New Albany
Investment Management

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Market Insight: Will this rally continue?

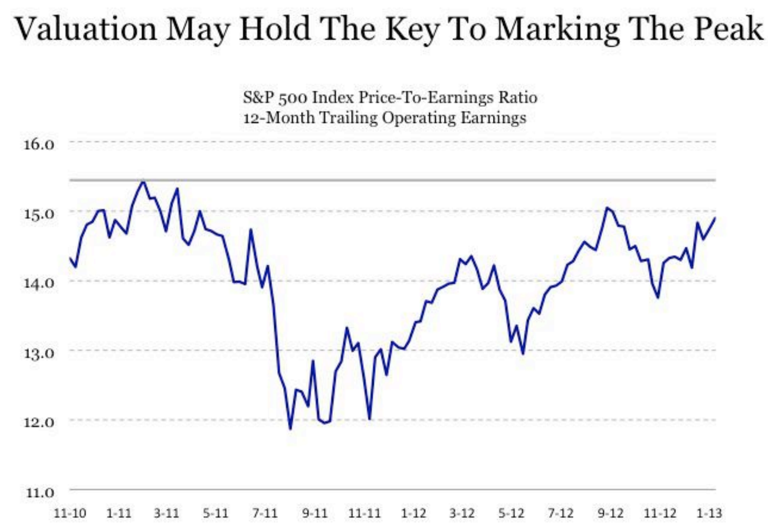
By Barbara Huff

The stock market has enjoyed quite a run so far in 2013. Almost all indices have advanced, including the S&P 500, in each of the last eight trading days, the longest such winning streak since 2004. In the process, the S&P 500 has crested above 1500 for the first time in over five years. Given such a strong recent advance, can the market keep moving higher, or have stocks run their course for now?

To answer this question, we must first consider what is driving the market. Is it valuation, investor sentiment, the economy, Washington, or Fed's easy money policy? Only one of these factors is really significant and the key to future gains. Can you guess which? Let's take a look.

Valuation: Neutral

The Price-Earnings (P/E**)** ratio is one metric to quantify valuation. Currently, the S&P P/E ratio is just under 15, which is "Neutral". The chart below shows P/E's peaked at 15.4 in mid February 2011. Since that time, earnings growth has been slowing and stocks have yet to return to these valuation levels in the nearly two years, despite reaching new highs on a price basis. This is because earnings growth has not kept pace and in fact is now in decline. But, if corporate earnings for the remainder of the quarter manage to hold the current consensus estimate, stocks would arrive at this prior peak valuation at roughly 1560 on the S&P 500 Index, or about +4.7% higher than the current level, and just a few points away from its all-time high of 1576 back in October.



Investor Sentiment: Neutral

Fear and greed drive investor sentiment. A good measure of investor sentiment is the amount of risk premium investors demand to own stocks verses a 'risk-free' investment, such as US Treasuries. When fear subsides, investors feel confident to take risk, and buy riskier assets, such as stocks. Risk premium is measured by taking the inverse of the P/E ratio. The higher the P/E ratio, the lower the risk premium and means investors are willing to pay more to own a riskier investment. The chart below shows the risk premium of 4.7%, which is in "Neutral" territory. However, as seen in early 2011, it certainly can continue lower, which implies stock could move higher.

Economy: Neutral

Global growth for 2013 is expected to be subdued at about 2%, enough to keep another recession from occurring, but not enough for corporate earnings to grow. The bright spot in the US is the improving housing market, providing a positive 'wealth effect' and ultimately, will create jobs. Outside the US, China and Asia are the main sources of growth. On the negative side, there are two big drags to growth: continued stringent austerity measures in Europe, and Washington's inability to actually address the ever-growing deficit.

Fed Liquidity & Stocks: Strong Positive

Make no mistake, the deluge of liquidity poured into the markets by the Fed has been the primary impetus, both directly and indirectly, for the rise in stock prices. The chart below shows the growth in the Fed's balance sheet (green) and stock prices s (blue) since 2009 when Quantitative Easing (QE) began. Each time the Fed announced a new QE program, the market surged higher for several months. And, literally the moment the Fed stopped expanding its balance sheet at any point along the way (yellow highlight), the market has almost immediately plunged into phases of sharp volatility marked by swift and extreme corrections ranging from -10% to -25% in a matter of weeks.

Conclusion: Positive

So more than what anyone may believe good or bad about valuation, investor sentiment, corporate earnings or the global economy, the infusion of enormous liquidity by the Fed and other major central banks has unfortunately dominated financial markets by drowning out nearly all else that would otherwise be critically important in investor decision making.

On January 4th, the Fed announced a key change to QE where they are now buying an <u>additional $40 billion a month</u> in US Treasuries. This new initiative along with the postponement of the debt ceiling debate (again), will continue to provide a positive influence on stocks. Enjoy it while it last!