Outlook 2014: Of Equities and the Economy

Much like the revelers in Times Square on New Year's Eve, U.S. stock investors had reason to celebrate in 2013.

In terms of GDP growth, few economists predict a boom in 2014. Instead, most foresee an economy that will perform better this year than it has for the past several years.

The stock market, as measured by the S&P 500, posted an annual gain of nearly 30% -- its best relative performance versus bonds on record and its biggest percentage gain in 16 years.[1,2] All 10 of the index's sectors also gained in price, led by the Consumer Discretionary (+37.9%), Health Care (+36.8%), and Industrials (+34.0%) sectors.[3]

The current rally -- part and parcel of the bull market in stocks that celebrates its fifth birthday in March 2014 -- lifted all major U.S. stock indexes to record or near-record highs.[2,4]

- The S&P 500 -- up 29.6%, its best annual performance since 1997.
- The Dow Jones Industrial Average -- up 26.5%, its best annual performance since 1995.
- The Nasdaq -- up 38.3%, its best year since 2009.
- The Russell 2000 -- up 37%, its best year since 2003.

In addition, in a sign of improving investor sentiment, the CBOE Volatility Index, otherwise known as the "fear index," fell 23.9% for the year, the biggest annual drop since 2009.[2]

An Economy Gaining Steam

A confluence of factors contributed to strong stock performance in 2013, chief among them unprecedented stimulus from the Federal Reserve in the form of its bond-buying program and an improving economy that, by many key indicators, appears to be gaining steam. In November, unemployment fell to 7%, while consumer spending rose 2.6% on an inflation-adjusted basis from a year earlier. Home prices have risen 14.8% since 2010, and household net worth is rebounding, albeit slowly, since the Great Recession.[5]

Other positive factors include growing U.S. energy production, a revival in the manufacturing sector, and better conditions for U.S. exports as global economies also strengthen.

Heading into 2014, economists are optimistic that the economy will continue to improve in several key areas:[5]

- Household wealth. Perhaps influenced by impressive gains in the stock market, government data showed solid increases in consumer spending in the fall of 2013. Housing starts increased by 20% over the previous year; home appliance manufacturers predict that their 2013 sales will finish 9% ahead of 2012 sales; and U.S. auto sales surged at their strongest pace in more than six years.
- Business investment. If consumer demand/spending picks up, business spending should follow.
- Fewer legislative obstacles. Automatic government spending cuts, or so-called sequestration, coupled with tax hikes significantly curtailed economic growth in 2013. The new budget deal approved by Congress in December should ease government headwinds for the next two years, allowing the underlying strength in the private sector to spur economic growth.

Growth and Investment Forecasts

In terms of GDP growth, few economists predict a boom in 2014. Instead, most foresee an economy that will perform better this year than it has for the past several years. For its part, the Federal Reserve (which announced in December that it would begin tapering its aggressive bond-buying program due to improvements in the economy) forecasts GDP growth between 2.8% and 3.2% in 2014.[5]

In his final news conference as Federal Reserve chairman, Ben Bernanke stated that the recovery remains "far from complete," but if the economy continued to improve as expected, the bond purchases likely would continue to be cut at a "measured pace" throughout 2014. The Fed also indicated that it will keep short-term interest rates near zero for 2014 and beyond.[6]

What lies ahead for stocks in 2014 -- or put another way, how long can this bull run? According to Sam Stovall, chief equity strategist at S&P Capital IQ, "good years tend to follow great years." And history shows that, on average, the S&P 500 has risen 10% in the year following a year in which the index has advanced more than 20% (versus an average gain of 8.7% for all years since 1945) and it has increased in price nearly 80% of the time versus the more normal 70%.[3]

Other analysts tend to echo Stovall's outlook, indicating that 2014 will offer up another round of gains for U.S. stocks, in the range of 8% to 10%, including dividends. That forecast is based on the assumption that economic and corporate underpinnings will continue to strengthen and that all-important investor sentiment will continue to improve.[7]

Sources:

[1]*Financial Planning*, "In $3.7 Trillion Year, Stocks Beat Bonds by Most Ever," December 31, 2013.

[2]Reuters, "Wall St. ends best year since 1990s with moderate gains," December 31, 2013.

[3]S&P Capital IQ, Global Equity Research, "Performance Probabilities," December 20, 2013.

[4]*USA Today*, "Investors cheer record-setting year on Wall St.," December 31, 2013.

[5]*The Wall Street Journal*, "Hopeful Signs for U.S. Economy in 2014," January 1, 2014.

[6]CNBC, "Fed to taper bond buying by $10 billion a month," December 18, 2013.

[7]*Kiplinger's Personal Finance*, "Kiplinger's 2014 Stock Market Outlook: More Gains," January 2014.