NOYES CAPITAL MANAGEMENT® LLC
Personal Financial Planning & Prudent Investment Management
17 Village Road, New Vernon, NJ 07976-0271 + 973-267-8120

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Low Interest Rates Keep the Market Moving Higher
By Scott P. Noyes, CFA® CFP®

Many believe that global central banks have successfully managed to inflate markets, suppress volatility and create a false sense of stability. One day market volatility will come roaring back and result in a severely dislocated market. For many long-term investors, the current stock market rally feels "too good to be true." Even though the Dow Jones Index was up 2.9% and the S&P 500 was up 6.9% during the first half of 2014, the ongoing wall of worry may help the market continue to reach new highs.

The bullish retort would be that the markets have overcome a tremendous amount of adversity over the last 5 years, what is different now? The lack of volatility is caused by the dearth of excesses in the system: little inflation, moderate growth, a stable currency. The U.S. stock market currently appears fairly valued, the economy is healing and the U.S. bond market has settled down to a new low-yield level. The conflicts in Ukraine, Gaza and Iraq are not likely to cause significant disruptions in the markets. Earnings growth should take the lead over P/E multiple expansion in propelling the stock market higher. Capital spending increases should help the economy continue to expand. So, the odds favor a higher U.S. stock market by the end of the year.

While I have no answer to the conflicting market opinions, our strategy has been to reduce risk to normal target levels by selling higher beta (more volatile) securities and concentrating holdings in U.S. and developed country dividend-growth securities. In the event of a major market dislocation, we would view it as a buying opportunity. There are few good alternatives to equities.

The Federal Reserve is Thrilled

Janet Yellen and the Federal Reserve's mission in 2014 have been to unwind QE stimulus, mitigate bubbles in stocks and bonds and keep the economy moving forward. Federal Reserve officials agreed at June's policy meeting to end their bond-buying program in October, putting an explicit end date on Quantitative Easing. Since January, Quantitative Easing has declined by approximately $10 billion every Fed meeting (see Table 1). It has been a surprise to many that the unwinding of QE has not led to a more negative impact on the bond and stock markets. The end of QE without a bond or stock market "crash" is an excellent outcome for the Fed.

With the end of Quantitative Easing the bond market will debate when the Federal Reserve will take the next step and start to raise short-term interest rates. Some want higher rates to pop the stock market bubble. However, Janet Yellen has stated that interest rates are not the best tool for deflating financial bubbles. She believes it is better to use limits on financial leverage and higher lending standards to constrain financial excess and has made it clear that rates would be kept near zero for a considerable time. Unless there is significant wage pressure feeding into an accelerating rate of inflation, the Fed will be content to move slowly toward its first interest rate hike. In my opinion, U.S. interest rates are likely to remain near current levels +/- 35 basis points over the next 9-12 months.

Table 1 - Quantitative Easing will be completed by year end.

2014 FOMC Meetings		QE expected to be cut to
January	28-29	$65 billion
March	18-19*	$55 billion
April	29-30	$45 billion
June	17-18*	$35 billion
July	29-30	$25 billion
September	16-17*	$15 billion
October	28-29	$5 billion
December	16-17*	0

* Meeting associated with a Summary of Economic Projections and a press conference by the Chairman.

Table 2 - U.S. bond yields remain attractive

Global 10 yr. yields	
US 10yr	2.50%
German 10yr	1.17%
Italy 10yr	2.84%
Spain 10yr	2.82%
U.K 10yr	2.58%
Japan 10yr	0.54%

Many investors look at the current level of interest rates as a Fed induced anomaly, however in a global context, U.S. interest rates appear quite attractive. As described in Table 2 above, U.S. 10-year bonds appear relatively inexpensive versus other developed country bonds, making U.S. bonds are one of the best deals around. Foreign buying of U.S. bonds has helped keep interest rates from rising in spite of the elimination of Quantitative Easing.

Economic Growth Disappoints

Disappointing economic growth in 2014 has been a surprise. A cold-weather-related slowdown in the first quarter resulted in negative 2.9% GDP growth. Even if the economy grows at 3% the rest of the year, the annual average will be only 1.52%. This is a far cry from the early optimists expecting 3% growth for the year. The "muddle along" recovery continues. Overall, I see the United States continuing to grow at about 2% in real terms. To grow at 3% we would need another building boom and I don't see that happening anytime soon. It is clear that the performance of the market is being driven by more than economic growth: ongoing low interest rates and expanding corporate profitability have been major positive catalysts.

While the June jobs report indicated that 288,000 jobs were created last month, many of the jobs were part-time, which is not the type of employment that really boosts economic growth. In fact, 275,000 full-time jobs were actually lost in June compared with the previous month. In addition, wages increased by a mere 2 percent year-over-year. When you adjust for inflation, wages are barely keeping up in real terms. These newly employed part-timers are not going to support the economy during the coming months and as a result economic growth could begin to slow.

International economic growth is a mixed bag. In Europe, the industrial-based economies have the strongest growth: Germany, Northern Italy and the U.K. With tourism picking up, the economies of Greece, Spain and Portugal have benefited. However, Europe in general is still fighting very low inflation resulting in ongoing stimulus from central banks. Japan remains an improving story with growth and inflation picking up for the first time in decades. While Europe and Japan offer some hope for improvement, the U.S. is one of the leading contributors to global growth.

Inflation

Although the rate of inflation has been increasing, it remains well within normal ranges. Over the last 12 months the CPI has increased 2.0%. The areas of the economy showing the largest increases are: tuition at 3.4%; energy at 3.3%; shelter at 2.9% and services at 2.7%. On the weaker side are: household furnishings at –2.5%; transportation excluding energy at 0.3%; apparel at 0.8%; and medical commodities including prescriptions at 1.6%; Overall, labor costs are increasing at a greater rate than the cost of physical goods.

Technology is Creating a New Industrial Revolution

The use of robotics and technology has helped improve the productivity of many U.S. and European industrial companies and has enabled them to sustain high profit margins. Technology is good news for the world because things can be done more efficiently, but the negative byproduct is that fewer workers are needed to perform the services or make the goods. Creating new jobs must come through faster growth, which is hard to achieve in a mature economy. Technology has raised the level of skills necessary to get and hold a good job. As a result, we have to learn to live with a higher level of unemployment and the social and political issues associated with it.

Companies that innovate, create and transform their industries are likely to lead the new industrial revolution. The U.S. currently is the epicenter of two world-leading industries: internet-based technology and biotechnology. These two sectors are transforming the landscape and will likely lead to extraordinary growth and success over the next decade. We use Primecap mutual funds and others to invest in this area as their portfolios are heavily focused on these industry innovators.

Major Demographic Shifts are Underway

The United States is facing a demographic wall…or cliff, as some like to call it. With the largest population segment in the history of America, the baby boomers, past their peak spending years and saving money for retirement, consumer demand is going to suffer. It's easy to understand when you think of it simply…there are 65 million Generation X'ers trying to replace the buying-power of 80 million baby boomers. With this large demographic segment of the population in retirement, demand for real estate, cars, home appliances and risky assets declines. This, of course, leads to slower economic growth, higher budget deficits, a weaker dollar and increased demand for income related investments.

Things should change dramatically in 8-10 years when you have 65 million Gen Xer's being chased by 85 million echo-boomers or millennials trying to buy their assets. Home prices should rise again, labor shortages will make wages increase, growth will come back with a vengeance and so will the stock market….only this time from true economic fundamentals not quantitative easing and money printing.

It could be a true golden age, not just financially but for living standards. New healthcare breakthroughs, many we can't even imagine now, may make serious disease a thing of the past. The Dow Jones Index may be triple its current level with half of the current companies replaced by new market leaders.

Dividend Growth Strategy

We have deployed dividend-growth strategies in most of our portfolios. The low yields on fixed income, CDs and cash are barely keeping up with inflation which has eroded purchasing power. Dividend-paying stocks can generate income and offer the potential for capital appreciation as well. In addition, these stocks may provide better risk attributes, such as lower volatility and some level of downside protection when markets decline. Even for investors not focused on income, dividend stocks may offer advantages for long-term capital growth both from income reinvestment and stock price appreciation. You are likely to see one of several Vanguard mutual funds or exchange traded funds (ETF's) used as a backbone to our dividend growth strategies in your portfolio.

Dow 20,000 in 2014?

Could the Dow Jones Index reach 20,000? The Dow Jones Industrial Index is up 2.9%, YTD through June and ended the month at 16,832. If the Dow moved to 18,000 by year-end, the return would increase to 9.8%; a move to the 20,000 mark would bring the gain for the year to over 21.0%. With moderate economic growth and consistently low interest rates, a more reasonable goal would be for the Dow to reach the 17,500 to 18,500 range by year-end, a respectable target nonetheless.

A Correction is Inevitable… and may be an Opportunity

Many believe that a correction is inevitable and is a normal part of all market cycles. However, the exact tops and bottoms are all but impossible to forecast. It may happen next week, triggered by European and Chinese credit concerns. It's been more than 1,000 days since the Standard & Poor's 500 Index had a decline of 10% or more. The key to surviving these regular fears and market corrections is to make a plan while you are still objective and unemotional. The alternatives, panic, run for the hills or respond to TV commentators' recommendations, can be quite costly.

Our strategy has been to reduce risk to normal target levels as defined in your Investment Policy Statement by selling higher beta (more volatile) small-cap equity securities and concentrating holdings in U.S. and developed-country securities. A large portion of the portfolio is held in high-dividend and dividend-growth investments. We are maintaining 8%-10% in cash equivalents that can be redeployed into the market if a material correction occurs. Corrections become buying opportunities.

Scott P. Noyes, CFA®, CFP® is the President of Noyes Capital Management®, LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey. www.noyescapital.com

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