

ECONOMIC OUTLOOK

Summary

The final revision for third-quarter GDP showed improved consumer spending as growth was revised to a 4.1% annual rate. Economic figures released during the fourth quarter continued to be more positive and showed an economy working through many challenges and concerns. Although the Institute for Supply Management (ISM) manufacturing index fell slightly in December, it is still at its second-highest reading since April 2011. The new orders component was the strongest and helped generate a small gain in the employment component, while inventories declined after several months of being positive. The ISM nonmanufacturing index fell slightly in December to a six-month low as the measure of new orders in the service industries fell to its lowest level since May 2009. The Conference Board's Leading Economic Index also indicates positives within the economy for the next few months, in November reaching its highest level since February 2008.

The consumer has been feeling better about the economy and its prospects as a result of improvements in the labor market, higher housing values and the strong stock market. As a result, the Conference Board's consumer confidence index rose again in December. Since the consumer represents almost 70% of the U.S. economy, increased confidence is important for further economic improvement.

The Federal Reserve's decision in December to begin tapering its bond purchases was more evidence that the economy is improving. Although there are signs the economy is doing better, there are no indications of a robust economic recovery. Concerns remain regarding foreign growth, but the signs are encouraging. Congress reached an agreement on the budget, which alleviated the concern about another government shutdown. Although economic growth is not expected to be robust, we anticipate a slight improvement over this past year.

Positives

Conference Board's consumer confidence index rose in December to its highest level since April 2008

Federal Reserve made its first tapering move to reduce the amount of its monthly bond purchases

In November, housing starts showed the greatest increase in more than five years

Conference Board's Leading Economic Index rose in November to its highest level since February 2008

Negatives

Significant inventory growth in third quarter may be reversed in coming quarters

New orders component of ISM nonmanufacturing index fell to lowest level since May 2009

Unknowns

Higher interest rates' impact on housing; economic impact of the Health Care Act implementation; federal budget agreement

EQUITY OUTLOOK

Summary

Buoyed by a sea change in expectations for easy money, global growth and confidence, U.S. equity markets responded with double-digit returns as investors fled bond and gold positions while handily trouncing global equities.

The S&P 500 gained 32.4% in 2013, powered by the consumer discretionary and health care sectors, up 43.1% and 41.3%, respectively. The defensive sectors of utilities and telecommunications – strong in the first quarter of 2013 – succumbed to rising interest rates in the last half, up 13.2% and 11.5% for the year, respectively. The MSCI EAFE, a proxy for developed equity markets outside the United States, gained just 19.4%.

So how will 2014 shape up? We believe two developments are critical for positive returns in the U.S. equity market this year. First, markets have factored in improvement in the economy at a gradual pace. An orderly normalization of long interest rates, coupled with an unwinding of the Federal Reserve's asset-purchase program, shouldn't present too much of a headwind for equities. After all, an improving economy bodes well for corporate earnings as leverage from four years of cost reductions reaches the bottom line.

One spoiler for this scenario would be an unexpected acceleration in GDP. If the economy achieves "escape velocity" we could see an increase in inflation expectations, a spike in bond yields and/or forward guidance from the Fed that runs counter to the current accommodative regime.

At the other end of the spectrum is the as-yet unsettled debate about whether legislation (e.g. Affordable Care Act, Dodd-Frank) will be a permanent headwind that has an impact on innovation,

job creation and confidence. The current regulatory environment may well indeed cast a pall of uncertainty over corporate and individual decisions.

Under these two scenarios, earnings growth could remain muted, and the market would primarily depend on multiple expansion as a driving force for continued gains. We place a high probability on the market navigating clear of these obstacles, resulting in a positive market in 2014.

Positives

Short interest rates stable

Economic indicators point to expansion

Northern Europe bottoming

Negatives

Too much unbridled enthusiasm for equities

Unknowns

Middle East

FIXED INCOME OUTLOOK

Summary

Interest rates marched steadily higher in December as several improving economic reports fueled optimism that the country's growth rate would accelerate and that the risk of a sharp slowdown has diminished. Adding to the confidence was the removal of some significant uncertainties that were headwinds for growth. First, the Senate Banking Committee approved Janet Yellen to succeed Ben Bernanke to chair the Federal Reserve. Second, a bipartisan congressional committee agreed to a new budget that all but eliminates the potential of another government shutdown for the next two years. Finally, the Fed's mid-December announcement that it would begin reducing asset purchases eliminated one of the greatest uncertainties for investors. For the month, rates within the five- to seven-year belly of the yield curve rose more than 35 basis points (bp), while longer and shorter rates increased by a lesser degree. The 10-year notes rose 28 bp and the 30-year rate increased about 16 bp. All major bond indexes that include maturities longer than three years had negative returns for the month. For only the third time within the past 25 years, Barclay's Capital Government/Credit Index delivered a negative return for a calendar year.

We do not expect rates to continue to rise significantly from current levels, even with the removal of major headwinds, faster economic growth and a reduction in the amount of Fed purchases. An analysis of the "roll" suggests longer rates can only rise so much if short rates remain fairly well anchored. When longer rates (10 years) are significantly higher than short rates (2 years), it creates a steep yield curve. As bonds age, they reprice to an increasingly lower yield and therefore appreciate in value. This price gain can be a meaningful contributor to a bond's total return. The steeper the curve, the more bonds can increase in price as they age. At about a 250-bp spread

between 2- and 10-year bonds, the curve is more than twice as steep as its 20-year average and has only been steeper on a few short occasions. As long as the Fed remains committed to maintaining an accommodative policy regarding overnight lending rates, we see little reason to believe short rates should rise sharply, which would limit a rise in longer rates as well. Understanding the impact of a steep curve keeps us optimistic about returns that bond investors are likely to receive in 2014.

Positives

Inflation remains below the Fed's target, and commodity prices, in aggregate, continue to be weak

The historically steep yield curve provides increased return potential from bonds aging or rolling down the yield curve

Strong equity market performance could lead to incremental demand for fixed income as portfolios are rebalanced

Negatives

Retail flows into bonds are declining and could offset large plan rebalancing

Stronger economic data could lead to inflation fears

Unknowns

International demand for U.S. investments
