INVESTMENT OUTLOOK

Dixon, Hubard, Feinour & Brown, Inc. investment counsel

- Stock market stalls in first quarter.
- Federal Reserve keeps tapering on track.
- U.S. Economy to gain momentum.

First Quarter 2014 Review & Outlook

by Whitney Brown

Also in This Issue

Last December the stock market seemed unstoppable, racing into the New Year on a dead run. Yet, with a big 2013 in the record books, the market took a breather instead. For the quarter, most of the major U.S market averages were up only slightly after recouping a brief but sharp setback in late January. The exception was the Dow Jones Industrial Average which finished fractionally down. The broad international indexes also ended the quarter where they started.

The market's hesitancy so far this year has been confounding to both the bulls and the bears. The most bullish of forecasters had called for the market to "melt up" as easy Federal Reserve policy continued and the economy gathered steam. The bears entered 2014 talking about bubble valuations, higher interest rates, a waning U.S. recovery, and an economic bust in China.

Both views merit some consideration, but reality lies somewhere in between. The market is more richly valued after the big run up last year, and there are signs of bubble-like activity in a few select groups such as social media stocks and some biotech names. On the whole, stocks are fully valued but not extremely overvalued; and there are undervalued pockets of opportunity. The harsh winter has had a negative impact on U.S. growth though those effects appear temporary as employment continues to improve and auto sales have rebounded. China is transitioning to a less export-based economy and has ample reserves to stimulate the economy and manage any potential domestic credit crisis.

The Fed has remained steady on tapering their quantitative easing program and has set the stage for eventual rate hikes as early as 2015. On the other hand, they have loudly voiced willingness to show flexibility should the economy falter. The Fed is, very gingerly, starting to normalize monetary policy after more than five years of essentially unlimited ease. The process will take quite some time, and "normal" will be a lot easier than it was before 2008. Even so, the question at hand is how a market that has thrived on easy money will react.

Market Measures	1st Qtr. & YTD	
S & P 500 (price)	+1.3%	
Dow Jones Industrial Average	-0.7%	
NASDAQ Composite	+0.5%	
Russell 2000	+0.8%	
MSCI EAFE	0.0%	
Barclays Capital Inter Gov't/Credit Bond Index	+1.0%	
	3/31/14	3/31/13
10-Year Treasury Bond Yield	2.73%	1.85%
Three-month Treasury Bill Yield	0.05%	0.07%

There are more positives than negatives in our outlook. The U.S. economy should reaccelerate this year with increased government outlays relative to last year, income growth from an improving employment picture, and an expected pick up in capital spending. Market sentiment has been overly optimistic in the short-term, and the market's seasonal advantage usually fades with the onset of springtime; but the technical underpinnings of this long-running bull market remain favorable (see article on page 2). Barring any drastic changes in the global economic trajectory, investors could expect the stock market to consolidate further before resuming the uptrend later this year. Bonds should be a steadier bet than last year with less volatility in interest rates.

Measuring the Market's Health **by Watt Dixon**

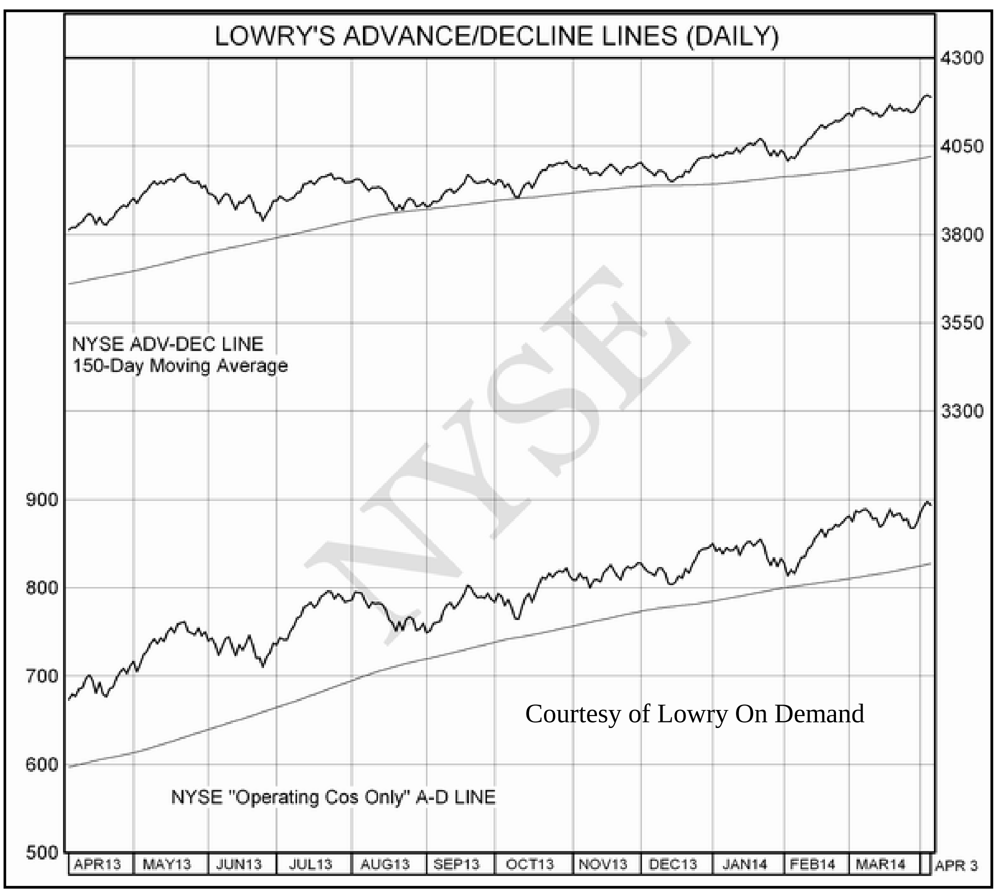
By most measures, this current bull market is over 60 months old. One of the best indicators of a bull market's "health" is the market breadth. Breadth indicators measure the degree to which the vast majority of individual stocks are participating in a market move. It monitors the extent of a market trend. Generally speaking, the fewer the number of issues moving in the direction of the major averages, the greater the probability of an imminent reversal in trend.

The Advance/Decline line is the most widely used indicator of market breadth. The construction of the A/D line is quite simple. The most common way to calculate the A/D line is to take the difference between the number of advancing issues and the number of declining issues each day. If there are more advancing issues than declines, the A/D number for that day is positive. If there are more declines than advances, the A/D line for that day is negative. The chart below illustrates the Advance/ Decline line for the NYSE Index and the NYSE Operating Companies Only Index which removes closed-end bond funds and other issues traded on the exchange that are not operating companies. The A/D line normally rises and falls in sync with the major market averages, but it usually peaks well ahead of them.

Just because this bull market is getting on in age doesn't necessarily mean that the end is near. Duration and level of a market trend alone are rarely useful as means of identifying a major market top. Currently, the Dow Jones Industrial Average (DJIA) is a good example. In early March, big, mid and small cap market indexes were making new bull market highs; the DJIA was not. Some market observers saw this as a sign of a final market top. However, these indexes are not calculated in the same manner. The DJIA is a price-weighted index, meaning that the higher priced stocks within the DJIA affect the averages more than lower priced companies that are part of the DJIA. A number of higher priced stocks that are part of the DJIA such as IBM, Goldman Sachs and Boeing were lagging, thus putting pressure on the DJIA. The other indexes are capitalization-weighted. A capitalization-weighted index is an index whose individual issues are weighted according to their market capitalization, so that larger issues carry a larger percentage weighting. So, the underperformance of the DJIA during this time period was more indicative of a handful of stocks underperforming, not the entire market. In fact, the early March highs were confirmed by all the A/D lines for major indexes, a healthy sign.

Particularly important during an aging bull market are the small and mid-cap A/D lines. Small and mid-cap stocks are typically among the first to show signs of weakness in the latter stages of a bull market. The A/D lines in both of these indexes are not currently showing signs of weakness.

The Advance/Decline line is a descriptive type technical indicator. In most healthy bull markets eight out of ten stocks are participating in the move up. It doesn't show which stocks to buy or sell, but it has proven to be a valuable tool in assessing the health of a bull market. Historically, the Advance/Decline line will begin declining 4-6 months before the major averages will. By looking at the A/D line of the NYSE in the chart at left, we can see the advancing issues are out numbering declining issues, a healthy sign for stocks.



Courtesy of Lowry On Demand

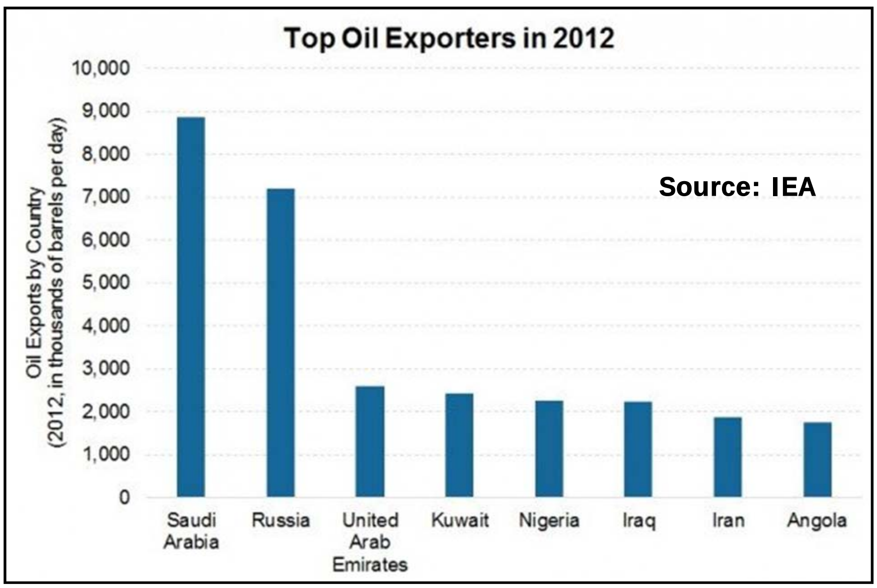
Will Russian-Ukrainian Tensions Affect Crude Oil Prices? by Stebbins Hubard

Russia was the world's second-largest producer of oil in 2012, accounting for 12.6 percent of global supplies, according to the International Energy Agency (IEA). Escalating tensions between Russia and Ukraine have been a recent catalyst in oil prices. When news of a conflict first broke out, the market's initial reaction was to bid up the price of crude oil on fears that geopolitical events such as severe economic sanctions or more intense conflict would limit world supply and push up prices.

However, prices have trended down recently, as markets have begun to conclude that there doesn't seem to be an immediate and severe threat to Russian oil exports. Plus, the sanctions that have been announced so far have appeared to be relatively minor. Meanwhile, other factors have put negative pressure on oil prices, such as rising U.S. oil supplies, lower demand from refineries undergoing seasonal maintenance, and concerns over economic growth in China.

While there doesn't seem to be much fear over short-term oil supplies, given the situation between Russia and Ukraine, there could be consequences for long-term energy supplies if U.S. or European oil companies are reluctant to invest in developing oil and gas resources in Eastern Europe. Royal Dutch Shell said that it had pulled out of negotiations on an offshore exploration deal to develop the Skifska hydrocarbon resource in the Black Sea, near Crimea. Exxon was also supposed to prospectively develop the area, but management commented earlier in the month that the company maintains it's "interest in the Skifska license, but it is on hold due to current circumstances."

Russia gets about 70% of its export revenue from oil and gas, so even a modest drop would be a significant blow. There has been talk of the U.S. unleashing a flood of oil from the Strategic Petroleum Reserve that would drive down prices in order to punish Russia. Most dismiss this as a serious option. The impact of an oil sale, if it actually succeeded in lowering oil prices, would probably be temporary as Saudi Arabian incentives aren't exactly in line with such a move. As the world's largest oil producer, Saudi Arabia would suffer from a drop in oil prices. The fiscal breakeven oil price for Saudi Arabia is rather high, considering its budget necessities. The Saudis need a global oil price above $85 per barrel for their budget to breakeven. The Saudis are not inclined to want oil prices much below the current $105-$110 range, where they have been for the last few months. Therefore, the Saudis would probably cut back on production to keep oil prices at current levels.



While the geopolitical situation has caused some ripples in the oil market, most participants don't expect a significant effect on ongoing short-term operations. Exxon stated in early March at the company's annual analyst meeting that there had been no impact from the Russia-Ukraine situation on the company's activities, and that they didn't expect there to be any, "barring governments taking steps that are beyond our control."

What To Do With Excess Corporate Cash? by Jim Hall

Over the past five years as our economy has slowly been recovering, you may have noticed many companies have either been carrying larger cash balances, declaring special dividends or announcing share repurchases. During 2013, the pool of companies forming the Russell 3000 repurchased a whopping $567.6B of their own shares.[1] "Buybacks" ideally make sense when corporate management feels their company's stock price significantly undervalues their company or when they feel capital expenditures or acquisitions wouldn't increase value or offer a higher rate of return.

Many investors seek out investment opportunities in companies who have a history of repurchasing their own shares. Their reasoning involves thinking they will be rewarded with more cash dividends because the company would allocate the same dividend amount to a smaller group of shareholders or they would be rewarded with higher share prices because there would be fewer available shares on the market.

In general, companies sell a product or service for a profit and can choose to use their profits in the following

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What To Do With Excess Corporate Cash? (continued)

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manner:

1. Repay debt;
2. Pay Dividends;
3. Repurchase existing stock;
4. Hold for an emergency;
5. Invest in newer facilities and equipment;
6. Invest in new technology either through development or acquisition.

In 2008, as businesses felt the economy slowing, the level of general economic uncertainty created an environment that stifled reinvesting in facilities, equipment or technology. Now that our economy is strengthening again, companies will be facing the decision of where to allocate their excess cash. Investment "activists" who wish to make quick profits will continue to urge management to increase dividends being paid or authorize larger stock buy-back programs. These options are fine in moderation; however, excess funds used to reward the shareholders merely provide a quick one-time slug of cash at the expense of long-term operating efficiencies.

A recent Barron's article pointed out 3 concerning trends: the average age of US business structures is the highest since 1964; the average age of equipment is the highest since 1995; and the average age of intellectual property/software is the highest since 1983.[2]

Obviously, many companies have been choosing to postpone upgrades and replacements in order to maintain healthy cash positions. Now that our economy is strengthening, our companies should be focusing on enhancing/updating equipment and facilities or developing new products/services. Doing so will create greater efficiencies, improve long-term profits and ultimately create greater shareholder value in the future. A failure to reinvest in capital assets or intellectual property via research and development can open the door for their competition to gain a greater market share and ultimately threaten future earnings. In evaluating companies, it is important to notice dividends paid and stock buybacks but also pay attention to Capital Expenditures (Cap Ex) as well as Research and Development (R&D) as these investments should create value and insure viability far into the future.

Footnotes:
[1] Jason Zweig, Wall Street Journal, "Stock Buy Backs. Will They Bite Back?," March 22-23, 2014, p. B1.
[2] Jack Hough, Barron's, "Profit From the Next Wave of Corporate Spending," March 17, 2014, p. 21.