Market Review and Outlook—April 5, 2014

Largely a sideways quarter. We had Winter Olympics with little controversy, but followed that up with turmoil in the Ukraine. While Janet Yellen was confirmed as our new Fed Chair (the first female chair), replacing Ben Bernanke, she appears to plan to continue the Fed's recent practices, at least initially. Europe is very slowly crawling out of its sovereign debt crisis-led double dip recession. Following a very strong year for stocks, the past quarter brought very modest results, from both stocks and bonds. Bonds, rising 1-2%, kept up with, and in some cases outperformed, stocks this quarter. **The average investor, with a 'moderate allocation' approach, earned 1.6% in the past three months.**

The US economy ended 2013 with solid 2.6% growth, however the 1st quarter will likely come in much lower due to the harsh winter. Fortunately, **solid growth is expected in the US for the rest of 2014**. Vehicle sales continue to run above average levels, as do real capital goods orders. Real estate prices, both residential and commercial, continue to rebound, and inventories of houses on the market are down to, and are remaining at, normal levels. The federal budget deficit is about 3%, at or below where it was for most of 1975-1995, and well below its 10% peak in 2009. Unemployment has fallen to 6.7%, and is approaching its 50-year average level of 6.1%. Inflation fell during the quarter, and is up only 1.1% in the past year, partially due to declines in energy and transportation costs.

Overseas economies in developed markets generally enjoyed steady growth in 2013, from near-zero levels at the start of the year to 2% by the 4th quarter. Emerging market countries also enjoyed fairly steady economic growth in 2013, and while they are expected to see their growth slow slightly this year, this is from an attractive 4% current level. Globally, manufacturing activity/momentum slowed a small amount during the quarter, but continues to be above average. The only notable exceptions are Australia, China, Greece, and Russia.

In the past quarter, precious metals leapt 12%, but are still down over 30% for the past year. Real estate rose 9%, while utility stocks and long-term government bonds returned more than 7%. Healthcare stocks rose over 6%. Latin American stocks were the only notable investment segment which fell more than 1% during the past quarter. Investors continued to buy more stock funds than bonds during the quarter, but the amount of difference declined, compared with late 2013.

As the quarter brought almost equal results from stocks and bonds, **many investors may find that minimal rebalancing is required at this point**. Investors who have not yet rebalanced their portfolios after 2013 should not delay; the benefits are still available to you, for now. We are making some changes within our target bond levels.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.08%	+1.70%
Intermediate Term Bond	+1.94%	+0.21%	+3.99%	+6.62%	+4.28%
Intermediate Muni Bond	+2.33%	-0.29%	+4.56%	+4.99%	+3.50%
Large-Cap Stock	+1.70%	+21.17%	+13.09%	+20.02%	+6.92%
Mid-Cap Stock	+2.54%	+22.66%	+12.27%	+22.97%	+8.31%
Small-Cap Stock	+1.45%	+24.10%	+12.74%	+24.09%	+8.61%
Foreign Large-Cap Stock	+0.11%	+15.39%	+5.80%	+15.41%	+6.36%
Real Estate	+9.06%	+3.73%	+9.67%	+27.18%	+7.52%
Natural Resources	+2.69%	+8.64%	-1.74%	+14.59%	+9.54%
Technology	+2.39%	+30.00%	+10.58%	+21.68%	+8.08%
Moderate Allocation	+1.64%	+11.86%	+8.40%	+14.55%	+6.01%

The data in this table comes from Morningstar and is as of March 31, 2014.
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Due to the VERY gradual pace, **the economic recovery in the US appears have plenty of room to continue**, despite completing its 5th year this quarter. Similarly, while the US stock market has been recovering for 5 solid years, current stock prices are not clearly expensive as they have largely merely kept pace with the underlying companies' profits. Certainly stock market profits from this point forward will most likely be much more modest than profits from this time, than from one, two, or five years ago.

Similarly, we have recommended a much higher-than-normal use of 'opportunity bonds' in the past five years, as the recovering economy has favored bonds with more credit risk. In the past five years, high-yield bonds have outperformed intermediate-term bonds by a large margin. Thus future profits in this area will most likely be harder to come by than in the recent few years, so **it is time to start becoming more wary for opportunity bonds**.

The two areas with the best risk:reward characteristics we see at this time are Europe and emerging market stocks. Both are out of favor, largely for good reasons. Europe took less drastic actions in 2008-2009, and thus began to emerge from the financial meltdown later than the US, and then it suffered a double-dip, with the Greece and other peripheral country-led sovereign debt crisis. We appear to be at or just beyond a turnaround point, such that new developments are generally better than expected. As such, we have been establishing positions in European stocks for a few months.

Emerging market stocks have similarly been under a cloud, but for less time, less than a year. China always presents challenges for investors. Other emerging markets have been rejected by investors, due to concerns over their reliance on sale of natural resources (which have been under pressure for the past year or more), and due to concerns with their susceptibility of pressure when the US interest rates rise. Those are good reasons, good concerns. However, at some point investors will likely recognize that those worries are fully reflected in the relatively low prices of emerging market stocks. For these reasons, **we have been stubbornly maintaining a fairly high level of emerging market stocks**.

Overall the past quarter was fairly quiet for investors. As a result, our outlook is largely unchanged. We continue to find cash unappealing. Bonds are OK but uninspiring. Given the alternatives, we like stocks a little more than normal. We like the economics backing up the companies behind the stocks. We also like the tailwind which the continuing shift of investors' dollars from cash into both stocks and bonds (more to stocks for the past nine months).

As contrarians, we like to be early to the party, but to leave before the police arrive. We prefer to purchase investments before they become popular, and thus before they become expensive, and we like to sell investments while they are popular, while they are expensive. This doesn't mean broad SELL THIS, BUY THAT moves, but rather we prune—we cut back areas that have been stronger, and maintain or boost areas which remain out of the spotlight.

At this time, this means that we are ensuring that we are at or below normal levels for utilities and health-care stocks. We are also being more strategic with our high yield bonds, and we are reducing our position in bank loan bond funds, due to their recent popularity (and resultant reduced upside). We remain committed to **emerging markets stocks**, despite their being out of favor for a few quarters. In the second half of 2013 we began establishing a **Europe-only stock position**, and we continue this approach. While the European economy is not out of the woods, the region is doing more good things than bad, and stock prices do not yet reflect the coming recovery. As we saw clearly from 2009 forward, US stocks began strong recoveries well before economic growth was well established, and we expect the same in Europe.

We are taking advantage of two apparent bond opportunities at this time. We are establishing a very small allocation to **long-term bonds**. These were hurt badly in 2013, and have recovered a little in the past quarter. They appear to offer adequate yield and prices, relative to their risks. We are also focusing a small slice of client bond money in **high-yield municipal bonds**, even for tax-deferred accounts and low-tax bracket investors. This is due to the pure potential return, yield and price increase, that they offer, regardless of tax benefits. Here we are trying to take advantage of an out-of-favor sector of the overall bond market.

For the rest of 2014, we currently expect continued modest returns from stocks, led both by profit growth and growing investor confidence. Bonds should continue to have challenges, but could end the year with positive returns. Investors always face risks, however **a well-diversified portfolio, with protections for all likely risks, regularly rebalanced, should shield investors from the most painful challenges around the corner**.