Investment Watch

1st Quarter, 2014

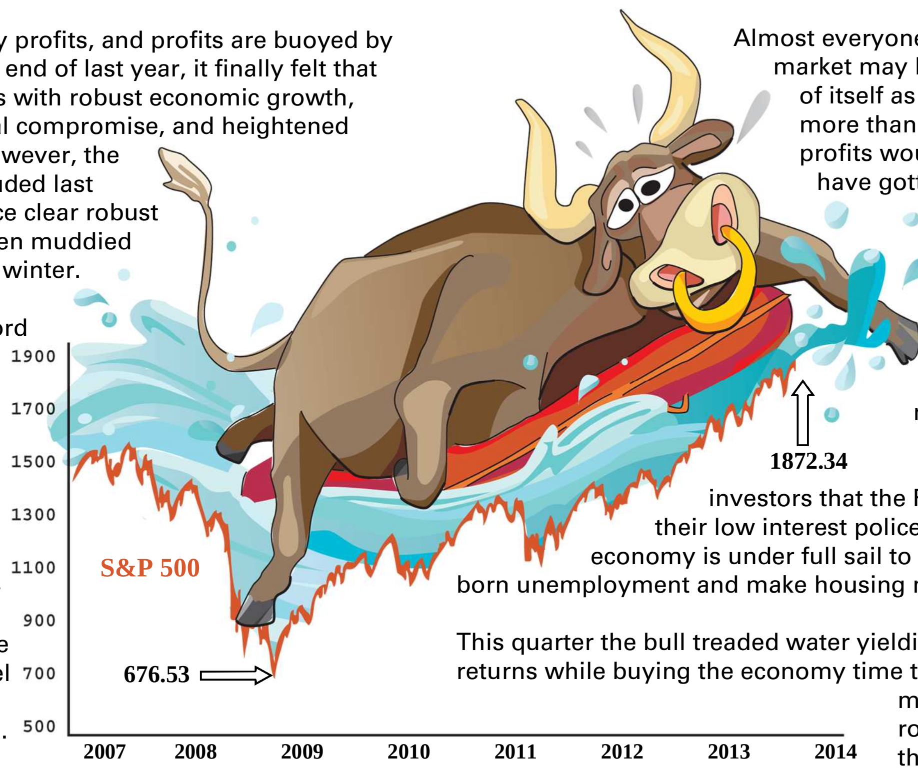
Happy 5th Birthday

That old stock market bull turned 5 on March 9th. Wish him a happy birthday, with thanks for the market's blistering, record setting rally last year. The subprime mortgage crisis submerged the economy and drove the stock market meltdown. Measured by the Standard and Poor's 500, the stock market sank to the bottom at 676.53 on March 9, 2009, which also marked the start of the bull's run. For five long years swimming upstream in a sluggish economy, this bull has driven a strong market surge with nary a falter.

Stock market bull runs occur when the gains exceed 20% without experiencing a correction, a decline of 20%. The bull narrowly avoided a correction during the fall of 2011 when the market dipped 19.4%, but since then it's been smooth sailing ahead without a 7% pullback. Today the S&P 500 stands at 1872.34, 177% above that deep-sea depth of five years ago. But where do we go from here? Is the bull too tired to fight that long, overdue market correction? Or can the economy embark on its own and set sail in these new, uncharted waters?

The markets are driven by profits, and profits are buoyed by a strong economy. At the end of last year, it finally felt that the wind was at our backs with robust economic growth, unexpected congressional compromise, and heightened consumer confidence. However, the bleak winter weather clouded last year's optimism. This once clear robust economic outlook has been muddied by the dampening, harsh winter.

2013 was one for the record books with the S&P 500 achieving countless all-time highs and yielding 32%, its strongest advance in 16 years. The current record was set on March 7th, ironically two days before the bull's 5th birthday. Most prognosticators predict while 2014 will be positive it won't be as exciting, but others feel that we are long overdue for that market correction. Let's look at both sides.



The March 17th Wall Street Journal article *"Sailing the High Seas of Corporate Profits"* points out that the S&P 500 hit record highs 50 times in the 12 months ending on the bull run's fifth anniversary. The reason—corporate profitability. According to FactSet, companies' net profit margin grew to an all-time high of 9.8% in the 4th quarter of last year. Financial analysts polled by FactSet actually foresee net profit margins hitting another record of 10.5% by the end of this year. Uncharted territory, but good news for the bull.

According to the Commerce Department, hefty corporate profits hit a new record of 11.1% of the Gross Domestic Profit (GDP) in the last quarter of 2013. This profit expansion is a result of companies keeping a lid on costs. Productivity gains have allowed companies to be slow to hire while at the same time, high unemployment has held down wages. Companies, hoarding these excess profits, are sitting on piles of cash rather than expanding or buying new equipment. Although admitting that this trend cannot continue forever, many pundits envision corporate America extracting even more gains, buoying profits to historic levels.

Riding in the stern, the more pessimistic pundits believe that this bull market has run out of steam. They feel these record setting corporate profits are unsustainable and will begin to decline, eventually reverting to the mean. They predict that this tired bull market may have a hard time treading water as lower profits would result in lower prices. These skeptical pundits, rightfully so, are nervous about the withdrawal of the Federal Reserve's monetary accommodation, the Chinese slowdown, stubborn unemployment and a soft spot in the housing market.

Almost everyone agrees that the market may have gotten ahead of itself as prices have risen more than even these record profits would explain. Stocks have gotten more expensive. However they are still within a normal range, albeit at the high end. The Fed has tried to calm the markets. Today Fed Chair, Janet Yellen, tried to reassure investors that the Fed will continue their low interest polices even after the economy is under full sail to bring down stubborn unemployment and make housing more affordable.

This quarter the bull treaded water yielding more normal returns while buying the economy time to catch up with the markets. There will be rough seas ahead but the Fed's at the helm, guiding us through these treacherous waters. Navigating from an economy buoyed by easy money policies to a self-sustaining, robust economy won't be easy. Markets may be volatile, but long-term investors can ride out the choppy waters ahead.

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