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2013 4th Quarter Economic Update

Wow – what a year! Federal Reserve chairman Ben Bernanke provided us with cheap credit for the 5th straight year, encouraging consumers to purchase big-ticket items, which kept the U.S. factories humming. These low interest rates pushed passbook savers and investors seeking conservative returns into the unpredictable securities market, which increased demand and in turn assisted in the increase of the markets. *(Source: Barron's, December 23, 2013)*

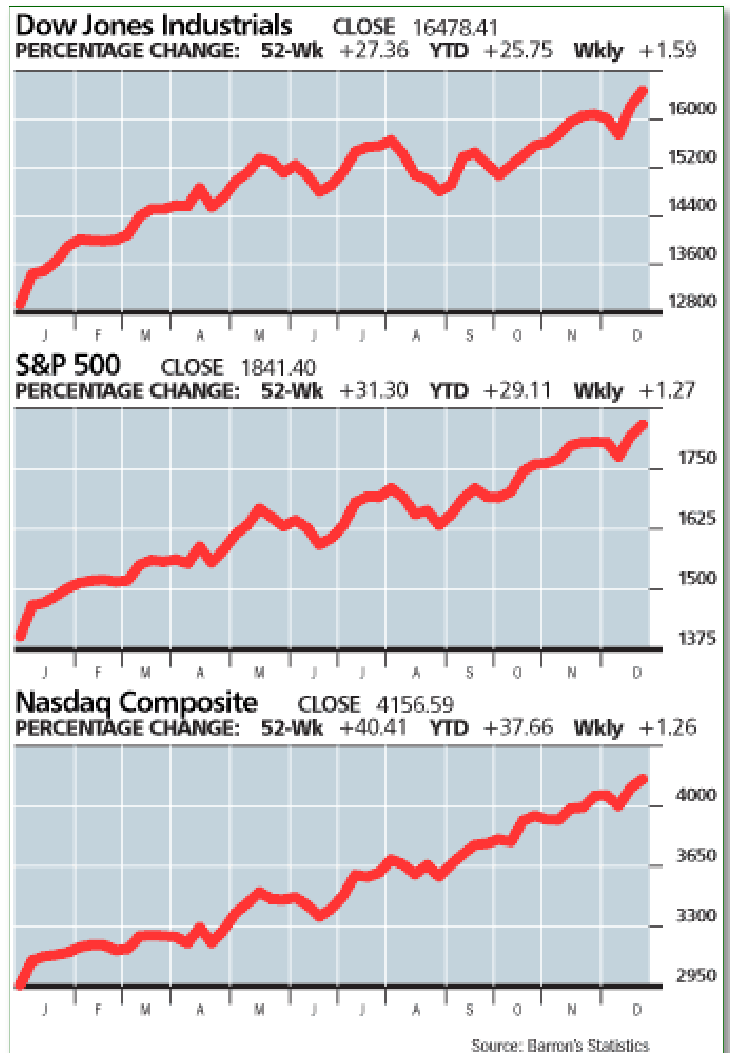
The Dow Jones Industrials climbed 27% during 2013, logging its best annual performance since 1995. In fact, the Dow Jones achieved a record high 52 times last year. The S&P 500 and the NASDAQ Composite also experienced significant gains last year, with total returns of 30% and 32%, respectively. *(Source: WSJ, Jan. 2, 2014)*

2013 was certainly a year to remember. Let's review some notable highlights:

- **January 1st** – Democrats and the GOP announced the budget deal that averted the fiscal cliff
- **March 15th** – the Cyprus banking crisis marked a turning point for Europe, with a new tax on many bank depositors
- **March 28th** – the Dow Jones Industrials and the S&P 500 finally surpassed their October 2007 highs
- **May 22nd** – Ben Bernanke notified Congress the central bank might taper the size of its bond-buying program, which had kept interest rates low and lent support to the economy and the stock market
- **September 18th** – the Fed decided not to taper and the markets reacted favorably
- **October 1st & October 16th** – Congress failed to strike a budget deal, and nonessential government services shut down
- **November 22nd** – the S&P 500 topped 1800 for the first time, a day after the Dow hit a new high above 16,000. *(Source: Barron's, Dec.16, 2013)*

When you consider all of the problems that the economy encountered last year, including the prospect of reduced federal stimulus and the Federal Government shutdown, you might ask how we arrived at these above-average returns. The contributing factors included:

- **Continued earnings and profit growth**, even though it was at a very slow pace.
- **Investors were willing to pay more for earnings** in recent years, especially in 2013.
- **Investors' worst fears were not realized**—the U.S. did not default on its debt, China didn't



Update! As of October 16, 2013, President Obama signed a bill to end the partial shutdown of the government and extend the debt ceiling until February 7, 2014.

experience a hard economic landing, interest rates remained low, and Europe's debt crisis abated.

- **U.S. consumers felt more upbeat** about the economy in December than during the prior two months, recovering from pessimism about the October government shutdown (according to the Conference Board's index of consumer confidence).
- **Consumers are stepping up their spending**, which is vital since it represents 70% of the economy.
- **Steady economic growth** gave investors more confidence that companies rated investment grade (the equivalent of triple-B-minus or higher) wouldn't have problems paying back bondholders.
- **A booming U.S. energy sector and rising overseas demand** brightened the economic picture in the last quarter, sharply increasing estimates for economic growth and hope for a stronger expansion.
- **A scarcity of attractive investments outside of equities** brought numerous investors to the stock market, and the increase in money and demand helped boost returns.
- **Buybacks have increased per-share profits** and signaled management's confidence. In the biggest of these buybacks, the Federal Reserve spent more than $1 trillion last year to purchase U.S. Treasury and agency paper on the open market to foster economic growth.
- **Companies are returning cash to shareholders via dividends.** Payouts by the S&P 500 have increased by nearly 15% in the past year, nearly triple the historical average. *(Source: The Complete Investor, December 30, 2013)*

Looking Ahead to 2014

Tapering, which is the easing of the U.S. Federal Reserve's $85 billion-a-month bond purchases, could affect the economy in 2014. Tapering is a vote of confidence in the improvement in the U.S. economy. To be successful, the Federal Reserve must get the timing of any move right, and must make clear the distinction between tapering and an actual rate hike.

The Fed has not always communicated its intentions well, and this tapering could become a major cause for a rocky stock market. In 2013, mere mention of tapering sent jitters through the markets, with stocks dropping as much as 6% last spring after Bernanke, on May 22, 2013, broached the idea of stimulus removal.

When the Fed announced in December to "taper" or scale back its stimulus starting in January 2014, many investors simply shrugged off the announcement. Investors now worry that the Fed could make missteps under its new boss, Janet Yellen, who will replace Chairman Ben Bernanke on February 1, 2014. Until the market has time to become comfortable with Yellen, there is greater potential for error or misinterpretation.

Another concern is an increased probability of a market correction. The current bull market began in March 2009 and the S&P 500 has rallied 162% since then. "Typically, bull markets that last more than four years eventually are knocked off course because of a recession," states Thomas Lee, investment officer at JPMorgan Chase. Despite this, many economists predict stocks rising about 10% on the basis of corporate fundamentals. Lower gains might seem boring, but boring could be just what we need to renew investor confidence. *(Source: Barron's, Dec. 16, 2013)*

Many strategists will be keeping an eye on Washington to see if Congress can reach an agreement in the spring on raising the Federal debt ceiling. A bipartisan budget deal was finalized in December and that offers some hope that politics won't derail the bull market.

Bond Market

The bond market experienced a negative year with the return for the Barclays U.S. Aggregate Bond Index down 2%, its first decline since 1999. Many economists are concerned that one of the biggest risks for the bond market is that the economic upturn could end up accelerating even more, causing a continuing bearish environment for bonds. Bond yields remain low by historical standards and returns could suffer if interest rates rise, weighing on bond prices.

Highly rated companies sold a record $1.111 trillion of bonds in the U.S. in 2013, even as the debt offered the worst returns in five years. *(Source: WSJ, January 2, 2014)*

Yields on 10-year Treasury notes, the bond market's main benchmark, jumped from 1.6% last May to just over 3% in December. For the year, the yield rose 1.27%, its largest annual climb since 2009 as investors

positioned for the Fed's tapering to begin. *(Source: WSJ, January 2, 2014)*

Even with an improving economy, given what they've experienced in recent years, many companies are likely to remain reluctant to increase capital spending or make acquisitions. Yet they have a mounting pile of cash at their disposal. The companies that comprise the S&P 500 (excluding the financials) held cash and marketable securities of $1.36 trillion at the end of the third quarter – an 18% increase from the same period a year ago. *(Source: The Complete Investor, December 30, 2013)*

International Countries

Many market indexes throughout the world had double-digit percentage gains as easy-money policies washed over concerns about growth. Japan's Nikkei Stock Average surged 57% for its biggest gain since 1972. Germany's DAX gained 25%, France's CAC-40 rose 18% and Spain's IBEX 35 climbed 21%. *(Source: WSJ, January 2, 2014)* European equities could add 15% in 2014, according to the Barron's survey of 12 market strategists. Most analysts see the good times continuing for at least a couple years beyond 2014. *(Source: Barron's, Dec. 30, 2013)*

Inflation

Inflation measures were well below the Fed's 2% target. Core inflation, which excludes food and energy, has been around the 1.1% level, year after year. Many believe that the lingering threat of inflation could result in monetary policy being looser than expected, fueling continued rallies in stocks and keeping bond yields relatively low. *(Source: Bob LeClair's, Dec. 28, 2013)*

Gold

Many economists had predicted 2013 would be lucky for gold. It appeared that all the pieces that inspired rallies in 2011 and 2012 were still in place, and gold had a seemingly unstoppable 12-year bull run behind it. Instead, gold fell and ended the year with a 28% loss. Investors, seeing little need for safety as stocks rose and inflation barely budged, sent gold to its first annual loss since 2000.

Unemployment

The government reported the U.S. economy has added jobs for 35 straight months, unemployment has fallen to a 4½ year low, and employers are laying off fewer workers. As Mark Twain said, "there are three types of lies: lies, damned lies, and statistics." On August 2013, the official unemployment rate fell to 7.3%, the lowest level since December 2008. The harsh reality, however, is that more than 4 million Americans have been unemployed for more than 6 months. Since 1994, the government only counts people as unemployed if they are receiving jobless benefits. Once the benefits run out, they are no longer considered by the government to be unemployed.

Some people are going back to work for minimum wage. Some Baby Boomers have decided just to retire at a very young age. Some have decided to go back to school. Many more have simply been beaten down by constant rejection. On average, there are now three unemployed workers for every job opening. Some have gone on disability or other welfare, or are no longer productive.

Even Ben Bernanke says that long-term unemployment had become a "national crisis." John Williams, editor of Shadow Government Statistics, calculates the actual unemployment rate at more than 23%. "The unemployment rates have not dropped from peak levels due to a surge of hiring; instead, they generally have dropped because of discouraged workers being eliminated from headline labor-force accounting."

What do you do with this bad news? Simply be cautious. Even while the overall outlook remains positive, it is always best to be aware of potential problems and understand that various risks remain.

Conclusion

Yes, there are risks, but let's review a few of the reasons as to why the bull market might continue: consumers are optimistic, manufacturing continues strong, construction spending improves and auto sales are up. In fact, many economists believe that the risks that lay ahead are more likely to be political and international rather than economic. Sure, we would like faster growth and even more jobs, but at least we

are moving in the right direction. *(Source: Bob Le'Clair's, January 4, 2014)*

This year could be very confusing for investors. We are constantly monitoring the economic environment and our goal is to keep you aware as things change. If you have any immediate concerns about your specific situation and finances, please contact our office.

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If you are not currently a client of Heritage Retirement Advisors, we would like to offer you a complimentary, one-hour, private consultation with one of our professionals at absolutely no cost or obligation to you.

To schedule your financial check-up, please call Raylene **at Heritage Retirement Advisors, Inc. at (858) 487-1111.**

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Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs or expenses. No investment strategy, such as asset allocation and rebalancing, can guarantee a profit or protect against loss in periods of declining values.

In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that investments in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

Sources: Wall Street Journal (1/2/14), Barron's (12/16/13, 12/23/13), Bob LeClair's Finance (12/28/13, 1/4/14), Bob Livingston Letter (November 2013), The Complete Investor (12/30/13), American Spectator (November 2013)