Polaris Wealth Advisers, LLC

Polaris Educational Series

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Equal Opportunity Worrying

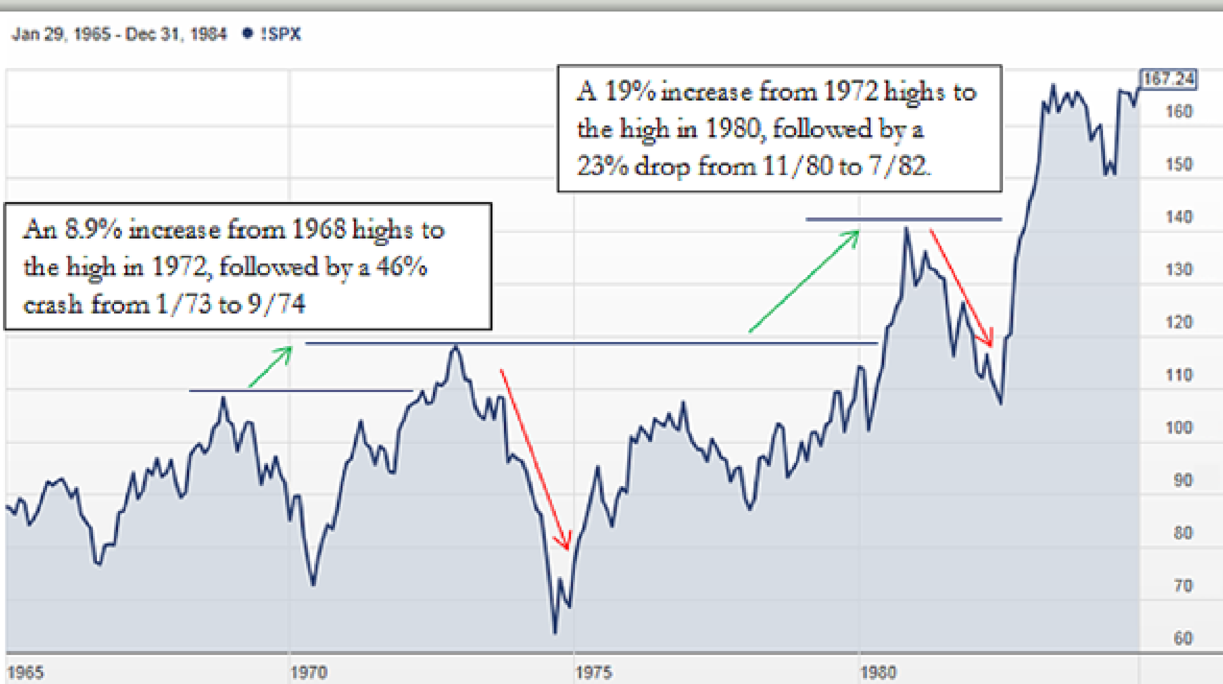
(A look at the 1st half of 2014 and what's ahead for the rest of the year)

I recently had a client call me up expressing his concern about how much the markets had run up and was worried that there was a good chance that the markets would correct. As he put it, "I'm an equal opportunity worrier." I loved the expression and thought it would be worth discussing his concerns as well as another related common question, "Are we finished with our secular bear market?"

A History Lesson:

Those of you that have attended one of our educational seminars know that we discuss the particulars of secular bull markets and secular bear markets. A secular bear market is an elongated period in the stock market (the average is 13 years) in which the markets are trade ranged. In other words, they go up and then fall right back down to where they were. They go up again, only to fall back.

The below chart shows the last secular bear market we had, which lasted from the end of 1965 through most of 1982. This is a 16 year time period in which you would have made virtually no money if you had incorporated a "buy and hold" investment philosophy. An investor had to be very agile and tactical to make any money during this last secular bear market, lowering exposure to the stock market during the downturns and increasing it during upturns.



Graph created using MSN Money, data by Standard & Poors, and analytics and comments by Polaris Wealth Advisers, LLC

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In our first chart you will see that the S&P 500 broke above previous highs at the end of 1972 and at the end of 1980. The 1972 new high was approximately 10% above previous highs, whereas the high in 1980 looked more like a real break out. In both cases, the S&P 500 corrected significantly due to recessions. The 1973-74 recession was very similar to the Great Recession of 2008 in terms of depth and duration. The correction that occurred from late 1980 to mid-1982 was due to a fairly significant double dip recession.

Once an investor made it through this final correction, however, the secular bear market ended and we went on to experience one of the greatest runs in the market's history from 1982 through 2000. But how did you know that the secular bear market you were in the midst of was over and that a new secular bull market had begun? This is an exceedingly important thing to consider. Most intelligent investors will shift their investment tactics at the onset of a secular bull market in the attempt to capture more of the long-term upside typically experienced in a secular bull market. The problem is that you really only know when a secular bear market is over several years after the fact and once you are well into the new secular bull market.

Where are we now?

I think that it is very valid to call into question, "Is our secular bear market over?" June's quarter end saw the S&P 500 25% higher than the last peak.

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Could we have a significant correction similar to 1973-74 or 1980-82? Anything is possible. We haven't had a significant pull back in the markets since 2011. If it did occur, a correction would most likely stem from a shifting of investor sentiment and not as a result of a recession (as was the case in 1973-74 and 1980-82). Based on all current economic and financial data, there isn't anything statistically glaring on the horizon that would indicate an imminent correction.

According to research conducted by JP Morgan Asset Management (JPMAM), the S&P 500's current Price-to-Earnings ratio was 15.6, Price-to-Earnings-to-Growth was 1.5, Price-to-Book was 2.8, Price-to-Cash Flow was 11, and the dividend yield was 1.9%. These are right in line with the 25 year averages for each category. In other words, the markets appear to be properly valued from a historic perspective. You must also take into consideration current monetary policy and its effect on asset pricing. Given our zero interest rate environment, our markets appear to be properly valued based upon most long-term historical norms.

Valuation Measure	Description	Latest	25-Year Avg.
P/E	Price to Earnings Ratio	15.6x	15.5x
PEG	Price/Earning to Growth Ratio	1.5	1.4
P/B	Price to Book Ratio	2.8	2.9
P/CF	Price to Cash Flow Ratio	11.0	10.6
Div. Yield	Dividend Yield	1.9%	2.1%

Source: JP Morgan Asset Management, Data as of 6/30/2014

Most companies have deleveraged themselves over the past several years. The S&P 500's debt-to-equity ratio is 102%. This is very low compared to its 25 year average of 171%. This is very impressive given how much cash these same companies have raised at the same time. S&P 500 companies now have over 30% cash as a percentage of current assets. Dividend payouts are at all-time highs, with share repurchasing near all-time highs. Corporate profit margins also remain near all-time highs at 9.8%.

Most individuals have deleveraged too. Debt as a percentage of disposable personal income is at 9.9%, its lowest point since 1980. The average person's total net worth has increased by over 20% since the highs experienced in 2007.

The economy is chugging along at a very methodical, average pace. While we are still running a deficit, our $490 billion deficit represents only 2.9% of GDP, according to Ned Davis Research. This is a significant decline from the Great Recession, when we were running a $1.4 trillion dollar deficit which represented over 10% of our GDP. All quantitative easing is set to end in November as the Federal Reserve will stop purchasing U.S. Treasuries. Inflation seems to be held in check with headline and core Consumer Price Indexes at about half their 50 year norms, at 2.1% and 1.9% respectively.

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While there are a lot of important economic data points announced regularly, the Federal Reserve has made it clear that unemployment is very high on their list (and therefore high on ours too). The most recent unemployment figures provided by the Bureau of Labor Statistics were very strong, coming in at 6.1% (known as U3 unemployment). Participation in the recovery remained low with only 59% of the population working, a statistic we have not seen in over 30 years. U6 unemployment, which counts underemployment (not working the hours you wish to work) and people that don't qualify for unemployment is almost double U3 unemployment at 12.1%. These statistics make complete sense. As the Baby Boomer generation retires, unemployment will drop as the job is filled by someone currently unemployed.

I think that it is a little too soon to call the end to the secular bear market. The S&P 500, however, is 25% above the 2007 highs. There doesn't seem to be anything to stop it from continuing its upward movement (besides a short-term cooling off period). Therefore, I think that we will look back at these times as the beginning of the next secular bull market.

Polaris Wealth is well positioned to help you take advantage of the next secular bull market if it is indeed upon us. If the trend fails, we are equipped to help you defend your portfolio from unnecessary risk. If you'd like to learn more about how we will do both, please feel free to write me or speak with your local Polaris representative.

As always, I look forward to your questions and comments.

Sincerely,

Jeff