MV Capital Management Weekly Market Flash

2013: The Year In Review

December 27, 2013

There are but a couple trading days left in 2013. This has been a good year to be an equity investor, particularly an investor in U.S. equities. In fact, the real stomach-churning roller coaster ride this year was not in stocks, but in fixed income instruments. A somewhat off-the-cuff utterance of the word “taper” by soon to be outgoing Fed Chairman Ben Bernanke in May sent bond markets into a tizzy. The rate on the 10-year Treasury note soared from 1.5% in early May to graze 3% by September. That’s just about where the rate is now, as the year draws to a close. With the QE taper now officially underway, if still only modestly, the direction of bonds is likely to continue weighing on Wall Street minds as the New Year gets underway.

U.S. Equities: American Pie

The banner year in stocks was most concentrated in U.S. equities. As of the December 26 close the Russell 3000, a broad all-cap benchmark, was up just over 33% for the year to date. That represents the strongest calendar year performance since the post-recession recovery year of 2003. Most major asset classes got a share of the love, with small cap growth leading the way. The Russell 2000 Growth index clocked in at 43.08% as of the 12/26 close.

Among industry sectors the notable laggard was utilities, with a comparatively modest gain of just under 12% as the year comes to an end. This traditionally defensive, dividend-oriented sector had a good start to the year, but ran out of gas when interest rates started to trend upwards in May. On the other end of the performance spectrum, the healthcare, industrials and consumer discretionary sectors are closing out 2013 ahead of the pack.

After flagging somewhat in the first half of December, U.S. equities enjoyed a good old fashioned holiday rally on the back of a string of promising macroeconomic data points. Employment and GDP data in particular look stronger than they have in years. The data were instrumental in giving the Fed confidence to start reducing QE by $10 billion, and that was the move that sent the year-end bulls into the streets.

Non-U.S. Equities: Emerging Malaise

The notable wallflower at this year’s equity party was emerging markets. This asset class has not fared well over the last couple years, but 2013 was a particularly bad year. The MSCI Emerging Markets Index was down by -3.2% as of the 12/26 close. Traditional growth engine economies in Asia and Latin America have had trouble keeping up the levels to which investors have become accustomed in recent years. Tepid growth in Europe and (until recently) the U.S. has proved troublesome for these still export-dependent economies. Although emerging markets stocks look attractive by traditional valuation measures, and may benefit from the uptick in U.S. economic growth, this remains in our opinion a sector that continues to merit caution.

Developed non-U.S. markets mostly fared better than their emerging cousins, with the Eurozone showing the best regional performance. The MSCI EAFE index was up 21.3% as of 12/26, with the EMU index showing 27.7% for the same period. The laggard was the Pacific ex-Japan region, which managed to eke out a 4.5% gain. Non-U.S. markets broadly suffered from currency trends mostly working in favor of the U.S. dollar for much of the year.

Fixed Income: The Big Question

Market chatter continues to fixate on the beleaguered fixed income markets. A scan of the Barclays U.S. fixed income indexes reflects a sea of red, from governments and agencies to corporate investment grade and municipals. The notable exception is high yield, which as an asset class tends to trade in closer correlation with equities than with other fixed income styles. Not surprisingly, the hardest hit sectors are long-dated Treasuries. The 20+ year sector leads on the downside with a -13.6% performance year to date. Rising interest rates have a sharper impact on long-dated issues, all else being equal.

The good news for bondholders, such as it may be, is that the rate trend for 2014 may be less steep than it was this year. A level of 3.5% for the 10 year note seems to have emerged as a kind of consensus among market watchers for an upper limit in 2014 (though of course that does not rule out the possibility for rates to go higher). Even with the faster pace of economic growth, there is not much fundamental economic pressure pushing rates up. Inflation remains below the Fed's 2% target – in fact that fact alone will probably keep any talk of orchestrated rate hikes off the table for a long time to come. We expect to see rates generally trend upwards, and have measurably reduced the target duration levels of our strategy models accordingly.

And so we ring out 2013. We will of course be back with more research and commentary as the New Year gets underway, with insights on whatever twists and turns the capital markets have in store. Meanwhile, we wish all of you a happy and healthy holiday, and a prosperous 2014.

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