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Building Better Futures
...a View from the Top

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Take a Deep Breath!

It has been an interesting start to the new year in terms of crazy weather and increasingly volatile financial markets. This is not exactly the way we wanted to kick off 2014, but this too shall pass.

In this special VFT we review some of the areas that are driving the current uncertainty and nervousness in the markets:

- *Federal Reserve monetary policy*
- *impact of tapering on emerging markets*
- *current US market valuations*
- *potential risks in the financial markets this year*

It has been an interesting start to the new year in terms of crazy weather and increasingly volatile financial markets. This is not exactly the way we wanted to kick off 2014, but this too shall pass.

It is one of those periods of time in the financial markets when we need to remind ourselves that we are long-term investors, our focus is on maintaining diversification in portfolios because diversification works, and the market never goes in one direction forever.

Financial Markets Take a Break

We have been advising that stocks were due for a soft patch, given the relentless rise we saw from the latter part of 2012 through 2013. When you throw in the fact that US small cap stocks, in particular, were no longer inexpensive, it was just a matter of time. Point of fact, however, there has not been a real correction, defined as a decline in the broad-market averages of 10% or more, since 2011.

The S&P 500 returned 32.33% in 2013 and has posted a return of negative 3.46% in January, 2014. The odds are pretty good that we will see some level of continued weakness in the market.

Global stocks got hit late in January after a disappointing report on manufacturing out of China, after Argentina gave up defending its peso and after Turkey decided against raising rates to support its

lira. These three events, coupled with concerns over whether China will allow defaults by trust loans, a form of shadow banking, caused stock prices to fall and bond prices to rise.

On January 29th, Turkey's central bank had second thoughts about taking no action and did move to

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defend the lira by raising rates dramatically. They raised their benchmark weekly lending rate for banks from 4.5% to 10% in a bold attempt to defend their currency and to fight inflation. Rate hikes have been seen in other emerging markets such as India, South Africa and Argentina. These central bankers are effectively fighting major capital outflows as the US Federal Reserve tapers its bond buying and investors who had sought higher yields in emerging markets are deciding to bring funds back to the US bond market. It is difficult for central bankers to defend their currencies once investors have decided to move out. This wave of selling of emerging markets' currencies, bonds and equities will at some point subside, as valuations become more and more apparent.

At last week's meeting of the FOMC, the Fed announced that they will taper the amount of bonds they buy over the next month from $75 billion to $65 billion. The Fed did not change their timetable even with the volatility in emerging markets. If they had decided not to cut back on their bond buying by the $10 billion expected, they may well have caused investors to be even more concerned.

The Fed made it clear that it would take a lot more than a weak jobs report or turbulence in emerging markets for them to be persuaded to stop reducing bond purchases by $10 billion a month going forward. This is the path that was laid out in December, and it is important that the Fed stick with it. The Fed also emphasized that the Fed Funds target rate will be maintained "well past the time" that unemployment declines below 6 1/2 percent, especially if inflation stays below their long-range goal of 2%.

The emerging markets economies have been big beneficiaries of the very easy monetary policy conducted by the Fed over the past few years, as much of the excess liquidity created flowed into these economies. Money flowed into countries like Brazil, Indonesia and Turkey where rates were higher and economic prospects were stronger than in countries in the developed world. We began to see this trend reverse last year as the Fed started to talk about tapering its bond purchases.

In the countries where these inflows were used to buy more foreign goods than domestic goods were being sold, large current account deficits began to develop. As a result, several of the countries that benefitted the most from this excess liquidity are the ones that have seen the most serious depreciation of their local currencies. Turkey is a prime example of an emerging market country with

both significant current account deficits and political issues as well. Mexico, on the other hand, is an example of an emerging market country with rather benign inflation, relatively strong current accounts and an improving political and fiscal outlook.

Investors are often leery of currency weakness in emerging markets given the history of problems in these countries that began this way. Dollars have flowed out of emerging markets funds for some time based on these concerns. They may continue to struggle to retain investment dollars as rates rise in the US and as China tries to navigate its transition from an investment-led to a consumer-led economy.

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.

Having said this, we continue to believe that over the medium term, emerging markets equities should perform well, as they will grow faster than the developed world given their growing middle classes and/or stronger fiscal positions. For long-term investors, emerging markets look reasonably valued, trading at a forward P/E of 10.2 times compared to a 10-year average of 11.1 times. Looking at the price/book ratio, the emerging markets index looks even more undervalued, trading at 1.5 times vs. a 10-year average of 1.9 times.

Valuation Does Matter

The forward P/E on the S&P 500 now stands at 14.8 times vs. 15.31 times 2 weeks ago. Given last year's move up in US stocks, we are continuing to rebalance out of US stocks and into underweighted short-term bond positions, global real estate and emerging markets asset classes. The most important factor is to remain disciplined and rebalance as needed based on the portfolio objective and the client's needs.

We are always happy to take advantage of market swoons because they allow us to buy into funds or ETFs at better prices. We continue to believe that stocks will provide positive returns in 2014 but also expect that there will be more volatility this year than last, given current valuations and the fact that the Fed is in the process of withdrawing an unprecedented level of monetary stimulus. We expect that more opportunities to buy stocks cheaper may yet arise. We will be on the lookout and will be taking advantage when they come along.

Risks in the Stock Market

As mentioned, the Fed is withdrawing an extraordinary amount of stimulus. This has never been done before and, this reason alone gives us pause. We believe that the Fed will be successful in tapering its bond buying program under quantitative easing. That being said, there may well be some bumps in

the road. Just as volatility was kept low under QE, it seems likely to increase as the Fed tapers.

We are also concerned about the increasingly bellicose tone of interactions between China and Japan and the recurrent spikes in short-term rates in China.

Finally, there are several important elections taking place this year, including in Turkey, Indonesia, India, South Africa and Brazil, and we expect there could be some volatility around these elections.

So………………... the potential exists for stocks to provide more excitement as we go through this year. Just remember that our portfolios have certain built-in measures to reduce volatility. These include the following:

- Pair the use of low-cost passive indices with actively managed funds with a quality bias which are less volatile than the index.
- Reduced duration and average maturity of bond portfolios.
- Utilizing hedge strategy funds to protect portfolios against stock market declines, while still capturing a reasonable level of gains when markets do well.

As always, we ask that you let us know as far in advance as possible of any cash need which you may have. This enables us to raise cash over time rather than after stocks have already been hit by a downturn.

Stay warm and have a wonderful winter!

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