# Rochester Financial Services

*Fee-Only* Financial Management Services*

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| Dow Jones | S&P 500 | NASDAQ | Russell 2000 | 10 yr Treas | Earnings Yield (S&P) | Gold | Crude Oil |
|---|---|---|---|---|---|---|---|
| 16,441 | 1,832 | 4,143 | 1,151 | 2.99% | 6.33% | $1,223 | $95.45 |

## *Investment Strategy Report*

### *Markets Begin New Year on the Wrong Foot. A Prelude of What's to Come?*

For the first time since 2008, the stock market began the new year on the down side, with the major indices falling almost 1%. And the reaction from many investors is that this is a sign, a sign that after 5 years of a tremendous run in stocks, the party might be ending. After all, we all know what happened in 2008. And a popular stock market maxim says that as goes January, so goes the rest of the year. The maxim continues to say that as goes the first 5 trading days of January, so goes the rest of the month. So unless we see a turn around in the next few days, it's time to lock in our gains. The storm that we have been warned about for so long (and I don't mean the snow storm hitting us northeasterners now) will soon be upon us.

I had a quick listen to Jim Cramer tonight (on CNBC) to see what he had to say during his inaugural show of 2014. As he has done so often during the past few years, he made fun of the chicken littlers who will take their cue from today's market action and run for the hills. "It's obvious that we're going down this year" he predicted that the bears would say after such an inauspicious beginning. Just like it was obvious last year that the markets could not go higher in the face of a) ineptitude in Washington, b) foreign problems in Cyprus, Brazil, and China, c) $100 oil, d) the spike in interest rates that was going to deal a death blow to housing and auto sales, e) Obamacare that was going to hurt small businesses, f) the Fed tapering that was going to remove stimulus from the economy, etc., etc.

The bottom line for 2013 was that the economy continued to improve. By the end of the year, we saw solid GDP growth and an improving employment picture. Consumers were spending more than was expected. Demand for housing and autos was very strong. So despite all the negatives that "should" have kept a lid on stock prices, the stock market had its best year since 1997.

Another reason to be positive on stocks is that the biggest threat to stocks, an impending recession, is no where to be seen. Very often, economies experiencing rapid growth with rising inflationary expectations reach a breaking point which is soon followed by a cyclical economic downturn, i.e., a recession. However, we have been experiencing slow but steady growth over the past few years. And despite this growth, there is still enough slack in the economy (e.g., excess capacity, higher than desired unemployment) to prevent the economy from overheating. With little expectation of a recession, stocks should not be in store for a significant downturn.

In last month's letter, I talked about a forecast for the S&P 500 to reach a level of 2014 this year (2014 in 2014). Earnings for the S&P 500 are projected to be about $116 this year. So with the S&P currently at 1832, that gives a P/E ratio of 15.8, which is a very reasonable number. With interest rates as low as they now are, compared to historical standards, the P/E ratio could rise to 16.5 - 17.0 and still be in a reasonable range. If earnings for 2015 rise another 6% to $123, then a P/E ratio at the end of 2014 of 16.5 to 17.0 (which would be looking at 2015 earnings) could result in an S&P 500 level of 2030 to 2090. That would translate into an increase this year of 11 to 14%.

Many of my clients have been asking me during the last few weeks about whether we should now be shifting more money from bond funds into stocks funds. After all, if interest rates resume their rise this year, that could produce another year of mediocre returns for bond funds. So why suffer through that when my forecast for stocks is so much rosier? The answer is as follows. 1) While 2013 was the worst year in bonds since 1994, we fared fairly well. While the Vanguard Total Bond Market Index fund was down 2.1% for the year (and the Vanguard Inflation Protected fund was down 8.9%), our bond funds were up on average over 4%. My feeling is that if 2014 is only marginally better, our bond funds could very likely return closer to 6%. Compare this to a stock market that could be up 10 to 15% but could also be down that much. Don't forget, no one has a crystal ball. Stocks are much more volatile than bonds. Keeping an eye on risk is something that we cannot forget to do.

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