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10 for '14

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Each December we publish a list of investment themes that we feel are critical to the coming year.

Here are our themes for 2014:

1) **The US stock market continues its bull run.**

Rationale: We continue to believe that the US stock market may be in the midst of one of the biggest bull markets of our careers. It seems odd to us that investors seem to disregard the existence of a stock market cycle despite that the rotations and leadership in the US market have followed the normal historical pattern. Indicators that have historically been reliable forecasters of bear markets still seem quite benign. The yield curve remains positively sloped, valuation appears normal for this point in the cycle, and sentiment remains very attractive according to our models. Although stocks in 2014 might not provide returns as high as those during 2013, the US stock market's return might be above average in 2014.

2) **Japan outperforms emerging markets – The Currency Wars Begin.**

Rationale: As of the date of this report, the Nikkei 225's YTD total return of roughly 53% has far outpaced the MSCI Emerging Market's -1%. We think Japan is likely to outperform emerging markets again during 2014. The aftershocks of the global credit bubble (i.e., massive global overcapacity and falling productivity in the emerging markets) could result in currency wars. Our bullishness on Japan in 2013 was based on a falling Yen, and we think Japan may be the first country to recognize that countries must compete on price (i.e., depreciating currency) in the absence of improving demographics and productivity. Although consensus return expectations for Japan do not seem conservative, we still believe that investors have yet to fully recognize the significant structural headwinds facing the emerging markets.

3) **European small cap stocks lead global equity performance.**

Rationale: The European economic recovery has lagged the US during this cycle, which is typical by historical standards. Smaller capitalization stocks tend to lead markets during most early-cycle periods. In addition, smaller capitalization European stocks currently have the world's strongest 12-month earnings growth forecast, yet few investors seem aware of these superior growth prospects.



4) High yield municipals lead the bond market.

Rationale: We like to search for gaps between perception and reality, and there seems to be a wide gap regarding municipal bond fundamentals. Whereas investors seem quite wary of municipals, municipal finances are generally getting stronger. Investors also seem very concerned that interest rates will rise, but an increase in interest rates can actually improve pension funding status (the present value of future liabilities shrinks as interest rates rise). Because of such factors, high yield municipal bonds might lead bond market performance during 2014.

5) Gold falls below \$1,000.

Rationale: Investors often think of gold as a hedge against inflation, and history suggests that abnormally high inflation rates are often stimulated by strong credit growth. However, the global credit bubble is deflating, and developed economies' inflation rates continue to fall without credit's fuel. We can understand Yen-based investors' interest in gold as the Japanese economy reflatates (see #2), but we think US-dollar based investors should emphasize financial assets rather than real assets like gold. In USD terms, we think gold will continue its bear market, and could fall below \$1,000/oz.

6) The American Industrial Renaissance continues.

Rationale: Smaller, domestically-focused US industrial and manufacturing companies have been gaining market share, and we think that trend is likely to continue. Energy costs, productivity, transportation costs, quality control, political stability, and labor costs are some of the contributing factors. Despite the significant outperformance of these small and mid-cap companies in 2013, we feel the investment theme remains in its early stages and expect the theme to outperform again in 2014.

7) The Fed stays on hold much longer than investors expect.

Rationale: Contrary to popular belief, the Fed has historically been a lagging, not a leading, indicator. The Fed has said that policy changes will be "data dependent" during this cycle (what exactly were they in past cycles if not data dependent?), and we interpret that to mean that Fed policy changes may lag more than they did in previous cycles. The fear of replaying 2008 is not only still central in investors' minds, it is apparently still central to the Fed's decisions. If our assertions are correct, then stock market valuations could be higher and volatility could be lower than investors currently expect.

8) Investors realize that the term "Liquid Alts" may be an oxymoron.

Rationale: During the early-1990s, I argued that illiquidity was one of the reasons alternative investments outperformed. Investors did not have ready access to their funds, and had to receive higher returns than available in liquid investments as compensation for taking illiquidity risk. Within that context, the term "liquid alternatives" seems like an oxymoron. Basic financial theory suggests that liquid alternatives should provide inferior return/risk potential versus illiquid alternatives. Ongoing fears of replaying 2008's bear market suggest to us that investors may be paying too much for liquidity, and that liquid alternatives' returns could be inferior to those of plain old-fashioned stocks.



9) The king has no clothes: high quality stocks underperform.

Rationale: Many investors believe that quality stocks outperform over the long-term. Unfortunately, there is little objective data to support that contention. Rather, there is substantial evidence that “bad” companies have historically tended to make “good” investments over the long-term. Much like in #7 and #8 above, 2008’s lingering fears have led investors toward more conservative, higher quality stocks. We think that trend might reverse during 2014.

10) Small banks.

Rationale: Bubbles create capacity that typically isn’t needed once the bubble deflates. The expansion of bank balance sheets was the capacity created during the credit bubble. Larger banks’ balance sheets ballooned during the credit bubble, but their balance sheets have yet to fully contract. Smaller bank balance sheets seem much better aligned to the post-bubble credit world. The S&P SmallCap 600® Bank index outperformed the S&P 500® Bank index by roughly 15 percentage points so far during 2013. We expect smaller banks to again outperform larger banks in 2014.



INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

EM: MSCI Emerging Markets (EM) Index. The MSCI EM Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of emerging markets.

Japan: The Nikkei 225 Index. The Nikkei-225 Stock Average is a price-weighted index comprised of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

S&P SmallCap 600® Banks Index : The Standard and Poor's SmallCap® 600 Banks Index is a capitalization-weighted index. The index was developed with a base value of 100 as of December 31, 1993. This is a GICS Level 2 Industry group.

S&P 500® Banks Index : The Standard and Poor's 500® Banks Index is a capitalization-weighted index. The index was developed with a base level of 10 for the 1941-43 base periods. This is a GICS Level 2 Industry group.

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