

Spring 2013

Market Strategies



Ho Hum Higher

The unfortunate folks who are required to pontificate daily on the movements of the stock market are thoroughly disappointed with 2013.

It appears that a steady dose of boring, slightly positive news has pushed the markets higher, but it is not the least bit exciting to report. At the end of every day the reports contain comments along the lines of “grinded higher,” “very quiet volume,” “news flow was light,” “today’s session was exceptionally slow,” and the most creative, “the broader narrow macro narrative hasn’t shifted all that much lately.” While reporting the steady ascent of the stock market might not draw viewers to CNBC, it is wonderful to our ears and for your portfolio. The reasons behind this market advance are many, and the good news is the humdrum pace should continue.

The media’s latest concern, now that the stock market is above a previous high, is whether share prices are now trading at too lofty a level. The last time the stock market was at this level, it was the year 2000 including inflation, and in 2007 without inflation. You’ve heard past performance is no indication of future performance, and this holds true for the overall market. In March, 2000 the S&P 500 Stock Index was trading at 26 times earnings; in October of 2007 it was trading at 20 times earnings and today it is trading at 14 times earnings. This means valuations are far from a high point, which is when risk is high. Six years ago corporate earnings for the S&P 500 were \$88/share; this year they should hit \$108/share and over \$120/share next year. The stock market should be going higher based on the growth of these earnings, despite the “dull” numbers

In 2007, the consumer confidence level was at a high point of 99.5 compared to the present level of 69.6. Experience has taught us that investing when consumer confidence is high rarely is a good idea, since there is no way to go but down. At 69.6, skepticism is everywhere and those investors haven’t piled into the stock market yet.

Additional indications are the flow of investor assets and trading volume. December was the first month that more money flowed into stock mutual funds than bond mutual funds in many months. The pace has only accelerated this year in January and February. Six years ago it was a popular complaint of investors that the large market swings were caused by the tremendous trading driven by the hefty hedge funds and private equity firms. Back then the average trading volume of the NYSE was 1.3 billion shares per day and today that figure is down to ~545 million shares per day. The “smart money” lost a ton of money and that fast money has slowed down. It is refreshing to believe the market is again trading on company fundamentals, which is good for investors.

The economic news has been slowly improving, which means that the risk of another recession is less likely. In the fourth quarter of last year, new jobs were created at a pace of 135,000 per month. That pace has picked up to 236,000 new jobs for February. We need to get to a rate of 400,000 new jobs per month to really accelerate the economy, but the progress is positive. The manufacturing

sector has been a key driver of this recovery and home prices are getting close to a 10% increase year-over-year.

This drives consumer confidence more than any government program can ever deliver. There certainly are headwinds given the 2% increase in the payroll tax, the upcoming sequester/budget cuts and gasoline prices which have in-

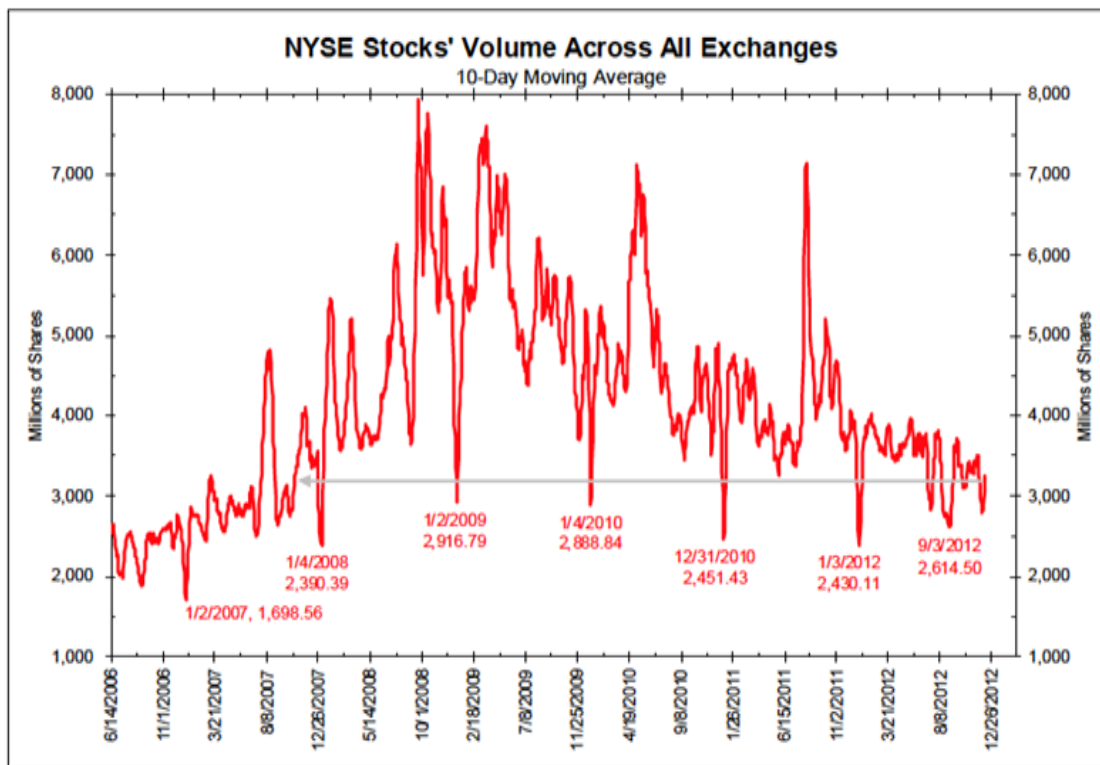
creased significantly this year. Therefore, we see a continuation of the 2% GDP growth, modest inflation, an accommodative Federal Reserve stance and continued corporate growth.

For what seems like years, we have been concerned with the risk of rising interest rates on the assets dedicated to bonds. When interest rates rise, we know bonds will begin to lose value so we have positioned assets to protect against this risk. While the Federal Reserve is committed to keeping interest rates low, the invisible hand of the bond market has started to push yields higher. So far this year the bond index we follow, the Barclay's Aggregate Bond Index, is essentially flat in performance. Therefore, the minor yield received has been offset by a fall in bond prices. This might just be the beginning of the rise of interest rates. Therefore the total return performance for bonds is not expected to be strong the rest of the year. When this reality hits most investors next year, it could result in a mass exodus from bond mutual funds. Historically, the destination for these dollars will be the stock market, pushing prices higher. Unfortunately for those investors, they will pile in at the wrong time, four years too late.

During this period of limited growth, we have moved to position portfolios into growing businesses that

can produce earnings growth relatively independent of the economic environment. Great companies continue to grow their businesses, and this is an environment in which their shares are being rewarded. While it

might be boring for many who have to report on the snail's pace of growth, we are working so you can fully participate with as little risk as possible as we go higher.



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