

[Martone Capital Management: Weekly Investment Commentary \(1/6/2014\)](#)

There was not much in the way of economic data released last week, but on Thursday, the December ISM manufacturing survey numbers did come out. The data showed a second month of strong manufacturing activity and, even more impressive, a surge in new orders, which reached their highest level since April 2010.

The impressive ISM report is consistent with the broader pattern of better-than-expected economic data we have been seeing in recent weeks. The Citi Economic Surprise Index (a measure that tracks economic data in relation to economists' forecasts of that data) is close to its highest readings of the past two years. In other words, U.S. economic data is exceeding expectations to the greatest extent we have seen in quite a while.

Improving data is good news for the U.S. economy, but it is a double-edged sword for stocks. On the positive side, better growth should help support corporate earnings in 2014, which, in turn, should be a positive for stock prices. Faster growth, however, is also leading to an increase in interest rates. At 3.00%, the yield on the 10-year Treasury is close to 0.25% higher than it was a month ago and more than a full percentage point higher than it was one year ago.

Higher interest rates represent one risk for stocks in the New Year. A second risk is equity valuations. Last year, U.S. equity valuations rose by roughly 20%, which represents the largest increase since the tech boom of 1998. Historically, when both long-term interest rates and stock valuations rise, the subsequent year has seen modest returns for stocks. Between 1954 and 2013, there were 14 years when both equity valuations and the yield on the 10-year Treasury advanced; on average, the S&P 500 returned between 2% and 3% the following year.

Does this mean stocks are doomed to see a year of close to 0% returns in 2014? Not necessarily. One mitigating factor is that interest rates are rising from such unusually low levels. The yield on the 10-year Treasury is still well below its 20-year average of 4.5%. As a result, we still believe stocks look inexpensive relative to bonds. For the coming year, we expect stocks to advance and out perform bonds, but given the headwinds of higher rates and higher valuations, gains should be more muted than they were last year.

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