Investment Update

BNY MELLON
WEALTH MANAGEMENT

January 2014

Debunking Market Assumptions

Some people are just wired to look at the glass as half full, while others seem to perpetually look at the glass as half empty. While most of us would prefer an optimist over a pessimist as a dinner companion, both types of people can be dangerous when it comes to assessing the market's return potential. Why? Successful investment decisions should derive from looking at the complete picture. Any assumption about the market without rigorous analysis is likely to lead investors down the wrong path—and away from reaching their long-term goals.

After a remarkable 2013 for stocks, countless opinions are circulating about the markets, both positive and negative. I'd like to address three common perceptions in particular that seem especially prevalent. The facts beneath the surface warrant a closer look and, in many cases, suggest cause for a more confident outlook in 2014 than some might expect.

"Too Far, Too Fast"

Many people talk about "too far, too fast," simply because the market has been rising. They may worry they are buying at market highs. A strong bull market has the ability to reach new peaks, and then push through them to continue upward. Investors should realize that today's market has come a long way over the past five years.

Exhibit 1 shows a cross section of relevant market and economic data that illustrates some of the key differences between the market at the end of 2013 and at the last market peak, in October 2007. While we don't think we are at a peak today, a comparison of the two time periods illustrates why the current market exhibits relative strength. In addition, a comparison of the general trend of the data (as illustrated by the up and down arrows) shows a stronger market today.

For example, household debt levels are lower today, while earnings and valuations are rising. Spreads on high yield corporate bonds, which illustrates the risk that investors are willing to take to hold the debt, also are declining, suggesting more conviction in the market. The rate on 3-month Libor, a gauge of confidence within the banking system, is far lower. Consumer confidence is lower than it was in 2007, but is trending higher. Likewise, unemployment is higher today but is on the decline. Taken together, the underpinnings of this market and the economy today are much better, suggesting stocks may have more room to run.

Exhibit 1—Bull Markets Then and Now: Why Today's Market is Stronger

	Oct-2007	Dec-2013
S&P 500 Level	1565 ↓	1848 ↑
U.S. Corp. High Yield Bond Spreads[2]	3.7% ↑	3.9% ↓
Household Debt as % of Disp. Pers. Income[3]	129% ↓	104% ↓
3-Month LIBOR[1]	5.25% ↓	0.25% ↓
S&P 500 EPS (2007 v 2013E)[3, 4]	$83 ↓	$107 ↑
S&P 500 P/E Ratio (Trailing 1-Year)[3]	16.3x ↓	17.7x ↑
Conf. Board Consumer Confidence[3]	95.2 ↓	70.4 ↑
Unemployment Rate[1]	4.7% ↑	6.7% ↓

Source: [1]FactSet, [2]Barclays Capital, [3]Ned Davis Research, and [4]BNY Mellon Wealth Management.
Arrows depict the general trend of the data shown.

"Stocks are Too Expensive"

How expensive is this market? By the most common measure, the price/earnings ratio (P/E), the market appears to be fairly valued. The current P/E on the S&P 500 of 17.7 is in line with longer term averages.

At the same time, valuation alone should not be used as a timing tool, as markets have a history of remaining overvalued or undervalued for extended periods of time. We must analyze valuations within the context of other key influencers to determine our market outlook and implications for portfolio positioning. In the aggregate, these other influencers, specifically the following macroeconomic factors, are creating a supportive backdrop for equities:

Interest rates – When the P/E ratio is adjusted for interest rates, valuations look even better. With rates projected to stay low for at least the near term, one could easily make the case that stocks are more likely to be attractively priced than they are to be expensive.

Inflation – Inflation remains low. While we should never turn our backs on this most important variable, inflation shows little sign of endangering our outlook. We believe rates will move higher in 2014 because the economy is strengthening, not because of higher inflation. This dynamic will result in higher real rates (interest rates less the rate of inflation), which historically have provided a positive backdrop for equities and P/Es.

Economy – The U.S. economy should continue to strengthen in 2014. Specifically, we are forecasting 3% real U.S. GDP growth for each of the next three years. This should allow firms to grow their revenues at reasonable levels, creating a solid backdrop for earnings. We believe earnings growth will be the lynchpin for upward market movements in 2014.

"The Fed___________ " [Insert Opinion Here]

Investors have no shortage of opinions about the Federal Reserve since it has finally begun to taper its easy money policies. Strong views are understandable given the heightened volatility that has resulted from Fed action in recent months. We could see more volatility in 2014 as the Fed continues to change course under the direction of newly confirmed Chairman Janet Yellen. More opinions on the Fed are likely as well.

The prospect for rising rates should be viewed as a positive for equity markets, as it signals a strengthening economy. Consider what happened in mid-December when the Fed announced it would modestly slow its asset purchases by $10 billion: the S&P 500 rallied nearly 300 points on the same day. Although only a one-day movement, this dramatic change shows that the market can react favorably to measured Fed action. This behavior also suggests that markets are beginning to focus on growth and earnings in 2014—and moving away from concentrating solely on the economic or political landscape. This should bode well for risk assets, as global growth is expected to improve in the new year.

Conclusion

An old saying attributed to the writer Mark Twain (or the inventor Charles Kettering, depending on who you believe) contends that "it ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." This is sound advice within the context of markets. Investors who focus on the fundamentals in today's environment will be better positioned to withstand volatility and identify new opportunities in the future.

Jeff Mortimer, CFA
Director of Investment Strategy