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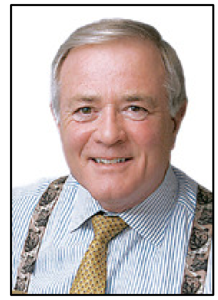

William Rutherford

# Markets hit pothole after long run-up

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In the second quarter of this year, U.S. equity markets returned 5.2 percent, as measured by the Standard and Poor's 500 indexes, and outperformed most other developed markets.

This was the sixth straight quarter of positive returns posted by the S&P 500 through June 30, 2014. Because of growing turbulence in the Middle East, the prices of energy stocks were bid up. U.S. Growth and Value stocks posted identical returns at 4.9 percent. Commercial property real estate investment trusts posted stellar returns of 7.1 percent, the 17th consecutive quarter in the black.

However on the last day of July, the Dow Jones industrial average dropped 1.9 percent. After weeks of complacency, the volatility index spiked up, although not to alarming levels. For the past several years, these spikes in the volatility index have been followed by market rallies.

This past bull market has been a lesson in "don't fight the Federal Reserve." With central banks throughout the world working to support the economy, it would not be wise to bet against them. For the past several years those who have bet against the Fed and the equity market have lost.

That the equity market has taken a breather should be no surprise. The gloom-and-doom prognosticators have been predicting a market crash for years. A stopped clock is right twice a day. However, the markets marched steadily upward, much to the distress of the doomsayers.

Now they can say, "I told you so," but it is not doom yet. Nor is it likely to be. For instance, David J. Kostin, strategist for Goldman Sachs Group, sees a strong divergence between the equity and bond markets in the years ahead. He expects the S&P 500 to gain 8 percent over the next 12 months. By the beginning of 2018, he sees the S&P 500 at about 19 percent above current levels. He expects the 10-year Treasury note to return just 1 percent during that time.

The revised numbers for gross domestic product for the second quarter of this year show the economy growing at 4 percent in a rebound from the negative numbers of the first quarter. More than 200,000 new jobs were created for the sixth month in a row. While unemployment rose from 6.1 percent to 6.2 percent, it appears that more people who had been sitting on the sideline are re-entering the improving job market.

Profit growth in this earnings season is a credible 7.5 percent so far, with 74 percent of firms beating street estimates. The purchasing manager's index for the U.S. showed a gain of 58.7 at the end of July, stronger than the expected 56.5 percent. Personal spending remained steady, rising at 0.4 percent in June. Corporations are carrying lots of cash on their balance sheets, which could yet be deployed.

The U.S. is now producing more oil than either Russia or Saudi Arabia, with our production growing. We can do even more.

Weighing on the markets were headline events surrounding Ukraine and the Israel Hamas conflict. Additional reasons for the downturn in the markets were a) the extended period of the run up; b) new highs were reached, but they were highs on tepid volume; c) the markets began to look frothy. A talk of bubbles was common. Even Federal Reserve Chairwoman Janet Yellen called out “extended valuations in the social media sector.” An unwritten rule of Fed leadership has been to not comment directly on the market and say nothing that will move the markets. Her testimony was reminiscent of Alan Greenspan’s admonition to get variable interest rate mortgages while interest rates were attractive. It is not clear what Yellen’s bonafides are on stock selection. Greenspan’s recommendation did not end well.

A recent spate of initial public offerings also suggested we were nearing a market peak, as these new IPOs pulled money out of existing equity holdings. Since the money was withdrawn from larger and more liquid equities, which were often in an index, and the new IPOS were not in an index, the indexes were pressured down. Additionally, because the economy seems to be getting on a more-sound footing, expectations of an interest rate increase – earlier, rather than later – intensified. The Federal Reserve would not be raising interest rates unless it thought the economy was improving. Rising interest rates will make for a stronger dollar, which is already happening. A strong dollar is good for the U.S., as oil will become cheaper (because oil contracts are typically priced in dollars), and a strong dollar will attract capital to the U.S. An increase in interest rates would be good for bank stocks, and banks are typically a leader in the markets.

The rest of the economy does not appear to justify the downturn. It may just have been fatigue with the headlines and the record highs. Normally at this time in the election cycle, the government – regardless of which party is in power – will bring out the check book. That may not be possible in today’s more overextended government. Nevertheless, the economy should be able to lumber on, and the markets should reach new highs before year end.

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