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INSIGHTS

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2013 Q4 INSIGHTS:
The Timing of the Taper ~ Part III

RECAP: Finally! Just days after we went to press with our December newsletter, in which we suggested the "Taper was imminent," the Federal Reserve and Ben Bernanke announced that not only would they begin to reduce the size (taper) of large scale asset purchases (Quantitative Easing) in January, but would also keep short-term interest rates near zero until "well past" the previous 6.5% unemployment threshold—especially if inflation remains below 2.0%. Investors viewed the announcement as a win-win.

First, easy monetary policy and zero-interest rate policy (ZIRP) will continue for the foreseeable future—perhaps until late 2015 or 2016. Zero interest rates force negative real returns (after-inflation) on cash, which in turn force investors and entrepreneurs to put excess cash to work. This stimulates both the economy and financial "risk assets," thus making the investment landscape still favorable for stocks and lower quality bonds.

Second, the Fed now is in a position to taper only because the economic data is improving. Better GDP numbers and improving U-6 unemployment data (see December 2013 newsletter) suggest that the training wheels can be removed from the U.S. economy. Extreme, highly aggressive, crisis-induced versions of monetary policy (Quantitative Easing) are no longer necessary. Once again, this means the investment landscape should be favorable for stocks and lower quality bonds.

Equity markets embraced the win-win. The ensuing "Santa Bernanke" rally pushed stocks to new all-time highs: stocks (S&P 500) reached their 2013 high on the last day of the year and gained over 150 points (10.51%) in the fourth quarter and over 380 points (32.39%) for 2013. It was the best calendar gain since 1997 and the 10th best year ever going back to 1928.

Appropriately, government and other high-quality bonds reacted negatively as yields climbed higher (yields up, prices down). The 10-year Treasury Bond yield also reached its high for 2013 on the last day of the year and broke 3.00% for the first time since July 2011, when the debt-ceiling showdown and U.S. sovereign debt downgrade plummeted yields from 3.00% to under 1.80% in a just a few months.

	Notable Sectors	Q4	2013
Stocks	**Global Equity**	**7.31**	**22.80**
	U.S. Large Cap (S&P 500)	10.51	32.39
	U.S. Small Cap (Russell 2000)	8.72	38.82
	International Equity	4.77	15.29
	Emerging Markets Equity	1.83	-2.60
Bonds	**Global Bonds**	**-0.44**	**-2.60**
	U.S. Aggregate (High Quality)	-0.14	-2.02
	U.S. High Yield (Low Quality)	3.58	7.44
	International Aggregate	-0.72	-3.08
	Emerging Market Debt	1.17	-4.12
Other	Gold	-9.40	-28.26
	Oil	-3.82	7.19
	Inflation	-0.36	1.62

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2121 Avenue of the Stars, Suite 1600
Los Angeles, California 90067
telephone 310.712.2323
facsimile 310.712.2345

2010 Main Street, Suite 220
Irvine, California 92614
telephone 949.705.5188
facsimile 949.705.5199

3452 East Foothill Blvd., Suite 1140
Pasadena, California 91107
telephone 626.795.2944
facsimile 626.795.2994

1815 Via El Prado, Suite 100
Redondo Beach, California 90277
telephone 310.712.2322
facsimile 310.712.2377

8607 Westwood Center Dr., 3rd Floor
Vienna, Virginia 22182
telephone 877.301.7342
facsimile 703.287.7122

EQUITY: Global Equity followed the U.S. lead and moved to new highs on December 31st, returning over 7% for the quarter and near 20% for 2013. The U.S. equity market (10.51%) was the standout, as it bested foreign Developed Markets (5.71%), which were curtailed by Japan's low single-digit return for the quarter. Emerging Markets (1.83%) lagged Developed and continued to struggle with a loss (-2.60%) for 2013.

Within the U.S., equities finished in positive territory for the fourth consecutive quarter. Return patterns were similar under the surface as Growth (10.25%) marginally beat Value (9.95%) and Large Caps (10.51%) edged out Small Caps (8.72%) for the first time in 2013. Other recent trends also continued. In Q3, investors witnessed the reemergence of cyclical "offensive" sector leadership, which continued in Q4. Industrials (13.53%) and Technology (13.26%) led all sectors while more defensive sectors like Utilities (2.79%) and Telecom (5.47%) lagged.

FIXED INCOME: Similar to Q3 and mirroring equities, more aggressive sectors of the bond market such as High Yield (3.58%) outperformed. More conservative sectors lagged as rising interest rates provided a stiff headwind to high quality bonds. Again, high quality and long duration was not the place to be as Long-Term Treasuries (-0.75%) lost ground for the sixth consecutive quarter.

ALTERNATIVE ASSETS: Real assets not only lagged financial assets (equities) in the quarter but also for all of 2013. Master Limited Partnerships (5.28%) avoided losses but joined Real Estate (-0.68%) in trailing global equities as rising interest rates hurt most income-oriented assets. Commodities (-1.05%) also lost ground, as the gains in energy could not offset the large losses in gold (-9.40%) and other precious metals.

OUTLOOK: Our outlook from Q3 is still largely intact. In the long run, more meaningful data for stocks and bonds will focus on whether global GDP growth (and corresponding jobs creation) will live up to current projections. There are encouraging data points around the globe. Europe's economic data is improving and the era of austerity is winding down, which should set the stage for positive economic growth in the quarters and years to come. A healing Europe will further boost China, which is the continent's leading trading partner. Meanwhile, Japan is bolstering its economy with experimental monetary policy in an attempt to reverse long-entrenched de¬flationary pressures. Finally, the U.S. economy should strengthen as the effects of the fiscal drag diminish in 2014. But time and time again, overly optimistic GDP estimates from the Fed have failed to live up to expectations. Expectations are high, as investors have priced into stocks the first globally synchronous growth in GDP since the onset of the financial crisis six years ago. Unlike prior years, it is now critical that economies live up to these expectations now that equity valuations are elevated. With price-multiples now near fair value, investors have lost "valuation" as a tailwind; but, if the global economy can transition to real "growth," this new tailwind can allow the bull-run to continue a good while longer.

Sincerely,
Deron T. McCoy, CFA, CAIA, CFP®, AIF®
Chief Investment Officer