Summit Financial Resources, Inc.

Year-end 2013 Investment Newsletter

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Executive Summary

Last year began with a New Year's Day congressional deal to avoid much of the fiscal cliff. The resulting relief rally gained further strength from favorable economic reports, easing global tensions, and improvement in China's economic growth. By the end of the month, creative legislation to delay government debt ceiling drama and a resolutely dovish Federal Reserve were sufficient to propel U.S. stocks to within striking distance of all-time highs.

Investment returns in February were generally positive despite a steady stream of challenges during the month. Retailers expressed caution as consumers faced headwinds from higher payroll taxes and rising gasoline prices. Additionally, Federal Reserve meeting minutes revealed more discussion of backing off the monetary throttle, and Congress failed to sidestep $85 billion in sequestration cuts.

Despite geopolitical tensions from Iran, China, and North Korea, stock markets managed to hit new all-time highs in March. Renewed vigor in U.S. manufacturing, continued housing and auto strength, and jobless claims pushing against a five year low were contributing factors.

Data released at the start of the second quarter suggested weakness. Against previous months, labor markets weakened, manufacturing growth eased materially, and both retail sales and durable goods orders contracted in March. China's first quarter growth was disappointing, and the nation's resurgence in economic growth was increasingly doubted as the quarter progressed. The world's second largest economy faced slowing retail sales growth, fading industrial production, and weakness in both export demand and investment spending.

Despite a weaker economic landscape, investment markets performed well during April, and investor sentiment was unabashedly bullish. U.S. credit spreads tightened to 2007 levels, stock markets hit new highs, and margin debt rose to over 2% of GDP for only the fourth time in history. In contrast, gold collapsed during the month due to diminished inflation fears and rumors of forced selling by beleaguered European nations.

Exuberance diminished in May as a contraction in Chinese manufacturing intensified global growth concerns and tripped up the meteoric rise of the Japanese stock market. U.S. monetary policy also went under a microscope following suggestions by Bernanke that the Fed might back off of bond buying in coming meetings. On this news, bonds weakened, capital market volatility rose, and the dollar rallied. By month end, every major asset class other than domestic equities had lost ground.

Global growth concerns and Fed watching continued into June. Details of Japan's economic reform plans came up short, and statements following the Fed's June meeting proved disconcerting to investment markets. U.S. bond funds of all types suffered record outflows, interest rates backed up to two year highs, and Japanese stocks were volatile. Fixed income markets worldwide, from Europe to emerging markets, were hit by the potential of Fed unwinding. Every asset class was down in June. The carnage was broad and in some cases deep.

Investors, globally, became consumed by the issue of Fed tapering and a new period of market tumult was born. Despite investment gains, July had its share of non-Fed related pressure points. Detroit's bankruptcy filing became the largest municipal failure in U.S. history, China's growth continued to slow, political turmoil rose in peripheral Europe, and Egypt erupted into violence following a military coup that ousted President Mohamed Morsi.

In August, generally favorable economic developments were overshadowed by escalating tensions with Syria and the related potential for military strikes. Domestic monetary and fiscal policy issues added fuel to the fire. Fears of Fed tapering were renewed and increased noise out of Washington foreshadowed the budget battle to come. Investment markets fared poorly. U.S. interest rates ticked higher, bond fund outflows continued to hit the record books, and a number of emerging market currencies were hammered.

Risks diminished in September and rising optimism carried investment markets higher. The widely expected Fed tapering was delayed and Russia brokered a diplomatic solution to Syria's use of chemical weapons. Europe showed increasing evidence of an upturn, stabilization in China eased fears of a hard landing, and Japan's Abenomics program continued to bear fruit.

Despite a turbulent and circuitous path, most investment segments finished up in the third quarter. International stocks of developed markets were the stars of the show, gaining 11.6%. Aided in part by dollar weakness, these markets nearly closed the year-to-date gap with high flying U.S. counterparts. Commodities, bonds, and emerging market stocks recouped some of their first half losses, but remained down for the year.

Dysfunction in the nation's capital resulted in a 16 day partial government shutdown in October, but had little impact on investment markets. Following relatively benign movement during the first half of the month, stocks promptly hit new highs once government funding was restored.

Most key economic releases in November were stronger than expected. Despite the government shutdown in October, the labor market showed unexpected resilience and retail sales actually accelerated from the previous month. Resulting equity market gains were only enhanced by the news of Janet Yellen's nomination to head the Federal Reserve.

Stronger economic data pushed the Federal Reserve to begin tapering in December - earlier than expected. The Fed also extended the timeframe of their zero interest rate policy to well past their unemployment rate target of 6.5%. Markets cheered the news. As for the fiscal side of government, Congress ended the year with a two year budget deal and effectively avoided another looming government shutdown.

When the dust settled on 2013, stocks from developed markets soared while just about everything else fell. From a fundamental perspective, investment opportunities going forward are different than they were one year ago. Slow revenue growth, record margins, and much higher valuations should temper enthusiasm for domestic stock market gains in the future. Likewise, higher nominal as well as real yields make various pockets of fixed income more compelling.

As for the economy in 2014, the following pages posit an uptick in domestic growth, albeit more from reduced fiscal headwinds than from any kind of reacceleration. Global growth looks somewhat more inviting as well. The U.S. consumer's financial health has definitely improved but not because of reduced unemployment, which is an illusion. The fact is, fewer people in the labor force make for improved unemployment rate headlines, but it certainly does not help those individuals or their economy. As for housing markets, they may become victims of their own success. Higher prices and reduced inventory will slow activity to a more moderate pace of improvement. Of course, higher mortgage rates will be a drag as well. Lastly, diverging inflation trends, rising in emerging markets but falling in developed markets, pose challenges to policymakers. Capital flows, economic growth rates, currency values, and investment markets will all be impacted.

Economic Review and Outlook

Economic Growth

U.S. gross domestic product (GDP) grew at an annualized rate of 4.1% in the third quarter of 2013.

Data Source: U.S. Department of Commerce

Growth starved economists, policymakers, and investors latched onto the headline number as evidence of a so far illusive uptick in the pace of economic activity. Yet, aside from a substantial inventory build, the result was remarkably similar to that of the second quarter.

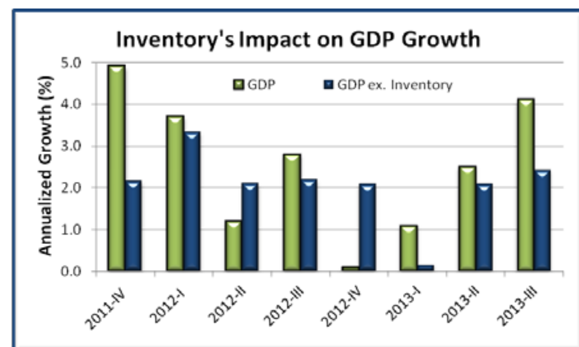
Contributions to GDP Growth*

GDP Component	Q2 2013	Q3 2013
Personal Consumption	1.2	1.4
Investment (ex. inventory)	1.0	0.9
Net Exports	-0.1	0.1
Government	-0.1	0.1
Sub-total (ex. inventory)	**2.1**	**2.4**
Inventory	0.4	1.7
Final GDP	**2.5**	**4.1**

Data Sources: U.S. Department of Commerce, Summit
* Numbers may not sum due to rounding

Admittedly, an accelerating pace of inventory growth could indeed be a harbinger of greater future demand. That said, it is a leap of faith, and early days, to suggest this one volatile data item portends a quickening pace of economic activity.

The phenomenon of inventory induced distortions is nothing new for the post crisis recovery. The following graph illustrates GDP growth over the past two years. The green bars suggest a generally slowing pace of economic activity throughout 2012 followed by a resurgence in growth in 2013.



Data Sources: U.S. Department of Commerce, Summit

The inventory adjusted blue bars show no such trends existed. As a matter of fact, with only two brief exceptions, the steady pace of about 2% real growth has been surprisingly consistent over the past two years.

Historical data is clearly less exciting than many have come to believe. Furthermore, extrapolating past data is insufficient to forecast what many have called a "breakout year of growth" in 2014. That said, *other* factors do point to a faster pace of growth over the coming year. First, fiscal headwinds will diminish. The Congressional Budget Office (CBO) estimates the tax hikes and government spending cuts of 2013 created a drag of 1.5% on 2013 growth. The impact of fiscal tightening will be far less severe this year. Second, trade data has improved markedly. Domestic energy production, up 64% in five years, led to record petroleum exports in November.

Petroleum imports hit a three year low that same month. The balance of trade is also benefitting from dollar weakness, cheap domestic energy, and higher labor costs in China. All told, exports are at a new high and the trade deficit has declined from 5.8% of GDP at the end of 2005 to 3.0% in the third quarter of 2013.

For 2014, the U.S. economy is forecast to grow 3.0 - 3.5% following a projections of 3.0% growth in the final quarter of 2013 and 1.9% for all of last year.

Turning to the global landscape, economic growth in advanced economies may have hit a bottom in 2013 and is expected to show solid improvement in 2014.

Global Economic Growth Rates[1]

	Q3 2013	Q4 2013	Q1 2014	2012	2013	2014
Advanced	**1.4**	**2.1**	**2.4**	**1.4**	**1.3**	**2.4**
Euro[2]	0.4	0.9	1.2	-0.6	-0.4	1.1
U.S.[2]	4.1	3.0	3.0	2.8	1.9	3.3
Japan[2]	1.1	3.4	3.9	1.5	1.7	1.4
U.K.[2]	3.2	3.3	3.3	0.3	1.9	3.0
Canada[2]	1.8	2.0	2.1	1.7	1.6	2.1
Emerging	**5.1**	**5.0**	**5.1**	**5.4**	**5.2**	**5.3**
China	7.8	7.7	7.9	7.7	7.7	7.8
India	4.8	4.2	4.2	5.1	4.5	5.0
Russia	1.2	2.4	2.6	3.4	1.5	3.0
Brazil	2.2	1.8	2.4	1.0	2.2	2.3
World	**3.0**	**3.3**	**3.6**	**3.1**	**2.9**	**3.7**

Data Sources: Goldman Sachs, Central Intelligence Agency
[1]Q3 2013 and 2012 are actual, all others are forecasts
[2]Quarterly numbers are sequential annualized, others are YOY

The euro area emerged from recession last year and is projected to show its first calendar year of positive growth since 2011. Japan's recent resurgence in economic growth, driven by aggressive expansionary policies, will be negatively impacted by a material sales tax hike starting in the second quarter of this year. Despite this headwind, resulting in a slower rate of growth, Japan is expected to maintain positive year-over-year growth in 2014.

Similar to advanced economies, emerging market growth is expected to accelerate this year following several years of deceleration.

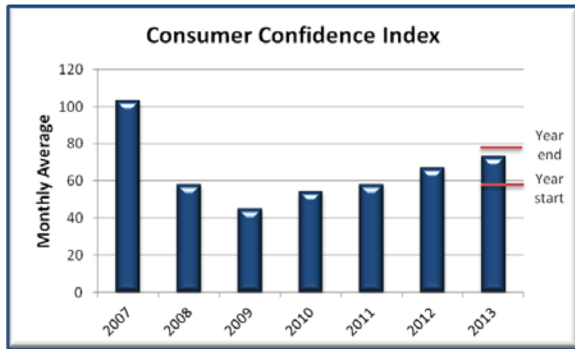
Data Source: Goldman Sachs

Interestingly, the EM rate of change is less impressive than that of developed counterparts. Nonetheless, developing nation growth is once again expected to outpace that of advanced economies this year.

Weighing the dynamics of both advanced and emerging nations, the global economy is projected to expand by 3.7% this year following only 2.9% in 2013. If forecasts prove correct, 2014 will be the first year of accelerating global growth since 2010.

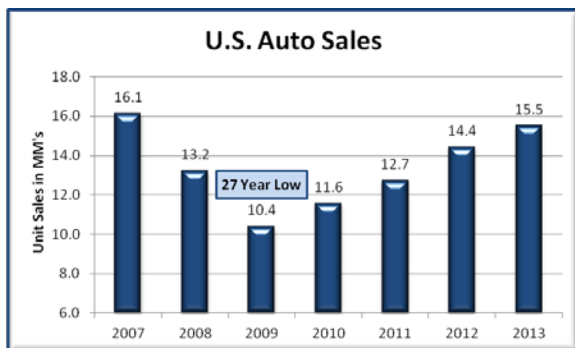
The Consumer

Consumer confidence fell during the October government shutdown and accompanying debt ceiling uncertainty. Aside from that relatively brief period of time, consumer confidence rose steadily from lower levels at the start of 2013 to reach new post-crisis highs in the second half of the year. As shown in the following graph, this positive progress extends a steady, albeit slow, trend of improvement since the dark days of 2009.



Data Source: The Conference Board

Other metrics support the notion of a healthier and more positive consumer. Mortgage debt increased in the third quarter of 2013 for the first time post-recession. Retail sales grew in 2013 at about a 4% clip and auto sales hit an annualized rate of 16.3 million units in November - a level not seen since the third quarter of 2007. For the year, auto sales exceeding 15.5 million units represented nearly 8% year-over-year growth and a 50% jump from the bottom in 2009.



Data Source: Bloomberg

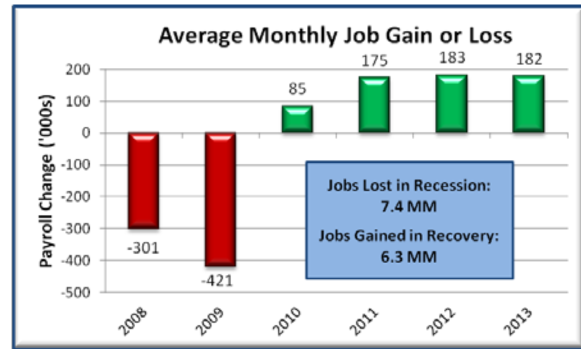
The consumer had cause to celebrate in 2013. Household wealth continued to climb as home prices, in aggregate, rose by double digits and stock markets reached new highs. Consumer debt relative to GDP, already at a 10 year low, continued to fall. Delinquencies on consumer loans and credit cards are well below pre-crisis levels and the consumer now spends less of their paycheck on fixed expenses than at any time since the early 1980s. This fact is captured by the Federal Reserve's financial obligations ratio, which includes items such as mortgage and rent payments, auto lease payments, property taxes, and homeowners' insurance.

Data Source: U.S. Federal Reserve

Lastly, even with the rise in both home prices and mortgage rates, housing remains more affordable than it was prior to the financial crisis (as per the National Association of Realtors Housing Affordability Index).

Despite the positives, economic imbalances remain and bad habits are on the rise. It seems U.S. consumers have short memories and poor fiscal discipline. For decades, U.S. households regularly saved in excess of 11% of their disposable income (including pension contributions as per recent Bureau of Economic Analysis revisions). Starting around the mid 1980s consumption took on a life of its own. Greater availability of cheaper and cheaper credit fueled excessive consumption, and savings gradually became an antiquated notion. The average savings rate fell by about 40% from the mid 1980s through 1999. By the new millennium, savings had dropped by two thirds and periods when savings went negative became common (excluding pension contributions).

Data Source: U.S. Bureau of Economic Analysis



Data Sources: U.S. Department of Labor/Summit

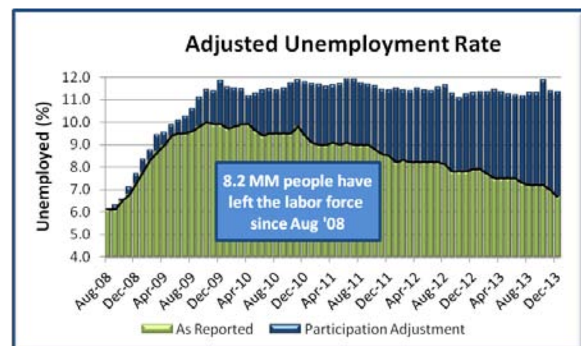
Following the financial crisis, consumers initially seemed to find fiscal religion. As shown above, savings rates rose nicely in 2009. Perhaps the economic catastrophe enlightened the population to the dangers of profligate consumption, excessive leverage, and de minimis savings. Then again, as the subsequent downward trend illustrates, perhaps not.

Two other consumer related pressures are worthy of monitoring. First, employment, discussed in the next section, remains very weak. Second, the 2013 year-end expiration of extended unemployment benefits affects an initial 1.3 million long-term unemployed workers and two million more within six months.

Employment

The labor market was a mixed bag in 2013. Average weekly hours were flat, hourly earnings rose slightly faster than the pace of inflation, and initial and continuing jobless claims each fell by about 30,000. Individuals characterized as long-term unemployed, those out of work for over six months, declined from 4.8 to 3.9 million - a comparable decline to that in 2012. As shown in the following graph, monthly job growth was essentially identical to that of 2012, which itself was just slightly better than 2011.

Nearly five years into the recovery, the economy remains 1.1 million jobs shy of the pre-recession level. While that number itself is disappointing enough, it falls far short of capturing the magnitude of the employment issues in the U.S. Since the beginning of the financial crisis, the civilian non-institutional population has grown by 12.6 million people. Considering it is normal for about two-thirds of this cohort to seek gainful employment, the economy has not only failed to recover 1.1 million jobs lost in the recession, it has also failed to meet the employment needs of an additional eight million individuals that would normally be working. Perhaps the best way to absorb this concept is to consider the unemployment rate adjusted for the negative trend in participation rate.

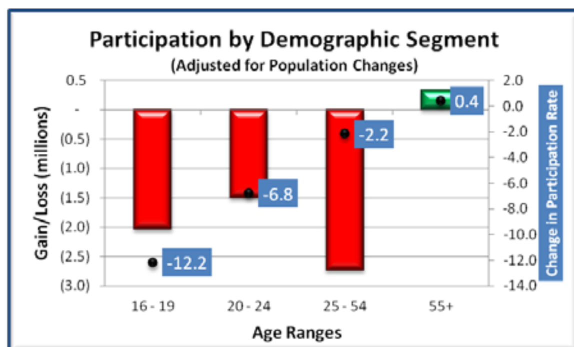


Data Sources: U.S. Department of Labor, Summit

The green bars illustrate the headline U.S. unemployment rate. This narrow metric has shown progress. Indeed, the rate of

improvement unexpectedly accelerated in 2013 with the jobless rate falling to 6.7% - well below forecasts. The problem is this number fails to incorporate individuals that have left the labor force due to a lack of opportunity. That gap, captured by the blue bars, shows the economy has literally made zero progress on employment since the recession. As a matter of fact, the number of "missing" jobs at this time actually *surpasses* the number of jobs lost in the crisis - truly remarkable.

Many who have considered this issue dismiss it as a natural result of an aging workforce. They suggest demographic trends, i.e. retirements, are a key culprit to a declining participation rate. This is not the case.



Data Sources: U.S. Department of Labor, Summit
Note: A rise in disabilities, not shown, accounts for an additional drop of 1.8 million workers from the labor force.

The analysis summarized above encompasses data from August '08 through December '13. Importantly, it fully adjusts for population changes across each demographic cohort over time. As shown, the participation rate of younger workers, (ages 16 - 54) has declined. In total, 6.3 million additional people in these age categories are neither working nor looking for work than would have been the case pre-crisis. In contrast, the participation rate of those over 55 has *increased*. As a result, 0.3 million more individuals are in the labor force than would have been the case pre-crisis. Clearly, the retirement of baby boomers is not behind the aggregate drop in labor force participation. If anything, the data suggests just the opposite.

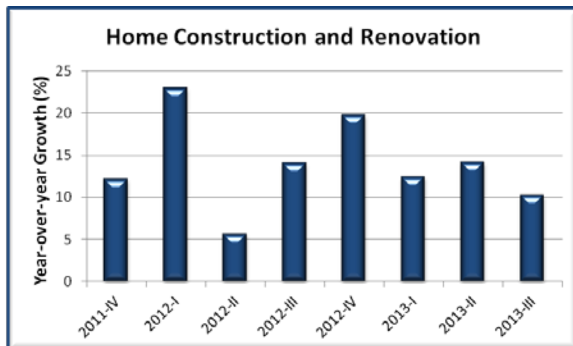
The previous discussion is more than a mind-numbing theoretical construct. First, there are 6.3 million young people (16 - 24) who are either unemployed or have given up looking for work. These are the years when young people search for careers, build resumes, and utilize new educations. Long-term economic productivity and growth, household formation, and even social stability are reliant on this progression. Second, an additional 8.6 million middle-aged people (25 - 54) are also unemployed or have given up on work. Individuals in this demographic are the engines of economic productivity, typically achieve maximum earnings potential, and work toward establishing financial stability. Their underutilization hinders economic growth and productivity, consumption, retirement readiness, and standards of living. It also preordains a greater strain on social safety nets now and in the future. Despite the seemingly improved employment headlines, and the Federal Reserve's willingness to begin backing away from monetary stimulus, a great deal of labor market repair is yet needed.

Real Estate

As mentioned earlier, auto sales have been a bright spot over the past two years. The same goes for the housing market. After peaking in April of 2006, home prices fell 33.9% to their low in January of 2012. Prices have risen sequentially in every month since then. Through October of last year, values were up 19.7% from the floor,

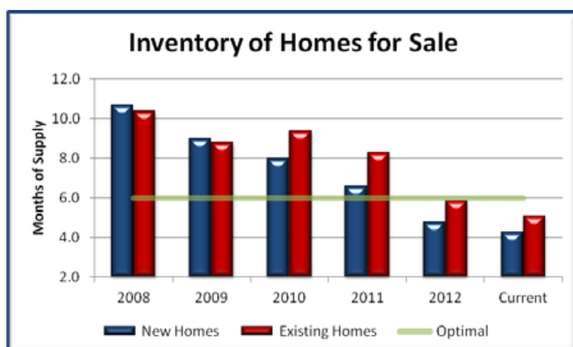
and year-over-year price gains have been in the double digits since early 2013. October also marked the largest annual price gain to date, up 13.6%.

Furthermore, double digit growth in home construction and renovation have accounted for nearly 15% of U.S. GDP expansion over the past two years.



Data Source: U.S. Department of Commerce

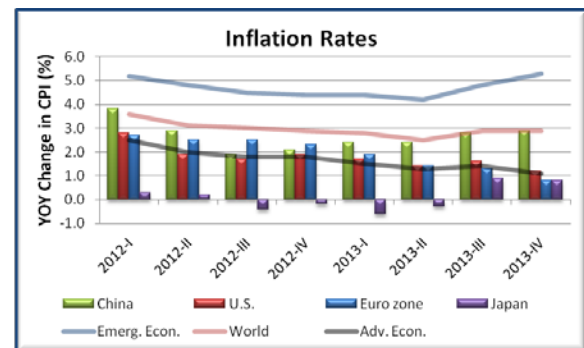
Results have been positive, but the housing market faces headwinds, and future price gains are expected to moderate. After two years of strong volume and price gains, unit sales of both new and existing homes declined following the jump in mortgage rates last summer. Through November, sales of new homes had recovered, but existing home sales were down 9%. Elevated prices and higher financing costs are not the only issues. Limited inventories are also a challenge.



Data Sources: U.S. Census Bureau, Nat'l Association of Realtors

Inflation

In 2012, disinflation (a lower rate of inflation) was a prevalent issue worldwide. Things changed last year. Worldwide stabilization of inflation obfuscated diverging trends. Most advanced economies continued to experience disinflation, to concerning levels, but inflation rose in many emerging markets.



Data Source: Goldman Sachs

The diverging trends have posed an interesting dichotomy for global monetary policy. Emerging market central bankers have raised interest rates to protect currencies and put a lid on inflation. Meanwhile, unconventional monetary easing continues in both the U.S. and Japan, and the European Central Bank (ECB) is being encouraged to do the same - this following an ECB interest rate cut in November. Global monetary policy is no longer one directional and universally expansionary. Relative rates of economic growth, capital flows, interest rate levels, currency values, and stock market returns will all be impacted.

Monetary Policy

The Federal Reserve's latest round of unconventional monetary policy, otherwise known as QE3, began with the new year. Nearly right out of the box, Federal Reserve meeting minutes revealed heightened

debate over the risks of this program, and investors began to handicap the timing of its end. The eventuality of adjustments to this program became *the* central issue to investment markets in 2013.

Chairman Bernanke's introduction of, and elaboration on, the concept of dialing back, or tapering, bond purchases kicked off a financial tsunami of sorts starting in May. In the two-month carnage that ensued, assets worldwide were repriced, and the 10-year Treasury yield moved from an early May low of 1.66% to an early July high of 2.73%.

In following meetings, the Fed held off on policy changes. Inflation was low, unemployment was high, and economic growth remained below trend. Tight fiscal policy, a dysfunctional Congress, and the eventual government shutdown also gave the Fed pause.

In December, nearly one year after the start of QE3, the Fed announced a modest tapering of this open-ended $85 billion per month acquisition of Treasuries and mortgage backed securities. By this time, a fair amount of fiscal uncertainty had been resolved and headline growth and unemployment numbers had improved. Judging by the favorable capital market reaction, investors had also grown more comfortable with the Fed backing off of the gas pedal.

Going forward, Fed guidance is for a continued gradual reduction in bond purchases with a target of program completion by year-end. The Fed's zero interest rate policy is expected to continue well past their original unemployment rate target of 6.5%.

Fiscal Policy and Legislative Activity

The year was book-ended by a flurry of fiscal activity. The American Taxpayer Relief Act of 2012, passed on New Year's Day, avoided across the board tax hikes but only delayed sequestration cuts. Likewise, resolution of the debt ceiling was also put off for a later day.

Following relative calm over the summer, fiscal issues came to a head in the fall. Congressional failure to approve either a budget or a Continuing Resolution by the start of the new fiscal year resulted in a partial shutdown of the U.S. government on October 1. Adding to that uncertainty, the additional failure to raise the debt ceiling only funded the government through the middle of October. In true form, Congress reached yet another last minute deal. This time, the government would be funded through January 15 and the debt ceiling would be extended through February 7. The deal also laid the groundwork for talks over broader budget issues.

Congress ended the year with a two year budget deal. While impressive for such a dysfunctional group, the agreement was basically devoid of any hard choices. The deal avoids a government shutdown that would have otherwise taken place as we go to print. It also tempers the impact of sequestration cuts by increasing short-term spending on domestic and defense programs. Such measures are to be paid for through cuts to federal and military pensions as well as increased airline passenger fees.

Capital Markets Review and Outlook

Overview

In terms of investment market returns, 2013 was a tale of two cities. It was the best of times for developed market equities. Major international stock markets gained 22.8% and U.S. equities had their best showing since 1995.

Capital Market Returns

	4th Qtr 2013	Full Year
U.S. Treasury Bills	0.0%	0.1%
Barclays Aggregate Bond	-0.1%	-2.0%
Barclays Municipal Bond	0.3%	-2.6%
S & P 500	10.5%	32.4%
Wilshire 5000	10.1%	33.4%
MSCI ACWI ex. U.S.	4.7%	15.8%
MSCI EAFE (Int'l Stocks)	5.7%	22.8%
MSCI EM (Emerg. Mkts)	1.8%	-2.6%
DJ UBS Commodity Index	-1.1%	-9.5%

Data Source: Morningstar

In contrast, it was the worst of times for many other asset classes. Commodities, emerging market debt, and inflation linked Treasuries were all down by nearly double digits. Emerging market equities also fell and real estate, heretofore a market darling, returned only low single digits. Bonds, with the exception of speculative grade credits, were down globally. This included mortgages, corporate and municipal bonds, and U.S. Treasury notes and bonds. As a whole, the 2.0% drop in investment grade domestic bonds was the first negative return in 14 years and the worst since 1994.

Investors with prudently diversified portfolios may have been surprised, if not disappointed, by what may be perceived as muted 2013 performance. After all, investors own many different kinds of assets, but primarily hear, see, and read about stocks. This decidedly one-sided flow of information, however, deserves a more balanced, holistic evaluation...and perhaps a bit of reflection.

Last year's political and macroeconomic backdrop posed a great deal of uncertainty. In the wee hours of 2013, U.S. government policymakers inked a deal to avoid a fiscal path that would have launched the U.S. economy into certain and immediate recession. Catastrophe avoided, the remaining economic headwind was still forecast to wipe out 50 to 75% of the nation's demonstrated growth potential. Moreover, fiscal challenges remained and the October government shutdown put an exclamation point on Washington's dysfunction as well as systemic risks posed to equity markets.

As for monetary policy, only months after the Federal Reserve's third round of quantitative easing had been launched, investors were fixated on the timing and pace of its reduction and end. This was understandable considering common wisdom suggests risk assets have been pushed, if not entirely supported, by the Fed's unconventional monetary programs. Clearly, it would be bold if not imprudent to bet the farm on a stock laden table as Bernanke grasps the tablecloth to execute a never before attempted parlor trick.

Internationally, Europe had backed away from extreme crisis, but the region remained in recession and, to this day, is

heavy on need for reform yet light on will to make it happen. Few structural problems are fixed. Debt levels continue to rise, and unemployment remains near the high. Japan had embarked on a monetary experiment that conjures up images of Bernanke holding a pea shooter, and the level, pace, and even trajectory of China's growth were up in the air. This remains the case today. Additionally, the world's second largest economy has gained zero momentum in its attempt to migrate from a focus on exports and infrastructure to one of greater household consumption. Credit fueled infrastructure investments have shown no signs of abating. This 'more of the same' behavior throws doubt on China's political resolve, and more debt only heightens the nation's economic risk.

In January 2014, it can be all too easy to ruminate on the missed opportunity of greater upside last year. Yet, taking into account historical rates of return on well-balanced globally diversified portfolios, results were quite attractive. Likewise, the stock market returns of 2013 were born out of rather high levels of uncertainty and risk. Not too long ago, the world witnessed the downside of stocks when that uncertainty went the wrong way.

Fixed Income

Treasury yields have changed little following the initial jump last summer. This suggests the market did a reasonably efficient job of adjusting to the Fed's new tapering regime. Likewise, accounting for low levels of inflation, real yields on bonds are once again positive. The Barclay's Aggregate Bond index now has a yield spread over inflation of 1.2% versus 10 and 15 year averages of 1.5% and 2.2%, respectively. This suggests interest rates could creep marginally higher, but forecasts of dramatically higher yields and catastrophic bond losses are unfounded.

Low rates of default and an investor push for yield have driven high yield credit spreads ever lower. Spreads are currently at a level last seen at the 2007 market peak. Provided the economy continues to plod along, defaults should remain low, and credit will be a reasonable place to achieve higher returns. That said, speculative grade credit now possesses considerable downside risk should the economy stumble.

After jumping about 1 to 1.5% last year, yields on inflation protected securities no longer trade at exceptionally poor levels of inflation adjusted, or real, yield. Likewise, diminished fears of rising prices have modestly lowered the inflation expectations dialed into the capital markets. The combination of these two additive factors make TIPS a much more interesting investment than they have been in years.

Lastly, municipal bonds continue to trade at attractive yields against comparable taxable bonds.

Equity Markets

As discussed, developed market stocks performed exceedingly well last year. The 32.4% return on the S&P 500 index was mostly driven by multiple expansion as operating earnings grew just under 11%. Considering revenue growth was only 2.5%, earnings gains were dependant on expanding profit margins. These rose over 8% to hit a new all-time high in 2013.

Stock market returns will be harder to come by in future periods. Tepid revenue growth has thus far been enhanced by rising

margins. This will be more difficult to achieve considering margins are already at a record level. On that point, the fact that margins are a strongly mean reverting data series suggests margin *compression* is a better bet in coming years. As for valuations, a number of widely followed metrics suggest stocks are quite rich.

None of this precludes reasonable gains for stocks over the near term - particularly considering momentum, retail flows, unattractive alternatives, decades-high bullish sentiment, and a general air of complacency, if not exuberance. That said, the key fundamental factors that drive stock markets higher (revenue, margins, earnings, and valuation) are all stretched thin and suggest more modest expectations are in order. Higher interest rates and a tapering Fed may make gains more challenging as well.

Disclaimers

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