American Heritage Financial

**October Update** **October 1, 2014**

# Uncomfortably Strong Markets

## When *Good* just doesn't feel *Right*

An enduring characteristic of this long bull market is that it ***should not be happening!*** The five and a half year bull-run has given validation to the old axiom that *"bull markets climb a wall of worry."* That axiom goes to the heart of market psychology—bull markets begin when investors are the most pessimistic and don't end until they become excessively optimistic. As long as investors are skeptical, there is still cash held aside which, assuming reasonable economic conditions, will ultimately move into the market and push prices higher.


Market psychology is identified as *investor sentiment* so it is important to look at sentiment, along with economic conditions, to gauge the health of this aging bull market. A third important consideration is valuation (which is still reasonable) but valuations can be extreme on both the top and the bottom of markets and extreme valuations are driven by investor sentiment and economic conditions.

Overall, investor sentiment remains at levels which suggest the bull market has further to run. According to the ***American Association of Individual Investors*** (AAII), the eight week average of investors bullish on the market is 42%. This is above the long-term bullish average of 39% but still not at the 45% to 50% level typical of market extremes. AAII primarily measures *individual* investors. ***Investors Intelligence*** (II) is a service which measures *professional* investor sentiment and one of their main indicators is the ration of bullish to bearish investors. When that ratio is over 3, it is considered extreme. This ratio has been over 3 for most of the past twelve months—an unusually long and consistent reading for this indicator. Of course markets have performed well in the past year—to the point we have to question the validity of that indicator, or the wisdom of professional investors!

These indicators provide statistical measures of investor sentiment. To these, we can add personal, anecdotal input from our long experience in dealing with markets and average investors (you!), Based on our observations, it seems most investors continue to be extremely cautious but not showing the extreme fear they had in the recent past. Most investors remain more focused on preserving their investment assets than they are stretching for return. Generally, it seems investors are taking a cautiously healthy approach to their portfolios. We also observe more sanity in the media. Although there are still plenty of frantic doom and gloom stories, it seems that many of the perma-bears and fear mongers have tamped down the hype.

The economy also continues to offer positive but mixed signals. There are more than enough positive and negative economic releases to justify either a bullish or bearish outlook. Recent reports on housing highlight the gloom. Existing home sales ***declined*** by 1.8% to 5.05 million units in August. Home prices also showed less improvement with the Case/Shiller price index gaining 6.7% compared to 8.0% the previous month. Still, home sales remain over the 5 million mark which is considered "healthy" and the price gain is still substantial and well above inflation. Likewise consumer confidence; it took an unexpected 7.4 point drop to 86 in September, showing less optimistic consumers—but the August reading was the highest recorded since October 2007, prior to the last recession. A respected measure of manufacturing activity, the Purchasing Managers Index, slipped to 60.5 in September versus estimates of 62.0 and down from 64.3 in August. Still, the index is well above the 50 reading that indicates expansion, as well as above its 10-year average of 55.8. Additionally, respondents to the PMI survey describe future activity as "strong" and "surging." Of course employment is a pillar of economic growth and it too has been ambiguous. The employment releases later this week will be closely watched.

As confusing as measurements of investor sentiment or the economy can be, the evidence favors a continuation of trends which are supportive for the stock market. Of course, a change in the Fed's interest rate policies (not likely but continually debated) could create stock market weakness. Additionally, global economic concerns, which are being exacerbated by the latest mid-East terror uprising, are wild cards which threaten to dampen the positive environment for U.S. financial markets.

Through the end of the third quarter the Dow is up 2.8% year-to-date while the S&P' 500 boasts a strong 6.7% gain so far this year. Returns in September were slightly negative (only the third month this year for negative results) while the third quarter's gains of 1.3% for the Dow and 0.6% for the S&P were the smallest quarterly gains this year. So the market, like many indicators, seems to be losing steam but remains moving in the right direction. Summing it all up: It looks like we will have to continue to experience these uncomfortably good conditions awhile longer!

**Best regards,**

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**Questions or comments?**

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