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The Biggest Question for 2014

The biggest question for 2014 is not whether the US stock market will be able to perform a repeat of the exuberant gains achieved in 2013. It does, however, relate to whether stocks will be able to repeat their exuberant gains. Ultimately though, that depends on the sentiment of investors and the perception of where capital should flow in the coming months and year ahead. A key contributor to that will be the pace at which the Fed tapers backs their bond purchases versus what the markets expectations will be, which at this point is to see the Fed's Quantitative Easing (QE) wound down by the end of 2014. Moreover, tapering is associated with the expectation of continued modest improvements in the labour market and broader economy. But the more important investment question for the year ahead looks beyond the recent action in the markets and surrounds the debate of economic growth, the prospects for the US and global economy, and particularly the premises of a return to normalcy versus secular stagnation.

Another way of asking that question, what is it about the general economic growth environment that influencing financial markets?

The most striking fact of 2013 is that companies who make up the S&P 500 will payout or return the greatest amount of funds to investors since 2006. This was done in the form of dividends or stock buybacks, and some final totals sum up to over 500 billion dollars. The even bigger number though is that "Blue Chip" firms, comprising the Dow 30 paid out their highest levels since the late 1990's. What this could say about the American and global economy is twofold.

On the one hand, American corporations are still finding their share prices relatively cheap. They would opt to repurchase their shares in what has been a rallying market, and seize the opportunity to issue debt at record low interest rates. Obviously, if they are seizing the opportunity to buy back shares at current prices, their outlook is for their share prices to trade higher, if not see some level of stability, but the other major factor of buying back stock means the number of outstanding shares in a company is falling and with the same growth potential share value increases.

That being said, there is also a flipside to firms returning cash to shareholders, and that is that the present value of investment opportunities is less than what shareholders might be able to earn elsewhere. Or simply put, investment in research and development for American companies is becoming exhausted. In this view, there are few and far between opportunities for American business. Instead of employing that extra worker or investing in new equipment, cash is being returned to shareholders. This is something that fits with the hypothesis (hyped by Larry Summers) of secular stagnation, but at the same time, US capital expenditure contradicts this as its highest level in 2013 in November.

Going into the beginning of this year, I think it's evident that money will continue to flow into equities. It's trading off the dynamics of central banker's interference in the economy. And as markets climb a wall of worry, investors will be looking to hedge and limit their downside risk. A hedge, by definition, is an asset that is negatively correlated, or uncorrelated with another asset. Over the last year, the S&P500 gained approximately 30 percent and gold lost that amount. Gold is, and always has been a hedge for risk assets, but as the markets trade higher into 2014 gold will continue to catch bids as investor's hedge their exposure to equities, and it's my opinion a bottom will be in place following the first half of this year.

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