Infomail

February 4, 2013

A Tough Sell for the Bears

Much like 2012, 2013 has started with the market trading nicely higher. In fact, in the USA, January will go down as the best in almost two decades! Granted most of the positive move was a temporary relief over the Fiscal Cliff issue, nonetheless, they are higher.

The past 40 times since 1950 that US stocks posted positive gains for the first 5 days of trading, full year gains followed 34 times, or 85% of the time, with an average gain of 14% (The last time it gave a faulty reading was in 2002 in fact!).

As January goes, so goes the year? According to the Stock Traders Almanac, since 1950 this barometer has only registered six major errors, or a 90% accuracy ratio. If it holds true, 2013 should be an up year.

Given the recent quick move, we are due for a little rest/pullback. There are always going to be concerns, and we already know the market will have to digest the Debt Ceiling/Sequestration battle, which could be worse than people think. These will be hotly contested issues by a Washington government that has shown they do not like working with each other, and seem to have a personal dislike for each other.

These are the biggest near term risks for the markets. Any hiccups, continued rhetoric or another US debt downgrade could have a negative impact and strain on already fragile confidence. The past three years, 2010, 2011 and 2012 have all had tough summer trading patterns.

The markets have lots to be positive about:

- Economic reports from all over the globe have been improving
- Corporate earnings (especially in the USA) have been excellent overall
- US housing market is improving
- Record amounts of cash on the sidelines combined with:
    - A rising risk appetite
    - Technical support levels broken on important indices
    - China looks like they are back. Remember they are the #2 economy
    - Japan is improving for the first time in decades (#3 economy)
    - Volatility has been greatly reduced
    - Interest rates should remain historically lower for at least 12-18 months
    - Corporate balance sheets are the best they've been in decades
    - Inflation seems subdued

What could go wrong?

- Europe continues to be a drag and could slip further in a recession in 2013

- The Middle east could flare up – Israel feels isolated by the Obama administration and may decide it has to act
- Fiscal drag from the US government

For the first time in a long time, the bear case list is much shorter than the bullish argument. But the next big upward leg of the market rally may not be a reflection of the US economy. It may simply be a result of Europe stabilizing, China coming on strong, and the rest of the world following in line.

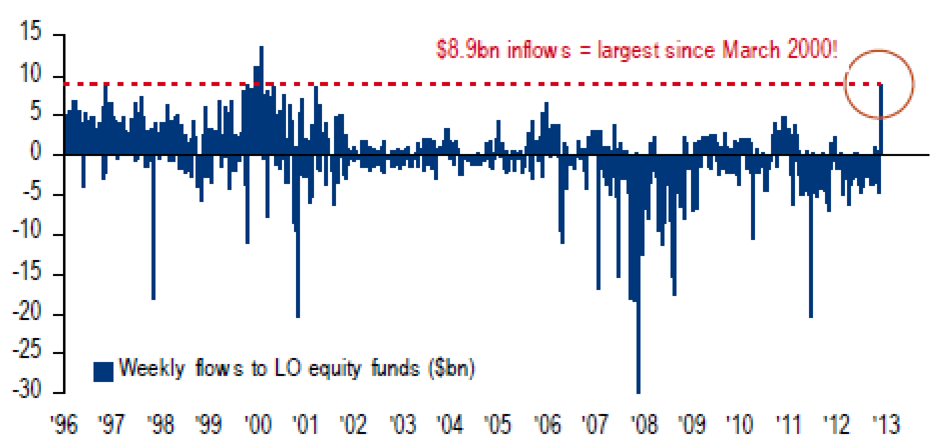
Emerging nations could add more than advancing nations just thanks to better valuations, global peace, and a sector reallocation/rotation.

GDP Trends Advanced Nations	2013 GDP		GDP Trends Developing Nations	2013 GDP
USA	1.8%		China	6.9%
Europe	0.3%		India	4.7%
Japan	1.6%	VS	Other Asia	5.0%
Other Advanced	2.4%		Latin America	2.9%
			Russia	2.9%
Total Advanced Nations	1.3%		Total Emerging Nations	4.7%

The S&P500 Price to Earnings Ratio (P/E) is just north of 14X versus the historic average (since 1995) of 18.2X.

The biggest story is the big rotation starting from bonds to equities, and cash finally moving off the sidelines. During the first two weeks of January, almost $22 Billion USD poured into equity funds, that being the best two weeks since April 2000 (Lipper).

Chart 1: Fourth largest ever weekly flows to LO equity funds ($bn)



That would signal an encouraging change in sentiment, because equity funds have been in net withdrawals since 2007. Traditionally people have been told to rebalance investments as they become older, but what we have seen are virtually all groups fleeing equities.

Equity Participation	20s	30s	40s	50s	60s
2000	55%	59%	55%	51%	40%
2010	60%	54%	40%	26%	21%

Lost faith in the USA?

Net Mutual Fund Investment Flows	1999	2011
Domestic USA	$54.0 billion	$18.0 billion
World Equities	$2.0 billion	$17.0 billion
Bonds	$5.0 billion	$20.0 billion

In my opinion, investors have shunned stocks for a variety of reasons:

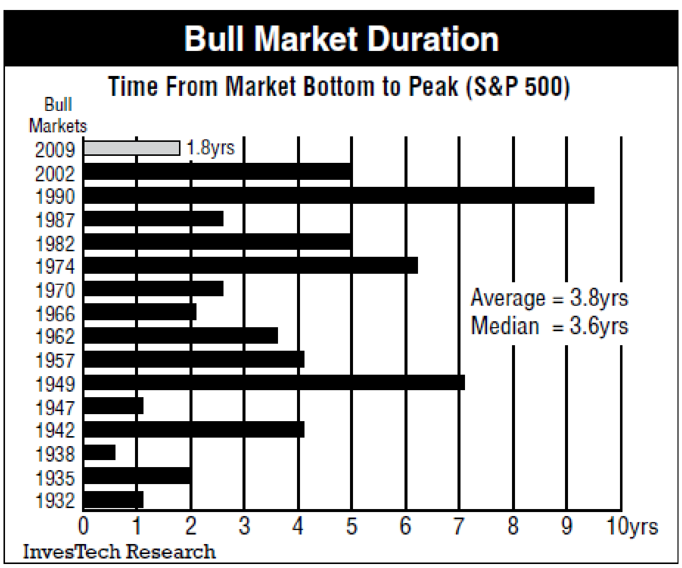
- Two big bear markets in the last decade (2000-2002; 2008-2009)
- The demonization of Wall Street (which hurts confidence)
- Scandals (like Madoff)
- Lousy overall performance in all global equities since 2000

The final big question is, can the US offset the barriers the current US Administration and Congress are putting in place? Housing seems to have bottomed, the consumer is down but not dead, manufacturing seems to be rebounding……all these with the aforementioned Euro/China/Emerging Markets bounce, and we could get a decent upward surprise.

But has the easy money been made already, even though stocks remain attractive compared to the alternatives?

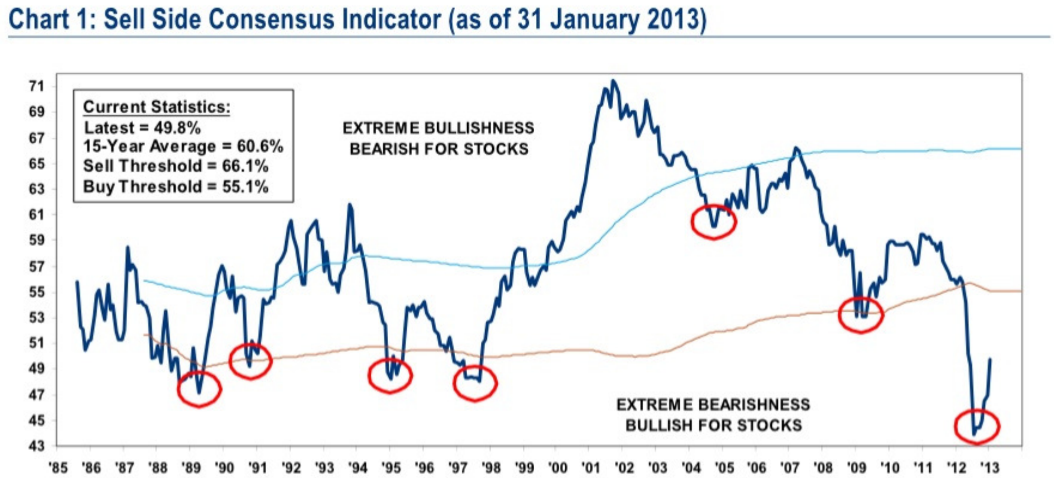
There are lots of ways to look at the question or how long cyclical bull markets run for. Each approach has specific strengths and weaknesses.

Jim Stack of Investech Research has one of the better charts: simple, straight forward, easy to understand.



The current rally that began in March 2009 is now 3.8 years old – that is the average duration of bull markets since 1929. (The current Fed interventions are the obvious wild card).

Despite the recent upward move, Wall Street is feeling better but far from bullish, as shown in the following chart:



I have noted repeatedly over the years how similar this cycle was to 1973-74. That rally went over 6 years before a serious 1980 recession and correction. This is not my forecast (I don't have one) but I would not be surprised if the current move is somewhat parallel to the post 73-74 rally.

The S&P 500 has rallied to all time highs for good reasons:

- Corporate/investment cash which has been on the sidelines has begun moving into equities
- The Fed will keep interest rates down as all nations try to keep their currency cheap to increase exports
- The beginning of a bond to equities allocation switch

I believe 2013 will end up in the 12-18% range, and if I err, I would guess I err on the low side. The USA will continue to outperform Canada, I like energy names, and I think cyclical – commodity names will have another run. Eventually the piper will have to be paid, but it will not be in 2013.

Stay tuned,

Vito Finucci
Vice President and Director
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