"Investing Is Speculating Enough"

Market Commentary – March 2014

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.4% in the fourth quarter of 2013. This is lower than the advance estimate of 3.2%. GDP readings are truly estimates, and they can be drastically revised as more data become available. As of December 2013, the Federal Reserve projected 2014 GDP at 2.8%-3.2%, 2015 GDP at 3.0%-3.4%, 2016 GDP at 2.5%-3.2%, and "longer run" GDP at 2.2%-2.4%. It is clear that the expectations of low growth are entrenched for as far as the eye can reasonably see. The Fed anticipates unemployment trickling down from 6.6% in January to 5.3%-5.8% by 2016. Importantly, the Fed forecasts inflation below 2% throughout this entire period (the consumer price index rose 1.6% year-over-year as of January 2014).

Federal Reserve Board Chair Janet Yellen has received a warm welcome from the U.S. financial markets, as the smooth transition from Ben Bernanke's leadership is officially complete. Financial markets like consistency and they get that with Yellen. She has a dovish reputation (like Bernanke), meaning that she leans in favor of monetary policy that will strengthen the tepid recovery rather than worry about the potential side effect of inflation down the road. In her talk with members of the Senate Banking Committee on February 27, Yellen said that "unseasonably cold weather has played a role" in the uptick in "soft data" over the past six weeks. She said that the Fed may pause on its bond tapering if the weakness continues, which was music to the ears of stock market investors. The next FOMC decision on monetary policy is scheduled for March 19.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $120.73, which implies a price-to-earnings (P/E) ratio of 15.4 with the S&P 500 at 1859. The earnings yield (E/P) of 6.49% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.66%. February saw stocks jump in price, quickly erasing the value that was created by the January correction.

Just when it looks like the stock market is going to have a significant correction, buyers rush in to propel stocks even higher. The S&P 500 closed February at a new all-time high of 1859. Interestingly, the index hit 1867.92 intraday on February 28, only to be met with selling. Technicians point out that a healthy "breakout" should have the market closing at its high for the day. We believe this is a clue that some market participants are hesitating to commit new money to the stock market at these loftier levels. On the S&P 500, old resistance at 1850 should act as new support. Below that, there is plenty of support at 1820 (50-day moving average), 1740 (February low), and 1730 (200-day moving average).

In anticipation of a choppy market this year, we have used several methods to manage risk. First, we have a healthy balance between stocks and cash (depending on the client portfolio, of course). Cash allows us to buy stocks on sale at lower prices, while helping us to remain relatively logical when others are falling victim to psychology. Second, our stocks have strong balance sheets (i.e. low debt) and low betas (measure of volatility). Such stocks tend to be more stable in a down market, although they are not as exciting in a rising market. Third, our stocks are generating solid dividends, with an average dividend yield of 3.3% (including all stocks in all portfolios). This compares favorably with the S&P 500, which yields only 2.0%. Finally, we have been selling covered calls into strength on a variety of stocks (depending on the portfolio). These call options expire between April and July. Covered calls generate excellent income while providing a discipline to sell high if the stock is called away. Overall, it is important to minimize speculation, especially in this environment. This is easier said than done. Investors can get lucky speculating and mistake their luck for brilliance. However, these people would be wise to consider a saying of money manager Nelson Kjos: "investing is speculating enough."