Lassus Wherley
Building Better Futures
...a View from the Top

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A Year to Remember!

It is the time of year when we begin to think about what we want to accomplish in the next year. Our goal here at Lassus Wherley is to continue to assist you in your quest to reach your long-term goals and objectives. Happy New Year and may 2014 be a year of not only great expectations but great accomplishments!

In this issue we share our view on the markets last year and into 2014, stressing the critical need for diversification. We include our thoughts around the Fed tapering and the budget deal, answer questions we have received, and share ways to protect against credit and identity theft.

This has been an exciting year in the US stock markets. We had great performance in both the S&P 500 (US large cap stock) rising at 32% plus and the Russell 2000 (US small cap stock) soaring close to 39%. Many of the international and emerging markets lagged the US in performance and we know bonds had a small negative return. Overall a pretty strong performance!

It has been a year where having a crystal ball would have come in really handy. It has been one of those years where we need to remind ourselves that what has happened in the recent past is not always what will happen in the future. Behavioral scientists call this "recency bias." It means that many folks will look at the past year and make assumptions that what happened last year will continue and they may be right. However, when you look at financial markets and draw conclusions based on the recent past, without research and planning, it can be hazardous to your wealth.

Diversification and disciplined rebalancing remain the most important elements of investing. Placing too high a percentage in bonds in 2013 because you were afraid of a stock market drop cost significantly in terms of return. Investing too high a percentage in stocks in 2014 because stocks did well in 2013 could also cost when the next correction comes - as we know it will. Maintaining a diversified portfolio, and taking profits when asset classes do well and buying when asset classes underperform, works over a long period of time.

We have to remind ourselves that

no trend continues forever, as much as we would like it to. Understanding this simple principle is critical to understanding and managing your investment portfolio. We know that markets can't go up forever and we also know they won't go down forever. What we don't know is exactly when they will change direction. So the key is

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to recognize that your diversified portfolio is not going to perform better than the S&P 500 when the markets are going up, but it could significantly outperform the S&P 500 when the market decides to go down. Remember that consistent returns from a well-diversified portfolio over a long period of time trumps the wild swings of the stock market during times of extreme volatility.

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Tapering Continues

On December 18th, the Federal Reserve announced that they would start to reduce their purchases of bonds by $10 billion per month. Until now it only took discussion about the possibility of tapering to get the financial markets to react negatively. Going forward, the Fed will thus be buying $75 billion in bonds each month rather than the $85 billion that they had been buying in an effort to keep interest rates low and support the economy.

The Fed took this step because they see that the job market is improving, they are pleased that Congress has been able to come to some kind of budget agreement, and housing looks to be strong enough to absorb the withdrawal of this extraordinary stimulus. Some thought that the Fed would hold back from announcing a move to taper since inflation is so low, but the Fed indicated that they expect inflation to drift back up to 2% as the economy recovers. We are glad that the Fed took this step, however small, to begin to unwind their bond-buying program known as quantitative easing.

Perhaps more important is the guidance which the Committee gave along with this first notice of tapering. They told the world that they will keep the federal funds rate near zero "well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the Committee's 2% longer-run goal". So, while the Fed may not be buying as many bonds as before, they have given their assurance that they intend to keep rates lower for longer.

Stocks initially moved down on the news and then quickly reversed direction and rose dramatically. The S&P 500 ended up 1.66% on the day of the announcement. Bonds ended the day about where they were before the announcement. International stock markets also applauded the move. The Fed had been preparing investors for this news for some time, and it appears that they were ready to accept it.

Investors understand that it is important for the Fed to start to exit from this extraordinary bond-buying program which has caused the size of the Fed's balance sheet to balloon from $900 billion in 2008 to just under $4 trillion today. What complicates the issue is that it is not just in the US, but also in Europe and in Japan that central banks have been using quantitative easing to keep rates low in an effort to support economic growth.

The longer these extraordinarily easy policies remain in place, the more likely they are to result in some potentially nasty side effects. While we do not believe stocks are in a bubble now, these bond-buying programs could eventually cause bubbles in stocks, housing and other assets. Another concern is that quantitative easing programs actually exacerbate income inequality as they keep rates artificially low for savers while boosting prices on stocks and other risky assets. Finally, the significant expansion of the balance sheets of these central banks could at some point lead to serious levels of inflation and to potential shocks to global bond markets.

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Back to the Budget

The bipartisan budget deal crafted by Senate Budget Committee Chairman Patty Murray (D., Wash.) and House Budget Committee Chairman Paul Ryan (R., Wis.) passed in the Senate on December 18th. President Obama signed the bill into law on December 26th. This is a small step in the right direction given the challenges of divided government, and it is probably all we can expect for now. This is one of only a very few bipartisan deals that have gone through the traditional Washington budget process in recent years.

The deal sets top-line spending levels for fiscal years 2014 and 2015 and reduces by $62 billion the spending cuts to domestic and defense programs which were due to take effect in January under the sequester. This increase in spending is offset by $85 billion of deficit-reduction measures for a net reduction in the deficit of $23 billion over 10 years. Enactment of the deal into law will maintain Federal government spending after January 15, 2014, when the current temporary spending bill expires.

While the deal reduces uncertainty around fiscal policy at least for the short term, it does nothing about several big issues, including the debt ceiling, tax reform, long-term entitlement reform or the expiration of unemployment benefits that had previously been extended.

The Federal government now faces a February 7th debt ceiling deadline. We hope that the progress made by Budget Committee Chairs Patty Murray and Paul Ryan in putting together a bipartisan deal indicates that it is possible that this hurdle can be overcome without significant disruption. We do know that the message has gotten across that the American people are tired of the partisanship and bickering. Unfortunately, showdowns around budget issues may well remain part of the political landscape for the foreseeable future, unless one party manages to take control of both houses of Congress. We aren't really looking for that to happen anytime soon.

Credit and Identity Theft Protection

If you used your credit card this hol-

iday season, you will want to pay close attention to your credit card statement when it arrives. The headlines concerning major data breaches at some of the nation's major retailers (such as Target) got everyone's attention. It means criminals could have access to customers' names, credit card numbers, expiration dates, security codes and PIN numbers. The risk from this is that the attackers could use the magnetic strip data to create counterfeit payment/credit cards. In cases like this there is nothing you could have done, short of paying cash to prevent your data from being compromised.

This time of year, whether or not you shopped at Target, is a really good time to review how to be vigilant in protecting your credit and identity. This issue will continue to challenge all of us since we are all becoming more technology-driven.

Here are some tips to help you keep your credit and identity safe:

- It is important that you go online to your credit card websites to periodically review your cards recent activity. This can allow you to catch issues more quickly than waiting for your monthly statement to arrive. Most credit card companies will show your recent transactions, sometimes immediately after they occur. This is a great time to keep a close eye on your credit and debit card statements because this is exactly the time of year that thieves push charges through. You are most likely protected from fraudulent charges, but it is still up to you to immediately alert the bank of suspicious charges. Some banks will contact you when they see charges that are outside your normal geographic area or in a store where you don't typically shop.
- Call your credit card company to ask about a fraud alert. A fraud alert can make it more difficult for someone to get credit in your name because it tells creditors to follow certain procedures to protect you, but it also may delay your ability to obtain credit. You may place a fraud alert in your file by calling just one of the three nationwide credit reporting agencies listed below. As soon as that agency processes your fraud alert, it will notify the other two agencies, which then must also place fraud alerts in your file. That will cause them to take extra precautions before anyone can open an account in your name.
- Ask the bank or credit card company what free services they offer to people whose information may have been breached. This could include a free fraud alert service or a security freeze on your credit report. A security freeze will prohibit a credit reporting agency from releasing information from your credit report without your prior written authorization.
- Check your credit report. Under

If you discover information on your credit report arising from a fraudulent transaction, you should request that the credit reporting agency delete that information from your credit report file.

federal law, you are entitled to order a free report from each of the three credit bureaus (Equifax, Experian and TransUnion) every 12 months. You may obtain a free copy of your credit report by going to www.AnnualCreditReport.com or by calling (877) 322-8228. This site is the one authorized by the Federal Trade Commission (FTC), so do not confuse it with other sites that claim to have "free credit reports." If you discover information on your credit report arising from a fraudulent transaction, you should request that the credit reporting agency delete that information from your credit report file.

In addition, you may contact the FTC or law enforcement to report incidents of identity theft or to learn about steps you can take to protect yourself from identity theft. To learn more, you can go to the FTC's Web site, at www.consumer.gov/idtheft, or call the FTC, at (877) IDTHEFT (438-4338) or write to Federal Trade Commission, Consumer Response Center, 600 Pennsylvania Avenue, NW, Washington, DC 20580.

A big thank you to our clients who continue to challenge us with great questions. Please let us know if you have any questions you would like to share. We really enjoy doing the research on some of the tough ones.

Questions

Here are some more great questions from our clients. Let us know if you have one you would like included.

Question: So, what does all the current activity with the Fed and the economy mean for the markets in 2014? Answer: 2014 should be another positive year for equities, although we expect to see more volatility than we did in 2013. As long as the Fed goes slowly in taking away the stimulus from quantitative easing, and reserves the right to start buying bonds again, if necessary, stock markets should be fine with the Fed's message. The Fed has effectively removed a little liquidity with its announcement that it will begin to taper its bond buying, but it has also added a dose of confidence. If the Fed feels confident enough to start to remove some of this market support, this indicates that the economy must be doing well enough to function without it. This is a major reason why the reaction of stocks was so positive.

The three most important drivers of equity performance are liquidity, valuation and earnings. All three of these factors remain positive at this point. The Fed and other major central banks are still providing liquidity as the global economy heals from the financial crisis. US stocks are not as cheap as they were a year ago, but the S&P 500 is still trading at a multiple of about 15 times next year's expected earnings. This multiple is in line with long-term averages. With a slowly healing global economy, earnings should continue to grow in 2014 at a slow but steady pace. In terms of our preferences, we think US large cap stocks are

more reasonably priced than US small caps and see value in international stocks as well.

As far as the bond market goes, 2014 could be another relatively bad year for bonds, just like 2013. Keep in mind that a bad year for bonds is nowhere near a bad year for equities. The yield on the 10-year US Treasury note was at 1.62% at the end of April, 2013, before Ben Bernanke started to discuss the Fed's intention to taper. As of December 26th, the yield on the 10-year note had risen to 3.00%. With yields on the 10-year expected to rise to about 3.50% in 2014, bonds have already priced in much of the expected rise in rates. Remember, when rates rise bond prices fall.

How quickly rates rise depends to a large degree on whether the US economy finally starts to achieve a self-sustaining recovery. If unemployment continues to decline at the pace we have seen in recent months and economic data continue to surprise on the upside, then investors may anticipate that the Fed would start to hike rates earlier than mid-2015. At this point, this seems unlikely but we will see. Bonds have a role to play in a well-diversified portfolio even when rates are rising. They contribute income to the returns and also serve as a buffer against volatility in equity markets.

Question: What is happening in Europe? Answer: While Europe as a whole is finally expected to emerge from recession in 2014, growth remains extremely low in spite of the fact that the European Central Bank (ECB) under Mario Draghi has been leading a very easy monetary policy. While the stronger countries, led by Germany, have recovered from the recession, the eurozone countries on the periphery of Europe, such as Italy, Spain and Portugal, have continued to struggle economically. Unemployment in the eurozone was recently reported at a record 12.2%.

While unemployment is high, inflation remains very low in Europe. The November eurozone inflation rate was 0.9%, and it is expected to remain below 1% for much of 2014. These very low rates of inflation are the result of the fiscal restructuring which countries on the periphery have been doing. Cutting back public employment has shrunk domestic demand. According to JP Morgan Asset Management, in 2014, Greek real wages will have fallen by more than 20% since 2009 and Spain's productivity will have risen by more than 9% since the start of the crisis. The countries on the periphery have had to face the challenge of bringing down domestic demand at the same time that they had to cut their debt levels. This has been an extremely painful adjustment to make.

We expect that eurozone growth and inflation will pick up slowly as we go through 2014 and 2015. In order to support the recovery, the ECB has made clear that they will

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continue to conduct a very easy monetary policy over the foreseeable future.

International stocks make up more than half of the world's equity market capitalization and should have an allocation in a well-diversified portfolio. We see value in Europe for long-term investors, but are aware that the road back from the crisis will be a long one for the countries in the periphery. While we do not see an early rebound in Europe, at current valuations, we feel that the issues there are adequately discounted.

Question: What do you think the major risks to the economy and/or the markets are for 2014? Answer: While our outlook for the markets is generally positive for 2014, there is always potential for risks which could upset any positive scenario. The main risks we see are:

1) expected GDP growth could disappoint;

2) profit margins could contract too quickly if corporations begin to increase wages and spend more on plant and equipment;

3) some geopolitical event could occur in the Middle East or elsewhere; and

4) partisanship in DC could make further compromises difficult, leading to increased uncertainty.

At this point, we believe that the rewards for long-term investors that come from investing in a well-diversified portfolio outweigh these risks.

Stay warm and have a wonderful winter!

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