First-Half Report Card: Modest Gains, Murky Outlook

It's hard to describe single-digit first half returns as a raging bull market, but it's also hard to feel too negative about a six month period when the S&P 500 recorded 22 record highs and virtually everything in your portfolio – including bonds – rose in value.

The Wilshire 5000 – the broadest measure of U.S. stocks and bonds – rose 4.83% for the second quarter – and now stands at a 6.96% gain for the first half of the year. The comparable Russell 3000 index gained 4.88% in the second three months of the year, posting a 6.94% gain in the first half of 2013.

The other U.S. market sectors experienced comparable gains. Large cap stocks, represented by the Wilshire U.S. Large Cap index, gained 5.12% in the second quarter, and is now up 7.17% so far for the year. The Russell 1000 large-cap index returned 5.12% for the quarter, up 7.27% for the year, while the widely-quoted S&P 500 index of large company stocks gained 4.69% for the quarter and is up 6.05% since January 1.

The Wilshire U.S. Mid-Cap index rose 4.50% in the second three months of the year, and is up 8.42% at the year's midway point. The Russell midcap index was up 4.97% for the quarter, and now stands at an 8.67% gain so far this year.

Small company stocks, as measured by the Wilshire U.S. Small-Cap, gained 2.71% in the second quarter; with the first quarter gains, the index is up 5.35% so far this year. The comparable Russell 2000 small-cap index was up 1.95% in the second three months of the year, posting a 3.19% gain in the year's first half. The technology-heavy Nasdaq Composite Index was up 5.94% for the quarter, and is up 5.30% for its investors so far this year, reaching levels that haven't been seen since March 2000.

The rest of the world is not doing as well. The broad-based EAFE index of larger foreign companies in developed economies rose 2.95% in dollar terms during the second quarter of the year, and is up the same 2.95% so far this year. The stocks across the Eurozone economies rose 1.90%, and are now up 3.45% for the first half of the year.

The news was much worse for emerging markets stocks, which have been touted as the world's engine of growth. The EAFE Emerging Markets index of lesser-developed economies rose 5.64% for the quarter, and are now up 4.80% for the year.

Looking over the other investment categories, real estate investments, as measured by the Wilshire REIT index, rose 7.47% for the quarter, and is standing at a remarkable 18.36% gain for the year. Commodities, as measured by the S&P GSCI index, rose 2.69% this past quarter, posting a gain of 5.71% for the year.

Most market participants and pundits expected bond rates to rise in the first half of the year, but once again bond returns surprised the experts. The Bloomberg U.S. Corporate Bond Index now has an effective yield of just 2.90%, while comparable yields in the Eurozone stand at 1.64%.

Treasury rates took their biggest first-half drop since 2010. 30-year Treasuries have seen their yields fall to 3.36% in the past six months, and 10-year Treasuries currently yield 2.53%. At the low end, 3-month T-bills are still yielding a miniscule 0.04%; 6-month bills are only slightly more generous, at 0.06%.

One of the most interesting questions batted around among professional investors these days is: are these low yields sustainable in the future? Can they keep dropping? Won't the appetite for Treasuries finally dry up, forcing rates higher? If you look at Treasury rates in isolation, current rates seem to be as low as they can go. But it is also interesting to look at the global bond markets from an international investor's perspective. Would you prefer to invest in U.S. 10-year Treasuries at 2.53%, or buy comparable Japanese government bonds, yielding just 0.563%? Are you more attracted to German 10-year bonds, trading at 1.25% yields? As little as they are yielding today, U.S. government bonds are still pulling in buyers from around the world, both as a safe haven and as a source of higher yields.

But depending on where you look, the economic news has been somewhat scary. The U.S. economy's GDP dropped 2.9% in the first quarter of the year – an enormous hit which has been largely blamed on the weather. The uncertainty in Iraq, including the recent ISIS capture of a major refinery, has sent the spot price of oil above $107 a barrel on global markets. Manufacturing activity fell in the past month, and the growth of jobs, which looked promising last year, has slowed down, with the unemployment rate stuck at 6.3%.

There are also positive signs, particularly in the statistics for housing demand. The pending home sales index for contracts to purchase previously-owned U.S. homes rose 6.1% in May, the largest advance since April 2010, when sales were boosted because the homebuyer's tax credit was on the verge of expiration. The rise in the overall REIT index suggests a strong bounceback in the real estate industry overall.

Even the government seems to be getting its books back in balance. You won't read about it in the newspapers, but the U.S. federal deficit has fallen from $1.4 trillion to around $400 billion in the space of one year. And the U.S. is now close to energy self-sufficiency, which means that the trade deficit (which has been largely driven by the cost of importing Middle Eastern oil) is shrinking dramatically vis a vis the rest of the world.

The Michigan Sentiment Index recently hit 82.5, which means that people are generally optimistic about the state of the economy and the world.

Where do we go from here? The future is never clear, but today it might be less clear than usual. The long bull market that started in March 2009 and the economic expansion that started nearly at the same time are both among the longest since the Civil War. Bull markets have to end eventually; we all know that. However, this growth period has been more like a marathon than the usual recovery sprint after a recession; the economy has grown at a 2% annualized rate since 2009, which is below the long-term average, and considerably below what is normal during a recovery from economic malaise. Marathon runners – at least in theory – can keep moving longer than sprinters. Is that the case today? The U.S. Federal Reserve has vowed to keep interest rates low for the next 12 months, and many investors seem to be comfortable with this approach, believing it could be a recipe for more economic growth, profits and clear stock market sailing in the foreseeable future.

The truth is, none of us can tell whether the markets will continue to test records or not. The best indicator, and it is not something you can pin down, is whether people are still anxious about the future and concerned about the possibility of a market plunge. So long as people are still worried, the market probably hasn't reached its top. Whenever you see most investors finally deciding that the market is on a permanent upward climb, whenever everybody finally gives up on worry and puts their money into the hot market, that is when stocks have probably peaked, and an unpleasant surprise awaits those who joined the party too late.

Where are we on this scale? Few investors seem to be enthusiastic about current market valuations, which some believe to be a bit overpriced. At the same time, the sentiment surveys are in the "complacent" zone, and we are not hearing quite the same shrill tone from perma-bears and pundits who probably feel a bit embarrassed about predicting disaster over and over again as the markets sailed through scary headlines and economic headwinds.

This may be the perfect time to celebrate the fact that we've managed to stay invested during fearful times, when government shutdowns, European banking crises and the threat of another meltdown at home were driving others away from the improbable upward trend. Since 2009, only the brave have stayed the course, and they earned the rewards of what, in retrospect, has been one of the most generous bull markets in U.S. history. How much more is in store for them, or when the inevitable pullback will come, is not something we mortals are given to know – despite the loud predictions you will hear from economists and pundits whose crystal balls are no more clear than yours.

Sources:

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