Eideard Group
GUARDIANS OF PROSPERITY

Market Commentary **January 2014**

The Year in Review

Despite a myriad of political and economic headwinds in 2013, US stocks delivered exceptionally outsized gains. Irrespective of market cap or investment style, cumulative gains averaged better than 30%; an overall best for stock market performance not seen since 1997.

Elsewhere, performance of the world's developed markets fell well behind the US capturing only half of its return while Japan virtually outpaced everyone with gains as high as 60%. To everyone's surprise, emerging markets, the darlings of the post financial crisis, delivered only volatility and negative returns as massive offshore cash flows quickly found their way back to US shores on the prospect of rising rates and a strengthening dollar. Meanwhile, bonds and most other interest sensitive investments continued to offer meager yields and either flat or negative total returns depending on maturity and duration. And while much is still not clear, absent any near-term tail risk, it is probably safe to say the bull market in bonds came to an end in 2013. For most of us, the next obsession is when, how fast and how high will interest rates rise when the Fed finally decides to take away the punchbowl.

So let's remind ourselves how 2013 unfolded. Heading into the year, it was evident to us that stocks had to overcome some significant headwinds just to sustain what we thought were already suspect valuations. After a four year bull market, analysis indicated that S&P revenues were beginning to level off, profit margins were already approaching post-war highs and earnings had reached their inflection point and arguably were beginning to reverse trend. Nonetheless in May, Mr. Bernanke surprised the world by intimating that bond tapering was now on his radar. This soft news sent the 10 year treasury yield soaring and bond prices plummeting. Stocks fared no better as they re-trenched by as much as six percent on the unwelcome news. In hindsight, reversing their original decision twice before year end made it obvious that even the Fed was uncertain of the reliability of its economic data and hence how and when to proceed.

Meanwhile on Capitol Hill it was all about more of the same: acrimony, partisanship, and dysfunction. The outcomes of the gridlock included the first indiscriminate budget cuts, a continued threat of a debt default and the government shutdown late in the year. And finally, geopolitically, the Syrian civil war was garnering headline news and tempting a US response that was thankfully averted.

All in all, looking back at the events of 2013 one would have concluded it was improbable that the year would have fostered such banner stock returns! In January no one had predicted it and by December no one would have believed it.

So why such remarkable performance? We agree with consensus that the economy despite some structural issues is finally expanding. Most indicators suggest it. We also realize the stock market is a voting machine and so discounts trends rather quickly. But to us, its current frothiness is not simply a matter of assimilating good news. It is also about, maybe even more about, the market's need for reassuring support from the Fed; easy money and the notion that interest rates will remain low "for a long time to come" as the Fed Chairman re-iterated in December. Note that following Mr. Bernanke's mid-month remarks stocks staged their final rally to close out the year on a high.

So we are convinced that unconventional policy, in no small measure, has and continues to be an indirect driver of current market valuations. 2013 saw this massive shift strengthen: a shift from low yielding, interest rate sensitive investments to equities where the hope of ever increasing values and dividend income which rivals bond yields is there simply for the taking. But in truth there are no free lunches.

The impact of this prolonged "stretch for income and capital growth" has resulted in the broad market having achieved fifty-five new highs in 2013. By year's end the S&P 500 PE multiple had advanced to over 19x earnings; a premium of some 27% to historical norm. If one believes snapshot PEs are generally unreliable, then consider the so called "PE10", a cyclically adjusted price earnings ratio (aka CAPE). This metric calculates a ten year average PE based on monthly real prices and earnings over a rolling ten years. The observation reinforces the point. By December the market was priced at a lofty 26.5x real earnings, a 40% premium to its cape average. Whoa! Unless it's somehow different this time around, we think valuations are approaching nosebleed territory and maybe dangerously high for unsuspecting investors who are intent on chasing performance. We aren't. We are grounded by our promise to manage and balance investment risk against return on behalf of our clients. Inherent in this fiduciary charge is that from time to time we may not capture all of the market's upside when it occurs but on the flipside it also means we will likely avoid the full measure of a downdraft when logic suggests markets could turn against us.

So pre-occupied as we were with frothy valuations, we took special interest in Janet Yellen's confirmation hearings. Frankly, we were surprised when she so abruptly dismissed the suggestion that a stock market bubble might be forming. But then we were equally not surprised when she also confessed that the Fed's track record at identifying bubbles was abysmal and that the Fed in the end was not responsible for the outcome of any bursting bubbles. We surmise then that those matters are left to the visceral discernment of the investing public and to those of us who advise them.

So - what to expect in 2014? We think and frankly hope that at best the stock market will level off for a while or in the worst case takes a modest dip on the front end of the year, allowing an expanding economy the chance to catch up. Witnessing a renewal in top line revenues and earnings growth could then help to justify current market multiples. As someone said, it may be the year when the stock market actually changes places with the economy - at least for a short time. In the long run this might be the best outcome for all of us!