Market Letter – Q1 2014

As we approach the five-year anniversary of the financial market's low point during the crisis of 2008-2009, let us consider domestic economic growth prospects, and the investment outlook for 2014 after one of the strongest years for stocks over the past two decades.

The Economy

2013 began with a host of economic uncertainty as investors focused on downside risk. Front and center on their minds were: sluggish domestic growth, a global economic slowdown, high unemployment and the extent to which the Fed would continue to stimulate the economy through quantitative easing. First quarter growth was revised down to a 1.8% annualized pace. Consumer and corporate deleveraging continued as the government reigned in its spending due to the automatic cuts known as "the sequester". The economy expanded during the second quarter at a 2.5% annualized pace as the amount of new hires increased and unemployment began to wane. The Fed saw this as a positive sign and hinted that they may "taper" their $85 billion per month purchases of Treasury and mortgage securities. The bond market was adversely effected as medium and long-term interest rates shot up, which in turn caused a decline in equity denominated assets as well. Chairman Bernanke addressed the issue a few days later and softened his language in an attempt to calm the markets. This resulted in a brief 4.5% correction on the major indexes.

The economy showed signs of expansion in the third quarter as corporations continued to selectively hire workers. Consumer spending (the largest component of the US economy) increased in bigger ticket items (white goods, automobiles etc.), and, along with business investment, propelled the economy to a 4.1% annualized increase during the third quarter. This allowed the Fed to gently *taper* its asset purchases down $10B to $75B per month. In doing so, Bernanke stated that the Fed will keep short-term rates low for an extended period, and investors are assuming less stimulus will be the norm.

While the economy may be stable, and inflation non-existent, the Fed still remains flexible enough to intervene if needed. U.S. annualized GDP growth in 2013 was 2%, the result of a strong third and fourth quarter, and mainly driven by consumer spending in spite of modest job creation. Global GDP was up 3% for the year due to moderate energy prices, a reduction in the pace of fiscal consolidation, and supportive monetary policy. In 2014 we are expecting an acceleration in the pace of growth, perhaps 3% in the U.S. We believe the fiscal drag of the deficit is slowing, and we see business investment continuing to increase at a modest rate, both helpful for growth.

The Equity Market

The year of 2013 proved to be one of the best of the past two decades for investors. In the face of the Fed's December announcement that they would taper bond purchases and thus their economic stimulus, equity markets posted excellent quarterly returns. The Morningstar US market index was up 10.09% for the 4th quarter, and 33% for the year. The Morningstar Global Ex-US index was up 4.81% during the 4th quarter, and 15.7% for the year, while emerging markets as measured by the MSCI Emerging Markets index returned 2.03% for the quarter, but fell -2.27% in 2014.

It was a rather light quarter for news as the Syria, fiscal cliff, and government shut-down headlines abated near the end of the third quarter. The most interesting story was the announcement of Janet Yellen as the successor to Ben Bernanke as Federal Reserve Chairperson. While initially her perceived dovish ideology sparked debate, by the end of the quarter it was not news worthy, nor fiscally impactful enough to rankle the markets.

Among style and categories, Growth stocks outperformed Value, and Small Cap outperformed Large Cap. Sectors with the best performance were Consumer Discretionary, Health Care, Industrials, and Financial Services, all up over 30% for the year as measured by Standard & Poor's. The major laggard was Real Estate up only 1.75%.

While some people question the sustainability of the rally in 2014, we are experiencing three important catalysts in our view: (1) a strengthening economy, (2) an abundance of un-invested dollars, and (3) corporations with very strong balance sheets. Short of a meaningful correction of 3-8%, we see a positive year for equities ahead of us in 2014.

The Fixed Income Market (Bonds)

Year to date, the Morningstar Broad Bond Index declined -1.89% during 2013, and declined -0.24% for the fourth quarter. The US Treasury Inflation Protected Securities (TIPS) index was negative -8.52%, while the US Government, Global Government, and Emerging Markets bond indexes were all negative for the year, down -2.74%, -3.55%, and -4.39% respectively.

Much of the discussion surrounding bonds has been centered on one factor: a rise in interest rates. This would not be the first time that we have experienced an increasing yield curve in quite some time, and it recalls the year of 1994 for many who experienced the sharp move in rates that year.

At the end of 1993, the market consensus for the 10-year and 30-year treasury yield was 6.2% and 6.5% respectively (BCA Research cited). By the end of 1994, the actual yields were 130 basis points higher at 7.8% and 7.85%. From September 1993 to the peak in November 1994, the Treasury index lost 5%. High-grade bonds such as agency mortgages, mortgaged-backed securities, and investment-grade corporates also suffered losses. Some of the same technical factors are in place today.

Against this backdrop, it is interesting to note that most investors are not expecting any meaningful rise in rates before the end of the decade. But based on work completed by BCA, the Fed's projections and investor's beliefs are in conflict. The Fed projects full employment by 2015, which would signal the beginning of a rise in interest rates and a reduction in Fed-based bond purchases. If this is true, then the next 5 years of potentially rising interest rates will likely have an adverse effect on the price of bonds.

Fixed Income Securities - are we at the Federal Reserve's mercy?

It is rather naïve to believe, at this point, that our elected officials have our best interest at heart when we experience a four week period like the end of 2013's third quarter. A neutralist view is that both sides are creating challenging outcomes for our citizens, whether it is the effect of a withdrawal of entitlements and debt spending, or impeding the government's daily operations. It is beyond the scope of this market update for us to opine regarding this enigmatic conversation, but the eventual withdrawal of government stimulus, which is apparent in either scenario, is perhaps a more directly discernable influence to the prices of both stock and bond denominated assets.

We recognize it is a contrarian view but we do not feel there is enough evidence to support much of an effect of further quantitative easing (QE – government increasing dollars in our system) on our equity markets. On the other hand, the tapering of asset purchases should not have much impact either in our view. By example, the correlation of daily and weekly purchase reports to the performance of the equity market is not strong and has been weakening for some time. According to Morgan Stanley & Co., the peak effect occurred in in the spring of 2013.

A simple cause and effect is emerging: good news on the economy is good news for markets. Bad news on the economy is bad news for the markets. However, really good news on the economy is bad for financial markets because of the near term effect of an acceleration of the decline in Federal Reserve's bond purchasing program (QE), but certainly that is a good outcome long-term. This game plan can be used to an investor's advantage as they navigate through 2014.

If we consider the most probable scenario is a continued slow to moderate acceleration in economic activity (2-3% for the next 2 years), a projected a 4% 10-year yield, and a 5% 30-year treasury yield, are reasonable conclusions. This indicates a strong percentage move in rates, but one that may impact Treasury bonds more than other sectors of the bond market. The fixed income market sectors least likely to be affected may be short-duration bonds, and low grade corporates, in our view.

So how does an investor navigate the next 6+ years? Within a diversified portfolio crossing multiple asset classes, inclusive of an allocation to fixed income securities, an investor will need to approach bond investing by spreading their holdings among a broad selection of fixed income sectors. This will allow for the greatest flexibility for an investor who needs yield and wants to avoid price erosion. Specific to stocks, we favor overweighting U.S. exposure, large caps, Consumer Staples, Health Care, and Industrials.

Past performance is no guarantee of future results. Indexes are unmanaged, do not incur fees or expenses and cannot be invested in directly. Investing in sectors may involve a greater degree of risk than investments with broader diversification. International investments are subject to additional risks such as currency fluctuations, political instability and the potential for illiquid markets. Investing in emerging markets can accentuate these risks.

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