April 25, 2014

Q1 2014 Commentary: Opportunity still knocking

After a prolonged period in the stock market without a 5% correction, we finally got one in late January. As has been consistently the case over the past eighteen months, the selling was short lived and stocks reversed course swiftly and within a month were back to making new all-time highs. Ultimately, the S&P 500 finished the quarter positively, gaining 1.8% after including dividends paid. Signs of a stumbling economy, weather related or not, helped to drive interest rates lower and give a nice boost to bond prices. Municipal and emerging market bonds performed very well, recovering from weakness in 2013. Like the S&P 500, the US aggregate bond market index advanced 1.8% in the quarter.

A resumption of historically average market volatility would be to our benefit. The stock market is currently valued within a broad range of what we would consider fair value. The global economy is something of a mixed bag, but is generally showing moderate growth. The US continues its below average recovery. Fears of a serious slowdown in the US were pretty much put to rest with the most recent employment report. Job growth of 192,000 in March and a revision higher for the previous two months indicate the economy is stable. Weather problems over much of the country are expected to delay, but not cancel spending. With little that can derail the economy and a stock market that is within the range of fair value, maintaining our current allocation of stock market exposure is appropriate.

The Federal Reserve, under the new leadership of Janet Yellen, has maintained the policies of her predecessor and continued the process of weaning the economy from its stimulus efforts. Scaling back the monthly mortgage and Treasury bond purchases continues and the Fed will have withdrawn completely from the market by the end of this year. These actions are just another step along the way toward more normal markets. In recent years, stocks have been highly correlated in their movements. That is, stocks seemed to move in lockstep as macroeconomic events took precedence in driving stock prices in what came to be known as the “risk on, risk off” trade. Stock market correlation is now much lower and we are seeing stock prices fluctuate more due to industry and company specific fundamentals. In this environment, our contrarian based investment process will be rewarded. As industries and companies fall from favor, prices will fall to attractive levels and we will be rewarded for acquiring at these prices over the long term.

This quarter marked the five year anniversary of the bear market low in March 2009. It has justifiably taken investors a long time to get over that period’s stock market and financial system crisis. It was a traumatic time and far worse than the 1987 crash or the bursting of the tech bubble because of the very real fundamental threat to our entire financial system. However, by most measures, the excesses of that period have been exorcised and systemic shocks are unlikely in the immediate future. At present, markets make sense; for the moment at least.