

Why This Bull Market Has Legs

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This seems to be the bull market everyone loves to hate. Maybe it's because many have consistently underestimated the expected return of stocks since the financial crisis of 2008. Others may resent this bull market because they missed large portions of the move. Some may even feel that it is undeserved or, worse, an illusion propped up by steroids injected into the economy by the Federal Reserve when it initiated quantitative easing in March 2009. Putting aside for a moment how, and when, this bull market may end, investors wishing to deal with the world as it is—and not as it ought to be—have to concede a simple fact: Over the last five years, stocks, as measured by the [S&P 500 Index](#), have outperformed government bonds, corporate credit, commodities, gold, silver and, of course, cash. And with interest rates still near zero, and evidence that the economy could strengthen from here on out, a real risk facing investors may actually be lowering their equity exposure prematurely, particularly if this bull market has another few years left in it. And I think it does. ***The first reason is that the fundamentals underpinning this bull market remain strong.*** The U.S. stock market discounts an amazing amount of information every day, but ultimately it trades in aggregate¹ as a multiple of two important income streams: the earnings generated by corporate America and the cash dividends U.S. companies pay to shareholders. After seeing a lull in earnings growth in the first half of 2013, profits of U.S. companies increased about 9% from this time last year.² And aggregate dividend growth, a key component of the total return of any equity market, has been robust in recent years. Dividends paid by companies in the S&P 500 grew 12% over the past year, and by double digits annualized over the past three years.³ In December, [WisdomTree projected](#) that the 1,400 companies that define the U.S. dividend segment of the market would increase regular cash dividends by roughly 11% in the year ahead, based on their most recently declared dividends per share. With aggregate dividends and aggregate earnings both at all-time highs in the U.S., we should not be surprised that major U.S. stock indexes are flirting with new peaks. Interestingly, when the S&P 500 Index sold off early this year, it found support at about 16 times trailing operating earnings, a reasonable valuation in this low interest rate environment. ***The second reason is that the economy, despite the slow-motion recovery, is healing.*** Gross domestic product (GDP) growth picked up in the second half of 2013, and consensus estimates call for the U.S. economy to grow between 2.5% and 3.0% in 2014. Consumer confidence and new orders, which impact business confidence, are back to where they were in 2008, before the financial crisis. And although January's frigid weather makes the most recent economic data murky, the trend since 2010 for building permits, housing starts, consumer spending, average weekly hours worked and initial jobless claims all reinforce the view that the economy is on much stronger footing than it was just a few years ago. After years of losing manufacturing jobs, manufacturing payroll in the United States has increased in 30 of the last 37 months, with 21,000 new manufacturing jobs added in January alone. And although the last two payroll numbers have disappointed, it's worth noting that employment growth still averaged

194,000 per month in 2013. At that pace of job creation, non-farm payroll—which presently stands at 137.5 million—will likely hit a new all-time high a few months from now. At that point, our \$16 trillion economy will likely consist of more employed Americans than ever before, with the highest aggregate levels of personal income and consumer spending in the country's history. That could be the point when consensus opinion tilts toward the notion that the ingredients for a self-sustaining recovery are in place. And because GDP growth has been slower than average coming out of the last recession, five years into the recovery the nation still has considerable slack in the labor market. This sets up a scenario where the economy can continue to make steady GDP gains for some time before driving up labor costs to levels that could trigger meaningfully higher levels of inflation. ***The third reason I think this bull market has legs is that interest rates are likely to remain low for at least another year.*** Capitalism begins with capital, and recapitalizing the banks was an important part of the economy's healing process over the past five years, when many banks and other financial institutions were in peril. The spread between what banks pay on deposits and what they receive on loans—their net interest margin—rises as the yield curve steepens. The Federal Reserve's monetary policy has kept the yield curve steep by essentially setting the short-term interest rate at zero. This has allowed community, regional and money center banks to absorb write-downs of bad loans while, in effect, reloading their capital reserves for the next upsurge in consumer and commercial demand for credit. With an improving economy, banks have seen a steady decline in non-performing loans (and reserves set aside for those bad loans), which has helped fuel their profitability. Low interest rates have also helped individuals refinance existing loans and repair household balance sheets. While aggregate consumer debt levels remain high, household debt service as a percentage of disposable income has fallen below 10%,⁴ its lowest level in 35 years. Low interest rates have enabled investment-grade companies to issue debt to finance expansion or, in many cases, to increase dividend payments or buy back their stock to increase per-share profits. With the market not expecting the Federal Reserve to begin raising interest rates until 2015, 2014 could well shape up to be another healthy year for earnings and dividend growth in the U.S. Finally, low interest rates impact the multiple that investors are willing to pay to own stocks and even the percentage of stocks investors own in their overall portfolio. With the dividend yield on the S&P 500 at nearly 2% (higher than what investors can get paid from owning a 5-year Treasury), competition from Treasury notes remains muted for investors searching for income on their invested capital. In the end, what typically ends bull markets are impending recessions. In the next part of [this series](#), we'll look at what the last two recessions had in common, and why a recession in the next 12 months remains a low probability. ¹This refers to the combination of information that impacts how earnings per share and dividends per share are expected to behave. Information thought to decrease either earnings or dividends typically yields a negative impact, whereas information thought to increase either earnings or dividends typically yields a positive impact. ²Source: S&P Dow Jones Indices for the S&P 500 Index from 3/31/2012 to 3/31/2013. ³Source: Bloomberg, with data as of 12/31/2013. ⁴Source: The Federal Reserve Board's Household Debt Service and Financial Obligations Ratios as of most recent update, 12/31/2013.

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