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Developed market equities have been the winners in 2013, and the asset class of choice, post the first indications of Fed tapering in May which had triggered an implicit stress test for markets. The U.S. stock market ranked second after Japan with +29%, followed by Spain and Germany. U.S. sovereign debt ranked third after Italy and German debt being down 3% in 2013 and in foreign exchange the Euro/USD was +4% and JPY/USD was -16% and commodities fell 1% headed by gold, which lost 27%. Central banks remained highly accommodative in 2013, buffering the impact of sequestration in the U.S. The market was mainly distracted by the debate of tapering, the US debt ceiling (fiscal cliff) deference, and the reforms and growth in China. This year was most unkind to diversification. Excluding equities, most asset classes had near zero to negative returns for the year. In 2014 the Fed will start to taper in Q1. Forward guidance indicates that first interest rate increases are not expected to take place before late 2015. The economy is likely to remain on track with ample liquidity in the market, a continuous low interest rate environment, a slowly improving labor market and a strong domestic market due to infrastructure, energy projects and the strong recovery of the auto industry.

Economy

With the global economy maintaining a slow, steady rate of growth, the trend has improved over the past few months. Developed economies generally remain in more favorable phases of the business cycle. China's late-cycle economic expansion has shown signs of incremental improvement and some emerging markets have stabilized, Germany is in an early-cycle recovery, and Japan and the U.S. firmly in the mid-cycle. A number of policy risks still exist, most notably the new U.S. fiscal deadlines and the debt ceiling, again, early next year. Fundamentals are on track to continue to improve at a modest pace, and we expect the U.S. economy to grow between 3% and 3.5% in 2014.

Fixed Income Market -Outlook

Corporate credit spreads surpassed their tightest levels since the end of the credit crisis, and are now as tight as they have been since July 2007. While the Federal Reserve announced it would begin to taper its asset-purchase program, the negative impact from slowing asset purchases was more than offset by the Fed's indication to keep the federal funds rate near zero well past the time that the unemployment rate declines below 6.5% which essentially means that federal funds rate will probably stay near zero until well into 2015. Even with the tapering beginning in January, the Fed will provide a substantial amount of new liquidity to the markets for the first half of 2014. If the Fed continues to reduce purchases at this pace, the program is likely to last until next September, and over that time frame, the Fed will purchase another $330 billion of securities, taking its portfolio to more than $4.3 trillion. The average spread in corporate bonds is +121 basis points, only 41 basis points wider than their all-time tights of +80 reached in February 2007. Over the short term, the corporate bond market will be supported by the Fed's assurance to keep the federal funds rate near zero for a longer time than anticipated by the market, stronger economic growth and the alleviation of congressional dysfunction, as both sides are likely to negotiate a deal that will avert another budgetary impasse and government shutdown. However, while credit spreads may continue to tighten in the short-term, we think that there is not much more room. Furthermore, if interest rates begin to increase faster as anticipated by the market, credit spreads could widen as money managers sell long-duration bonds to avoid losses from rising rates. Over the long term, we expect interest rates to normalize toward historical levels. The yield on the 10-year Treasury bond has averaged 200 to 250 basis points over a rolling three-month inflation rate. Even with inflation at the unusually low rate of 1.2%, the yield on the 10-year Treasury could increase to 3.2%-3.7% to reach historical norms. Since the 2-year bond is highly correlated to short-term interest rates and with the Federal Funds rate to remain near zero until sometime late in 2015, the yield of the 2-year Treasury bond should be well locked in. Based on where this spread has historically peaked, the 10-year yield could increase another 50 basis points over the 2-year before beginning to breach its prior ceiling. We, therefore, expect that the bond market will continue to underperform as an asset class and the return will be at best the coupon return.

Job Market

The United States lost 8.7 million jobs in the aftermath of the financial crisis. As of November, it had gained back about 7.4 million of those jobs. The unemployment rate fell to 7.0% -- the lowest level since November 2008. The job market has been improving for three years now, but at a frustratingly slow pace. The hiring was broad based, with big gains for sectors that tend to pay low wages, as well as those that offer higher salaries. The federal government continued to cut jobs, but state and local governments more than made up for those losses. 2013 is on track to be the best year for job creation since 2005, but the job market still has a long way to go until it is entirely healed from the recession. 11 million Americans still remain unemployed and only about 63% of Americans over the age of 16 participate in the job market which is nearly the lowest level since 1978, driven partly by Baby Boomers retiring, but also by workers who had simply given up hope. However, the consistently stronger employment growth should motivate job market dropouts to reenter the market.

Stock Market -Outlook

In an environment of gradual improvement in the business cycle, more economically sensitive assets, such as equities, will likely continue to benefit. Early-cycle dynamics and relatively attractive valuations provide fundamental support for equities in particular. Furthermore, central banks remain focused on avoiding deflation, and are likely to preserve liquidity in the markets to stimulate their economies, encourage employment and thus delay expectations of higher interest rates. Lastly, the reversal of flows from bonds into equities is likely to continue in 2014. The key question will be, how will the world look post QE? We expect that the Fed will unwind its bond buying program in an orderly process and yields will climb slowly, staying well below 4% in 2014, and will not spike dramatically in 2015. A forward PE of 15/16 can be sustained in this mid-earnings-cycle. We expect 10% to 15% upside in the market in 2014,- as high surplus free cash flow levels of the companies in the SPX are likely to fuel further share-buy backs and dividend increases. Furthermore, we expect investment spending and exports to improve as global growth is likely to rebound from an average of 2.9% between 2008 and 2013 to average 4% in the next four years. Developed markets are expected to rebound from a low of 0.7% to 2.5%, and emerging markets to contribute 70% to the global economy with an average growth rate of 5.5% in the next 4 years. That said, as long as corporate profits meet expectations of low to double digit growth in developed markets and 8% to 10% in the US, earnings upgrades are not necessary to drive the market. Companies will continue to improve cash flows, grow earnings, and raise dividends over time. Equity valuations are no more than mid-cycle for S&P 500. Diversification and a good mix between growth and income stocks will however be important as valuation levels will come into question if interest rates should rise too fast. We do not recommend to make drastic changes in the accounts as market uncertainty is high and market timing becomes increasingly challenging at this point in time. We will continue to take partial profits in existing positions and build new positions gradually over time. Signs of an improving economy and expectation of rising interest rates have caused conservative stocks to fall out of favor. Since May conservative stocks have generally underperformed riskier, cyclical, and economically sensitive stocks. This was a reversal from the first few months of the year, when conservative stocks such as utilities, real estate investment trusts, pipeline companies, consumer defensive firms, and other high-yielding, conservative investments were leading the rally. Value can therefore be found particularly in conservative large cap stocks at this mid-cycle point of the stock market.

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