

Like clockwork, earnings season has drawn to a close, creating an information vacuum for the stock market, one in which the media spends more time “making” the news than perhaps reporting it. The marginal dollar at trade – or the price maker in a high frequency dominated trading world - is one more likely to be concerned about the Fed's words over the next two days than the stream of earnings produced by corporate America over the next few quarters.

Action in the stock market has been consistent with an economy on the mend. The bond market has backed up a tad, perhaps acknowledging that the Fed might begin rate hikes by mid-2015. Rate sensitive stocks – defensives and bond proxy areas like utilities and REITs – have come under pressure. But one key difference has been the performance of energy stocks. Typically, commodity prices and energy stocks do better as demand in the economy and the cycle matures, not worse as has been the recent case. In spite of all the geopolitical concerns which would normally push prices upward, I've seen gas prices as low as \$3.25 per gallon at some of our local pumps.

This is a changed world, but one which is playing out exactly as we've previewed.

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Our domestic economy is gaining steam, with some clear signs of a maturing cycle - corporate capex and M&A activity are on the increase, joining stock buybacks and dividends as effective capital allocation tools in corporate boardrooms. International economies remain weak and in spite of geopolitical concerns, energy prices remain unusually punk. The emerging market economies that benefitted from a decade long period of industrial expansion and an insatiable appetite for all types of commodities that made it possible are now entering a potentially longer, digestive phase as that excess capacity is translated into slower growth, particularly in China.

In spite of the prevailing political debate, the United States is sitting in the driver's seat, positioned to benefit from the countervailing global weakness. Improving employment, new supplies of domestic energy, a leadership position in the most innovative fields, and the world's strongest military in an increasingly hostile planet are contributing to the US dollar's rise and a healthier consumer.

So what about the Fed's meeting over the next two days?

Ignore it.

As we've mentioned repeatedly in the past, Fed rate hikes have usually been undertaken to thwart budding inflationary pressures associated with a potentially overheating economy. Today, the outlook and justification for Fed rate increases is different; it's more about normalizing easy policy in recognition of sustainable improvement in the economy than thwarting what may quickly become an inflation problem stoked by excessive growth. In most of the prior rate hike cycles, commodities like oil were increasing in price, but today, thanks to global slack, domestic supplies, and a strong dollar, the opposite is proving true.

We'll say it again. The stock market loves environments where growth is stable and inflation is but a distant, faraway threat. In essence, stocks tend to love the type of economy we're likely to experience over the next few years.

If all of this is true, why has the S&P 500 struggled to make a convincing pass through the 2000 level? I think the answer is pretty obvious. After a tumultuous fifteen years, no one wants to be the sucker who top-ticks the market at all-time highs, especially when the number is so big and so well-rounded. It's a big psychological barrier and the market is going to need the momentum of stronger data or time to get over the hump. With the Fed meetings today, an absence of earnings releases, and seasonals for September that aren't all that favorable, we could be stuck in the mud for a few more weeks. But mark my words, we'll get through it.

Valuations don't look stretched and are generally in line with the long term averages. While some areas of the market feel a tad bubblicious, price corrections should be welcomed as opportunities to establish positions in what could become our future's brightest stars. As Facebook and Twitter have shown in the past year or two, sometimes it pays to be patient. Sentiment rarely stays so elevated, especially for the newly IPO'ed.

Yesterday, CalPERS, the nation's largest public pension fund, announced it would be eliminating hedge fund investments from its portfolio, citing complexity and high costs as reasons for doing so. While CalPERS has a tendency – at least in my experience - to buy high and sell low with major asset class decisions, I think they've likely got this one right, perhaps for no other reason than I've never been quite convinced that they are a new asset class to begin with. Warren Buffet's decade long bet that hedge funds aren't a new asset class as much as a new fee structure looks like the correct call. If the economic environment remains positive for the next few years, being short any area of the market will likely end up being a pretty significant barrier to outperformance.

For the most part, the money that has flown into equities over the past few years has largely found its way into passive investments like the S&P 500 and other index based exchange traded funds. As the beneficiary of the most significant portion of new dollars entering the equity markets in the past three years, it may come as no surprise that the index itself has become somewhat of a market darling. As the Fed fades into the background, the risk on, risk off mentality that has pervaded the markets and expressed itself far too easily through these trading vehicles will need to recalibrate to a new environment. No longer will both the deserving and undeserving benefit from the Fed's indirect largesse, but only those with a unique, sustainable and superior story to tell. A market with capitalist rather than socialist tendencies should begin its comeback.

Benjamin Graham and Warren Buffet have both said that investing is not about expressing an opinion. In the short run, the market may act like a voting mechanism, but in the long run, it's a weighing machine.

Differences, particularly the good ones – like earnings - should matter.

Kindest Regards,

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