BE CAREFUL WHAT YOU WISH FOR

The frightening headlines that warn of the European Union's break-up, the collapse of major financial institutions and fiscal cliffs have either dulled our senses or have lost their relative importance over the last year. This lack of "macro focus" and "correlated returns" has been giving way to a more normal level of market volatility which I described in detail in my last quarterly "Nothing to Worry About".

Consequently, the market appears to be a safer place to invest and valuations are rising.

However, there is one theme that underlies the market and that is, that there will continue to be economic growth. But, it's a mixed picture. It doesn't exist in Europe, it's good in China but fading, they're trying to restart it in Japan and it's stable but slow in North America. On balance, world growth is O.K. but not great. Although economic issues dominate the headlines, I've preached repeatedly in past quarterlies that it is liquidity and not economics that makes the market go, and we can relate this to various economic outcomes.

As I see it, there are three options going forward.

First, and most feared, is that economic growth falters, especially in the United States as monetary policy is overwhelmed by fiscal constraint driven by deficit reduction and tax increases.

Second, the economy continues to muddle along.

Third, the global economies find their bearings and growth picks-up. Europe turns the corner while housing, autos, energy self-sufficiency and the re-shoring of manufacturing drive employment and GDP growth in the U.S. And finally, China's new administration transitions the nation to greater reliance on the domestic consumer.

Wouldn't that be wonderful? Well, be careful what you wish for. Under scenario three, the central bankers, especially at the Federal Reserve would have to take their foot off of the liquidity accelerator and might, heaven forbid, tap on the monetary breaks. Liquidity would be drained and interest rates would move higher as the proverbial punch bowl is withdrawn from the party. Not good for stock markets. So the good news everyone hopes for might be bad news for your portfolio.

But what about scenario number one? Won't that also be bad for the markets? If it results in the solvency of financial institutions and sovereign governments again coming into question, probably yes. But if it's just lack of growth, then you can bet that the monetary punch bowl will stay full and all that liquidity will put a bid under the markets. They could be weak but we will likely not see a collapse.

The best option is what we've got. Slow, stable growth with lots of liquidity looking for better than fixed income returns with rising earnings in a market that isn't cheap, but certainly fairly priced.

Am I too optimistic? Well anytime you are feeling this good about the market is no time to let your guard down. But it's nice to be vindicated after pounding the table about equities, especially when we suggested that maybe a new secular bull market had started in our 2011 year-end quarterly.

Why bring it up? Not really to beat our chests, because it's too early to declare a bullish victory, but to make an observation.

The market averages are at all time new highs but the investor landscape is at best cautious if not doubtful and mistrusting of this bull.

From my perspective, that gives me some comfort. It means a lot of money remains trapped on the sidelines with investors wishing they had moved into equities sooner and hoping for a pull-back so they can put some money to work at a better valuation.

In my last two quarterlies, I've written about the psychology of investing: 1) how trends revert to the mean and how it's the aversion to risk that would correct this time and 2) The correlation of equities created by investor reaction to macro issues that creates volatility and as these macro issues fade from the headlines, how the market would appear to be a safer place to invest. This quarter, it might be worth addressing the investor psychology behind a bull market. It isn't as positive as you might think.

If we are in a new bull market then why are most investors still so cautious? Certainly, new all time highs on the indices would indicate this is something more than just a big rally in an ongoing bear market, as some of the "perma bears" have been suggesting.

The answer is, because that's the way it's supposed to be in order for the market to move higher. That might seem perverse, so let's examine the psychology of an investor at different stages of a market.

At the bottom, everyone is negative. More importantly, they have acted upon those emotions. They have finally capitulated, thrown in the towel, and sold their shares and when that's done, it's over. No one's left to sell and you get a bottom.

The first leg of a bull market results simply from a lack of sellers. They're out and it doesn't take much buying pressure to push prices higher. From 2009 until now, that marginal buying dollar has come from corporate treasuries as they have been buying back their shares in the face of continued "retail" selling through mutual funds. I'll have more to say about this shortly.

For those on the sidelines, have they missed the bottom? Absolutely. Those suggesting that it's a good time to get into the market and that we've just started a new bull market are four years too late. You've missed it. Unless you've been a Cumberland client. (Please forgive the shameless self-proclaimed advertisement).

We are now in what I might describe as the middle third of the cycle. The clouds are clearing, valuations have moved up but we aren't seeing any excesses. But for sure, those out of the market have missed the easy one third when just about everything goes up and the big investment discussion is simply whether to get in or not. As I said last quarter, stocks have been highly correlated meaning performance has not been distinguished by stock or industry selection. Just being in was good enough, but that started to change last year. Correlations dropped and stock selection started to make a difference. This is when solid analysis and well thought out investment strategies make a difference.

It's also the phase when those on the sidelines start to realize they're missing something. "Maybe things aren't so bad. Maybe I should put a little money back into the market. But maybe I'll wait until there's a pull-back so I can buy in a little cheaper" and that's the killer line…."I'll wait". Now we have latent buying power sitting on the sidelines as support for the market in the event of a pull-back. Inevitably, as the old adage goes, the market will do whatever it has to do to make the majority wrong.

Sidelined investors will wait for the pull-back. It will come but maybe not as much as they hoped for or perhaps the pull-back indicates a reversal. Either way, the potential buyer hesitates until the market again moves higher and he remains a latent and uncommitted purchaser, potentially supporting the market. "Thinking that next time, if it only gets back to where it was when it started the last correction, then I'll buy."

The second phase of a bull market traps would be investors on the sidelines, creating support for a market correction.

As an investor, you can still make money in this phase of the bull cycle. It isn't the easy money that's made in phase one, but intelligent investing works. You just can't wait too long before committing.

The last phase of the bull is where the sidelined investors can't stand it any longer. In their mind a green light has finally been given as the news environment becomes more constructive. And usually, there is a positive theme that gives investors comfort looking out into the future. Remember back in 2000 with the "New Economy" or in 2007 with "Peak Oil". These were irrefutable trends that would last well into the future. Trends that justified paying up for companies because even if your timing was wrong, the earnings potential would skate you on side.

At the 1972 top, there was a group called the "Nifty 50". We called them one decision stocks because once you bought them, you would never have to sell as future earnings growth was assured. Reality is, some of those "Nifty 50" companies don't even exist today.

When we hit this phase, it's time to get out. It is late in the game. All that potential buying power that has been sitting on the sidelines is used up. And when it's invested, there's no one left to buy and you get a top.

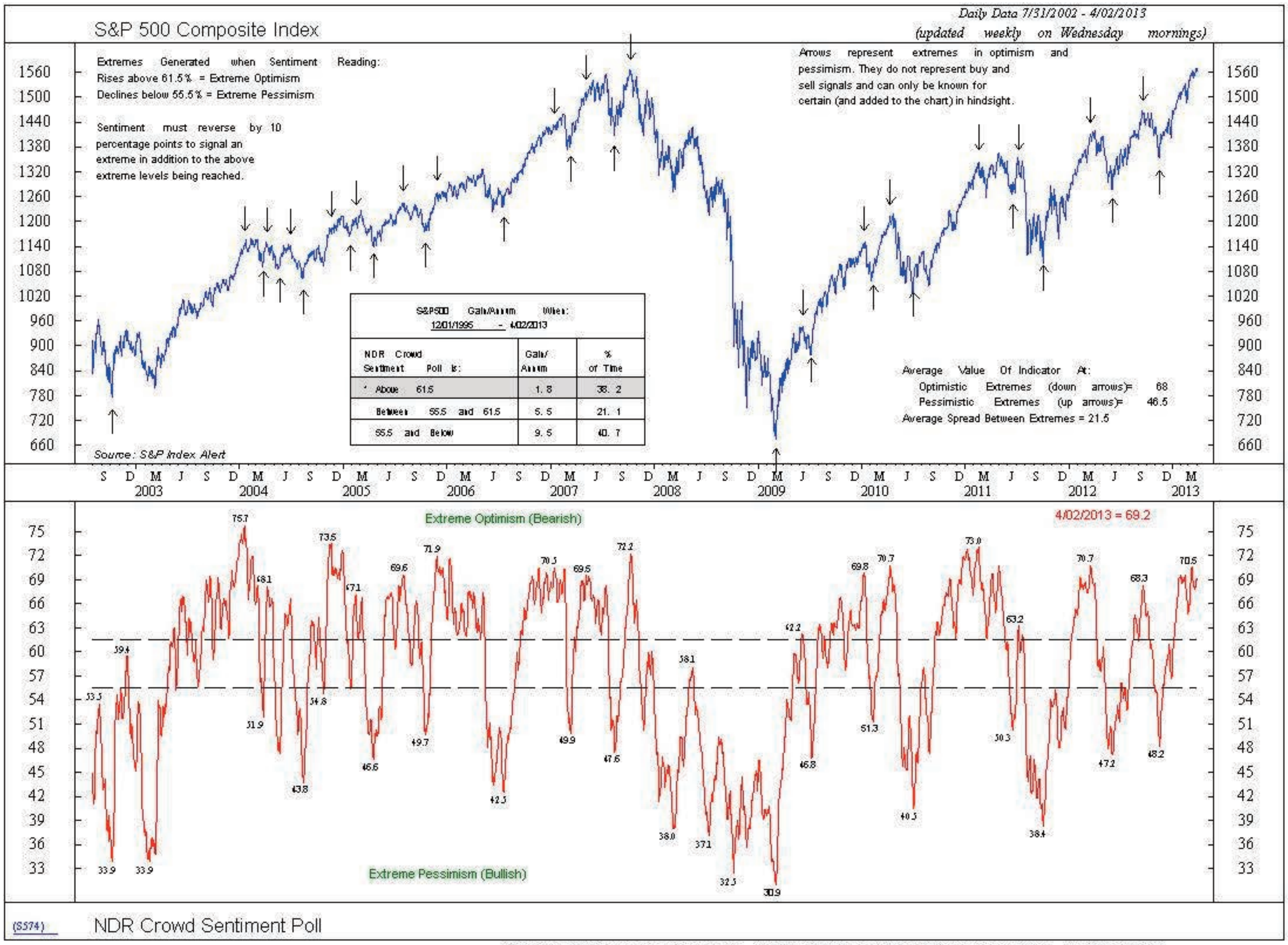
Now let's see how this contrasts to a bear market. Instead of being in cash, you own shares but wait to get out. The common instinct isn't to take a loss but to wait until the stock rallies so you can get your money back. But it doesn't. Now you're still long and are a latent seller, hoping that the shares get back to where they were when you first decided you wanted out, not cost. But again, the market doesn't co-operate and investors hold on, waiting for that rally and putting a lid on the market until they can't stand it any longer and finally capitulate. Better to take what little is left than continue to ride this thing down.

We've all been there before, except some of us have done it enough times to have learned our lesson.

These emotions are consistent from one cycle to the next. The news changes but the human emotions don't and it's why bull and bear markets have been labeled either "Climbing a Wall of Worry" or "Riding the Slope of Hope".

So where are we? In the longer term, I think we're in the middle third of a bull. People are still trapped on the sidelines, valuations are reasonable and liquidity abundant. More importantly, I think a bull market theme could be developing, which will be the "Renaissance of America" through energy self-sufficiency and the re-shoring of manufacturing. If it does, the investment horizon gets pushed well into the future, justifying paying up because the prospects are much clearer.

In the shorter term, I'm conflicted. Like a lot of latent bulls I'm expecting a pull-back for a better entry point. However, unlike the reluctant crowd I'm 80% committed, far from being a spectator.



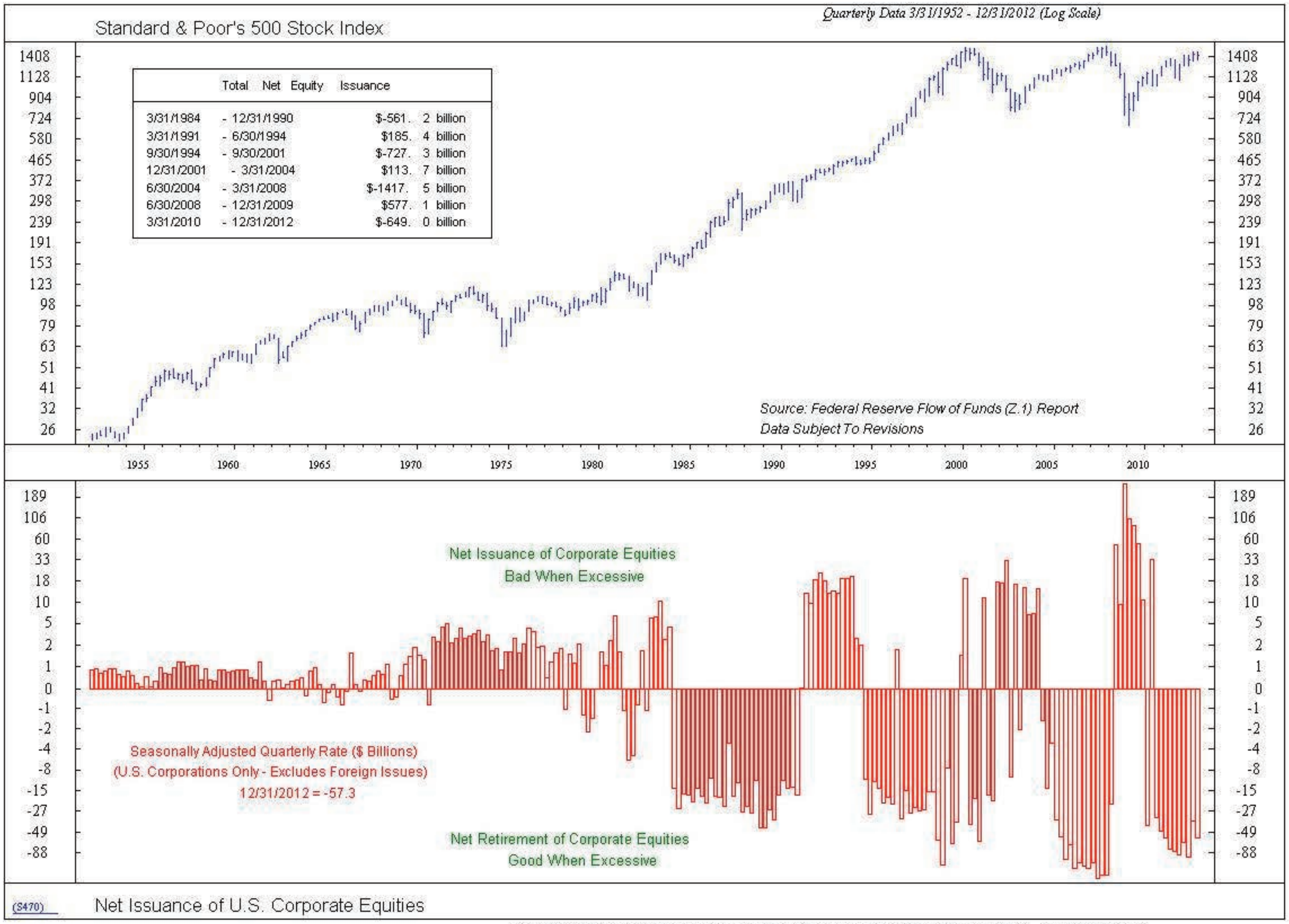
S&P500 Gain/Annum When: 12/01/1995 - 4/02/2013		
NDR Crowd Sentiment Poll is:	Gain/Annum	% of Time
* Above 61.5	1.8	38.2
Between 55.5 and 61.5	5.5	21.1
55.5 and Below	9.5	40.7

By far, the biggest reason for caution is the exuberance shown by the bulls, as seen in the bottom clip of this chart. Expectations have improved dramatically and concerns about Europe and the fiscal cliff have drifted off the radar screen, at least temporarily. Consequently, those who were underinvested have been willing to pay up in order to put surplus liquidity to work. It's my experience that inevitably, something will come along to create a setback for the market which will provide a good buying opportunity.

Otherwise, valuations remain attractive and the amount of money on the sidelines is compelling and probably worth quantifying.

As I said earlier, individuals have been net sellers of the market since it bottomed in March, 2009. While corporations, on the other hand, have been overwhelmingly acquiring their own shares or providing dividends for others to do the same.

From March, 2010 through December, 2012, corporations bought back a net US$649 billion in equities, far more than what mutual funds redeemed.

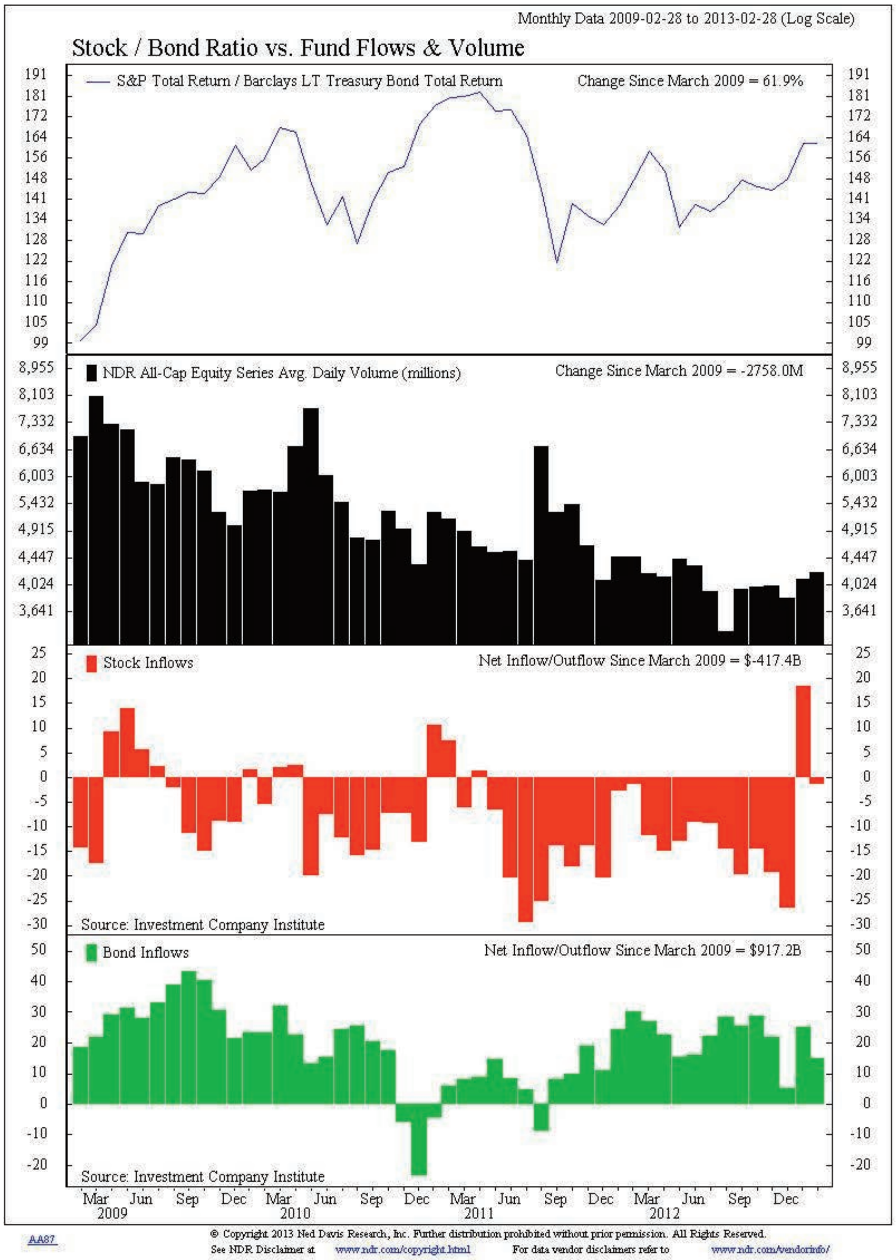


The bottom clip of this chart documents the annual share repurchases while the table in the top left provides cumulative totals for various periods.

Foreigners have also recently joined in. According to the U.S. Treasury, they have purchased US$212.4 billion in equities at an annual rate in the three months ended January. Of this, Europeans accounted for US$160.4 billion, or 75% of the total.

For corporations, it isn't hard to understand why they have been purchasers. Cash flows rose from a cyclical low of US$1.1 trillion during the 4th quarter of 2008 to a record US$1.9 trillion at the end of 2011. For the S&P 500 companies, stock repurchases and dividends expanded from a US$287 billion annual rate in the 2nd quarter of 2009, the market bottom, to US$693 billion by the 3rd quarter of 2012.

Cumulatively, since the start of the bull market, S&P 500 companies have repurchased US$1.228 trillion of their shares and paid out US$872 billion in dividends, for a total of US$2.1 trillion.



During a similar period, March, 2009 until the end of February, 2013, individuals have pulled US$417.4 billion out of equity mutual funds as seen in the 3rd clip of this chart and acquired US$917.2 billion of bond funds as shown in the bottom clip.

And remember, this doesn't include direct holdings of equities by households. The numbers are a little dated but suggest that in the four quarters through March, 2012, households liquidated an additional US$255 billion in equities.

Pension plans have also contributed their fair share to the supply. Over the last ten years, US public pension funds' equity allocations have fallen from 70% to 52%, while in the U.K. they are as low as 40%.

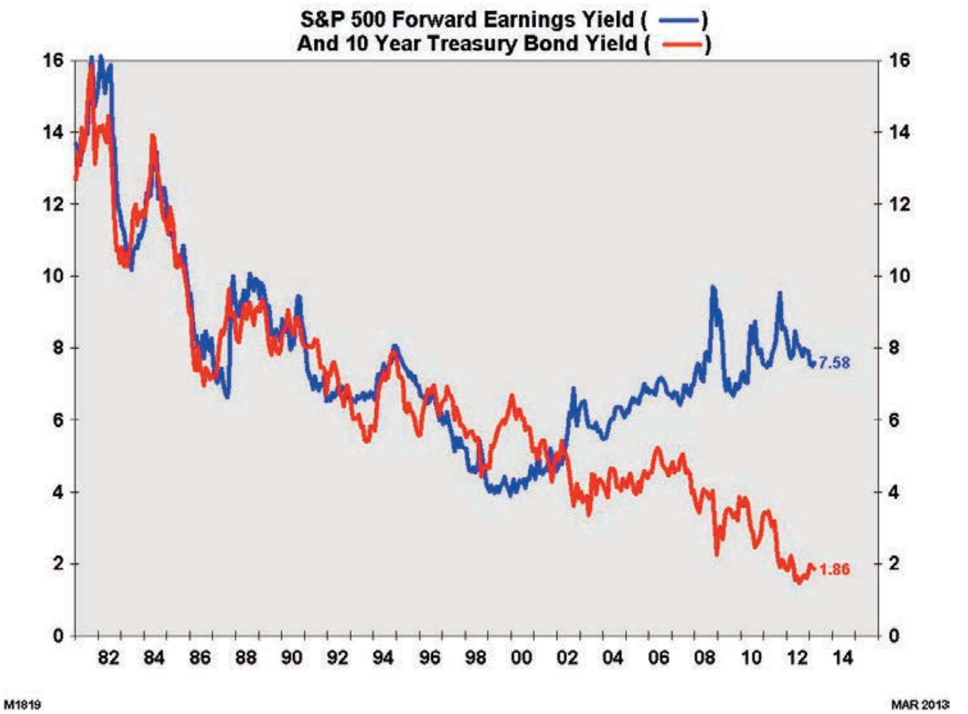
As a result, bond allocations now exceed equities for the first time in almost 40 years. By contrast, in the early 1990's British pensions had almost 80% of the investments dedicated to equities and had so for the previous 20 years.

A study from Mercer's shows that some European pensions over €2.5 billion have equity allocations as low as 24%, which is down from 40% as recently as 2010.

So from a supply and demand perspective, any positive change for equities by individuals or pensions could be significant for the market.

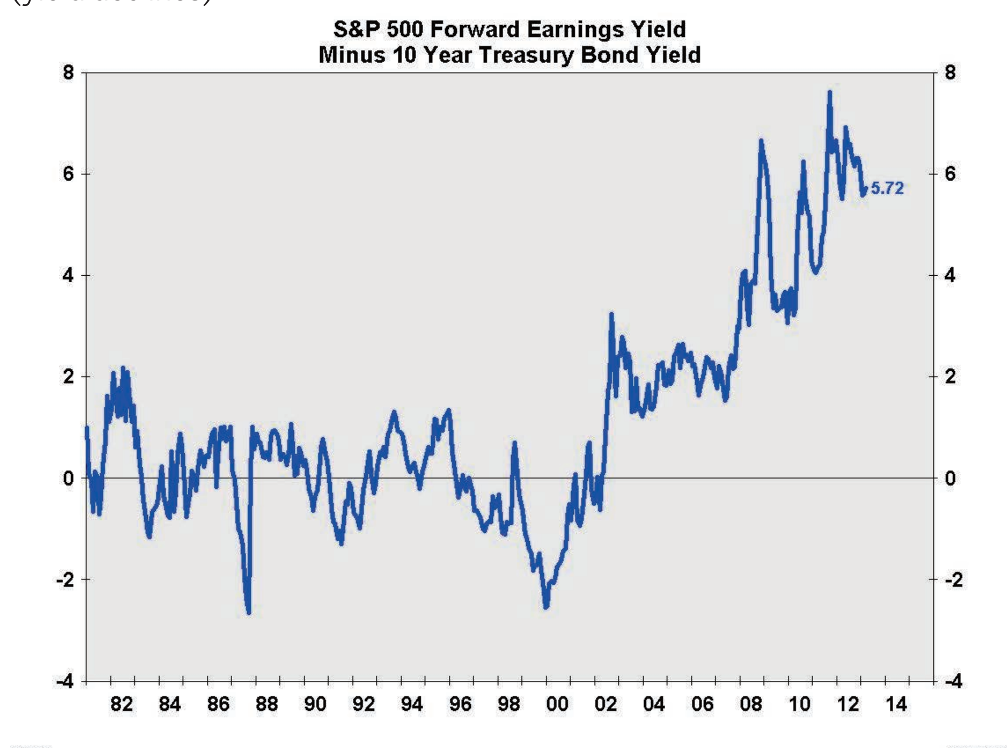
Valuations also remain reasonable.

As seen in the above chart, price earnings ratios (PE's) aren't much off their recent lows and are still well below their historical average of 16X.



When earning yields (earnings divided by the stock price) are compared to 10-year Treasury bond yields, the market remains extraordinarily cheap.

The chart above compares this earnings yield of 7.58% to the Treasury yield of 1.86%. Considering they usually approximate one another, there is room for either bond prices to decline (yield rises) or stock prices to rise (yield declines).



In this chart above, one can see how large the earnings/bond yield spread is relative to the last 30 years.

And finally, what can one expect after a market reaches a new high? Has it run its course?

This chart plots the history of the S&P 500 since 1929 and the table in the top left measures the market's performance after setting a new high until it ultimately peaks.

The chart itself looks a bit ominous in that the S&P 500 index could be establishing a treble top going back to 2000. However, the statistics suggest that once a new high is established, the market will continue to advance for another 417 days and 18.4%.

What gives us some comfort is that although the market has set new highs, so have earnings by even a wider margin allowing the valuations to be cheaper today than they were in either 2007 or 2000.

Conclusion

In the long term, I'm still constructive on the market both for psychological and fundamental reasons. There is still a lot of latent buying potential sitting on the sidelines and the economy and earnings are improving, even if slowly, which is good. Some of the "macro" concerns surrounding Europe haven't completely disappeared but they are at least dormant for the time being, but bear watching.

But, the overwhelming bullish factor is the amount of liquidity that is being generated by the central banks that will eventually have to be deployed. Historically, the financial markets are the first benefactors, which is certainly apparent in today's bond market. But more competitive returns in the stock markets and confidence in the future will inevitably lead investors to take on more risk and dedicate more funds to equities.

In the short term, this message hasn't been lost on investors and reluctantly money has moved into the market pushing the popular indexes to all time highs, driven by double digit returns in the first quarter alone which is enough to give us pause.

Sentiment is pretty positive but always volatile, meaning that history suggests that there will be a better entry point sometime in the future.

GRC/amh
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CREDITS Ned Davis
TD Securities
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