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Big and Quick and Headlong

By VITO J. RACANELLI

The fast-moving, upbeat, year-end stock market is a marvel. But will it maintain its momentum deep into 2014?

Vital Signs

Though many Wall Street participants took a holiday hiatus, stocks still managed a string of record closes and a win last week. Prices eased slightly on Friday, but the major indexes gained over 1% in a short trading week.

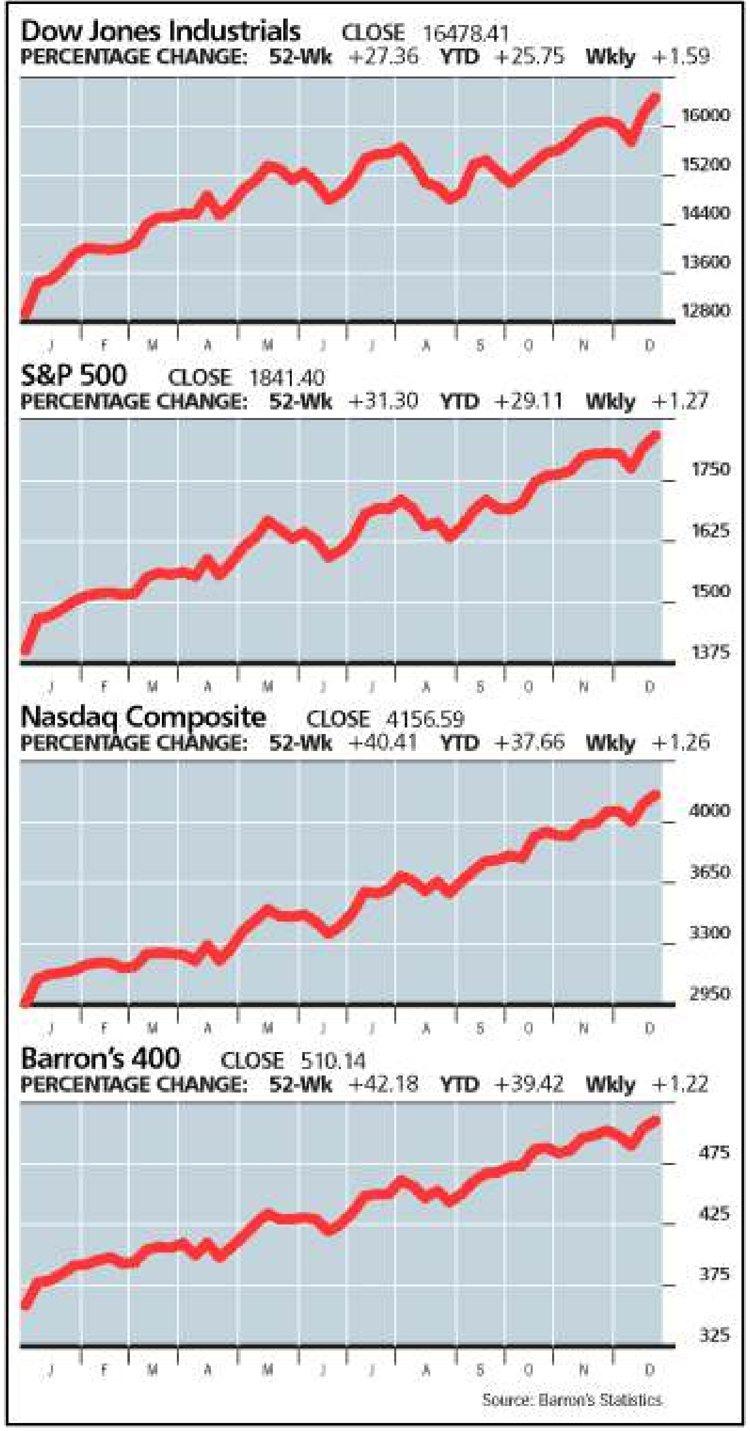
Prior to Friday, the stock market had closed at all-time highs for six consecutive sessions. There were few players on the scene, low volumes, little in the way of economic data, and corporate news flow was light, but "stocks are acting like they are in a race to the finish line," says Fred Dickson, chief investment strategist at D.A. Davidson. "It was a textbook Santa Claus rally week."

The Dow Jones Industrial Average advanced 1.6% or 257 points, to 16,478.41. Friday, the average eased slightly, but it remains up 26% on the year. The Standard & Poor's 500 index rose 1.3% or 23 points to 1841.40. The total return for the S&P 500 index as of Friday was 31.9%, a number that, if confirmed at year end, would make 2013 the thirteenth best year in the history of the index, according to Bespoke Investment Group. The Nasdaq Composite index picked up 1.3% or 52 points, to 4156.59.

To some extent last week, economic sentiment might have been boosted by what's turning out to be a good Christmas retail season, says Douglas Coté, chief market strategist at ING U.S. Investment Management. There was heavy media coverage of overwhelmed package-delivery companies, a "problem" that suggests the economy is busy, Coté says. Additionally, the stock market seemed to take in stride the move in the 10-year Treasury bond yield over the psychologically important 3% level, he adds.

The market's fourth-quarter "gangbusters" 10% rise is capping off a powerful year that could potentially draw back individual investors, who have missed most of the rally from 2009 lows, Coté says. Expectations that stock prices will rise over the next six months jumped 7.6 percentage points to 55.1%, the highest in three years, according to the American Association of Individual Investors' latest survey. (More on this below.)

From a technical point of view, says Dickson, the rally looks stretched, based on a number of metrics. The thrust has been big and quick and "usually what happens is a pause or small pullback short term," he says, after this kind of move.



AS THE CALENDAR GRINDS inexorably forward, it's time for Trader's take on 2014. Whither U.S. equities? Up again, probably, and if so, perhaps by a lot.

Early in December, with the market up over 25%, many strategists predicted a comparatively tepid 10% rise in 2014. Some now find their year-end targets already being approached. Our view is that the bull either charges another 15% to 20% or it stops, and the weight of evidence is against the bears.

Our sanguinity derives more from seeing few fundamental risks than from new positive catalysts. The market's default mode is up and the inertia of 2013's big rise will be hard to stop short of an improbable recession or unpredictable shock.

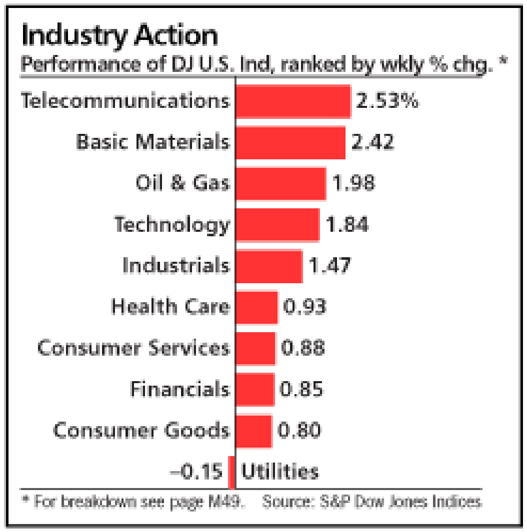
To paraphrase a former secretary of defense, let's begin with the "known knowns." The relatively buoyant consumer and housing market look to stay that way. A deleveraged Corporate America is flush with cash, some $1.8 trillion worth. Stock buybacks and dividends are growing at record levels. Earnings-per-share growth of 5% to 7% next year isn't fabulous, but good enough when interest rates and inflation are so low.

U.S. mutual-fund flows will continue to exit from fixed-income funds and move toward equities. Other pots of money could find their way into stocks. As JPMorgan Funds' chief global strategist, David Kelly, points out, "There's $10 trillion dollars sitting in cash accounts, and that's earning nothing." Trader anticipates individual investors will warm up to stocks next year. That said, a return en masse could be a bearish longer-term sign. This bull is already closer to the end than the beginning.

We see increased confidence levels, both among investors and corporate honchos. Long-dormant capital spending and mergers-and-acquisitions should pick up.

A 28% collapse in gold prices this year and the expansion in the market's forward price/earnings ratio to about 15 times from 13 times a year ago both indicate that confidence has finally recovered from the financial crisis. The P/E ratio is neither cheap nor expensive but rather right on the long-term average. Few strategists look for P/E expansion, but given artificially low rates and inflation, there's some possibility for a P/E rise to 16 or even 17.

There is a strong likelihood of synchronous global growth next year, and—even if the Federal Reserve has said it will begin tapering its bond-buying program next month—monetary policy around the world will remain mostly accommodative for 2014.



One factor that doesn't get enough ink is something few would have thought possible five years ago: The U.S. is now the world's biggest energy producer again. That means lower energy costs for American industry, making it more competitive, and fostering job growth there and in adjacent fields.

The main caveats to our view fall into the category of known unknowns. The Fed will taper, says Brian Jacobsen, chief portfolio strategist at Wells Fargo Funds Management, but will new chair Janet Yellen be able to execute the maneuver to investor satisfaction? "The accommodation must be relative to investor expectations," he adds.

That's not an easy task. "You've got two generations of investors who haven't seen a bad bond market," says John Stoltzfus, chief investment strategist at Oppenheimer Asset Management. Should interest rates back up faster and higher than anticipated, that could shake up both bond and stock markets, he adds. It could bring a correction—something equity markets haven't seen in over 18 months—or worse.

There also remains the risk of a reprise of political dysfunction in Washington, D. C. (For more on this, see **D.C. Current**.) Human nature being what it is, wars and pestilence and the like are ever-present and can derail markets. The biggest dangers lurk amid the unknown unknowns. Black swans are not predictable by anyone, though many try.

In the final analysis, investors must weigh their views of the alternative asset classes. Bonds or cash to outperform stocks? Not likely. Gold or commodities? Doubtful. Real Estate? Perhaps. For equities, the investment theme of "What's the alternative?" isn't intellectually satisfying but bears currently can't counter it.

THE NEW PLAYSTATION 4 and Xbox One videogame consoles from **Sony** (ticker: SNE) and **Microsoft** (MSFT), respectively, have been flying off retailer shelves this holiday season, sparking hopes for a good year for videogame makers, like **Electronic Arts** (EA), among others. Many companies have suffered in recent years from the secular move by gamers to playing cheaper games on smartphones or tablets, or online, rather than on consoles.

Over the past 18 months, shares of the Redwood City, Calif.-based maker of popular games such as FIFA and *Battlefield 4* have more than doubled from decade lows of $11 to Friday's close of $24. Lately, results have improved at EA, but none of it comes from sales growth. After such a run, the share price might be discounting more hope than operational improvements likely in 2014.

In the March 31-ended 2013 fiscal year, EA posted a profit of 31 cents per share, up from 23 cents in fiscal 2012 and a big improvement on the 84-cent loss in 2011. EA bulls and the company like to use certain non-generally accepted accounting principle figures that exclude costs like stock-based compensation, arguing it better reflects the underlying business. EA recently raised non-GAAP EPS guidance for fiscal 2014 to $1.25 from $1.20, versus a non-GAAP 82 cents in fiscal 2013. That looks like a 50% jump.

However, now that the EA trades at a rich P/E ratio of 19, investors should take a closer look at both non-GAAP and GAAP numbers. Bottom-line results have improved but from cost and other reductions, not from a better top line. That's fine for now, but eventually investor concerns will arise if, as is likely, EA sales don't rebound.

EA revenue has effectively been flat since 2007, even as the company went on a $2 billion buying splurge of smaller, fast- growing game makers in an effort to enter social and mobile gaming. There's little to show for that. Non-GAAP net revenue at Sept. 30 was down over 10% on a trailing 12-month basis to $3.76 billion.

Instead, improved EPS has come mainly from lower spending on marketing and research and development. Another factor is lower contingent acquisition-related costs, notes David Trainer, president of New Constructs. Because certain acquired companies didn't perform as well as expected, he adds, EA was able to boost operating earnings in fiscal 2013 through smaller acquisition-related payouts. Specifically, in fiscal 2013, reductions in those three costs totaled more than the entire $121 million of operating income. In the six months ended Sept. 30, 2013, such reductions represented $103 million of the $130 million improvement in operating results. In highly competitive gaming, it's hard to see how long marketing and R&D can be cut without hurting sales.

Maybe that's why EA games, apart from FIFA, haven't been doing that well. The much-awaited *Battlefield 4*, out last October and accounting for a significant chunk of revenue, has run into so many glitches that earlier this month that EA said its Digital Illusions Creative Entertainment unit was "devoting 100% of its development resources to fixing issues at *Battlefield 4*."

EA's relaunch of SimCity last March was plagued by similar problems, notes Daniel Ernst, a Hudson Square Research analyst.

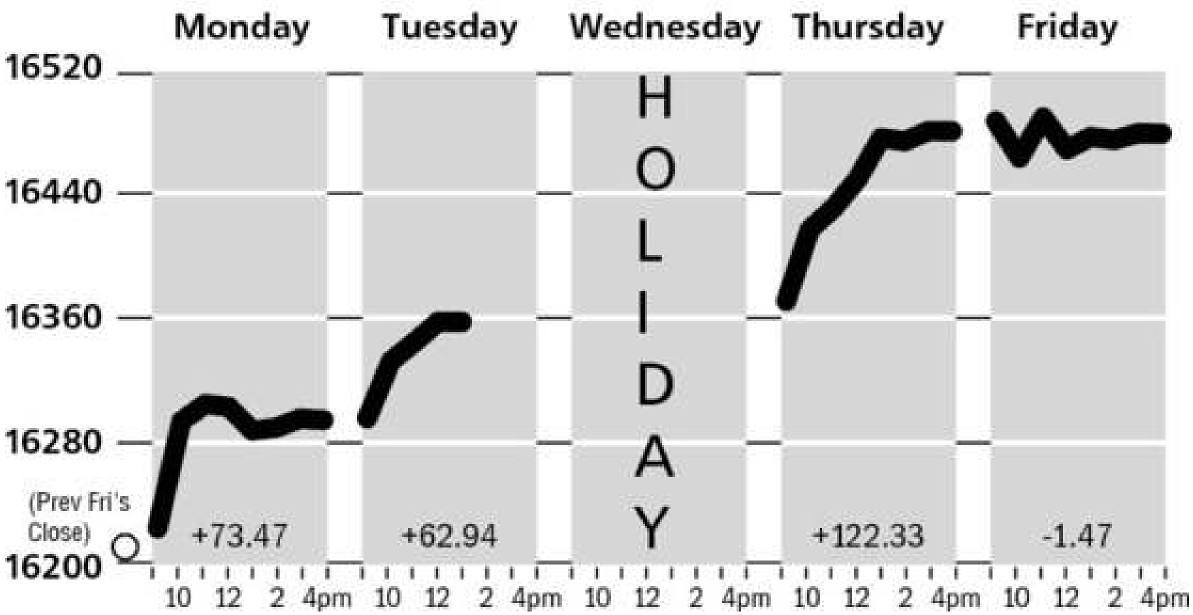
In an e-mailed response, EA Chief Financial Officer Blake Jorgensen says marketing and R&D costs have been "well above" rivals for years, leaving "a large opportunity to reduce these costs without hurting revenues. We've only just started our journey into the plus-20% operating margins." EA declined to comment on unconfirmed reports out of China Friday that said the government had banned *Battlefield 4*.

EA's revenue growth has slowed markedly from an average 22% before 2003 to 5% since. EPS has been inconsistent at best over the past decade. At the peak of the previous console cycle, about eight years ago, Ernst adds, EA's operating margins were running at 30%. In the past 10 years they've averaged 8%.

What kind of multiple do investors put on a company with little or no sales growth? We guess less than the market P/E, not significantly more, as it is now.

FIVE-DAY DOW COMPOSITE

Holiday Rally: Santa brought six consecutive record closes on the Dow before Friday's slight loss. It's up 26% this year and all Dow stocks rose last week.



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