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Fearless Forecast 2014

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It's really embarrassing that it's been almost two months since I began speaking about my thoughts for 2014, yet I have been unable to mass distribute them. Shame on me! So far, to those folks who have read them, the comments and questions have been great. Keep them coming! I presented the forecast at the DMI meeting in Hingham MA yesterday and the attendees seemed to be very receptive and engaged. Thank you Ann Sexton for inviting me.

Regular readers of Street$marts and www.InvestForTomorrowBlog.comwon't be surprised at most of the forecast, but I did throw in a few new ones. As always, I had a lot of fun thinking about it and creating it, although it has no bearing on how we manage money for our clients.

Keep checking the blog as I am posting short-term comments during the week.

Stock market - After an epic 2013 for the stock market, what can we expect for an encore? To begin with, it's a mid-term election year and the second year of the president's term. Historically, that hasn't been so kind to investors with some of the largest declines in history as well as the end of some bear markets More recently, however, 2010 and 2006 were kind in the end, but volatile during the year.
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Looking at the big picture, there are no signs yet that the old and wrinkly bull market is ending anytime soon and my analysis still has upside projections to at least 17,000. We typically see a number of warning signs with various leads times, but only one of those are in place today and that may be corrected. Those warnings signs may set up later, but at this time, stocks remain the place to be on any dips. With that said, a routine, normal and healthy 5-10% bull market pullback should be seen during the first quarter that leads to more all-time highs later in the year.

On the index front, although the major US indices are highly correlated to each other, it's time for the Russell 2000 index of small caps to cede leadership to its large and mega cap cousins.

Turning to market sectors, technology is usually the group of choice each January and I continue to rank it as a market performer at best. I wouldn't run out and load up on this sector unless we saw a sizable market correction. As the economy and markets are late in the cycle, sectors like REITs and energy should provide solid relative performance, especially later in the year. Even perennially hated utilities should grab a bid. With my long-term positive stance on the dollar, it makes liking commodities more difficult but I do believe 2014 will reward buying the dip and selling the rip in this area.

On the wild side, biotech, pharma and healthcare should go parabolic during the first half of the year with the social media group also a possible candidate. Investors should keep in mind that parabolic rallies like the Dotcoms never, ever end by going sideways to rest. They end in disaster and ruin like we saw with crude oil in 2008.

It's rare for me to really hammer on sectors in the annual forecast, but after five years of strong outperformance, I am very negative on consumer discretionary and retail. I think 2014 will be the beginning of the end for this trade and similar to my stance on the small caps in general, I would pair this with a long in large or mega caps.

All in all, 2014 looks to be more of a digestive year, like 2011, 2004 and 1992 than a full fledged bull or bear year.

Volatility - There are many ways to discuss volatility, but the one that resonates well with me is that of a sine wave. It moves fully from one side all the way to the other, like a pendulum. While the market may not operate so neatly, low periods of vol are usually followed by higher periods of vol and vice versa Put another way; volatility compression leads to volatility expansion and volatility expansion leads to volatility compression.

2012 was largely a non volatile year, but 2013 was downright boring from a volatility standpoint. That can be traced to the Fed's QE Unlimited, which will be going away. So 2014 looks to be a whole lot more volatile than 2013 and probably 2012. If so, that will likely lead to 2015 being even more so as volatility normalizes.

In short, the investment play is to buy vol anytime it heads back to the low end of the range and sell it into spikes, which there should be many.

Long-term treasuries -I am so beyond sick and tired of hearing the pundits proclaim that "bonds are in a bubble". Statements like those absolutely wreak of ignorance. Bubbles are all about greed, clamoring and fear of missing the boat. They are formed in many stages with the final one being a total rush into the asset, primarily by the public. During the modern investing era, new products are launched to give greater access to Main Street. Your neighbors all own the asset and it's all over the media. There is nothing about bubbles that has pertained to the bond market and there never will be.

The secular bull market in bonds may have officially ended in mid 2012, but that doesn't mean and shouldn't mean that interest rates are heading higher in spike fashion. Clearly, over the coming years and decades, rates will normalize and head back to mid single digits unless the Fed makes a huge blunder like the Arthur Burns led Fed did in the 1970s.

I envision rates heading higher like we saw in the 1950s and 60s, slowly and gradually. Two steps up and one step back. We have already seen the 10 year note yield double as the first stage of the bear market began. I do not believe we will see anything close to a doubling anytime soon. Rather, as I first wrote about and publicized last November, bond market sentiment had become so negative that a rally in bond (decline in yields) wasn't too far off.

For 2014, the bond market should offer a solid risk/return profile, at least for the first half of the year as inflation remains nearly non existent, our economy slows and Europe deals with deflation, all against the backdrop of the Fed reducing its purchase of treasuries, for now. While the 3.50% to 4% area on the 10 year looks like a good intermediate-term target, it should not get there right away and investors should not become perma bears on bonds.

Corporate bonds - This group has seen a much stronger rally from their 2013 lows than their treasury cousins, but still behaves well and should see strength during the first half of 2014. Further down the risk spectrum, high yield bonds will continue their 2013 position of lagging and underperforming as the slightest ripple in the liquidity stream could upset this apple cart quickly.

Dollar - I am posting the exact comments as I did last year. Since THE bottom in 2008, the dollar has been in a trading range which I have stated is the beginning of a new, long-term secular bull market. Anyone who has bought strength or sold weakness has been punished and that's likely to continue for a while before the greenback finally breaks out above 90 on its way to target number one at 100 over the coming years.

I remain very bullish on the buck long-term and believe it can be bought into weakness for a long time, especially given the Fed's exit from QE, the ramping up of QE in Japan and the anticipated QE in Europe.

Gold - The yellow metal's secular bull market is not over and it will take another year or so to reinvigorate it. Gold saw twin price lows in the $1180 area that should lead to test targets of $1360, potentially $1440 with a chance of seeing north of $1500 before ultimately turning lower again. When the ECB hops on board the QE bandwagon, look for gold to break out above $2000 later this decade on its way to $2500 and higher.

Commodities - I continue to favor the agricultural and tropical commodities like wheat, corn, beans, sugar, coffee and cotton over the rest with corn being among the candidates for trade of the year. They have been under pressure for a while and weakness should be viewed favorably.

Inflation - I still feel like a broken record year after year after year after year, but I don't have many concerns about inflation, at least not until we get to the other side of the next recession. The Fed is trying to engineer some healthy inflation, very unsuccessfully I might add. $5 TRILLION in QE didn't produce any. Money velocity continues its downward spiral. Housing prices are stable. Wage growth is essentially zero and the banks are holding trillions of dollars on reserve with the Fed. This economy still has rolling whiffs of deflation, but nothing compared to the outright deflation in Europe and Japan.

Economy - As we start another new post financial crisis year, no one should be shocked to learn that the masses are positive on our economy yet again with projected GDP growth rates in the mid 3s. I think I have said it every year since the recovery began, but I will repeat it again. We are living through the typical post financial crisis recovery that teases and tantalizes on the upside and worries and frets on the downside. As with other post financial crisis recoveries around the globe, our economy will not return to an historical sense of normalcy until we get to the other side of the next recession.

Federal Reserve - It's a whole new ball game for the Fed in 2014; or is it as Janet Yellen takes over for one of my financial heroes, Ben S. Bernanke. I believe history will judge Bernanke as the single greatest Fed chair of all-time who should have been given hazard for having to sit and endure so many hours in front of the incompetents in Congress.

With all of the permanent voting members but Jeremy Stein in the dove camp, Richard Fisher and Charles Plosser will have their hawkish hands full this year dissenting on any vote that doesn't involve continued tapering. Keep in mind that Fisher, Plosser and Jeff Lacker were the three amigos who fought cutting rates and turning on the fire hoses during the summer of 2007 when the sub prime crisis was unfolding.

The Fed's multi year money printing program or QE will sadly come to an end in 2014 reaching my longstanding target of $5 trillion. I vividly remember throwing out that number almost four years ago on CNBC's Squawk Box and was almost laughed off the show. That one comment generated more emails than any other forecast I have made on TV.

As I have said for more than a year, I absolutely do not believe the Fed should even consider tapering until we get to the other side of the next recession, even though QE is having diminished results. It's the wrong thing to do at the wrong time. It was wrong in 1937 and that caused the Great Depression Part II. It was wrong in Japan more times than I can count over the past 25 years. The Fed should not stop QE.

Obviously, I am also 100% against even considering raising short-term interest rates at all in 2014 and likely much longer into the future. I am sure the three amigos of Plosser, Fisher and Lacker are foaming at the mouth in anticipation of higher rates, but if history has shown us anything about these bankers, they are usually dead wrong.

Unemployment - If you told me that the unemployment rate would fall towards 6.5% in 2013, I would have fallen on the floor and passed out from shock. The economy would have to have grown at 4% or more. Had I any inclination that the labor participation rate would fall to levels not seen since the mid 70s, I would have questioned the accuracy of the government's numbers. Both occurred last year and those trends should continue in 2014 creating a conundrum for the Fed and economists. The raw unemployment number is strong, but certainly not for the right reasons.

Japanese Yen - And I thought Bernanke's QE was the greatest financial experiment of all-time. Silly me! That title now belongs to the Bank of Japan. Not only is the yen in a confirmed bear market after a 15 year secular bull market, but the Bank of Japan remains committed to an historic money printing program that will dwarf that of the Bernanke Fed.

It's Abe, Abe and more Abe. The yen has much, much farther to fall and all rallies can be sold until further notice. The BoJ has learned from their mistakes of the past when they prematurely ended QE. Look for them to go overboard in hopes of ending what has essentially mounted to 25 years of economic malaise and rolling bouts of deflation.

As the world saw in the previous "greatest financial experiment of all-time" with leverage, mortgages, artificially low rates, the alphabet soup of exotic financial products that no one understood and on and on, they rarely end well. Long-term, I have serious doubts, but for now...

Japan - If the Bank of Japan is going to print baby print, it's very difficult not to be positive on the Nikkei for 2014. If their economy doesn't respond quick enough or if their markets fall too fast, the BoJ will just crank it up a notch until it works. I remember arguing on TV that investors should never fight with the guy who owns the printing press and that certainly holds true in Japan. The Nikkei should be a leading developed market index in 2014.

Europe - Euro zone problems are far from over, but have taken a breather over the past year. ECB chief Mario Draghi's jawboning to save the Euro currency has certainly worked in the short-term with sovereign bond yields declining precipitously in the PIIGS countries. At the same time, however, austerity is causing all sorts of economic issues with deflation being chief among them. If that genie gets out of the bottle in meaningful way, look out below!

Additionally, all is not well beneath the surface as a major, major crisis looms in France possibly late in 2014, 2015 or even into early 2016. Germany was certainly not happy about the bailouts in Greece and Cyprus or the ECB programs designed to save Spain and Italy. The big test comes when the Germans have to figure out how to save a country that is too big to fail and too big to save. I smell a constitutional battle brewing to allow the ECB to outright print money.

Emerging Markets - Coming off an horrific 2013, emerging markets begin the new year on their heels with continued unrest, currency dilemmas and slowing growth. I will go out on a limb and forecast that the sector sees a significant low in the first half of 2014 and outright leadership and strength during the second half of the year led by the secondary countries. The macro trade would be owning a broad emerging markets ETF against a short in the US small caps.

To Your Financial Success,

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