OUTLOOK 2014

A Report for Investors by Rincon Pacific Management

January 2014

The stock market finished a banner year with the Dow Jones Industrial Average and the S&P500 Index both at all time highs. The Dow rose 26% in 2013 and the S&P500 finished at 1848 – a rise of 29%. Despite obstacles in its path, the market managed to march steadily higher over the past year. We are almost five years into one of those historic rallies where, no matter what hurdle appears, the stock market continues to advance. This is largely a result of global central banks promoting economic recovery with monetary stimulus. The United States Federal Reserve has both sparked and maintained the stock market rise with a continuation of cheap money flows without historical precedent. Thus the force behind the market rise – the monetary stimulus from the Federal Reserve - has been and continues to be the force driving stock prices higher. *

As noted, the Fed's Quantitative Easing has played the dominate role in the equity market's performance over the last few years. Now, the Fed has begun to taper bond purchases and the price of money is on the rise. The rate on the 10-year Treasury bond has almost doubled since summer 2013 as rates moved off a low of 1.7% in April-May. But higher rates, although they may moderate the advance in stock prices, are not necessarily bad for the economy. The Fed lowered interest rates to support the economy by boosting asset prices. They wanted to lift home prices, support stock prices, and raise consumer confidence. The plan has worked. But at the same time, these historically low interest rates have not had the same effect on the economy. The reason: banks have been reluctant to lend to businesses and lending activity has stagnated. When interest rates are low, the "margin" the banks earn between the deposit rates and lending rates is very thin. Lending activity dropped and money velocity slowed as the Fed concentrated on stimulus by holding

Applying a 17-month moving average to the S&P500 confirms the stock markets long term uptrend.

short term rates near zero. On a short term basis, higher interest rates would definitely be a shock for the market. Longer term, it could be a different story: the money flowing into the economy would improve and thus eliminate a drag on businesses and consumers.

Is now a last gasp rally or is the bull market to continue? There is no question that the bull market is aging. So now, closing out the fifth year of a rising market, should we prepare for another crash? There are a lot of warnings in the investment community and the financial press about a stock market "bubble". At the same time, the economy is slowly getting better, the unemployment rate is dropping, and global central banks seem committed to holding interest rates at low levels.

These are indicators we have found to be useful in recognizing major market tops:

- **Most important is the primary trend of the market.** The accompanying chart of the S&P500, with monthly pricing, shows the price index over the last fourteen-plus years. The 17-month moving average is used to define market trend. Note that, with the exception of a couple of false moves or "whipsaws" in 2012, applying the moving average to the chart yields a useful method of determining the trend. This indicator confirms the uptrend that began in 2009. **
- **Weak market breadth.** A sign of a major market top is when fewer and fewer stocks are participating in an up-swing. When this occurs, you hear the expression "the generals are leading but the troops aren't following". It's a bad sign if the major market indices are advancing but the number of advancing stocks vs. those declining narrows. Another warning sign is the number of stocks making new highs. Divergence occurs when the market is making new highs while the number of stocks registering new highs is trending lower. To some extent this is to be expected as a bull market ages. Divergence is not a timing device - it is a measurement of risk. Over the past twelve months, as the stock market recorded new highs, the NYSE advance/decline line has confirmed the moves with a series of positive advances.
- **The Federal Reserve is tightening.** There would be cause for concern if the Federal Reserve were actually increasing reserve requirements and increasing rates to cool off an over-heated economy. Clearly, this is not the case. Janet Yellen, the incoming Federal Reserve chief, has made it clear that her focus, like Ben Bernanke's, is on an improving jobs market and continuing economic recovery. Any Federal Reserve tightening should be incremental and moderate.
- **Wide spread public participation in the stock market.** Long term bull markets do not end without public participation. Frothy bull markets typically end with wide-spread public infatuation with the stock market. This bull market has been driven largely by institutional investors: mutual funds, hedge funds, and private institutional investors. Public participation compared to past bull markets has lagged.
- **Market tops take a long time to form.** There are usually multiple corrections and recoveries as the last of the sideline investors pile into the market. Before the 2000-2003 bear market, the S&P500 had three declines of 10% or more that were fully recovered before the ultimate high. The whole topping

process took about a year. Before the 2007-2009 bear market, there was one 10% correction that was fully recovered, followed by a 10% correction only partially recovered. We would expect to see a 10%-12% market correction in the early part of 2014. Even so, that would not mark the end of this bull market.

SUMMARY

On a short term basis, we believe that probabilities favor a market correction in the 8-12% range. The Federal Reserve has begun to taper their bond purchases, and the result may be a continuation of up-ticks in interest rates. From a technical standpoint, the S&P500 and the DJIA haven't had a setback of more that 5% or 6% for over two years. And finally, although the political environment in Washington seems to be improving, the debt ceiling impasse that was punted to 2014 will again have to be addressed as the debt limit was only suspended through February 7, 2014. With the two major political parties having completely different views on government spending, entitlements and the tax system, this is not just routine disagreement.

The bull market is not over, but at the same time we are no longer in the early stages of a market advance. In early 2014, the weight of the evidence suggests to us that stocks, short term bonds and money markets should be equally weighted in anticipation of a buying opportunity at lower prices on market weakness.

Craig F. Cooper

*Source for percentages and figures quoted: QUOOD Financial Services. **Chart of the S&P500 provided by Big Charts.com

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