

August 6, 2013

**Stock Market: Bubble or Bargain?**

**The continued rise of equity prices has pushed many sectors of the US market to new highs.** For the year, total return in various US sectors range from +14% on NYSE Index to +24% on Small Caps. At the same time however, earnings growth has been lack luster, increasing only +2.5%. For the first since this 4yr bull market began, equity **returns in 2013 are running at 4- to 5-times the rate of EPS growth!** Should investors be concerned? Is another stock bubble forming, or do prices still have room to rise? To answer this we must first look at what is driving up prices.

Earnings Growth: History has shown that stock prices and earnings growth broadly align with each other. Since the low in 2008 thru the end of 2012, earnings have risen 106% while stock prices have risen 111%. But with growth now slowing to anemic levels, stocks will need another impetus for further appreciation.

Low Interest Rates: Extraordinary low long-term rates have fueled the rally in stocks on two fronts: higher valuations and adding to return. Current price-earnings valuation is near 20, which is high by historical standards, but looks cheap compared to the low level of interest rates. At the same time low rates have contributed to corporate earnings, aiding higher dividend payouts, encouraging capital spending, stock repurchases, and acquisitions – all supporting stock prices. But falling rates have come to an end, and in fact rates are beginning to rise (+100bpts since June). At some point, rising rates will become a drag on stock prices.

Rotation out of Bonds: With low rates and miniscule returns, bond investors were already beginning to dip their toe into stocks in the first quarter. But then in June, with the Fed announcing their intention to gradually withdrawal bond purchases possibly as soon as September, bond investors dumped their holdings and plowed even more funds into stocks. **With cash earning zero and bonds going down in price (negative return), by default, stocks have become the new 'safe haven'.**

Best house in a bad neighborhood: The global economy continues to struggle. China's growth is slowing rapidly and Europe has yet to find bottom. Japan may provide some help, but more from a weakening Yen, than actual increase in productivity. Net, the US economy is the best house in town. Despite anemic GDP of 1.7%, US companies are still growing, albeit slowly, and thus they are perceived to be the healthiest investment globally. So again, **by default, money is flowing to US stocks.**

Can stock prices continue to rise? For now, probably yes. Are stocks vulnerable to correction? Most definitely! Stay tuned.

Portfolio Strategy: Bond positions were reduced early in 2<sup>nd</sup> quarter with the anticipation of rising rates. More recently, Cash levels were raised slightly.

As always, please contact me with any questions or concerns.

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