American Heritage Financial

June Update **June 2, 2014**

I'll Make You Pay!

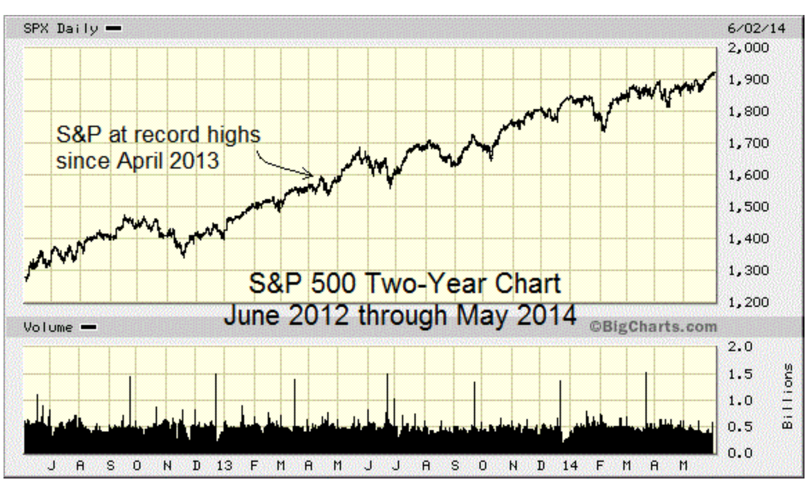
Sometimes it seems like the market is a big guy with a shaved head and pin-striped suit threatening to *"make you pay!"* Of course the market makes you pay in ways other than what is inferred by the guy in the commercial, but it seems the market invariably ***makes us pay* by doing what is least expected by the most investors.**

With five months in the books for the year, we can point to numerous unexpected outcomes that have cost investors who bet on consensus forecasts at the beginning of the year. The biggest surprise has been interest rates, specifically 10 to 30 year Treasury bond rates. Forecasters (including us) had been calling for "eventual" higher interest rates for the past few years, but by the beginning of 2014, it was all but certain that the genie of low interest rates was out of the bottle. Rates had already risen dramatically since spring 2013, when the Fed began talk of reducing stimulus programs. The 10 year was as low as 1.68% in late April 2013 and it rose to 3.0% by January 2014. The 30 year was 2.8% in the spring and finished 2014 just a few ticks below 4.0%. Considering the strengthening economy, the Fed's plans to increase rates and the fact that rates had already been increasing for eight months, it seemed only natural to expect higher rates in 2014. Economists' estimates at the time were for the 10 year to increase to 3.5% by the end of 2014, and for the 30 year to rise to 4.5%. Surprise! Interest rates have fallen consistently for five straight months and the 10 year is currently at 2.49% while the 30 year yields 3.34%. To help clarify the jumble of numbers, we have summarized those rates in the attached table.

The interest rate surprise	Apr '13 Low	Jan '14 Actual	Yearend '14 EST	Current Rate
10 yr tsy yield	1.7 %	3.0%	3.5%	2.5%
30 yr tsy yield	2.8%	4.0%	4.5%	3.3%

While most people don't think a lot about interest rates, rates are a big deal which requires investor awareness. The surprise in rates has been hard to explain even in hindsight, but it is partially due to a weaker than expected economy (weather reduced first quarter GDP to a surprisingly negative 1.0%), partially due to nervous and yield hungry investors and (probably mostly) due to rate cuts in Europe and general global economic weakness. The low rates matter because they mean lower mortgage rates and a boost to housing as well as other areas of the economy and markets—see below. Also, the rates mean investors need to reconsider what has changed in 2014 and how that may impact the outlook going forward. Most economists feel the economy is rebounding dramatically and still expect higher rates by yearend, but the headwinds of early 2014 have dampened expectations for stocks, interest rates and the economy.

Another interesting phenomenon of 2014 is the explosion of mergers and acquisitions. There has been a big pick-up in bank loans to corporations since February and, along with enormous cash balances already sitting in their coffers and helped by the low interest rates, corporations have been increasingly on a buying binge this year. According to the company, Dealogic, U.S.-based companies have agreed to $640 billion in mergers and acquisitions this year. That is the highest amount ever recorded (numbers are only available back to 1995). M&A activity is at, or near, record levels in healthcare, telecommunications, technology, energy, food, utilities and finance. The only major sector not showing a big pickup from last year is real estate.



The increased M&A activity has positive implications for the markets and the economy because it shows a renewed willingness to take on risk and invest for growth. Banks are more willing to lend—using a type of lending that has been very limited since the financial crisis—and corporations have increased confidence in investing for future growth. The pickup in M&A activity implies corporations may soon start spending in other positive ways such as more hiring and capital spending; all which should have a snowball effect to promote more economic growth.

The M&A activity also brightens the prospects of the equity market. Each time a company chooses to acquire rather than build, it announces that equities remain attractively priced, that even after all the stock gains of past years, it is still cheaper to buy than to build. Price movements around these deals speak to both points. According to Dealogic, shares of acquired companies in recent deals have risen 18% on average the day after the deal is announced, more than historically. More remarkable, the shares of the acquirer also have risen, on average, by 4.6%. Historically, the shares of the acquirer have typically fallen on average 1.4% the day after the announcement. That they have risen implicitly reflects the market's judgment that the acquirer received a good price.

The drop in interest rates and pickup in mergers and acquisitions have been two positive influences on a stock market that has searched for meaning this year—even as it steadily increases to ever-higher record levels. Most analysts predicted higher stock prices for 2014, but they expected only single digit gains amid extreme volatility. Thus far, the low gains expectation is holding true but volatility has declined to confoundingly low levels. Other than the fact that the market "historically" has a 10% correction about every 12 months and it last corrected by that amount nearly three years ago, conditions continue to look favorable for stocks. Overall volatility has been low but the more aggressive, high P/E, high momentum stocks have experienced a severe correction—helping tame the animal spirits of the market. Valuations remain reasonable since the S&P is trading at 16.3 times (p/e) the $118 earnings estimate for 2014, according to Wells Fargo Advisors. One of the most positive factors for this market continues to be cautious and skeptical investors. A month ago, the doomsters were transfixed with the "sell in May" concept but the 2.1% gain in the S&P, once again, ***made them pay*** if they followed that advice.

Best regards,

Ted Ingraham

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Questions or comments?
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