Andresen & Associates Inc.

P.O. Box 1434 Salinas, CA 93902-1434
Phone: (831) 758-1575 or 1-800-345-9644
Fax: (831) 758-1576
PETE@ANDRESENASSOC.COM
WWW.ANDRESENASSOC.COM

01/22/2014	Value	YTD %
Dow Jones Industrial Avg	16414	-1 %
Vanguard 500 Index	170.05	-.2 %
Vanguard Total Bond Index	10.64	.9%

January 22, 2014

2014 Financial Markets

Happy Asian New Year! This is the year of the Horse. As is traditional for Andresen & Associates, we are sending you money to express our wish that you have a year of health, joy, and prosperity.

This year's money is a dinara note from the now-defunct nation of Yugoslavia. If you post this note on your refrigerator or another viewable location, it will help you remember that history may take unexpected paths. When Yugoslavia was a thriving country, almost nobody predicted or expected its demise. Also your money is for 500000 dinar. In its final years, Yugoslavia endured incredible inflation when its currency became worthless as time passed.

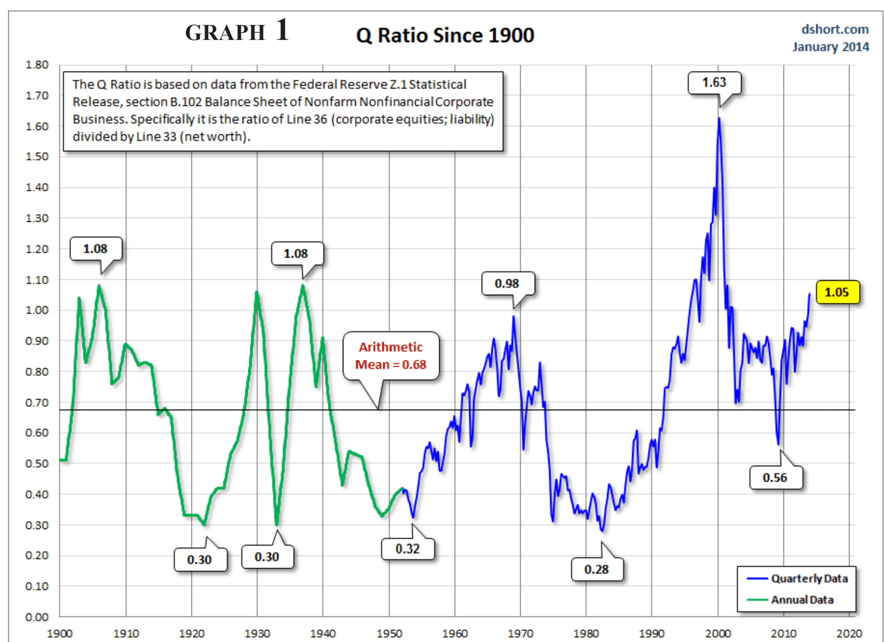
It's wise to ponder this Yugoslavian dinara note because as we enter 2014, the statistics are telling us a very compelling and unusual story. From a valuation standpoint, stock markets are profoundly overvalued by historical standards. In 2013, the stock markets went from "overvalued" to "really overvalued," at least according to valuation statistics. Yet the stock market continues to go up.

There are four valuation statistics worthy of your attention. They all employ different statistical details to measure the same thing: what is the price you are paying for a dollar of earnings relative to what people paid in the past?

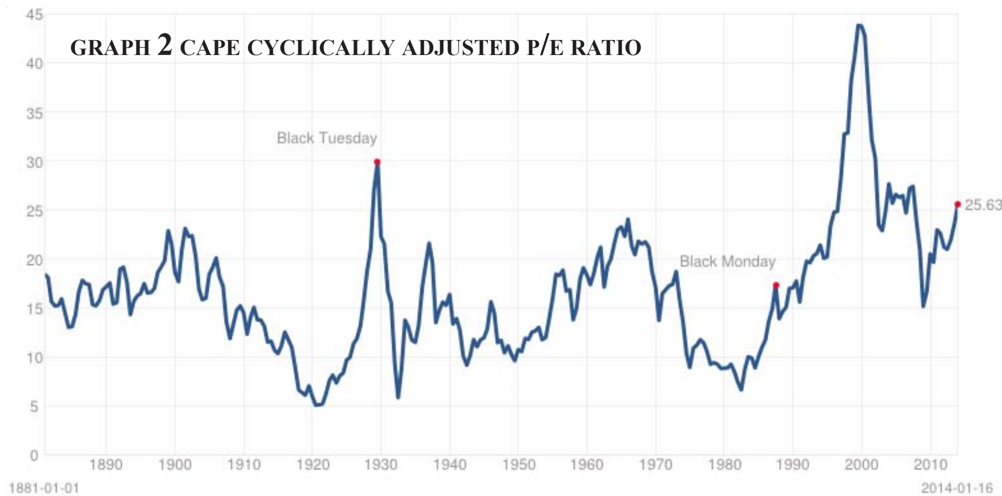
All four statistics are historically very well correlated to stock market returns. In other words, they had a very good predictive effect in the past. They work.

All four statistics also are agonizingly long-term in their predictive value. In other words, what they predict may take YEARS to happen. However, when the predicted event DOES take place, stock market valuations tend to go to the place predicted. Most investors don't have the patience to wait long enough. Hopefully, we do.

The first graph (GRAPH 1) measures the Q statistic, or "Tobin's Q." This was invented by James Tobin, winner of the 1981 Nobel Prize in economics. The Q statistic measures the valuation of the stock market relative to the replacement cost of the assets of the corporations in the stock market. You can see that the Q ratio is now telling us that stock market valuations are about as high as they have ever been except for the tech bubble in the year 2000. As you look at this graph, high is dangerous/overvalued, while low is safer/bargain.



Our second graph (GRAPH 2) measures the CAPE, or "Cyclically Adjusted Price Earnings" ratio. This statistic was invented by Robert Shiller of Yale University, who also won the Nobel Prize in economics. It is created by dividing price by the average of inflation-adjusted earnings for the past decade. Once again, high is dangerous/overvalued, while low is safer/bargain. You can see that the CAPE is relatively high. Currently it is higher than 29 of the 35 market tops since the year 1900.



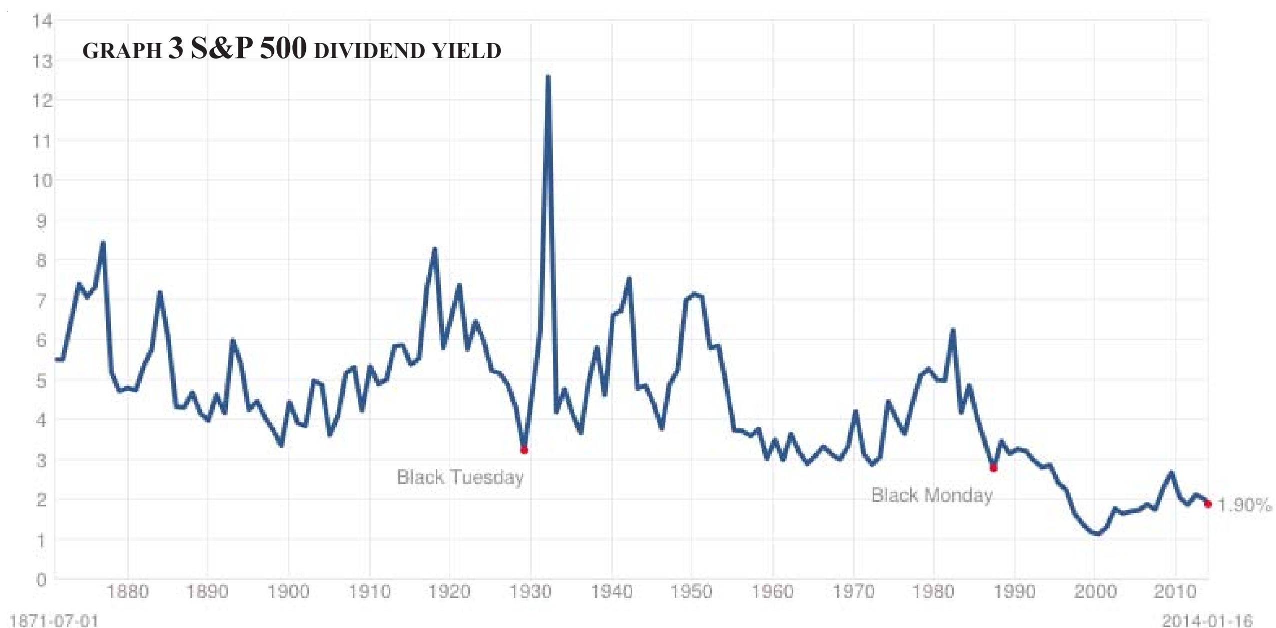
GRAPH 2 CAPE CYCLICALLY ADJUSTED P/E RATIO

Our third graph (GRAPH 3) is that of the dividend yield of the Standard and Poor's 500. Personally, I think that the data is a bit skewed by the reality that ALL interest rates are currently low. The dividend yield statistic has a predictive effect of only about 60%. In *this* graph, high is safe/bargain, while low is dangerous/overvalued. The dividend yield of the Standard and Poor's 500 is now lower than it was in 30 of the 35 market tops since 1900.

If you've been reading my comments for a long time, you know that I hang my professional hat on the fourth statistic, the Value Line Manager's Appreciation Potential (VLMAP), which measures the expectations of the analysts of the Value Line Corporation. I've gone on like a broken record about how low it is currently with a reading of 30%. With the VLMAP, low is dangerous/overvalued. I've trotted out all of these other statistics to validate my concerns that the stock market is profoundly overvalued.

We also face the gigantic caveat that ALL of these statistic have only a long-term predictive effect. In other words, the stock market could keep going up for years from here. That's why, despite my concerns, most of us are still invested in the stock market in some way. However, we also know from history that at some point the stock market will swing to an undervalued state. That means that we face a profound possibility that the stock market will drop all the way back to 2011/2012 levels. That's why I am keeping you only partially invested.

We also face another caveat: while valuation statistics are shrieking that the stock market is very overvalued, economic statistics point to a gradually healing economy. Real estate is recovering nicely. Interest rates are historically low, and I'm not seeing looming potential events which could cause them to spike.



GRAPH 3 S&P 500 DIVIDEND YIELD

If there's a 2008-level financial panic out there, I'm not seeing the trigger. But a genuine Black Swan event is possible.

If valuation statistics are saying that the stock market is overvalued, but the economic statistics appear to be relatively healthy, we conclude that the most probable downturn will be a 1987-style valuation crash, moving quickly and healing quickly, within a year or two. I'm not seeing the data to suggest that a decade-long economic sinkhole lies ahead.

What are our choices? Currently we are maintaining broadly-diversified portfolios and choosing to lag the stock market's rise. Could we be choosing any other path?

I'm reluctant to flirt with more stock market exposure or expand into lower credit quality in our bond allocation because of the "What If": what if we DO have a 2008-style financial panic? I'm concerned that we'll see a 2008-style correlation rise, when all asset types moved together and diversification was less effective. At the moment, I'm keeping our bond maturities relatively defensive. Although we hold positions in bond mutual funds which hold "junk bonds", those holdings are relatively limited. Yes, I want yield as badly as the next investor but I'm seeking to avoid any surprises. One lesson from 2008 is that we don't know which investments will go down, we don't really know how mutual fund portfolios will behave, and we don't know how any potential downturn will spread. So we're playing relatively safe in the bond markets as well.

Why shouldn't we invest more in gold? We already hold gold in several diversified mutual funds, but why not buy it outright? After all, gold is a defensive play, right?

A new study by Claude Erb indicates that gold correlates 78% with interest rates. The combination of these two variables may represent a "fear trade" a measure of insecurity. If a downturn in the stock market DOES happen, and interest rates aren't involved, we can thus expect interest rates to drop, due to a flight to quality, and a short-term increase to take place in the price of gold.

But so long as fear in the stock market continues to recede, and interest rates continue to creep upwards, we aren't likely to see gold make any substantial price gains. For the time being, then, I'm willing to let the mutual fund managers make the call on gold. I'm happy to watch the price decline, for now.

All this suggests the following possible most likely scenario for 2014:

1. The stock market will continue to rise, and our more-diversified portfolios will continue to lag that rise, perhaps even through 2014.
2. I will very gradually invest our cash into short-term bond funds or short-term CD's to capture whatever miniscule gains are available. This is not a long-term solution, but until bargains appear we have to garner whatever crumbs are available.
3. At some point, perhaps in 2014, we expect that the stock market will decline, probably unexpectedly.
4. We DON'T expect this to spread into a world-wide economic malaise, at least with the statistics we are seeing now.
5. We will then gradually buy INTO the stock market when the statistics indicate that bargains exist, with up to 25% of your portfolio being allocated to new buys. This won't be perfect, and we're likely to occasionally experience short term losses with these new holdings. We might harvest some tax losses if that occurs. In the long term, history tells us that investing when bargains are available will produce above-average returns.

Meanwhile, our primary emphasis is to stay diversified, stay reasonably safe, and wait it out. It's a waiting game. ■