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Investment Outlook

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Predictions of Doom? The Stock Market Isn't Listening

It's been interesting to watch the US stock market's stellar performance since its weeklong pullback way back in early November. Especially during a string of events pointing to a dearth of leadership in the nation's capital: No compromise on fiscal policy, a third consecutive year without a budget, a brief step over and back from the Fiscal Cliff and, with no agreed upon plan to reduce the deficit, Sequestration initiated in March. These factors would normally make for a period of very rough sledding for stocks much like we saw in 2010 and 2011. So what's happened to change investors' view of such macro-economic risks? It appears that our leaders' warnings of impending doom for the economy are being ignored by the markets. Investors aren't buying what Washington is selling, they're buying equities instead.

Enjoy the Rally While it Lasts

The S&P 500's gain of more than 11% marked its best first quarter since 1998. Ironically, it followed in the wake of a seemingly unending string of pratfalls emanating from the banks and halls of governments throughout the developed world. We now know what "event fatigue" feels like: One crisis after another, all threatening to take us back to the dark days of 2008. Funny thing though, none of those dire warnings and fear-mongering speeches have rung true. Not a single crisis has been resolved and yet the economy continues to move ahead and the stock market's perfect record of *always* recovering to eventually make new highs remains intact as both the DOW and S & P 500 have posted *new* all-time record highs. Their record of recovering when the world doesn't come to an end remains intact.

We think investors have become weary of leaders crying wolf as they campaign for a version of an economy where government is *the* big player rather than the referee. No budget? No long-term fiscal policy? Tax increases? Fiscal Cliff? Sequestration? Investors and the markets have figured it out: Despite the ineptness of our leaders the recovery continues and the double-dip recession, predicted by so many experts, has yet to make an appearance. In our opinion, Congress and the Administration, immersed in the theater of a grid-locked Washington, have joined the Kardashians in the pantheon of irrelevance to American Business. Will that condition persist? Thankfully no. Sooner or later something will get done in D.C. and the markets will pass judgment on it. We'll just enjoy this for now.

Transition in the Economy

The markets have moved higher without an assist from policy-makers. However, someone in Washington has been busy. Fueled by a desire to avert a deflationary spiral, Chairman Ben Bernanke of the Fed has fired up the economy by super-sizing the debt with Quantitative Easing. A good portion of that liquidity has spilled over into stock and real estate markets. That's only part of the story. Companies have been busy the past several years, shoring up balance sheets, trimming costs, and increasing productivity. Becoming lean and efficient in an economy awash in liquidity is paying off for American business. So much so that even the most ardent predictors of doom haven't dampened investors' enthusiasm for equities during this 4-year long bull market.

A reason might be the quiet but steady transition of the US economy from one that was structurally impaired to one that is now only cyclically challenged by factors that determine the *direction* of markets rather than threaten their *existence*. This is an important stage of this recovery where the risk of depression transformed to that of recession. You already know the story of 2008: The markets decline on news of a massive misallocation of capital to the housing market. That leads to the discovery of an unregulated financial casino built by the big banks and brokers in the shadows of the markets. The result? Near destruction of the economy and its financial system.

Four years and several trillion dollars later, many of the culprits still walk the streets but the threat of devastation to the economy and financial system has been displaced by that of cyclical downturn. That's good news and we can live with that. Recession is part of the natural ebb and flow of an economy where markets correct excesses and misallocations of capital and resources created by human beings. It's cure? Liquidity and fiscal policy that engenders confidence in business and consumers. Today, we have the liquidity, courtesy of the Fed, but have nothing in the way of an assist from fiscal policy-makers. Instead, we have new and higher taxes coupled with unfulfilled promises of investment in infrastructure and job creation. In our view, our leaders' efforts have pushed real recovery down the road along with the can they've been kicking.

Are Stocks Disconnecting from the Economy?

Right now, the US markets are rewarding the good work done by companies in the private sector and ignoring the lack of *any* work being done in Washington. However, its possible investors are just turning a deaf ear to a couple of very obvious sources of cyclical risk that could threaten the economy in the year ahead: Sequestration and higher taxes. Sequestration proscribes $85 billion in across-the-board cuts in defense and other programs deemed discretionary or non-essential. Higher tax rates for the wealthy were accompanied by the new Obamacare tax and a reinstated payroll tax. These are headwinds for the economy and should be for stocks too. However, at this juncture it seems that the massive amounts of capital and liquidity the Fed is pumping into the economy has trumped taxes and Sequestration where investors are concerned.

We agree with those that say that US stocks could be disconnecting from the global economy and its markets. Data indicates low inflation accompanying modest GDP growth of 2-2.5%. Our expectations for the recovery were already modest so we're happy to see that continue for the next year or two. Unfortunately, other more recent data indicates that taxes and Sequestration could be undermining the confidence of both business and consumers. It's too early to tell if that will trigger the next recession but it's entirely possible even if the Fed keeps the spigot flowing with cheap money. A meek consumer and tentative private sector is unlikely to do the heavy lifting of the economy amid the uncertainty flowing from the lack of any pro-growth fiscal policy coming out of Washington.

Will This Bull Market End In Tears?

They always do. The next recession will bring with it the next bear market. The question isn't if, but when. As we said before, it's an inherent part of a free-market economy managed by and for people who yo-yo between the extremes of fear and greed. Chalk it up to human nature. There have been 11 recessions since 1948, an average of one every 5-6 years. So, while we're enjoying the fruits of this rally and don't see recession in the near future, it doesn't hurt to think about what could change down the road.

While we remain alert to data pointing to a slowdown in the recovery, the elephant in the room is the Fed. What will Chairman Ben's second act look like and when will he put it on stage? We're talking about reeling in the liquidity and credit that he's dispensed since 2009. If stocks are being floated on a sea of cheap money, it takes little imagination to figure out what happens when the tide goes out. The real question for investors is what happens if the economic data deteriorates and the Fed is forced to keep the liquidity flowing? There's a possibility the stock market could further disconnect from the fundamentals, setting the stage for something other than the milder "pullback" so many (including us) have been anticipating.

This is where fiscal policy becomes important. All this liquidity will go for naught if left unaccompanied by pro-growth policies that ignite demand and create inflation: the type that flows throughout the economy and not just into the equities markets. We think the Fed has gone as far as it can without an assist from the rest of Washington. If forced to continue priming the pump, we may see stocks carried to levels where investors find it painful when markets reconnect to the underlying economy. The ride to the top might be fun, but the return to reality? Not so much. That's why we'd prefer to see the market reconnect today rather than months from now.

Is that any reason to pack up your portfolio and head to another asset class? No. We think it's critical that investors participate in *all* asset classes right now, matching their liquidity needs and an investment horizon to each. We think that beyond whatever pullback, correction, recession, or bear market that's out there, owning private sector enterprises will pay big rewards when compared to bonds and cash. We're counting on companies to continue the good work while we're left waiting for tailwinds, not headwinds, to emerge from government. Let's hope change in Washington brings about something other than what we've seen so far.

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