New Albany Investment Management

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Market Insight:
Why Stocks Keep Rising…

The divergence between Stocks and the US Economy has many puzzled. For six months, the market has rallied without any meaningful correction. And now, in the face of weaker economic data, stock prices have not only surpassed their 2007 highs, but are continuing to march higher. Are investors no longer concerned about the economy? Are they becoming irrational, creating another asset bubble? The arguments below represent the current market sentiment.

Rationale for not worrying about the slowing economy:

- **Bad news is not bad enough**. The economy is slowing but not falling off a cliff. Slack labor markets and soft raw material (commodities) prices continue to provide support to corporate top line growth.
- **Bad news is good news:** Central Banks around the world are ferociously printing money, pushing interest rates to near zero. Just this week, the European Central Bank cut the main financing rate to 0.5%, a record low. Thus, borrowing cost for businesses (including the least credit worthy) has never been cheaper. Junk Bonds are now yielding just 5.0%, a record low. Cheap financing is contributing to better margins.
- **Good news will follow bad news.** The impact of the Sequester (fiscal tightening) is transitory. Growth will pick up by Fall. The private sector will continue to gain traction

Rationale for buying stocks at these levels:

- **Low rates make Stocks look cheap relative to Bonds for Individual investors**. With rates near zero, bonds no longer offer any return. In fact, the year-to-date returns on US Bond Index is only 0.5% as compared to the broad stock market of 10.5%. Investors, hungry for return, are being forced to take more risk- a.k.a.- buy stocks.
- **Low rates make Stocks look cheap relative to Bonds for Corporate investors**. The low cost of issuing bonds allows companies to raise cheap cash, which is then used to buy back stock. Just recently, Apple issued debt practically for free and used the proceeds to buy back their stock.

Rotation from Protecting Wealth to Expanding Wealth:

- **Fear of Market Crash is diminishing:** Since the market crash in 2008, investors have mainly been focusing on protecting their wealth. It explains the huge surge in gold prices, commodities and especially treasury bonds. However, when economic activity picked up again in the US and emerging markets, the ***focus from investors shifted from protection towards expanding wealth.***
- **Rising Real Estate prices creates investor confidence**: The fall in homes prices wiped out even more wealth than the drop in stocks. With home prices now rising, investors are once again more confident to put money into riskier assets.

- **US Treasuries guarantee negative inflation adjusted return**: To expand wealth, investors need to first beat inflation. With an inflation level of around 2% and 10yr US Treasuries yielding 1.7%, investors are locking in a NEGATIVE -0.3% return. Thus, fixed income investments (CD's, Savings accounts, Investment Grade Bonds) are no longer a viable inflation hedge. And, Commodities, that did well during the 'protection' faze, are now falling in price. What's left? Stocks.
- **'Goldilocks' Economy- not too hot** for the Fed to take away the punch bowl; **not too cold** for companies to grow earnings. Between dividends of 2.0% and capital appreciation, stocks offer the only alternative to create wealth.

Conclusion: So are these arguments correct? Yes, no, and maybe. As I have stated before, there are many, many different drivers of the stock market. Each one can be a 'legitimate' reason to own/buy stocks, until it is not. That is, the **investing environment is constantly changing which is why actively managing your investments is a requirement to both preserve and grow wealth!**

Investment Strategy: Allocation to US equities was increased in March and early April. With the market now breaking out, momentum is likely to drive equity prices higher into mid summer. If this is the case, risk positions will likely be scaled back at some point.

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

May your Mother's Day be filled with joy!

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