MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

# "Perhaps a Little *Too* Quiet"

"The US equity market continued its remarkable run in the quarter just ended." It has been a pleasure to be able to include some form of that sentence in each of our last 10 issues of *Consilium*. Squeezing out a 0.3% total return for the three months ending June 30, the market remains in the midst of its longest winning streak since 1998.

Notwithstanding the positive overall trend, this year has been unusual in that the market has made little progress in either direction. After a 3.4% drop in January, the S&P 500 rallied for a 6% gain in February – and since then has fluctuated by no more than 3%. But this quiet spell masks some larger moves occurring beneath the surface, and not all of them are positive. For example, as the bond market has sold off this year and interest rates on benchmark 10-year US Treasury notes have risen (from a low of 1.65% in January to a recent high near 2.5%), income-oriented investment vehicles have been very poor performers:

Price Change: January 31-June 30, 2015

Utilities -14.3% (S&P Utility Index)
Real Estate Investment Trusts -13.6% (MSCI US REIT Index)
Master Limited Partnerships -10.3% (Alerian MLP Index)
10-year US Treasury Notes -7.2%

It is also worth noting that more and more stocks have stopped participating in the bull market and have fallen into declines. For example, on the New York Stock Exchange nearly a third of stocks are down at least 20% from their most recent highs – a year ago that figure was 15%. And today only 13% of NYSE stocks are within 2% of their highs, while a year ago that figure was 38%. The phenomenon of fewer and fewer stocks participating in the market's advance, and a smaller group of stocks keeping the market elevated, is a clear-cut sign of an aging market cycle. Selectivity, always important in developing market exposure and building portfolios, is therefore even more critical at this stage.

The character of the equity market is changing, and the reason seems straightforward: the end of the Federal Reserve's long period of extraordinary monetary stimulus is ending. Having already concluded its massive bond-buying program, Fed officials have been unusually clear (by their standards) that they would like to begin to "normalize" short term interest rates (which have been held near zero since 2008) this year. There is still considerable uncertainty as to the timing of any short term rate increase, which undoubtedly has played a role in the market's indecisiveness.

*Sources: Baseline, FactSet, Lowry Research*

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A natural response to the above might be: "Everyone knows this. The Fed has been discussing a change in interest rate policy for nearly a year. Why should the market be impacted by something so well advertised?" The answer is that, as in every past cycle, there is almost no certainty as to *how high* rates might rise; even the Fed doesn't know. The upside potential for interest rates seems limited given moderate growth, continued tame inflation, and generally weak economies elsewhere in the world, although such forecasts are based on probabilities only. When uncertainty about the macroeconomic environment (and especially Fed policy) rises, it is hard to make progress in stocks. Markets have become unsettled, even if briefly, every time the Fed has changed course over the last 45 years, and this is where equity investors find themselves at present. They ask: when short term rates rise for the first time in nearly a decade, will it be a one-time event? Or a 10-time event?

Mid-Continent Capital's best forecast is that the US economy, led by stronger consumer spending and housing activity, is shaking off the effects of another very cold winter and a sharp retrenchment by the oil sector. But an inflationary "boom" that might result in an extended period of rapidly rising interest rates appears to be only a remote possibility. On the other hand, the risk of an economic downturn that would seriously hurt corporate profits, and hence stock prices, also seems quite low at present.

For the longer term investor, the level and direction of company earnings are the factors that bear watching most closely in developing expectations, not temporary volatility based on whether the Fed raises rates by a quarter of a percentage point. Asking questions, analyzing data and then reacting with any necessary adjustments – not the other way around – puts the long term investor in the best position to emerge from the "uncertainty tunnel" with capital intact.

We hope our readers enjoy the summer months and we look forward to our next report in October.


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