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GOOD ADVICE

WHERE HAVE ALL THE BEARS GONE?

Our analysis strongly indicates that the U.S. market is coming into a significant juncture or turning point and investors should prepare themselves for a 20% correction in 2014. This market juncture or topping process may last into late March, which would be the fifth anniversary of the current cyclic bull market. We see limited upside potential from current levels – probably 5% or less. We think that equities have gotten well ahead of fundamentals and are due for a retreat. We continue to see the economy in a slow growth mode, which means the fundamentals are not materially changing.

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The Bears Have Left the Building

In trying to ascertain the U.S. market's direction for next year we look at cyclic indicators, valuation, investor sentiment (is everyone bullish?), buying power (is there lots of cash still to invest?) and breadth indicators – how many stocks are participating in the rally. We also assign price targets for each asset class using regression analysis for upside potential versus downside risk. Our cyclic measure work is pointing to a major top in 2014. The secular (multi-year) cycle is still on a sell signal. The important cycle measure for us at this time is the seven year cycle which is set up to give a sell signal at the end of December, or not later than the end of March 2014.

The last significant seven year sell signals were in 1987, 2000 and 2007. Both the four year cycle and nine month cycle are close to giving sell signals. Thus, three of these cycles are close to giving a sell signal and the fourth is already there. The good news is that the secular decline that started in 2000 will be coming to an end over the next two years. We need to be aware of this potential as a significant decline in 2014 might be a great buying opportunity.

Valuations are extended. After almost five years, the market has reached the kinds of overbought levels that have always been associated with meaningful market tops. While the market boomed this year, earnings growth has declined sharply. This market (along with other assets) has been artificially propelled by extraordinary Fed policy. The last time gains in stocks outpaced profit expansion by this much was in 1999. The previous time was 1987. If you compare the market valuations to revenue for the underlying companies, the median price to sales ratio is the highest in recorded history. Profit margins are also at historical highs so further gains in earnings cannot come from profit expansion – they will eventually regress to the mean which is around 6.5%. These levels are unsustainable unless sales and earnings rapidly increase.

Investor sentiment is the most bullish since 1987. Where have the bears gone? Investors are so bullish that they are borrowing against their portfolios; margin debt is at historical highs. Both individual and institutional investors currently see no risk in borrowing money to "enhance" their portfolio return. One example of investor euphoria is the current mania with social media stocks. Twitter is a great company but is currently selling at 59X sales – sales not earnings and there is no P/E as there are no earnings. And none are expected in 2014. Also there is no price to cash flow ratio since cash flow is negative and no price to book value ratio since book value is negative. And yet the stock is going up!

One of the "arguments" for a continuing bull market is that there is plenty of cash on the sidelines waiting to get in. In fact, the percent of Money Market Funds to stock market value is near its historical low. Again, as we mentioned, investors are borrowing money to invest and active money managers have begun leveraging their portfolios for the first time in history.

Market breadth, to be a positive force, must be broad and include most stocks. On a global basis, almost all stocks outside the U.S. topped out three months ago. In the U.S. of the 14 sectors we monitor, only 3 (21%) are outperforming the S&P 500. Net new highs on the NYSE were 535 at the May 2013 high. Recently, two days after the market hit new highs, the number of new lows (not highs) was 215. Most stocks have not been going up with the major weighted indices. A few big cap stocks are leading the parade similar to the Nifty SO in 1972 and nifty 25 in 2000, where 5% of the stocks accounted for 45% of the index value. Even the stocks in the S&P 500 are not keeping up with the S&P. An equal weighted S&P has underperformed the weighted S&P for the last four months.

All of the above points to a significant correction in 2014 but the turning point will not happen until the uptrend in the big cap indices is broken. So far the trend has not been broken. Until it is, it is premature to get overly bearish. Ned Davis Research averages all of the one-year seasonal market cycles, the four-year midterm election cycle and a 10-year cycle. This study would suggest that the market could be flat to slightly higher until April 2014, when it finally tops out.

Asset Allocation

We are currently over weighting cash and under weighting bonds, the U.S. and international stock markets, REITs and natural resources. Our price target work limits the upside for the U.S. market to 0-5% from current levels coupled with a downside risk of over 20%. The same is true for most international stocks, except emerging, China and Japan that may perform counter to the rest of the world, as they have already suffered major bear markets. Looking forward, the areas that look interesting are these underperformers in 2013: bonds, REITs, natural resources, emerging markets and gold.

Bonds and REITs are very sensitive to interest rate changes. The bond market was crushed in 2013 (the long Treasury bond was down 14%) but currently is attractive with a 15% upside and almost no downside. Our cycle work must turn positive before we overweight bonds. Investors are extremely bearish on bonds and institutional bond managers are emphasizing short maturities. Declining interest rates could be the big surprise in 2014. REITs are down 20% from their highs and have a 20% upside target versus 0% downside. They are currently selling for an 11% discount to Net Asset Value versus an historical 2% premium (102% of NAV). They sell at the lowest P/E in three years and offer a nice dividend yield. As with bonds we are waiting for our cycle work to turn positive before over weighting REITs, but we have been gradually increasing exposure.

If natural resources decline from current levels they would become attractive. Currently they have roughly a 20% upside to 20% downside. The same is true for emerging markets. Gold looks quite attractive given its 60% upside to 10% downside. We have a small position in gold which we will add to if the trend moves to the upside.

Please give any of us a call if you have questions concerning this piece or if you would like to discuss our analysis in greater detail.

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