The Bull's Sixth Year: Opportunities and Peril

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The current bull market was born in March, 2009, when the Dow briefly plunged below 6500. Now in its sixth year, an aging bull means caution. Since World War II, only three bulls have seen a sixth birthday, and the average is just two and a half years.

Stock prices are a product of earnings and the multiple that investors are willing to pay for them. Both inputs are flashing yellow as earnings are decelerating and price to earnings ratios are stretched.

Still, stocks' big competition, fixed income, is anything but attractive. With the ten year Treasury yielding just 2.53%, bonds are just plain expensive. Although real estate remains below its 2007 bubble peak, it can hardly be said to be a haven. The New York Times reports that prices have recovered sufficiently in coastal areas that "buying a home again looks like a perilous investment."

So, given something of a mixed picture on the economy, valuations and corporate earnings, where are the opportunities and pitfalls?

In a Nutshell

Equities remain the most attractive asset class. The Federal Reserve engineered low interest rates make fixed income unappealing. Traditional fixed income buyers have piled into riskier income-oriented investments making them generally overpriced.

Among equities, despite a recent retreat, many small caps, including biotechs, cloud plays, and social media firms, remain overpriced. Domestic large caps still offer value, particularly in the financial and technology space.

Stocks: Risks Abound

Stocks are pricier now than at any time since the 1999-2000 bubble period. On a trailing basis, stocks now trade at nearly 17 times earnings, greater than the average 15 prevailing since 1929. Stocks trade at close to 1.66 times sales, more than than the 1.26 considered fair value.

These high valuations are particularly troublesome given that profit margins are at historic highs; if margins decline the case for paying historically high multiples fades fast.

Caution is further underscored when considering the Federal Reserve's plans: The monetary stimulus is slowly being removed as the Fed tapers its bond buying and prepares to raise short term rates, admittedly most likely in 2015.

Growth, too, is scarce. Q1 2014 showed just a smidge, with GDP up 0.1%. Q2 will be the litmus test as to whether Q1's disappointing GDP result was driven by the lousy winter weather or something more ominous.

Corporate earnings growth is disappointing. While beating Q1 expectations of negative year over year profit gains, the 2.1% reported rise does not give comfort that higher than normal valuations are sensible. Fewer forecasts were upbeat than is normally the case.

Up to half of all sales by the S&P 500 are overseas. That does not give great confidence. The planet's second largest economy, China's, is seeing rapidly decelerating growth while grappling with a property bubble reminiscent of our own in 2008. Japan, meanwhile, is desperately pursuing the Bernanke playbook of massive monetary stimulus to jumpstart growth. Many say the issues require structural reform to help their aging populace. Europe is also contemplating American style monetary stimulus, which indicates that this inflation-fearing continent believes the problems require taking the risks of printing (more) money. Meanwhile, the emerging markets are feeling the fallout from the slowdown elsewhere, particularly in China, a big consumer of their raw materials.

Stocks Still Trump Bonds Longer Term

Despite the risks, we maintain a constructive outlook on equities. It all comes down to the question, if not stocks then what? We believe stocks are still the best asset class.

Quite simply, the ten year Treasury bond is yielding just 2.53%. Retirees, pensions, endowments, and other longer term investors can't meet their goals by hiding in that haven for long. The earnings yield on stocks, the inverse of the price to earnings ratio, hovers currently around 6%. That pick up in return remains compelling, and would be even more so should there be any pull back.

What if bond yields rise, reducing the so called risk premium, meaning the margin of stocks' earnings yield over the ten year Treasury's? Well, that's not good for any asset class, and will be felt hardest by long dated assets, including stocks. However, that rise in rates will probably be accompanied by increased economic activity, helping corporations grow profits. So, the earnings yield may well rise in line with the higher bond yields, thus preserving or even increasing the risk premium.

Although our Federal Reserve is laying out plans to reduce monetary stimulus, that bias is not shared by the other developed countries' central banks. European Central Bank president

Mario Draghi has all but assured the world of further stimulus, probably in the form of bond buying, next month.

The hawkish plans by our own Federal Reserve are far from certain. With inflation running well below the targeted 2%, and unemployment improvements being aided by many simply retiring, it's not clear that a change of course won't occur. A steep equity retreat may well be met with an end to tapering and launch of a new round of quantitative easing.

Opportunity: Financial Stocks

In this environment, the classic strategy makes sense: Target stocks of companies that dominate their industries and pay growing dividends. To avoid overpaying, focus on less expensive and out of favor sectors.

Financials have not yet recovered from the 2008 downturn. With restrictions on their return of capital to shareholders, concerns about new regulatory burdens, and uncertainty over the impact of higher interest rates, they are unloved.

The good news is that this has left them with bargain valuations, in many cases below liquidation value. Further, nearly all of the larger institutions have passed the Fed's stress tests, indicating they are battle ready for the next storm.

The effect of higher interest rates depends somewhat on the durations of their portfolios and the lag between the conclusion of the taper and the lifting of short term rates. However, in many scenarios financials benefit from higher rates because the revenues on their key product, loans, rise.

Investment bank **Goldman Sachs (GS)** and diversified **JP Morgan (JPM)** are attractive. Goldman is the preeminent investment bank, and benefits from the wave of companies departing this field. The stock remains attractively valued, at just 9 times earnings, trading at book value, and down one third from its 2007 high.

JP Morgan is another category killer. Its blue chip name and solid performance during the downturn give it an advantage. Trading at nine times earnings, book value and 10% off its recent high, it provides high quality exposure.

Opportunity: Large Cap Tech Offers Compelling Risk/Reward Tradeoff

Growth and momentum stock investors have shunned large cap tech, flocking instead to narrow hyper growth tech niches focused on social media, the cloud, or mobile. Value investors have yet to fully embrace large cap tech, concerned about sustainability of cash flows in a rapidly changing environment.

The current low stock prices discount much of the technology revolution's uncertainty. Much software and hardware is extremely sticky; it's not easy to cast aside what is currently in use to adopt the latest fad.

Further, while large cap tech has traditionally reinvested its prodigious cash flows, in an effort to placate shareholders these companies have been initiating and hiking dividends, plus buying back stock.

We favor Dow components **Cisco (CSCO)** and **IBM (IBM).** Cisco is the category leader in switchers and routers, and those who would change providers face substantial costs. Cisco's commitment to returning money to shareholders is impressive. It initiated dividends in 2011 at a quarterly $0.06. By February that had more than tripled to $0.19, now giving it a 3.1% dividend yield. Late last year it increased its stock buyback authorization to $15 billion, or nearly 11% of its market value.

IBM's strength resides in its popular hardware, software and service offerings, generating dependable, recurring revenues. The death of its mainframes has been widely exaggerated; these legacy offerings have proven amazingly resilient and highly risky to leave. IBM's stock is 15% off last year's highs. The company spent $14 billion on share repurchases last year, or about 7% of its capitalization. It recently raised its dividend 15%. At nine times forward earnings the stock remains a bargain.

Potential Peril: High Yield Bonds

This asset class is a misnomer. The latest yield on Merrill Lynch's "High Yield 100" index is just 4.6%, only 2.07% above the 10 year Treasury.

How did this come to pass? Most investors acknowledge the poor yields but feel helpless. They need yield and neither high quality bonds nor stocks satisfy them.

The apologists point to the ultra-low default rates. True, just 1.7% of all issuers are in default, the lowest in five years. However, it would be unrealistic to project that long into the future, as at some point the economy will soften and there'll be a reversion to the mean of greater incidences of nonpayment.

Bulls also note that spreads of junk bond funds over comparable Treasuries are at 3.78%, greater than the tightest on record, 2.7% in June 2007. Back then Treasury yields were decent, with the 10 year at over 5%, giving junk bond buyers substantially more interest rate risk cushion.

Junk bonds do a poor job diversifying equity risk, as they tend to move with stocks. This is unlike high quality bonds, which tend to zig when equities zag. For example, when stocks dropped 37% in 2008, junk bonds plunged 26%, but the high quality Barclay's Aggregate bond index advanced 5.2%.

Bottom line: Junk bonds have two ways to lose now. Interest rates can move higher or the economy deteriorates and defaults grow. The current paltry rates don't offer enough compensation for those risks.

In Sum

The low hanging fruit has been picked from the stock market. With continued low interest rates, areas of the market offering solid fundamentals but still cheap prices continue to make sense. Stay clear of credit challenged bonds as there's just not enough of cushion to offset the risks.