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Innovative Thinking + Smart Strategies

2014: The Year Ahead

MVCM Annual Market Outlook

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The Year Ahead: 2014 Annual Outlook

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I. Markets in 2014: How Much More?

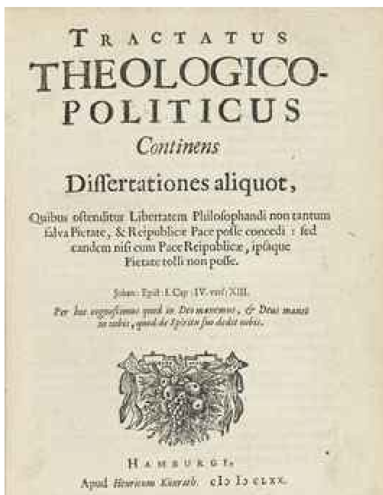
La superstition est une maladie presque incurable de l'esprit humain.

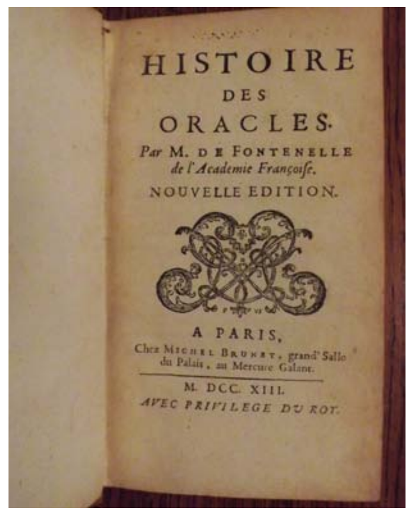
Superstition is a nearly incurable condition of the human spirit.

--Nicolas Fréret (1688-1749)

A. Markets, Faith and Reason

The second half of the 17th century was a time of fecund intellectual activity in Europe. This was the dawn of what would come to be called the Enlightenment: a time of paradigm-changing scientific discovery, new views on the rights and roles of humans as political citizens, and fundamental challenges to a system of public discourse hitherto dominated by confessional allegiances on one side or other of the belief systems that occupied different geographical regions of post-Reformation Europe. It was the time of, among others, Descartes, Newton, Locke and Spinoza, whose contribution to their own age would have an immense impact on all ages to come, all the world over.





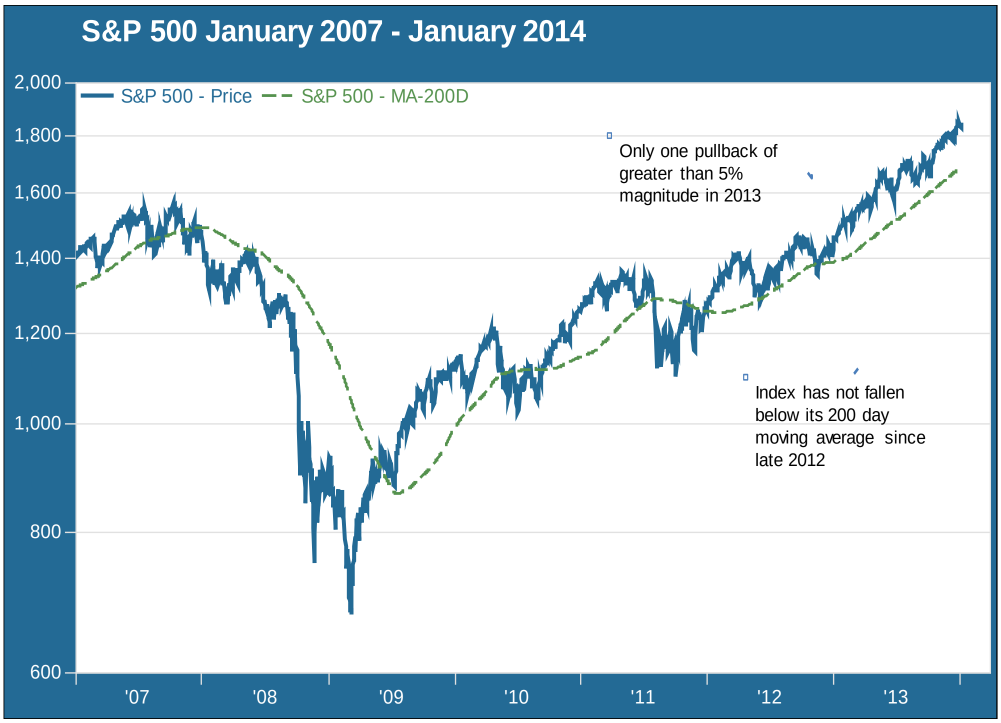
As with any paradigm shift, the new learning left plenty of disruption in its wake. The quote shown above by Nicolas Fréret, a leading early-18th century Parisian philologist, refers to a longstanding dispute over the existence of supernatural forces. A handful of publications in the second half of the 17th century, notably the *Tractatus Theologico-Politicus* by Baruch Spinoza and the *Histoire des oracles* by Bernard le Bouvier de Fontenelle, generated a great deal of controversy by arguing that Scriptural references to angels, demons and the like were not actually trying to describe things outside the boundaries of natural laws. Their argument was that one could be faithful to the teaching of Scripture without believing in ghosts. That may sound reasonable today, but back then it was a shocking thing to think, let alone publish.

Fréret's wry observation on the human spirit rings true more than 350 years later. Rationality, superstition, faith, reason and emotion still tussle with each other to win hearts and minds. This is as true in financial markets as elsewhere. We expect markets to be purely rational, dispassionate mechanisms for allocating goods and services among buyers and sellers. Yet those buyers and sellers are humans. Yes, even the software programs that place and execute over 60% of the daily trading volume in global equities are the intellectual creations of organic human beings. Where humans go, behavioral traits follow that are never 100% rational, nor free from biases, superstitions, or beliefs that override the brain's logic gates.

Keep On Believing?

One question on our mind is how much faith is left in the rally that propelled the S&P 500 to a cumulative gain of 200%, from its low point on March 9, 2009 to the end of 2013. That rally has soared on the wings of several key factors which we will explore below. And there are promising signs about the economy's growth trajectory. But in the wake of the biggest banner year for U.S. equities since 1997, we are not sure that 2014 can be carried by faith alone. We're going to need reasoned, empirical justification that the recovery is indeed gaining speed, and that businesses will benefit in the form of sales and profits growth.

Chart 1: S&P 500 7 Year Price Performance



Source: MVCM Research, FactSet

Faith and the Fed

Such is the institutional power of the Fed that a single word – in this case being "taper" – can launch a thousand ships of fear into the turbulent wine-dark seas of the bond market. The Fed has hitherto earned the faith of investors not by hollow promises, but by delivering the goods. The "Bernanke put", soon to be inherited by incoming Fed Chairwoman Janet Yellen, is explicit. High asset prices are not the end in itself, but the only seemingly viable means to that end, which is the Fed's stated policy mandate of full employment and stable prices. The steady stream of diminishing stock market pullbacks, reflected in the above chart, attests to the market's coming to accept Fed support as an article of faith.

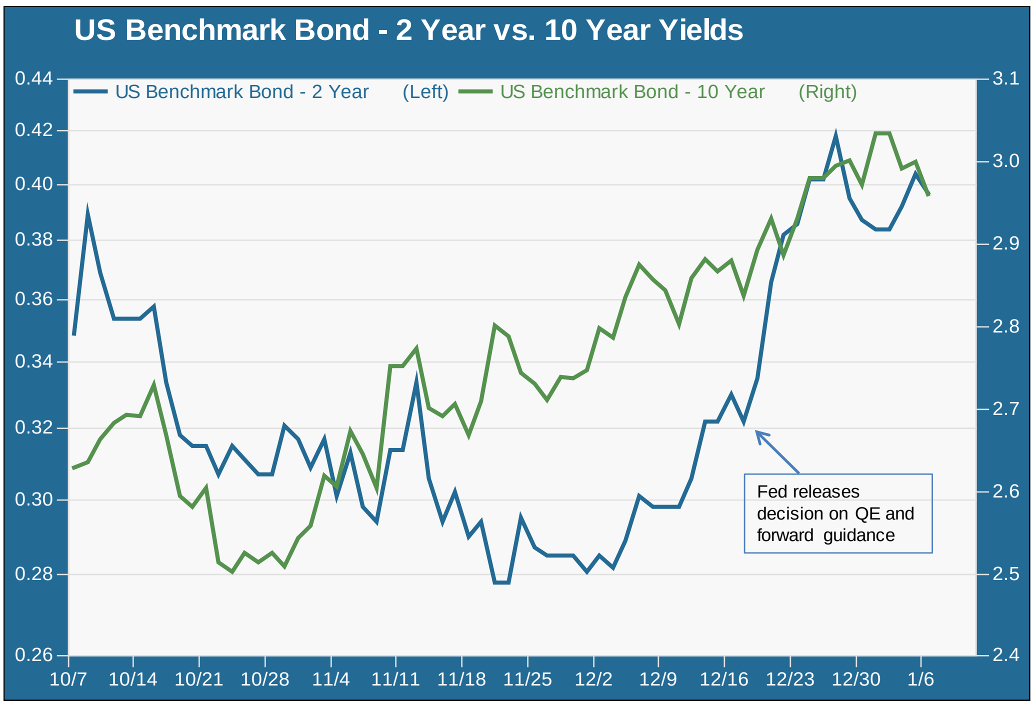
Forward Guidance is the New Black

But that faith may be tested in the weeks and months ahead. The current expectation is that QE3, the $85 billion monthly bond-buying program which started in September 2012, will come to an end with a measured series of $10 billion reductions each month. This was the decision announced at the last Board of Governors meeting in December. So with QE on the wane, how will the Fed continue to work its magic on the market?

The answer is forward guidance, which up to now has been the awkward wallflower sister to the more glamorous QE. Forward guidance is the message the Fed sends to the market about when, and under what conditions, it would prepare to bring an end to the historically unprecedented era of near-zero interest rates. FG's coming-out party as the Fed's policy centerpiece was at that same December meeting. The equation the Fed wanted to beat into the head of credit markets is that tapering does not equal rate hike. That's forward guidance.

The interesting thing to point out here is that markets don't seem to be convinced by the Fed's FG targets, given how interest rates moved following the December meeting.

Chart 2: Rate Trends in 2 Year & 10 Year Treasuries, 10/2013 – 1/2014



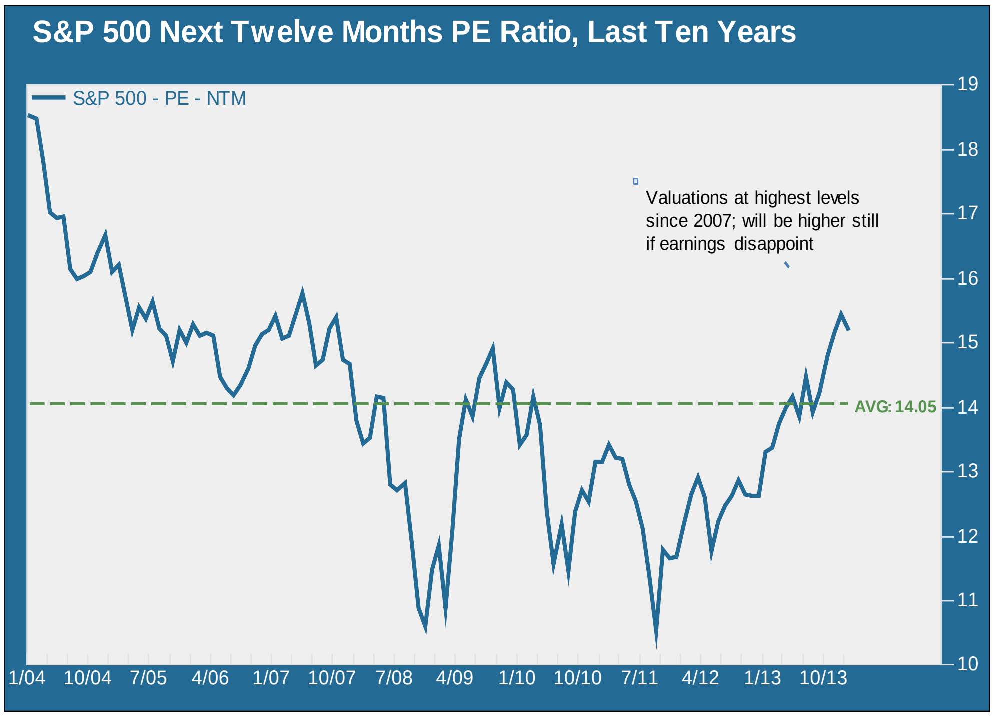
Source: MVCM Research, FactSet

It makes sense that the 10 year yield rose after December 18. After all, quantitative easing takes place in the long end of the yield curve, so a $10 billion cumulative monthly reduction in demand for Treasuries and mortgage-backs should send rates up. What makes much less sense – if you believe in the new forward guidance language – is how the 2 year yield shot up. The mystery of why a key short term rate soared as soon as the Fed announced that short term rates will be kept low until way in to 2015, if not later, is something to which we are paying close attention. We will come back to this discussion in our Investment Thesis section.

B. S&P Also Means Sales & Profits

One important barometer we believe will influence how much more juice is left in the stock market rally is corporate financial performance. As the chart below shows, the market's impressive returns have put pressure on valuations, which are at their highest levels in seven years. The measure we consider in the chart below is next twelve months' (NTM) price to earnings (P/E) ratio.

Chart 3: S&P 500 Next Twelve Months Price to Earnings Ratio



Source: MVCM Research, FactSet

Gazing at the Crystal Ball, Murkily

The NTM metric reflects the consensus estimates of economists for corporate earnings performance in the next twelve months. Unfortunately, the economists' crystal ball has been murky of late, in ways that could have a negative impact on market performance.

Economists and industry analysts make their predictions based on forward-looking models they create from company financial statements, and report these predictions to a market research company like I/B/E/S or FactSet. As time goes by and new information comes in, they will revise their estimates accordingly.

And in 2013 revise they did – steadily downwards over the course of the year. At the beginning of 2013, the consensus outlook for earnings per share (EPS) growth for the full calendar year was 9.1%. In other words, they expected the average EPS for companies in the S&P 500 to be 9.1% higher at the end of Q4 than they were at the beginning of Q1. Well, companies are releasing their Q4 results now and in the coming weeks. As of January 7, the consensus estimate for full year 2013 EPS growth was 4.8%. In other words, the same industry experts who were predicting 9.1% growth at the beginning of the year now expect it to come in at just about half that rate.

Expensive, Or Wildly Expensive?

That last sentence is very important, so let's repeat it for emphasis. *Expectations for 2013 full year EPS growth are now around half of what they were at the beginning of the year*. Now, the EPS measure is what goes in the denominator of the P/E ratio. The higher the EPS, the lower the P/E and thus the less expensive the market. Look back at the above chart showing the NTM P/E for the S&P 500. It's currently around 15.4x, higher (i.e. more expensive) than at any time since 2007. But not outrageously high, right?

The problem is that the 15.4x estimate is based on what the consensus believes earnings will be at the end of Q4 2014. Currently, the EPS growth estimate for full year 2014 is 10.3%. Yes, those same economists who predicted 9.1% growth for 2013, a prediction that turned out to be wildly optimistic, see it coming in over 10% this year. To put it another way: the NTM P/E is 15.4x, as opposed to a much higher number than 15.4x, because the EPS denominator reflects a 10% growth estimate. If that prediction is also wildly off-base, then valuation levels are much more expensive now than they appear.

Stocks, Bonds, Or What Else?

One of the more unusual data points we are looking at right now is the 12 month correlation between stocks and bonds. That number is usually negative: for example the correlation between the S&P 500 and the Barclays U.S. Aggregate Bond Index from January 2009 to December 2013 was -0.14. But for the one year ended 12/31/13 the correlation between the two indexes was 0.33, meaning that the two asset classes moved along in the same direction much more often than is usually the case.

High correlation anomalies make it challenging to properly and prudently diversify a portfolio. The danger is that stocks, bonds and alternative assets (which have also exhibited higher than average correlations recently) could fare poorly for the same reasons in 2014: fears of rising rates alongside economic growth high enough to compel the Fed to continue tapering, but not enough to keep corporate earnings from disappointing.

That's the negative scenario. The countering point of view is that money has to go somewhere. Even after the gains of 2013 there is still a large stockpile of cash sitting on the sidelines, basically earning nothing. Unless there emerges a more compelling case for really weak fundamentals, it is hard to imagine that at least a good portion of this money would not seek out more favorable returns from some combination of the major asset classes.

And the fundamentals are not all that bad. As we will describe further in the Investment Thesis part of this Outlook, the GDP and employment picture in the U.S. look brighter today than they have in years. Europe is still in one piece, and even in the troubled periphery bond yields are substantially lower than they were in when the Eurozone crisis was in full swing. Japan is continuing with a series of bold reforms, even removing the longstanding (and politically motivated) subsidies for the country's rice farmers. China, as well, closed its Third Plenum in November with a bold set of initiatives aimed at keeping the country on track to double its GDP between 2010 and 2020, while cooling down the overheated credit sector.

In summary, there are some very valid reasons to ask "how much more" as we look at the year ahead, but there are some likewise compelling reasons to believe that the potential for at least reasonable returns in major asset classes does exist. As always, we look to the data for insights on the right course of action to take for our clients.

II. 2014 Investment Thesis

A. Executive Summary

- Our 2014 investment thesis – our base case – will likely depend in large part on the following key drivers: confirmation of the nascent improvement in U.S. economic growth; translation of that growth into strong corporate financial performance; the ability of the new Yellen Fed to successfully engineer a shift from QE to forward guidance as the main policy tool; stability and modest growth in Europe; China's ability to dial back its frothy credit markets without jeopardizing GDP growth rates; and a continuation of the promisingly bold reforms Japan started in 2013. Oh, and a minimum of geopolitical flare-ups in the more volatile regions of the world.

- Like any base case, our thesis is subject to many factors – known and unknown – that could produce a wildly different outcome. If it more or less comes to pass, though, we would expect to see moderately positive performance in most asset classes. Risk levels may remain subdued relative to longer term averages, though perhaps somewhat higher than the extremely tame risk environment of 2013. We would also expect a gradual upward trend in interest rates, but not of the magnitude of the breathless run-up in bond yields from May-September last year.

- Politically speaking, there are a handful of key elections this year, but the impact scale is quite a bit less than the 13 months from November 2012 to the end of 2013. That period encompassed the U.S. presidential election, Japan's general election bringing Shinzo Abe to power, the ascent of Xi Jinping in China, and Angela Merkel's victory in Germany. This year, the U.S. midterms are probably the biggest event. There are also general elections in Brazil and India, and for the European Parliament. Focus this year will be on the performance of incumbents more than the uncertainties of leadership changes.

- In the U.S., a combination of recovering growth and reduced energy imports is slowly having a positive impact on the twin deficits (budget and trade). That contributes to a case for another year of strong U.S. dollar performance versus other currencies. That in turn could mean yet another year of relative strength in U.S. versus non-U.S. equities, even though the latter trade now at more attractive valuation levels. Emerging markets, which fared much worse than other equity and fixed income asset classes in 2013, continue to be a major question mark.

- If 2014 is a modestly up year for equities, as our base case contemplates, then it may be one of those periodic "return to quality" events after a year in which investors were rather less discriminating about the names they put into their portfolios. Smaller cap and growth-oriented stocks did better on average last year; we would not be surprised to see that swing back towards large caps and value.

- In fixed income, focus remains on interest rates. It's less about direction: we have a high conviction in the likelihood of upward rates over an extended horizon. Rather, it's basic calculus: the rate of change will over a defined period of time. We believe the pace may be less dramatic in 2014 than it was last year, but that it still warrants a move towards lower duration and generally less rate-sensitive exposures.

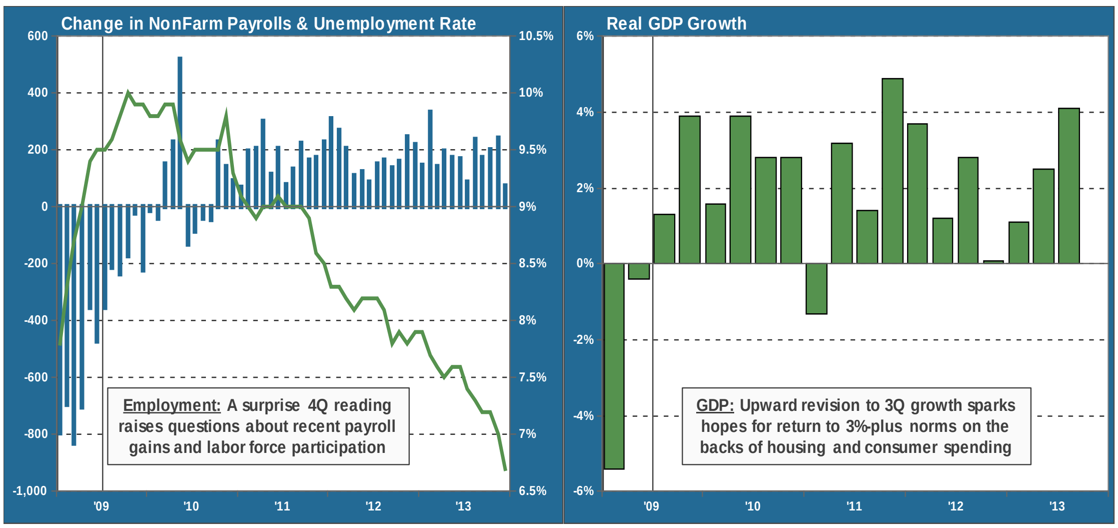
- For alternative assets, the primary objective is to maintain an active defense against potential X-factors that could negatively impact our expectations for equities and/or fixed income. Market signal models and unconstrained bond strategies are among the tools at our disposal for this purpose.

B. State of the Global Economy

Performance is uneven among the constituent parts of the global economy, each of which deserves analysis. We start with the largest (the U.S.), then consider the growth engine (China), the problem case (Europe), and the would-be prodigal son (Japan). There are other economic stories, but these are the ones we think merit particular study for the year ahead.

U.S.: Sunshine Scenario or Yellen Dilemma?

Chart 4: Key US Economic Performance Measures, 2008-13



Source: MVCM Research, FactSet

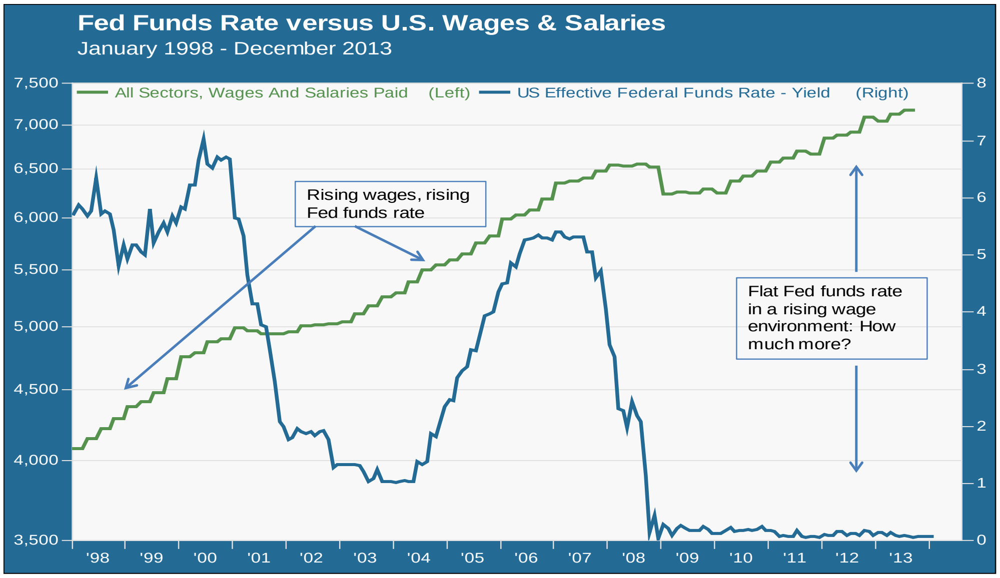
With the latest upward revision in Q3-13 real GDP growth (right), the talk is of reversion back to the long-term sustainable growth rate of 3-3.5%. Recent employment trends have been positive as well, though a surprisingly low reading in December payroll gains and a fall in the labor force participation rate cast some doubt on what's underneath the headline figures.

The unemployment rate measures the number of people out of work and actively looking for work, as a percentage of the total work force. The key phrase is "actively looking for work". If you've been looking for a job with no luck and decide to give up looking, you are no longer counted in that pool of job seekers. In effect, you are reducing the unemployment rate by one body. If lots of people give up looking for a job, it can mean that the unemployment rate goes down without meaning that more people are finding jobs.

Here's why that's important. The Fed's forward guidance target of 6.5% assumes a labor force drop-out component. If that component is substantial, then the Fed feels more comfortable about extending the zero-interest rate regime "well past" the time when the rate hits 6.5%. The December number of 74,000 would seem to accommodate that FG target.

But the December reading may be a one-off anomaly in an otherwise-positive trend. If the economic growth picture is now more vigorous, it may imply that a larger part of the drop in unemployment comes from actual job-seekers finding actual jobs. Of course, that is the goal we really want! But in the perverse looking-glass relationship between Fed policy and credit markets, a heating-up labor market will put upward pressure on wages, which in turn will put upward pressure on prices. And that in turn will put upward pressure on the Fed funds rate that Yellen & Co. want to keep at zero percent for as long as possible.

Chart 5: Federal Funds Rate and Household Wages



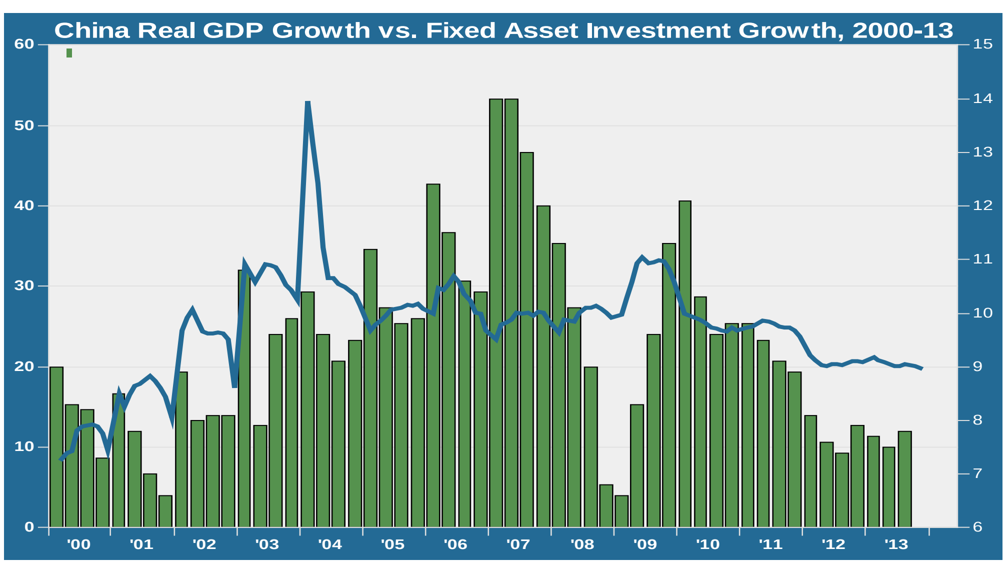
Source: MVCM Research, FactSet

Chart 5 shows that, in environments of rising wages and salaries, the Fed responds by raising the Fed funds rate. Looking at the most recent period, we see wages again on the rise, while the Fed funds rate is at an all-time low. This may shed light on why short-term rates soared after the last Fed meeting: credit markets see potential upward pressure on rates.

China: Growth & the Credit Bubble

China's government aims to double real GDP from 2010-2020. From 2010-12 GDP grew 17.8%, which means that an annual average rate of 6.9% for the rest of the decade will meet that target. Let's consider the chart below, which shows long-term annual GDP growth versus growth in urban fixed asset investment for the same period.

Chart 6: China Real GDP Growth and Fixed Asset Investment Growth, 2000-13



Source: MVCM Research, FactSet

Currently China is maintaining a year-on-year growth clip of between 7-8%. That's less than the torrid pace of the last decade, where growth of 10% or more was the norm. But it is a far more robust rate than any other top 10 economy. Assuming a pick-up in demand from key export partners like the U.S. and Germany, it shouldn't look like too much of a stretch for China to maintain a 6.9% annual pace through to the end of the decade.

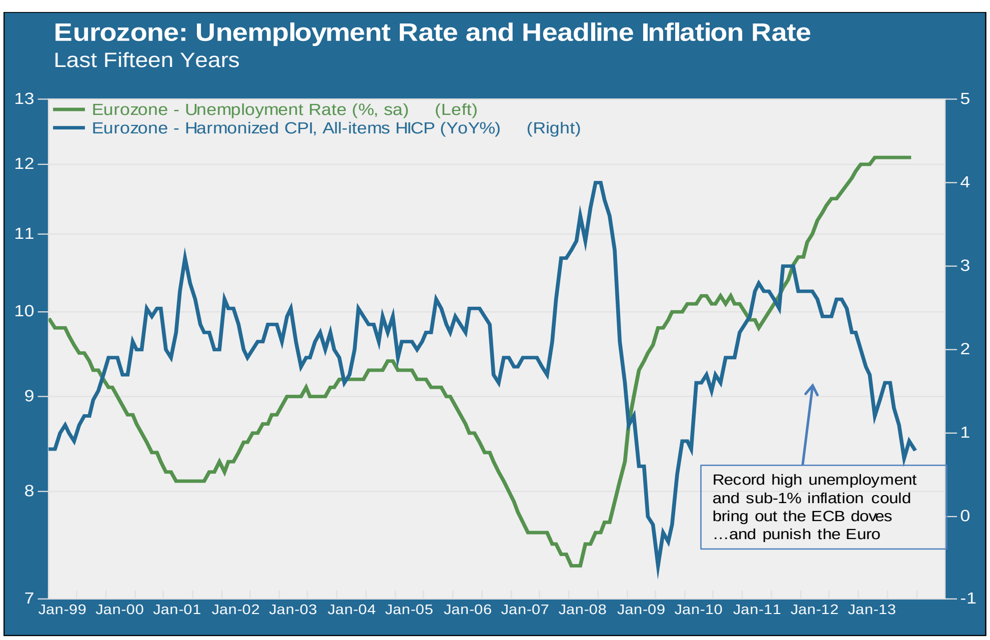
The problem is that, while growth still looks healthy, many China-watchers are concerned about the possibility of a credit bubble. The second metric on the above chart shows the rate of growth in urban fixed asset investment. The current investment growth rate, while high, concerns analysts less than where many of those investments are directed. Evidence suggests that much of the new investment, fueled by loans from banks and shadowy non-bank lending entities, is more speculative in nature and is focused on real estate ventures in major urban areas.

At its Third Plenum this past November, economic policy leaders articulated an ambitious set of reforms, including measures aimed at taming credit speculation and bringing more transparency to the country's notoriously opaque financial sector. The question is whether they can bring the credit sector back to earth without unduly impacting the rate of growth. A corollary question is whether they can encourage a reallocation of the GDP equation to favor a higher level of domestic consumption. Right now personal consumption expenditures account for about 35% of GDP, compared to about 70% in the U.S. A trend towards more robust spending would be a sign of more durable growth.

Europe: Decision Time for the ECB

The good news about the Eurozone is that it is still…well, the Eurozone. The single currency region almost fee apart in 2011-12 but didn't, thanks in no small part to ECB Chairman Mario Draghi jawboning the markets with his tough "whatever it takes" speech in summer 2012. But Europe is not out of the woods, with persistently high unemployment keeping a lid on growth. As the chart below shows, unemployment remains far and away at its highest levels in more than fifteen years, while inflation is far below the ECB's 2% target rate.

Chart 7: Eurozone Unemployment and Inflation



Source: MVCM Research, FactSet

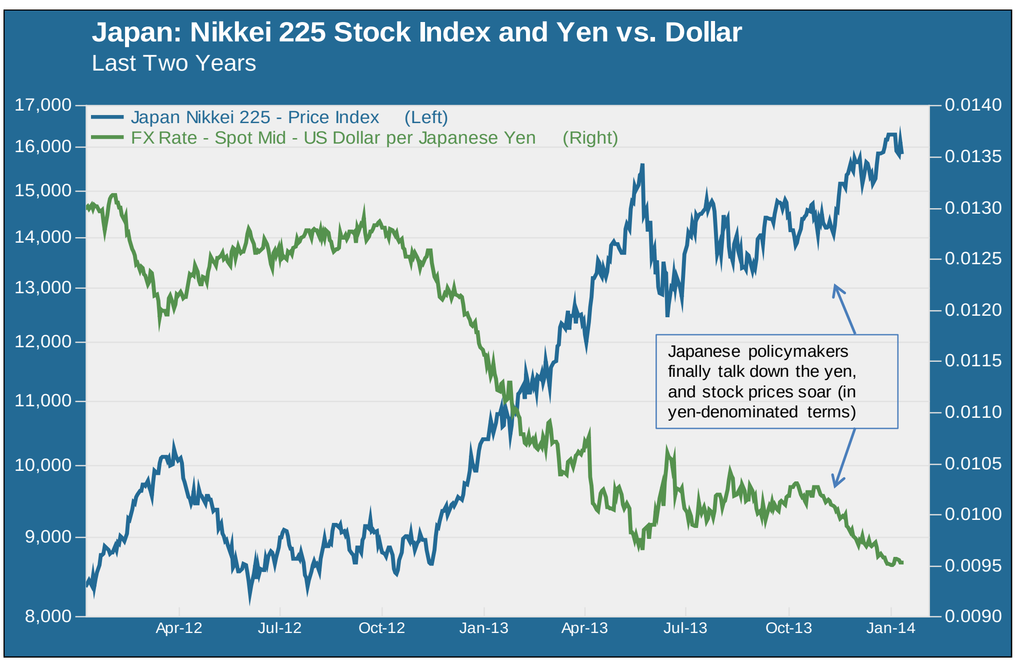
For the moment, anyway, the ECB is not shifting to a more dovish stance on rate policy, keeping its main refinancing rate at 0.25% without additional stimulus. Policymakers note some bright spots amidst the gloomy headline employment and inflation numbers. Retail sales in November 2013 were the highest in 12 years. Ireland recently launched a sovereign debt issue at its lowest borrowing costs in nearly ten years, and Portugal has also successfully returned to the bond market. Germany's economic juggernaut continues apace.

But those headline numbers can't be ignored. In particular the Euro-wide employment data do not reveal the full extent of the misery: unemployment remains over 25% in Spain, for example, and nearly double that for the below-age 30 workforce. If the ECB is forced to turn to more stimulus, it could exacerbate the Euro's recent weakness against the dollar, leading to another year of relative underperformance by European equities.

Japan: Return from the Wilderness?

Japan normally does not earn a section of its own in our Annual Outlooks, mostly because it has been the same, sad old song year in and year out since the early 1990s: deflation, a lackluster private sector and a stock market that at its worst has been valued at less than 25% of its 1989 peak. But the song changed in 2013 with the surprisingly proactive government of Shinzo Abe and a central banker with actual clout, Haruhiko Kuroda. The program known as "Abenomics", the main objective of which is to reflate the economy and catalyze Japanese businesses to stop being global also-rans, has caused investors to sit up and take notice of the world's third largest economy again.

Chart 8: Japan Stock Prices and Currency Trends



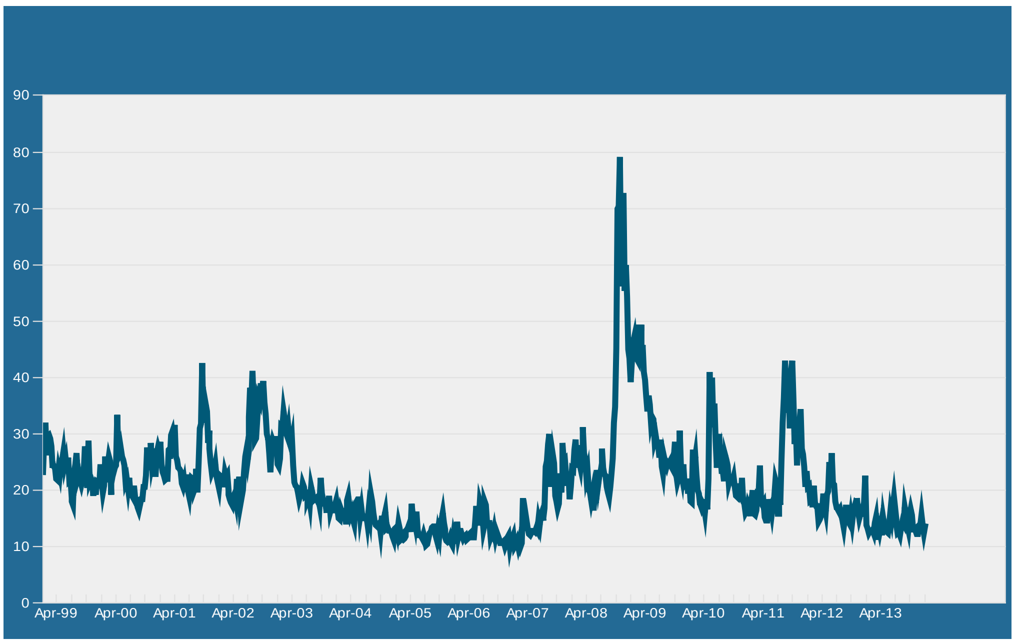
Source: MVCM Research, FactSet

Japan's impressive 2013 stock market rally, shown above, did not look as attractive in U.S. investors' portfolio statements. The rally was driven by a steadily declining Japanese yen, so when you translate the local-currency returns (shown above) into U.S. dollars, you find you would have been better off being invested in the S&P 500. The weakened yen, though, was a big policy triumph for Bank of Japan head Kuroda. It gave a jolt to output and turned consumer prices positive for the first time in four years. The Economist Intelligence Unit forecasts an inflation rate of 1.5% by 2015, while Abe's policymakers are now pushing for the same 2% target as the Fed and ECB. 2014 may be a tricky year, though. Among other measures aimed at reducing Japan's massive $10 trillion national debt is an increase in the consumption tax from 5% to 8%. That may create a hiccup on the road to higher GDP growth if consumers slam their pocketbooks shut in response.

C. Stocks, Bonds and Risk

One of the distinctive features of equity market performance in 2013 was that while absolute returns on their own were good, risk-adjusted returns were even better. Consider the chart below, showing the long-term performance of the CBOE VIX index, a measure of volatility popularly known as the "market fear gauge", for the past fifteen years.

Chart 9: Long Term Equity Market Volatility

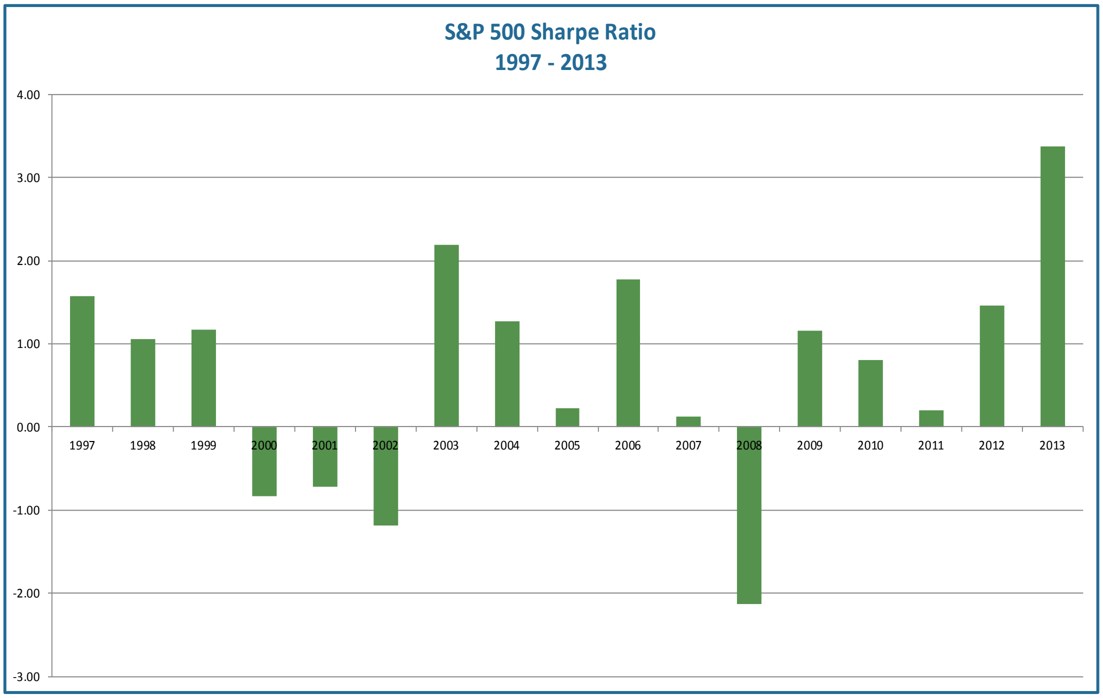


Source: MVCM Research, FactSet

Mean reversion is as close to a fact of life as exists in financial markets, so at some time we would expect risk to move back up to higher ground. But there is a reasonable case to make that 2014 might not be that time, at least in equity markets. Looking at the VIX in Chart 9 above, one notable thing we observe is that the risk pattern in the years following the 2000-02 bear market was markedly different from that of the recovery which began in 2009. There was a sustained period of low risk from 2003-07, before the subprime jitters of that year heralded the following year's market crash. But after the 2008-09 crash, volatility didn't settle down to '03-'07 levels until mid-2012. So it is entirely conceivable that, if the year plays out somewhere along the lines of the base case we outlined in the Executive Summary section above, risk could remain at tamer levels for some time yet.

This relative calm, unsurprisingly, has flowed directly into risk-adjusted equity returns. Risk is a critical part of the overall return equation. One measure we pay close attention to at MVCM is the Sharpe ratio. This tells you how much incremental return you get for every additional unit of risk. Consider the following chart, which shows the Sharpe ratio for the S&P 500 for each year since 1997. We chose 1997 as a starting point because it was the last year for which the S&P 500 total return was as high as it was in 2013.

Chart 10: S&P 500 Annual Sharpe Ratio, 1997-2013



Source: MVCM Research, Morningstar Direct

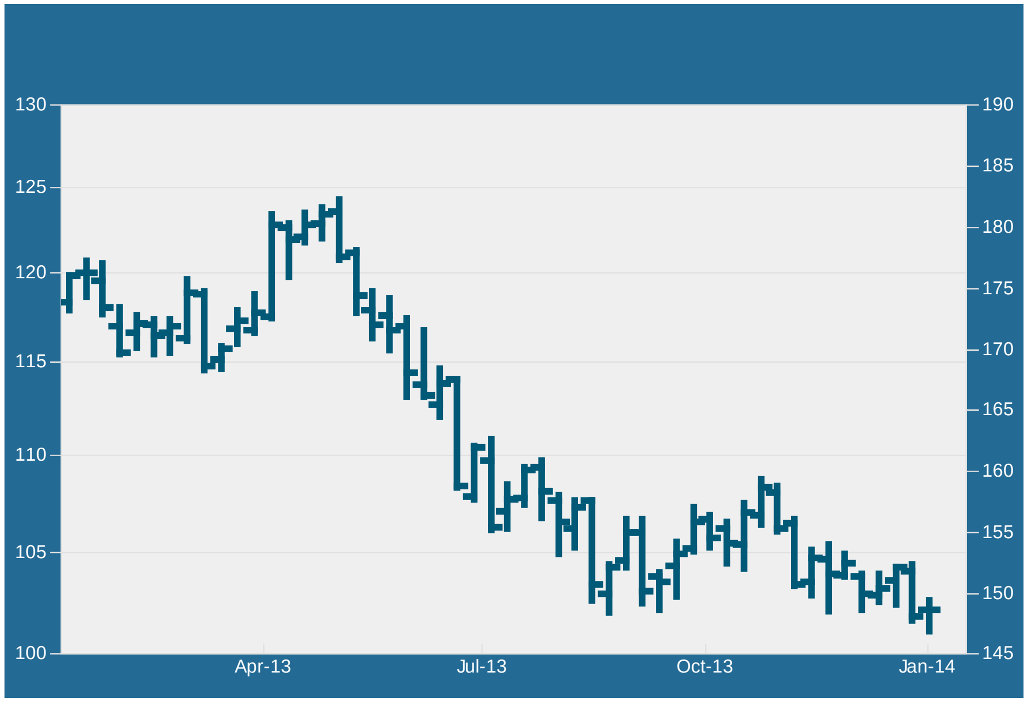
According to this chart, 2013 was something approximating a free lunch: a year of phenomenal returns with very low risk. Consider that even in the last three years of the Internet boom, from 1997-99, the risk-adjusted return as measured by the Sharpe ratio was less than half of its result in 2013. Now, what we know about free lunches is that they are rare birds. If risk levels do stay low in 2014, we would not be surprised to see the Sharpe ratio come down to more historic norms through more modest price appreciation (which is consistent with the scenario which we have outlined throughout this report).

The Bond's The Thing

In any event, the real risk action in the near- to mid-term future may not be in equities as much as in fixed income. This runs counter to conventional investment wisdom. Fixed income securities are contractual obligations: the issuer effectively promises to pay bondholders a fixed amount of income on specified dates, and any breach of that promise puts the issuer in default and gives the bondholders recourse to whatever assets of value the issuer possesses. Equities, by contrast, are simply the residual amount left over when you subtract a company's total liabilities from its total assets. If that amount is negative, then the holder of the equity claim on a company's assets gets nothing.

That little digression into capital structure theory provides a useful context for the following chart. In 2013 U.S. equity markets experienced one significant pullback period, from late May to late June when the S&P 500 retreated by 5.7%. But from early May to September the bond market – in particular the intermediate to long regions of the yield curve in government and high-grade corporate debt – went into a tailspin. The chart below charts the fortunes of two asset classes – broad market equities and long-dated U.S. Treasuries – over this period.

Chart 11: ETF Performance Comparison: S&P 500 (SPY) vs. 20 Year+ Treasuries (TLT)



Source: MVCM Research, FactSet

Almost no one would argue that long-dated Treasury bonds are inherently riskier investments than large cap equities, for the reasons described in our lead-in to this chart above. But this is the tangible effect that interest rate risk has on fixed income securities. The ETF representing 20 year-plus Treasuries fell in value by 14.8% - more than twice what the S&P 500 lost – over a period four times longer, with high intraday volatility.

Elsewhere in this report we have stated our belief that the most likely case for the direction of interest rates is higher, but gradually rather than sudden. This chart, though, shows what can happen when markets react irrationally to events and move in ways not supported by the fundamentals. It happened to high quality bond asset classes in 2013, and it can happen again. In today's credit markets, vigilance is required.

D. X-Factor Watch

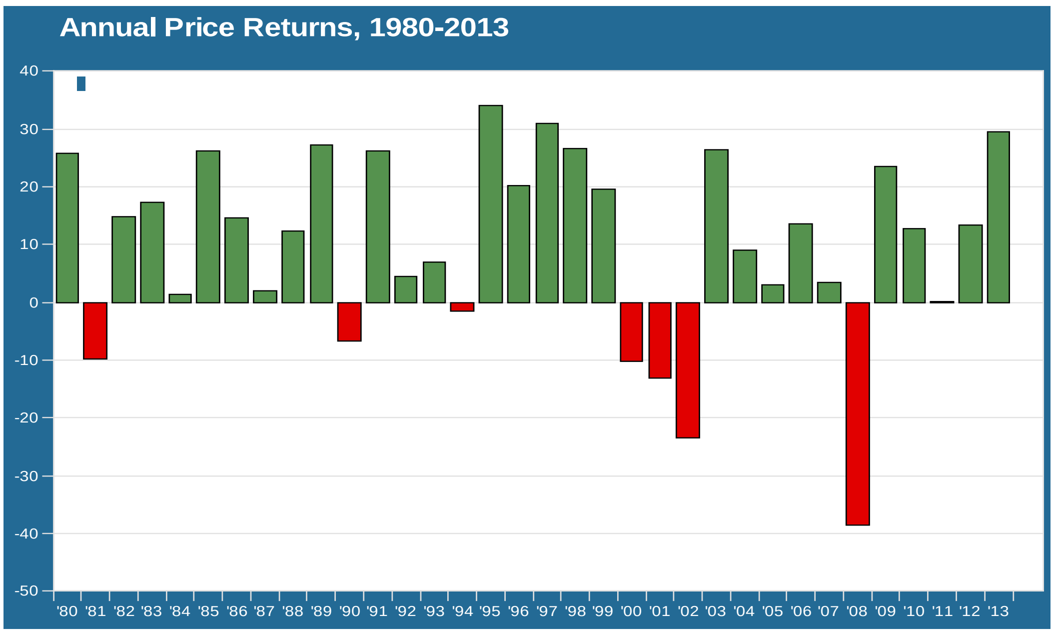
In these first two sections of this Outlook we have analyzed global factors we deem to be of particular importance for 2014. This by no means is exhaustive, nor can there be any assurance that other events will not materialize over the course of the year that prove to have an even greater impact. Astute readers will note that we have not raised the issue of gold prices in this section, nor the state of the world's energy markets and particularly the impact of the booming U.S. domestic oil and gas production industries on, not only world commodity prices, but geopolitical relationships as well. Flashpoints that could make an unwelcome presence this year include the disputed airspace over the Senkaku Islands in the China Sea, or election-related riots in India if the worst elements of the nationalist BJP party run rampant. And there is always the troublesome powder keg that is the Middle East. Rest assured, these and many other issues besides (Bitcoin, even?) are on our radar screen, and as the year progresses our understanding of what events are of immediate urgency and what ones are not will undoubtedly evolve accordingly.

III. Asset Class Observations and Outlook

A. U.S. Equities

Three major U.S. benchmark indexes broke through "round number resistance" levels in Q4 2013. The Dow Jones Industrial Average breached 16,000, the S&P 500 took the commanding heights above 1,800, and the NASDAQ clawed its way above 4,000. Both the Dow and the S&P 500 closed out the year at record highs. The NASDAQ still has one more big round number to scale before it gets within reach of the all-time peak close of 5,048.

Chart 12: S&P 500 Annual Price Performance



Source: MVCM Research, Standard & Poor's, FactSet

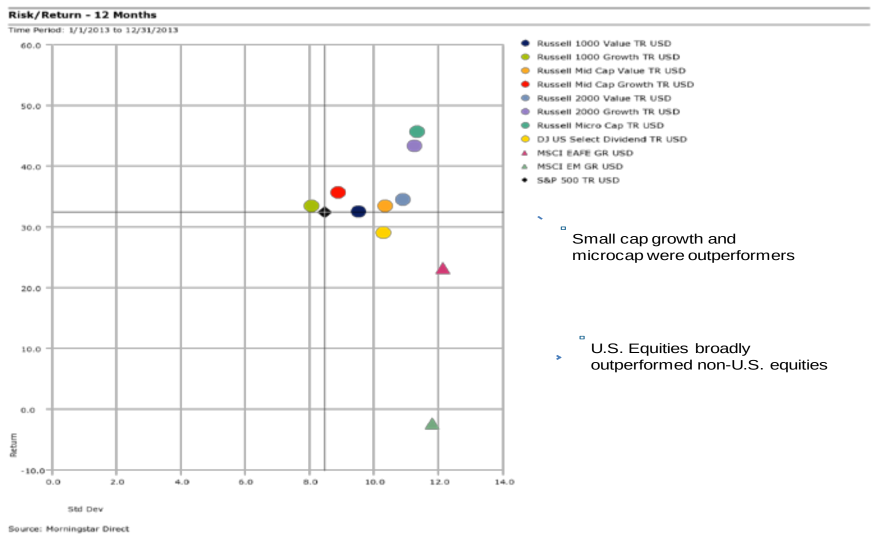
Of Growth and Gaps

From 2009-13 we experienced four years of double digit growth in the S&P 500 and one year when it was flat. Compare that to two other periods: the growth market formation from 1982-86, and the false dawn of 2003-07 before the 2000-12 gap market resumed. In the '82-'86 stretch we also got four years of double digit growth and one lackluster year. From '03-'07 there were three years of single digit growth and two of double digit. Our base case scenario is for a continued growth trend, likely with some pullbacks along the way, for the intermediate term. Bear in mind, of course, that past performance is not a reliable guide for future returns.

Style and Cap Considerations

There weren't too many breakout performances among U.S. equity styles in 2013, with the exception of small cap growth and microcaps. Generally speaking, the year went through two distinct phases. From January to May, defensive sectors and value-oriented strategies outperformed the overall market. Then came taper talk and the May-June pullback, following which cyclical sectors and growth stocks tended to do better.

Chart 13: 2013 Selected Equity Asset Class Performance



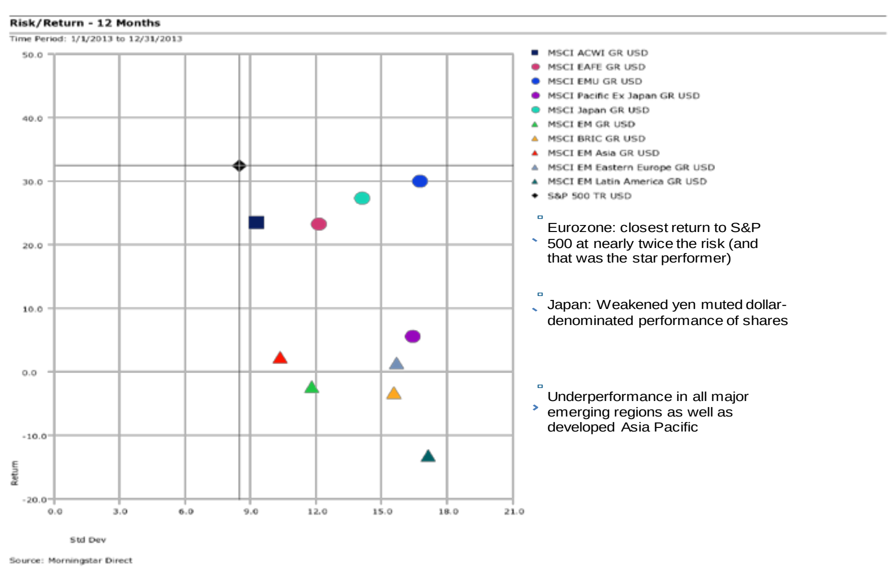
Source: MVCM Research, Morningstar Direct

2014 may also be a tough year for style bets. Anything that causes the Fed to pause in its taper plans could also benefit the yield-driven sectors that lost in the latter part of next year. But, a continuation of the stronger-growth narrative could favor cyclicals and small caps.

B. Non-U.S. Equities

Emerging markets suffered a dismal 2013, finishing the year in negative territory when most everything else equity-related enjoyed double-digit growth. When might the fever break?

Chart 14: Key Non-U.S. Equities Asset Classes



Source: MVCM Research, Morningstar Direct

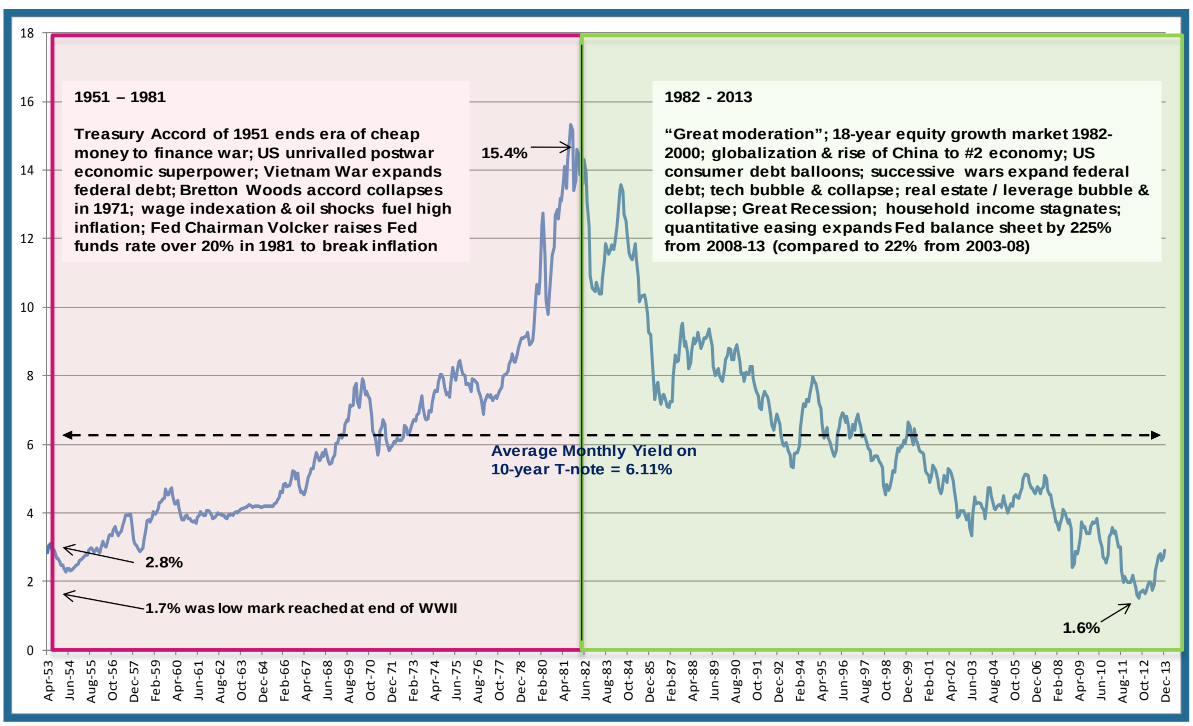
2013 showed that emerging markets are still an integral part of the global carry trade. When interest rates are low, risk-seeking investors borrow cheap debt and invest the proceeds in assets with potential for high returns. When the well dries up (more precisely, when investors think the well may dry up sometime in the foreseeable future) that money moves to other destinations. When taper talk began in May, fickle portfolio capital made a run for the exits. A couple rallies pulled shares back up, but turned out to be unsustainable through year-end.

At current valuation levels one could make a case for overweighting emerging markets (and non-U.S. markets generally). We remain cautious, though. As mentioned elsewhere in this Outlook, currency trends continue to lean in favor of the dollar, China's growth/credit conundrum weighs in, and there may be X-factors associated with general elections in India and Brazil this year. Our take on developed markets is also cautious for some of the same reasons as well as for region-specific factors in key markets like Europe (employment and price patterns) and Australia (weak commodity prices). Again, there may be opportunities for tactical moves in this asset class as the year develops.

C. Fixed Income

Fixed income presents a special challenge that other asset classes do not share. For example, if we do not like the look of emerging market equities we can maintain a very low level of exposure to that asset class. But fixed income is a cornerstone of risk management. In the current environment we need to maintain prudent risk levels while constraining exposure to interest rate risk. Chart 15 below illustrates the potential magnitude of this risk.

Chart 15: Rate Environment for the 10-Year Treasury Yield, 1953-2013



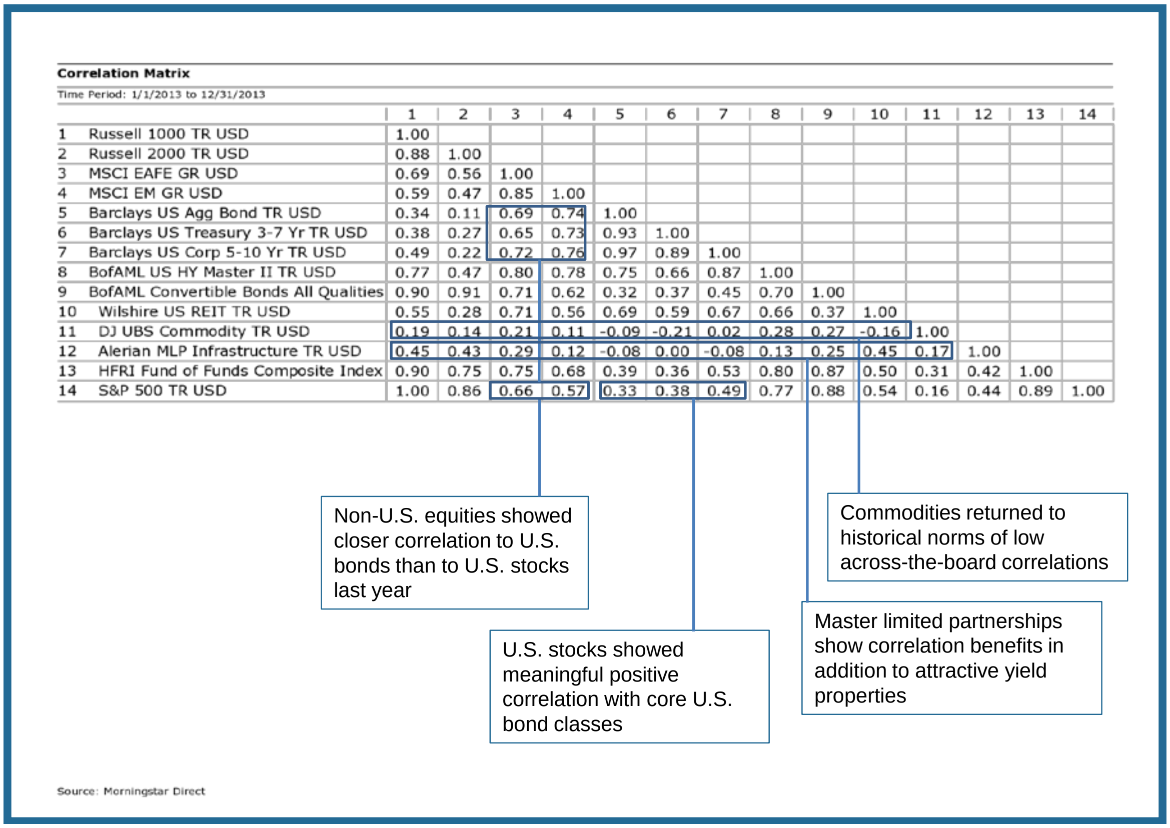
Source: MVCM Research, U.S. Federal Reserve Database

Macro interest rate trends tend to be very long: there have only been two such trends since 1951. We don't imagine that rates are heading back towards double digits any time soon, but a secular upward direction seems to us the most likely scenario. As a result, we are overweight low-duration securities, with an emphasis on floating rate instruments that protect against loss of principal value when rates rise. We also have select exposures to unconstrained bond strategies, which typically can delve into a wider range of asset classes to insulate investors from the most interest rate-risk sensitive sectors.

D. Alternative Assets

Alternative assets normally play the role of a hedge for both equity and fixed income exposures. One of the important metrics we normally look at is correlation between alternatives and equity & fixed income asset classes. This yielded some surprises in 2013.

Chart 16: Correlations Between Selected Asset Classes, Full Year 2013



Correlation Matrix

Time Period: 1/1/2013 to 12/31/2013

		1	2	3	4	5	6	7	8	9	10	11	12	13	14
1	Russell 1000 TR USD	1.00													
2	Russell 2000 TR USD	0.88	1.00												
3	MSCI EAFE GR USD	0.69	0.56	1.00											
4	MSCI EM GR USD	0.59	0.47	0.85	1.00										
5	Barclays US Agg Bond TR USD	0.34	0.11	0.69	0.74	1.00									
6	Barclays US Treasury 3-7 Yr TR USD	0.38	0.27	0.65	0.73	0.93	1.00								
7	Barclays US Corp 5-10 Yr TR USD	0.49	0.22	0.72	0.76	0.97	0.89	1.00							
8	BofAML US HY Master II TR USD	0.77	0.47	0.80	0.78	0.75	0.66	0.87	1.00						
9	BofAML Convertible Bonds All Qualities	0.90	0.91	0.71	0.62	0.32	0.37	0.45	0.70	1.00					
10	Wilshire US REIT TR USD	0.55	0.28	0.71	0.56	0.69	0.59	0.67	0.66	0.37	1.00				
11	DJ UBS Commodity TR USD	0.19	0.14	0.21	0.11	-0.09	-0.21	0.02	0.28	0.27	-0.16	1.00			
12	Alerian MLP Infrastructure TR USD	0.45	0.43	0.29	0.12	-0.08	0.00	-0.08	0.13	0.25	0.45	0.17	1.00		
13	HFRI Fund of Funds Composite Index	0.90	0.75	0.75	0.68	0.39	0.36	0.53	0.80	0.87	0.50	0.31	0.42	1.00	
14	S&P 500 TR USD	1.00	0.86	0.66	0.57	0.33	0.38	0.49	0.77	0.88	0.54	0.16	0.44	0.89	1.00

Source: MVCM Research, Morningstar Direct

We found closer than average correlations where we would not expect them (e.g. between stocks and bonds, especially non-U.S. stocks), and a return to lower correlations in alternative classes like commodities and master limited partnerships than has been the case over recent years. While we have taken our commodities exposures down to zero in light of what we perceive as potentially ongoing secular weakness in commodity price trends, it is good to see a return of its traditional low correlation benefits.

Higher correlation alternative assets are not necessarily bad, however. Convertible bonds (shown above) are closely correlated with equities but are typically less volatile and also offer yield benefits. Market signal-driven defensive equity strategies (not shown above) will tend to be closely correlated with stock indexes during growth markets, but because they can retreat to large or full cash positions in drawdown environments, they will show low correlation properties in those periods. We maintain exposures in both those alternative classes, as well as in MLPs, hedge fund of funds & long/short strategies, and unconstrained bonds.

IV. Conclusions

- 2013 was the best year for U.S. equities since 1997. Given that the returns came on the back of low levels of market risk, the risk-adjusted returns for the S&P 500 and other major indexes were even better than the absolute returns. We believe it will be hard for the market to pull off a repeat performance in 2014, but our base case sees the potential for modest gains.

- The notable absentee at the equity party was the emerging markets sector. Portfolio capital proved to be flighty when QE tapering fears came into focus. The sector is heavily undervalued by valuation metrics, but may continue to face some fundamental headwinds along the road to recovery.

- The real drama in 2013 was in fixed income, where core intermediate and long duration bonds took a beating over a four month period from May to September. Our base case contemplates a systematic, but gradual, upwards trend in rates that could mark the beginning of the third macro rate environment since the early 1950s. However we are mindful of the potential for unexpected events that produce irrational price movements like the May-September rate spike.

- The U.S. dollar has been an important tailwind for domestic equities. A bullish case for the greenback continues into 2014, particularly if the QE taper continues without hiccups and rates trend upwards.

- The incoming Yellen Fed will have to deal with an inconclusive picture of the U.S. economy and particularly employment trends. GDP and employment data points came in strong during the fourth quarter, supported by healthy consumer spending and housing market activity, but the December employment numbers came in much lower than expected and have thrown confusion into the mix.

- Although a strong recovery will probably be the best outcome for equities and other assets in the long term, a stronger than expected pace of growth in 2014 may cast doubts on the Fed's ability to hold rates at zero until late 2015 or 2016. That could potentially speed up the pace of rising rates and have a negative impact in lending and risk asset markets.

- Elsewhere in the global economy China's economics mandarins are taking bold measures to avert a risky credit bubble while still navigating policies to grow economic output in 2020 to double its value in 2010. The economy will have to grow at an annual average of 6.9% for the rest of the decade to achieve that.

- Europe has managed to stave off a deeper recession, and recent readings in retail sales and peripheral sovereign debt yields give cause for cheer. But unemployment remains at record highs, and prices are dangerously close to the deflation zone.

- Investors will be paying close attention to Q413 corporate sales and earnings to evaluate whether current valuation levels are even more expensive than they seem at face value. The consensus next twelve months estimate for S&P 500 earnings is 10%. But economists proved to be overly optimistic in 2013, with growth eventually proving to be about half of what they had originally predicted.

V. Important Disclosures

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