Market Review and Outlook—January 7, 2014

In case you didn't notice, 2013 was a GREAT year for investors. US stocks jumped up more than 30%, foreign stocks earned almost 20%, and science and technology gained over 35%. While bonds fell, it was a small amount, and average investors (those investing in a 60% stock, moderate-allocation fund) earned over 15% in 2013. How was this possible?

2013's headlines were focused on the federal government—the last minute budget deal, the sequester, the restoration of the full payroll taxes, and the government shutdown. Less than 20% of the US economy, however, relies on government spending. The 2013 reduction in government spending was overwhelmed by increased spending by individuals and corporations. Thus, despite the headlines, the US economy grew in 2013, and as a result, US companies did well. Some investors (not too many, for there is still a lot of cash on the sidelines) bought stocks in 2013, and the multiples widened. This means that stocks became pricier, as the amount investors were willing to pay for one dollar of earnings rose. Together, this led to a hit-the-ball-out-of-the-park year for US stock investors. In the past quarter, US stocks rose close to 10%, foreign stocks rose about 6%, while bonds barely broke even.

Bonds provided mixed results in 2013. Long-term government bonds lost over 13%, inflation-linked government bonds fell close to 8%, emerging markets bond funds fell over 7%, while short-term bonds managed a slight gain, and high-yield bonds gained almost 7%. Municipal bonds did worse than corporates, as worries about Detroit and Puerto Rico led to price declines. In 2013 high-yield municipal bonds lost 6%.

Similarly, stocks delivered a mixed bag of results. Healthcare stocks rose over 48%, while precious metals stock fell over 48%. While foreign stocks generally had a good year, emerging market stocks fell slightly (-0.14%). Concerns in Europe diminished, and with that, the sky-high yields for foreign government bonds, such as Greece's, came down to earth. Yields on Spanish and Italian 10-year government bonds are now barely above 4%. This provided the backdrop for growing confidence in Europe. With a strengthening US and Europe, the rest of the world benefits. This broad economic improvement led to the broad stock market gains of 2013.

The flat bond results and strong (and varied) stock market gains leave investors with out-of-balance portfolios. More than anytime since 2009, investors should focus on rebalancing their portfolios, sealing in profits and being intentional with the level of risk their portfolios carry. Rebalancing guarantees that you sell winners and buy losers, and that you will never outperform the strongest area of your portfolio, yet more importantly it also protects you from the sharpest losses in bad times, and it provides a smoother path for your portfolio. Make rebalancing your 2014 resolution.

Category	**3 Months**	**Past Year**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.14%	+1.72%
Intermediate Term Bond	+0.29%	-1.44%	+3.64%	+6.31%	+4.33%
Intermediate Muni Bond	+0.22%	-2.27%	+3.96%	+5.24%	+3.38%
Large-Cap Stock	+9.76%	+31.54%	+14.49%	+17.10%	+6.93%
Mid-Cap Stock	+8.76%	+34.10%	+14.22%	+20.01%	+8.57%
Small-Cap Stock	+9.22%	+37.48%	+15.15%	+20.37%	+9.05%
Foreign Large-Cap Stock	+6.03%	+19.46%	+6.74%	+12.31%	+6.96%
Real Estate	-0.40%	+1.48%	+8.65%	+16.21%	+7.83%
Natural Resources	+3.96%	+8.75%	-0.16%	+13.49%	+9.63%
Science/Technology	+10.16%	+35.45%	+11.93%	+22.18%	+8.05%
Moderate Allocation	+5.39%	+16.48%	+9.16%	+12.84%	+6.05%

The data in this table comes from Morningstar and is as of December 31, 2013.
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So, How Did I Do? Regardless of how painful, each January, I review the accuracy of my predictions for the past year, and then share my predictions for the upcoming year. On January 4, 2013 the MARKET REVIEW AND OUTLOOK forecasted that 2013 would be good, but not as good as 2012 was. The great news is that I was wrong—2013 was even better for investors than 2012. While bonds lost a small amount, foreign stocks returned almost +20%, and US stocks returned over +30%.

Actually, my 2013 predictions were mixed—I got five out of eight correct. My misses weren't off by much. High-yield bonds returned +6.9% and I predicted 7% or more. I expected general bonds to post minor gains, less than +5%. They actually lost a small amount: -1.4%. Similarly, I expected modest gains by non-US bonds, but instead they fell, –2.6%. My concern for real estate was deserved—it returned only +1.5%, and I expected gains, of less than 7%. Growth did outperform value, by 2.5%. I expected both US and foreign stocks to post good gains, of +7% or more—the actual results were dramatically better.

Sector	2013 Prediction	2013 Actual	2014 Prediction
Large-cap US Stocks	Up 7% or more	+31.5%	More than +9%
Smaller US Stocks	Up 7% or more	+35.2%	More than +7%
Non-US Stocks	Up 9% or more	+19.5%	More than +8%
Growth vs Value	Growth outperforms	Growth +34.8%, Value +32.3%	Growth outperforms
Real Estate	Up less than 7%	+1.5%	More than +5%
General Bonds	Up less than 5%	-1.4%	Less than +4%
High-yield bonds	Up 7% or more	+6.9%	More than +5%
Non-US bonds	Up less than 7%	-2.6%	N/A

2014 Predictions—While foreign stocks are the cheapest, I expect that investors in 2014 will favor US stocks, and large US stocks in particular. In 2014, as interest rates rise, value stocks should become less attractive to investors. This, coupled with some great 2013 results for growth sectors (such as biotech), leads me to expect growth to lead in 2014. Real estate has mostly positive factors, but could be limited due to rising interest rates. For that reason I have a more modest 2014 expectation for real estate.

General bonds should provide very muted returns, perhaps even another slightly negative total return. Our clients fared better in 2013, due to our use of shorter-term bonds, and our use of opportunity bonds (including high-yield). I expect high-yield bonds to outperform general bonds again in 2014, although likely by a smaller margin. We no longer believe that there is value to investing in focused non-US bonds. These are affected by too many factors that are impossible to forecast.

My primary theme for 2014 is for more of the same, but with a smaller magnitude. Stocks should do well, but not spectacularly, and bonds should be nearly flat. I am very optimistic about the US and global economy, and in US and global stock prices. **What I expect to change in 2014 is that by the end of the year, investors will be optimistic, and that will be a major change.**

The Fed plans to keep short-term rates near zero in 2014 (and perhaps through 2015), and longer-term bond interest rates are unlikely to rise more in 2014 than they did in 2013. General bonds should therefore earn low single-digits. The US economy did fine in 2013, despite significant government headwinds such as the sequester, the full payroll tax resumption, and the October partial shutdown. **No government headwinds are on-deck in 2014.** The US housing industry continues to strengthen, and in 2014 it should add further to US economic growth. The global economy is recovering, with China's slowdown behind it, and with Europe clearly having turned the corner from its crisis. This should lead to growing US exports, also helping our economy. **2014 looks good.**

Stocks are not expensive. They are 3.4% more expensive than their long-term average, but given the absurdly low current level of interest rates, and the very low level of inflation, this is reasonable. In fact, given the level of interest rates and inflation, stocks are downright cheap. Foreign stocks are even cheaper, and US investors have very low levels of foreign stocks in their portfolios.

I am fundamentally a contrarian. Therefore, all of this good news normally would lead me to be cautious with stocks for 2014. There is only one reason that I am not, and it is a strong reason. Few people believe that stocks will rise in 2014. Robert Wiedemer, 'an esteemed economist and author of the New York Times best-selling book *Aftershock*' is predicting a drop in the stock market of up to 90%. Investors hold over $10 trillion in cash, money markets, and savings. More investors are worried about stocks than excited. These are not the signs of the top of a stock market; these are signs of a market with much room to rise.

I expect that one more year of strong stock market returns (high single digits or better), and another year of disappointing bond market returns will make believers of many investors. In a year, I expect to be advising more caution, to seal in your 2014 profits. But not now, not in January 2014. 2013 may have been the best year in quite awhile, but **2014 looks to be very kind to stock investors**.