WealthHealth
Personal Wealth Management

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Market Review

Global markets experienced a choppy first quarter but ended mostly positive amidst the continued slow economic recovery in the United States and Europe, the change in leadership at the Federal Reserve (the Fed), as well as developments such as Russia's annexation of Crimea and further evidence that China's growth is slowing amidst government efforts to manage a credit bubble.

As the table of returns below indicates, after last year's blistering pace, US stocks set a more muted tone and eked out a gain for the quarter. In terms of U.S. economic growth, the quarter's progress was complicated by severe winter weather that likely depressed some of the short-term indicators of the economy's health. Overall, though, the picture remains one of modest but steady growth with a noteworthy rebound in housing alongside persistently slow-to-recover employment. U.S. stocks cooled from last year's pace but posted gains for the quarter. Large cap stocks outperformed small cap stocks, a trend we haven't seen much of in the past years.

Index Returns *Through 3/31/2014*

Index	QTD	YTD	Annualized Returns 1-Year	3-Year	5-Year
S&P 500	1.81%	1.81%	21.86%	14.66%	21.16%
Russell 2000	1.12%	1.12%	24.90%	13.18%	24.31%
MSCI EAFE	0.66%	0.66%	17.56%	7.21%	16.02%
MSCI All Country World Index	1.36%	1.36%	17.17%	8.68%	18.59%
MSCI Emerging Markets Index	-0.43%	-0.43%	-1.43%	-2.86%	14.48%
Barclay Capital US Aggregate Bond	1.84%	1.84%	-0.10%	3.75%	4.80%
Barclay Capital Municipals	3.32%	3.32%	0.39%	5.79%	5.71%
Dow Jones UBS Commodity	6.99%	6.99%	-2.10%	-7.37%	4.24%
HFRI Fund of Funds Composite Index	0.38%	0.38%	5.85%	2.31%	4.87%

Developed international stocks in aggregate were flat for the quarter, largely due to a sizeable decline in Japan, where a new sales tax which went into effect this month is the latest uncertainty as the country tries to achieve sustainable growth and healthy inflation. Against a backdrop of slow growth but still-high unemployment and very low inflation (and deflation fears), many European markets rose.

Emerging markets have been beset by ongoing concerns about economic growth alongside macroeconomic instability in countries, including Ukraine (most recently) and Turkey. These issues have continued to weigh on markets and have been a headwind over the past year leading to a small first quarter loss for emerging-markets stocks.

On the fixed income front, core bonds were among the quarter's stronger performers, reinforcing the important role they can play during uncertain times. Yields on the 10-year Treasury declined from 3% at the end of 2013 to 2.73% at quarter's end and even lower as we write this piece (good for mortgage lending and refi's to further support the housing recovery). Even as the Fed continues its tapering, bonds benefited from their relative safe-haven status in the face of geopolitical tensions in the Ukraine as well as concerns over slower economic growth (primarily in the emerging markets). Corporate bonds across the credit spectrum were strong performers benefiting our portfolios as corporate fiscal health remained

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It is important to note distinction between the short-term news and information that seems to drive markets day to day (and over any given quarter) and the longer-term analysis that underlies our asset-allocation strategies/models.

We remain mindful that we have not yet achieved "normal" economic status.

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robust and bond defaults low. Finally, municipal bonds were another positive spot in the quarter, as state and municipal economies have shown improvement and the quarter was devoid of any headline-based scares.

Current Views and Portfolio Positioning

Five years after the worst financial crisis since the Great Depression, we feel fortunate to be where we are today. Households have brought down debt levels (deleveraged) at a faster pace than expected and household balance sheets have improved significantly as the housing and stock markets have risen. In fact, household net worth is now higher than pre-crisis highs. This progress in private sector deleveraging, alongside a steadily improving economy supported by the Federal Reserve's commitment to maintaining low interest rates and only slowly scaling back its bond purchasing program, has supported our positive view of the overall macro landscape.

One key question we do struggle with is, can the Fed unwind its huge balance sheet and normalize interest rates without major disruptions in the markets? Two main points of view on this exist among investors and economists. One group, and this seems to be the majority, sees it as a huge uncertainty and an unknowable risk. The other group offers a benign view and suggests the Fed has the tools to accomplish its goals without a major impact on the markets and/or the real economy. They even say the Fed may decide not to unwind its balance sheet, and through its new inventions control the flow of excess reserves into the economy (and hence inflation) without compromising its ability to target short-term interest rates. (There is also a third group that sees the Fed's actions as leading inevitably to another crisis, such as hyperinflation.) While it's possible the Fed can have its cake and eat it too, it's hard for us to gain conviction in this benign view or to base investment decisions on it. We think this is a risk we must factor into our decision making, at least until we better understand the new era of monetary policy the Fed seems to be embarking upon.

The Fed continues to dial back its stimulus, reducing its monthly bond purchases by $10 billion and has indicated that it plans to do so monthly at the same pace, thereby concluding its program by this fall. More recently, the Fed has stated that it plans to keep interest rates near zero well past the time that the unemployment rate falls below 6.5%, reminding us of its stated goal of pushing inflation higher to its goal of 2% per year.

Outside the United States, turmoil in the emerging markets has led us to revisit our investment thesis for emerging markets bonds and stocks as well. We have seen that, despite their better balance sheets and better long-term economic fundamentals (such as lower debt levels) relative to developed markets, emerging-market countries in aggregate do not have as much control over their monetary policies as thought, and they remain susceptible to short-term capital outflows (money exiting the country's financial markets). Because these outflows can contaminate emerging-markets fundamentals, and we cannot confidently predict when sentiment will worsen and when outflows will occur, the risks we perceive today with emerging-markets investing are slightly higher than they were a year ago.

Recently, the International Monetary Fund (IMF) warned of the potential for growth to slow and interest rates to rise in these fast- growing economies. This would result in an increase in the cost to service these debts. The IMF reported that annual corporate bond issuance from emerging markets had more than tripled since 2008, with a record sold last year. In addition

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to corporate bonds there has been a broad increase of credit relative to GDP in many emerging markets. At the same time, we are taking into account our assessment of the valuation risk posed by stocks within these emerging markets. Having said that, we maintain a favorable long-term view of the emerging-markets asset classes and will continue to keep a close watch over our investment thesis.

Overall, we remain mindful that we have not yet achieved “normal” economic status. The potential for a sharp slowdown in China’s economy is one risk that concerns us. As mentioned above, we also remain skeptical as to how the Fed will unwind its very large balance sheet (assuming it does) and normalize interest rates without major market upheaval.

More broadly, there’s a whole laundry list of concerns and uncertainties that we always weigh in our investment decisions. The core question we must ask in each situation is how material are these risks and what’s the likelihood of them playing out. Coming out of the financial crisis, we felt it prudent to protect our clients against the risk scenario of a very disruptive deleveraging process. Part of that protection came in the form of underweighting stocks, which resulted in some opportunity cost during the market rally that followed. However, the overall economy and our clients would be in far worse financial shape if our concerns related to deleveraging were realized. By definition, if a risk scenario we were insuring against does not play out, then there will be a cost (as there is in paying annual premiums on car insurance when no accident occurs). But longer term we believe that cost can be recovered from other investment decisions we make at the portfolio level. At present, the biggest risk in the equity markets is US valuation risk. Stocks are not egregiously expensive (yet), but they are definitely not cheap (and do not adequately compensate investors for taking on full equity risk).

Moreover, in the current period of extremely low bond yields where there isn’t a lot of cushion against a recession or an economic shock, the need to insure against downside risks is greater than when yields were higher. Ultimately, our asset class weightings—and, specifically, our willingness to take on equity risk—rest on our assessment of the risk and return potential for each asset class as well as the objectives and risk threshold of each portfolio. These are our foremost, and ongoing, considerations as we manage our portfolios and work with clients to help achieve their goals.

As always, we appreciate your confidence and welcome questions about your individual situation.

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