Economy Steady as Volatility Returns

As predicted in our January newsletter, the first quarter was met with heightened volatility and the choppy stock market turned in mixed results for the period. Through the end of March, the S&P 500 and NASDAQ Composite registered respective gains of 1.30% and 0.54%, while the Dow Jones Industrial Average declined by -0.72%.

After such a strong 2013, it is not surprising that some investors booked profits and took some proverbial chips off the table. The approximate 150 point swing in the S&P 500, with 1890 marking the high and 1740 marking the low, indicates a potentially tight trading range that the stock market seems destined to probe. Whether the market breaks through the recent ceiling and on to new all-time highs or whether we finally see a full-fledged correction will of course depend on economic data, earnings and interest rates.

On the economic front, recent data continues to point to moderate growth and sufficient traction for the recovery to continue its path toward escape velocity. The ISM Manufacturing Index rose to 53.7 in March from 53.2 in February, while the ISM Services Index rose to 53.1 in March from 51.6 in February. The February ISM Service activity was the weakest such report in four years, so the strong rebound offers ample evidence that February's weakness was temporary. While GDP will very likely have proved to have decelerated in the first quarter from the 2.6% annual GDP growth registered in the fourth quarter of 2013, it is becoming clear that the U.S. economy is not at risk of falling into recession and that much of the observed first quarter weakness can be pinned on extreme weather.

The labor market continues to gradually improve. Private employers added 192,000 jobs in March, after adding 144,000 and 197,000 new jobs respectively in January and February, bringing the three-month average to 178,000 new jobs. Unemployment remained at 6.7% in March. Interesting to note and perhaps coincidentally, the overall labor force grew by 1.29 million people since the end of 2013, approximate to the 1.35 million whose emergency unemployment benefits expired in January. Although the Federal Reserve officially removed its 6.5% unemployment target as a possible catalyst to hike rates, the labor market seems destined to soon test the 6.5% threshold and the Fed's resolve to maintain accommodative monetary policy in the face of a tightening labor market.

We have mentioned in previous newsletters that the percentage of discretionary income needed to service revolving debts is at a multi-decade low, as historically low interest rates have given the U.S. consumer a generational opportunity to refinance debts. Recent retail sales data confirms that consumer spending is robust and likely to drive GDP in the coming months. Excluding gasoline, retail sales surged 1.4% in March which was the sharpest increase since March 2010. Sales at department stores and general merchandise stores climbed 1.2% which was the largest such increase since March 2007. The combination of a confident consumer and banks seemingly more willing to lend drove the largest quarterly increase in outstanding credit since the third quarter of 2007.

Meanwhile, the housing market remains strong. The march towards energy independence is real. Corporate profits are at all-time highs and corporate balance sheets are in Fort Knox condition. Productivity continues to find enhancements made possible by technological

advances such as 3D printing, cloud computing, mobile broadband and pad computing. Rising tax revenues combined with government spending held in check by the Republican-majority House has alleviated concerns about our budget deficit. And demand for U.S. products by a growing middle class in emerging markets is a secular trend that remains in the very early innings.

With regard to earnings, analysts have steadily lowered estimates so that the consensus now calls for a 1.6% year-over-year decline in earnings for the S&P 500 for the first quarter. It is typical for companies to surpass consensus estimates after having lowered the hurdle of expectations to a level that can be more easily met. Should the S&P 500 actually turn in a quarterly decline in year-over-year profits, it would mark the first such decline since the third quarter of 2012. All that said, the consensus for 12 month earnings for the S&P 500 stands at $122.48, implying a reasonable forward PE of 15 at today's level. With the economic underpinnings intact, today's earnings estimates are reasonable and may prove conservative.

We believe that stock selection will play an increasingly important role this year and that a rising tide will not lift all boats as it did in 2013. Already in 2014, we have seen the decimation of previous momentum darlings that sold at wild valuations and became very crowded trades for the hedge fund community. Speaking of hedge funds, Goldman Sachs recently reported that hedge fund losses during the final weeks of March were among the worst suffered since 2001. Our focus on high-quality, financial strength, predictable earnings, consistent dividend growth and reasonable valuation will continue to deliver for portfolios and serve our clients well.

Interest rates may prove to be the greatest catalyst, one way or the other, for the stock market. With the Fed's tapering program continuing and quantitative easing expected to cease this Fall, the markets will become laser-focused on the Fed's next campaign to finally normalize monetary policy. Fed Chair Yellen recently testified that the Fed would likely begin to raise rates six months after the end of tapering, implying that we might see the Fed hike rates as early as next April. Of course, the market will not wait until next April to price in the expected increase in rates. Depending on the pace of economic growth in the coming months, with particular attention paid to employment and inflation data, bond vigilantes and the market may force the Fed's hand earlier than is currently anticipated. An unexpected rise in interest rates would almost certainly be catalyst for corrections in both the equity and fixed income markets.

We continue to hold a high cash balance as an important part of our investment strategy. Stocks have enjoyed a marvelous climb and, while fairly priced, are no longer selling at bargain valuations. Bonds are entirely unattractive and offer no compelling value. We will opportunistically invest this cash as bargains become available in stocks or bonds or both.