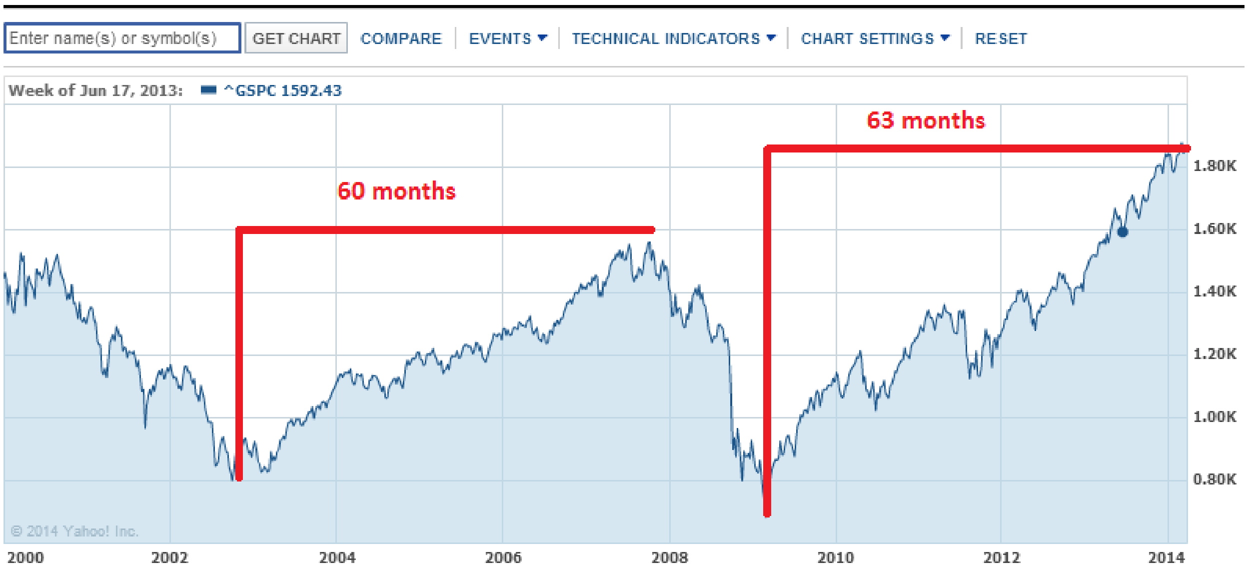
June 2014

Market Update

We are almost half way through 2014 and it a great time to check in on the markets. As I write, the S&P 500 is a hair from its all time high and the bull market is now 63 months old. We have already exceeded the length of the last bull market that lasted from late September 2002 to October 2007. Investors with any sense of market history should be starting to wonder how much longer this cycle will last. In times like these it is important to separate your emotions from markets and try to look at them objectively.



The last 14 years of the S&P 500. This cycle has already exceeded the length and returns of the last one. Source: Yahoo Finance!

Almost every category of bonds lost money in 2013 and at the start of this year, virtually everyone thought more money would rotate into stocks and out of bonds. With hindsight it is easy to see that we were at an extreme in sentiment and that it was a good time to bet on hated bonds.

Below is a year to date performance chart of the Nikkei 225 (Japan in Blue), S&P 500 (Red), Russell 2000 (Small Companies in Dark Green), and 20 + Year US Government Bonds (Light Green). As you can see many of the trends of 2013 have reversed on investors in 2014. Japanese stocks were the big winners of 2013 and returned almost 50%. In 2014, they were down over 15% by April. The primary cause of their suffering was investors fearing a national sales tax hike from 5% to 8% in April would slow down their economy.[1] It is still too early to tell if the selling was justified. Japanese stocks had a very nice recovery for the second half of May. One of the many big losers of 2013 was long term US government bonds. As

[1] http://www.nytimes.com/2014/05/30/business/international/japanese-sales-fall-after-tax-increase.html?_r=0

you can see below, they are now beating the returns of U.S. stocks. 2013 saw U.S. Small Companies outperform large companies and this year has seen a reversal of that trend.

Year to date returns of the Nikkei 225, US Large Caps, US Small Caps, and US Long Bonds. Source: Yahoo Finance

The Russell 3000 is a broad index of U.S. Stocks. Below you can see how the largest stocks in the index have faired best and how since 3-14-14, the smaller the company the worse it has done. Investors seem to believe that the giant companies are the place to be this year after the relative outperformance of small companies since the bottom in March of 2009.

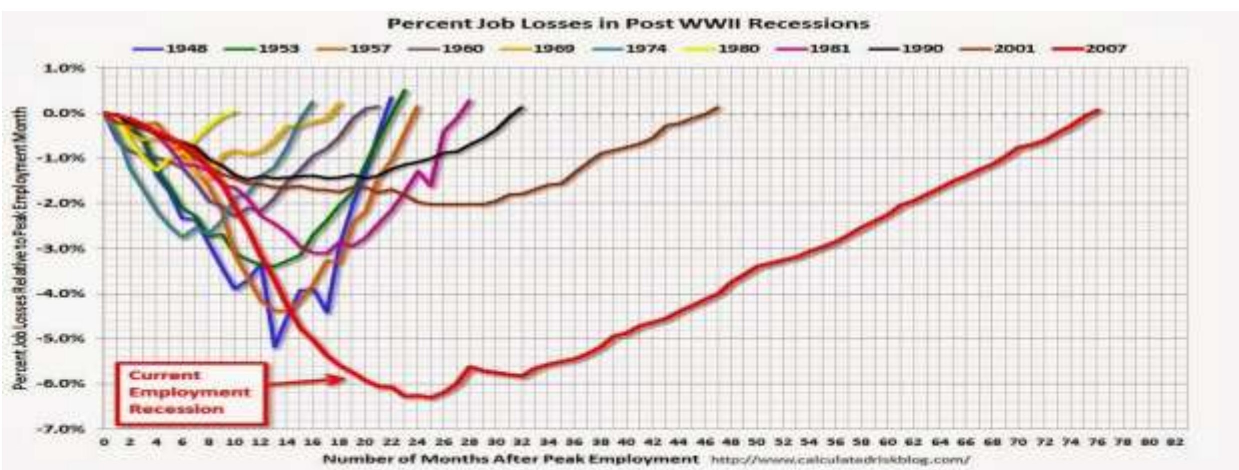
Source: Pension Partners

Although U.S. stocks have had an epic run from the March of 2009 low, I don't see their demise *immediately* ahead of us. I think we are likely in the eighth inning of this cycle and further gains are ahead after a correction. It is also extremely improbable for the U.S. stock market to not make a major high at any point in the next two years. Once the major high is made, investors should expect the next 20-40% bear market.

One of the reasons that I think we are in the 8th inning is that towards the end of a cycle, you often see energy stocks outperform consumer discretionary stocks (cars, houses, purses, stuff you don't need to live). Below is the XLE ETF that represents the energy sector (blue) compared to the XLY ETF that represents the consumer discretionary sector (red). As you can see there is about a 10% difference in their performance year to date.

The XLE vs. XLY, year to date. Source: Yahoo Finance

There are many positives to the U.S. economy. On June 6, 2014 we have finally recovered the jobs lost during the 08-09 recession. As you can see this recovery took a lot longer than prior recessions.



The job recovery was painfully long during this recovery. Source: Calculated Risk

I also like to watch the NYSE Advanced Decline line for clues for when a major top is going to occurr. It usually turns down 2-6 months before the actual stock market turns. It is very close to registering an all time high and does not have me worried at the present time.

The NYSE Advance-Decline Line still looks very healthy. Source: StockCharts.com

The last market I want to touch on in this report is the gold market. Gold peaked at $1927.40 per ounce on 9/6/2011 and is now in its 33rd month of correcting. Gold is often bought as a hedge against bad things happening to the financial system. With the recent euphoria in stocks, investors have not felt a need to bid up the price of gold.


The almost three year gold bear market. Source: Thinkorswim

For the last year, gold has been an increadibly boring asset class to watch as it has been in a trading range from roughly $1200 to $1420. I don't know if the June 28, 2013 low of $1178.60 is going to hold. 33 months is right in the range for a bear market to end from a time stand point and it does appear that gold has been building a base. It could be forming a head and shoulders bottoming pattern here or it could have one more last washout before it is ready to go higher. Either way, it appears to me that there is much more upside from here than downside. Hedgefund manager, Eric Sprott, recently wrote a bullish piece on why he thinks gold is a good buy here:

http://www.sprottglobal.com/markets-at-a-glance/maag-article/?id=9599

Have an excellent month.

Domestique Capital LLC
1413 E 15th St
Plano, TX 75074
214.556.8904 phone
www.domestiquecap.com