Marketline Monthly, January 2014

***Domestic Stocks***

January brought a rough start to stocks. The Dow sank -5.3%; the S&P 500 was off -3.6% and the Nasdaq declined -1.7%. The underpinning of this decline resides in the uncertainty around the transition from lots of Fed support to less – but still positive – Fed support. Coincident with the Fed’s slight pullback, China’s growth appears to be slowing as it enters its own transition; emerging markets hooked on low interest rates are crumbling; some US data points have been less than stellar; and earnings season, while good, has brought many a weak forecast. Suddenly, everyone is questioning the thesis that the economy is finally gaining traction.

The market is behaving as it ought: the risk of owning assets has increased, because this transition has an uncertain outcome. When risk increases, prices should fall. How far, we’re not sure. But the fact that this reaction has not been delayed, and is orderly without turning into a panic, is encouraging. At least so far, it looks as if we may get away with a garden variety, down 10% sort of decline, the kind that happens nearly every year. While we don’t know how long this will last, or where it will stop, we think it will do stocks a world of good to become a little cheaper. A cheaper market will eventually attract buyers, setting us up for the continuation of a bull market. Although this is a well-worn argument, it’s worth noting again that the US is a pretty good bet compared to, say, anyone else. Here’s a handy field guide to world markets that we prepared as an illustration:

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| --- | --- | --- | --- |
| **Market** | **2013 Return** | **2014 Return**  | **Look Out For:** |
|  |  | Jan or as of writing |  |
| **Japan** | 56.7% | -8.4% | Debt, debt, and more debt. Throw in disputes with China & aging population |
| **Europe** | 14.4% | -3.5% | Semi-permanent recession, deflation, protests, strikes, straightjacket currency |
| **Brazil** | 15.5% | -7.5% | Protests, currency devaluation, inflation, commodity busts |
| **Mexico** | -2.2% | -4.3% | Not bad, drug wars and inflation are negatives; economic reforms a plus |
| **Russia** | -1.2% | -10.5% | Graft, corruption, erratic rule of law, weird president, vodka |
| **Hong Kong** | 2.9% | -5.5% | Slowing growth in China, overheated real estate markets |
| **India** | 9.0% | -4.0% | Cultural impediments, graft, debt, currency issues, slow growth, inflation |
| **Canada** | 9.6% | 0.5% | Not bad at all, commodity prices are biggest concern |
| **Australia** | 14.6% | -4.2% | Commodity busts, drought, changing politics, China influence |
| **U. S.**  | 32.4% | -3.6% | Dysfunctional politics |

Makes the U.S. look angelic, eh?

***Fixed Income***

Last month we said we were evaluating how we should position bond portfolios because we felt that the consensus around bonds – calling for higher interest rates and big principal losses due to the Fed taper - was wrong. We didn’t need to do much. Bonds rallied strongly as the year opened, bringing prices of bonds already owned up sharply. The snap back was sudden. The long bond fell all the way from 3.9% in yield to 3.6%, giving investors a roughly 5.4% return exclusive of income. The ten year, used to set mortgage rates, fell from 2.83% to 2.64%, which was indeed enough to reduce the thirty year mortgage rate. Munis gained nearly what they lost in all of 2013. While we were happy to see this outcome, it happened so fast that at this point we don’t think there’s much more in the offing. Our outlook on interest rates remains benign. We do not see the danger that everyone else does in this market. For cash flow, relative performance in the bond universe, and providing diversification to portfolios our favorite picks are munis and corporate issues where credit quality has been a concern but is healing. These sectors offer better than average possibilities in the context of bond returns.

***International***

Our field guide to foreign markets above shows January or year to date returns for several major indices around the world, a decidedly negative picture for sure. But the big news this year has been in markets we don’t really follow – so-called emerging markets. (One thing to note: emerging markets rarely emerge. I don’t think a single emerging market has emerged in my entire career. I guess it’s sort of like watching evolution happen.) These markets have crashed this year, so if you were thinking down Dow 5% is bad, you should be happy you are not invested in the Morgan Stanley Emerging Markets index, down nearly 9% so far this year. That said, for investors of the right temperament, these smaller markets offer huge potential gains when things go well. Predicting when that’s going to happen is impossible of course. Tread carefully. For our part, we continue to stick with Canadian and European issues though we’d be tempted by Mexico if the right stock came along.

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