MAINSTAY CAPITAL MANAGEMENT LLC

Is The Past Prologue?

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A particularly scary story going around financial circles right now is that of a chart showing the recent Dow Jones Industrial Average tracing an almost parallel course to its path in 1928-29 (just before the 1929 stock market crash and start of the Great Depression).

The notoriety of the 1929-parallels chart probably says more about the fragile psyches of investors than anything else. It is also worth noting that some of the big proponents of the parallel are hedge fund managers that are shorting the market and publishers looking for a headline grabbing topic.

So where do we stand? First, we believe economic growth will be accelerating this year. We do not believe we are heading towards a recession, which would usually precede a major bear market. We also believe we have come a long way in the past 85 years regarding the policy and structural mistakes that ushered in the Great Depression.

In our January 8th communication, I called for a 7% to 12% pullback in the first half of 2014. The recent pullback in the Dow Jones Industrial Average just barely met this criterion with a 7.4% pullback, peak to trough. The Russell 2000 (small cap stock index) decline fell further into the range of our forecast with a decline of 8.4%.

Could we still get another pullback this year, with even more magnitude? Of course, but we believe we are still in a secular bull market for stocks, not on a path to the next Great Depression.

Likewise, as we have discussed several times now, we believe we have entered a secular bear market for bonds (interest rate sensitive bonds, such as Treasuries) that will last for years. Interest rates will fall from time to time as in the first two months of this year, but the long-term direction for interest rates is higher, which will send Treasury bond prices lower.

Our strategy continues to be positive on stocks, although we expect a far more modest return over the next year or two when compared to 2013. We also expect the volatility of the first two months of this year to be a sign of more to come. Anticipation of more volatility caused us to reduce leverage and risk in portfolios in late December and January, after a "risk-on" strategy to make the most of last year's stock market gains. Indeed, our more aggressive portfolios gained over 47% in 2013.

In a rising interest rate environment, there are limited options to diversify portfolios in fixed income that offer positive returns. However, there are long/short funds, market neutral funds, and other strategies in IRA and non-retirement accounts that provide opportunities to diversify our portfolios and hedge risk. In 401(k) accounts, we can utilize the stable value fund to mitigate risk - an investment option we know will have a positive return. See my February Dow Jones *MarketWatch* column, "Tame the indexes with a market-neutral approach".

No, we don't think the next 1929 stock market crash is on the horizon. But, we do believe more caution is warranted in portfolios after the heady gains we enjoyed in 2013.

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