2014 INVESTMENT OUTLOOK

The U.S. equity markets completed a remarkable 2013 with the S&P 500 generating a total return of more than 32%, its best annual performance since 1997. Such returns occurred amidst a sub-par economic environment of just 3% global GDP growth and 5% operating earnings growth for S&P 500 companies. What gives? Investor risk appetite has returned and equities have reset higher in anticipation of less volatile economic progression following 4+ years of quite abnormal recovery. This inclination is best reflected by the market's expanding P/E multiple, which started the year at 13.8x trailing earnings and ended it at 16.9x. If investor sentiment was described as "extremely bearish" and the public's perception of equities as "no good" in March 2009 at the stock market bottom, then one could argue that current sentiment and perception of stocks has made a 180 degree turn since then.

The upside in the near term is that the advance could continue as long as earnings push higher and given the current P/E multiple is still below the 17-18x range where nearly every bull market has peaked since World War II. Furthermore, according to JP Morgan, bull markets lasting longer than four years (since 1897) have only ended with a recession—i.e., they typically do not end just because "everyone is too bullish." The economy is actually picking up some momentum as the new year commences. While U.S. GDP has grown at an annualized rate of 2.0% over the past year, growth in the second half of 2013 will probably be closer to 3% once the final numbers come in, driven by inventory accumulation and a pickup in spending by both consumers and businesses.

The downside is that future compound annual stock returns are likely to be far below the nearly 18% realized annually over the past five years given the length of the bull market, elevated corporate profit margins, and the tapering of easy money. From a policy standpoint there is less room for error due to the high government debt levels of developed economies, which makes it difficult to fiscally stimulate growth should there be a hiccup. Weaning the economy off unprecedented monetary stimulus following the reflation of wealth is likely to lead to some unintended consequences, too, but this should be an expected cost of what many argue has been a successful policy response to avert a once-in-a-century financial crisis.

2013 Equity Market Returns (excluding income)

	12/31/13 Price	Y/Y % Change
Dow 30 Industrials	16,577	+26.5%
S&P 500	1,848	+29.6%
NASDAQ Composite	4,177	+38.3%
MSCI All Country World Index ex-USA	281	+12.3%

Near and Intermediate Term Outlook

The fruits of the Federal Reserve's labor were on full display in 2013 as stock prices climbed to all-time highs and housing prices rose nearly 14%. This so-called "wealth effect" has had positive implications for the underlying economy for the time being. The wealthiest 20% account for some 50% of discretionary consumer spending in the U.S., and this quintile of consumers spending their growing wealth has clearly underpinned economic progress amidst a lackluster recovery for the broad citizenry. Fiscal headwinds are subsiding but the U.S. is about to face a tapering of the quantitative easing that has dominated the policy backdrop over the past five years.

While GDP has grown at just 2.3% since the end of the Great Recession, the underlying trend growth of the private sector at nearly 3% has been much stronger and exhibits some near term momentum. Housing and business capital spending are still at recession-like levels as a percentage of the economy despite recent improvement, and leading indicators for both point to further gains ahead. While financial asset prices have risen sharply over the past two years, it's hard to argue that the real economy is anywhere near a level of overinvestment, a typical pre-cursor to a recession. In fact, consumption of existing capital (i.e., depreciation of structures, equipment, and technology) still exceeds new investment. There tends to be an inverse relationship between the federal government deficit and net investment in the economy, thus with the deficit shrinking for now the environment is gradually improving for private investment.

In terms of the consumer, payroll growth has averaged about 200k per month recently, wages are slowly picking up, and household deleveraging appeared to end in Q3—trends that are all positive for consumer spending. Discretionary federal government spending will soon flatten out due to the recent government budget agreement to avert some of the sequester cuts. This would be an improvement compared to the 3.2% annualized decline experienced over the past three years. Therefore, with the private sector contributing approximately 83% to economic growth and expanding at an underlying trend rate of 3%, overall GDP growth could be at least 2.5% in the year ahead. That would be a pickup from the sub-2% growth rate experienced for full year 2013.

New housing starts have made a dramatic recovery over the past two years. The National Association of Home Builders (NAHB) confidence index, a leading indicator of housing starts, continues to rise and is at its highest level since November 2005. Thus, residential investment as a percentage of the economy should continue to rise from current recessed levels of 3.2% (the long run average is 4.8%). Rising starts eventually feed into housing-related retail sales of items such as appliances, furniture, and electronics. Recent retail sales data verify this virtuous trend as housing-related retail sales growth has outperformed general merchandise and apparel chain store sales over the past year.

Generational low interest rates and bargain hunting have lured private equity investors and 100% cash buyers into the existing home market over the past three years, leading to a 11% annualized increase in existing home sales volumes since the mid-2010 bottom. Although sales have slowed recently, such activity has fed a significant recovery in home prices. The S&P/Case-Shiller Index was up 13.6% year-over-year in October (most recent month of data) and is up nearly 20% since the January 2012 bottom in prices. The index is still some 20% below the peak level of April 2006. Rising home prices have helped a considerable number of homeowners escape negative equity. According to CoreLogic data, 6.4 million homeowners remain underwater, a substantial improvement compared to more than 12 million just two years ago. Such progress in household balance sheets has enabled consumers to add to debt levels over the past year. Household debt outstanding was up 1.3% year-over-year in the third quarter of 2013, the first positive gain in almost five years. A continuation of this trend in 2014 would be another tailwind for consumer spending.

There are some risks and caveats to the housing recovery that investors should consider. The mere hint of Federal Reserve tapering of asset purchases in early May '13 led to a 125 bps spike in mortgage rates within four months. Current mortgage rates are near 4.8% and are rising after touching 3.6% in December '12. A further spike in rates could make conditions too tight for the current economic backdrop, thus slowing the recovery.

Additionally, weekly mortgage applications—a good indicator of household demand—imply a lower level of sales activity than the current overall run-rate of 4.9 million home sales. Private equity and cash buyers have played a meaningful role in propelling recent gains, accounting for more than half of residential sales, according to RealtyTrac. However, these investors probably have a limited appetite for properties. Demand must now be sustained via higher sales to households, which is dependent on job growth and household formation. Unfortunately, existing home sales have fallen more than 9% since August following the spike in rates and are still some 19% below the long term growth trend. Furthermore, the recovery in housing is obscured through the lens of the homeownership rate, which has fallen throughout the recovery and is back to 1996 levels of 65% of households. Given the above trends, we expect further gains in home prices to be much more modest in the year ahead.

New orders for business capital goods have slowed to a 2.2% annualized rate since the end of 2011, and below the 7.1% underlying trend since the end of the recession. This slowdown coincides with the most recent Eurozone recession and the intermittent tightening of credit that resulted. During normal cycles, business investment grows at 2-3 times the rate of GDP growth in the middle of a cycle as management expands capacity to meet demand.

Recently, the Eurozone recession ended and leading indicators point to some acceleration in capital spending as we enter 2014. Such an occurrence would be welcome, especially by technology and industrial companies because business investment is what drives their sales and profit growth. Both the U.S. and global purchasing manager indices (PMIs) indicate a pickup in new orders. Hard data from various global industrial companies verify this momentum. Also, an easing in bank lending standards for commercial & industrial (C&I) loans—a solid leading metric for capex—indicates better growth. Despite various regulatory headwinds, U.S. banks are also in better shape to step-up lending since bank leverage is at a 30-year low, per Credit Suisse data.

Considering that productivity growth has fallen to just 0.4% over the past year—its lowest level since 1994—businesses will eventually need to invest to maintain current levels of efficiency and to offset obsolescence. The recent decline in productivity growth has actually commenced some better wage growth for workers as average hourly earnings are up 2.2% compared to a year ago. Wage growth hit a low in the fall of 2012 near 1.4%, so acceleration in this metric is welcomed by the consumer spending part of the economy. Wage growth could continue to strengthen in 2014 as job openings in corporate America are rising but the supply of qualified labor is stagnant.

While the unemployment rate at 7% is at a cycle low, the percentage of the population that is employed is also near a cycle low and at its lowest level since 1983 as labor force participation has plummeted. Half of the decline in labor force participation since the Great Recession hit can probably be explained by baby boomers reaching retirement age and leaving the workforce; but the other half is likely cyclical in nature and unemployed individuals not having the proper skills for the current job environment. Nonetheless, solid employment growth should continue in 2014 as small business hiring intentions are the strongest since February 2008. Total nonfarm payrolls should fully recover the jobs lost during the recession before mid-year and thus pass the previous peak of 138.1 million payrolls.

Global GDP growth troughed in the first quarter of 2013 at about 2.5% and gained momentum in the following quarters after a three-year slowdown. The Eurozone saw its recession end by mid-year and most developed economies realized stronger growth in the second half. Business surveys point to global GDP picking up to a 3.0% to 3.5% rate for 2014. While such a level of growth is near the 30-year average, it is well below the 5%+ rates experienced during the strongest years of the previous decade. Developed economies face less fiscal headwinds (i.e., tax increases, budget cuts, austerity) in the coming year which should allow the private sector to have a stronger impact on overall growth. However, the recovery in Europe generally remains weak despite the end to the recession, and emerging markets must begin to adjust to the realities of weaker secular demand in developed economies.

While Europe has made progress with some reforms over the past several years, the steps are still too slow and too modest. In reality, the region is just one recession away from being back in crisis yet again. Deflation is currently a real threat to the Eurozone, especially in some of the troubled peripheral nations. Unfortunately, in order to become more competitive with stronger economies like Germany, wage deflation in particular is a necessary adjustment in many of the southern countries. However, deflation naturally leads to more burdensome debt loads as a percentage of GDP. At some point in the future the answer to such debt burdens will be significant restructurings and haircuts, or else risk collapse of the common currency and integration. In the meantime, budget deficits are generally shrinking and the region is running a trade surplus, which has supported the euro currency and enables the region to internally finance its debt needs. One component that needs to improve for the Eurozone to avoid tipping back into recession is the transmission of credit to businesses. Loan growth to corporations is contracting, falling more than 3% over the past year. Contrast this with the U.S. where business loans are growing at nearly 8%.

Perhaps some of the greater risks to the 2014 outlook can be found in emerging markets and China. Such economies are slowly transitioning to becoming more consumer-oriented internally but are still too dependent on trade flows, demand from developed regions, and credit growth. Emerging market stock returns were actually negative for 2013, declining 2.3% on a total return basis. The five-year compound annual return of 15.2% for emerging market stocks now trails that of the S&P 500. The easy money policies of the Fed caused capital to flow into emerging markets following the Great Recession in a chase for yield and higher returns, but this trend reversed hard last May when Chairman Bernanke hinted at the Fed potentially tapering its asset purchases by the end of 2013. Many emerging market currencies were down against the dollar for the year as private capital flows reversed. There is the risk that the tapering program in 2014 and rising U.S. interest rates could cause a further deterioration in emerging market capital flows and currencies, thus impacting corporate earnings via lower profitability and foreign exchange headwinds.

Policymakers in these economies have less flexibility to support growth since inflation tends to rise in such a scenario. The dollar itself has some solid underpinnings over the next several years relative to the broad foreign currency universe: QE could be ending and interest rates have started to rise; the federal budget deficit is shrinking as a percentage of the economy and below the rate of nominal GDP growth; and U.S. energy production is rapidly advancing, lowering the trade deficit.

The regime in China is attempting to pull off a soft landing in its economy following a rapid rise in credit and fixed asset investment over the past five years. Chinese banks funding themselves with short term debt faced volatile and rising interest rates throughout 2013, especially when the Chinese central bank tightened liquidity operations. Policymakers want banks to tighten lending standards to slow down the pace of credit extension and prevent a spike in bad loans and defaults. Slower credit growth almost always translates into slower GDP growth. Chinese GDP rose approximately 7.6% in 2013, the slowest since 1999, and risks moderating even more in the coming year in response to tighter policy. Chinese manufacturing activity has slowed since October and the 51.0 reading for the most recent purchasing manager survey indicates a level of activity that is barely expanding. Rising wages due to minimum wage laws, a decreasing supply of skilled labor, excess capacity from overinvestment, and weak secular developed market demand paint a difficult fundamental backdrop for Chinese-domiciled companies. This is a big reason why Chinese stocks have performed so poorly the past three years.

Investment Conclusions

2014 will see the Federal Reserve attempting to normalize policy following five years of unprecedented stimulus. Such a move is likely to bring higher levels of volatility in financial markets than experienced in 2013 as a reversal of its bond buying is bound to cause some negative consequences. Given that stock valuations have broadly normalized, further gains in equities will be more dependent on earnings growth, which we see advancing at a 5-6% rate in the year ahead. Long term interest rates have already moved nearly 140 bps higher since early May in anticipation of the tapering program, taking the 10-year Treasury note to a current 3.0% yield. The backup in yields could continue but will eventually begin to impact stock valuations via competition for funds. A further spike in long term rates similar to 2013 would probably require better than expected economic growth and/or a doubling of inflation versus the current CPI rate of 1.2%. A meaningful rise in short rates is probably a 2015 event as the Fed is determined to allow various economic metrics normalize to levels that are more typical of mid-cycle progress.

Overall, we see the risk-reward for stocks as less favorable relative to a few years ago when the economic and corporate profit cycles were less mature and valuations less demanding. Future compound annual returns from current levels are expected to be much more modest than those experienced since the end of 2008. Thus, we have begun to trim equity allocations where they have risen above long term target ranges, and have reached the stage of the stock market cycle where risk management and capital preservation become as important as return generation. Higher cash levels should be seen as an insurance policy against the inevitable stock market correction. In the meantime, opportunities in the municipal bond market offer the best value in investment grade fixed income at the moment and a continued rise in yields could eventually offer a larger opportunity set to generate income than we’ve seen in several years.

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