Big Ending

Yes, Virginia there is a Santa Claus! How else to explain the spectacular returns from equities? The S&P 500 finished the year at an all-time high after surging 10.51% in the final quarter and 32.39% for the year. Developed international stocks were up 5.18% in the quarter and 17.78% for the year – good but nowhere near the performance of U.S. stocks. Emerging market stocks were the big losers falling by over 4% on the year, marking the largest divergence from U.S. stocks ever recorded. Emerging market stocks are universally hated and cheap, and likely one of the best opportunities for long-term investors (Chart).

Bonds also suffered. Interest rates surprised most investors by moving up, most likely due to an improving economy and fear over the Fed buying slightly fewer bonds. The broad bond market was down by about 2% while intermediate U.S. Treasuries lost over 6%!

Last year was a reminder to investors that stocks seldom return in any calendar year its long-term average return. In fact, looking at history the stock market advances by 10% or more, or declines by -10% or more roughly 2/3rds of the time. Bear that statistic in mind when you read pundits' outlooks for 2014.

There are many logical explanations for last year's strong performance. The most obvious is that the Fed was successful in coaxing money out of cash and into stocks. Momentum is a powerful force on Wall Street, especially when there is a dearth of really negative news. We believe the bears retreated after one of their main tenets came under attack in April. The intellectual foundation for many bears was based on academic work by Carmen Reinhart and Kenneth Rogoff in their book, *This Time is Different.* Their message was that growth slows down significantly for countries after a financial crisis and once sovereign debt reaches 90% of GDP. The conclusion for many was that slow growth meant weak earnings and a lackluster stock market. However, other researchers discovered some errors in their work, which the two acknowledged, causing many to question the legitimacy of the bearish outlook. To be clear we are not making a statement one way or another about the message of their research, we are merely hypothesizing that this event sent the bears into hibernation and helped propel the stock market.

Investing is often described as being a combination of science and art. We are definitely in the "art" part of the discipline. Risks and opportunity seem balanced and could tip in either direction in 2014. Stocks are not cheap, but neither are they grossly overvalued if current earnings can be maintained. A major concern is the poor quality of earnings in 2013. Much of the growth was attributed to lower taxes, significant share repurchases, and lower interest rates. We'd really like to see Corporate America invest their excess cash and hire more people. That type of activity would signal a robust economy with everyone participating. Unfortunately many households are not benefiting from today's prosperity. Since the start of the current economic expansion, real median household income has fallen 4.3%, a totally unprecedented occurrence. This data point is not healthy and needs to change. A short-term concern is sentiment measures which are looking a bit frothy.

One of the clear bright spots in the second half of 2013 was the improving global economy. Business confidence surged in rich countries, purchasing managers' indexes rose worldwide, and industrial metals were firm all suggesting a more stable footing for the world economy. Investor confidence is also high as expressed in the small number of Bearish investors in recent surveys (Chart).

The magnificent returns last year were a nice gift. While anything can happen in 2014 long-term returns from these levels are bound to be more modest. As a result preservation of capital is becoming more important but not yet the driving force. Possible signs of a momentum change include increased volatility, sell-off of bubble-stock like Tesla or Netflix, earnings disappointments, or higher interest rates.

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