As We See It….  

The year 2013 will be remembered as the year of records. It was a record setting year for equities in many ways. The year closed with the S&P 500 Index hitting a new record high for the 45th time. Companies beat or matched previous highs in earnings, profit margins, dividends and cash balances. We also saw historically low levels of volatility. Investors responded by putting $347 billion to work in equity mutual funds and ETFs. Stock prices were supported by an improving economy and accommodative monetary policy.

The strong returns in the equity market are due to several factors, but, over the long term, one important driver of equity returns is earnings growth. The past three quarters have seen record highs in operating earnings per share. Earnings growth can be attributed to three main components: profit margin expansion, revenue growth and change in share count. Over the past several years, companies have been focused on running lean operations, which has helped push profit margins to historically high levels. Margins have also been supported by lower corporate taxes and interest costs. Companies have taken advantage of lower interest rates to refinance debt and lower their interest expense. Revenue growth can provide a direct boost to earnings. Over the last two quarters, revenue growth has played a bigger role in helping achieve these record levels. This is an important trend, as revenue growth is a major factor in future earnings growth. The last component is changes in the number of outstanding shares. Companies have accumulated record levels of cash and are putting it to work buying back shares. Share buybacks reduce the number of shares outstanding and in turn boost the reported earnings per share. This action has provided a small but measurable benefit over the last two years. The combination of these three factors has helped push earnings to new highs this year.

Unfortunately, fixed income investors did not experience this same euphoria as equity investors. The bond market spent the fourth quarter much like it did most of 2013, attempting to decipher and predict Federal Reserve monetary policy. After enjoying a bond rally in the first part of the year, bonds suffered losses, as investors prepared for reduced monetary stimulus and the possibility of higher interest rates. The Federal Reserve finally provided some clarity in December, when they announced a $10 billion reduction in asset purchases, known as quantitative easing, along with reiterating their commitment to maintain low interest rates. The announcement gave investors some clues on how the central bank will unwind the stimulus program and the future path of interest rates.

We saw a violent increase in interest rates along with a steepening of the yield curve in 2013. After touching a low of 1.70% in April, the 10 Year Treasury Note closed the year at 3.04%. Fixed income investors are concerned about how much further rates can rise. The bond market is very complex, but one tool used to value bonds is the difference in yield between two instruments, called the “spread.” The spread between short term bonds and long term bonds measures the steepness of the yield curve. Historically, the largest spread between the Fed Funds Rate and the 10 Year Treasury has been 370 basis points, indicating an extremely steep yield curve. The current spread is approximately 300 basis points. This measure would indicate that rates could continue to rise, but market forces could limit by how much. This is just one of many data points we utilize in our decision making process.

In early 2013, one of the primary economic questions we faced was, would the economy reach escape velocity? Could the economy produce sustainable growth without the support of monetary policy? As the year comes to a close, we are beginning to get answers to these questions. GDP growth accelerated in the third quarter, housing has continued to recover, employment has been improving and fiscal risk in Washington has moderated. All of these trends have helped place the economy on a path toward improving growth. We expect these trends to be sustainable, and we see continued economic improvement over the next year. Everyone at The Pacific Financial Group would like to wish you a prosperous 2014!
Portfolio Commentary

Equity Portfolio

During the fourth quarter, all major equity indexes had positive gains. Large caps were the highest performers with the S&P 500 returning 10.5% during the last three months of 2013 and finishing the year up 32.4%. Revenue and earnings growth during the quarter continued to be positive which helped propel equity prices higher.

The recovery appears to be at a self-sustaining point and we believe areas of the market that are sensitive to growth will continue to perform well. We currently see pockets of opportunity in the Industrials and Financials sectors. Additionally, Retail and Healthcare are areas that performed well for us during 2013 and continue to look attractive. Our outlook remains positive for a strengthening U.S. economic picture that continues to support equity prices.

Fixed Income Portfolio

Policymakers took center stage again in the fourth quarter, with the Federal Reserve significantly influencing returns in the bond market, generally lower. High Yield (3.6%) and U.S. Corporate (1.1%) bonds were the only major fixed income sectors to end the quarter with positive returns, and High Yield (7.4%) stood alone for the year in the black. The poorest performing sector for both the quarter and full year was Treasury Inflation Protected Securities (TIPS), with -2.0% and -8.6% respectively.

Despite the small Fed taper, interest rates can continue to rise gradually, but remain at relatively low historic levels due to the accommodative Fed policy and low inflation expectations. Defaults have been quite low and fundamentals appear to favor credit markets versus Treasuries.

Balanced Portfolio

Rising equity markets more than canceled out the modest downward move of fixed income over the past three months, providing Balanced strategies with attractive returns. Consensus estimates for GDP growth have been on the rise recently, which should continue to propel equities while providing headwinds for bond prices.

Large caps led the way throughout nearly all of the fourth quarter, holding off a December surge from small caps. The S&P 500 gained 10.5%, while the S&P SmallCap 600 rose 9.8%. Midcaps pulled up the rear with 8.3%. The Treasury yield curve steepened over the quarter, as longer rates rose more quickly than shorter rates.

Absolute Return Portfolio

Market volatility as represented by the CBOE VIX Index moderated significantly after the first two weeks of October, settling into a sideways trend. The days leading up to the December FOMC meeting were volatile as investors tried to guess which way policy may go. After the meeting and the announcement of a taper, the markets quickly calmed back down as the new year approached.

Historically, stretches of time when the VIX Index hovers below 14, as it has since mid-October, have been followed by increases in market volatility. If current economic conditions persist, however, we could continue to enjoy stable markets in the coming year. The combination of moderate growth, improving employment, and reduced risk from fiscal policy issues could keep a lid on volatility for risk assets.

Global Portfolio

International markets, as measured by the MSCI EAFE, were up 5.71% in the fourth quarter of 2013. Strong performance in the fourth quarter indicates a recovery in investor confidence and better market fundamentals. Europe and Japan led the global equity rally as confidence in the region’s political stability and economic recovery started to grow across the region. However, the path forward is not expected to be a smooth ride. In particular, global markets are operating in an extraordinary policy environment, with monetary conditions very loose and significant fiscal adjustment still on the horizon in some key economies. We expect global growth to accelerate gradually in 2014 as activity picks up in developed markets, which should have spillover effects in emerging markets. We will continue to stay overweighted in developed markets for now and look out for the prospect of better emerging markets returns before shifting our allocation.

HIGHLIGHTS

- GDP increased at a 4.1% annual rate in the third quarter after all final revisions.
- Employment data continued to improve with more than 200,000 jobs created in October and November.
- Weekly jobless claims were volatile during the quarter, with the 4-week average rising to 356,000.
- Consumer sentiment rose throughout the quarter, reaching 82.5 in December.
- Existing home sales moderated during the quarter to 5.12 million units in October and 4.9 million units in November.
- Construction spending exceeded expectations, growing 0.8% in October and 1.0% in November.
- In October, the S&P/Case-Shiller Home Price Index: Composite 20 rose 1.05% for the month and increased 13.6% on a year over year basis. Home prices rose in all of the 20 cities measured.
- The headline CPI inflation rate was flat for the month of November, while the year over year core CPI inflation rate was 1.7% in November.
- Durable goods orders were down -0.7% for October but rose 3.5% in November, exceeding expectations.
- Retail sales beat expectations in November, increasing 0.7%.
- The ISM manufacturing index finished the quarter stronger than expected at 57.0, due to an uptick in construction spending.
- Manufacturing Purchasing Managers’ Index (PMI) rose more than expected to 55.0 in December.
- Consumer spending increased 0.5% in November, the 3rd straight month of growth.
- Personal income grew in November by 0.21%, after a -0.1% decline in October.
- Average hourly wages increased 0.17% in November, the 4th consecutive month of positive growth.
Has anything happened we should know about? If there are any changes in your financial situation, investment objectives or specific restrictions, please contact your investment advisor or The Pacific Financial Group, Inc. It is critical to the achievement of your investment goals and the success of our relationship to discuss any changes in your financial needs.

Our clients receive quarterly performance on their accounts. For performance on any of our strategies, please contact your Investment Advisor.
What’s in the Future?

The future is looking brighter as we begin a new year. Good news continues to come in from many areas, and we expect investment portfolios to be rewarded again. Economic growth in the U.S. is expected to pick up, driven by continued gains in housing, consumption, and a rebound in business investment. In fact, 2014 may be the best year for economic growth over several years. For the first time in years, it appears likely that more economic surprises could be positive rather than negative. Increases in household wealth, on average, lead to greater levels of consumption and spending, which is the largest proportion of gross domestic product (GDP). This so-called wealth effect appears to be finally coming to fruition from robust gains in housing and investment portfolios. Another factor helping a potential acceleration in economic growth is the fading of fiscal drag, meaning that, going forward, government should not pull down GDP.

Global growth is expected to look better too. We believe developed economies are progressing toward modest, but synchronized growth. The U.S. has been one of the few drivers of global expansion over the past few years, and we should be joined in the coming year by a similar recovery from the U.K., and Europe will likely also post positive growth. After 18 months of recession, even marginally positive economic growth out of Europe will contribute significantly to the global recovery. Japan has undertaken aggressive policy initiatives to stimulate growth, and this year these policies may gain traction.

Monetary policy is still very accommodative and is expected to be supportive of higher equity markets. In the U.S., the Federal Reserve (Fed) has responded to increased domestic economic strength by modestly tapering its quantitative easing (QE) program at its December meeting. We believe the Fed will incrementally decrease its monthly Treasury and mortgage-backed securities purchases, with the program ending by year-end 2014. The Fed has gone to great lengths to separate the start of tapering from the expectation for rate hikes. We expect the central bank to hold the federal funds rate at its current level through 2015, and maintain their current easy policy.

Interest rates are expected to modestly rise, yet we do not project a sharp back up in bond yields and interest rates, as was experienced at the beginning of last summer. The yield on 10-year Treasuries could finish the year between 3.25% - 3.5%, but it is expected to be at a more gradual, manageable pace.

Housing has been one of the bright points in the economic recovery, and it is expected to continue. The prospect of rising interest rates is not expected to choke off the recovery in housing. The Fed has stated a clear intent of supporting the domestic housing market. While home prices have experienced a healthy upward move, affordability is still excellent, as measured by average mortgage payment as a percent of household income. Not only is this affordability index well below its historic average, it is still near record lows, meaning homes are still very affordable. We believe that housing will continue to improve.

Inflation is not anticipated to pose a problem in the coming year. Usually, strong economic growth expectations are also accompanied by inflation fears. That looks quite unlikely at present. While the job market is recovering, there is still sufficient slack in the labor force to keep a lid on wage pressures. Excess reserves continue to remain on deposit rather than making their way back into circulation through lending, neutralizing the growth in money supply. In addition, significant technological advances in energy production have served to lower domestic energy costs; in fact, the U.S. has become a net fuel exporter amid the shale-gas boom. This greatly reduces the upward pressure on prices typically experienced from rising energy costs.

We remain enthusiastic about investment prospects for 2014. Stronger growth should generate increased corporate profits, a lift in confidence, and a more resilient economic environment. We expect stocks to outperform bonds over the year, and are optimistic that investment returns are poised to rise further.