THE BUTTONWOOD

On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

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FIRST QUARTER 2014

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One Step Forward, One Step Back

A quick glance at the first quarter performance of 10 widely followed US stock indices shows very little in the way of positive gains. This occurred despite the fact that the Dow Jones Industrial Average had multiple triple digit days. The best evidence of this sideways movement is the S&P 500. Despite hitting an all-time high (1,878.04) on March 7, 2014 the S&P finished the quarter with a gain of 1.30%. While no other index hit an all-time high, results were generally in the range of plus or minus one percent.

Further evidence of a lackluster quarter is that the Barclays US Aggregate Bond Index weighed in with a 1.84% gain. We do not expect bonds to continue to outperform major stock indices, but it is interesting to note that most recently investors have pulled money from stock funds and sent cash to various bond funds. The logical explanation for this is that at year end 2013 stocks had appreciated to a point where they looked expensive and bonds looked cheap to many market timers.

The lack of investor conviction in US equity markets is understandable when you consider that economic data has been skewed by winter weather, the international picture is clouded by the Ukraine-Russia situation, and the Federal Reserve is in a transitional period with respect to the Chair and several new members. And, as mentioned above, US stocks had a banner year in 2013.

While far from perfect, we view the current market environment as favorable for patient, long term investors. We'll briefly mention 6 areas that have a significant impact on the economy and the markets starting with GDP growth.

GDP Growth

Economic growth is expected to grow at a 2.7% pace this year despite the negative weather related impact in 2014's first quarter. Gains should come as business and consumer confidence strengthen and Europe emerges from its long slump. It is important to note that consumer spending and confidence are still well below normal levels seen in previous economic expansions. As job growth improves and consumers feel more secure, quarterly growth could exceed a 3% annualized pace. This is likely to occur in the second half of 2014 and continue into 2015.

Labor & Jobs

On the labor front the better than expected February job growth of 175,000 indicates good momentum going into Q2 2014. Analysts are looking for increased business spending, growing consumer confidence, a continued up trend in housing starts and healthy exports throughout 2014. If this develops, the consensus is that job gains of 200,000 per month are attainable. It has been noted that the smaller than expected job gains in December (84,000) and January (129,000) were attributable to severe weather. Another important point is that average hourly wages gained 2.2% over the last 12 months. This, combined with low inflation, resulted in worker purchasing power increasing by 0.9%.

Interest Rates

Interest rates will continue to nudge up but there is no evidence of rates rising dramatically any time soon. The financial markets seem to be taking slowly rising rates in stride which was not the case last year. Consensus estimates peg the 10-year Treasury at 3.3% by year end up from about 2.7% today. You can be certain that the headlines will trumpet this as a 20%+ increase in rates and to be certain it is, but some historical context is necessary when looking at these numbers. A 10-year Treasury at 3.3% is still far below the 143 year historical average of 4.63%. The point is that while rates will go up, they are simply returning to historical norms. In addition, Chairwoman Yellen, in a recent Wall Street Journal article reiterated her commitment to low rates until the economy is much stronger.

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Inflation

Inflation in the US remains benign by any measure. A core inflation rate, which takes out food and energy, of 1.8% is forecasted for 2014, which is below the Fed's target of 2%. It is important to remember that general upward price pressures tend to lag an improving economy by a year or more. Therefore, the slow recovery we are experiencing now will likely keep inflation in check for the foreseeable future. Global competition will help keep prices low, a slowly improving labor market should keep wage inflation in check, and energy self-sufficiency should keep energy prices at reasonable levels. In Europe the focus is on developing a strategy to increase the rate of inflation. A recent Wall Street Journal article mentioned that the European Central Bank (ECB) would consider "bolder moves to guard against low inflation". Recently the ECB was criticized "for being too slow to act in the face of mounting evidence of falling inflation and near-record unemployment". From our vantage point, therefore, inflation appears to be well within acceptable norms.

Business Spending

It has been suggested by many that for this economic recovery to gain meaningful traction business spending must increase. The latest statistics suggest that business spending is slowly improving but is far from robust. Capital expenditures, the long-term investments businesses make on equipment in order to maintain and improve productive capacity, fell 1.3% in February. This is the second decline in three months. This is in contrast to the durable goods (items intended to last more than three years) reports which came in at a better than expected 2.2% boosted by strong demand for autos. It should be noted that business spending gained momentum in the second half of 2013, and the current economic landscape is free from governmental disruptions this year thanks to the two year budget deal. This is a positive for businesses and they should gain more confidence from the aforementioned forecast of 2.7% GDP growth for 2014. Analysts' consensus suggests that there should be a revival in this area over the next year.

Housing

The Kiplinger Letter reported that there is likely more expansion ahead for the housing market in 2014. Kiplinger expects about a 4% increase in existing home sales to 5.3 million this year up from 5.1 million in 2013. Sales of new homes are expected to climb by 15% to 500,000 in 2014. This follows gains of 17.0% in 2013 and 20.2% in 2012. Also, new homes stayed on the market an average of 3.3 months before selling. This figure is well below the 5.5 month average over the past 30 years.

It is important to note that the housing market for both new and existing homes is better in some regions than others as is typically the case. For example, prices in Denver and Dallas have hit record highs, while prices in large cities such as Chicago have struggled to rebound. Also the housing market could come under some pressure when mortgage rates rise as they inevitably will.

So Where Do We Go From Here?

In the aggregate what we've discussed is currently positive or appears to be trending in a positive direction. While 2013's performance will likely not be matched this year, we do remain positive in our assessment for the stock market. In our opinion US stocks are still the best place for equity investors in 2014 and beyond. While US stocks are not as inexpensive as they were last year, you can rest assured that stocks are not expensive at these levels either. Price appreciation will likely come as a result of improving fundamentals rather than Federal Reserve policy. This is no different than any post-recession period.

Typically during a recession the Federal Reserve is accommodative allowing the economy to recover. This is a significant positive for stock prices. As the economy does recover, the Fed reduces its accommodative posture allowing for additional stock price appreciation due to improving fundamentals such as revenue and earnings growth, increased capital expenditures, GDP growth, reasonable interest rates, etc. This usually occurs as interest rates are rising to more normal levels. We think that this is where we are now in the economic cycle.

As we have stated many times, a modest correction is overdue and would help to bring stock prices down to more attractive valuations. Having said that, if the underlying fundamentals do improve significantly, a correction could be pushed out on the timeline. Since no one can successfully time the markets we continue to believe that the patient, long term, conservative investor will do very well over the next several years. As always please call or email us with any questions, thoughts or comments. And remember…***Get Rich Slow***.