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Bonds Away!

Global Markets and Regions

	4th QTR	2013 YTD
US	5.7%	32.6%
Developed Europe	7.9%	26.0%
Asia	2.9%	13.7%
Emerging Markets	0.9%	1.5%

US Markets

	4th QTR	2013 YTD
Dow 30	10.2%	26.5%
Large Cap Cos.	10.2%	33.1%
Mid. Cap Cos.	8.3%	34.76%
Small Cap Cos.	8.73%	38.82%
Bonds	-0.11%	-2.34%

Diversification is the foundation of any sound portfolio. It's how risk is controlled; a process of balancing potential negatives against potential positives and the tempering of uncertainty. Diversification buffers surprises, both good and bad. The financial media has coined the phrases "Risk-on" and "Risk-off" to identify positive and negative investment climates. "Risk-on" has certainly been an accurate description for the US stock market for 2013 and it appears, at least for now, 2014. Risk has its positive moments. Stocks just finished their best year since 1997. An allocation to bonds in a portfolio has been a way to balance risk as historically bonds have more consistent returns and more consistently positive returns. The last year bonds recorded a negative return was 1999; and now 2013. The stock markets have, as a rule, more consistently varied returns both positive and negative.

Since the 2008 financial crisis and the "Great Recession" the world's central banks have been very actively intervening in the bond markets to address and avoid defaults by major financial institutions as well as sovereign countries. Quantitative Easing (QE) is the US version. The Federal Reserve has kept Fed Funds rates at essentially zero and have been active buyers of bonds in the open market in order to keep key lending rates low, there by stimulating the economy and allowing governments to keep borrowing costs down. This has been a good deal for borrowers, not such a good deal for savers and investors who depend on interest payments.

There has been vigorous debate over whether the Fed's efforts have been "successful". One of the Fed's stated goals is to stimulate inflation and prevent deflation. The authorities say that inflation is an essential component of economic growth, the kind of growth that results in more investment and better employment and overall economic circumstances for the country and the world. There certainly has

been asset inflation, though not necessarily general price inflation. Stocks posted their best returns since 1997. Home prices are higher than a year ago. As for the broader economy, private payrolls are expanding, industrial production is up and corporate profits continue to expand. It seems that the Federal Reserve is succeeding. And still, the sense of unease. The Fed begins to discuss "tapering" their Quantitative Easing efforts and the bond market takes an unprecedented tumble. The word unprecedented seems to attach itself to much of what is happening these days.

As we begin 2014, we look back on 2013 and see that the economy, as measured by GDP growth, has grown each quarter and has actually started to pick up speed as we enter the New Year. Forecasts are for a steady increase through the year. Corporate profits have continued to increase at a modest pace through the year. Price to earnings multiples, a key measurement of stock values, have expanded through the year as investors continue to bid up prices. Stocks have been a good thing to own. Bonds have not been such a good thing to own. One component of a portfolio has produced out sized returns and another component has outsized returns in the other direction.

The Fed has been telling us all through this era of Quantitative Easing that decisions regarding changes in policy would be "data dependent". Data points such as the unemployment rate falling below 7.5% and inflation getting to 2.5% are to be goals that will direct future changes. As those milestones come into view are they going to change policy or move the goal posts? We saw what happened to bonds when they first raised the issue this past summer. Some analysts have concluded that the Fed easing policy has been a major catalyst for the surge in stock prices and if they reverse policy stock prices will follow. Others have concluded that it is time for the Fed to back off and allow the economy to stand on its own.

Corporate America has been very good at keeping earnings growing in spite of a challenging and difficult economic environment. They have upheld their part of the price to earnings equation. The Fed, by keeping interest rates low, has also done their part. The economy and the consumer have done their part by continuing to plod forward. We haven't mentioned Congress or the Administration and the role they have played. I think "play" is a good term. If the Fed is successful in reigniting inflation and begins to diminish or reverse their easing the burden of supporting the market will begin to narrow. We'll see if they can carry the load. This should be a very interesting year.

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