EMERALD
ASSET ADVISORS, LLC

Investment Strategists for
Successful Families

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Thank you for reading GreenThought$. It is our privilege to provide you with our insight on current financial market events and our outlook on topics relevant to you.

Emerald Economic Commentary

As Yogi Berra once said, “You got to be careful if you don't know where you're going, because you might not get there.” As we look back on 2013 and look ahead to 2014,we want to share our thoughts on the road traveled and more importantly, the possible road ahead.

The fourth quarter of 2013 provided further evidence of economic recovery. While we don’t have final numbers to reference, Q4 GDP growth is estimated to have been near 4% on an annualized basis, continuing the 4% GDP growth realized in Q3. Moreover, many economists believe that GDP remains well below America’s productive capacity. Corporate America is just now showing signs of economic confidence and more willingness to invest their enormous cash hoards. Companies have been hiring at a steady pace across a wide range of industries and continued business investment would bolster the ranks of the employed and spur innovation, both of which are additive to GDP.

Adding fuel to economic prospects is a booming energy sector and rising overseas demand, which reflects a gradual global recovery. U.S. crude oil output has risen 64% in the past five years and petroleum exports, not adjusted for inflation, reached their highest level on record in November 2013. This is all happening concurrent with a decrease in U.S. petroleum consumption, allowing for a greatly improved trade gap. The result of being a net exporter of energy will have broad-reaching impact on our economy by creating more jobs, lowering transportation costs and expenses for energy-intensive industries. Undoubtedly, the U.S. continues to face long-term, structurally embedded fiscal challenges. However, the improving trend of energy production and export along with the benefits of rekindled global growth provide the needed cushion to find solutions for longer term challenges.

Below are some key drivers we look to for 2014.

Gross Domestic Product (GDP)

For the year ahead, we believe that the economy will sustain the momentum built in 2013, though we are unlikely to see an acceleration of growth. In fact, we are likely to see a down-tick in the rate of GDP growth. GDP growth will be highly dependent on the rate of business investment and consumer confidence. To the extent corporate America continues the trend of business investment, the employment situation should improve and along with it, consumer confidence. Excess capacity world-wide should continue to keep inflation at or around the 2% level, and continued low interest rates should help fuel business investment and consumer spending.

Housing

In 2013, we saw the mortgage benchmark 10-year Treasury increase from 1.5% to near 3%. The resulting increase in mortgage rates contributed to the new-home sales slump from the 5.4 million units sold in August. However, existing home inventories remain tight and existing home prices are still rising, albeit at a slower pace, and this gives homebuilders the expectation that the slump will be temporary and there will be a resumption of demand. Continued rising home prices is also a key factor in consumer confidence, which directly impacts consumer spending and GDP growth.

Employment

Generally speaking, the employment picture improved in Q4 2013 with meaningful job creation in a wide-array of private sectors. While the unemployment rate dropped to 6.7% by the end of the year, job creation in the month of December was well below trend, which many economists are considering an aberration. Of further concern is the workforce-participation rate which finished the year at 63%, the lowest level in 35 years. The workforce-participation rate takes into consideration the unemployed as well as those who have dropped out of the workforce and are no longer seeking jobs. Continued business investment should create more jobs and help to reverse the current trend of workforce-participation and positively impact the overall employment picture.

Fed Policy

Janet Yellen was recently approved as the first woman to Chair the Federal Reserve Board. Yellen will succeed Ben Bernanke on January 31st and she is expected to continue a policy of quantitative easing for as long as circumstances warrant her to do so. At the December meeting of the Federal Open Market Committee (FOMC), the long-awaited decision was made to “taper” the Fed’s quantitative easing program. The FOMC announced that beginning in January it would reduce the amount of monthly purchases from $85 billion to $75 billion, with the reductions split equally among government and mortgage-backed securities. At the same time, the FOMC stated that the fed funds rate will remain at its current target level of 0%-0.25% well beyond the point at which the unemployment rate falls below the 6.5% target. Many analysts interpret this strong interest rate guidance as offsetting the impact of the reduced tapering. In its statement, the FOMC indicated that tapering will occur in measured steps, with the implication being that no course of action has been pre-determined and any course of action will be highly dependent on economic circumstances. The Fed continues to forecast a very moderate 2% inflation rate over the next few years, which further supports its aggressive monetary policy.

Fixed-Income

On December 18th Federal Reserve Chairman Bernanke announced that the Fed would reduce bond purchases by $10 billion per month beginning in January. This was the actual "taper" announcement that had been anticipated for some time and resulted in fixed income volatility and declining performance in Q3. New Fed Chairperson Yellen has been a staunch supporter of the Fed's aggressive monetary easing policy and has made it clear that further easing will be dependent on further improvement in economic conditions. We fully expect the action of the Fed to be deliberate and transparent and that further reductions in bond purchases will likely have little impact on bond prices.

On December 31, the yield on the benchmark 10-year U.S. Treasury had risen to 3.03% from 2.61% on September 30th. The rise in the 10-year Treasury during Q4 culminated a 127 basis point (1.27%) move from a rate of 1.76% at the beginning of the year. This rise in short rates relative to intermediate and long-term rates caused a flattening of the yield curve and resulted in losses for most bond indexes. The Barclays U.S. Aggregate Bond Index lost 0.14% for the quarter, 2.02% for the year, and recorded its first full-year negative return since 1999. The Barclays U.S. 1-3 Year Government Bond Index posted quarterly and annual gains of 0.07% and 0.37%, respectively, while 13-week Treasury Bills returned 0.01% for the quarter and 0.05% for the year. The Barclays U.S. Corporate High-Yield Bond Index fared better posting quarterly and annual gains of 3.58% and 7.44%, respectively, reflecting a low-default rate and investor demand for higher-yielding credits.

For the year ahead, until or unless the inflation rate increases much above the expected level of 2% -2.5%, we anticipate that interest rates and bond yields will remain steady and bond prices to be flat. If economic conditions continue to improve, higher yielding bonds should continue to provide the best returns in the fixed income market. In addition, we expect continued improvement in the municipal bond market as municipalities continue to make fiscal headway through pension reform, and an improving economy and rising real estate prices bolster revenue.

Commodities

Unlike Led Zeppelin's Stairway to Heaven lyric, "There's a lady who's sure all that glitters was NOT gold." Major Commodity Indexes recorded their second annual double-digit decline in the last three years. Going forward, we expect the dollar to continue to strengthen as economic growth and the FED tapering continue. These factors will continue to put pressure on commodity prices.

Our main exposure to commodities has been a small weighting to Gold. In recent weeks demand has begun to pick up for gold as lower prices are attracting buyers in Asia and Hedge funds are raising their exposures. What will ultimately drive gold prices higher is inflation, poor economic data and any geopolitical risks.

Equities

During the fourth quarter 2013 we saw continued improvements in economic fundamentals, a resolution to a budget impasse, and continued Fed easing which pushed the U.S.equity markets to record highs. For the full year 2013, the domestic equity markets had their largest advance since 1995. Moreover, this market advance was marked by moderate volatility as the markets advanced steadily throughout the year. The consistency of the markets' advance was impressive, namely, the S&P 500 posted gains in 58.33% of all trading days in 2013.

International stocks had trouble keeping pace with U.S. equities in 2013 as the international developed markets meaningfully underperformed both the U.S. and many of the other international markets. The MSCI EAFE Index gained 23% for the year, led by a 58% return in Japan's Nikkei and hindered by negative returns in the emerging markets. The Eurozone economic crisis seems to have quieted and though their equity markets trailed U.S. markets for the year, expectations are for a return to growth in 2014, though a meaningful acceleration in growth is unexpected. The MSCI Europe Index performed well in Q4, portending a resumption of growth and improving economic health. The emerging markets continue to experience challenges in the year(s) ahead and we expect highly mixed results country to country. Accordingly, we think that while valuations have come down significantly, broad emerging market exposure should be narrowed to those emerging market countries where economic and political disruptions are less likely.

Outlook

While the U.S. and the world continue to face numerous embedded economic challenges, there is considerable evidence that the global economy continues to recover from the Great Recession. A meaningful economic rebound has taken significantly longer than expected, but continued and sustainable growth appears to be on the horizon. Much of this improvement was reflected in the equity price returns of 2013 and in the current record highs of most domestic equity indices.

Current equity levels raise the expectation for a market sell-off in 2014. While it would not be surprising to see a retracement in equity averages over the near term, there is some precedent for higher equity prices in 2014. Since 1926, there have been nine years in which the S&P 500 has increased greater than 30% and in six of the years following those gains the S&P 500 increased an average of 21%. In the other three years, the S&P 500 declined an average of -9.5%. One of those declines was in 1937 during a period of austere fiscal policy, the polar opposite of the environment we have today.

Further adding to our 2014 optimism are improving economic conditions, equity valuations that are historically reasonable, and a modicum of hope that Congress will avoid embarrassing themselves further with a protracted debt-ceiling debate, especially as the 2016 election campaigning draws near. We expect the Fed to be methodical and transparent in their unwinding of quantitative easing, and absent any economic or geo-political dislocations we expect the markets to move up further in 2014. Analysts are predicting S&P 500 earnings growth in the 6-8% range and if we factor in a modest increase in market multiple, equity price increases in the range of 8% -10% are certainly possible.

As always, if you have any questions please do not hesitate to contact us.

The Emerald Team

Disclosure
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