Prepared Comments from 1/27/2014 Conference Call

Let me begin by apologizing for failing to hold this two weeks ago—it slipped through the cracks. We expect to provide quarterly calls the week of the 15th of April, July, and October this year.

2013 was incredibly profitable for stock investors, and while most bonds lost money, the magnitude of the losses were minor, and overwhelmed by stock gains enjoyed by balanced investors.

What is the single best economic justification for 2013's stock gains? Nothing major failed. Tax increases at the start of the year, and even a multi-week federal government shutdown were unable to break the back of the 2013 US economy.

What awaits the US economy in 2014? The US economy is expected to fare better in 2014 than in 2013, as there is no hefty headwind, and in fact there are some tailwinds. Auto sales are at normal levels, and should rise and remain above-normal for some time, given the age of the average car out on our roads. Housing prices have already recovered a fair amount, and inventories of unsold homes are back to normal levels, having worked through the glut of the past 8 years. Despite some recent rise in mortgage interest rates, housing affordability remains VERY favorable.

While we have a new Chair of the Fed, the Federal Reserve Bank, no significant change in direction is expected. The Fed continues to share its thinking, to minimize surprises. They continue to stimulate the economy, as they have been doing for over five years. The question is fast approaching, can they put on the brakes to avoid run-away inflation, without crippling the US economy. I offer two factors which give me optimism. First, inflation is no where in sight, with core inflation at 1.7% in the past year, and headline inflation even lower due to energy price declines. Second, as the Fed re-wrote the book on how it could and should stimulate a crippled economy, this has left it with an incredibly broad set of tools to slow things down. While the Fed has few tools to further help accelerate our economy, it is up to its eyeballs with tools to slow us down.

Europe suffered with the US in the 2008-2009 fiscal crisis, and then suffered a second serious crisis, beginning with Greece and in time involving several additional 'peripheral' nations. As a result, its economic recovery is a few years behind the US', however in 2013 Europe appeared to turn a corner, as business confidence has solidified, and confidence is growing that the worst is behind Europe. As a measure of investor worry, 10-year Greek government bonds peaked at over 35%; they ended the year at 8¼%, and Italian and Spanish government bonds are barely over 4%.

Congress has appeared to have decreased its appetite for self-created crises. I do not expect a debt-ceiling standoff this year. While this is an election year, it is not a Presidential election year, and the election impact on the US Congress is unlikely to change either house's leading party.

The annual federal deficit, as a percent of our US economy, fell sharply in 2013, and is expected to fall again, by a much lesser amount, this year. The total federal debt, as a percent of our economy, is plateauing at about 73%, and is expected to not rise further.

The national unemployment rate has fallen from its 2009 peak of 10% to the current 7%, and we are on pace to have replaced the 8.8 million jobs lost during the downturn, later this year. This is good both for consumer confidence, and for the federal and state governments, which pay for much of unemployment costs.

Global purchasing managers are much more confident than they have been at any point in the past two years. With the exception of France and Greece, most of developed Europe has growing prospects. The only other two notable countries with subpar prospects are Australia and Russia, and both cloudy outlooks are partially due to depressed energy and natural resource prices.

Growth rates—emerging markets continue to have better past and projected real economic growth rates than developed markets, about 4% versus just under 2%. Strongest growth is expected from China, India, and Korea in the emerging area, and UK, US, Canada, and Germany for developed markets.

Investors have begun to become more comfortable with stocks than with bonds. For the first time since 2007, in 2013 investors have bought more stock funds than they sold. That said, since early 2007, investors have bought $0.50B of stock funds but $1.35B of bond funds, so we are far from a normal level. While stock purchases have outweighed bond purchases for the past few months, the balance has been opposite for this, almost for the prior 48 straight months. We are far from normal.

While US stocks have marched upward almost unimpeded for two years, and dramatically in the past five, the prices have largely risen at the same pace as cash flow, earnings, and dividends. In other words, US stock prices have earned the right to be where they are. Typical measures of whether stocks are cheap or expensive, such as forward P/E levels, are well within the range of normal values. While they were cheaper in the past five years, they are not clearly expensive today.

The bubble is beginning to burst for bonds. That really is an overstatement—let's just say that the pressure within the balloon is slowly diminishing. Bond prices fell across the board in 2013, in most cases by more than the interest received (overall by 1 or 2% total). Bond prices falling, however, lead to higher yields, which means that now bond prices would have to fall more in 2014 for bond investors to lose as much as they did in 2013 (since the yield cushion is higher). Furthermore, the Fed has been very clear that they plan to act very slowly and gradually in tapering the stimulus it has been providing to the bond markets. Thus it appears that while bonds have a headwind in 2014 and beyond, the likelihood of large bond losses are fairly small.

Earlier this month JP Morgan's chief strategist shared five 2013 resolutions. First rebalance—the dramatic stock gains, and modest bond losses almost certainly have caused your portfolio to be out of balance. Take steps now to ensure that your portfolio is where you want it to be, deliberately—don't let it merely drift.

Second—look for total return, not just yield. 30 year treasuries yielded 3.3% in 2013, but provided a 15% loss to investors. In hindsight, it was better to hold a lower-yielding bond with less interest-rate sensitivity, or even a stock with a 2.5% yield. Investors receive both income and capital gain/loss; this is called the total return. If you focus too much on just yield, just income, you can make poor decisions.

Include foreign stocks sensibly. The US stock market makes up less than 50% of the global stock market, and yet US investors typically have only 25% of their stocks invested overseas.

This results in less access to diversifying regions, including those with greater growth rates, as mentioned earlier. In 2013 this more global approach would have hurt you, compared with a US-only stock approach. Yet over time, shifting your stocks to be more reflective of our entire planet should serve you well.

Stocks are no longer bargains. They are fairly priced. I have already heard from clients this month (but not since Friday), interested in stepping up their level of stocks, partially due to the strength of 2013's results. Hearing that investors are too optimistic worries me. For this reason, Friday's sharp stock market drop actually gave me confidence, that it will be easier for investors to see both the promise and risks of boosting stocks. I find stocks to be fairly priced now, and bonds to be a bit overpriced, however in both cases, this was more extreme a year ago—stocks were cheaper then, and bonds were more overpriced.

Kelly's last resolution was 'When cash pays nothing, get invested in something.' He notes that there is over $10 trillion in cash/savings. At current interest rates, these dollars are guaranteed to lose 1% or more annually to inflation. You are guaranteed to lose. We all need some ultra-safe resources, but for long-term money, cash is a losing proposition.

Thank you for listening

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