New Albany Investment Management

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Market Insight: A Peculiar Rally
Defensive Sectors Lead Market Higher

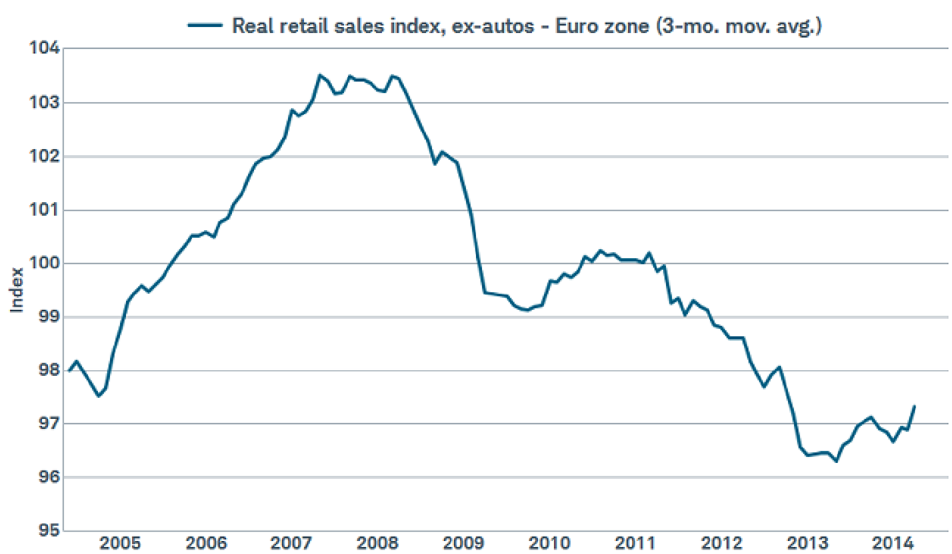
After more than two months of choppy trading and a dramatic rotation in market leadership from small-cap (high risk) to large-cap (defensive), the S&P index has now pushed up to new all-time highs. During this time period, small cap stocks saw as much as a 10% correction while other sectors like utilities advance more than 8%. At the same time Bond yields have fallen dramatically which is often a signal of slowing economic growth. Normally new highs are justified by high volume and broad base sector leadership, but instead, this advance is tepid at best, with only the most stable stocks leading the way. Will this peculiar rally gain momentum, or dissolve into a summertime lull?

Below are some key measures of market and economic conditions that lay out the debate. From negative to neutral to positive, these factors are influencing price action.

Warning Signs:

Dangerous time in the Calendar for Stocks: Price history shows that both mid-term election periods and May through October are generally weak periods for stocks. Inflows into equity funds have been more like a trickle this year, and surveys of individual investors show lots of fence-sitting confusion rather than bold upside expectations.

European Growth Slowing: After emerging from recession in 2013, growth slowed to near zero in the first quarter of 2014. Italy and Portugal fell back into negative territory and France stagnated; and when combined with consumer prices still falling in many countries, some have questioned whether the region will fall back into recession. However, overall in the EU, consumer spending is modestly higher (chart below) and could be the catalyst to pulling growth back into the positive.



China's economy continues to slow: A bubble in the property market, risks of a shadow banking crisis, excessive local government debt, and industrial overcapacity have been met with restrictive monetary policy which in turn is slowing growth. The risk is that this action will cause a major contraction and affect global growth which in turn ultimately impacts earnings and stock prices. (The US largest companies generate over 45% of revenue outside the US.)

Neutral Measures:

Fed Continues to Pull Back: Purchases of Government securities are down from $85 billion to $45 billion per month, and likely headed toward zero before the end of the year. With that action largely baked into the market, attention has turned to when the Fed will begin hiking short-term rates. The Fed has signaled that it will be well into 2015 before that occurs, but developments in the economy could force their hand sooner.

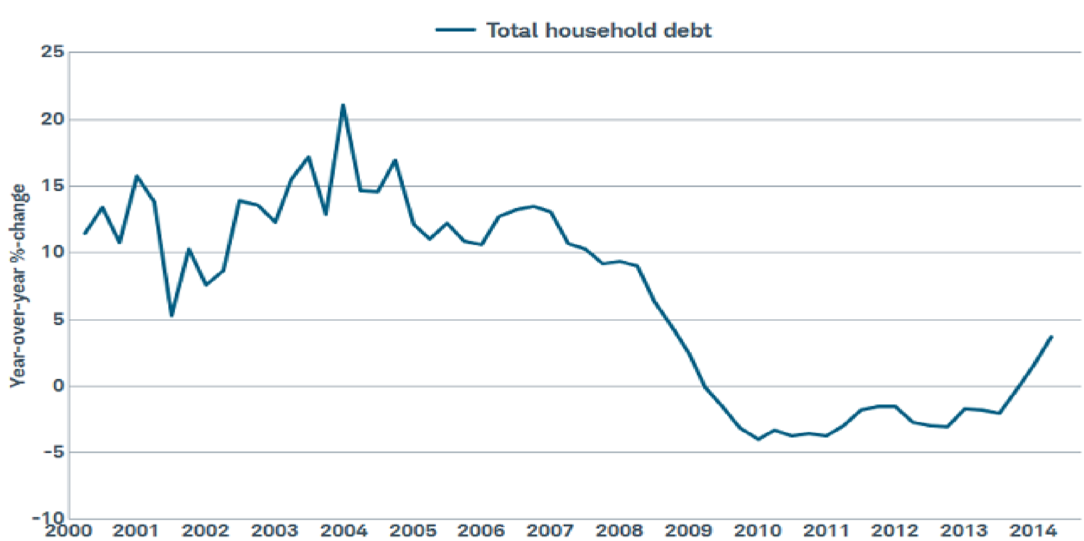
Volatility of stock prices is back to multi-year lows indicating Investors' are ominously calm (little fear) when it comes to taking risk. This can be a negative sign. However, perhaps it is a justifiable response to the policies of developed-world central banks keeping official rates near zero and flooding the system with fresh cash. In effect, the central banks have created a 'safety net' for investors.

Unemployment Rate falling to 6.3% is the lowest since 2009 however much of the drop is due to lower participation rate.

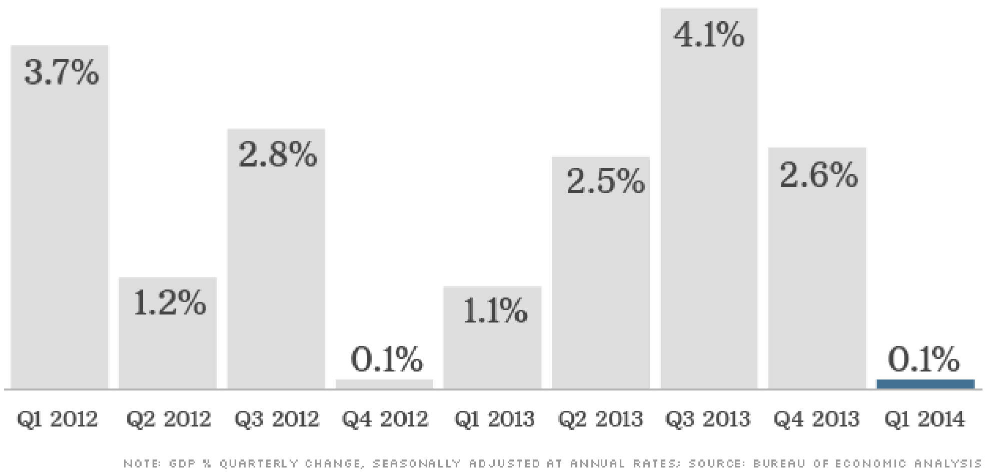
Corporate and individual Investor confidence is back to pre-2008 crash levels: Merger & acquisitions activity, margin borrowing, and Junk bond yields are benefiting from cheap money and indicate speculation is on the rise.

Positive Indicators:

Household Debt is accelerating: More debt will facilitate consumer spending. (We've seen this movie before!) The good news is that balance sheets are much healthier than in 2007.

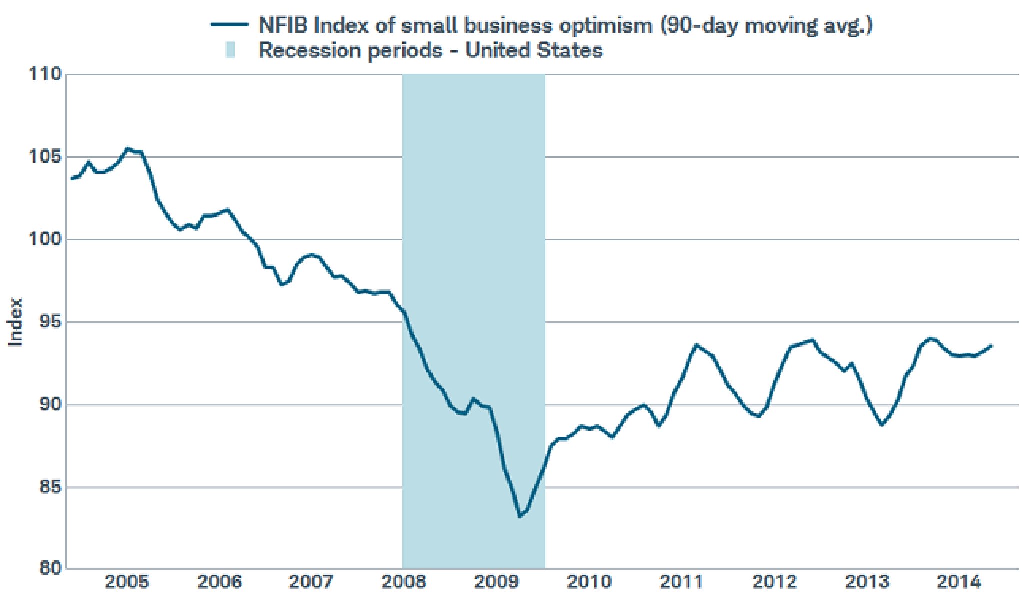


Economic Expansion appears to be gaining strength after ultra-weak first quarter. Second half growth is forecasted to be above 3%. Acceleration of growth will continue to propel corporate profitability. The chart below shows the choppy growth pattern of GDP.



Falling Yields may not be due to expectation of slowing US growth but deflationary impulses from Europe, China, Japan and geopolitical risk with Russia. Never the less, cheap money makes all financial assets look more attractive and can give a big lift to stock prices.

Small business optimism, a good leading indicator of economic growth, remains near its 5yr high (see chart below).



Conclusion: We are in the 5th year of this bull market, and after the spectacular run in 2014, the bull appears to be slowing down. Not surprising, a majority of measures are in the 'neutral' camp but it is the cheap money factor that wins out. Thus, the current market condition is more indicative of a late stage Bull Market. Eventually bull markets get pushed to extremes and become vulnerable to any hint of bad news. But in the meantime**,** hope once again overtakes caution and the markets grind higher.

Investment Strategy: A broad base correction never materialized. Price action is expected to continue to be choppy with an upward bias. Portfolios are fully invested however risk has been reduced through broader diversification across asset classes, exposure to more defensive sectors, and more emphasis on income from dividend paying stocks.

Please don't hesitate to contact me with any questions or concerns.

Kind Regards,

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