Market Commentary
Mid-Year 2013
Prepared July 2, 2013

Dear Clients and Friends,

<u>The Stock Market</u>. For the first half of 2013, the stock market, as measured by the S&P 500 index, rallied by 12.6%. A bull market peak was registered on May 21st 2013 when the S&P 500 index closed at 1,669 on that day, before closing the quarter at 1,606.

<u>Bull/Bear Market Scorecard</u>. While late bull market behavior is becoming increasingly visible, the weight of the evidence indicates that the bull market that began on March 9, 2009, is still in force. See my discussion and summary below.

TECHNICAL, SENTIMENT AND TIMING CHARACTERISTICS OF TYPICAL BULL OR BEAR MARKETS/ CURRENT STATUS

<u>Bull or Bear</u>. A bull market has been in progress since March 9, 2009. As of June 30, 2013, the bull market is 52 months old, challenging the outer limits of an extended cyclical bull market advance. The 2003-2007 bull cycle that ran for 52 months and the super-bull market of 1982 to 2000 (notwithstanding the 1987 crash and other periodic corrections), illustrated the potential for bull cycles to extend past "outer limits".

<u>Initial Public Offerings (IPOs)/ Secondary Offerings</u>. IPOs and 'secondary' activity has accelerated in 2013. For example, the dollar volume of 'secondary' offerings for May was more than **6 times** the prior year and IPOs offered in May were **triple** the number of IPOs of the year earlier period. Junk bond offerings have been at record levels for most of 2013. The point is that when security markets improve (as the bull market progresses), insiders and corporations tend to take advantage of improving market conditions to sell securities at high prices. **CONCLUSION: LATE BULL MARKET BEHAVIOR.**

<u>Technical Indicators</u>. The advance-decline line of publicly-traded operating companies made a fresh bull market high concurrent with the May 21st price peak. Bull markets rarely top out concurrent with an A-D line peak. A bull market top should be expected within six months after the peak, so the May A-D line peak is a signal of an extension of the bull trend into late 2013, at a minimum. **CONCLUSION: BULLISH.**

<u>Interest Rates.</u> The advance-decline line of all issues traded on the New York Stock Exchange broke down badly in June. For example, on June 21st, new 52-week highs (63), were swamped by new 52-week lows (644). This is due to the recent price breakdowns in a large number of traded issues that are "interest-rate" sensitive. When interest rates rise, prices of interest-rate sensitive issues tend to decline. As the 30-year US Treasury Bond plunged during June, so did "interest-rate" sensitive stocks. This illustrates the ultimate importance of the level of interest rates. In the very short term, rising interest rates place selling pressure on the market as the initial reaction to rising interest rates is viewed bearishly. Afterwards, as the stock market begins to recover, rising interest rates are viewed positively as the result of an improving economy.

For most of this bull market, the dividend yield produced by the components of the S&P 500 index has been higher than the yield of the 10-year US Treasury Note, illustrating the comparative attractiveness of stocks over fixed-income securities. As bonds declined in price in recent weeks, this relationship flipped to where the 10-year US Treasury Note now yields .5% more than the S&P 500. Over long time periods, the 10-year Treasury Note's yield is roughly 65% higher than the yield offered by the S&P 500, and may be twice the S&P 500 yield at bull market tops. As of quarter's end, the yield of 10-year US Treasury Note is 2.5%, 25% higher than the yield of the S&P 500 index (1.99%). **CONCLUSION: BULLISH.**

Margin Account Debt. As of the date of this writing, margin account debt (money borrowed by speculators to invest in stocks), as a percentage of GDP has reached, nearly exactly, peaks of the two prior bull market tops (years 2000 and 2007) - approximately 2.6% of GDP. I would note, that right at the July 2007 market top, margin account debt spiked 11%, representing a surge in speculators' animal spirits. This indicator deserves close monitoring. **CONCLUSION: BEARISH/ LATE BULL MARKET BEHAVIOR.**

Investor Sentiment. One condition for the wind-up of a bull cycle is the retail investing public's conversion from **contempt and disdain** for the stock market to an attitude of **acceptance and euphoria**. Following several months of inflows into equity mutual funds and ETFs early in 2013, money has begun to again flow out of equity securities in May and June in response to the recent correction. This is evidence that negative sentiment is not too far from the surface. I do not believe we will have a major stock market top until that negative investor sentiment turns to euphoria. Perhaps the memory of the extreme pain of the 2008-2009 bear market is at a level high enough that the public's contempt and disdain for the stock market might last for an extended period of time – years maybe. If so, this bull market might have quite a bit of time still to go. The attendant at the SAX Car Wash wanted to talk about stocks during the summer of 2007, but so far this year he's only interested in talking about baseball. The "euphoria" stage of this bull market has been notably absent. **CONCLUSION: BULLISH**

Conversion of Perma Bears/ Outlandish Bullish Forecasts. A phenomena typically seen in the late stages of bull markets is the conversion of stock market forecasters who remained incorrectly bearish throughout the entire bull market, and then convert to the bullish case way late. One prominent bear who had remained bearish since the 2007 top until November 2012, became a late convert in response to strengthening economic conditions. The conversion was about 44 months late, I think……And then there is the well-known economist who at the 2009 bottom with the S&P 500 at 666, predicted a further drop to 400. The drop never came and he remained steadfastly bearish until the spring of 2013 when he predicted a new stock market rally to last 2 years……How about the economist who, in August of 2012, when the DOW stood at 13,165, forecast that the DOW would rise 29% in 4 months to 17,000 at year-end, but alas, the DOW finished at 13,104. But there's no quit in that dog, as his yearend forecast for 2013 is once again 17,000……In June a popular market analyst proclaimed that she is now more bullish than ever. I submit that the time to have been more bullish than ever, would have been more than 4 years ago, on March 9, 2009……Lastly a well known hedge fund manager recently projected a Dow of 60,000, by simply compounding the DOW to rise by 7% per year until 60,000 is reached. **60,000!** I say, let's take it 1,000 points at a time.

I've noted several ultra bullish newspaper covers in recent months – "DOW 16,000" (Barrons, April 22, 2013); "Get Ready for a Record on the Dow" (Barrons, February 4, 2013); "DOW

15,000 (Barrons, February 13 2013); "DOW 15,000 – The Bull Still has Room to Run" (Barrons, May 13, 2013); "Bull Run Now on Solid Footing" (USA Today, May 29, 2013). The Barron's cover of April 30, 2007 blared "DOW 14,000" which did, in fact, precede DOW 14,000 and the bull market top being registered a few months later. These are not absolute "market top" indicators – I view them as anecdotal evidence of a growing level of euphoria that just might usher in an important top at some point in the not-too-distant future. **CONCLUSION: BEARISH/LATE BULL MARKET BEHAVIOR.**

The News. News as reported by most media outlets is overwhelmingly negative. That seems to be the prevailing mood of the investing public, so the media, being in the business of attracting viewers, satisfies the negative mood of the public. It is much easier to articulate a negative case for economic conditions – conditions are always bearish in the short-term. So that's what the media gives us – first it's Greece, then it's Cyprus, then it's the debt ceiling, then it's the budget deficit, blah, blah, blah! Importantly, the market has shrugged off "bad" news of the past few years in a bullish fashion by going up. We won't have a major top until the media starts reporting about people getting rich from day-trading, or reporting about the booming global economy. **CONCLUSION: BULLISH**

Economic Conditions. The US budget deficit is rapidly dropping, so I assume that Tiffany finally got through to the powers-that-be. That's great news! The economy is growing slowly with annualized GDP growth less than 2% in recent quarters. Earnings of publicly traded companies are at record levels. Investors know that impending recessions produce bear markets. A recession in the United States does not appear to be imminent at this time. Major stock market rallies are more likely to be born out of depressed or muted economic conditions; major stock market tops are more likely to occur at the peak of economic booms. **CONCLUSION: BULLISH**

Summary Conclusion: While some bearish evidence has emerged in recent months, the weight of the evidence supports a continuation of the bull market. We are in an ***unfinished*** bull market. Technical deterioration, usually present at stock market tops, is notably absent. And, the euphoria stage, the stage in which I finally get stock tips from the car wash attendant at SAX, is still ahead of us. **CONCLUSION: BULLISH**

The Nature of Crashes. Lately I have had several clients ask me if I thought the market could crash. While anything is possible, my response is that the odds of a crash anytime soon are remote. Although volatility, as measured by the VIX index, has spiked up in the past few weeks, overall market volatility has been historically low during the past year. Crashes do not occur overnight out of low-volatility market environments. Just the opposite is true – both the crashes of 1929 and 1987 were preceded by an extended period of highly volatile/emotional trading and large point swings both up and down. An interesting historical fact is that both the 1929 and 1987 bull markets topped out within 8 calendar days of each other, and then crashed exactly 55-56 calendar days later. The amount of the market decline for each of those episodes was 39.6% and 31%, respectively. The takeaway from both episodes is that crashes tend to occur during highly emotionally charged market environments and after some time frame of volatile trading. It takes time to build the necessary level of anxiety that leads to a crash.

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