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Update on Current Market Conditions

Mark Burkhardt, Portfolio Manager April 15th, 2014

After the lofty gains of last year, the first quarter was a disappointment for many investors with the S&P 500 index up by only 1.3 % and the Dow Industrials showing a slight loss. While the averages were largely unchanged, it was the week to week volatility that really took a toll on investor nerves. Unfortunately, many of the reasons for that uncertainty remain unresolved as we head into the 2nd quarter. There are a number of factors that have given managers reason to pause and reevaluate their portfolio risk allocations.

The biggest concern is the seeming inability of our nation's economy to kick into a higher rate of growth. The very muted growth in GDP over the last five years have labeled this recovery as one of the weakest since the late 1930's. Just when we start to see broad based indicators of growth as in the strong 4.1% growth rate in the 3rd quarter of last year we tend to stall and are unable to build on and sustain that previous strength as we saw with the 4th quarter posting a gain of only 2.6%. While politicians from both sides of the aisle will have their own reasons of why this recovery has been so anemic, the real answer lies with the long perspective that only history can provide.

What we have gone through cannot really be described as a recession or even the "Great Recession" even though our elected officials prefer that terminology. Recessions are caused by tight monetary policies, a tight lending environment and high interest rates. Depressions, yes the dreaded "D" word, are always caused by a financial crisis brought on by excessive lending, credit and leverage that happen when interest rates are historically low. That is what happened to us in 2008-2009 and even though we aren't supposed to use the "D" word we were hit with a depression, not a "Great Depression" like in the 1930's but rather much like the depressions this country endured during the 1800's when they were then quite appropriately called "Financial Panics".

Most people, including many economists, still believe that a depression is just a very bad recession, when in fact the two as I have pointed out have very different origins. The depth and damage of our most recent financial crisis was in many ways averted by the enormous response of the government and the especially the Federal Reserve which combined have spent over $8 trillion in stimulus, borrowing and asset purchases that allowed the nation to weather the storm. Like a ship's captain at sea, you must do whatever you have to in order to save the ship, because you can't repair a ship that never makes it back to port. It's easier to repair a financial system that's broken than rebuild one that's collapsed.

The good news is that with time, many things including our economy will heal. The greater the damage, the longer the recovery. Looking back once more, using history as a guide, you find that the average time that a mature and developed economy takes to recover from a financial crisis is right around 8-10 years, so after 5 years we are actually doing better than we think, even though its effects will continue to linger for some time.

Soon, right around April 30th, we will be getting our first reading on 1st quarter GDP and many economists are looking for a very weak reading of about 1% growth. But much of that weakness has already been priced into the markets as much of that slow growth will and should be blamed on what was a very harsh weather environment. Now just speaking for myself, I know I didn't go out very often either to shop or to eat out. And I certainly didn't feel like looking at a frozen piece of property to build a house on, or test driving a cold car at a dealer whose lot is covered in snow. As slow as January and February were, the recent economic data that has come in for the last weeks in March were actually much stronger than many expected.

The GDP outlook for the remaining three quarters of 2014 is looking better with the consensus estimates averaging between 3.2% to 3.5%. These growth expectations are gaining greater importance due to the winding down this year of the Federal Reserve's $1 trillion per year asset purchasing program of "Quantitative Easing". This is very important for all investors as this ongoing reduction in stimulus by the Fed, stimulus which has provided enormous support for all asset classes, needs to be offset by real and sustainable economic growth. If that future growth comes in as expected, then the current stock market valuations can be sustained. If those growth estimates fail to materialize then the stock market, which now looks fairly valued could easily become overvalued. It is important to remember that most of last year's gains in the stock market was not because of actual growth but rather the expectation of much stronger growth this year.

The other issue that I want to address is the ongoing geopolitical and global growth concerns that have caused quite a bit of volatility both to our markets and those overseas. The Russia-Ukraine crisis continues to add an element of event risk to the European equity markets and to a lesser degree the global markets. Ukraine's economy is quite small and despite gaining their independence from the former Soviet Union over twenty years ago, chronic cronyism and corruption have taken quite a toll on their economic potential. The real risk to investors is if Russia does move to occupy additional territory and the resulting economic sanctions that will be imposed upon them could have a very real impact upon their closest trade partners which includes many US corporations.

For now, my investment perspective will remain cautiously optimistic, which is prudent considering the risks and rewards that the markets are currently presenting us. I believe that our economy will continue to gain strength and momentum throughout the year and therefore our portfolios will remain invested in what I consider to be the highest quality companies. Each possessing a commanding market share and a compelling path for future growth while trading at a valuation that will allow investors to enjoy long term gains.