Dear Friend: January 1, 2014

2013 Year End Recap

The US stock market was invincible in 2013!

Global investors could not have asked for a better finish to a somewhat volatile year. While there was a bit of turmoil throughout the year, investors enjoyed one of the best performing markets in history. One analyst said it was as if investors were wearing "noise-cancelling headphones". A possible U.S. government shut down with fears of a default, threat of military action in Syria, big budget cuts, a Cypriot bailout, and dysfunctional politicians in Washington- any number of events that in 2012 would have derailed the markets, were shrugged off by investors in 2013.

All major indices returned exceptional results, thanks to: improving corporate earnings, recovering global economies, robust leading indicators specifically from the US, continuing support from the Federal Reserve Bank's (Fed) ongoing quantitative easing, and December's employment data supporting a stronger job market in the U.S.

As we came into the year-end, the Fed provided additional market support with very favorable news regarding future quantitative easing (gradual reduction to $75 billion per month versus speculation of a more dramatic pull back of easing activity). This announcement was coupled with Fed guidance to continue to hold short-term rates near zero at least as long as unemployment is above 6.5 percent and forecast inflation is below 2.5 percent. This news further rallied global markets. The S&P 500 climbed a further 3.7% in the last two weeks of the year (2.2% for the month of December and 9.9% for quarter), resulting in the domestic markets being up 10 months out of 12 in 2013!

Index	Index Close	Q3 Price Return (%)	YTD Price Return (%)
S&P 500	1,848.36	9.92%	29.60%
DJIA	16,576.66	9.56%	26.50%
NASDAQ	4,176.59	10.74%	38.32%
Barclays Aggregate Bond	106.43	-0.72%	-4.19%
MSCI Europe-Australasia-Far East	67.10	5.17%	18.01%
MSCI Emerging Markets	41.80	2.55%	-5.75%

The S&P 500 jumped 29.6% for the full year, its best year since 1997 and one of the top 5 rallies in history! All 10 main industries in the S&P 500 advanced this year, led by a 41% gain in consumer-discretionary companies. Phone companies had the weakest performance, with a 6.5 percent increase.

The Dow also posted a banner year in 2013 with a 26.5% rally, its best performance since 1995. The NASDAQ posted exceptional returns as well with a 38.32% jump. Finally, the Russell 2000 outpaced all domestic indices with a robust return over 40% for the year.

This picture is consistent globally, as well. The MSCI EAFE rose 18.01% this year, its best annual return since 2009 as the European Union turned the corner from its stressed situation from many of its member nations. Additionally, and a strong indicator for the stability of the Euro, the EU welcomed its latest country to adopt the Euro as its official currency. On January 1st, Latvia became the 18th country to adopt the Euro.

Emerging Markets were the one drag on equity portfolios for the year, returning -5.75%. Difficult markets in China and Brazil, and to a lesser extent, Russia and India, were the principle drivers of these poor returns.

While famed University of Pennsylvania economic professor and renowned “bull”, Jeremy Siegel, projects a 9-10% rally in 2014, the consensus from Wall Street strategists is for equity returns to remain positive, but to slow significantly. The S&P 500 will end 2014 at 1,950, according to the average of 20 estimates compiled by Bloomberg. This forecast represents a 5.5% gain over the next 12 months.

From a bond/ interest rate perspective, the Barclay Aggregate generated a negative return in 2013, officially ending the 30 year rally in bonds! As the Fed moves away from its easing monetary policy, the fixed income markets will need to find an equilibrium that is in line with economic and inflation trends. For 2014, the trends point to continued "modest to moderate" economic growth, a “sideways to firmer” U.S. dollar and continued low inflation. While not a completely negative backdrop for bonds, we will be closely monitoring economic data for signs of strength.

As the economy continues to improve, fixed income analysts see a potential for rates to move up in 2014 to the 3% to 3.5% range in 10-year Treasuries. Barring a big surprise in terms of inflation or growth, there should be buyers at higher yields— such as pension funds, insurance companies and foreign sovereign wealth funds that need to match up high quality long-term assets against their long-term liabilities. We also believe that individual investors who have been sidelined, waiting for interest rates in high quality bonds to move up, will welcome the opportunity to add longer-term bonds with higher yields to their portfolios over time. This incremental demand should help stabilize rates.

We look forward to connecting with you. In the interim, if you have any questions or issues, please feel free to contact us.

Happy New Year and best wishes for a prosperous 2014 and a continuation of favorable markets!

Locust Capital Management, LLC