

Altamont Wealth Management

Fourth Quarter 2013 Performance

“Every time you spend money, you’re casting a vote for the kind of world you want.”

Anna Lappe

To say that 2013 was a good year for stocks would be a bit of an understatement. Nothing could derail the U.S. stock market last year and let’s just say that at times it seemed that Congress and Federal Reserve were trying to slow down the train. But the bull market train powered through the surprise rapid rise of interest rates by the Federal Reserve in the spring to the government shutdown in the fall. The S&P 500 index (of U.S. Large Cap stocks) rose 32% for the year and 10½% in the fourth quarter. The Dow Jones Industrial Average (the oldest U.S. stock index) and the S&P500 hit all-time highs in 2013.

Mid and Small Cap U.S. stocks had a similarly spectacular year with Mid Cap S&P400 and Small Cap S&P600 up 34% and 41%, respectively. The small and midcap sectors haven’t generated returns even close to this level for 10 years. The Small and Midcap U.S. equity markets tend to be volatile. For instance during the 2008 financial crisis, the smaller indices fell almost 40%.

The biggest story in the fourth quarter, and for 2013 for that matter, was the Fed's quantitative easing program. The market was fixated for months on the timing of the central bank's exit from its aggressive support of the financial markets. Beginning in the first half of 2013, Chairman Ben Bernanke began discussing the possibility of tapering the purchases of securities in the face of improving economic data. The Fed’s unanticipated guidance in May led to a sharp and sudden increase in Treasury rates as the 10-year Treasury yield moved from 1.7% at the start of May to 2.2% in less than four weeks. Though the bond markets were expecting the Fed to unwind its support programs in the *future* this sooner-than-anticipated guidance hit the bond market hard.

Long-government bond funds were the clear losers in the fourth quarter and the year as rates moved higher ahead of the Fed's decision to reduce the size of its bond-buying program. The category was down 3.5% in the quarter and down 14.0% for the year. Other categories, from emerging-markets bond (down 7%) to long-term bond (down 6%), also had challenging years. High-yield bonds had the brightest quarter (up 2.9%) and year (up 6.8%).

Fourth Quarter 2013 Benchmark Index Returns

	Fourth Quarter	2013 Year
Large-Cap Benchmarks		
S&P 500 iShares	10.5%	32.3%
S&P 500 Growth iShares	11.0%	32.5%
S&P 500 Value iShares	9.8%	31.6%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	8.2%	33.5%
S&P 400 Mid Growth iShares	8.2%	32.6%
S&P 400 Midcap Value iShares	8.1%	34.0%
Small-Cap Benchmarks		
S&P 600 iShares	9.7%	41.3%
S&P 600 Growth iShares	9.7%	42.3%
S&P 600 Value iShares	9.3%	39.3%
Other Benchmarks		
MSCI EAFE Int'l iShares	6.1%	21.4%
MSCI EM Int'l iShares	3.5%	-3.7%
Vanguard Total Bond ETF	-0.2%	-2.2%
DJ-UBS Commodities iPath ETF	-1.4%	-11.1%

The precipitous fall in rates caused the Fed to back track. The Federal Reserve Board began a PR campaign to convince the market that they would not begin the taper until the economy was strong enough to support it and would leave short-term rates to remain extremely low for the foreseeable future.

By the time Fed officials announced in December that they were going to reduce the size of their bond purchases by \$10 billion a month, the stock market reaction was quite muted as investors had already priced in the taper. However, the bond market continued to fall as interest rates rose in the fourth quarter, with the 10-year Treasury rate touching 3% just before the end of the year.

The PR campaign worked to shore up the U.S. equity markets but not the bond markets. Essentially any investment used to manage risk performed poorly in 2013. All sectors of the bond markets performed poorly. The Vanguard Total Bond ETF, which is good proxy for the total bond market, fell 2.2%. Certain sectors of the bond market were hit hard by rising interest rates. Long Term U.S. bonds fell 10%. Inflation Protected bonds (TIPS) fell almost 8%. Besides most sectors of the bond market, commodities fell 11% in 2013. Mutual funds that used derivatives to counterbalance risk fell significantly as well. It was the year when diversification and risk management hurt.

This story is far from over. The Fed still has a long way to go to exit all of its extraordinary measures. And if 2013 showed us anything, it was that it's incredibly difficult to predict how the market will react to the Fed's moves in the years to come. Just like there was no road map for putting these interventions into place, there is no clear path of how to exit them.

Washington provided another saga this year. In addition to the Fed and its monetary policy in 2013, there was political wrangling over fiscal policy. It was a Congressional soap opera of on again and then off again bargains. Initially both sides of the Legislative aisle were able to come together to strike a last-minute deal to avert the worst of the fiscal-cliff tax hikes and spending cuts with an extension of the debt ceiling. But all semblance of cooperation dissolved by October with the government shut down. The 16-day shutdown came to an end with another bipartisan deal that laid the groundwork for a subsequent deal that will fund the government for the next two years. The good news for investors is that after years of shakiness, the budget deal reached at the end of the year will provide a level of certainty over fiscal policy for some time.

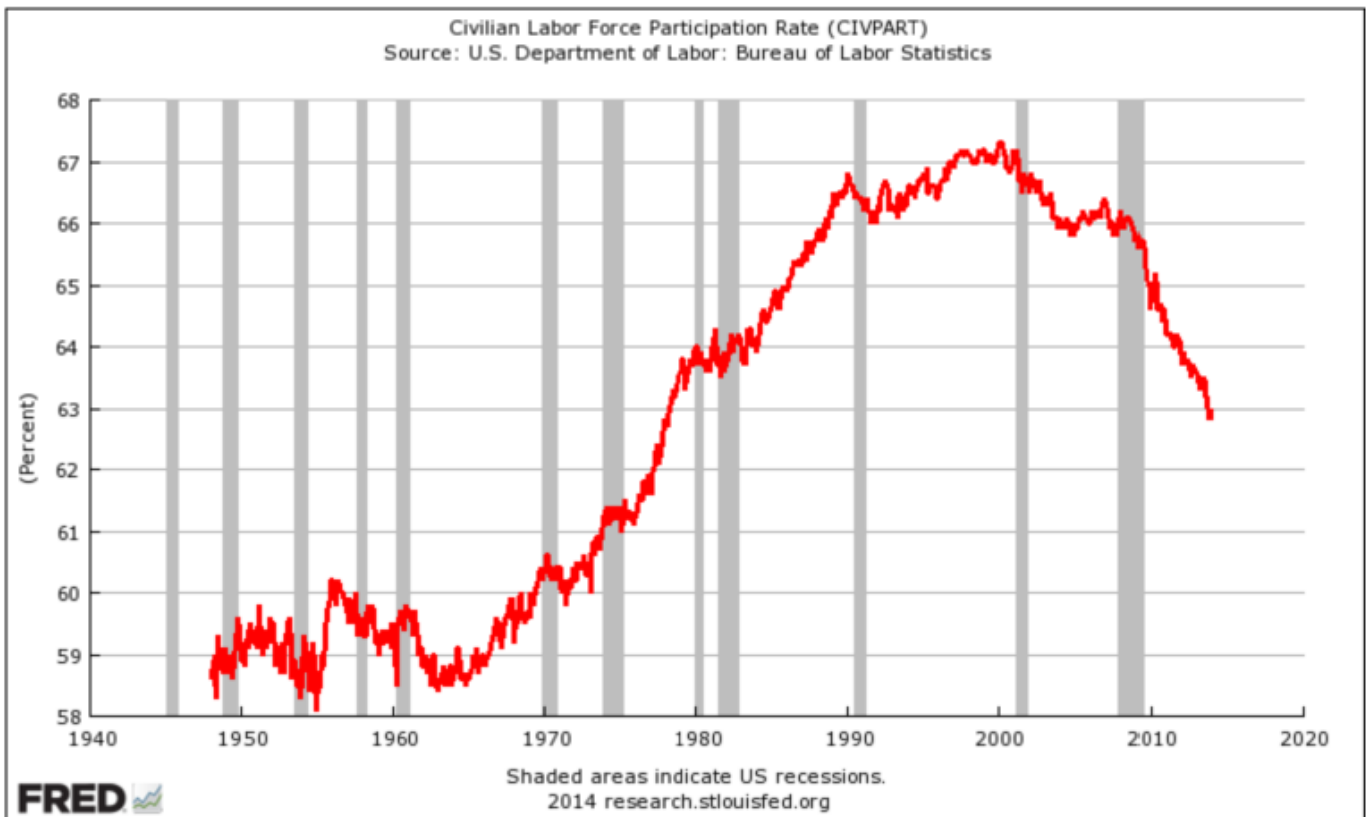
The backdrop against which the Fed and Congress were making decisions was a slowly improving domestic economy. Gross Domestic Product growth rate expanded around 2.3% last year, which is above the 2.0% growth rate experienced the last two years. Though this is an improvement it is not even close to the average GDP growth rate of 3.2% that postwar Americans have enjoyed from 1948 through 2000. Most economists see a continuation of the slow-growth theme in 2014 and further. The consensus estimates are

that the U.S. could muster, at best, an average GDP growth of around 1.9% between 2012 and 2032. This is why economists are calling this a lukewarm or suboptimal economy.

Though unemployment fell in 2013 to 6.7%, it did so because people fell out of the labor force and not because they found jobs. In fact the portion of the population now working or looking for work is smaller than it's been since 1978. So the statistic to track is labor force participation which is the percentage of working-age people in an economy who are employed and are unemployed but looking for a job. In the United States the labor force participation rate is usually around 67% to 68%. Currently labor force is heading towards 62%, a rate not seen for over 35 years.

Most disturbing is the loss of jobs in for the prime-aged (25-to-54-year-old) workers over the past year. Their participation rate dropped from 83% in the fourth quarter of 2006 to 81% in the third quarter of 2013. In addition, youth (aged 16 to 24) rates have declined from 65% in 1988 to just 46% in 2012, while females (age 20 and over) saw a dramatic rise in their participation from 35% in 1968 to 58% in 2000, only to fall back to 55% in 2012. The loss in labor participation is especially destructive in the prime and youth age groups. Some workers will never reach, or recover the careers they would have had or from the earnings loss after all the years of unemployment.

A falling unemployment rate is misleading. The statistic that bears monitoring is labor



force participation rate. This tepid economy will never start cranking at full bore until the labor force participation rate begins to rise again. That will require significant consistent

month-to-month job creation before the U.S. economy can begin to really crank. In the meantime it will continue to do well but the middle class will continue to suffer.

There were significant disruptions in the U.S. municipal-bond market last year. The fallout from the 2008 financial crisis is impacting municipalities around the country and their ability to pay their municipal bond obligations. This culminated with Detroit's municipal bankruptcy filing in June, the largest-ever such filing. It has always been debated whether municipalities could file for bankruptcy and walk away from their unfulfilled pension obligations. A Federal judge ruled in December that the bankruptcy could. Detroit's bankruptcy could set a precedent for other highly indebted municipalities like Chicago. Despite all the negative headlines, the overall health of the muni market as a whole remains healthy, with many municipalities recovering well as the U.S. economy gains some steam.

International markets performed well in 2013, with developed countries' stock markets gaining 21%. Japan woke from its slumber in 2013 with the launch of an economic three-pronged plan by Prime Minister Shinzo Abe. The plan is designed to jump-start the Japanese economy. So far the plan has been successful by lowering the value of the yen. At the beginning of the year, you could buy 87 Japanese Yen for a dollar versus 104 Yen now. In response, the Japanese stock market (the Nikkei) rose 57% during the year.

In Europe, the euro crisis remained mostly silent as leaders worked on plans (unsuccessfully so far) to try to fix some of the systemic issues that face the common currency. European economies also seemed to have turned the corner out of recession and back to very slow growth.

China had an uneven year as the country struggled with how to move from an investment-led economy to one driven by consumer demand. Growth seemed to have picked up somewhat in the fourth quarter.

International-equity funds as a whole trailed domestic-equity funds in the fourth quarter. India equity (up 12%) was tops in the quarter but among the worst for the year, losing more than 10%. Europe stock (up 7%) and world stock (up 6%) also had good quarters. Latin America stock was the biggest loser in the quarter (down 3%) and year (down 11%). Japan stock (up 26%) was the best performer in the year.

What to expect in 2014? It is never clear but it wouldn't be unusual to back track from the from last year's run up. This is normal to test new highs. Despite this bump it is a very likely that the U.S. stock market will have a decent year. Returns may be sub-par if the economy continues to just plod along. Only a significant uptick in the economy (especially in the labor force participation rate) will provide the fuel needed to ignite the U.S. stock market.

International stock markets and especially Emerging markets are cheap compared to the U.S. stock market. However, if the U.S. stock markets fall it will drag the Emerging markets with it. Conversely, if the Emerging economies, particularly China, experience sharp declines in their growth rates, they could pull the U.S. markets into their downdraft. The global economies are more connected and dependent upon each other than ever.

The bond market will not offer much solace in this tepid environment. Interest rates will begin to rise as the Federal Reserve starts tapering its market support. Rising rates will make it difficult for the bond market to generate a positive return. (Remember, the value of bonds and interest rates are inversely related). Bonds are still valuable because they offer shelter in a market meltdown.

As you can tell, I anticipate that the markets will remain volatile in 2014. Uncertainty equals volatility but can also mean opportunity. It is likely that any decline will be a temporary setback. Staying diversified to avoid heavy losses while trying to capture as much of the upside (and avoiding as much of the downside) as possible remains our refrain; managing risk while grabbing return. It is a tune that should play well in 2014.

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