The Stock Market May Win By Default

Scott Finlay

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2013 proved to be better than even the most optimistic of forecasts. The combination of increased consumer confidence, an improved housing market, support from the Fed, and outflows from the bond market focused cash flows squarely on the equity market. The United States is leading the global recovery, anemic as that recovery may be, and funds from all over the world are flowing in our direction. By all indications, these flows should continue into 2014 and with luck, continue boosting both the stock market and the US dollar. What gives me confidence is that valuations still appear to be reasonable, and optimism, while improving, is still tempered. Also, there are still plenty of skeptics as well as a significant amount of cash on the sidelines, and potentially more cash coming out of the bond market. The stock market may win by default (a phrase we never use when describing the bond market!).

We look for US GDP growth, the measure of total goods and services produced, to average 2.5%, up from 2% in 2013, a good trend. S&P earnings are expected to grow another 5%, but it's our belief that increasing confidence could allow for continued P/E multiple expansion. While the US economy is still highly leveraged, and our national debt has pushed through the $17 trillion dollar mark, the rate of our annual spending deficit has decreased from $1.5 trillion to just over $700 billion dollars, an unsustainable number but one that's heading in the right direction.

The housing market is intriguing. On the surface it might seem that with rising interest rates, we would see slower housing activity, but my sense is there are several things at work that may provide us with a growth rate that is quite a bit higher than what most people are expecting. First, there's a pent-up demand for housing. The younger generation, and I'm speaking about young adults ages 25 to 35, whose only experience in the "aware" stage of their lives has been a housing debacle, have chosen to rent versus own. Many have focused on careers, saved significant dollars, and are now settling down and thinking about having a family. With that often comes buying a first home. As rental rates have hit new highs, the economics of homeownership, especially homeownership with a large initial down payment, becomes almost a no-brainer. Increasing mortgage rates may in fact prompt decision-making rather than hesitation, and in the larger scope of things, mortgage rates in the 5% to 6% range are still well below what they have averaged in prior years. Combine these factors with investment portfolios that have grown significantly over the past year, and I think we may be setting ourselves up for a very positive real estate market. We're already starting to see the effects of increased confidence in large-ticket items such as automobiles.

I would expect that 2014 will provide us with more modest returns than we saw last year and probably more volatility as well. Dividend-paying stocks are still and will continue to be in high demand, driven by demographics. With the Fed withdrawing its support in the bond market, the heavy lifting now rests on the shoulders of supply and demand. Fed tapering implies stronger US economic activity (otherwise they wouldn't be tapering). It's a good news/bad news scenario, but ultimately, a self-supporting economy is what we are all after.

Best regards,

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