SUNDAY JOURNAL

Mutual Funds Can Ride the Market Up in 2014

Wall Street Pros Say Stocks Could See Another Impressive Year

By GREGORY ZUCKERMAN

Jan. 4, 2014 8:36 p.m. ET

The stock market shocked investors in 2013 with huge gains. It could happen again in 2014 as long as corporate earnings cooperate.

A year ago, a poll of 11 top Wall Street strategists predicted the S&P 500 would rise just 8.2% in 2013, not including dividends, according to research firm Birinyi Associates. Instead, the U.S. stock market scored its best gains in 16 years, as the Dow Jones Industrial Average rose 27% and the S&P 500 jumped 30%.

Phil Foster

Credit for the heady gains goes to low interest rates and efforts by the Federal Reserve to pump money into the economy, encouraging investors to make more aggressive bets.

An improving housing market and resilient U.S. economy also helped.

The gains came even though U.S. gross domestic product is estimated to have grown just 1.7% and corporate profits likely rose 5.7% in the year, according to FactSet Research.

The bond market came under more pressure—the Barclays US Aggregate Bond Total Return Index fell over 2% in 2013 as investors began anticipating a shift by the Fed to reduce its bond purchases.

In 2014, the Fed is expected to continue reducing its bond buying, which could push up interest rates. But unless rates shoot much higher, stocks could see another impressive year, analysts say, thanks to continued economic growth and improving corporate profits.

What Could Possibly Go Wrong?

Here are a few potential surprises that Wall Street pros will be on the lookout for in 2014:

Taper Panic: Faster-than-expected growth could send the bond market tumbling while keeping a lid on

It helps that stocks aren't at expensive levels, though they're also not cheap. The S&P 500 trades at about 15 times expected earnings over the next year. Given how low interest rates are, some investors think that's a reasonable price to pay.

need to act more aggressively to hike interest rates.

Stock Scramble: If there's been one lesson of recent years it's that financial markets move to extremes. While markets are reasonably priced, more good news and low interest rates could spark a scramble by investors to get their hands on stocks.

Recession Replay: Economic downturns seem to occur every seven or eight years. It's been six years since the 2008 crisis. This year may see early concerns that the next recession is around the bend, one that central banks are in a weaker position to deal with.

As the Fed pulls back from its easy-money policies, further gains likely will depend on continued earnings growth, which is expected to rise about 6% in 2014.

There are other reasons for bullishness, such as record levels of stock buybacks and dividend increases. The housing market continues to strengthen and retail sales and business spending could keep strengthening. And the U.S. has emerged as the world's largest energy producer, lowering costs for a range of businesses and helping to restrain inflation.

"We see this stellar performance in the middle of the year as a sign that the underlying pace of economic growth is healthy," says Citigroup economist Peter D'Antonio, who predicts the economy will grow "around 3%" in 2014.

"The Fed will continue to treat the market with kid gloves," says Darren Pollock, portfolio manager at Cheviot Value Management. "This Fed is focused on finding ways to refill the punch bowl so that the party never stops."

Audio

Greg Zuckerman and WSJ's Hank Weisbecker look at strategies for 2014

AllianceBernstein has been shifting its portfolios toward so-called cyclical shares, especially retail stocks and other "consumer-discretionary" stocks, betting that the economy will improve. Some analysts recommend the SPRD S&P Retail exchange-traded fund (XRT), which owns retail stocks such as Groupon and Supervalu.

"The bears would like you to believe that we are in a U.S. stock-market bubble," says Alan Zafran, managing director of First Republic Investment Management. But he's more upbeat, citing strong corporate balance sheets, a Fed that has promised to keep rates low, and reason to think more individual investors will shift to stocks.

Reasons for concern remain, however. A growing number of companies in the S&P 500 are issuing earnings estimates for the fourth quarter below analyst estimates.

And James Paulsen, the usually bullish chief investment strategist at Wells Capital Management, argues that U.S. and global economic growth "will quicken more than most anticipate," leading to worries about rising interest rates and a pause in the stock surge.

"The market is extended," says Uri Landesman, president of hedge-fund firm Platinum Partners. "Bullishness is way too rampant."

For those seeking a conservative way to play stocks, analysts recommend a low-cost exchange-traded fund tracking consumer staples, such as Vanguard Consumer Staples ETF (VDC), that owns stocks like Procter & Gamble and Coca-Cola.

Some experts urge continued caution about bonds, as the Fed pulls back from its recent bond buying. Many investors are shifting to funds that have the freedom to buy a range of bonds and even make investments that would pay off if rates rise.

One example: The Goldman Sachs Strategic Income Fund (GSZAX), which has climbed about 5.4% over the past year.

For those seeking broader exposure to commodities, John Brynjolfsson, who runs hedge fund Armored Wolf, recommends the Eaton Vance Commodity Strategy Fund (EICSX).

"Though commodities struggled in 2013, they should benefit as excess reserves on the Fed balance sheet get deployed to stoke inflation pressures in 2014," says Mr. Brynjolfsson.

Still, Sharmin Mossavar-Rahmani, chief investment officer for Goldman Sachs Group's private wealth-management unit, says it's too early to make direct bets on gold, which plunged 28% in 2013.

Just as 2013's gains came as a surprise, investors should brace for new surprises in 2014, some analysts say. Actions by the government, not just companies, play a bigger role—and they can be harder to anticipate than changes in corporate earnings.

"We started 2013 with massive dysfunction in Washington," says Tobias Levkovich, chief U.S. equity strategist at Citigroup. "But there was fiscal improvement and even a budget deal as the year progressed."

That's why investors need to be flexible and keep cash on hand to cushion any drop and take advantage of any selloff, analysts say. Morgan Stanley's chief U.S. equity strategist, Adam Parker, began 2013 with a cautious stance, for example, but became more bullish during the year. For 2014, Mr. Parker thinks the S&P 500 will rise 9%.

"We expect more volatility in the year ahead," notes Mr. Pollock. "Declines in 2013 were abnormally subdued. Within most calendar years there are declines larger than 10%; last year had none…. After times of tranquility, it often pays to expect a return to more volatile markets."

— gregory.zuckerman@wsj.com; @GZuckerman