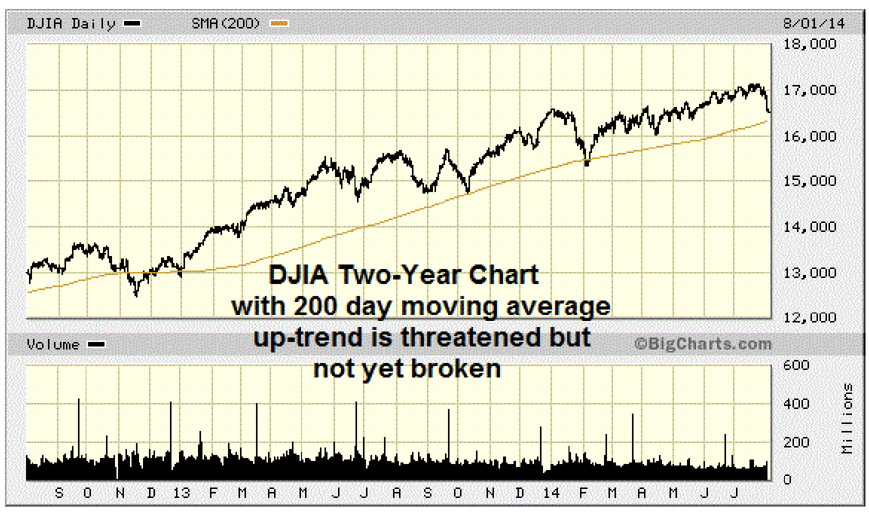
American Heritage Financial

August Update **August 1, 2014**

The Bears Are Growling!

With the sudden and violent stock market sell-off at the end of July, you might think all that noise coming from the “bears” is a roar of victory. But in spite of recent weakness, the bears are growling because of pain, not gain. More than five years since the last bear market ended it seems the bear camp is still growing—or at least becoming more vocal. As the 2014 stock market continues to show its resilience, along with marginal but frequent new record highs, the bears are finding that it is never a smart idea to stay negative on the U.S. economy and/or stock market for long, and it has been an especially bad idea during the past year and a half.

After two devastating bear markets within a nine-year span (between 2000 and 2008) many investors were seized by permanent fear and a focus on the negatives. Of course there are always people who believe the opposite view is appropriate; and that is what makes a market. Yes, being negative can be profitable for a while; one might lighten exposure, take profits, or (in the extreme) go to cash or even short the market. But staying negative too long usually proves costly.



Financial media has fed the investor paranoia with constant articles about bubbles, overvaluation, macro concerns, collapse around every corner, etc. Most of this is media hype which draws the same conclusion: Investors will see a repeat of the 2008 crisis, stocks will get smoked again, we will all end up penniless.

After months, no years, of investor cautiousness (at best) and outright bearishness (at worst), an increased level of frustration is setting in as the stock market has ignored the hype. Let's face it; there have been ample opportunities to get something going to the downside this year, especially lately. Here are "issues" the bears are currently growling about:

- Fed hints rates may rise sooner than expected
- Renewed bank problems in Europe
- Europe's economy is clearly slowing
- A whiff of inflation in the air
- Argentina defaults on debt (again)
- Deteriorating relations with Russia
- Malaysia Airliner shot down in Ukraine
- Massive new unrest in Iraq
- Russian sanctions threaten global economy
- Israel’s escalating invasion of Gaza (again)
- The "momentum meltdown" in small-caps
- And, Janet Yellen's warning of over-valuation in certain stock sectors. (Recalls Alan Greenspan’s “Irrational exuberance” warning in 1997 – three years before the market turn in year 2000.)

During a weak market, any of the above could cause the market to crumble. The key to that sentence—and the key for investors today—is that we are not in a “weak market” and the reaction of the market to all the turmoil and uncertainty this year is an indication of just how strong the market is.

We acknowledge that negative arguments and legitimate concerns about the direction of the market continue to grow. Many individual stocks are at extreme valuations and it is very hard to find truly “cheap” stocks. Strong earnings growth is needed to maintain the uptrend but margins are stretched and sales have been inconsistent. And, “time” is not on investors’ side because a normal correction is long overdue. Based on historical trends, we experience a correction of at least 10% about once every twelve months. We have not had a correction of 10% since 2011.

So, some kind of sell-off or correction is long overdue. It may or may not have already begun. It is easy to see why one might be bearish or at least cautious. Yet, there are valid reasons to expect the long-term bears will continue to be frustrated: 1. **Market trends remain positive**. Even with the recent sell-off, stocks are only 3.5% lower than their all-time high, hit just six trading days back, on July 24. Fighting a trend, or trying to predict a change in trend before it happens, is not a profitable investment strategy. 2. **Bull markets rarely end while the economy is still growing**. The decline in first quarter GDP was a shock but the preliminary estimate of 4% growth for the second quarter (announced this week) shows the slide was an anomaly. 3. **Bull markets do not end until investors become aggressively over-exposed** ("irrationally exuberant" in Greenspan-speak). In spite of the five-year bull market, investors remain cautious. The unending stream of negative hype is one sign of the focus on fear, not greed. Also, we continue to see investment advisors' marketing pitches focused on risk and safety. Such pitches often change to an unhealthy emphasis on gains in the final stages of a bull market.

Considering today's frustrated bears, continued high cash holdings and the resilient, improving economy, there is greater risk of a "blow off" to the upside than a devastating decline. If we get that "blow-off," or if the Fed suddenly reverses policy and increases rates, there will be reason for real concern. In the meantime, stay with the trend, stay diversified and use any short-term weakness as an opportunity to buy the highest quality stocks offering real growth at a reasonable price. And, don't growl with the bears!

Best regards,

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