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Quarterly Report: First 1/4 2014

On the Markets....

Here's a curious little secret: beneath a dry and somber exterior, most economists have a wonderful sense of humor- consider it part of an occupational first-aid kit. One of the oldest jokes is that on the eighth day, the economist was created in order to improve the self-esteem of the weather forecaster.

As this interminable winter persists and this aging bull market endures, perhaps there's more of a connection between the markets and the weather than we ever suspected.

Although bull markets don't come with an expiration tag, this bull is now the 5th longest since 1928 and ranks number 4, Casey Kasem, in terms of its strength. Clients ask- "are we nearing the end?"

Caution precludes prediction: in upstate NY we can easily remember snow in May, on Mother's Day.

But of course, the season inevitably turns. It has been 18 months since the market has corrected even 6% and there are expanding indications of significant changes in the tone and tenor of our capital markets.

Following a preceding year in which the S&P rallied more than 29%, stocks ended the first quarter up little more than 1%. Volatility was more pronounced these last 3 months than in the previous 12. And if we previously enjoyed a rising market tide that lifted all boats, we are now experiencing strong winds and strange waters that have swamped some stocks and carried others kindly.

As the tacticians say, the easy money has been made. Now it is less a stock market and more a market of stocks which will reward careful selection.

In our January market letter and Performance Report we forecast the most likely scenario as a period of consolidation and a pullback in the S&P to a level around 1760. We would regard this behavior as a healthy reset in which high momentum and over-valued stocks sold off and the market refocused on large, well-managed and more-reasonably priced companies whose stocks have lagged the broad advance. It is a function of basic human nature (which markets reflect) that we swing from one extreme to another. In the short term, markets move primarily on sentiment; over longer -and for disciplined investors, more meaningful- time frames, the valuation of the business that the stock represents will drive the price.

Here is why we remain constructive on the markets going forward.

-While we can never rule out the sudden emergence of a massive, unforeseen catalyst- geopolitical, geological, pandemic or systemic- most profound and & prolonged market sell-offs are the result of a recession, where the economy significantly contracts. We see no sign of this.

-Quite the opposite: we believe we are witnessing a global economic expansion. The International Monetary Fund (IMF) forecasts global economic growth to increase from 3% in 2013 to 3.6% in 2014 and 3.9% in 2015. Moreover they forecast a broad-based expansion to include an accelerating recovery in Europe and Japan and sustained high rates of growth for China, India and developing markets like sub Saharan Africa where growth rates are projected to be greater than 5%.

-U.S. equity markets will continue to benefit as the reach of American corporations have become increasingly exposed to global growth. The profitability of U.S. multinational companies is at record levels, largely due to increased productivity and cost-cutting. What has been largely absent is an increase in revenues. We see encouraging signs that this has begun.

-Chief Operating Officer confidence is beginning to build. As this materializes in increased business investment for capital expenditures and increased lending on the part of the major banks which have been sitting with “excess reserves” for the past 5 years, this will furnish substantial additional drivers for positive economic activity.

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-Consumer spending is estimated to be roughly 70% of U.S. gross domestic product (GDP), while monthly statistics on the labor market have fluctuated, there is a clear trend of meaningful improvement which has developed over the past 15 months. Job growth is a trailing, rather than a leading economic indicator.

-We are also in a (mid-term, Congressional) election year which should draw the attention of lawmakers away from intrusive policy reform while they focus on re-election.

-Inflation is largely absent, despite considerable monetary stimulus by central banks around the world. While we remain somewhat concerned about the possibility of deflation, the increase in commodity prices, particularly agricultural, is reassuring. The stock market can accommodate rising interest rates over time, as long as the movement is gradual and policymakers appear sensitive to this.

-This market has shown itself to be stubborn and resilient. While there has been an easily identified cohort of glamorous, "growth" stocks without sufficient current earnings to justify their lofty prices, the market as a whole is not over-valued by most historical measures. Orderly corrections of 10% or more are healthy. Contrary to our recent experience and short memories, they are to be expected as a function of normal market behavior.

To paraphrase John Maynard Keynes, when the facts change, we reserve the right to alter our conclusions. Until then, we remain vigilant in your behalf, looking for opportunities to add value and manage risk. Please freely share your thoughts, concerns and questions.

We deeply appreciate your trust and confidence.

Thank you.

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