FROM THE DESK OF BOB CENTRELLA, CFA: ***Jan 8, 2014***

2013 REVIEW AND 2014 MARKET OUTLOOK

Encore! Encore! Stock investors around the world are "Flicking their Bics" in hopes of one more year by the stock market in 2014. 2013 was quite a year to be in equities. With the Federal Reserve and other Central Banks providing the music, investors spun record after record and increased their risk appetite as there were few other places to go for returns. The S&P 500 returned 32% including bookends of greater than 10% return in both the 1st and 4th quarters. There was not a period where the market declined more than 6% all year and only June and August produced negative returns. The best year since 1997 was also the 5th straight year of positive returns (+128% since end of '08). Outside the US, markets around the world were mostly higher with Japan's Nikkei jumping 56.7% to lead the charge. Europe was up around 17% as even Spain (+21%) and Italy (+16%) got in on the action. On the downside Brazil and Chile were both down about 15.5% and China fell almost 7% as growth there slowed from its hyper years.

Small cap stocks outshined all other in the US with the Russell 2000 climbing 37% in price. The NASDAQ was one of the few indexes not to make a new high but it still jumped 38% mostly thanks to biotech stocks and technology companies (except Apple which was down for the year).

Gold dropped 28%, its worst year since 1981 when it closed at $400/oz, as inflation never reared its ugly head in 2013. The bond market had its first down year since 1999 as the yield on the 10-year UST went from 1.76% to 3.03% causing a big drop in principal in long-term bonds. It was the worst year for bonds since 1994 and only the 3rd time bonds were down since 1976 (as per the Aggregate index).

Although there were a lot of headlines, overall there weren't any big enough to put fear in equity investors other than Taper talk and the government shutdown. So what ***do*** we do for an encore? It's not going to be easy to duplicate 2013 so let's break it down into interest rates, the economy, earnings and international.

INTEREST RATES & ECONOMY

On the rate front, the Fed has already signaled its intention to dial back it's easing by $10 Billion a month with a likelihood that this will increase steadily during the year. However they are also committed to keeping short-term rates near zero for the foreseeable future. As such, the 10-year UST yield (now 3%) is poised to head higher, most expect to 3.5% but I believe as high as 4% by year-end, again lowering bond prices and pressuring principal. In terms of the economy, I am feeling optimistic that housing will continue to improve in terms of starts and pricing. Manufacturing will continue to expand and the unemployment rate will fall further as the year progresses. However, we need better quality jobs not just jobs, and a higher labor force participation rate which is at 63% down from 66% trend level. Economists predict GDP growth of about 2.5% in 2014 and I actually think it can be better than that since consensus economists are rarely right. The big unknown is the effect of the Fed Taper and Janet Yellen's tenure as Fed Chair. This is all new so we will have to wait and see how the markets digest this.

EARNINGS

That brings us to earnings. S&P 500 earnings probably grew about 4-5% in 2013 on revenue growth of only about 2%. So, the market moved higher not on earnings growth but PE (Price/EPS) multiple expansion and the expectation of future growth. The PE multiple on the S&P went from about 14x to 18x trailing 12 months earnings. S&P earnings need to grow closer to or greater than 10% in 2014 for this market to go meaningfully higher. For that to happen, we need revenue growth of at least 5% or greater. That also means that things better progress as the year unfolds because growth is still meager as we speak. We get a look at Q4 earnings starting this week and we will be on the lookout for better "color" from managements than we got last quarter. I am hopeful that we can reach that target and possibly end the year in strong fashion. With double digit EPS growth, the market can move higher by double digits.

INTERNATIONAL

Finally, let's take an international tour. I'm not an international expert by any means but my view is that Europe is about a year or so behind the US recovery. So if you go with that premise, then 2014 will be a continuation of its recovery and resurrection. Here's the likely we know -- The Italian government is likely to collapse while Spain seems to have put the worst behind them but are still far from solid recovery mode. Germany & the UK will continue to provide stability but France is drowning and will introduce more taxes and who knows what else. Oh, and Greece could at last exit the Euro. Having said that, the ECB is committed to doing whatever is necessary to right the ship and is following the Fed's playbook to some extent. I actually think that European stocks can outperform US stocks this year as companies are undervalued in many cases relative to their US counterparts. Outside of Europe, China and Japan remain key. Japan Central Bank is providing tremendous liquidity and will keep rates at 0 or below to move its stagnant economy. China still is an enigma in my eyes but baseline GDP growth of about 7.5% would still be good for the rest of the world. The big wildcard is terrorism and the Middle East. This is something we have to live with and markets will react so there is not much we can do as investors.

Back to our markets and my outlook. On the optimistic side I think that the economy continues to recover, markets accept and adapt to Tapering, politicians behave somewhat due to mid-term elections, earnings get better and US stocks return up to 15% or greater in 2014. If I want to be pessimistic, I have to believe that things get no better, politics get messy, Europe implodes or goes back in to recession and China growth stalls. If this happens, US stocks could fall double digits. I'm not a pessimist, but an optimist. I still like US stocks and see double digit returns in 2014. However, I also think that at some point this year, we may see up to a 10% decline that will test investors. When it will come I don't know but the most likely scenario would be the summer. For stocks I still favor a diversified portfolio and like financials and the cyclical sectors but think strategists are too bearish on consumer and defensive sectors so I would keep money there too. Valuation will matter again so be disciplined. I also do like developed European countries' equities and think investors should have an allocation there. On the fixed income front, last year I said it would be a tough year for bond investors. This year I am saying the same thing. I favor short term corporate bonds in the 1-4 year maturity range, high yield bonds, bank loan funds and convertible securities. Again I would sacrifice yield to preserve principal. Muni yields are also enticing but be careful to keep to safer states and shorter maturities. Speculators are watching Puerto Rico where rates are about high enough that you get paid for the risk. But buyers beware. Speaking of speculation, if you really want to have fun, buy some Bitcoins! Or short them!

Have a tremendous 2014 and feel free to call me anytime at 908-344-9790. Ciao!