blue chips, you could be in for a rougher ride than you know. As the Fed continues to print money and interest rates are held in check, the paltry bond returns will remain well, paltry. Moreover, the chickens will come home to roost when interest rates rise and the bond values drop. This is an inevitable part of our current cycle. On the blue chip side, valuations are reasonable (as you will see in the table below) but the slowdown in Europe and what now appears to be incrementally slower growth in China and Japan has already had an effect on revenue growth for the blue chip companies that derive an ever-increasing portion of revenue abroad.

Look, our economy isn't on the greatest footing, but it is on better ground than what is happening overseas. Nonetheless, if material slowdown occurs, that could be one of the stumbling blocks for a lasting bull market. Of course a quick end to the Fed pumping $ here would not help either. Still, there is another wild card that no one wants to address, but we will do it first in these pages.

During the Clinton years, there were a series of scandals that for the most part went away because Clinton led the country through an unprecedented economic boom and he was smart enough to foster relationships with the other side of the aisle. Viewed as a potentially divisive influence, Clinton, love him or hate him, knew how to play the game.

Conversely, the 3 concurrent scandals facing President Obama, along with an ever-building outcry against Obamacare, the war on terror, and gun control by even Democrats could be the domestic triple-whammy that gives the markets pause. Make no mistake, the 3 scandals on their own, the Benghazi cover-up, IRS targeting, and journalism wiretaps on their own would be headaches. However, with the confluence of these events, we could have real concerns regarding leadership, civil liberties, and stability and confidence in our nation's direction. In the absence of leadership, markets drop. Folks, this is a real issue that we could see curtailing the market this summer, depending upon how things shake out. Obama will likely emerged unscathed, but we could be in for pain before gain and one should always be prepared for a potential shoe to drop.

Let me throw one other quiet tidbit out there. (cont'd)

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Is the Party Over? (cont'd)

The leadership of Google (NASDAQ—GOOG) and Apple (NASDAQ—AAPL) were major supporters of this Administration. Within the past week, the Apple CEO has been called to testify before Congress about the Company paying low taxes and Google is being investigated by the FTC. They are not happy and feel as if there is some sense of betrayal. That is the central theme of all 3 scandals and is he likely failure of Obamacare. And that is why we have to monitor the hearings as investors as well as Americans.

On the plus side, earnings were generally solid for 2Q13, although the market is eerily reminiscent of 2009-2010 when firms eked out EPS rises and market growth through productivity gains rather than revenue growth. According to Factset, 69% of the companies in the S&P 500 Index reported Q2 earnings above the mean estimate and the average EPS growth was 3.3% versus a decline in 1Q13. The problem is that revenue growth was anemic and will likely remain that way due to Europe, as mentioned earlier. A number of companies even guided lower for Q2. On the plus side, earnings growth in 2H13 is expected to be stronger than 1H13. We should note that valuations for the major indices reflect this increase in earnings growth with 12-month forward P/E multiples smack dab in the middle of their historical averages.

Friday, May 24, 2013

	P/E RATIO			DIV YIELD	
	5/24/2013†	Year ago†	Estimate^	5/24/2013†	Year ago†
Russell 2000	**35.85**	33.12	17.51	**1.73**	1.65
Nasdaq 100	**18.56**	10.59	16.34	**1.44**	1.00
S&P 500	**19.24**	14.85	14.99	**2.05**	2.13

† Trailing 12 months
^ Forward 12 months from Birinyi Associates; updated weekly on Friday.
P/E data based on as-reported earnings; estimate data based on operating earnings.
Source: Birinyi Associates

All in all, we view the market as fairly valued, not too pricey nor expensive, especially when considering there is nowhere else to put one's money. Small caps should do better than big caps since they have little exposure to Europe and can eke out better returns. So, definitely buy small caps on dips and do not chase stocks. If the 2H13 earnings estimates continue to drop, these P/Es will rise and make the market pricey which is not a good thing. Bonus: Due to the unusually cold Memorial Day weekend season in the Northeast, be cautious of consumer stocks as they may have a weaker than expected May.

Until next week….

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