Mid-Year 2013 Market Update

The selling in the stock market last week was driven by comments coming from the Federal Reserve (FED) discussing the economy and its quantitative easing bond buying program. After FED Chairman Bernanke's June 19th statement, the stock and bond markets reacted immediately and negatively and market expectations of when the FED's bond buying will "taper" changed dramatically--Bernanke's comments signaled the FED will be tapering sooner than had been expected by most market watchers.

As a result, bond yields rose immediately on Bernanke's comments. Currently the ten-year treasury yield is around 2.50%. At the beginning of last week, the ten-year yield was 2.14%. To put this into context, at the end this March, the treasury yield was 1.87%. Last week's 37 basis point bond yield increase can be directly attributed to Bernanke's comments.

In addition to causing interest rates to go up and as a result bond price to fall, the US dollar strengthened and domestic stocks sold-off. In addition, commodities fell and international equities dropped in value—again, all of this happened because of Bernanke's statements. And ironically all of this occurring even though no explicit action was taken or defined by the FED--meaning it did not change the size of its current bond-buying program, nor did it change the bond dollar volume being held or purchased. Furthermore, no change was made to interest rates. What did change was the tenor of the language used by Bernanke and the FED—that is, the economy is now better and improving.

Despite all the short-term market roiling last week, the fundamental investment issue remains: whether or not the economic recovery continues. In our estimation, the answer to this question is an unqualified "yes," and if one analyzes how interest rates move over time, there is a distinct relationship between an improving economy and the direction of rates—meaning, an upward bias in rates means an improving economy. Furthermore, when rates begin an upward rise, it is likely they will continue in that direction. This means, with some fits and starts, we anticipate bond yields to continue to rise.

Unless we see a recession start to materialize--which we do not expect--there is little chance bonds will perform very well over the next year-plus, meaning the multi-year bull market in fixed income securities has likely ended--but the advance of equities is still on track.

In the short-run, quantitative easing (or bond buying by the Fed) ending earlier than the market anticipated is not good for the equity market. However, rising interest rates and the bond buying “tapering” by the FED as a result of an improving economy, means the equity market will likely continue to appreciate the remainder of the year and into the future, and we still see a total domestic equity market return of double digits in 2013. Next year’s equity returns and the next several years will likely be in the single digit range. The upward path will be volatile and subject to sell-offs, influenced by geo-political and economic events, particularly in China, Europe, Japan, and Washington, DC.

Why will equity values increase during a heightened interest rate environment? Answer: a growing economy means increasing corporate earnings, which tend to counterbalance the impact of rising rates. We are now entering an era in which the economy is likely to expand and rates likely to rise, and the market should perform decently in such an environment but not as well as it has since the 2008 financial crisis. This to be expected because financial risk has diminished on the margin and less risk translates into less reward.

The FED appears to believe the economy will surprise to the upside and it is more bullish than consensus estimates regarding GDP expansion (GDP expansion generally tracks corporate profit expansion). Currently, the FED is forecasting year-over-year GDP growth of about 2.5% in 2013 and 3.25%-plus in 2014. The consensus estimate of GDP growth from economists surveyed from Bloomberg is for 1.9% GDP this year and 2.7% GDP next year. We see GDP growth as being closer to the FED’s estimates than consensus forecasts—in large part due to an accelerating improvement in the housing market. As a result, we do not believe the bull market in stocks has ended but as mentioned above the rate of growth during the next five-year period has likely slowed from recent levels.

If the FED is correct and the economic expansion actually is stronger than what is generally expected, the sell-off in the market at this time presents a buying opportunity. For a long-term investor, or someone with a time-horizon greater than 2-4 years, we recommend buying the dips over the next month or two.

In regard to bonds, this outlook should not be interpreted as an abandonment of this asset class. Diversification is important and over time, bonds are a good and necessary countervailing diversification tool for most portfolios. This said, given the prevailing environment in large part “engineered” by the FED, bond mutual funds are particularly not a good place to be during the next several months and overall bond durations should be shortened.

While sporadic weakness in the equity market should be expected, most likely the economic expansion is on track and inflation remaining under control. Although increasing treasury yield makes the equity market less compelling on a valuation basis, the bull market is by no means over and stocks remain far more attractive than bonds.

Our most heightened concern right now is China and the credit dislocations occurring in its financial system. It is too early to tell if there will be a hard landing there, or a slowing GDP rate, as well as gauging its impact on the general world economy, particularly the developing world, which relies on it for commodities.

So where does this leave us for the summer? Volatility and a trading range until we see the economy get more in gear—and when that appears, it will be too late to capitalize on today’s uncertainty. Bottom line: stay the course and rotate on the margin to cyclical or sectors that do well in an improving economic environment. June 24, 2013

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