KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 1

A Market Review of 2013 and an Outlook for 2014

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Welcome to our inaugural edition of KayneCast. This is Doug Foreman, Chief Investment Officer of Kayne Anderson Rudnick. Now that 2014 is upon us, we wanted to provide you with a review of the economy and financial markets in 2013 and our outlook for the year ahead.

2013 was a fantastic year for U.S. equities across the board. With the S&P 500 returning over 30% in terms of total return (the last time it did this was 1997, which was also an extraordinary year). Small-cap stocks had a sensational year leading the way up almost 39%, so the U.S. equity markets were very strong overall but, unlike previous years, there were numerous parts of asset classes that really didn't perform well in 2013. Principal among them, the price of gold went down almost 29% during the year as fears of global chaos receded and fears of improving interest rates hit the market place. Emerging-market equities and emerging-market debt also did extremely poorly in response to fears about the Fed tapering, and fixed income also did very poorly (not quite as bad as emerging markets), but it was down a couple percent and the Barclays Aggregate hadn't had a down period in terms of total return since 1999.

So why did stocks do so surprisingly well in 2013? I think there were 2 principal reasons: 1) Macroeconomic reasons; and 2) microeconomic reasons that I'll go into. The macro reasons that equity stocks did well were principally the Fed continued to support the markets with fairly easy money policies across the board with their zero interest-rate policy and continued bond buying for most of the year. Housing also staged a remarkable recovery. Housing, which had been in the doldrums and the principal cause of this financial crisis that we experienced, clearly recovered over the last 12 months with inventories down at low levels and prices starting to rise in multiple markets across the board. U.S. employment, while it's been disappointing in terms of its pace of recovery certainly relative to political expectations and even the Fed's expectations, continued to improve throughout the year which was noticeable as well.

Now Europe, which was a principal wild card coming into the year, many observers thought would go into a more meaningful recession actually stabilized over the course of the year and this had a very positive impact for corporate earnings overall. As many large companies particularly have about a quarter of their operations and operating earnings tied to the European economy, so we clearly saw some stability there. Even the biggest basket case in Europe, which is Greece, saw their credit rating upgraded during the course of the year. China also stabilized. China coming into the year, many observers had feared would experience a hard landing in 2013 in their economy as it was trying make a transition from an export-led economy to a consumption-led economy was slowed dramatically and found it difficult to generate any growth. China did go through this transition and is still in the process of going through this transition, but they are still able to generate growth on the order of 7% plus. So China at least stabilized over the course of 2013, which was also a very pleasant surprise relative to what people expected coming into the year.

So what were the micro-reasons stocks did so well in 2013? First and foremost, corporate profits continue to grow. They're not growing at a solid double-digit rate across the board. They are growing at a good single-digit rate across the board and corporate profit margins, by historical standards, are very high. Companies are very profitable. They're making a lot of money, they're generating a lot of excess capital, and they're deploying that capital very wisely in the form of either corporate buybacks, corporate dividend increases, or good acquisitions for the most part.

The second thing that's happening that's probably the most underreported and least talked about factor, which I believe is actually very important to what equity prices are actually doing in the marketplace today, and that's the tremendous innovation that's occurring across a variety of industries. Innovation tends to come in waves, but I think it's one of the key competitive advantages that the United States has versus the rest of the world (emerging markets, Japan, Europe, China, etc.) and innovation is alive and well in this country in multiple industries. In technology, there's changes occurring in big data, cloud-based software, corporate architectures, and the way corporate computing is done is being completely redesigned in terms of server farms, storage, software delivery, etc. So there is very, very robust meaningful change going on in the corporate IT environment, which has created tremendous opportunities for small/medium-sized businesses in particular to exploit this. In the energy area, there's a shale revolution going on. The U.S. should be in a position to actually export energy in about four to six more years, which was completely unthinkable 10, 15, or even five years ago. The natural-gas discoveries that have been made in this country and the infrastructure that's being put into place to deliver those products both here and increasingly abroad is truly amazing. In health care there's tremendous innovation going on, not just because of the affordable health-care act which is providing opportunities for private exchanges and changing the ways that employers can deliver health care to their employees, changing the way that the uninsured can get insured, and also biotech is going through numerous discoveries. Many products have been approved at the FDA. In the last 12 months alone, more products have been approved than in the prior five to ten years combined, so there's tremendous innovation going on in the biotech area as well. In alternative energy, electric cars and solar power are increasingly making their way into our lives as well.

So what's our outlook for 2014? We think we're going to continue to see a recovery in growth rates globally, and business should actually pick up somewhat. We're not predicting a big boom, but we do believe that the second derivative, if you will, of economic activity will be positive and upward to the right over the next 12 to 18 months. The reasons are the U.S. should experience less fiscal drag in 2014 than it did in 2013, and the rest of the world, particularly Europe, is no exception to that. They'll experience much less fiscal drag which should go well for increasing growth rates globally. China we assume will continue to be stable at at least 7% plus. Europe should continue its recovery and actually generate positive growth in 2014. The U.S. should pick up because of less impact on taxation, less impact on sequestration, and less fiscal drag, as I mentioned earlier. So we think the odds are that business activity should continue to improve, employment should continue to get better, and housing, although it slowed down in the second half of this year in response to a pretty big increase in interest rates over a short period of time, we think housing will continue to recover because affordability is still very attractive and inventories are still very low. We think the year will experience positive returns for the equity market overall. We're not in the camp of fixed income will be a complete disaster, but we do think rates will head slightly higher over the course of the year, perhaps a tangible move from 2.8/2.9 to the 3/3.5 range. That's what we expect over the next 12 months as business activity continues to improve and the Fed continues to wind down its QE program, and so corporate profitability should hang in there at a very high level. Overall, we expect positive returns from the equity market for the year, certainly not of the type of 2013, but in a five to ten percent range we think for the overall benchmarks.

I do want to caution investors, however, that we are overdue for a correction. The stock market hasn't had a significant setback of 10% or more over the last 2 years. Typically, even in raging bull markets, the stock market has a five or ten percent correction along the way, which shakes up investors in the short run and allows people on the sideline to get into the market.

So far in 2014 we have seen weak stock prices. This has been triggered by three key variables I believe. Number one: Weaker-than-expected economic data out of the U.S. over the last month or two. I believe this has been triggered primarily by weather. Many parts of the country have been severely impacted by a very cold winter in the month of December and January has been even worse. I believe this has distorted many of the economic statistics, like retail sales and employment data. The second reason is China has seen some modest slowdown in their PMIs (that's their Purchasing Manager Index), which is an indicator of economic activity, but I would point out that the slowdown has been very modest but the second derivative has been negative and that has gotten investors concerned once again about the stability of the Chinese economy which clearly is important for world growth rates. The third thing is the emerging-market sideshow (which I believe is actually the minor factor in the market's decline so far this year), which is rapid inflation in Argentina and some political unrest and current account deficits in certain countries like Turkey and India. I believe these countries are much different than the problems we had in the eurozone when Greece started with their fiscal difficulties several years ago. Greece wasn't able to devalue because it's on the euro and the euro was obviously Germany and France and the bigger players and the marketplace was not about to devalue the euro significantly. So the typical playbook for getting out of a current account deficit of devaluing your currency, exporting more, importing less as interest rates rise in your country and consumption domestically decreases and eventually rectifies the problem has not been allowed to play out in Greece, which is why its created such problems in the eurozone. But we don't think that's going to happen in these different markets. You know the Turkish market has their own currency and the Argentina currency as well is pegged to the dollar and they can simply revalue that. So I think that the emerging-market issues that we've seen, although significant for emerging-market investors, I don't think they really have any big impact or domino theory impact on the U.S. market overall.

If we prove to be correct on these three factors being somewhat temporary, then it remains to be seen whether this is the beginning of a more material correction and more material fundamental event than it is right now. My best guess is that this is not the beginning of some major global slowdown. I think it's more that this is just the beginning of a typical correction where people are looking for reasons to take some profits after the enormous run-up the stock prices have had.

So we continue to have a positive long-term outlook. If this correction deepens, which wouldn't surprise us given the magnitude of the decline so far, we're just going to continue on the quality of businesses that we own over the long haul.

So I hope you've enjoyed the podcast. We're trying to find new and clever ways to communicate with our clients. We wish you all a happy and prosperous 2014.