2013 RECAP, 2014 OUTLOOK JANUARY 2014

2013: GREED OVERCOMES FEAR

The year that just passed contained many noteworthy economic and market events, but will go down in financial history as a wonderful year in which stock investing seemed easy and Wall Street showered money on investors. In reality, of course, there's more to it. The foundation of the good outcome came from the steady increase in jobs created and the accompanying reduction in the unemployment rate. The market's upward march took an uncharacteristically minor pause during the debt-ceiling crisis, but was more shaken from the Fed's announcement that it was considering starting to withdraw the easy-money punch bowl. These two events, which normally would be enough to cause a market "correction", were no match for the improved investing sentiment exhibited by investors worldwide. After pulling money out of stock mutual funds for five straight years, investors decided to plow cash into the market (after watching it double from March 2009). This shift in the flow of money (from bonds and cash to stocks) is the primary reason the markets produced above-average gains. This is what happens when the demand for shares of stocks exceeds the supply. (Likewise, the exodus of money from bonds caused long-term U.S. Government bonds to lose over 20%.) As a result, the markets have finally moved from a valuation level that was below average, based on corporate profits, to a level that is roughly the average of where it has been the past century. Going forward, any potential market gains that are above the rate of corporate profit growth will be the result of the market creeping into pricey territory.

POSSIBLE ECONOMIC ISSUES FOR 2014

The continued momentum the economy has shown bodes well for the intermediate future. The U.S. economy appears to have reached a point where it is picking up steam as a critical mass of the population has moved further out of the woods from the recession and has quit postponing trips to shopping malls, car lots, and model home open houses. This development is also showing early signs of life in Europe, although it is at a much more fragile stage, similar to where the U.S. was in 2010 – 2011.

A possible problem could develop if interest rates increase faster than expected. No one knows the interest rate it would take, but at some level, higher rates would cause a dramatic reduction in home sale activity if the increase occurred in the near-to-intermediate future. Since we're currently at rock-bottom rates, this threshold rate would be significantly lower than what many would expect. Think 5-6%, not the double digits of 33 years ago. With the housing market being such a large driver of the economy, this risk is significant.

A related concern deals with the potential unintended consequences that could result from the Fed's stimulus efforts that have printed money and kept interest rates at all-time lows for five years. It would be naïve to think that this genie could be put back in the bottle without any repercussions. Nothing is impossible, but having a completely smooth landing would be a miracle.

That being said, the upcoming year could see a surprising acceleration in growth coming from three areas: One; consumers' increased financial health and the confidence gained from a recovering stock market could lead to an increased pace in spending. Two; the improved outlook could cause businesses to finally quit deferring maintenance and expenditures and start spending the accumulated cash hordes. Three; the immediate economic drag caused by 2013's government spending cuts will fade. (This might not be good for the long run, but the focus of this report is 2014.)

POSSIBLE INVESTMENT MARKET SCENARIOS FOR 2014

As we enter 2014, investors need to realize that we are overdue for a pullback of between 10-20%. However, even though it's overdue, it might not happen for a while, which will only make it worse when it eventually occurs. Additionally, it's important to remember that prices in the publicly traded securities markets are always in a state of flux that in the short term are based entirely on people's moods. While the market has been on nearly a one-way run for approximately 18 months, a lot of the gains represent economic improvements that occurred from 2010 – 2012 and also represent improvements that are expected in 2014. It's kind of like getting an annual bonus and pay raise around the same time . . . it feels great when it all hits at once, but you put in the work for the bonus a long time ago and the raise is for work in the future.

Greed is back among investors. It took five years, but it finally overcame fear. This broad phenomenon can be spotted even more clearly in the way investors are driving up prices on internet and social media stocks to very questionable valuations. To a lesser degree, the IPO's of fast growing restaurant chains are experiencing this. Investors are falling over themselves in the chase for any company with high growth rates in today's slow-growing economy. While this might not end well for people buying these stocks at the current levels, it is a positive change that people are investing based on optimism. It should be noted that while the broad market is no longer at below-average levels based on profits, it is nowhere near the inflated level it reached in 2000. For example, while the Dow Jones Industrial Average closed 2013 at approximately 16,576, if it traded at the valuation it had at the height of the tech bubble in 2000 (based on current corporate profits) it would be around 27,500.

Overall, investors should brace for the return to normal volatility (meaning one or two declines per year in the 10-15% range) and be cognizant of the potential for the unintended consequences from the Fed's tapering of stimulus to catch everybody by surprise. That being said, the positive achievements the economy has made are being recognized and could lead to accelerated growth. While this probably won't create an environment as tranquil or as profitable as what occurred in 2013, it is a far cry from the tumultuous environment of a few years ago.

As always, at Ryan Poage & Co. we take a pragmatic view of the possible outcomes and work toward being adaptable to the ever-changing nature of the economic and market cycles.