Review & Outlook

FOURTH QUARTER 2013

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Review

Without a doubt, 2013 was a fantastic year for the US stock market. The S&P 500 index returned 32.4% (including dividends), making it the S&P's best year since 1997. But the market's outstanding performance underscored some confounding investor activity. The stock market was curiously strong during the first quarter, despite the sequester, and lingering concerns about Europe. Then, somewhat ironically, positive economic news in the second quarter sent the S&P 500 and other indices down, as investors worried that the improving economy would bring an end to easy money from the Federal Reserve.

The market decline that occurred during the 16-day government shutdown in October was slight and unexpectedly short-lived. Many people expected investors to panic, but the stock market slouched for only 6 days at the beginning of the closure, before steadily rising for the entire second week of the shutdown, despite the lack of any encouraging news from Congress. By the time the government reopened, stock prices had more than recovered. Remarkably, Twitter's IPO was successful, even though that company does not earn a profit. And Amazon.com, a Wall Street darling, is further proof that poor fundamentals are not always a deterrent to enamored investors, as is evidenced by Amazon's price-earnings ratio, which exceeds 1400, based on its most recent earnings. Time and again, it seemed that investors were reacting out of emotion, rather than reason.

> *"It is not clear how rising interest rates will affect stock prices, due to the low starting point, and effort by the Fed to keep short-term rates low. But it is clear that earnings growth will be critical."*

But most curious to us is why the stock market did so well at the same time corporate earnings declined (see Figure 2). While interest rates remained low during the year, they did start to rise, and bond prices fell. The Bar Cap US Aggregate Bond Index declined by 2.0% for the year. And the price of US Treasuries with maturities in excess of 20 years declined by more than 13.9%. The expectation is that the Fed will try to keep short-term rates low for another year or two, while encouraging mid- and longer-term rates to rise. These factors will keep bond returns low, possibly negative, for some time. In order to minimize the impact of rising rates on portfolio performance, and lock in the returns-to-maturity on purchase, we will continue to move capital from bond mutual funds to shorter-term individual bonds. Given the current market conditions, it seems unlikely that 2014 will be as rewarding as 2013 has been.

Outlook

Looking ahead to 2014, we have already identified some potential challenges. In the current environment of rising stock prices and stagnant earnings, we can find few, if any, attractive buys. In 2013, stocks in general appeared overvalued, so we allowed portfolio cash reserves to grow larger than usual, and we used a broad market index fund in lieu of individual stocks to keep cash allocations at reasonable levels. If earnings do not improve, we will continue to employ the broad market index fund strategy to avoid purchasing unattractive stocks that do not meet our criteria.

Current market conditions lead us to believe that a market correction is increasingly likely if earnings do not grow rapidly in 2014. However, a strong increase in earnings could prompt the Fed to accelerate the tapering of its stimulus program, which could then cause stock prices to decline, as investors might pay more attention to the Fed's decisions than to stock fundamentals.

We doubt that conditions will be such that the Fed would allow short-term interest rates to increase, but longer term rates, which started to rise in 2013, are likely to increase even more in 2014. In general, rising interest rates tend to make stocks less attractive, as investors flock to the security offered by bonds. But we can't know exactly how rising interest rates will influence stock prices in 2014, given that the Fed will be trying

to keep short-term rates low. So, with all these contradictory forces working on stock prices, what do we defend against: a correction in the market caused by overvaluation, or a correction in the market caused by rising interest rates? Do we even need to prepare to defend against anything at all?

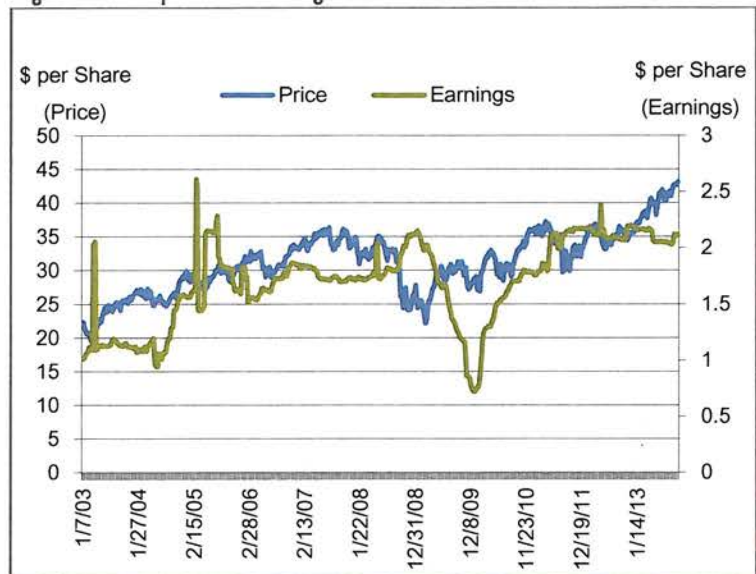
History suggests that a portfolio designed to do relatively well in a generic market downturn might not perform as well if the problem is caused by rising interest rates, and vice versa. For example, a portfolio with defensive stocks, like utilities, might do relatively well in a broad market downturn, but suffer with rising interest rates. A portfolio that emphasizes large-cap stocks might hold up better in an environment of rising interest rates, but not perform quite so well in the event of a broad market correction. While history is certainly helpful, it is not a perfect guide for the future. And it does not provide us with examples of the sorts of interest rates that we have right now, or models for how to manage the challenges that those rates present.

Figure 1: Bond Rates

Bond Type	Yields for Nov. 2013	Adjusted for Inflation	Average 2003-2013 (Unadjusted)
12-Month US Treasury	0.12	-1.5	1.76
10-Year US Treasury	2.72	0.55	3.60
30-Year US Treasury	3.8	1.51	4.4

It seems likely that the yield on 10-year US Treasuries could climb towards 3.5% by the end of 2014, close to its average since 2003. And we expect shorter term rates to stay close to zero. Keeping short-term rates low will require a degree of intervention from the Fed, and should help support equity prices. As we have noted, it is not clear how rising interest rates will affect stock prices, due to the low starting point, and effort by the Fed to keep short-term rates low. But it is clear that earnings growth will be critical.

Figure 2: Corporate Earnings and Stock Prices



While we are anticipating a market correction in 2014 if earnings do not improve, we do not expect it to be significant. Our strategy is to stay invested, and to be properly diversified. Our goal is not to be overly exposed to any particular type of risk, and not to prepare for just one scenario. We think that the Technology and Industrial sectors could do well, recovering from weaker performances in 2013, and that the Energy sector could improve as the recovery continues. Energy stocks, in particular, may benefit more from broad conditions, and be less influenced by rising rates or a general market correction. We are, however, a bit concerned about retailers, and cyclically oriented stocks, given their gains in 2013.

Finally, we note that the year ended with a renewed emphasis on fundamentals. With tapering by the Fed underway, and positive news about the economy overall, stocks with the strongest fundamentals performed best during the fourth quarter. Our portfolios also finished the year strong, which is not surprising since our focus is fundamentals. We believe this is a better strategy than trying to defend against any one particular factor, like rising longer term interest rates, or a possible market correction. As such, we will continue to watch corporate earnings carefully, and respond quickly to information that could tell us when, and how, to be defensive. As we move into 2014, we remain hopeful and vigilant.

1. Figure 1: Source: Federal Reserve (http://www.federalreserve.gov).
   Note: Figures for adjusted 12-month treasuries, and 2003-13 average for 30 year treasuries, calculated at Waycross for illustrative purposes only.
2. Figure 2: QED/Waycross. Chart created with data from QED, our proprietary analysis software.

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