Financial Markets Perspective

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ARE STOCKS OR BONDS "OVERVALUED"?

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FINANCIAL MARKETS IN THE FIRST HALF OF 2014

After impressive gains for the stock market in 2013, most observers expected a rather lackluster 2014 as frequently happens after a record-setting year. So far this year, the stock market is on target to turn in above-average returns if the second half is anything like the first. The first half gain of 7% for the S&P 500 index (that most professional money managers try to beat) was clearly better than expected. Conversely, the index most followed by Main Street (the Dow Jones Industrial Average) only posted a gain of 2.7% for the first six months of this year.

Foreign stock markets also had positive returns for the first half of the year. The tottering European economy appeared to stabilize somewhat as continued monetary policy implemented by the European Central Bank is breathing new life into individual countries that were experiencing financial turbulence due to rising budget problems. Effectively the ECB has become a branch of the U.S. Federal Reserve and is extending a financial safety net under any country that needs such support. As a result, the European economy is recovering—albeit at a slow pace. Stock market returns across the continent were divergent through June with Italian and Spanish stocks gaining more than 11% and German stocks losing almost 1%.

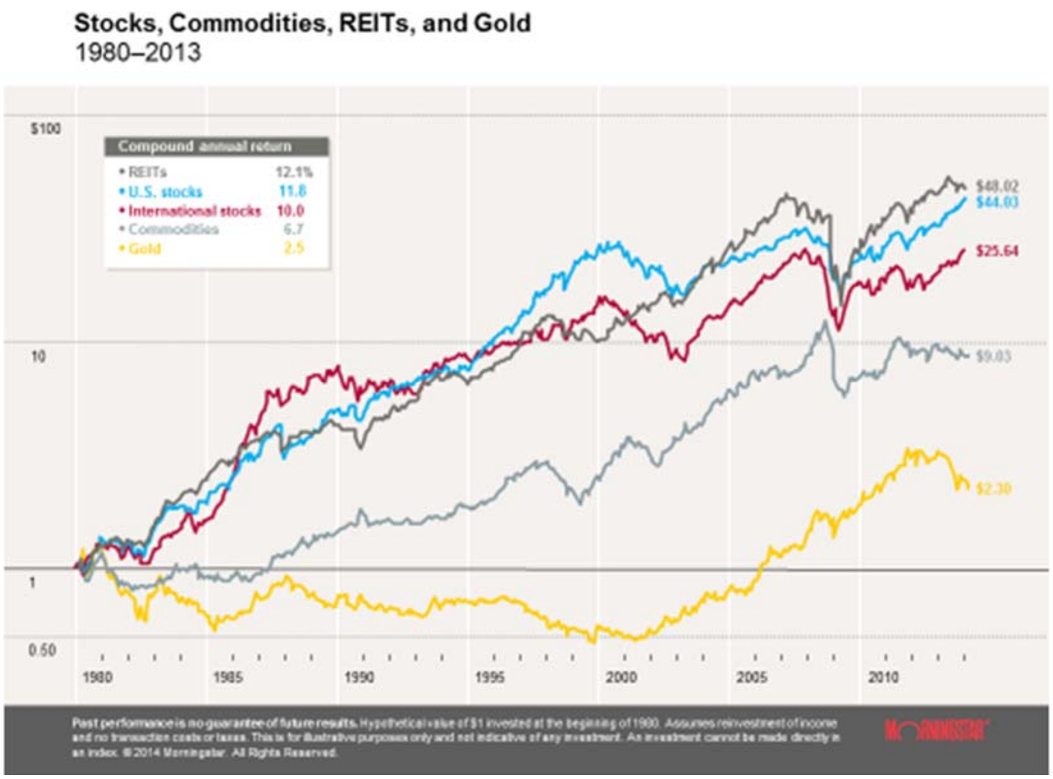
Looking Eastward, a number of economic statistics in Japan were better than expected but investors shunned Japanese stocks that finished down 6% for the first six months. Chinese stocks are still unloved and fell by almost 4% on skepticism that policy makers can transition from middle-income to high-income status—a difficult and delicate task. Additionally, China's growth rate is constantly being questioned and, as most experienced investors know, strong economic growth does not translate into stock market gains. Data from Bank of America Merrill Lynch Global research showed that more than $4.6 billion has flowed out of Chinese equities year to date—far greater than the $451 million outflow from Brazilian equities and $303 million from Russian equities. One would think that Russia would log more outflows than China given the recent turmoil surrounding the Ukraine. Converesely, Indian stocks surged almost 20% on the back of the election of Narendra Modi as Prime Minister with a decisive victory for the Bharatiya Janata Party (BJP). Clearly, there has been a high level of divergence among equity markets so far in 2014.

The big surprise so far this year is the continued strong price performance of the bond market. The yield on the U.S. Treasury 10-year note, which moves inversely to its price, fell to 2.51%, from 2.76% at the end of the first quarter. Corporate bonds extended their gains with the Barclays U.S. Aggregate index gaining 1.95% during the quarter while the Barclays U.S. Corporate High Yield index rose 2.4.

On balance, the first half of 2014 was better than expected for both bond and stock markets. This outperformance has many market pundits pondering whether we are at a market top and whether or not stocks and bonds are overvalued especially given the backdrop of political instability in the Ukraine and the Middle East and the disappointing decline in US economic activity.

HOW TO VALUE THE STOCK MARKET

The following exhibit provides the long-term returns of various asset classes. Stocks have been volatile in the short-term but over the long-term are a superior asset class. Note the history of gold prices—many television ads tout the value of gold as an investment yet history does not support this contention.



Valuing the stock market is very subjective. Traditional methods of evaluation compare the price of a stock or, in this case, the market to the earnings of that company or the earnings of the companies in the market. This measure is known as the price/earnings ratio (P/E) and is used as an indicator when the current P/E is much higher or lower than the average historical P/E. More often than not this indicator has only short-term significance—usually over one business cycle. Since this measure is a ratio between two variables, fluctuations in stock prices can be offset by fluctuations in earnings. For example, if the stock market's P/E is historically high, it might be because earnings have fallen in a recessionary environment. Analysts have to carefully weigh both the absolute level of the market and the direction of corporate earnings when making a valuation of the market. Not only are current earnings important but also the expected <u>growth</u> in earnings plays a critical role in driving the direction of stock prices.

Looking at earnings alone can be misleading. The level of inflation can play an important role in valuing the future of stock prices. When inflation is high and interest rates are high, bonds offer serious competition to stocks. Back in the late Seventies and early Eighties bond yields exceeded the long-term return of stocks—with substantially less risk. While this period was an anomaly, it proved that using the P/E ratio as an important indicator of stock prices failed to predict a positive environment for investing in the stock market.

Fortunately, there is a dynamic of incentives built into company managements and their desire to improve the earnings of the companies they manage. This incentive benefits both the owners, managers, workers and the shareholders. While the media portray stock market investments as being risky, history tells us that a broadly diversified stock portfolio can provide well above average returns that outweigh the short-term risks of being in the stock market.

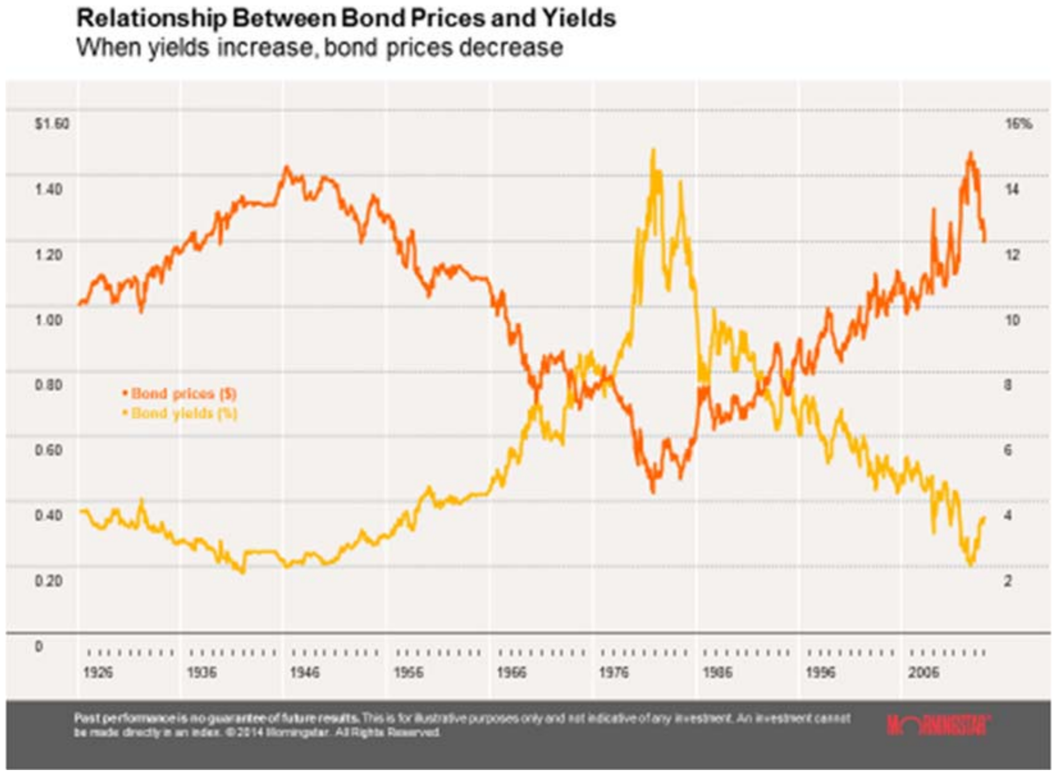
We have referred to this exhibit many times to justify our investment management style to build wealth for individual clients. The financial downturns of 2000 and 2008 and the related flat performance of stocks in general for the first decade of the twentieth century have deterred many investors from choosing stocks over bonds. Even during the past five years of record low interest rates, bond funds have attracted billions of dollars. At this point into the second decade of this century, equity prices are back to providing the historic returns that investors had become accustomed to experiencing. Yet now, observers are suggesting that stocks are overvalued and that a bear market is right around the corner. We don’t share this perspective.

While current P/E ratios are at or above the long-term historical average, we are still in a growth stage for corporate America. The ongoing energy renaissance is adding value to the economy through the fracking industry that is spreading prosperity to whole new parts of the country. Corporate wealth is also at record levels allowing companies to take actions that will improve their profitability. Once a slow growth economy gives way to normal growth rates corporate profits should show an unusual surge which would provide the underpinnings for a continued rally in stock prices.

HOW TO VALUE THE BOND MARKET

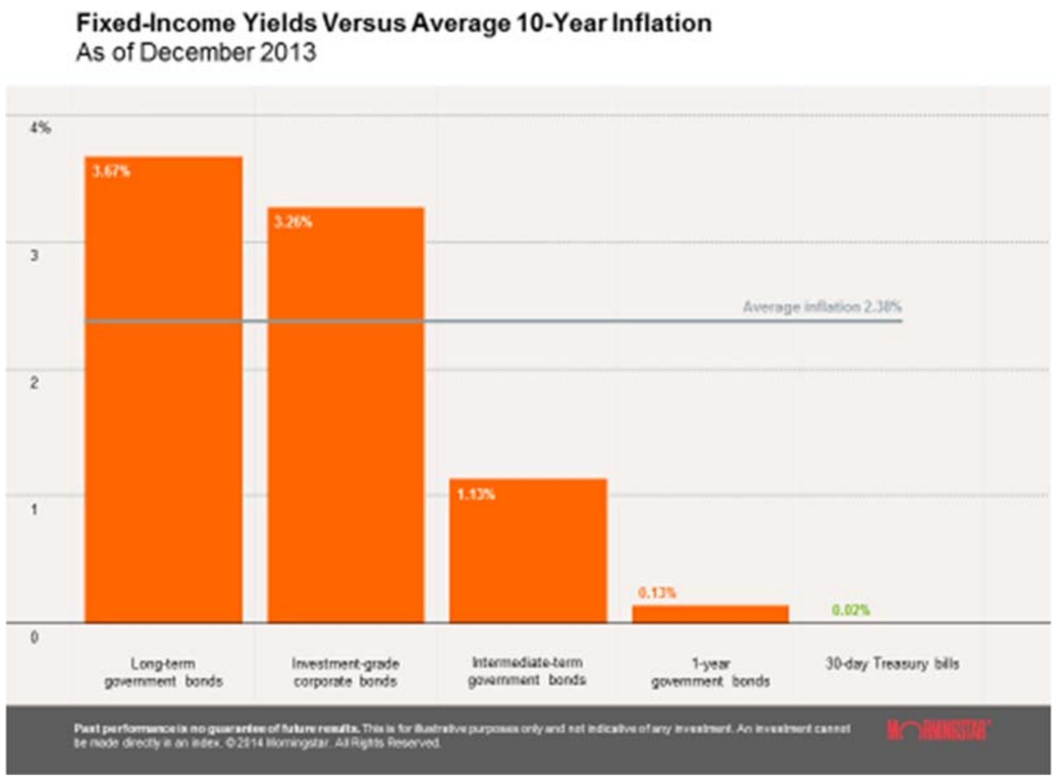
For many investors, fixed income securities i.e., bonds have become a fixture in many conservative portfolios. Holding such securities has gained favor because of the historic returns provided. For more than thirty years, bond coupons (the stated interest rate on a bond) have been falling while market values rose. From peak rates of return in the early Eighties, long-term government bonds that yielded in excess of 15% have fallen to near 3%! However, for investors who either hold bonds or intend to buy them for income, safety or both, the key factor to evaluate is the current interest rate.

The financial calamity of 2008-2009 and the Federal Reserve’s response of holding interest rates near record lows to allow businesses to benefit has been penalizing bond investors. Record low interest rates mean bond interest rates are low and the only way, in the short-term, for investors to accrue a higher return from bond investments is if interest rates go even lower. Note the relationship between bond prices and yields in the exhibit on the following page.



As yields rose during the Sixties and Seventies, bond prices fell. Then when bond yields peaked in the early Eighties, bond prices rose. Since the best forecast of interest rates is the current interest rate then the long-term outlook for bond investors is for low returns. On that basis, bonds are overpriced and the only way that there can be an improvement in returns is if bond interest rates go higher. Of course bond holders will suffer a short-term decline in the price of their bonds as interest rates rise but those higher interest rates will give investors the opportunity to receive higher income from new bond investments. So, the “bursting of the bond bubble” is not a permanent risk for bond buyers and future purchases of bonds will be more rewarding.

Another important input for fixed income investors is whether or not the real return on the bond allows for any increase in value. The real return on a bond is the total interest payment less the rate of inflation. During the Seventies, nominal yields were high but so was inflation negating the effect of high bond yields. The recent stability in inflation in the 2% range allows some real yield from bonds depending on the maturity. The exhibit on the following page provides some insight as to the relationship between bonds and inflation. Investors in long-term bonds can expect to experience some real return on their investments as long as interest rates remain under control.



CONCLUSION

The first six months of 2014 produced above-average returns for both stocks and bonds. Investors are concerned that both asset classes are over-valued. Most measures of stock market valuation are at or near the historical average leading investors to question further buying. Yet, history demonstrates that stocks provide the best opportunity to build wealth over the long-term despite periods of short-term volatility.

For bond market investors who put safety first, US bonds offer real yields of just 0.3% for 10 years, while junk bonds are no longer high yield and cash yields zero. Given these low returns, the argument to own stocks makes more sense.

Finally, after the lessons learned from the last decade, we expect to see more bond money flowing into the stock market in coming years as the gradual improvement in the economy prevents the historical boom/bust cycle that will allow investors to gain more confidence in equity investing.

July 10, 2014