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Heady Rally Unlikely to Repeat Next Year

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U.S. stocks' amazing run in 2013 raises the stakes for next year. Will markets keep rising, powered by steady economic growth and low interest rates, or will they take a breather after the Federal Reserve begins paring back economic stimulus?

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That is the question on the minds of bullish and bearish investors alike as the year winds down. Friday's 1.3% gain in the Dow Jones Industrial Average following a positive employment report left money managers hoping for a strong finish to what so far is the best year for stocks in a decade. The Dow is up 22%.

History seems to support the idea that 2014 will be less historic than 2013. Since 1927, there have been 23 years in which the S&P 500 has risen 20% or more, according to Birinyi Associates. It averaged a further gain of 6.4% in the next year. That is only slightly better than the 5.5% gain the S&P averaged for all years since 1927.

As a result, even some bulls are warning clients not to anticipate stocks will match these rampaging gains next year.

“We certainly don’t expect any kind of return next year to be close to what we have seen so far this year,” said Scott Wren, senior stock strategist at Wells Fargo Advisors, which oversees $1.3 trillion as the brokerage arm of Wells Fargo & Co.

Mr. Wren is hardly a bear. He projects more gains in 2014, but his target for the S&P 500 stock index a year from now is 1850 to 1900, a gain of only 2% to 5% from where the index stands today. That compares with a 27% run-up in the S&P 500 so far this year.

Mr. Wren’s reasoning is simple: His market models, which take into account 200 factors including inflation, interest rates, industrial production and even scrap-metal prices, show the S&P 500 today stands 6% above what all those economic factors suggest. It is overdue for a pause.

Mr. Wren is one of many bullish analysts saying stocks’ gains going forward might be limited.

Jack Ablin, chief investment officer at BMO Private Bank, which oversees $66 billion in Chicago, told clients that he is “tiptoeing with trepidation into 2014 with a full equity weighting,” meaning his firm holds a lot of stocks despite his concerns.

He said the market is fueled by momentum and central-bank support, and “appears to have defied fundamentals.” A mathematical regression based on the ratio of stock prices to sales at S&P component companies suggests the S&P index should gain “3.4% per year over the next three years,” he said.

But Mr. Ablin isn’t one to fight the market. “The bottom line is that momentum and liquidity are important factors. While we believe market valuations are stretched, investors that exit based on valuations alone may be leaving money on the table,” he said. Although he will monitor market conditions closely and bite his nails, he said, “for now, we are enjoying the gains.”

Ned Davis Research, which has been bullish through most of the current bull market, also is beginning to sound downright uncomfortable.

While the firm remains bullish, it warns that risks will rise in 2014.

“We could be facing the most restrictive combination of monetary and fiscal policy since before the financial crisis,” said Ed Clissold, the firm’s U.S. market strategist.

Stocks have benefited from the $85 billion in stimulus the Fed has pumped into financial markets each month since late last year. Stocks have been able to overcome deteriorating fundamentals, Mr. Clissold said. But now, the S&P 500 is trading at about 18 times its companies’ earnings for the past year, above the historical average of 16, and both earnings and sales are growing at sluggish rates.

The Fed, meanwhile, is preparing to wind down its stimulus. Friday’s strong employment news made some economists think the Fed could announce stimulus cuts as soon as its next meeting, in about 10 days. Most prognosticators think it will delay a little longer to be sure the data continue their positive path.

But in the coming months, barring an economic setback or fresh Washington turmoil, the Fed is widely expected to reduce and eventually eliminate its stimulus. The Fed will remain supportive of stocks, and could well resume stimulus if markets began to drop, but its stance would be the least supportive at least since 2011.

And Congress is reported to be heading toward an agreement that would continue to restrict federal spending, meaning that the net effect of Washington policy could be harsher in 2014 than at any time in years.

Like Messrs. Wren and Ablin, Mr. Clissold isn't predicting disaster. He expects stocks to be up by the end of 2014, but he worries that there could be a hiccup in the middle.

On only one of those 23 occasions of 20%-plus annual gains did the S&P improve its performance in the following year. In 1997 it rose 31% after a 20% gain in 1996. It rose again in 1998, by 27%, and in 1999, by 20%. Those were the days.

The S&P 500 has been known to decline in the year after a 20% gain. That has happened eight times. Six times it put in another 20% gain.

Data comparing the expansion of the S&P 500′s price/earnings ratio with past years, and comparing the performance at the current stage in the economic cycle, suggest gains of 6% to 9%.

It is possible that 2014 will be another year like 1997 and stocks will rise even faster than in 2013. Many in the market think the new Fed chairwoman, Janet Yellen, slated to take office Feb. 1 pending Senate confirmation, will delay withdrawing stimulus and fuel another big market year.

But before betting that 2014 will be better than 2013, investors might consider that it has happened once since 1927.