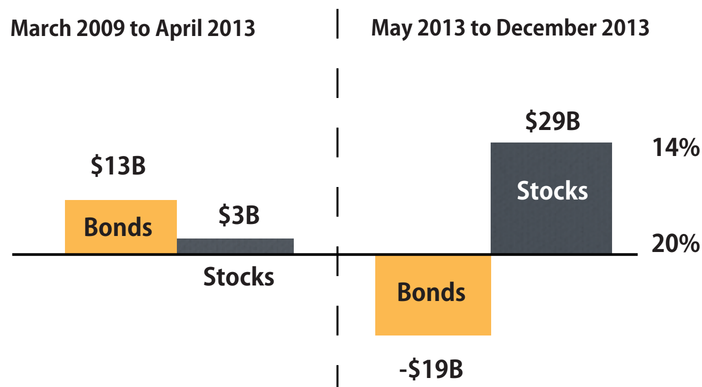
Changing Policy and Rising Rates:
Will they derail the bull-market?

March 1, 2014

Since March 2009 the S&P has climbed over 170% and is now trading at levels never seen before. Five years into the bull market investors are questioning if stocks are ahead of themselves and if a sharp correction lays ahead. Moreover, the Federal Reserve's decision to start tapering its asset purchases is creating additional anxiety, as its impact and outcome for markets is unknown.

Investor Sentiment has clearly shifted, although not in the way most think. As the chart below illustrates, from March 2009 to April 2013 investors poured an average of $13 billion per month into bond mutual funds and ETFs, compared to a meager $3 billion per month into stock mutual funds and ETFs

Average monthly net cash flow



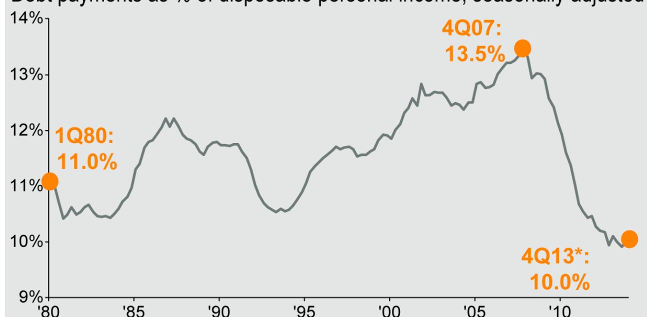
Source: Morningstar, Vanguard calculations. Notes: Cash flows include flows to active, index and ETF funds. Bond category includes U.S. taxable market. Stock category includes U.S., developed, and emerging markets. Data through December 30, 2013.

That all changed in May 2013, when then Chairman Ben Bernanke mentioned that the Federal Reserve may begin tapering its asset purchases later that year. Investors were clearly spooked and started withdrawing funds from their fixed income based investments and added some $29 billion per month into equities. This shift in asset flows and sentiment is a good start to explain the S&P's record setting rise in the second half of 2013. In our view, the current sentiment that favors stocks will likely stay in place, as five-year average annual returns will now start looking much more attractive than they did a year ago. The annualized return of the S&P 500 for the five years ending December 31, 2012 was a meager 1.7%. Now that the horrible performance of 2008 drops off the five year number, the S&P's annualize five year return jumps to 18% for the period ending December 31, 2013. Given that investors love strong returns and often "chase" them, we think that asset flows into equities will continue to be strong. Of course, asset flows aren't enough to justify or cause markets to rise. Fundamental factors are critical to sustain rising stock prices.

THE ECONOMY: BULLS VS. BEARS

There is no question that the U.S., and global economy have strengthened significantly since the great recession of 2008 and 2009. However, with underemployment and unemployment remaining elevated, and the Federal Reserve beginning to taper asset purchases, there are serious questions as to whether the recovery is strong enough to help drive economic growth and corporate profits on its own. While both bulls and bears have valid points, we believe that the bull argument is stronger. We base our conclusion on the following factors:

- Both the Private and Public sector have deleveraged significantly over the past five years. Household debts to income ratios are now at their lowest levels in over 30 years.

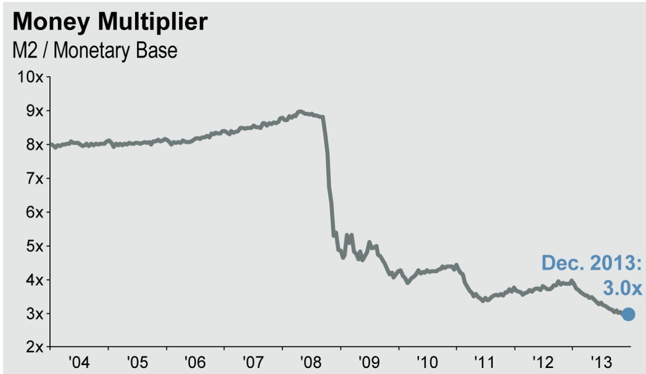


*Source: BEA, FRB, J.P. Morgan Asset Management. *4Q13 household debt service ratio and household net worth are J.P. Morgan Asset Management estimates.*

- The housing market is on strong footing and single-family home inventories are near all-time lows.

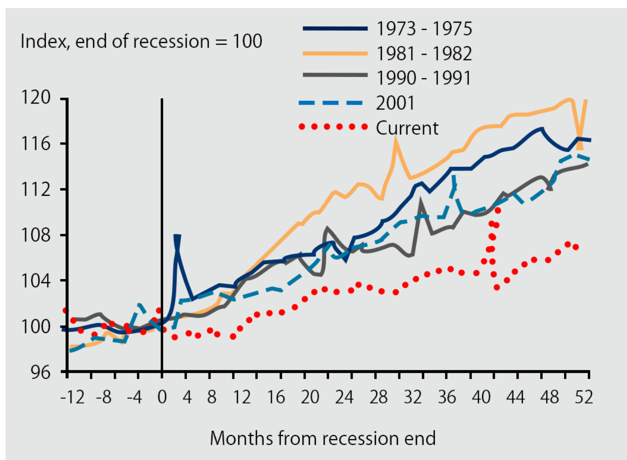
Source: Census Bureau, National Association of Realtors, J.P. Morgan Asset Management.

Those who are less optimistic about the strength of the recovery will point to the fact that in spite of the extraordinary measures the Federal Reserve has undertaken over the past few years, lending and the velocity of money is still very low.



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management. Money multiplier defined as M2 divided by the monetary base.

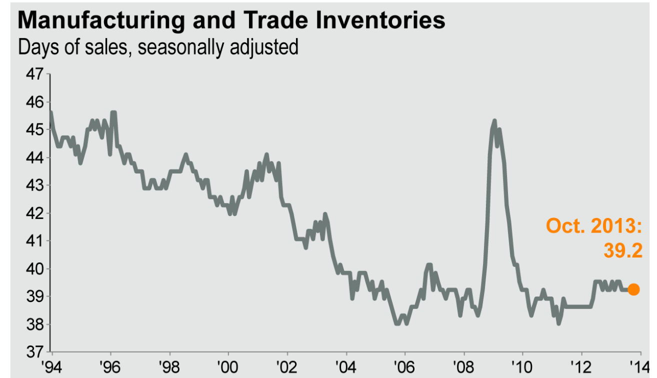
Additionally, even though debt to income ratios look very low, disposable income for the average American is also very low.



Source: Bureau of Economic Analysis, Haver Analytics

In other words, while many American's have lowered their debts and improved their balance sheets, there is much more work to be done. Moreover, the pronounced wage and skills gap our nation is facing could have a significant impact on future economic expansion.

More broadly speaking, the 'Bulls' can point to the fact that the U.S. economy grew at a much faster pace than forecast in both the third and fourth quarter of 2013. Moreover, the Federal Reserve has pledged to keep interest rates very low for an extended period of time, most likely through 2015. In other words, the U.S. economy is gaining steam all the while supportive monetary policy will likely remain in place for quite some time. Additionally, given the current low levels of manufacturing and trade inventories, it is reasonable to expect an expansion in capital expenditures.



Source: Census Bureau, FactSet, J.P. Morgan Asset Management

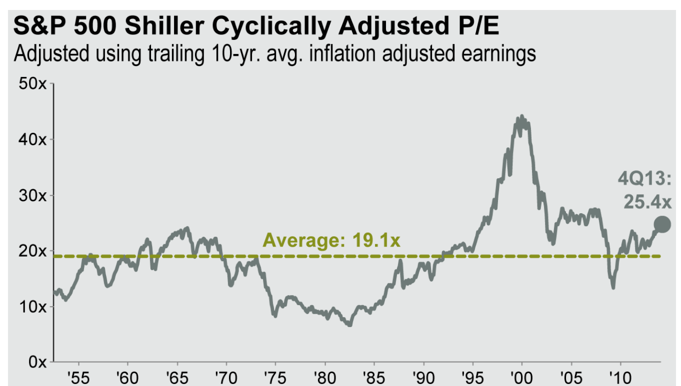
In our view, the bull case for the U.S. economy is stronger than the bear case. However, it is clear that the recovery continues to require support and since the impact of the Fed's asset purchase tapering is unknown, vigilance and caution are required.

THE MARKET: BULLS VS. BEARS

Economic strength along with fiscal and monetary policy clearly impact business decisions. From an investment perspective, economic growth is sufficient to propel corporate growth, but have stocks risen too far too quickly? Here too Bulls and Bears have solid footing in their arguments.

Bears can point to sharp rise in stock prices over the past five years as a reason for their position. Moreover, several traditional valuation metrics are flashing warning signs.

This argument is most evident in the (Professor Robert Shiller) Shiller CASE PE ratios, which are significantly above historical averages.



*Source: Cyclically adjusted P/E uses as reported earnings throughout. *Latest reflects data as of 12/31/2013.*

However, as is so often the case, the information above only tells part of the story. In fact, historically speaking there are several market segments that are still trading below their historical average valuations. Moreover, corporations are holding a record amount of cash on their balance sheets and dividend payout ratios remain historically low.

Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

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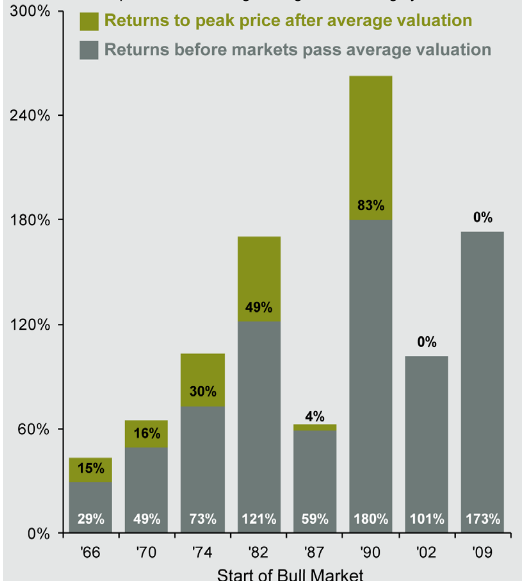
Hence, by some metrics, stocks – at least some – continue to be attractively valued. Most significantly, even if you believe that markets are "fairly" valued at these levels, it is important to recognize that bull markets rarely stop their run at fair-value. Rather, they typically extend gains into over-valued territory. As the chart below illustrates, with the exception of 2002, when the NASDAQ Tech bubble, which was certainly well past fair value, burst, markets continued to climb well after fair-value.



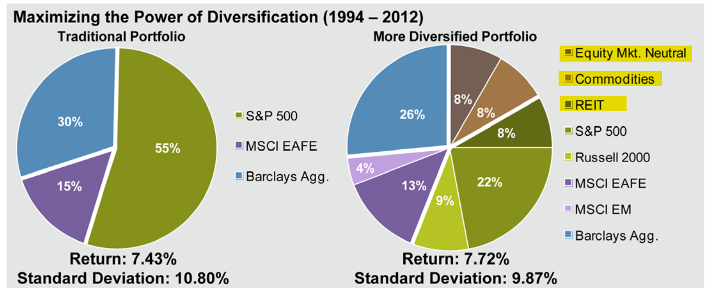
Source: Standard & Poor's, J.P. Morgan Asset Management. Period after average valuation defined by 15-day moving average passing below average real earnings yield.

WHAT ABOUT RISING RATES?

We are clearly in uncharted territory when it comes to the unprecedented steps the Federal Reserve has taken over the past 5 ½ years. As such, it is impossible to know what will happen when the Fed eventually raises rates. However, we've looked at history and note that since 1980 the Fed has raised interest rates 67 times. To our surprise the S&P 500 rose 60 of 67 times in the two years following the Fed rate hike nearly 90% of the time, pretty good odds if you ask us.

IN CONCLUSION

Neither the economic or market environment are sending clear signals at this time –then again, they rarely do. While there has been clear progress in our and the global economic recovery, significant challenges remain, and the valuation of some market segments are becoming stretched. In our view, diversification continues to be paramount to building a successful long-term investment strategy.



Source: Standard & Poor's, J.P. Morgan Asset Management. Charts are shown for illustrative purposes only. Past performance is not indicative of future returns. Diversification does not guarantee investment returns and does not eliminate risk of loss. Data are as of 12/31/13.

While "simple" diversification will lead to reasonable results over time, active portfolio management is critical to avoid short-term mishaps. Given the current environment, we believe that our disciplined investment approach is best suited to help investors reduce the impact of market volatility without hampering the potential for significant capital appreciation. By focusing our investment selection process on companies with:

- Strong Balance Sheets
- A visible and predictable revenue stream
- Above Average Category Growth outlook
- Paying and raising its dividend consistently

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Hedging and Derivatives Risk. The investment committee may seek to execute an investment strategy or hedge by purchasing or entering into derivative contracts such as futures, options on futures, swaps, or purchasing securities whose prices are expected to move inversely to prices of the investor's portfolio of securities. The investment committee may use derivatives (including swaps, structured notes, options, futures, and options on futures) to enhance returns or hedge against market declines. The investment committee's use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments. These risks include (i) the risk that the counterparty to a derivative transaction may not fulfill its contractual obligations; (ii) risk of mispricing or improper valuation; and (iii) the risk that changes in the value of the derivative may not correlate perfectly with the underlying asset, rate or index. These risks could cause the portfolios to lose more than the principal amount invested. In addition, investments in derivatives may involve leverage, which means a small percentage of assets invested in derivatives can have a disproportionately large impact on the portfolio.

Correlation or Tracking Risk. Correlation risk is the risk that there might be imperfect correlation, or even no correlation, between price movements of an instrument and price movements of investments being hedged. Such a lack of correlation might occur due to factors unrelated to the value of the investments being hedged such as speculative or other pressures on the markets in which these instruments are traded. The effectiveness of hedges using instruments based on indices will depend, in part, on the degree of correlation between price movements in the index and price movements in the investments being hedged.

Gain-Limiting Risk. Hedging strategies, if successful, can reduce the risk of loss by wholly or partially offsetting the negative effect of unfavorable price movements in the investments being hedged. However, hedging strategies can also reduce the opportunity for gain by offsetting the positive effect of favorable price movements in the hedged investments.

Leverage Risk. Hedging instruments may include elements of leverage and therefore may magnify the fluctuation of the value of hedging derivative instruments in relation to the underlying asset. The successful use of derivative instruments depends upon a variety of factors, particularly the ability of the adviser to predict movements of the securities markets, which requires different skills than predicting changes in the prices of individual securities. There can be no assurance that any particular strategy adopted will succeed. The adviser's decision to engage in a hedging derivative transaction will reflect its judgment that the derivative transaction will provide value to the firm's clients.

Liquidity Risk. Liquidity risk is the risk that a hedging security or derivative instrument cannot be sold, terminated early, or replaced quickly at or very close to its market value. Generally, exchange contracts are liquid because the exchange clearinghouse is the counterparty of every contract. Over-the-counter transactions are less liquid than exchange-traded derivatives since they often can only be closed out with the other party to the transaction. If the firm were unable to close out its positions in such instruments, it might be required to continue to maintain such assets until the position expired, matured or was closed out. The firm's ability to sell or close out a position