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Market Commentary

Appraising 2014's DNA

People sometimes think of a New Year as a new baby, so I was wondering what kind of DNA 2014 possesses. How will the various sectors and geographies that make up the world's economy behave in the New Year? What problems might arise?

Before going into more detail on these questions, let's take a final look back at 2013.

One of the biggest stories of last year was the power of U.S. (and other developed nation) stocks (see Figure 1), the result of improving economic confidence and an absence of downside catalysts. The S&P 500 hit an all-time (intraday) record of 1,849.44 late in the year. For the full year, most of the returns to stocks (about 80%) came from expanding P/E multiples, with operating earnings only responsible for about 7%.

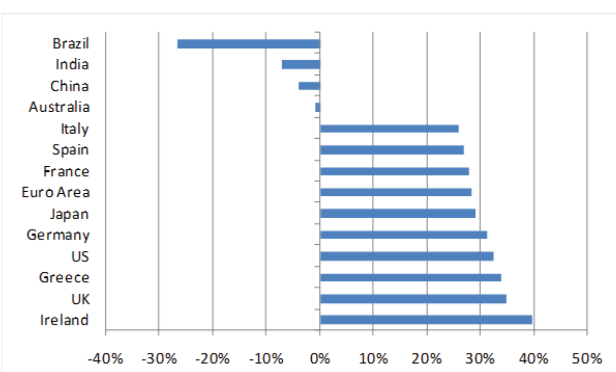

Figure 1. Stock market returns in 2013 (source: Thomson Reuters Datastream / Fathom Consulting)

The bulls were not thrown off by a December announcement from the Federal Reserve that QE stimulus tapering would begin in January. The market took the announcement as confirmation that the Federal Reserve believes the expansion is becoming self-sustaining.

On the negative side, low rates that started to rise in 2013 brought challenges to fixed income markets. The Barclay's U.S. Aggregate Bond Index fell 2% for the year. Long-term Treasuries were down 12.7%.

Emerging markets had a rough year as well (see Figure 1 above), thanks partly to continued slow global growth. But the news was not all bad. November saw the Third Plenum of the 18th Party Congress of China release plans for bold reforms and an increasingly open economy for the next ten years. That has bolstered the outlook for medium to long-term economic growth, which is where China's, and much of the emerging world's, strength still lies

Our Take on 2014

Looking ahead, we feel **U.S. stocks** are no longer undervalued. Further returns will likely need to be accompanied by earnings growth. The good news is that earnings growth should happen. Thomson Reuters estimates about 8% growth in operating earnings for 2014. Investors may be sensitive to any news bearing on earnings, meaning greater volatility than 2013, when the drawdown to stocks was only 5.8%.

U.S. housing has truly turned the corner to become a net contributor to economic growth. In fact, some markets are said to be showing characteristics of a new bubble. What a difference a year can make! The bubble talk may be a little premature, though, particularly with the prospect of rising interest rates in 2014.

We expect economically sensitive sectors of the U.S. market (energy, materials, industrials and technol-

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ogy) to outperform in 2014, a result of ongoing economic improvement. Combine this with strong corporate balance sheets and we could see firms gain confidence to replenish an aging stock of equipment, facilities and technology. We could also see growth in mergers and acquisitions, share buy-backs and dividends.

The outlook for **Europe** is broadly positive as well. Continued low interest rates, lessening fiscal drag and better global growth should create more appetite for external trade. But political sensitivities remain, and signs of a weakening recovery could change the outcome. It will bear close watching.

For the first half of 2014, performance in the export-driven **emerging markets** may be muted, especially with stimulus tapering ramping up in the U.S. As the year develops, and assuming the U.S., Europe and Japan all remain on track for positive growth for the first time since 2010, a more favorable dynamic could evolve; the search for value may improve investor perceptions of these markets by the second half of 2014.

We're singing a familiar refrain on **bonds**. Keep durations short, especially with Treasuries. As economic growth improves, we expect yields will continue to rise. A steep yield curve offers some protection farther out, so that 10-year Treasuries may not rise significantly in the near-term. But this protection is likely to erode over time. On balance, we still favor the high-yield sector of the bond market, and expect it to remain healthy well into 2014 as corporations look to refinance higher coupon debt while costs are still low. But if leveraged buy-outs and mergers & acquisitions pick up as we expect, leverage levels will need to be watched carefully. Active management should find opportunities to add value by shifting duration and quality as conditions dictate. As rates rise over the year, any negative impact on stocks could increase the attractiveness of bonds as a diversifier.

After a difficult 2013 for **commodities**, we expect global economic growth to help keep prices stable early in 2014, then lead to (moderate) strength as the year continues. Gold may be the exception, with any price strength hard to come by in an increasingly risk-on environment. Generally speaking, broad commodity indexes gain strength as economic expansion heats up. Portfolio holdings for diversification and inflation-hedging purposes, though, can make good sense throughout the business cycle.

We expect improving U.S. economic growth, rising yields, a developing energy revival and improved manufacturing clout to lead **the Dollar** to appreciate against most other currencies in 2014. But there could be downside pressure as well—from budget and balance-of-payments deficits, lower global risk aversion and ongoing (if tapering) easy monetary policy.

Overall, our reading of this baby's DNA says he should grow into a healthy adulthood, at least as far as economic prospects are concerned. But risk scenarios remain, as always. In particular, if interest rates should rise rapidly as the Federal Reserve unwinds stimulus, it could dampen economic and market performance. We don't currently expect such a rapid rise, but a declining U.S. trade deficit, while in many ways good, could theoretically put extra pressure on rates by reducing global savings. It's another factor to watch.

Those are the most prominent and pressing issues on our radar right now. Going forward, we can always be certain of uncertainty, so we will be monitoring the situation closely and getting back to you as the situation warrants. We send thanks to those of you who are our clients. We value the trust you have placed in our firm and we sincerely appreciate your business. Please do not hesitate to call or email us if you have any questions or concerns.

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