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The 6% correction in equities in January was followed by an impressive rebound of 6% and was a cyclical correction in a secular bull market, which in our opinion reflected three misconceptions. Firstly, that the rotation out of bonds into equities would be swift, secondly, that pessimists are beginning to believe that China will slow much more than expected and thirdly, that there is a blanket ban on all emerging markets, which represent 8% of world GDP. Ultimately, corrections are about emotions, as not much has fundamentally changed. Just like in 1997/1998, when emerging markets started to struggle and all of Asia entered into a recession, it impacted the U.S., but did not derail the economic recovery and the bull market in those years. China has enough levers to pull to ultimately grow at target, most emerging markets today do not have a rigid exchange peg anymore that they have to protect and have used the years of easy money to get their houses in order. Their external debt requirements are much lower today and they can avoid defaulting on their local debt by printing money. We also do not anticipate that the political unrest in the Ukraine and the incursion of Russia will have a longer lasting impact on the markets, as this issue is being addressed multilaterally by world leaders. Lastly, central banks around the world have a much higher stake in the markets today, and are, therefore, coordinating their efforts better on a global basis. As a result of quantitative easing the Fed for example holds 25% of all treasuries. If the Fed takes markets off guard, its own balance sheet will be affected.

We expect policy rates to stay at 0.25% at least until the end of 2015. The Fed is likely to unwind their quantitative easing program in smaller increments first and end the program in November 2014. The Fed is pivoting. Instead of focusing on the unemployment rate, which is reaching its target of 6.5% (6.6% at present) the Fed is shifting their focus on core inflation (ex food and energy), which is statistically the most reliable inflation gauge. The Fed's target is 2.5% for the PCE (personal consumption expansion) deflator, which is at 1.1% year over year, the lowest level since record keeping began in 1960. Therefore, it is very likely that an increase in the Fed Funds rate will be postponed until a much more robust labor market results in wage increases of 2.5% from the present low annual 1.9% level (historically 3%) and a meaningful acceleration in consumption will warrant it. This is likely to happen slowly as wage increases are being held back by global competitiveness, advances in technology and demographics. If we are right and the Fed Funds rate stays the same, this will affect the 2, 5 and 10 year interest rates and will allow borrowing at reliable prices which is important for the leveraged private sector and the government. Furthermore, we are seeing modest non-inflationary economic growth and plenty of cash on the sidelines in the U.S. During the transition from a credit fueled economy and the structural damage to the banking system, an anemic subpar economic growth was to be expected, but the more fundamentals in the U.S. improve, the more likely it will be for the U.S. economy to gain traction in 2014.

Fixed Income Market -Outlook

The corporate bond market has largely recovered to pre-selloff levels late January/ February, as the improving domestic economy coupled with international unease, which tends to drive investors to safe havens like U.S. Treasuries, augur well for fixed-income investments in 2014. The current ultra low interest rate environment, coupled with concerns about the effects of an eventually less accommodative Fed policy, has been causing an unprecedented reallocation of assets away from longer to shorter durations. We continue to believe that from a fundamental, long-term perspective, corporate bonds are fairly valued in this trading range. Corporate credit risk will either remain stable or improve slightly, but gains will likely be offset by an increase in debt-funded mergers and acquisitions. Over the long term, we expect interest rates to normalize toward historical metrics which include the spread between current inflation and interest rates, inflation expectations, and the steepness of the Treasury curve. Historically, the yield on the 10-year Treasury bond has averaged 2 to 2.5% 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 3.20%-3.70% to reach historical norms. While we expect interest rates to normalize at higher levels during tapering, we do not believe that interest rates will rise much above historical averages. Currently, the spread between the 2-year and 10-year Treasury bond is nearing its widest levels. As mentioned in our last market letter, since the 2-year bond is highly correlated to short-term interest rates and the Fed is planning on keeping the Fed Funds rate at 0.25%, the yield of the 2-year Treasury bond should be well anchored. 2013 was the first year since the 2008-09 credit crisis in which the financial sector has performed better than industrials. We continue to recommend keeping durations relatively short and focus on undervalued sectors. We expect that the financial sector will continue to outperform in this range-bound market as credit quality continues to improve and capital levels rise. Also interesting is the energy sector, especially given the recent increase in U.S. natural gas prices to over $6/mmbtu.

Economy

Housing data which was substantially weaker and much less weather related than expected in January is indicative of a less than robust economy. As a result, most estimates for GDP growth for the first quarter of 2014 are now well under 2%. Consumer prices for the month of January grew a little less than expected, increasing just 0.1% compared with December data. The year-over-year comparison reflects a small uptick from the unusually low levels in Q4 (which were due to special factors in the drug industry and relatively low gasoline prices). The increase is too low to slow consumption, but enough to avoid a deflation. At a 1.4% GDP growth today, the U.S. economy remains far away from overheating and thus driving inflation. Well-controlled energy prices, tame commodity prices, tight fiscal policies, and an output gap until 2017 (recent budget report from Congressional Budget Office) all suggest that inflation will remain well under control for some time to come.

Stock Market -Outlook

We continue to be in an environment of slower economic growth than many recoveries from deep recessions and certainly in an environment of slower revenue growth and low earnings per share growth. The market is up 202% from its bottom in 2009, which is a 17.9% annualized return over the last 5 years. Thus, after the initial recovery phase, which lasted much longer than usual after recessions, the stock market, largely driven by share buy backs and dividend increases, is relatively fully valued with a PE on normalized earnings of 21 versus the historical average of 16 and is likely to trade flat until fundamentals catching up with stock prices. Valuation is a concern for investors. We expect, however, normal earnings growth, normal PEs and normal volatility in 2014, as there is ample surplus free cash flow ($ 450 billion) among the companies in the SPX 500 Index for further dividend increases and share buy backs. Also, despite revenue growth of just 0.8%, earnings grew 8.5% in Q4/13 and continually seem to beat lowered expectations, and with interest rates close to zero and the Fed continuing to support the economy, revenue and growth prospects are likely to continue to improve in 2014.

The crucial issue for the equity market is in our opinion a normal process of tapering to allow interest rates to climb slowly. If so, normal total returns adjusted for inflation of 6% to 10% in 2014 should be realistic. The stock market will continue to be powered in 2014 by share buybacks and dividend increases as debt financing to fund stock buybacks is already in excess of 55% of the total of the year 2013, since the beginning of 2014. Furthermore, for the first time in over 40 years the dividend yield is higher than the treasury yield, making stock investments relatively more attractive than bond investments. We recommend to overweight equity exposure, underweight bond exposure and substitute income with investments in attractively yielding closed-end funds, master limited partnerships and REITs. Within the equity exposure we recommend allocating one third to dividend stocks, one third to value companies as many, especially in the technology sector, still look reasonably priced and one third to growth stocks. Overall there are "pockets of value" to be found in all industry sectors with the exception of consumer staples, which look attractive, especially in the energy-, technology and finance sectors.

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