NOYES CAPITAL MANAGEMENT®, LLC
Personal Financial Planning & Prudent Investment Management
17 Village Road, New Vernon, NJ 07976-0271 + 973-267-8120

January 8, 2014

Managing Risk vs. Reward in a Rising Market
By Scott P. Noyes, CFA® CFP®

Strong equity markets and solid economic data made for memorable portfolio performance in 2013. Last year in anticipation of an improving economy, we underweighted bonds, shortened bond maturities and fully invested in equities. We remain committed to this theme for the first quarter of 2014. Beyond that, it is too hard to predict the varied effects the Federal Reserve's unwinding of the Quantitative Easing program on bond and stock markets. We are hopeful that higher interest rates will lead to a decent bond buying opportunity for the first time in several years. As is always the case, we intend to manage portfolios accordingly by adjusting the exposure to areas we feel will outperform.

2013 Market Performance Summary

Pinch me! It doesn't get much better than 2013 for the U.S stock market, in fact this was the best year since 1998. The S&P 500 was up 29% on a nominal basis and 32% if dividends are included. An improving economy, combined with low interest rates, modest inflation and strong corporate profit margins were catalysts for the surge. Credit should be given to Ben Bernanke and the Federal Reserve for helping to restore confidence in both the economy and the U.S. housing market.

Global stock markets fared well, but were not nearly as strong as in the United States. Japan rallied early in the year, gaining 27%, after two decades of stagnation while European stock markets, led by France, Germany and Spain, rallied 25%. Emerging markets were the laggards, declining by 3%, with Brazil and South America turning in the worst performances. Resource exporting countries such as Canada (+5.6%) and Australia (+4.2%) also had disappointing performances.

In the United States, small-cap stocks, as measured by the Russell 2000, led all segments of the market with a gain of 39%, while mid-caps rose 34.5% and large-caps increased 32%. At the sector level, the disparity between the top and bottom performing sectors was dramatic as noted in the table below. In addition, Gold bullion fell 29% over the course of the year and gold miners were down 52%. High dividend stocks, which led early in the year, underperformed during the second half as interest rates rose.

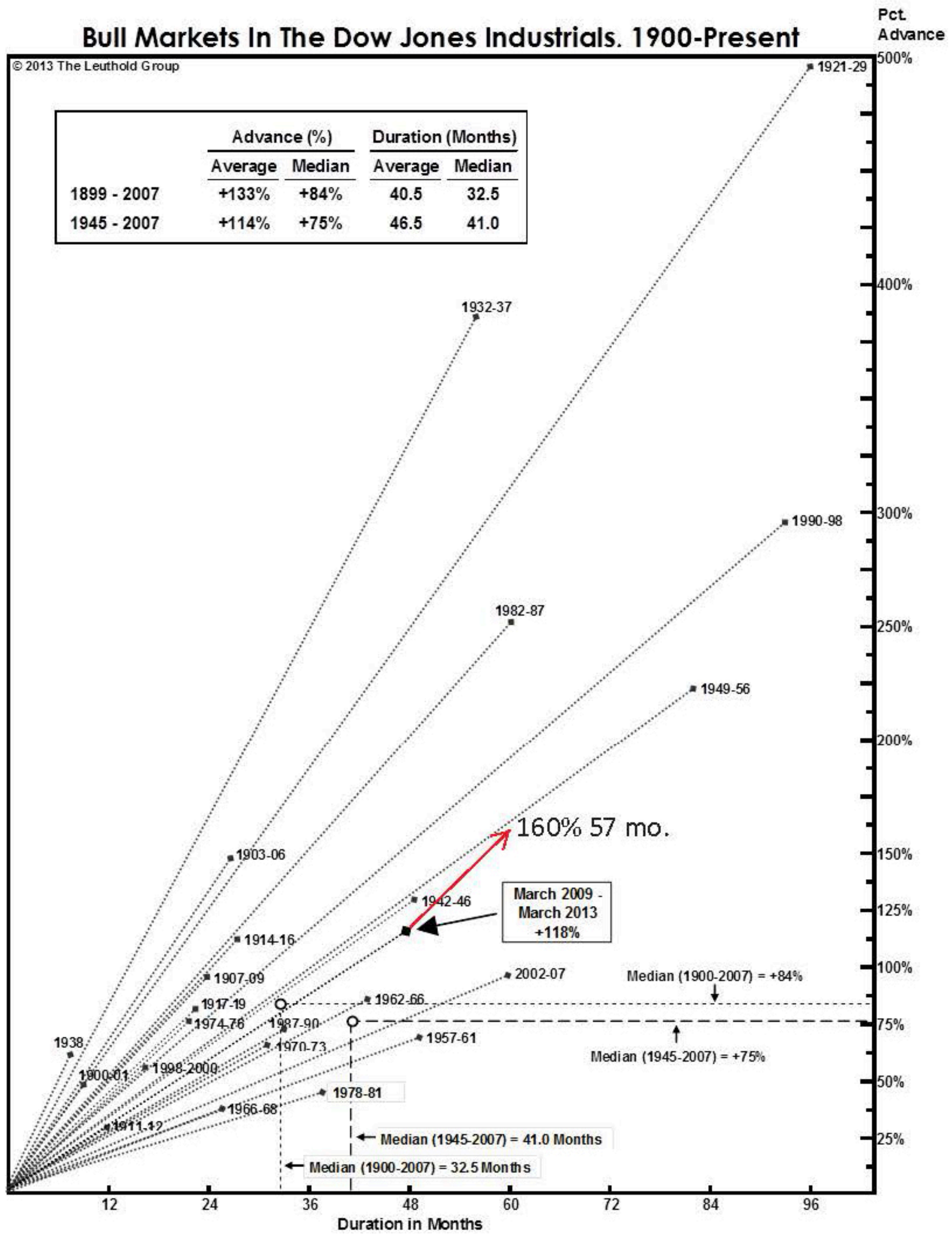
Best and Worst Global Sector Performances for 2013

Sector	Return	Sector	Return
Consumer Discretionary	37.5%	Commodities	-9.0%
Health Care	36.2	Long-term Bonds	-8.8
Industrials	32.1	Real Estate	2.5
Financials	27.2	Basic Materials	3.0

Bond markets bottomed on May 1, 2013 with 10-year U.S. Treasuries at 1.62%. Interest rates rose for the balance of the year with the 10-year closing at 3.02% on December 31st resulting in an 8% loss of principal. While long-term interest rates rose, short-term maturities were held in place by Federal Reserve bond purchase strategies. Mortgage rates, dependent on long-term bond rates, rose from 3.25% to 4.50%. Overall bonds and bond funds had a losing year for investors.

<u>Modern History of Bull Markets</u>

The current stock market rally, which began in March of 2009, has lasted 57 months and has produced a return of 160%. Since 1900, there have been 21 rallies but only three endured for more than 62 months. Given the slow start to this economic recovery, this rally may continue into 2015.



Economic Outlook for 2014

Economic growth in the United States should continue to improve in 2014. As we start the year, there are several economic positives that continue to bode well for the stock market: the housing recovery is ongoing, state and local government austerity is over for now, and household balance sheets are in much better shape after several years of deleveraging. Most of the obvious downside risks have also diminished. After a revised third-quarter GDP growth rate of 4.1%, U.S. economic growth is projected at 2.8% to 3.0% for 2014. This is based on several trends including:

1. **Consumer Spending** is likely to increase from 2.5% in 2013 to the 3% to 4% range in 2014 which will give a boost to GDP. This increase in consumer spending should provide an incentive for business investment. When combined with the ongoing housing recovery, and some increase in state and local government spending, the potential for 2014 to be the best year of the recovery with GDP growth at or above 3% becomes very real.

2. **Employment Growth** should continue to improve because of two important factors: 1) more jobs in construction and real estate-related areas resulting from the improvement in residential investment, and 2) the end of state and local government layoffs. Both of these will be positive for employment again in 2014. The unemployment rate will likely decline to the low 6% range by mid-year.

3. **Modestly increasing Inflation in 2014.** The current inflation rate is running slightly below the Fed's 2% target. I would expect inflation to increase modestly to 2.5% in 2014 as growth picks up, but too much inflation will not be a concern in 2014. I would not expect significant inflation until the banks start lending in a meaningful manner.

4. **Housing Market Moderates in 2014.** The boom in housing seen during the first half of 2013 is slowing. The number of refinancings has declined as mortgage rates increased from 3.25% to 4.5%. Home prices have risen 10% to 12% as inventory decreased due to improved sales, the number of rental properties increased and fewer foreclosures were on the market. Housing sales slowed as buyers qualify for smaller loans due to higher interest rates. For 2014, I would expect home prices to rise at a more modest rate of 2% to 5%, and housing sales to increase only slightly.

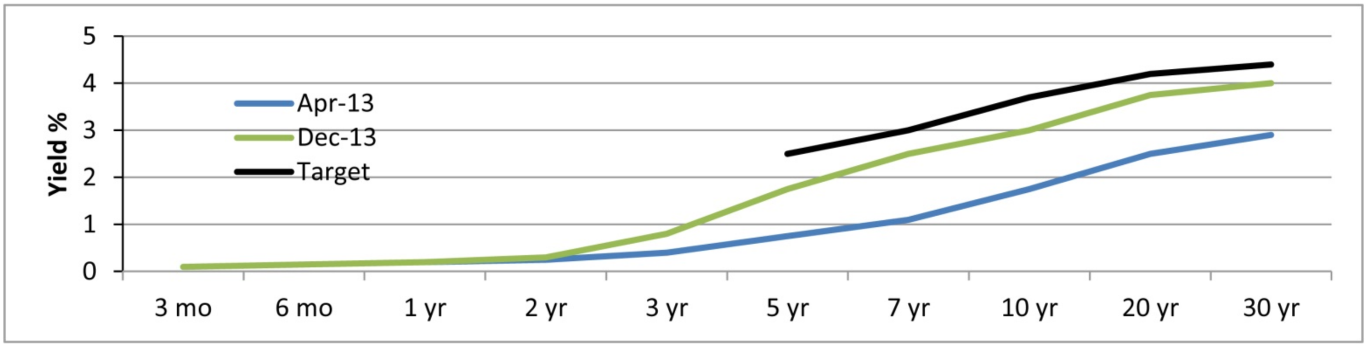
5. **The shift toward renting instead of buying will continue in 2014**. Millions of Americans will rent because they can't qualify for a home mortgage, and the days of staying in a delinquent home have pretty much come to an end. In particular, younger, first-time home buyers will find themselves unable to purchase due to both housing price inflation and the massive amount of student loan debt they have accumulated.

6. **Auto sales should remain strong in 2014**. U.S. auto sales rose 8% to 15.6 MM in 2013, thanks largely to a surge in pickup truck sales from the home construction and energy industries. A deeper look at the numbers reveals a large increase in subprime lending to finance consumer auto purchases. As long as the credit flows, auto sales could exceed 16 million units in 2014.

7. **Energy production should continue to improve in the U.S**. The boom in U.S energy production should continue and help provide a comparative advantage for U.S. based manufacturing and be a positive tailwind for employment.

Bonds Have Few Friends

The bond market is in the midst of adjusting from a fully Fed controlled market to fair market pricing. The path to higher long-term interest rates that started in May of last year is likely to find support when 10-year yields reach 3.50% -3.75%. At these target levels, 10-year bonds would offer a real return of 1.5% over a 2% expected inflation rate. This brings bond yields back to long-term historical average ranges and would not be considered a crisis. Short-term interest rates remain fully controlled by the Fed and are unlikely to rise in 2014. At some point this year, long-term municipal bonds could reach 5%, a pre-tax equivalent of 8% or more, and would be considered an interesting value opportunity. The implementation of Fed tapering is likely to be an opportunity for bond buyers.



Investors are Reallocating from Bonds to Stocks

In 2013 the air was let out of the bond market balloon. After the recession of 2008, many investors sought the safety of bonds and shunned stocks. The summer of 2013 marked a major turning point as investors began reducing their bond holdings and opted for stocks instead. Investors moved $212 billion into U.S. stock mutual funds during 2013, most of this increase occurred after May. This total is greater than the prior four years of equity fund purchases combined. In particular, bond investors rotated out of intermediate-term bond funds, the largest bond category, into more niche segments. These trends mark a stark shift in investor behavior away from bonds and into stocks.

A major driver for the shift is fear that rising interest rates will hurt bond fund values. When interest rates rise, prices for existing bonds fall because their yields suddenly look less attractive. Last summer, such worries flared as the yield on the 10-year Treasury note nearly doubled from 1.6% at the start of May to roughly 3.0% in September.

Most analysts believe that the U.S. bond market is 2-3 times larger than the U.S. equity market ($37 trillion vs. $21 trillion in 2011). It would be reasonable to project a further 1% allocation shift from bonds to stocks in 2014. This represents enormous potential buying power, approximately $370 billion, and would dwarf 2013's equity purchases of $212 billion. If this level of buying occurs, it would be within reason to project a 20,000 level for the Dow Jones Index in 2014. Investor buying behavior typically moves in waves that do not change quickly. Current momentum is positive for the equity markets and negative for bond and commodity markets.

Dow 20,000 in 2014?

Could the Dow Jones Index reach 20,000? Stock prices are higher because of better economic conditions and higher profit margins. The recently revised third-quarter GDP report showed economic growth increased at an annual rate of 4.1% and inflation as measured by personal consumption is running at a modest 1.8%. Many of the fears going into 2013 have faded or been reduced; the Euro did not crash, banks did not fail, corporate earnings remained strong and consumer spending continued to increase. Stock market gains from current levels are more likely dependent on corporate revenue growth supported by an improving economy.

The Dow Jones Index's closing value for 2013 was 16,576. An increase of 5.6% would take the market to 17,500; a gain of 11.6% would move it to 18,500; and a return of 20.6% would hit the 20,000 mark. A strong economy in 2014 is essential to continued stock market improvement and while Dow 20,000 is possible, a more reasonable goal would be in the 17,500 to 18,500 range.

Janet Yellen Could be a Surprise

Fed Chairman Bernanke's mission was to save the banks and grow the economy. He has succeeded on both counts. He is ending his tenure by starting to unwind Quantitative Easing in a systematic and scheduled manner. Most assume that the program will be cut in similar $10 billion steps at each of the coming meetings, provided the economic data would warrant it. That would mean that the program purchases would be reduced until there was just $5 billion remaining. This could be brought down to zero at the December 17th, 2014 meeting.

2014 FOMC Meetings		QE expected to be cut to
January	28-29	$65 billion
March	18-19*	$55 billion
April	29-30	$45 billion
June	17-18*	$35 billion
July	29-30	$25 billion
September	16-17*	$15 billion
October	28-29	$5 billion
December	16-17*	0

* Meeting associated with a Summary of Economic Projections and a press conference by the Chairman.

Janet Yellen's mission will be different from Bernanke's and possibly not of her own choosing. The main fear in Washington is not another banking crisis, but another stock-market bubble. Her mission will be how to best unwind QE stimulus and mitigate bubbles in stocks and bonds. So it may seem justified to let some air out of the market. In addition, with a change in leadership at the Fed, Ms. Yellen can play the blame game if she so chooses. In my opinion she will not immediately change the course of Fed tapering. But, she may risk a falling market for some time, and the correction would be attributed to former chairman Bernanke's overly accommodative policy. If she immediately inflated the market again, she would risk a real bubble, which would then be her mistake. A sharp correction now instead might be regarded as healthy and she would start her term as Fed Chair with a clean sheet instead of inheriting the bubble policy of her predecessor.

By the middle of 2014 QE may not be seen as justified any longer. I expect the unemployment rate to fall faster than many anticipate. I suspect that current economic conditions and a 6% unemployment rate would not justify a new QE program, even if the stock market does experience a significant correction.

Outlook of 2014

The market is starting 2014 in a clearly bullish pattern for both the economy and stock prices. Capital flows are clearly moving from bonds and into stocks and from overseas into the United States. This buying momentum could easily create new highs for the market, particularly in the first four months of the year. However, changes in Federal Reserve policy are likely to take their toll on the market by the summer. I would expect the market to lose its energy gradually, just as the QE program itself begins to taper. The stock market is likely to be more volatile than last year.

From a valuation standpoint, the S&P 500 has rebounded by more than 160% since its March 2009 low and P/E levels appear priced for perfection. Revenue growth remains tepid, profit margins are near all-time highs, and borrowing costs are near all-time lows. The scope for further profit margin expansion is limited and interest rates are likely to return to more normal levels. Unless revenue growth accelerates, we would expect slower earnings growth over the next few years than has been realized over the past few years.

I may be inclined to lighten up on equities by the end of April before the seasonally weak summer months begin. At this point QE purchases should already have been cut in half. We may not see the top by then, but I would argue that the risk is greater than the potential reward.

Scott P. Noyes, CFA®, CFP® is the President of Noyes Capital Management®, LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey. www.noyescapital.com

---