

One of the oldest adages about stocks is “rising markets climb a wall of worry”. 2013 has proven exactly how correct those words are. Forgetting the positives for now, here is a brief review of some of the news that caused concern for us and for financial markets in 2013.

We started the year with the U.S. “fiscal cliff” having been narrowly avoided, but not totally removed as a drag on GDP growth. In March, negotiations to deal with the U.S. deficit and debt ceiling had stalled again. There was a banking crisis in Cyprus and continued weakness in periphery countries such as Greece, Spain, Italy and Portugal that threatened to break up the European Union. Global economic growth remained disappointing or at least sluggish through the first half of the year. In particular, slowing growth in China, the world’s second largest economy, was a concern due to its effect on other global economies. The possibility of U.S. military action in Syria had everyone concerned. The Federal Reserve hurt its credibility and had investors totally befuddled with its so-called “taper caper”; suggesting in July quantitative easing would soon begin to slow, but then not acting in September when it was expected. The U.S. government shut down in October for 16 days, causing more of a disruption, and convincing the world Washington was totally out of control. Despite all that and more, world stock markets performed exceptionally well. The S&P/TSX Composite index including dividends was up 13% and the S&P 500 climbed 32%.

As we enter 2014 many of those concerns are in the past, or at least are less of a worry. In fact, for the most part, all looks positive going forward. The global economy continues to grow, if slowly and in fits and starts. So too do corporate earnings. Politics are likely to be much less of a negative factor at least early in the year; As well, markets seem to have accepted and discounted the fact that the U.S. Federal Reserve will be tapering its purchases of fixed income securities.

Importantly, the U.S. stock market shows strong internal strength (e.g. momentum) with few signs that any significant decline is in the offing over the short term.

Accepting the obvious is not always a productive strategy. Here are some of the factors we will be following closely that could change our outlook for the better or the worse. The U.S. is currently the dog wagging the tail of the rest of the world’s economic and investment outlook, and given our recommendation and strategy to be overweight that country, it will be the major focus of our attention. Now that Fed tapering is an accepted fact, it is extremely important that stronger economic and earnings growth comes through to support higher stock markets. It should be noted that the minutes of the last Fed meeting are unequivocal that should growth not be strong enough, the Fed is fully prepared to renew its stimulative policies (the so call “Fed Put”). As an aside, a concern we have longer term is that higher inflation is now a policy goal of the Federal Reserve and that is a horse that can be very difficult to get back in the barn if you lose control.

While S&P earnings per share growth over the last 5 years has been good, it has come as a result of lower costs (interest and wages mostly) and share buybacks. Since the March ’09 low, S&P 500 earnings per share are up over 105% while revenue per share are up only 7%. This is unsustainable. Therefore, we will be following revenue growth closely. An improvement in capital expenditures is one factor that we would view positively.

Both major parties in Washington have seen public discontent affect their approval ratings over the last six months. The Republicans were blamed for the government shutdown, and the Democrats for the debacle surrounding Obamacare. Going forward, we see fewer disruptions as each party prepares for the mid-term election. However, as the election nears it could well have an important impact on markets. If the Democrats win control of Congress, President Obama will be able, in his final two years in office, to push through his more populist agenda which would have a negative effect on the business community. A Republican victory, on the other hand, would suggest a more restrictive fiscal policy for 2015 as balancing the budget would be a priority. A continuation of the current standoff is probably the best outcome.

China is still attempting to lower its growth rate and inflation, so far without severe consequences. At the same time Japan is aggressively pursuing policies to increase its growth and inflation, which should take up some of the slack in the Far East.

The European Union has recovered from the very negative outlook of two years ago. A banking union seems soon to be a reality, which will make the stronger economies weaker, but will strengthen the weakest and thus the overall Union.

We remain constructive on equity markets, while being vigilant for any reason to change that outlook. As always we try to anticipate the unexpected.