Outlook for 2014

Our "Outlook for 2013" newsletter described the many bullish underpinnings that buoyed our optimism as we embarked on the new year. We listed the recovery in the U.S. housing market, the great shape of corporate balance sheets, the march toward U.S. energy independence, the strengthening labor market, economic expansion in China and generally robust economic indicators in the U.S. to support our bullishness. As it turns out, we weren't bullish enough.

The S&P 500 closed 2013 at 1848, up 29.60% for the year, while our most optimistic scenario called for the S&P 500 to close the year at 1680.

Directionally, we were spot on for a higher move in the stock market. Further, our bullish underpinnings proved to be on the mark and provided a solid foundation for the markets to advance.

Ironically, while we were correct that the ability for Congress to negotiate a debt ceiling and budget deal would have significant impact on the market, we were surprised to the level at which the markets ultimately reacted to a deal that was anything but the grand bargain we had hoped for. We have long said that a grand bargain that tackled the debt ceiling, entitlement reform, sequestration and the budget would be enormously bullish for stocks. We think that 2013's stellar performance clearly illustrates how markets perform when the growth of government is curtailed or even held in check. Despite all the hand wringing about how sequestration would throw our economy back into recession, the U.S. economy grew stronger as the year progressed, perhaps *because* of sequestration.

With government spending held steady largely due to sequestration and tax revenues rising as a result of the economic recovery, the budget deficit has plunged from a high of 10.2% of GDP at the peak of the crisis to only 3.3% today. Keynesian logic and the likes of noted economist and New York Times columnist Paul Krugman would have us believe that the fiscal contraction observed over the last several years would have doomed the economy. Instead, the economic recovery is gathering momentum. Take that Krugman.

Not only are we observing fiscal policy contraction, we are finally set to observe monetary policy contraction. Yes, the Federal Reserve announced that they would taper asset purchases by $10 billion monthly to $75 billion effective January. It is now expected that the Fed will announce similar tapering measures at each coming FOMC meeting, with quantitative easing potentially coming to an end by the end of 2014. At least thus far, the bond market has remained in a tight range with the yield on 10-year Treasury bonds unable to meaningfully pierce the 3% level. This is mostly because inflationary pressures remain subdued, with recent readings of core CPI coming in at 1.5% annualized. Today, the yield curve remains steep and long-term bonds remain well-behaved. We will be watching the yield curve and inflation metrics closely for any hint of a potential sea change. As long as inflation remains subdued, we think the Federal Reserve will accomplish its lofty goal of completing the tapering process without dramatically impacting long-term yields. However, we are mindful of the power yielded by the bond vigilante and remain concerned for a potentially disruptive climb in interest rates this year.

The super-tanker U.S. economy and all of the aforementioned bullish underpinnings remain on track and should support steady earnings growth in 2014. Presently, consensus estimates call for S&P 500 earnings to advance to $120.80 in 2014 and $133.85 in 2015. At 2013's year-end level, the S&P 500 trades at 15.2 times forward earnings and 13.8 times 2015 earnings estimates. Meanwhile, the S&P 500 trades at 17 times 2013 earnings, a significant expansion of valuation multiples granted the market in the past year. Maintaining its present PE multiple of 17, we can see the S&P 500 trading up to 2053 in 2014, implying an 11% return for the year. Even though the evidence clearly suggests that the economy is picking up steam, we believe that the stock market may have borrowed from future returns given 2013's meteoric rise. Further, we would not be surprised to see heightened volatility in 2014 as investors grapple with additional tapering and the potential for rising interest rates.

With stocks having enjoyed such a strong run and bond yields on the rise, we continue to believe that holding an above-average cash balance will serve us well in the coming months. We intend to deploy this cash as opportunities arise in the stock or bond market and probably both. We continue to believe, especially during such a period of interest rate uncertainty and potentially rising inflation, that global blue-chip companies that have demonstrated the ability to grow earnings and increase dividends year after year will provide Osher Van de Voorde clients with worthwhile total return, especially after adjusting for risk.