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Bull - Bear Contention ***Mid- Spring 2013***

Much like the gridlock which has come to characterize Washington politics, the bull-bear contention over stock market valuation is today surfacing as the topic du jour across Main Street. Years ago, basic finance taught us all to believe that future earnings growth is the principal driver of stock price. If that is true, the continued surge in US equities to record levels should have moderated by now to reflect slower earnings growth rates. Not so! At this writing the Dow, the S&P 500 and the NASDAQ are all breaking new ground on momentum that is reminiscent of their surges in the mid-late 90's and more recently of the '06-'08 period just before the Great Recession and Moderation. Are each of us really convicted enough to rely exclusively on the Fed and believe that this time it will be different?

In an effort to restrain ourselves and to counsel investors not to chase market tops which could easily become peaks the "day after", someone recently remarked "that markets do not obey mathematics, rather they are behavioral systems that reflect the aggregate nature and feedback of enormous numbers of unknown participants." We believe this truism has by far overshadowed reason as market demand continues to bid up stock prices. For those of us professionals serious about the business of providing financial advice, this is certainly not comforting!

So what then is driving current market levels? The answer rests almost exclusively in the Fed's now multi-year accommodative policy whose unequivocal objective was to reflate the economy. It is certainly doing that! Remember, Uncle Ben's edict shortly after the market's collapse: to employ whatever tools necessary to ensure a low rate environment until the economy recovered, targeted unemployment levels were achieved or inflation became unwieldy. To date, none of these objectives have yet to be realized and though financial indicators suggest our economy has become one of the bright spots in an otherwise recessionary world it still remains very fragile.

Similar to the US and instructive as to the effects of quantitative easing initiatives, the Japanese central bank reversed years of restrictive policy last November to effect massive Fed-like bond buying programs. Since that time its Nikkei stock index has jumped by over 33%; that's in less than six months while its Yen has tanked leaving it neighbors less competitive. Are we getting the warm and fuzzies yet?

In the meantime, back here in the US, investors are now starved for income from such lengthy domestic policies and are each day struggling with the discomfort of investing their money at near zero rates. That is precisely what Uncle Ben wanted! One outcome of this vexing environment is that investment decisions which were once built on quantifiable risk premiums

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related to an "unmanipulated" risk free yield curve have now migrated to actions that are being driven by a manipulated baseline and relative value - value that may even prove illusory!

Take for instance the Wall Street Journal's report of May 9th citing "the stampede into junk bonds passed another milestone, showing that investors are casting aside concerns about the economy's health for a shot at padding their pocketbooks". WSJ further reported that it was the first time since its inception that the US high yield bond index fell to below 5.0% (4.97%) on debt issued by some of its least creditworthy companies.

Now, extrapolate that discussion and apply it to the current stock market. Yes, despite what is now tax parity, stock yields today hold much more attraction for investors than bond yields. But make no mistake: in the effort to capture yield, income starved investors are each day bidding up stock prices. Let's hope that they too are not ignoring concerns about the economy's health or the downside risks associated with what may be an overbought market.

So what's the answer to investors who are frustrated by a hunger for income? Do your homework, know your investment and be alert to investment risk in an environment where decisions are based on relative value not quantifiable risk. Finally, keep your portfolio balanced among the various asset classes despite the returns offered. In the end, it is likely you will be rewarded for your cautionary posture. And keep in mind that "risk management is very forgiving of missed gains in an overvalued market".