FVCM

U.S. Market Report

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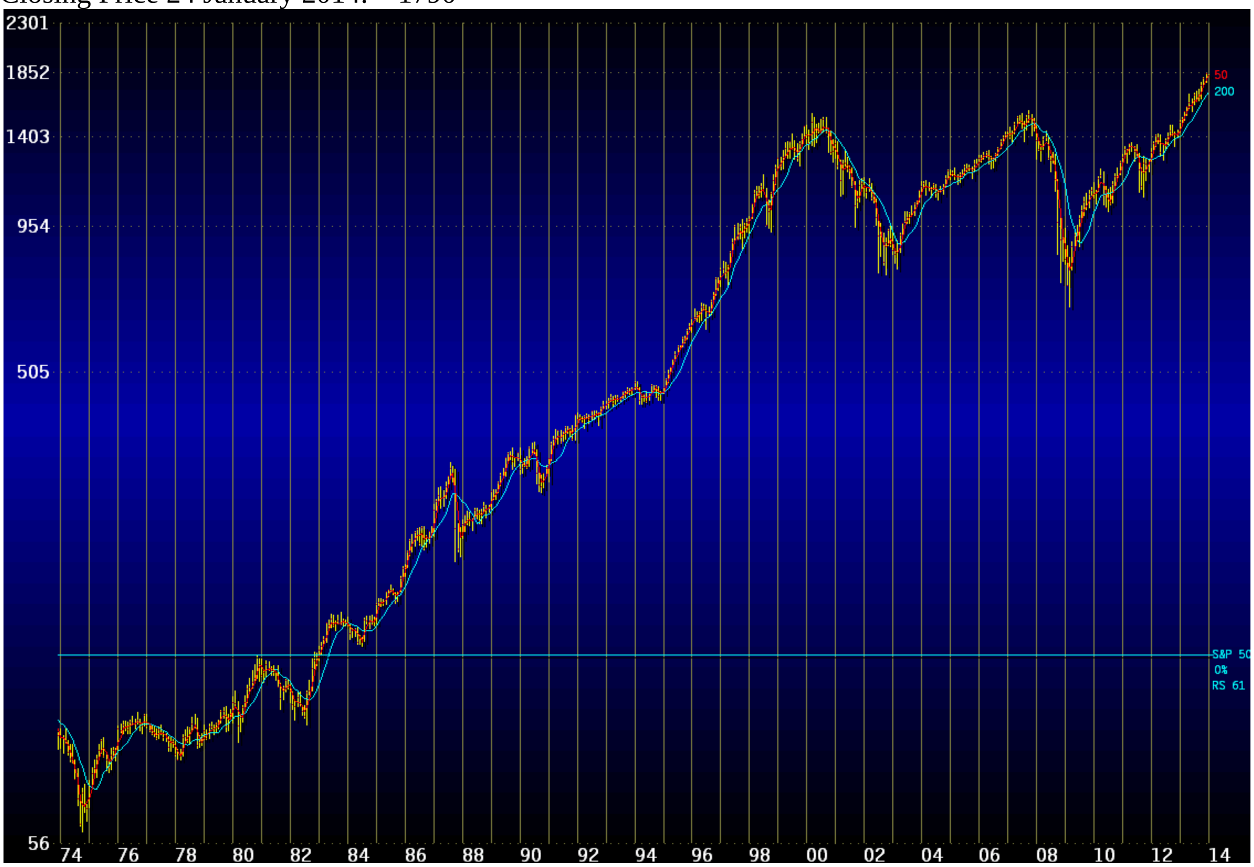
S&P 500

Closing Price 24 January 2014: 1790



As of today's close, the U.S. stock market is down about 3% from the recent peak of 1850 for the S&P 500. We think it may decline another 3%-to-5% before the long term uptrend resumes. Stocks have had a good run. The last pullback of more than 2% was in September/October when there was a 4% decline. Before that were declines of 5% in August and 6% in May/June. We suspect that this time the decline could end up bringing the S&P 500 down to around 1700, which would mean a drop totaling 8%, because it has been a fairly long while without any real pullback in prices. Also, from a technical perspective, the market would likely get some strong support at about the 1700 level, which is the current 200 day moving average. But the main point is that fundamentals and valuations continue to support higher stock prices and we think this will be an opportunity to buy more stocks.

The market has been resisting negative news during the past couple months, but investors are looking at the headlines and are now using them as a reason to take prices lower. Argentina and Venezuela have both been following ruinous economic policies for a long time, and now have been forced to devalue their currencies. Other "emerging markets" like Brazil have been struggling because of declining commodity prices, from where export earnings are made, and simultaneously facing rising domestic prices. Other negatives include weak manufacturing data out of China, concerns about deflation in Europe and Fed “tapering.” But the markets seem to oscillate between periods from when bad news is bad, and when bad news doesn’t matter. For the next couple weeks, bad is bad.

We don’t expect an economic and stock market peak for at least another two-to-four years. The U.S. economy has been showing increasing signs of momentum and is still coming from a low base. The housing market and construction is still well below the peaks of 2007 and there is pent-up demand for housing because of demographic growth and the fact that people have held back during the downturn. The current up cycle is still in the early stages. U.S. corporations have been extremely conservative with their capital spending despite the fact that they are sitting on a two trillion dollar pile of cash. The capital spending cycle is far closer to the recent bottom than the eventual top. U.S. exports have been growing strongly at the same time that imports have been weakening thanks in part to “fracking” and the sharp rise in domestic energy production. Labor costs are low and there is plenty of capacity for expansion. Furthermore, the Federal Reserve is committed to maintaining financial conditions that will encourage ongoing spending growth and further expansion.

Stock prices have been in a long-term upward trend and are expected to remain so until economic conditions are extended, inflation starts to accelerate, and the Fed is forced to raise interest rates. We are still a long way from that. Nominal spending growth in the U.S. has been running at a 3% year-over-year rate. That is simply not fast enough to generate inflationary pressures and it would likely take a couple years of faster spending for inflation to become an issue. In the meantime, the Fed can keep monetary policies easy. The S&P is trading at 16 times earnings, but earnings growth has begun to accelerate. Fourth quarter 2013 corporate earnings have been beating expectations and will be up about 8.5%. Earnings should rise more than 6% next year and with inflation running at only 1.5%, valuations can expand. We expect the S&P 500 to surpass 2000 in the year ahead and provide a total return in excess of 15%.

Some of the stocks we’d like to buy have had amazing run-ups and we plan to use this pullback as a change to add to our client portfolios. Some of the areas that have done very well, like consumer discretion, healthcare, financials and technology, still have plenty of upside and chances are good that they will re-establish their leadership in the quarters ahead.
