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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THIRD QUARTER 2014

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A Bull That is Long and Strong

The great bull market in stocks that began in March of 2009 continues to roll on and shows very few signs of coming to a halt. While many have warned of a downturn in prices, the US markets have not experienced a correction (defined as a price decline of greater than 10% & less than 20%) as measured by the S&P 500 since October of 2011. According to Sam Stovall, chief investment strategist at S&P Capital IQ, a 10% or greater correction occurs, on average, every 18 months. Furthermore, Mr. Stovall points out, there have only been four times since World War II that US stocks have evaded a correction for as long as 3 years. Certainly by those measures we are overdue.

The last market meltdown which began in April 2011, was largely triggered by the European debt crisis, fears that the euro zone could collapse, and the downgrade of US debt securities. Today the world faces a variety of challenges that include Ebola, Isis, the Ukraine, the Middle East, sluggish economic growth, etc. These challenges appear to be as significant as those in April 2011, yet US stock prices continue to rise.

While the data above might be impressive, it pales in comparison to the length and strength of the current bull market. As the following two charts illustrate, the current market ranks #4 all-time relative to length and percentage gain. For the purposes of disclosure and clarity, it should be noted that there have been 25 bull markets since 1929. A bull market is defined as price rise of 20% or more without a decline of 20% in between. The average bull market lasts 31 months, the average gain is 104% and the average frequency of a bull market is 3.4 years.

Ten Longest Bull Markets

Beginning Date	End date	# of Months
12/4/1987	3/24/2000	149.80
6/13/1949	8/2/1956	86.90
10/3/1974	11/28/1980	74.90
3/9/2009	**9/30/2014**	**66.70**
10/9/2002	10/9/2007	60.90
8/12/1982	8/25/1987	61.30
10/22/1957	12/12/1961	50.40
4/28/1942	5/29/1946	49.70
6/26/1962	2/9/1966	44.10
5/26/1970	1/11/1973	32.00

In terms of duration, this market would move to #3 on the list if there is not a 20%+ correction until August of 2015. What is very noteworthy about the market move from October of 1974 to November of 1980 is that it started after the severe market correction that took the S&P down by 40%+ over a 23 month period, not unlike the downturn from January 2007 to March 2009. There is a compelling similarity between these two market moves both on the downside and the upside. After two extreme bear markets some 34 years apart, we see two of the longest bull markets since 1929.

In order to get to #2 the market must avoid a 20% correction for another 20 months. Once again there is an interesting parallel between the 1949 - 1956 bull market and today. On 6/1/1949 the 10 year US Treasury rate was 2.31%. That rate would rise to 3.33% by 8/1/1956. The current bull market started in March 2009 with the 10 year Treasury at 2.82%. Today the 10 year stands at 2.52%. It is interesting that two of the strongest bull markets in history started 60 years apart when rates were at or near all-time lows. You may recall that the 3rd quarter 2012 ***Buttonwood*** mentioned that the interest rate cycle was about 60 years long with rates rising for about 30 years and then declining for about 30 years. None of these observations or coincidences guarantees that the current bull market will move to #2 on the list, but there is some meaningful precedent that suggests it could happen.

From a percentage gain perspective things become a bit muddled. We would make the argument that at this point it would be easier to surpass milestones in length rather than percentage gain. This is because the market could trade sideways for the next 20 months and hit the # 2 spot for duration and not jump up a spot on the percentage gain list. In fact, based on the criteria we spoke of earlier, the market could actually go down (as long as it doesn't drop by 20%) and still move up on the duration list. Regardless of what might transpire in this regard the facts speak for themselves – **this has been one of greatest bull markets in history.**

One final note regarding the current bull market - If you were to search for famous investment quotes you would undoubtedly find the name of Sir John Templeton, founder of the Templeton Funds (now called Franklin Templeton). Templeton's famous quote is ***"the four most dangerous words in investing are: this time it's different."*** What he is telling us is that we should follow market trends and history and not speculate that this particular time will be any different.

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Ten Strongest Bull Markets		
Beginning Date	**End date**	**% Gain**
12/4/1987	3/24/2000	582.15%
6/13/1949	8/2/1956	267.08%
8/12/1982	8/25/1987	228.81%
3/9/2009	**9/30/2014**	**195.53%**
4/28/1942	5/29/1946	157.70%
3/14/1935	3/10/1937	131.64%
10/3/1974	11/28/1980	125.63%
2/27/1933	7/18/1933	120.61%
6/1/1932	9/7/1932	111.59%
7/23/2002	10/9/2007	96.21%

Where do we go from here?

While the historical perspective is meaningful and offers some guidance as to where the market might trade, it is critically important to remember that the direction of the market always defaults to fundamentals. As we enter the 4th quarter of 2014 we thought we'd discuss where this market is from that perspective.

As we have stated many times in the past, stock market direction is a function of earnings. On this front, the picture is encouraging. Barron's recently polled their 10 top market analysts and they expect S&P earnings to come in at $118 this year, which is a 7% increase from 2013. Consensus estimates for 2015 call for an increase of 8.1% which would equal $127.56. Currently the S&P is trading at 15.5 times the $127.56 estimate. This suggests that stocks are not as cheap as they were over the last 24 months but they are not overvalued either. If economic growth accelerates we could expect some price/earnings ratio expansion. In addition, as the chart below shows, based on a variety of metrics, stocks are cheaper today than at the 2000 and 2007 peaks.

	2000	2007	2014
S&P 500	1527	1565	1972
Trailing 12-Mo. Earnings	$ 51.02	$ 90.06	$111.83
Trailing 12-Mo. P/E	29.9	17.4	17.6
Forward 12-Mo. P/E	25.1	15.0	15.5
Price/Book Value	5.4	3.0	2.8
Dividend Yield	1.1 %	1.8 %	1.9%
10-Year Treasury Yield	6.2 %	4.7 %	2.5%
S&P Companies w/ dividend yields higher than 10-year Treasury	6 %	7 %	32 %

Source: Bank of America Merrill Lynch

There are two interesting components of the economic cycle that could serve to increase earnings and earnings growth. Thomas Lee who recently left JP Morgan to start his own equity research firm, Fundstrat Global Advisors, recently discussed earnings per share growth and investment spending at past market peaks.

Lee's research shows that earnings per share growth at market tops peaks at 53.1% above the previous cycle highs. He says we have broken above the prior high of $87.72 (S&P earnings for calendar year 2006) by about 30%. Therefore, if we reach the average of 53.1% there is still 23% more growth in S&P earnings. Lee says that could take S&P earnings to $140. At a multiple of 15 to 16 times earnings the S&P would be trading at 2100 to 2240.

With regards to investment spending, also known as capital expenditures, Lee notes that at market peaks investment spending, on average, reaches 27.8% of GDP. Today we are at 23.2%. The difference equates to $800 billion in additional spending which would most likely stimulate economic growth and hence improve earnings.

From an interest rate perspective the fundamentals also look favorable on several fronts. As we stated many times we believe that when rates go up they will do so gradually. Also it will be important to remember that rates will be returning to normal levels from historic lows. As an example the 100 year average on the 10 year Treasury note is 4.98%, today the 10 year yield is 2.52%.

Two other scenarios usually play out relative to interest rates before a bull market ends. The first is that the yield curve inverts. That is to say longer term bonds yield less than shorter term bonds. As of 9/30/14 the 30 year Treasury was at 3.21% while the 10 year was 2.52%. That is a very normal yield curve. Secondly, stocks always get more over valued than bonds at market tops. Bond prices have increased in 2014 and remain more expensive than stocks.

As with any market there are plenty of risks both financial and geopolitical. It makes little sense to list them here, we are all aware of them. It does seem that a major 20%+ correction is not in the cards. The odds favor a market decline in the 10% to 15% range. In our opinion that would be healthy in the long run and a buying opportunity for cash reserves or new money.

Don't Try to Time the Market

As we've said many times it is a very foolish endeavor to try to time the market in the long run. It makes less sense to try and do the same in the short run. Legendary investor Peter Lynch, manager of the Fidelity Magellan Fund in its heyday said that "far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

A recent Schwab study using data provided by Standard and Poor's shows that between 1994-2013 missing the top ten days trying to time the market would have resulted in a reduction from a 9.2% annualized return to a 5.5% return. That's ten days over 20 years. Simply stated no one is that good!

We anticipate that the US economy will continue along its current slow expansion path with low inflation and a generally favorable interest rate environment on a relative and historic basis. With some meaningful historical precedent and solid fundamentals working in our favor, we believe the bull market can and will continue. When all is said and done this should prove to be a perfect scenario for investors to "***Get Rich Slow***."

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