Investment Perspective

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LUCKY '13 SETS THE STAGE

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Low expectations

The U.S. stock market navigated through significant cross currents to produce very robust returns last year. In practice, it seems the market often works to confound the most people. And it had been difficult for many to be optimistic about prospects coming into 2013.

Yet most of the big concerns later proved to be overhyped. Sclerosis in Washington was certainly a recurring theme. The threat of a *fiscal cliff* brought memories of the buildup to Y2K. Would we all awaken in early January and witness an economy ground to a halt? Later, the nation confronted a potential government debt default and then a 16-day shutdown. But investors eventually detected a predictable pattern to DC's dysfunction: The two sides would self-righteously argue and cajole, refuse to compromise, but then cobble an agreement together at the eleventh hour. So we started to tune them out.

Taper talk

Federal Reserve policy deliberations also caused plenty of chatter. In May, when Ben Bernanke hinted at *tapering* some of the Fed's extraordinary asset purchases, many panicked. The 10-year Treasury yield shot up a full percentage point; stocks sold off globally. However, he was just testing the waters. It later became clear that Fed policy would remain accommodative for quite some time.

Meanwhile, neither China nor the Eurozone imploded as some had predicted. China's growth rate has slowed, as new leadership rolls out much-needed reforms. But the *hard landing* scenario appears unlikely. In effect, China's leaders are saying, "It cannot be allowed to happen, so it won't." Europe began emerging from recession, the stage set by ECB President Mario Draghi's 2012 pledge to "do whatever it takes" to save the euro.

Healthy skeptics

Entering 2014, a fair amount of skepticism persists. But from where we sit, that's a healthy sign. Various pundits and media types have been throwing the *B-word* around with increasing frequency. Yet when was the last time the media correctly called a bubble? It just doesn't happen.

Some warn that stocks, as represented by the S&P 500, are up 170% from the March 2009 lows. That is true, but such growth should not be viewed in a vacuum. Stocks had plunged 60% over the preceding 17 months. The math required that they gain 150% just to get back to even. Furthermore, the price rise has been in line with the rebound in operating earnings.

How high is too high?

In a similar vein, some doomsayers also cite the fact that the major averages (the NASDAQ excepted) continued to hit all-time highs throughout the year. Again, that's true, but aren't new highs bullish, a phenomenon to be expected in a rising market? The claim that because they are up, stocks are about to collapse, is overly simplistic.

On the other hand, one could reasonably warn that valuations are getting pushed a bit now. As a group, stocks are no longer yard-sale cheap, as they were several years ago. Instead, by most measures, they seem fairly valued or modestly overvalued. Of course, the tendency is to select the metric that supports your viewpoint. For those suffering from *confirmation bias,* there is a stock valuation measure to make any case.

Two more points about valuation. First, stock prices rarely freeze at "fair value." Instead they will often overshoot or undershoot, depending on the direction of the trend. They can stay moderately overvalued (or undervalued) for years. Second, stocks can move back toward fair value in two ways: Either prices can adjust, or earnings can. In other words, an overvalued market can move to more reasonable value with an improving economy and rising earnings versus falling stock prices.

The Fed stays reserved

Valuation is a blunt and imperfect instrument to use as a market gauge. To us, the larger hurdle for stocks in 2014 will involve the Federal Reserve and the unwinding of its quantitative easing (QE) programs and zero interest-rate policy (ZIRP). It could be messy, as the full extent of any distortions caused by these polices will not be apparent until they are reversed. In December, the Fed announced that it would reduce bond purchases by $10 billion, down to a rate of $75 billion per month, beginning in January. In his final press conference, Bernanke set the expectation that the central bank would likely keep trimming at a similar pace following each meeting.

At the same time, he was careful to stress that short-term interest rates would stay near zero for an extended period. So while the asset purchase program (QE) may well be phased out in 2014, overall monetary policy will remain "highly accommodative for a considerable time after…the economic recovery strengthens." That is a critical distinction that was overlooked by many investors last spring, leading to the sell-off.

Stock and bond markets will continue to obsess over Fed policy which, under incoming Chairman Janet Yellen, should maintain its present course. But the Fed is in unchartered waters. Since the 2008 financial crisis, its balance sheet has quadrupled and stands near $4 trillion. The holdings consist primarily of U.S. Treasury bonds and Agency mortgage-backed securities. The counterpart to the buildup is about $3 trillion of excess and idle reserves (cash) in the banking system. This sea of liquidity will have to be unwound at some point. What will that look like, and how will it impact interest rates?

Inflation tightrope

The Federal Reserve — and other central banks — have been walking a fine line. At some point, the potential longer-term side effects of expansionary policies outweigh the near-term benefits. The main risk, of course, would be for inflation to break free from its shackles. Fortunately, with the current global backdrop, that's a low-probability outcome; most policymakers would instead prefer a bit more inflation today.

In other words, interest rates are abnormally low and need to eventually move up, reflecting an economy that is healed. The stock market could get noisy as this rate reversion plays out. Ironically, stocks may initially come under more pressure if economic growth surprises to the upside rather than to the downside. Many may then think the Fed would begin tightening, allowing rates to increase.

Historically, however, rising interest rates and rising stock prices have been able to co-exist when yields start from low levels. This is when inflation is still constrained, and the forces behind the rate move are an expanding economy and increased loan demand. There *will* be a threshold beyond which higher yields begin to stifle economic activity. In the meantime, it is important to distinguish whether yields are moving up for the "right" reasons (more activity) or "wrong" ones (higher inflation expectations).

Foundation firms up

Of course, the ever-fickle stock market will ultimately do what it will do. But today the economic and financial backdrop appears to offer more of a tailwind than headwind. Easy money worldwide should be bullish for stocks, assuming no large shocks. And global economic growth is poised to pick up in 2014.

For instance, in the United States, the *fiscal drag* from public sector spending cuts and higher taxes should dissipate. It subtracted somewhere between 1 and 2 percentage points from GDP growth in 2013. Other things being equal, the absence of such restraint will naturally bump up the economy's growth rate. Meanwhile, private sector activity has shown decent strength. The finances of consumers and businesses have improved significantly, at least in the aggregate. Critically, private sector credit growth has begun to rebound after an unprecedented contraction. Corporate investment spending has lagged behind profit growth largely due to a lack of confidence. As memories of the financial crisis recede and investments may no longer be deferred, capital spending should step up. Such spending helps drive growth and productivity.

Overseas improvements

Europe still faces a number of serious structural challenges, but the continent has begun to climb out of its hole. Many of the struggling nations on the periphery have seen dramatic improvements to their fiscal positions. In fact, according to the International Monetary Fund, Portugal, Italy, and Greece are all running primary budget *surpluses* (excludes interest payments). The IMF forecasts that Europe's GDP will edge up 1.3% in 2014.

The most interesting developments may be in Asia. Like China, Japan has new leadership bent on reform. Prime Minister Shinzo Abe has moved aggressively to begin shaking that country out of its long funk. He characterizes his program as a "three arrows strategy." This analogy is deeply rooted in Japan's cultural symbolism, with the lesson being that while one arrow may bend, three bundled together are hard to break. *Abenomics'* three prongs consist of: 1) aggressive monetary easing by the Bank of Japan to target 2% inflation; 2) massive fiscal stimulus focused on infrastructure projects; and 3) broad structural reform to boost competitiveness. The jury will be out for a while, but consumer and business confidence is up, corporate earnings have improved, and GDP growth has turned positive.

Profits and pullbacks

Importantly, corporate profits will benefit from the synchronized growth of the world's major economies. Indeed, Wall Street analysts expect total operating profits for S&P 500 companies to rise 13% in 2014. For stock prices in 2014, the larger question may be the multiples investors are willing to apply to those earnings. Often, a steep yield curve like today's is associated with expanding stock multiples.

As has been the case since 2008, central banks and the liquidity they have unleashed will continue to shape economic and investment outcomes this year. That stimulus continues to boost growth and encourage risk taking. But while the macro picture appears mostly favorable, U.S. stocks have really not had a meaningful pullback (10% or more) since 2011. Consequently, some measures of investor sentiment are indicating a bit of froth. Returning to our initial observation about the market's tendency to confound, this seemingly positive environment makes us somewhat wary in the nearer term. Temporary pullbacks, however, are both normal and healthy, and we expect to experience one in 2014. But given the favorable backdrop, we would also expect stocks to rebound and grind higher.

— Christopher J. Singleton, CFA, Managing Director

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