MISSION®
MANAGEMENT & TRUST CO.

QUARTERLY COMMENTARY
First Quarter 2014

The persistence of stock market gains, accentuated by the nearly two-year absence of positive returns from the fixed income area, has drawn increasing numbers of investors into equities, despite valuation levels that have led to substantial losses twice over the past 14 years. Many have justified defying valuation danger with the acronym TINA – There Is No Alternative. So far, that acceptance of risk has been handsomely rewarded, just as it was in the late-1990s and in 2006 and 2007. The twice repeated lesson of this century-to-date, however, is that overstaying your welcome in overvalued equities will be severely punished: stock prices plummeted by 50% and 57% in the prior two retreats from overvaluation. Make no mistake; stocks are seriously overvalued today. Only price-to-earnings ratios, while well above long-term average, are less than extreme. Price-to-sales, cash flow, dividends or book value are near all-time highs but for brief periods in the bubbles surrounding the 2000 and 2007 stock market peaks.

Notwithstanding extreme valuations, stocks have advanced on the wave of liquidity supplied by the Federal Reserve in this country and by other central banks elsewhere in the world. And prices could continue to rise so long as investors remain confident that central bankers will prevent any untoward equity price retreats. While central bankers are powerful, they are not omnipotent, and their best efforts have been insufficient to halt the ravages of serious intermittent bear markets over the decades. Recent supportive stimulus efforts have failed to hold down interest rates, despite massive direct intervention by the Fed for exactly that purpose. There is no guaranty that their persistent efforts to support equity prices will continue to succeed.

Longstanding clients know that, because of a combination of overvaluation and excessive debt throughout the economy, we began to caution against danger to equity prices before prices peaked in 2000. We anticipated a long weak cycle that could well last a decade and a half to two decades and that would ultimately expunge the valuation and debt excesses. So far within that long weak cycle, markets have experienced two massive declines and two powerful rallies resulting in low single digit annual returns since the market peak in 2000. Mission's clients have earned a better return over that span of time while maintaining a far more risk-averse portfolio structure.

With valuations only modestly improved from their peaks and national and international debt levels far worse today than in 2000 or 2007, we anticipate at least one more major stock market decline in this cycle to remove the excesses. Whether such a decline is imminent or a year or more in the distance is unknowable. In whatever time frame, the retreat will likely take stock prices well below where they sit today. Permanent equity positions will prove profitable from here only if prices can avoid such a precipitous decline. While possible, such an outcome would defy historic precedent. Our preference over permanent equity positions is to employ our strategic equity allocation process, which has historically captured a significant portion of stock market gains while protecting well against major declines.

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

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For money that is not equity-risk-oriented, returns are problematic at best. Risk-free securities continue to yield nothing, and the Fed remains intent on holding short rates near the zero bound. Most bonds have shown losses for the better part of the past two years, although rates declined slightly in the first quarter, putting a plus sign before the quarter's bond index returns. Many investors have gravitated to "high yield" bonds to scratch out some measurable return. So far, that has worked and, as with equities, it could continue to work so long as investors retain confidence in central bankers.

Any number of factors could eliminate that confidence quickly, however, including such non-investment issues as a sovereign exit from the Eurozone, a flare-up in the Middle East and, of course, an escalation of the Russia-Ukraine dispute or fallout from more severe sanctions imposed on Russia. We remain in a very high-risk environment. Should confidence disappear, investors may suffer painfully for chasing stocks and bonds whose prices have been artificially elevated by central bankers trying to rescue overindebted economies by creating a confidence-building wealth effect. Our attention to valuation levels has protected client assets extremely well through the century-to-date, and we expect it will be necessary again before the long weak cycle ends.

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