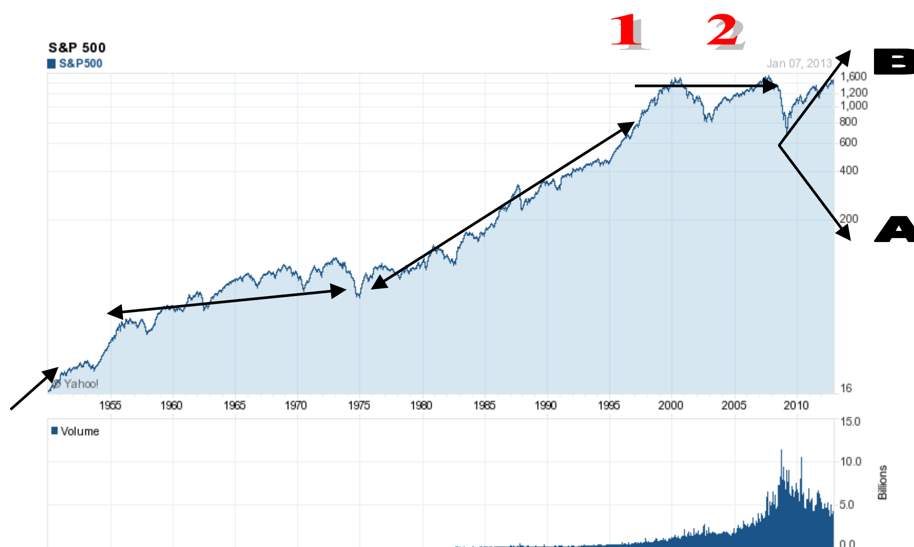
INVESTMENT COMMENTARY

January 2014

What a Year!

In our January 2013 Investment Commentary, we displayed the following chart and drew the two possible stock market scenarios that prices could take once the 2007 highs had been attained. We also felt that the most likely path would be "B" because we . . . " believe that this Bull Market has much further to go . . . "



*"The skeptics believe that once the old highs are reached, the stock market will once again repeat its secular bear market downward pattern. (**A**) Similar to the bull/bear stalemate of the 1960's. While often at this stage of a bull market advance it is prudent to brace for some sort of economic decline and a corresponding bear market, we believe this cycle is a bit different from some of the previous ones seen.* ***There are many reasons to believe that this bull market has much further to go over a longer time period, and possibly be in a secular bull market (B),*** *similar to the 1980-1990's. We focus on three main reasons we believe this may be the case:* ***economic growth, stock valuation, and investor attitudes.***" (January 2013 C&SM Investment Commentary)

In 2013, the Standard & Poor's 500 relentlessly climbed higher surpassing its September 2007 peak during the first quarter and never suffered a pullback more than 3-5% before advancing to higher highs. After achieving the impressive total return of nearly 20% during the first nine months, stocks shrugged off the Government shutdown and Federal Reserve Board taper concerns by capping off the sensational year with an additional 12% total return for the fourth quarter bringing the full year performance to a remarkable 32%. Nearly half of the fourth

quarter surge occurred after the Federal Reserve Board announced in December that ***it would begin to taper*** it's quantitative bond purchases surprising most strategists who did not expect any tapering to occur until later in 2014. Ironically, you may recall stocks surged also in September when the Federal Reserve Board announced ***it would not begin to taper*** although it had been widely expected to do so. Go Figure? The Federal Reserve Board announcement ended the overhanging concern of when and how it would begin to unravel its massive quantitative easing policy. In essence, the current Chairman, Ben Bernanke, has put monetary policy on a glide path before handing the controls over to the incoming Chairperson, Janet Yellin.

MARKET TIDBITS

- It was the fifth consecutive up year for the S&P 500. We've had two other five-year spans: 1995-1999 and 2003-2007; and one eight-year span: 1982-1989.

- The S&P 500's daily volatility was the lowest since 2006; with the market suffering only one correction of at least 5% (the least since 1995).

- The bond market (as measured by the Barclay's Aggregate Index) had its worst loss in 14 years; and was down for only the third time in 28 years.

- According to BCA, going all the way back to 1870 (using the Dow), there were 30 years when the Dow's returns exceeded 25%; with 23 being followed by another year of positive returns (mean of 12%). So, **based on history, there is a 77% probability of another positive year in 2014.**

- It was the 18th year in S&P 500 history with a price return of over 25%. **On average, the return the following year was a positive 6%;** with the only doozy of a down year coming during the Great Depression in 1937.

- Domestic (US equity mutual funds net cash flows ended 2013 in positive territory for the first time in eight years, with estimates ranging from $16 billion to $19 billion of inflows for the year. That, to some, is alarming (too frothy); but should be compared to the $548 billion that came out of those funds from 2008 through 2012!

- Bond mutual funds recorded their largest nominal annual net cash outflow ever in 2013, with estimates ranging from -$78 billion to -$88 billion of outflows for the year. That, to some, is also alarming; but should be compared to the $1.07 trillion that came into those funds from 2008 through 2012!

- At the beginning of 2013, traditional pension funds had more fixed income exposure than equity exposure.

. Source: Charles Schwab Turn the Page: Outlook for Economy/Stocks in 2014

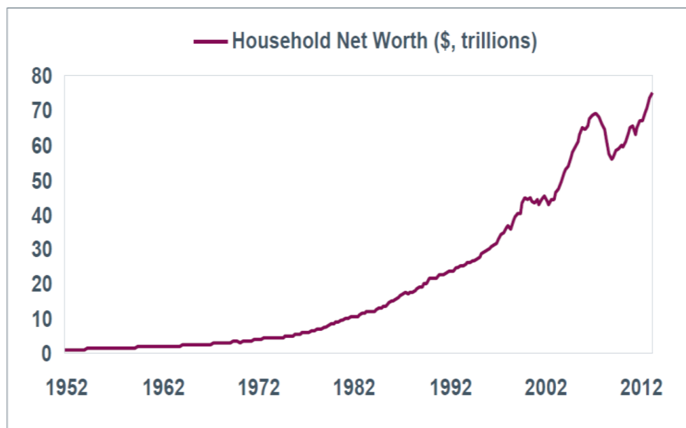
TALE OF TWO CITIES

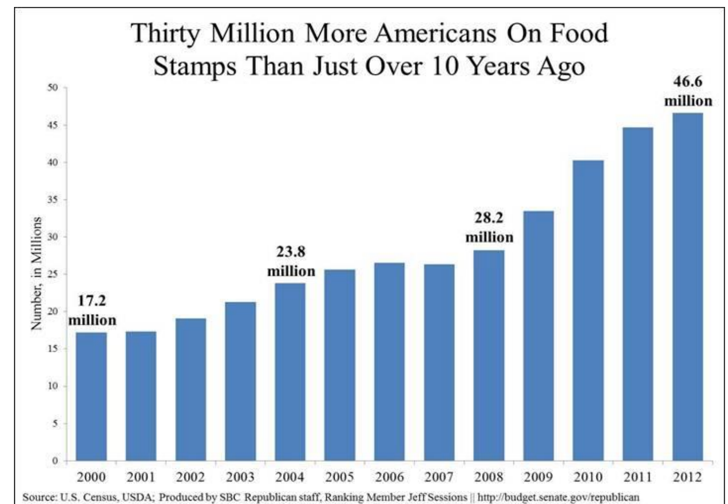
We all know the beginning of this great Dickens classic. “It was the best of times. It was the worst of times.” In many ways, this sums up the economic and net worth division in this country. For those who have been fortunate enough to have kept their jobs, homes, and hold onto their stock investments, their net worth has soared. On the other hand, those on long- term disability, unemployment compensation, and food stamps have also soared.

BEST OF TIMES ***WORST OF TIMES***

Net worth takes out prior high

Housing and stock market represent 2 largest components



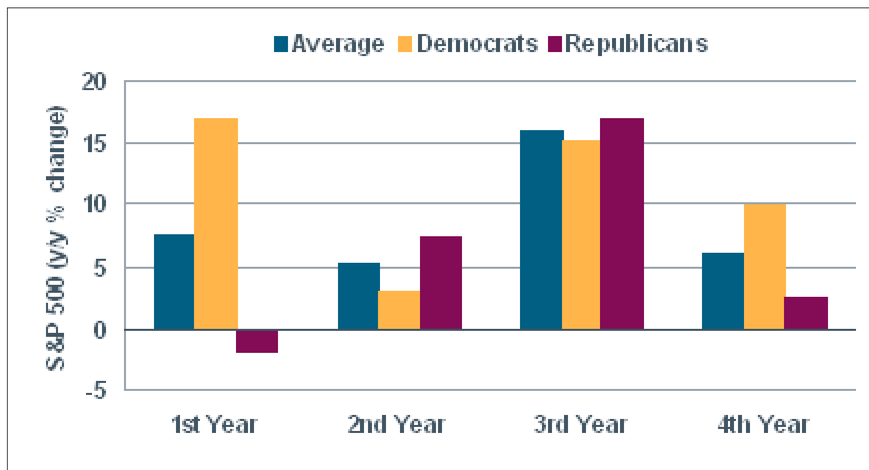


It is the best of times for borrowers – corporations or individuals purchasing homes and cars and paying historically low interest rates. It is the worst of times and will continue to be for savers and those in retirement years looking for decent safe returns on money market funds, Certificates of Deposit, and Treasury Notes.

One of the intended consequences of the Federal Reserve Board's easy monetary policy and quantitative easing was a rise in asset values, namely homes and equity prices. (i.e. the wealth effect.) This ***"trickle down"*** economics theory may have worked in the past as improving wealth stimulated spending and job creation. But one of the unintended consequences created by the constant rancor in Washington with its steady series of deadlines, ceilings, cliffs, and shutdown threats was the lack of confidence by businesses and individuals that has essentially negated any "trickle down" and thereby exacerbated the division between the "haves" and "have nots." Instead huge amounts of money is sitting on the sidelines looking for clarity on fiscal responsibility, impact of the health care insurance, taxes, etc. before having the confidence to invest, spend, or hire. Economic growth would accelerate with an increase in clarity on these issues.

"IT WAS THE AGE OF WISDOM, IT WAS THE AGE OF FOOLISHNESS …"

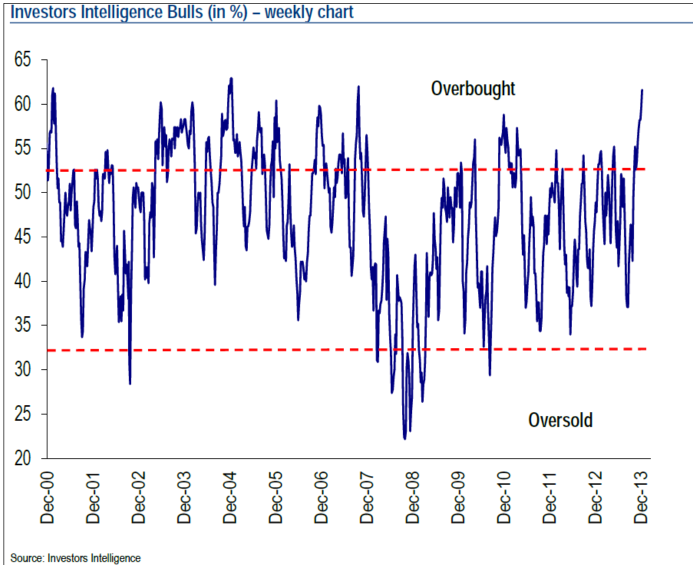
Indeed, the next words in the Dickens opening line seem to sum up the political contention in Washington as each side of the aisle seems to consider themselves the wise and the other side fools, with not a whole lot of room for compromise. While Congress has reached an agreement on the spending bill, compromise on the debt ceiling in April or May could not be as attainable. After witnessing the self-inflicted wounds in both parties during last fall's government shutdown fiasco, maybe cooler heads will prevail. However, as the rhetoric of the mid-term election year heats up, it may be more difficult for investors to ignore. The political divisions that will highlight the wisdom and foolishness will be how to solve income inequality, the pros and cons of a minimum wage increase, transfer payments and expanding government debt, entitlements, capitalism, and constitutionalism, etc. etc. etc. Historically, the second year of the four year Presidential cycle, as you can see from the following chart, for whatever reasons, has produced the worst performance in the post World War II period.

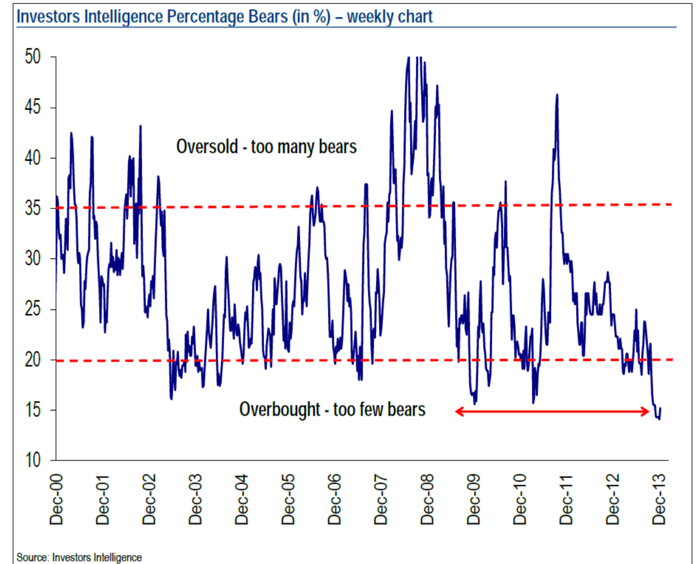


Source Charles Schwab: Bloomberg, 1945-2013

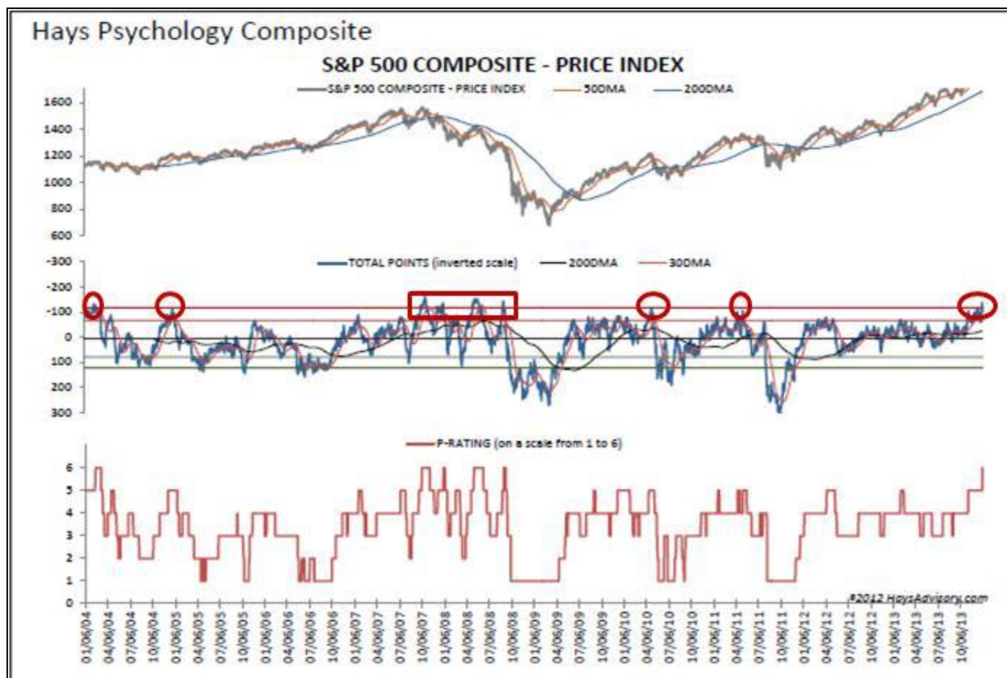
Another reason for the likelihood of a subpar year, or at least a correction is the degree of investor optimism. As you know, we tend to be market contrarians with a propensity to go

against the crowd, the consensus. **Never underestimate the stock market's uncanny ability to confound the consensus!** As we enter 2014, the overall level of stock market sentiment or psychology has become too optimistic. It is difficult to find a market strategist who is not bullish for 2014. Indeed, the next two charts are from Merrill Lynch Research measuring the "overbought" condition of the stock market with the high level of Investors Intelligence percent of Bulls and the flip side of that equation the "overbought" condition of too few Bears.



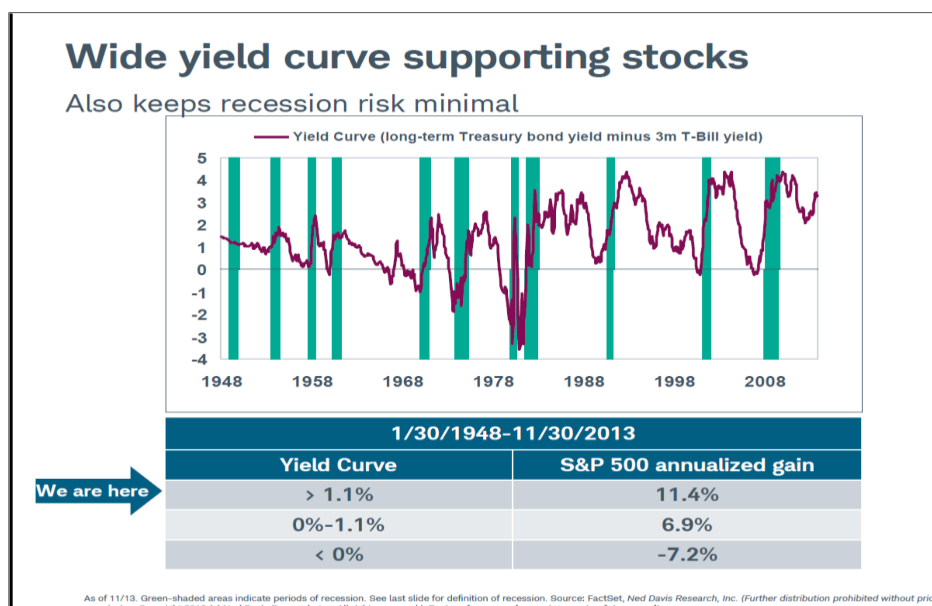


The next graph computed by one of our research sources, Hays Advisory, demonstrates an expanded index with nearly 100 technical indicators. This psychology index, which includes the high level of insiders selling and margin debt, is now at the extreme P 6 level, which you can see was attained prior to previous stock market declines.



THE LONGER TERM OUTLOOK

Expanding our time frame, we are more optimistic. If history is any guide, we are a long way from a flattening or inverting yield curve. As you know, we have previously cited that bull markets don't end and recessions don't begin until a tighter monetary policy causes short-term interest rates to climb up to longer-term levels. As the following graph displays when the difference between the yield on 3-month Treasury Bills and 30-year Treasury Bonds goes below "0," (the horizontal line in the center of the graph) recessions (the vertical shaded areas) normally follow and, historically, the annualized rate of return has declined to –7.2%. Strategists will continue the debate over the Federal Reserve Board's rate of tapering, data dependency, and forward guidance, but the fact remains short rates will stay low for a long time and if longer term Treasury rates continue to increase as we expect them to, a flat yield curve will be postponed for a much longer time period.



1/30/1948-11/30/2013	
Yield Curve	**S&P 500 annualized gain**
> 1.1%	11.4%
0%-1.1%	6.9%
< 0%	-7.2%

Source: Charles Schwab Market Snap Shot 12.26.2013

This economic and interest rate outlook compliments our belief that while we will have many corrections along the way, as shown in the following chart, the technical analysts at Merrill Lynch consider a pullback of 10-15% or so would be considered "healthy retest and add to the longevity of this secular bull market," which could quite possibly reach the 2330 level in several years, about 25%.

In summary, the irony is ….now that the economy may be getting stronger and just when the retail investor becomes more convinced to stick another toe into the stock market waters, there will be a correction that causes psychology to swing to the extreme level of pessimism. Who knows when the catalyst for a decline will occur, but the usual suspects could be faster growth causes a spike in long-term interest rates coupled with an inflationary scare, or some exogenous foreign event in China, Syria, Iran, etc. Accordingly, we anticipate continuing to reduce overall portfolio risk by trimming overextended stocks and looking for undervalued replacements as well as taking advantage of the 10%-15% market declines to add to attractive issues.