WEEKLY MARKET THOUGHTS

April 14, 2014

Flying Too Close to the Sun

According to Greek legend, Icarus, the son of Daedalus, wanted to fly using wings of feathers and wax. Icarus receives guidance not to fly too close to the sun (the heat will melt the wings) nor too low (the seawater will dampen the wings). Upon his maiden flight, Icarus is having so much fun flying that he forgets the warning about flying too high. His wings melt, and he plummets into the sea and drowns.

What does this story have to do with the economy and capital markets? Much. Since the first of the year, certain segments of the U.S. stock market have been "hot". The initial public offering (IPO) market has been very active. Technology and bio-tech stocks have been the rage on Wall Street.

Over the last few weeks, it has become apparent that, at least temporarily, these stocks were flying too high – the wax on their wings has started to melt and their prices have declined rapidly. While the broad-based markets have been correcting to a certain degree, the decline so far has been measured and well-behaved.

	Price Change 12/31/13-2/28/14	Price Change 2/28/14 – 4/10/14
Bio-Tech Index	+14.9%	-18.1%
S&P High Tech Index	+3.6%	-8.5%
Russell 2000 Index	+2.8%	-5.9%
S&P 500	+1.4%	-2.0%
EAFE Index	+1.1%	-0.8%

As can be seen from the table at right, the "frothy" segments of the equity market have been declining much more rapidly than the broader-based U.S. and foreign indexes (EAFE is the Europe, Australia and Far East index). The bio-tech and the technology spaces have experienced the bulk of the price contraction since the beginning of March. Will the significant price declines we have seen on the more speculative side of the market spill over into the broader market? Perhaps, to a certain degree. Some are asking if the price weakness we have seen recently is the start of something bigger.

Two Questions

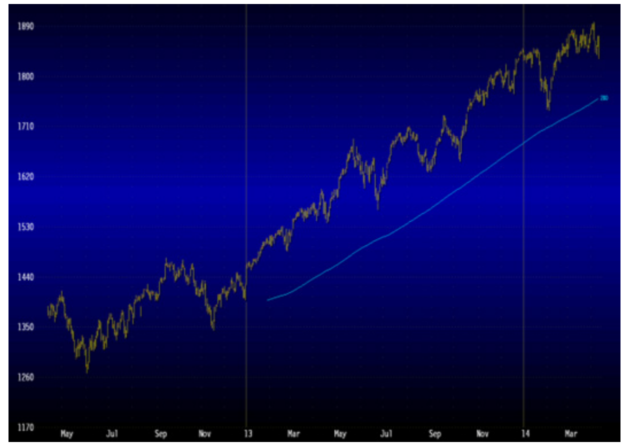
When a price correction is taking place within a well-defined bull stock market, I have always asked myself two questions, attempting to determine the sustainability of the downward shift in prices:

1. Has something fundamentally changed?

For example, has inflation risen dramatically? Has news regarding a systemic shift in our corporate profit outlook changed? Has the Federal Reserve dramatically shifted gears? If the answer to these three questions is "no", then nothing has radically changed to create a major correction in stock prices.

2. Has the overall intermediate-term price trend changed for the major market?

Is the market "talking" to us, saying that investors' perceptions have radically changed? If the answer to this question is "no", then the overall bullish trend and investors' preferences are still in place.



Our Answers to the Questions:

We don't sense that corporate earnings growth is currently at risk. Indeed, first-quarter earnings season is upon us. This past week was "financials" week—the week when many major New York financial institutions released their earnings. Wells Fargo had higher-than-expected earnings. Overall, we expect released earnings to exceed expectations for the majority of firms reporting over the next few weeks. The Fed isn't making any major moves (save the continued "taper" activities of their Quantitative Easing actions). Lastly, inflation is showing some signs of moving upwards, but from a very low base.

As can be seen from the chart above, stock prices are still in an uptrend (the chart shows the S&P 500 Index pricing over the last two years). The upward-sloping blue line is the 200-day moving average – if the index price penetrated the 200-day moving average in a downward spike, the trend would have been broken. Obviously, the market is a ways away from that occurring.

Since our current answers to the two questions above are "no", we expect the current weakness in stock prices to eventually subside, leaving valuations cheaper than before the price correction.

Bottom Line

We have been writing in the past of the market's capability of showing some degree of weakness – entering a correction phase. Are we seeing the start of this phase? Perhaps. But again, we don't sense the start of something major – beyond the potential for the market to correct more than 10% - 15% in price. In particular, the summer months (Sell in May and Go Away) may, as usual, prove volatile this year.

But at the end of the day, while many segments of the market (Bio-Technology, IPO's, etc.) have been flying too close to the sun, we sense the overall market's move has been rational and consequently should, with fits and starts, continue to rise in value over the intermediate-to-long term.

attempts to address a longer-term, structural issue our economy faces as we move forward.

Just For Fun

The theme of today's piece is essentially "expectations". Overinflated expectations normally lead to eventual disappointments in the investment world and in other life pursuits as well. Following are some wise quotes regarding expectations:

> *If you accept the expectations of others, especially negative ones, then you never will change the outcome. -- Michael Jordan*

> *Don't lower your expectations to meet your performance. Raise your level of performance to meet your expectations. Expect the best of yourself, and then do what is necessary to make it a reality. -- Ralph Marston*

And finally,

> *High expectations are the key to everything. -- Sam Walton*

We will be back next week.

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