What a Year!

We have put another year in the books and what a year it was. Record numbers on the Dow Jones Industrial Average and the S&P 500 dominated the news to the point that they almost became ho-hum. While the stock market had a fantastic year the slide continued in the fixed income markets as rates ticked higher due to talk of tapering and a growing economy. Hopefully the bond market won’t experience the same level of volatility in 2014 since the Fed announced in December that they will begin to taper their bond buying in January. The fear of that announcement in 2013 caused major market swings no matter what the Fed did to try and calm those fears. But now that the uncertainty of that decision is behind us, along with a budget deal in Washington, 2014 could see the markets, both stock and bond, react more to fundamentals than to outside influences. We’ll take a quick review of last year and look at some interesting data as we gaze into the crystal ball for 2014.

Last year was almost one of those close-your-eyes and throw a dart at the financial pages kind of year in the equity markets. What I mean is that pretty much everything did well and it really didn’t matter much where you turned with perhaps one notable exception – emerging markets. Other than that things did very well with the DJIA setting a new high on 50 or more occasions and finishing the year up 26.50%. The S&P 500 had a similar story and finished the year up 29.60%. The smaller indices did even better and even international stocks did well with the EAFE soaring 19.43%. A combination of economic growth and reasonable level of political uncertainty helped markets around the world soar.

While that news was positive for equity markets, it was less so for the fixed income markets. A mix of confusing signals from the Fed and continued economic growth caused a few headaches throughout the year for bond traders and investors. In the spring, traders became convinced that the Fed was going to begin the tapering process causing rates to soar and prices to drop only to have their expectations dashed as the Fed made no adjustments to their bond buying policies. The confusion was heightened by a speech given by Fed Chairman Bernanke in which he both offered a suggestion that the Fed would begin their tapering process and that they wouldn’t. There is nothing the markets like less than uncertainty and this was certainly a great example of that. In September, the markets again expected the Fed to announce that they would begin the process of tapering and again the markets gyrated both before and after the Fed surprised everyone by not tapering. Ultimately, the year finished in the red as the Barclays U.S. Aggregate Bond index fell 2.02%. The end of the year announcement that the tapering process would begin in January was met with much less noise and was almost a non-event. Maybe the markets have learned their lesson – don’t count on it!

I recently read a couple of very interesting market commentaries by Jeffrey Kleintop of LPL Financial that I thought I would summarize in this commentary. The first article was a somewhat tongue in cheek possibility of naming market storms (defined below) in a similar manner to naming hurricanes. The point was that it might raise investor awareness to what is going on. The article pointed out that on average, over the past 20 years, there have been four (4) market storms per year (defined as a peak to trough decline in the S&P 500 index of greater than 5%) and one (1) major market storm per year (defined as a peak to trough decline in the S&P 500 of greater than 10%). Last year we saw just one market storm (with a corresponding decline in the S&P 500 of just 5.8%) and no major market storms. So, while the year did seem to have its share of ups and downs, investors probably were more inclined to note the volatility in the fixed income markets than the equity markets.

Expectations for 2014 are that the equity markets will rise in the high single digits to mid double digits (8% to 15%). This growth will be fueled by the strength in the economy and by corporate earnings. In
other words, a return to fundamentals. Political and fiscal issues will likely take a back seat this year especially in light of the budget deal that came out of Washington recently. However, that return to fundamentals can have its own set of risks as investors watch for any sign of weakness in the economy or earnings and overreact to that news. Therefore, do not be surprised if we see somewhat greater volatility this year and see more market storms and even a major market storm at some point. While these could be cause for concern, we feel that these storms may represent solid buying opportunities.

The second article was a review of some things investors should keep in mind not only this year but at all times. Some of the more relevant points were the fact that bonds can lose money, time can heal all wounds, diversification matters, risks matter, and that government policy(s) are not all that drive the markets.

We have seen that the bond markets can lose value but that lesson seems hard to learn after a 20 plus year bull market that saw fixed income returns outpace equity returns at times. This year may be no different but likely will be less volatile. Time can heal investment wounds and that is starting to prove itself as some of the longer term averages start to put aside those steep negative returns of 2008 and 2009. This may be tougher to swallow for those in retirement but even those investors should consider their full life expectancy when investing and not just the fact that they are retired. While 2013 lulled investors to sleep by having virtually all equity sectors show strong results it was really an outlier when it comes to investing. Diversification does matter and does add value to portfolios over the long run and can be an important risk management tool.

Risks to investment returns can come in a variety of forms including economic and political. Some years these risks are shoved aside and others seem to allow the tiniest of events cause major harm to market returns. Again, 2013 saw many potential events that could have derailed the markets but seemingly none of them did (other than the on again, off again talk of tapering). Investors shouldn’t be caught unaware of the potential for some unknown event to cause major market strife this year. The good news is that that risk is less likely to come from a domestic political event this year. The recent budget deal combined with the announcement of the beginning of the tapering process has moved Washington off the center of investor’s sightlines. This is the first year in at least the last ten that is the case. Investors can finally focus specifically on economic and corporate news when making investment decisions.

As described above, we anticipate that this year will be a positive one for the equity markets and a flat-ish year for the bond markets. There will be bumps along the way but we expect those to be opportunities to rebalance portfolios vs. ultimate risks to portfolios. We also feel that the international equity markets may do somewhat better than the domestic markets, especially in Europe now that they appear to be turning to growth after several recessionary years. As always, we will monitor the economy, the markets, and the political fronts as we make investment decisions.

With the start of a new year, it is appropriate to review your portfolio and make sure that your investment objectives are up-to-date. Please do not hesitate to stop by one of our branches or call our Wealth Management department at (608)798-1515 to schedule an appointment.

Finally, please check out our blog, Wealth Matters, and our newsletter, Wealth Matters Insight for timely and relevant information on the markets and other financial matters.

As of December 31st, 2013.....
Dow Jones Industrial Average up 26.50% YTD
S&P 500 up 29.60% YTD
S&P 400 up 31.57% YTD
S&P 600 up 39.65% YTD

Barclays U.S. Agg. Bond Index down 2.02% YTD
EAFE up 19.43% YTD
Inflation (CPI) 1.2% (as of November 30th)

Thank you for your business – we look forward to speaking with you soon. (Note – this commentary used various articles from Morningstar, the Wall Street Journal, Northern Trust, CNNMoney.com, msn.com, Kiplingers.com, nytimes.com, Fidelity Investments, American Funds, LPL Financial and other tools as sources of information)