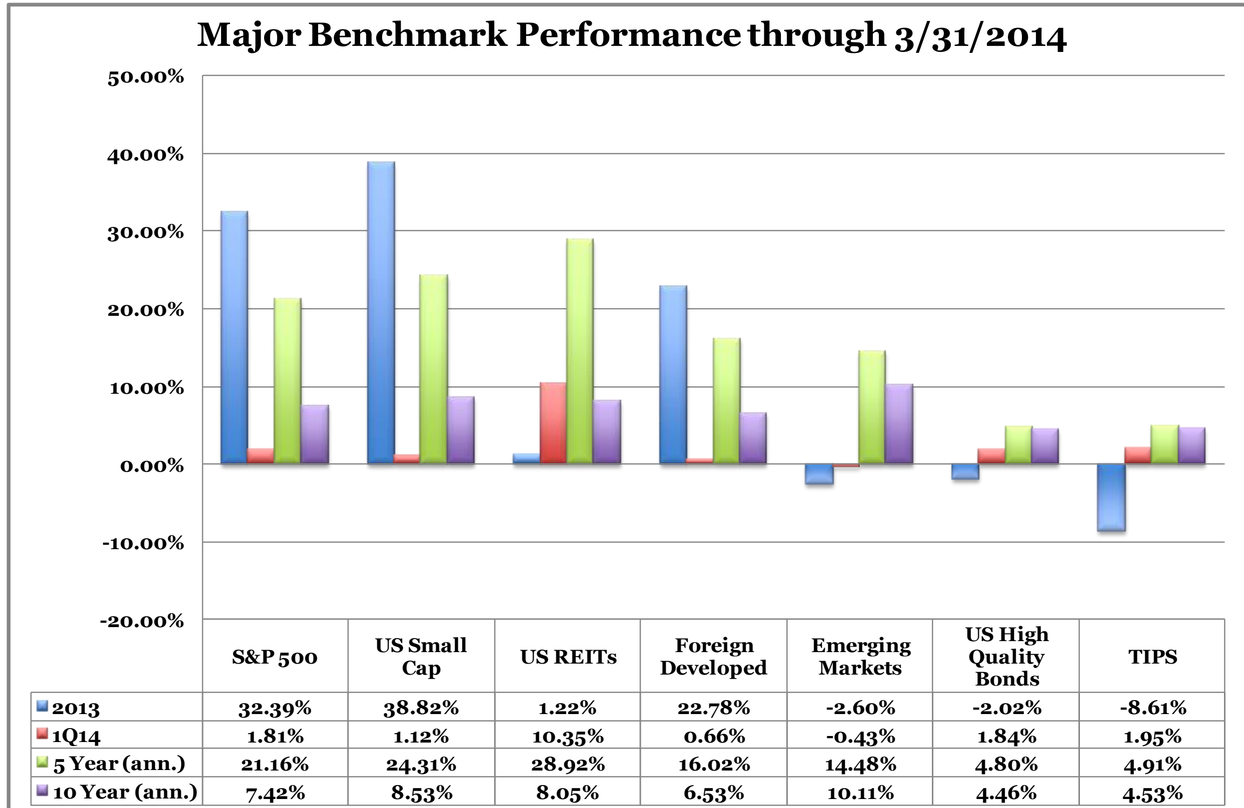
Market Summary and Outlook

1st Quarter 2014

After two banner years for the equity markets, first quarter performance in 2014 was more muted. In a typical year, a slight increase over one quarter would not be noteworthy; however, coming after such a strong 2013, it does stand out. The US equity, developed country equity, and REIT markets all advanced in the first quarter, and, in a reversal from 2013, fixed income categories were up as well. Emerging markets equities were slightly down. Below is performance for broad asset categories:



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds	TIPS
2013	32.39%	38.82%	1.22%	22.78%	-2.60%	-2.02%	-8.61%
1Q14	1.81%	1.12%	10.35%	0.66%	-0.43%	1.84%	1.95%
5 Year (ann.)	21.16%	24.31%	28.92%	16.02%	14.48%	4.80%	4.91%
10 Year (ann.)	7.42%	8.53%	8.05%	6.53%	10.11%	4.46%	4.53%

Source: DFA

Although the US economy is strong, growth remains slow. This winter, some of the setbacks were weather related. Additionally, there was some fall-out related to last fall's government shutdown and last year's rise in interest rates. The markets reacted in January to the uncertainty of a new Federal Reserve Chair, Janet Yellen. Internationally, there was concern about a slowdown in China's growth and political instability in Ukraine.

Because of the uncertainty related to the events mentioned above, there was a flight to quality in fixed income (bonds), which resulted in a drop in Treasury yields. This is what we would expect to see when equity markets are down and why we continue to recommend having fixed income as an important part of a diversified portfolio. To review what happened in 2013: Treasury rates increased out of anticipation

that the Federal Reserve would start tapering back its bond purchases. This resulted in high quality fixed income having its first negative year since 1999.

Looking Forward

While we expect to see rates rise in 2014, the Federal Reserve will do so in a slow and transparent manner to avoid spooking the markets. We believe a slow rate increase is priced into the market.

We also expect to see continued modest economic growth in 2014 manifested by the following trends:

- Slow but steady GDP growth. The IMF predicts the US will grow by 2.8% and worldwide GDP will grow by 3.7% this year
- A continued drop in unemployment (currently 6.7%). There is some discussion as to what percentage represents “full employment,” the point at which the Federal Reserve would be concerned about inflation starting to rise. Yellen’s most recent comments indicate she is more concerned about lowering unemployment than she is with inflation which could slow the Fed’s tapering of bond purchases. Related to unemployment, we have reached a noteworthy milestone: 8.8 million jobs were lost in the recession and now 8.8 million jobs have been gained since the recession ended in 2009.
- Housing continues to rebound although at a more sustainable level
- US energy production is expanding
- US auto sales are at their highest level since 2007

With the equity markets hitting records again, we think valuations are on the average to slightly high side based on historical measures. Fixed income does not look any more attractive considering a potential rise in interest rates. Because we cannot predict which sub-market will perform best, we believe now it is more important than ever to maintain a long term outlook with a diversified portfolio in equity and fixed income, US and international. January was a case in point: equity markets were down and high quality fixed income reverted to its historical pattern of appreciating. With regard to those clients who have cash, we continue to recommend investing it slowly (dollar cost averaging).

We thank you for your confidence in us and encourage you to call us anytime.

Janet & Barry

Sources: DFA, JP Morgan, Morningstar, WSJ, PIMCO, IMF, Barrons