RITTMANN

Capital Management

Q1 2014 Commentary

Note to Clients:

The memory of last year's record-breaking rally is fading fast.

Stocks kicked off 2014 on a sour note, with the Dow Jones Industrial Average falling in six of the first eight trading days of the year.

"Stocks entered January over-bought and over-believed and therefore, vulnerable to a changing environment," said one Wall Street trader. "When sentiment is extremely bullish it suggests that, for the short-term at least, a lot of buying power has been exhausted." After the big market gains last year, investor sentiment is fragile.

A few bits of bad economic news are scarcely grounds for a stock market selloff. Beyond any fundamental reason for the recent drop (January's disappointing jobs report added some mystery to the economic outlook), most market watchers say the decline was merely a pause after last year's rally. However, there were worries of a more fundamental slowdown mid-quarter, as retail sales, manufacturing output and housing had weakened.

Extreme cold and nasty winter weather in January and February plagued the Midwest and East Coast. Harsh weather conditions closed businesses, disrupted transportation systems and supply chains, and kept shoppers at home. Home builders were hurt as well. In addition, increased home heating bills act as a temporary tax on spending. The economy will bounce back as warmer temperatures unleash pent-up demand this spring.

In March, the February jobs number reported was very positive, giving the bulls temporary relief. For the first time in 46 months, more unemployed people found jobs than dropped out of the workforce. But there still exists a severe structural problem with the labor participation rate. Up to the 1990's, the U.S. was a nation in which employment, job creation and labor force participation went hand in hand. It is different now. While unemployment has dropped to 6.7% from a peak of 10%, the number of people looking for jobs has fallen. Economists think that a stronger economy will see more jobs added, but the number of baby boomers and people retiring is growing at faster pace than new jobs are being created. So we need to see a continued increase in jobs being added, more than those dropping out of the labor force.

With the lack of any real market catalyst in the post-earnings season, stocks were somewhat directionless and prone to volatility. Many of the big picture concerns of the last two years have faded. Europe's economy is seen as slowly mending and in the U.S., deals in Congress have taken a lot of the fiscal uncertainty off the table.

New Federal Reserve head, Janet Yellen, made her first appearance in front of Congress and provided comfort to the market. She signaled that the central bank would continue on its current course of easy-money policies, even as it pares back the bond purchases it had used to help support the economy. The Fed indicated that short term interest rates would remain near zero into 2015, but investors reacted negatively to a hint that rates might increase sooner than previously expected. She indicated that she has an "extraordinary commitment to boost the economy in a still struggling labor market", so that in itself is very bullish.

Late in the quarter, there was talk of a "market bubble" or the market getting ahead of itself. Well, we disagree completely as the S&P forward Price to Earnings Ratio (P/E) is at 16 times, just a little over its historical average and much lower than in 2000. Growth stocks, especially in biotechnology and technology, were out of favor late in the quarter as well. We saw some intense selling late in the first quarter and continuing into the second quarter, as some questioned projected growth rates, overall earnings trends, and sales momentum. This might be considered a sector rotation, but these sectors have traditionally been a great source of companies we want to own due to their innovative strategies as market disruptors.

There are some encouraging signs from the economy, and companies are beginning to grow and hire. Companies are finding different areas to use their cash on their balance sheets - in research and development, mergers and acquisitions, capital expenditures and stock buy backs. This spending is now starting to add momentum to the economic recovery. Low interest rates and strong corporate earnings are also reasons to have a positive outlook.

Amidst all the change in the market's behavior in the first quarter of 2014, I am still bullish. Businesses continue to be confident, but guarded. We will be looking closely at Q1 earnings due to be reported over the next few weeks. We remain confident in our stocks' long-term trajectory and strategy, even if there may be a few bumps along the way.