<u>Outlook for January, 2014: "Our Outlook…"</u>

"It is hard to make predictions, especially about the future" said the great Yankee catcher Yogi Berra! Despite our misgivings about making predictions, we will attempt to do so in this issue of the Outlook. While markets started off this year a little slowly, considering the outsized gains experienced by equity markets in 2013, we expect the ***sanguine outlook to continue – albeit with some caution*** thrown in for good measure!

Economic data released in the US has been ***mixed***: The Bureau of Labor Statistics of the Department of Labor computed job gains for December to be a ***paltry 74,000 jobs*** during the month with the private sector adding 87k to the rolls. Goods producing sectors of the economy lost 3k, while service providing sectors gained 77k. Trade, Transportation and Utilities (+69k) and Professional and Business Services (+19k) showed the largest gains while construction (-16k) and the Government sector (-13k) were the largest detractors.

The all-important ***unemployment rate*** fell a larger than expected three-tenths to ***6.7%*** as the civilian labor force fell by 347k during the month. The labor force participation rate fell to a multi-decade low of 62.8% (same level as October, 2013) implying that more people were "giving up" on looking for jobs. A broader measure of unemployment called the U-6 measure, stayed unchanged at a still elevated 13.1% for the month.

The Commerce Department pegged ***real GDP growth*** in the US economy at ***4.1% for 4Q2013*** – a larger than expected gain. The revised figures (this was the "final" and third revision to GDP data) showed a significant increase in spending by consumers on non-durables as well as a sharp increase in the intellectual property component of investment spending. All in all, this was a salutary report implying that the economy might finally be coming out of its moribund rate of growth.

Inflation readings continue to be ***quiescent*** for now: The core ex-food and energy reading on the Personal Consumption Deflator rose a mere 1.1% during the past year. Also, the more popular consumer price index's core ex-food and energy component rose 1.7% in the past twelve months – below the Federal Reserve's ***"implicit target"*** for inflation of 2.0% per year. This is not to say that we are never going to have an inflation problem – we are merely pointing out what current readings imply.

The Federal Reserve at its FOMC meeting in December did announce that they would begin ***"tapering"*** their Large Scale Asset Purchase Program from $85 billion a month to $75 Billion a month. In plain English, this means that the Fed is slowing its pace of Treasury and Mortgage paper buying beginning in January – a sign that perhaps the Fed feels that the economy might be entering a self-sustaining growth stage.

Market participants had feared "tapering" ever since the word had been uttered by Fed Chairman Ben Bernanke at a press conference in May 2013. However, subsequent speeches and actions suggest that "tapering" does not equate to a ***"tightening of monetary policy"*** thus assuaging some of the fears. The Fed probably has more to do in this realm, although yet again, we suspect that the mere change in action has introduced an added sense of policy uncertainty going forward.

The end of January also sees the end of Ben Bernanke's term as Fed Chairman: While Uncle Ben will be remembered for introducing press conferences after FOMC meetings, he will most likely be seen as a Fed Chair that reveled in the use of ***unconventional monetary policy tools***. His use of Large Scale Asset Purchases – the so called Quantitative Easing – implies a willingness to stray off the beaten path in pursuit of monetary policy goals. Sometimes the ends do justify the means, we suppose!

The US Senate voted 56-26 to appoint Janet Yellen as the next Chairman of the Board of Governors of the Federal Reserve making her the first ***distaff member*** to do so. As the current Vice-Chair of the FOMC, she obviously brings significant credibility to the job. The current Quantitative Easing measure as well as ongoing ***"policy guidance"*** are all hallmarks of her work. We expect the Fed to continue to retain its focus on bringing the unemployment rate down during her tenure.

After the outsized gains in the equity markets in 2013, this year seems to be starting off a little slow. ***Earnings expectations*** for the S&P500 for 2014 imply a ***gain of 13.3%*** for the entire year – after a gain of 10.7% for 2013. Indeed, the consensus earnings figure of $121.14 per share, suggests a prospective ***valuation multiple of 15.2 times***. Using the past twelve months (or trailing) earnings per share of $107.19 per share computes a ***trailing multiple of 17.2 times***.

In other words, despite the gain witnessed in 2013, valuation multiples are not stretched and appear to be ***"reasonable".*** While we do expect the S&P500 companies to be able to meet (or even exceed) what's built-in to current prices from an earnings expectation standpoint, we do not anticipate much in the way of an expansion of valuation multiples in 2014. Holding the valuation multiple steady would suggest that one ought to expect a ***10% to 12% gain in the S&P500*** for the year as a whole.

Meanwhile, ***interest rates*** have risen during the early part of 2014 continuing their ***"drift up"*** from 2013. While a significant deterioration in inflation fundamentals would be needed to see a sharp increase in interest rates, we suspect that the secular decline in interest rates over the past thirty odd years is now largely behind us. A rise in interest rates during the year could well be the base case for 2014.

It is quite clear that staying ***over-weight equities*** relative to fixed income (the way your portfolios have been positioned) is the appropriate stance from an asset allocation perspective. Cash and cash equivalents remain an undesirable asset class – given the woefully inadequate return expectations for that group. Within equities, we still like small and mid-capitalization sectors relative to large capitalization ones, despite the former's out-performance in 2013. Within fixed income, we continue to like ***"credit"*** relative to Treasuries.

We also believe that 2014 might see better tidings for international developed market equities – especially those of small capitalization companies – that are nimble and have the ability to produce consistent earnings growth over time as a direct result of their efforts.

Emerging market equities performed poorly in 2013 posting a negative total return of -5.0% for the year – especially relative to US equity markets (S&P500 total return: +32.4%). The contrarian in us salivates at the potential for a "fat pitch" from investing in emerging markets in 2014. However, we still believe that one is not being compensated for the additional risk of emerging markets yet. A further decline in this sector would begin to make it attractive to us long term investors.

The ***Municipal market*** suffered last year, with the Bond Buyer Muni 6% Index posting a ***decline of -14.3%*** for the year. In a classic "throwing the baby out with the bath water" move, muni investors were worried by the City of Detroit's bankruptcy filing as well as worries about deteriorating credit quality in Puerto Rico and other jurisdictions. Suffice it to say that we believe an ***adroit municipal bond fund manager*** has the skill to be able to navigate these treacherous waters – as most of your municipal fund managers did last year.

In summary, we do expect financial markets to perform reasonably well in 2014, but our outlook is tempered by a ***note of caution*** after the large gains of 2013. As always, our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain ***favorable investment outcomes*** over the long haul, remains steadfast.

We would like to wish all our regular readers a Happy New Year! Here's wishing you and yours, much prosperity and good health in 2014.

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