Investment Update

BNY MELLON
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Celebrating an Old Bull

While most anniversaries are commemorated happily, whether a birthday, wedding, or reunion, market anniversaries are generally seen in a more questioning, and less celebratory, light. As we move beyond the five-year anniversary of the bull market that began March 9, 2009, many investors are wondering how much longer it can last.

By many counts, this bull market could be said to be long in the tooth. Five-year anniversaries are rare, as only six of the 23 bull markets since 1900 have lasted this long. Even if the 2011 correction of nearly 20% in the S&P 500 represents the real start of the current bull market, as some believe, it has still been a long climb up. Only 10 of the 23 bull markets since 1900 lasted much over two years.

No matter when the party started, the returns of the S&P 500 have been impressive. Since the S&P hit a low of 666 in 2009, it has risen about 200%. Now, however, the S&P has paused in 2014, with many investors asking if the market has hit its top. To address this question, it helps to look at previous market tops and see how they compare to the current environment.

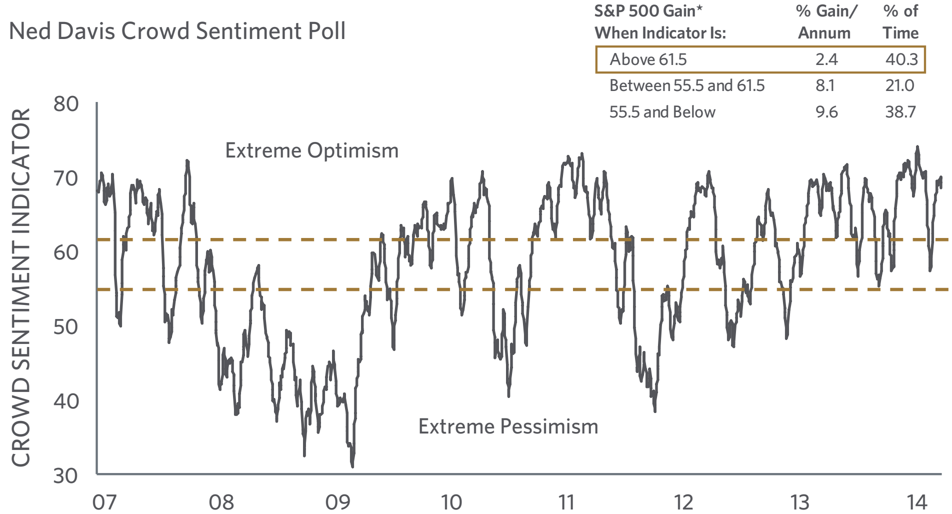
January 2014—The Recent Pullback Explained

Many people worried that the pullback at the outset of this year was a precursor to more market declines ahead. Concerns about slower growth in China and bad winter weather in the U.S. added fuel to that fire, causing some market participants to question whether the global economy could support higher equity prices.

In fact, we believe the January pullback was more a factor of sentiment as investors stepped back from a relatively high trend in restored market confidence toward the end of 2013. Ned Davis Research's Crowd Sentiment Index, a proxy for investor bullishness, outlines this pattern. The index tracks short- to intermediate-term swings in investor psychology based on seven different proprietary sentiment indicators. Markets always tend to struggle to push higher in an environment of excessive enthusiasm.

Extreme bullishness has also been an indicator of moderate market performance over the longer term. As illustrated in Exhibit 1, periods with high readings in the sentiment index have been associated with relatively muted returns in the S&P during the year that follows. Conversely, low readings showing higher bearishness have been associated with better than average gains during the ensuing year.

Exhibit 1—Investor Sentiment and Market Returns



S&P 500 Gain* When Indicator Is:	% Gain/ Annum	% of Time
Above 61.5	2.4	40.3
Between 55.5 and 61.5	8.1	21.0
55.5 and Below	9.6	38.7

Source: Ned Davis Research. As of 3/13/14. *S&P returns are from 12/1/95 through 3/11/14.

While this exhibit speaks to annual performance trends and their often inverse correlation with investor sentiment, a short-term shift in sentiment does not necessarily portend a longer term change in market performance.In the case of this year, for instance, the pullback in January quickly reset the indicator to more normal levels, and a rally ensued which erased all losses and took the market to new highs. We may continue to see more short-term 'investor reaction and market reset' patterns this year, as evidenced by the February rally once again pushing this indicator into optimistic territory, with markets then struggling in March.

As we have written in prior *Updates*, we expect volatility to return to markets in 2014. These past three months clearly serve as a blueprint for the remainder of the year, in our opinion. Investors should expect more volatility, with a modest upward drift in markets from here.

Internal Indicators: Market Could Move Modestly Higher

Rising inflation, sharply rising interest rates and stretched valuations are the usual suspects for expiring bull markets. None of these dynamics are present today. There are also other, more subtle causes of how markets form tops, none of which are evident today. Let's dig a bit deeper to inspect some of the market's internal features to show why we think equities are building a base from which to move modestly higher.

Small caps continue to outperform

Small caps continue to be a strong relative performer to large caps. Since January 2013, the Russell 2000 Index of small cap stocks is up 41.34% through the end of February, versus 33.66% for the S&P during the same time period. Small caps do not typically outperform when the market is peaking. All market tops, with the exception of 1936, have peaked with large caps leading the way to the top. Continued small cap outperformance in 2014 is a sign that this market has further to rise.

Price momentum—a strong factor in stock performance

Price momentum continues to be one of the strongest factors for stocks that are beating the market. Think of it this way: companies that have been doing well are continuing to do well. This phenomenon tends to take place in the middle to the end of bull markets. When this trend changes, the market usually pauses or declines. Seeing no evidence that this has or is transpiring gives us more confidence that a top is not at hand.

Dow Theory—an indicator that the market can move higher

This economic theory goes back over 100 years. It states that in a rising market, both the Dow Jones Industrials and Dow Jones Transportation Indexes—the makers and transporters of raw and finished products[1]—should be rising and therefore "confirming" each other. Thus, if the transports are not progressing like industrials, this would be cause for concern that a pullback in the broad averages may be at hand. As the industrials have moved close to new highs in 2014, so has the Transportation Index, in line with the thinking of the Dow Theory. The lag time on this indicator tends to be 9-12 months, so this bodes well for the market going forward.

How and Why the Market Can Push Higher

U.S. decouples with China

Global synchronized growth generally is the best backdrop for global equity markets and, historically, the U.S. and China have been strong contributors to that growth pattern. In fact, these two nations have been the major growth engines for the past 20 to 30 years in the global economy. However, strong domestic equity performance in the face of a slowing Chinese economic backdrop (projected GDP growth of 7% to 7.5%) also may suggest a decoupling is taking place. The U.S. economy continues to show signs of economic strength in spite of a slowing China. Markets seem to be signaling that the U.S. may be able to continue to grow at a more modest 3% rate going forward even without robust growth in China.

Earnings versus liquidity

The five-year anniversary of the '09 market low may prove to be a pause that refreshes for this rally, and not a stopping point. The first leg up has been driven by liquidity, as is often the case. The Federal Reserve (Fed) typically steps in after a bear market to provide easy monetary policy, usually in the form of low interest rates and/or quantitative easing. A pause should lead to a market that is driven more by earnings and company-specific news, and less by the Fed.

The pause could last most of this year, as we are only calling for a slightly higher market by year-end 2014. Weakness in the markets, however, should be used to rebalance, or 'true up' to appropriate positions in any stocks or asset classes that demonstrate long-term value.

Conclusion

While we are constantly on the lookout for signs of an equity market top, we don't believe the market is forming one now. While five years is a long bull market by historical standards, few warning signs are currently flashing that would indicate a peak is at hand. We believe the current choppiness is driven more by sentiment than by over valuation. With interest rates low, inflation tame and market internals strong, there seems to be little stopping the ultimate continued upward move in equities.

While no one typically celebrates market anniversaries, we feel, for this five-year mark, there is no reason to fear it, either.

Jeff Mortimer, CFA
Director of Investment Strategy

1 http://dowtheorybook.com/?page_id=78