INVESTMENT OUTLOOK

- Stocks finish year at record highs.
- Emerging markets lagged.
- Growth to accelerate in 2014.
- Rise in yields may prompt market correction.

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Fourth Quarter 2013 Review & Outlook for 2014

by Whitney Brown

The stock market ended a bang up year in high style. The S&P 500 Index closed at record highs on six of the last nine trading days of 2013. For the full year, major U. S. market indexes returned anywhere from 26% for the Dow Jones Industrial Average to 38% for the NASDAQ Composite. Many European markets also saw double digit returns. Even Japan soared on high hopes for new Prime Minister Abe's ambitious plans to rejuvenate his country's long stagnant economy.

Also in This Issue

The year began with stocks reasonably valued and investor sentiment still showing healthy amounts of skepticism about the prospects for the market and the economy. As has been the case since 2008, the Federal Reserve continued to backstop equities and other risk-based assets with ultra-easy monetary policy. As the year progressed, generally improving economic trends in the U.S. and better than awful data out of China and Europe allowed more investors to believe the glass really was half full rather than half empty. A mid-year spike in interest rates spooked many out of bond funds, and investor inflows to equity funds accelerated over the course of the year.

Unfortunately, markets for emerging country stocks such as Brazil and Indonesia did not fare well in 2013. The long-term growth potential in such countries is still a major global economic story of abundant resources and favorable demographics. However, a number of countries failed to consolidate their economic gains from the boom times with sufficient political and fiscal reforms to help weather the lean times of the past several years. Slow growth and political unrest have been commonplace in much of Latin America and emerging Asia. The countries most dependent on foreign financing of their debt and investment seem to be faring the worst.

There is plenty of upside to be had in the U.S. and global economies. A wide sampling of year-ahead forecasts gives the gist that improvement in the U.S. economy will accelerate in 2014. The recent budget deal has removed some of the fiscal drag in place last year due to the budget sequester. The housing market has maintained momentum. Capital spending by businesses is predicted to pick up. And, the boom in domestic oil and gas production is keeping a lid on energy costs, allowing U.S. manufacturing to be more competitive globally.

In fact, the upside for the economy could produce some downside for the markets. A cautious view is that too much strength in the economy could see the Federal Reserve fall behind in regulating inflation and forced to tighten policy sooner or more forcefully than the market expects. With the broader sluggishness in the global economy, that is not at all certain, but longer-term bond yields, more market-driven than the Fed-controlled short-term discount rate, could rise to levels offering some competition for stocks. Any market correction that might develop should prove to be a buying opportunity. Strength and confidence usually begets more of the same, and we see clear evidence of both in the markets and the economy.

Market Measures	4th Qtr.	YTD
S & P 500 (price)	9.9%	29.6%
Dow Jones Industrial Average	9.6%	26.5%
NASDAQ Composite	10.7%	38.3%
Russell 2000	8.4%	37.0%
MSCI EAFE	5.4%	19.4%
Barclays Capital Inter Gov't/Credit Bond Index	-0.2%	-0.9%
	12/31/13	12/31/12
10-Year Treasury Bond Yield	3.03%	1.76%
Three-month Treasury Bill Yield	0.07%	0.05%

Taper Speculation Resolved (Did QE work?) by Jim Hall

Wow! After almost nine months of speculation, the Federal Reserve delivered a commitment to begin the reduction (nicknamed "taper") of their monthly purchase of bonds. I am guessing I'm not the only one weary of the constant chatter by reporters, newscasters, and analysts trying to predict when the Fed would begin reducing their bond-buying program (otherwise known as "QE3"). Many have questioned the process and are debating whether it succeeded. It's probably a little too early to claim success; but, from a stock market perspective, things are looking positive.

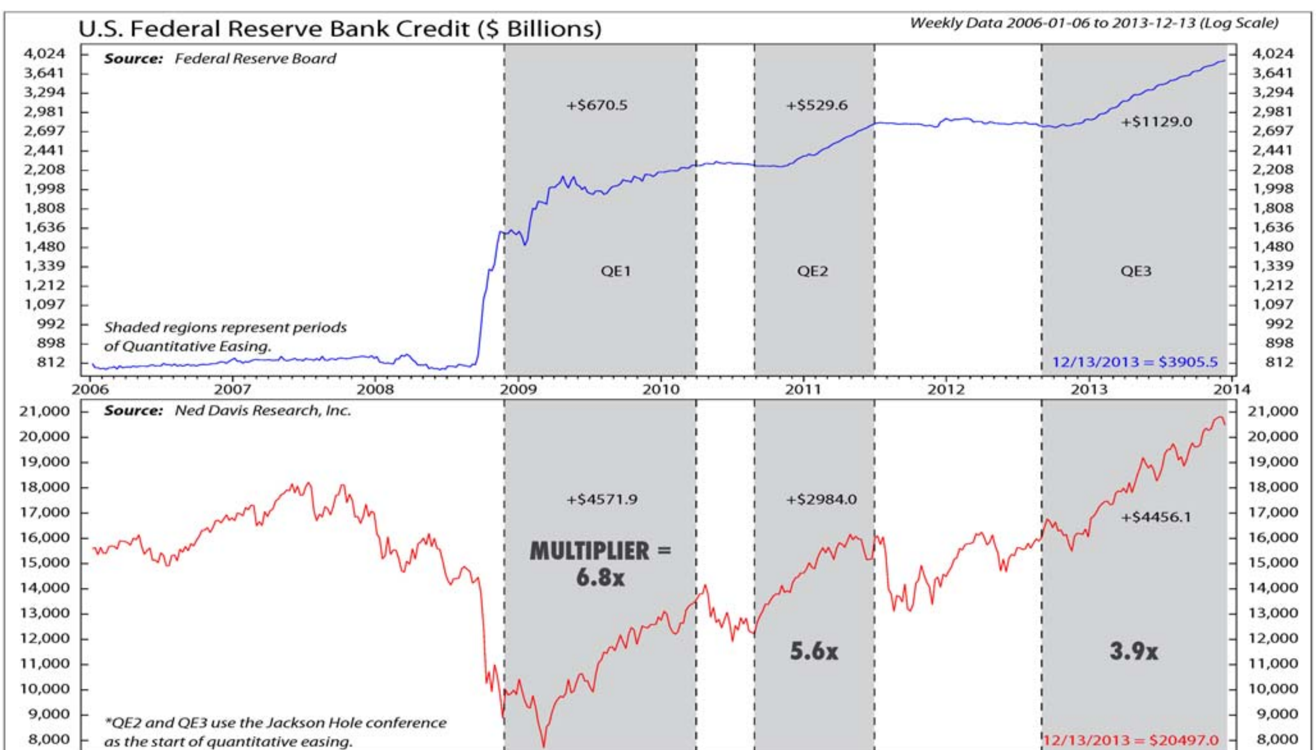
For an overly simplified background, one of the purposes of the Federal Reserve is to influence money and credit conditions in the economy with a goal of achieving full employment and stable prices. To assist in that goal, the Fed has many tools at their disposal. In years past, their most common method of influencing the economy would be to raise or lower the discount rate, the rate at which banks borrow short-term from the Fed. Raising the rate was their signal the economy was getting too robust and they feared inflation might increase. As they raised the discount rate, the cost of borrowing would increase, thus curbing economic activity. Conversely, when the economy was too anemic, lowering the discount rate effectively lowered the cost of borrowing, making the cost of new projects cheaper and ultimately spurring economic activity.

In the second half of 2007, the first ripples of a slow-down were beginning to be felt as some mortgage-related hedge funds began collapsing. In September 2008, Lehman Brothers failed, sending shivers through our entire banking system. The Fed slashed the discount rate, but because banks were reticent to lend any money at all, low rates had no effect on economic activity.

Realizing rates alone were not spurring activity, in late 2008, the Fed concluded they needed to support the credit markets and began buying a variety of fixed-income securities on the open market (officially called Quantitative Easing "QE"). QE was halted in May 2010 when they reached their asset purchase target. After seeing the economy begin to sag again, "QE2" was launched in November 2010 and continued until July 2011 when they reached their new asset purchase target. Once again, the economy showed signs of floundering. In response, the Fed launched "QE3" in September 2012 and chose not to cap the program as in their prior two efforts. Instead, they stated they would support the credit markets with $85 billion per month until unemployment dropped and the economy improved.

The two charts below reflect an excellent picture of the timelines involved and the level of debt incurred by the Fed contrasted with the estimate of the aggregate stock market capitalization of US companies. It is interesting to note since QE1 began in late 2008, the Fed has provided roughly $3.2 trillion in asset purchases, and the stock market capitalization has effectively doubled from around $10T to $20.5T. Stating it another way, each $1 of Fed-purchased assets stimulated approximately $3.30 in market cap expansion.

Increased market capitalization isn't the sole determinant of success, but judging by the stock market's positive reaction to the "taper" news, it appears the Fed may actually be achieving their goal of increasing employment in a growing economy while keeping a lid on inflation. It may be a few more months or quarters before we know the full impact of their efforts. In the meantime, it has certainly been a rewarding time to be investing in stocks.



Courtesy of Ned Davis Research, Inc.

Dow Theory Basics by Watt Dixon

Fundamental and technical analysis are the two main schools of thought when it comes to the study of stocks and the stock market. In its most basic form, fundamental analysis is the study of a company's business and financial statements. Technical analysis refers to the study of the "action" of the market as a whole or a particular stock or sector. Technical analysis deals in probabilities never certainties.

The Dow Theory is the granddaddy of all technical market studies. Much of today's technical analysis has roots based in the Dow Theory. Charles Dow and his partner Edward Jones founded Dow Jones & Company in 1882. Dow's tenets were further developed by others and eventually published as the Dow Theory in 1932. The Dow Theory assumes that the majority of stocks follow the underlying trend of the market most of the time. In order to measure the market, Dow constructed two indexes, which are now called the Dow Jones Industrial Average and Dow Jones Transportation Average. In order to interpret the Dow Theory correctly, it is necessary to have a record of the daily closing prices of the two averages and the total of daily transactions on the NYSE. The basic tenets of the Dow Theory are as follows:

1) **The Averages discount everything.** Changes in the daily closing prices reflect the aggregate judgment and emotions of all stock market participants. The markets reflect all known information and quickly assimilate the effects of unforeseen occurrences into the price action.
2) **The Market has three trends.** Dow defined an uptrend as a situation in which each successive rally closes higher than the previous rally high, and each successive rally low also closes higher than the previous rally low. The converse would define a downtrend. A trend is composed of primary, secondary, and minor moves, which he compared to the tide, waves, and ripples of the sea. The primary trend represents the tide; the secondary trend represents the waves; and the minor trends are ripples on the waves. The primary trend of the market is the most important.
3) **The primary trend has three phases.** Dow identified three distinct phases of a primary uptrend: an accumulation phase representing buying by the most astute investors; a public phase when trend followers buy in; and a distribution phase when the popular media is full of stories about how great the economy is and how the market will keep going up. It is during this last phase that the more astute investors begin selling.
4) **Volume must confirm the trend.** Dow recognized trading volume as an important factor in confirming price trends. In a major uptrend, volume should increase as prices move higher, and diminish as prices move lower. In a downtrend volume would increase as prices drop and diminish as they rally. For example, the market continuing to rise on decreasing volume could be a sign of a weakening trend.
5) **The Averages must confirm each other.** One of the most important principles of the Dow Theory is that the movement of the Industrial Average and the Transportation Average should be in sync to confirm the trend. It's not plausible for industrial companies to be successfully making and selling products if transportation companies aren't moving them to buyers.
6) **"Lines" indicate movement.** A Line in Dow Theory is a period of 2-3 weeks or longer during which price movement of both averages is limited to a range of approximately 5%. A Line signals that buying and selling pressures are roughly in balance. The direction of a price "break out" from a Line often indicates the direction of the next trend.
7) **A trend is assumed to be in effect until it gives definite signals of reversal.** This tenet of the Dow Theory is the most criticized because it is the most subject to personal interpretation. Judging whether a pullback in price is just a temporary move within a larger trend or the start of a major correction is often difficult.

The goal of the Dow Theory is to identify changes in the primary direction of the stock market. The Dow Theory addresses the direction of a trend but does not attempt to predict duration of a trend. Dow never intended to forecast the movement of the stock market but, instead, recognized the usefulness of the market direction as a leading economic indicator.

The Dow Theory has been followed for many years but does have its shortcomings. Many of its signals have been late. On average, Dow Theory misses 20 to 25% of a move before generating a signal. It does not capture exact market tops or bottoms, but does confirm major market moves. Dow Theory was developed in the Industrial Age and may not reflect the ways in which technology and the internet have vastly changed the types of goods and services produced and the ways they are delivered.

A current check of the Dow Theory confirms that both the Transportation and Industrial Averages are in uptrends with sufficient volume. The "public phase" is in full swing, so the market appears to be in a healthy and sustainable uptrend.

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Taxes and 2014 by Ted Feinour

Although the start of 2014 saw many deductions for small businesses terminate and an additional Medicare surtax on wages due to the Affordable Care Act, many investment related tax items remained the same as in 2013. For most investors, dividend and capital gains tax rates will remain the same this year. As before, investors in the 10% and 15% tax brackets will not have to pay anything on qualified dividends and long-term capital gains, and those in the 25%, 28%, 33% and 35% brackets will pay 15%. People in the 39.6% tax brackets (single filers in excess of $407,000 and joint filers in excess of $457,600) will see an increase to 20% for qualified dividends and long term capital gains.

Contribution limits for IRAs are staying at the same level in 2014 as they were last year. Investors under age 50 will be able to contribute $5,500 to their IRAs – either Roth or Traditional – and individuals over age 50 can contribute $6,500. As of this date the Congress has not decided whether to extend the provision for charitable contributions directly from one's IRA as part of the required mandatory distribution if over 70 ½ years of age. We hope that this will be decided favorably again in the near future and will let clients know as soon as we do.

The estate tax exemption will increase to $5.34 million per individual in 2014, up from $5.25 million last year. The annual gift exclusion also remains the same. This means that one can gift $14,000 a piece to an unlimited number of individuals without worrying about a gift tax. A married couple can jointly give $28,000 to any one person.

People may make tax-free gifts to 529 college savings plans for their children, grandchildren, or others. They may give up to $70,000 to a plan for a single individual in a single year without triggering a gift tax, assuming that they have not made prior contributions and that they make no further contributions to the same individual's plan for the next four years. These are called "catch up" provisions if one has not donated to a 529 savings plan before. Married couples could contribute $140,000 to one individual's plan assuming no further gifts are made from 2015 through 2018.

One may also make gifts to pay educational or medical expenses, circumventing the gift tax system altogether by making payments directly to the educational or medical institution. As always, our associates would be happy to discuss investment opportunities related to making the most of the 2014 tax provisions.