MARKET REVIEW

AUGUST 14, 2014

Dow	S&P 500	Nasdaq	Russell 2000	10-year Treasury	Brent Crude	Gold	VIX
16,957	1,958	3,981	1,147	2.4%	$102.59	1,297	12.42

Bull or Bear?

by Jason Self, CFA, CFP®

Speculating on short-term movements in the equity markets is a fool's errand due to the large number of variables involved. Consequently, we do not try to time the market itself. We do, however, think that there is sufficient information available for investors to make a reasonable determination if the balance of risk and return is skewed. If the balance is perceived to be disrupted, then we think it's wise to adjust investment portfolios accordingly.

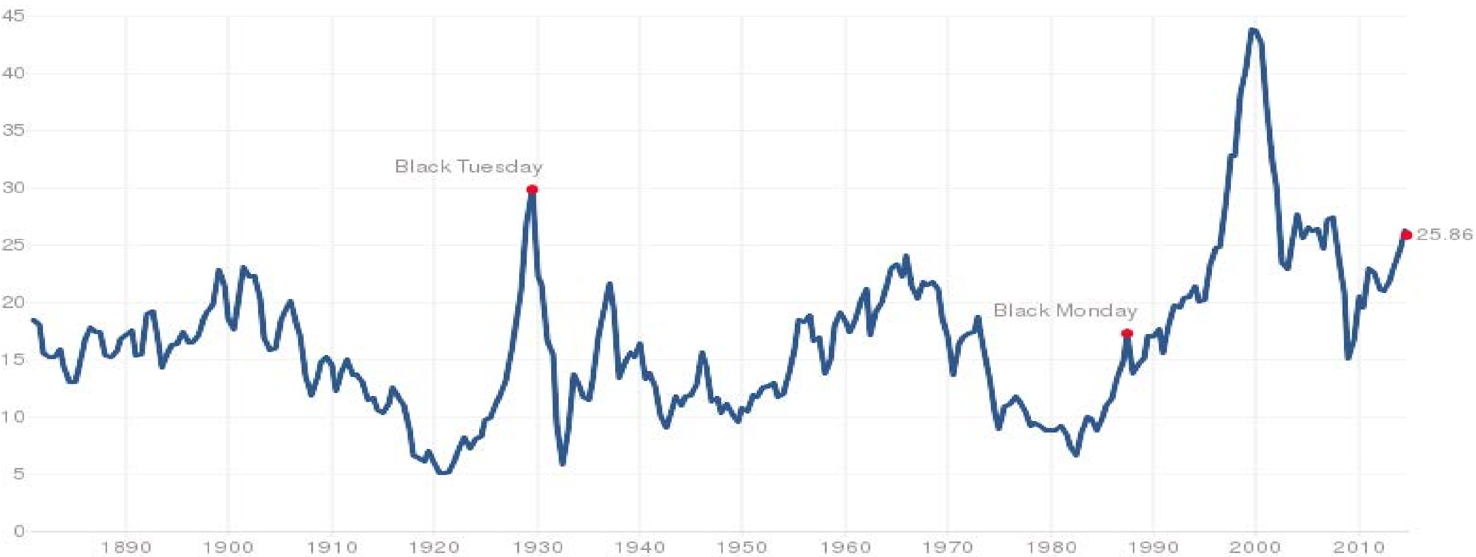
Portfolio changes should always be based on an investor's unique situation. We will discuss our outlook in a general sense only, which may not be applicable to everyone. It's always best to check with your financial advisor when considering your investments.

There are several key areas to consider when making a market assessment. The most important ones we see today are market valuation, market trend, investor sentiment, monetary policy, the economy, and geopolitical environment. Assessing the market requires that you not focus on any of these key areas in isolation. It's much more important to analyze each area collectively before an overall assessment can be made. Some of these areas are in or nearing extremes which fuels a bull vs. bear debate. We'll review each one to see if it's in bullish or bearish territory and make a final assessment.

Market Valuation

The cyclically adjusted price-to-earnings ratio (CAPE) advocated by Yale's Robert Shiller is a useful method of assessing market valuation. It uses a 10-year average of earnings and adjusts for inflation.

The CAPE for the S&P 500 is alarming many investors as it is currently near 26. That is about 54% above the historical average of 16.6. As you can see on the graph below, in the last 100+ years, we've only been at this level 3 times and a crash eventually followed each time. This includes the crash of 1929, 2000, and 2007. The market was in such a historic bubble in the late 90s leading up to the 2000 crash that the market continued to go up for about 2 years before the eventual crash in 2000. That's important to keep that in mind because correctly identifying a bubble is one thing and knowing when it is going to burst is another.



The 1 year P/E ratio on the S&P doesn't look quite as bad as the 10-year CAPE above. However, it shows that the S&P 500 is about 17.7% above median fair value according to Ned Davis Research (NDR). NDR also shows that the S&P is expensive on a price to sales, price to book, and price to cash flow basis compared to historical levels.

Comparing current markets to past markets is necessary when assessing valuation; however, every market has unique characteristics that complicate comparisons. The low interest rate environment and high level of Federal Reserve intervention is certainly one aspect of the current market that is unique. We just caution investors on succumbing too much to the mentality that "this time is different". It's only different for a short time before history tends to repeat itself. The **BEARS** win this one as valuation in the equity market should be a concern.

Market Trend

Since World War II, the S&P 500 has averaged a 10% correction every 344 days. We're now over 1,000 days since the last 10% correction going back to October 2011. There are only 4 other times during this almost 70-year period when the market exceed 1,000 days between 10% corrections.

Two of the most recent 1,000+ day extended rallies coincide with elevated CAPEs seen above. The S&P rallied for 2,553 days from October 1990 to October 1997 before it had a 10.8% correction. In October 2007, the S&P 500 had gone 1,673 days before a correction of 18.6%. The current CAPE of approximately 26 is in line with the 1997 & 2007 markets. We previously noted that the tech bubble continued for about 2 more years after the 1997 correction, but we see that period as an anomaly due to the extremity of the valuations during that period.

This current uptrend in the market is certainly aged by historical standards, but the market continues to climb higher. We've had a few pullbacks during this period that were all around 6%; however, the markets rebounded sharply each time as the result of fresh buying. That could very well happen again as there are always investors ready to buy the dips.

Ned David Research is a great resource we use for market trend data. Their Big Mo Tape Composite is currently neutral and trending lower. The breadth of the market also appears to be weakening. In June, 17% of the stocks on the NYSE were at new highs and only 2% were at new lows. Currently, 3% of NYSE stocks are at new highs and 6% are at new lows. We see market trend as really a toss-up between the bulls and bears. It has been weakening a bit recently but is still in neutral territory for now. **NEUTRAL**

Investor Sentiment

Investor sentiment is a contrarian indicator that is important to monitor for trend changes. It's contrarian in that overly optimistic sentiment is a negative sign for the markets and overly pessimistic sentiment is a positive sign for the markets. Overly optimistic investor sentiment generally means that investors have been making substantial asset purchases and there is often a decreased supply of funds available for additional purchases that would keep the rally intact.

One measure of sentiment is to look at U.S. household asset allocation to see how individuals are invested. A large allocation to equities indicates that investors are optimistic. According to NDR, the average household equity allocation is currently at 54% compared to a historical average of 44% since 1950. The household equity allocation bottomed around 36% during the last recession and climbed steadily to the current level. Cash is currently at 22% versus a historical average of 32%. We think this is an intended result of monetary policy that encourages the investment into riskier assets in order to achieve a return greater than 0% paid on cash equivalents. Thus, the use as a sentiment indicator has been corrupted.

Investor sentiment as measured by the American Association of Individual Investors (AAII) has been mostly in line with the long-term averages this year. The NDR Crowd Sentiment Poll has shown some signs of extreme optimism (bearish sign) but has moderated recently. Therefore, investor sentiment does not currently exhibit signs of a market top and imminent correction. The **BULLS** win this round in that investor sentiment is not at levels that are a cause for concern but is on watch for a change to a neutral rating.

The Federal Reserve - Inflation

The Federal Reserve's monetary policy has undoubtedly played a significant role in influencing the economy and in effecting the equity markets. Consequently, it continues to be of significant importance to monitor the Fed and anticipate their actions. We discussed our thoughts on the Fed in May and do not think much has changed since then.

A slight uptick in inflation caused a bit of stir in June, but inflation levels continue to remain in a range that should be comfortable for the Fed. The Personal Consumption Expenditures Index (PCE) is currently at 1.6% year over year through June while Core PCE, that removes food and energy from the index, measured 1.5% . The Consumer Price Index (CPI) measured 2.1% through June while Core CPI was at 1.5%. These levels are at or below the stated 2% target of the Fed. However, the PCE increased to an annualized 2.5% rate for the 2nd quarter resulting in fresh inflationary fears.

Federal Reserve members tend to be dovish (less concerned with inflation) or hawkish (more concerned with inflation) by nature. It's generally known which camp each member belongs to through their votes or commentary. As we mentioned in May, dissent in the Fed is likely and that became evident along with the uptick in inflation. However, we think a certain amount of this is posturing and not really indicative of true inflationary fears by some Federal Reserve members.

It's important to note that crude oil prices have declined measurably since June with Brent moving from $114 to $102 from June to August. West Texas Intermediate declined from $107 to $96 during this period. This should further help to keep a damper on inflation as crude prices greatly influence short-term inflation. Increased conflict in the Middle East, however, could result in a spike in crude prices either through actual disruption of supply or through an increased fear of a disruption in the form of a "fear premium".

The Federal Reserve – Employment

We continue to believe that the Federal Reserve will favor monetary policy that is focused more on increasing employment over fighting inflation. Many gains have been made in employment from the recession, but the unemployment rate remains stubbornly high at 6.2% through July. Long-term unemployment remains a concern with 32.9% of the unemployed being out of work longer than 27 weeks. This is symptomatic of the jobs/skills mismatch of structural unemployment instead of cyclical unemployment from the recession.

Structural unemployment is more of a concern because monetary policy is less likely to improve conditions. We believe that the unemployment rate will remain elevated while the labor market will actually tighten for skilled workers. There currently is no evidence of this as real average hourly earnings remain muted, but we think this is an important metric to watch for a change in Fed sentiment with regard to emphasis on employment or inflation.

The Federal Reserve – Monetary Policy

We believe that the Federal Reserve under Janet Yellen's leadership is moving in a prudent and predictable manner. The predictability is an important aspect as the Fed gradually reduces their extensive economic interference. A shock from an unforeseen Fed action could result in excessive movement in capital markets that currently appear to be complacent. The Fed is widely expected to conclude the quantitative easing (QE) stimulus in October this year and we completely agree that is the appropriate time. We do not see the Fed increasing short-term rates until QE has ended and likely well into 2015. We further believe that the Fed will subtly hint at policy changes well ahead of time to keep up the safety of being predictable. Ultimately, we believe that the Fed will have to concede that any lingering employment issues are structural in nature and largely beyond their control. That should put them in a position to gently ease back to normal interest rate levels. The easy monetary policy from the Fed is one for the **BULLS**. **Don't fight the Fed!**

The Economy

The economy, as measured by Gross Domestic Product (GDP), declined by 2.1% during the first quarter. This was largely attributed to the unusually cold weather. Fortunately, the GDP rebounded to a 4.0 annualized rate during the second quarter.

Leading economic indicators are in line with continued moderate growth. Average weekly hours are up to 42, initial jobless claims continue to trend lower at 315,000, factory orders continue to expand along with nondefense spending, and the S&P 500 continues to climb. Consumer sentiment remains well below prerecession levels, but continues to slowly trend higher.

The housing market looks mixed. The S&P/Case-Shiller Composite Home Price Index was up 9.3% year over year through May. Every region showed gains during this period. The highest gains were seen in Las Vegas at 16.8% while the lowest gains were seen in Cleveland at 2.3%. The downside of this rebound in home prices is that affordability is declining as income gains fail to match increases in home prices. New home sales declined 8.1% in June. New home inventory increased to 197,000 homes or roughly 5.8 months of supply.

The economy grew at a very modest 1.9% rate in 2013, so we really needed to see better growth in 2014 to put us back toward normal trend growth and firmly away from recessionary levels. The decline in the 1st quarter this year was certainly a cause for concern. Despite a rebound in the second quarter, economic growth looks to be fairly modest for the whole calendar year. A slow upward trend is still worthy of a slight **BULL** case.

Geopolitical Issues

There is likely always going to be conflict somewhere in the world. It's more on the forefront now than it was previously for a couple of reasons. Investors are much more aware of issues because news is more readily available through the proliferation of technology. Conflict matters more now as well since global economies are more interwoven via global trade.

That being said, we think it's clearly a time when there is elevated event driven risk from Russia/Ukraine, ISIS, and Israel/Hamas. The market seems to have largely ignored negative potential outcomes of these conflicts. We have no political knowledge or expertise, but we are concerned how these conflicts increase the uncertainty in the markets. The greater the uncertainty, the greater the discount that should be applied to market forecasts. We're simply not seeing it in the current environment. An escalation of any of these current conflicts could be a catalyst for a market decline. Consequently, we think this is clearly a winner for the **BEAR** case.

Opinion

We are concerned with the current valuation of the market. The length of this rally is causing some complacency in the market that is apparent with very low level of the VIX volatility measure. This complacency is likely to accentuate an eventual market correction. We think that the market is possibly headed for a 10-20% correction, but the timing of that is too speculative for us to call.

An overvaluation of the market alone is not sufficient for the market to suffer a correction. That's why we look at the other contributing factors mentioned earlier. Perhaps the most influential is the monetary policy from the Federal Reserve. An orderly end to their Quantitative Easing program will help the markets return to a more natural state. It is likely, however, that interest rates will remain subdued for the near future. Interest rates rising more quickly than anticipated could certainly be a catalyst to lead to a correction.

We're watching the market trend and investor sentiment closely for the early signs that the market could correct. These are factors that can change fairly quickly. These are both neutral or slightly bullish which can keep this rally going along with the Fed.

You can make a fundamental case for the market to be 10-20% lower, but it doesn't mean that it's going to happen right away. In general we consider the current market environment as one with asymmetry with regard to risk and return. We see the upside over the next 6-12 months as somewhere in the range of 5-7%. When you compare that to a downside potential of 10-20%, we think caution is warranted. Of course there is no certainty in a such short-term forecast, but we believe that you need to have a plan for a potential correction depending on your specific financial situation.

Investment Strategy

We'll keep most of our strategy and investment work available only to our clients. However, we think it's fine to share a few basic tactical calls we have at this time. We continue to like Master Limited Partnerships (MLP) for their safety, income production, and tax advantages. We are underweight small cap stocks which are even more overvalued than large cap. We are overweight domestic stocks over foreign.

We think that active management is likely to outperform passive management in this environment. Dividend paying stocks should weather a correction better than non-payers. For some clients, an equity barbell approach may be a good option if an active management approach is appropriate for them. We think that there will be attractive opportunities in almost any market environment and that a possible correction will increase the pool of attractive investments. We decreased equities across the board in late July and have been maintaining high levels of cash. We would see a correction as a buying opportunity for select investments.

Disclaimer

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Regards,

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