Keep
Calm
and
May The Force
Be With You

Lane Asset Management

January 6, 2014

2013 Review and 2014 Fearless Forecast

With fundamental economic performance replacing reaction to the Fed's Quantitative Easing program, at least the bond purchase part, and with the slow but steadily improving U.S. and global economy, I believe we may be in store for a long constructive investing environment. As a correction lasting a few months is likely sometime this year, this does not seem to be the moment to be overly aggressive. But nor does it seem to be the time to be overly concerned about the long term. The beginning of the year is a good time for investors to review their overall objectives and risk tolerance. But, as Yoda said, keep calm and may the force be with you.

All best for the New Year — Ed Lane

Market Recap for December 2013

As shown in the chart on the bottom of page 6, the S&P 500 (SPY) started the month slowly as analysts blamed the strongest manufacturing data since April 2011 (suggesting early Fed tapering) and profit-taking for market weakness. Even another 200,000 increase in non-farm payrolls and a decline in the unemployment rate to 7% for November wasn't enough to sustain but a short rally in the index as investors remained concerned about a Fed announcement of tapering at its mid-December meeting.

But suddenly, it seemed, good news became good news as the S&P 500 rose to an all-time high as the Fed announced a modest tapering program on growing strength of the economy and the Q3 GDP went through its third upward revision to an annualized rate of 4.1%.

After a sharper early month decline, Europe generally ran parallel to the S&P 500 thereafter while emerging markets barely closed in positive territory for the month (highlighting the need to be selective with international investments). Oil had a strong month, likely on account of the strengthening U.S. and global economy. Gold slipped further, noticeably so, as the Fed announced the beginning of its tapering program.

Recap for All of 2013

Who can deny it — 2013 was a blowout year. Not a single analyst, as far as I can tell, got anywhere close to estimating a total return for the S&P 500 to be the nearly 35% that it turned out to be, most missing by 20 percentage points or more. When we see what actually happened in 2013, however, it's hard to blame the analysts for one of their largest historical "misses."

Remember that we began 2013 still emerging from a deep recession, with high unemployment, especially in Europe; political discord in Washington; an annualized return of about 16% since the bottom of the market in the current recession in July 2010; and a healthy 15.4% return in 2012. With a long term total return from the S&P 500 of about 9%, projecting anything over 10-15% would have been a brave thing to do.

Note also that the principal driver of the stock market over the long term is corporate profits. However, according to David Bianco, chief U.S. equity strategist for Deutsche Bank, writing in the middle of November, 75% of the 2013 S&P return (at that point 26.5%) came from an increase in the P/E ratio ("multiple expansion"), not an increase in earnings.

Where did this expansion come from? In my opinion, the increase in investor confidence came from a combination of the following:

- A view that the Fed would continue to provide market liquidity through its bond purchase program (I've read that it's doubtful that the bond purchase program actually did put that much liquidity into the market but it's the perception that counts)
- The maintenance of a zero-bound Fed funds rate that artificially holds down interest rates throughout the yield curve, pushing investors into riskier investments (read: equities) and the Fed's promise to keep rates low for several more years even as the bond purchase program has begun to wind down

The charts on the following pages use mostly exchange-traded funds (ETFs) rather than market indexes since indexes cannot be invested in directly nor do they reflect the total return that comes from reinvested dividends. The ETFs are chosen to be as close as possible to the performance of the indexes while representing a realistic investment opportunity. Prospectuses for these ETFs can be found with an internet search on their symbol. Past performance is no guarantee of future results.

- **Consumer confidence that is at a 6-year high (and is highly correlated with increasing consumer spending)**
- **A steadily declining unemployment rate and a healthy run of increases in non-farm payrolls (both at or better than their respective levels when President Obama began his first term)**
- **A subdued inflation rate, and**
- **A variety of other positive economic indicators giving confidence to investors that the Great Recession is firmly, if slowly, receding.**

The overriding factor appears to have been both the psychological and real impact of the Fed's QE program. Psychological in that the bond purchase part of the program probably put a lot less money into the economy than the expansion of the Fed's balance sheet would have suggested and some might have thought (expansion of the Fed's balance sheet has been highly correlated with increases in the S&P 500 index), but real in the impact of the suppressed federal funds rate and the promise to keep it so through "at least 2015," motivating investors to pursue riskier assets (equities).

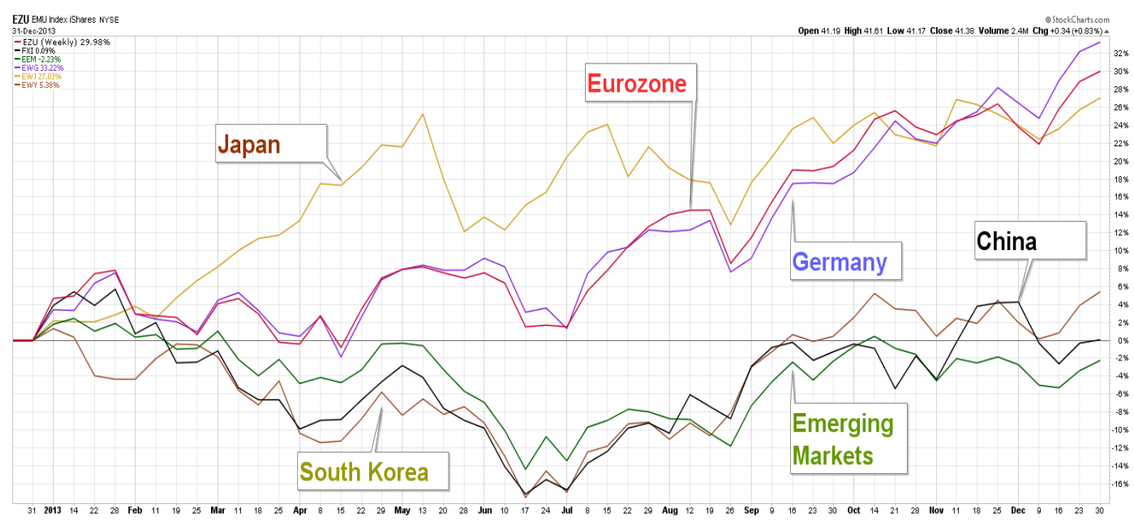
For much of the year, good economic news was met by minor hiccups in the market as concerns rose that QE would be wound down sooner than investors were hoping. But, when tapering actually began last month, the taper itself was very modest and the impact was much better than had been expected. Even more important, I think, is that the Fed message of being data-driven for additional tapering might be finally sinking into investors' minds, that is to say, tapering will be continued as long as the Fed believes the economy is improving.

Thus it appears that the Fed might have just found a way to create a win-win situation for itself despite earlier fears of skyrocketing interest rates and market collapse on the heels of tapering: all other things being equal, the market advances while the Fed continues QE, while the market also advances with the Fed's view of an improving economy that supports additional tapering. Of course, all this depends on continued positive corporate performance, even if it's modest.

While U.S. equities had a blowout year, bonds fared much more poorly. As shown on page 13, investment grade corporate bonds actually lost value on a total return basis in 2013 despite a current yield of 3.8%. This came as a surprise to me — not that I didn't think interest rates might not rise, but rather I didn't think the impact would be this much given the diversity of bond durations in the index.

Maybe the answer lies not with the increase in interest rates that did occur, but with the change in investor preferences as expectations of future interest rate increases were reinforced by constant press reminders and concerns over Fed easing. According to Lipper and Morningstar, through November, net redemptions from fixed income funds in 2013 approached $87 billion, almost half of which came from PIMCO's Total Return Fund.

Beyond the U.S., international equities experienced very disjointed performance in 2013. As shown below for selected countries and regions, emerging market and Asian equities (other than Japan) performed weakly while the developed markets in Japan and Europe performed much more strongly.



Investment Forecast for 2014

In preparing this forecast, I'm mindful of what Bob McTeer, the former head of the Dallas Fed once said, *"The first rule of forecasting should be don't do it. Nothing good comes from it. … My rule is, if you have to do it, do it often."* So what you read here is best taken with a grain of salt. The forecasts are likely to change over the coming year as conditions warrant.

Domestic Equities

Last year, my forecast was for the total return of the S&P 500 (with reinvested dividends) to be 9%. Like so many others, I completely undershot the mark. That said, with David Bianco's estimate that 75% of the 2013 S&P gain of what became nearly 36% was due to margin expansion and 25% due to earnings growth, and with an understanding earnings generally drive stock market performance, especially over the long term, then maybe I can take some solace if I look at my estimate from just an earnings perspective.

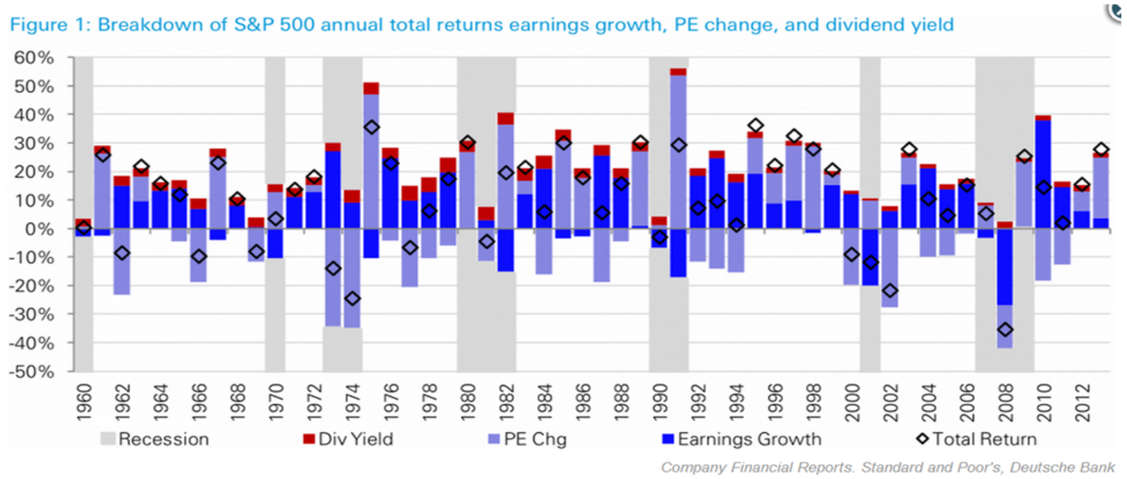
For 2014, I'll be using the following criteria to form my year-end estimate for the S&P 500:

- Long term performance. 20-year total return for the S&P 500 has been about 9%. This remains a good starting point.
- Corporate earnings. According to numbers reported by Howard Silverblatt at S&P Dow Jones, 12-month corporate earnings per share (EPS) for the last 20 years have a compound annual rate of growth of about 8.0% (his estimate for calendar 2013 is a seemingly high 11.8%). The estimate for calendar 2014 is about 9.6%. According to "consensus" forecasts recently reported by Barron's, 2014 earnings are expected to grow by 10.6% According to FactSet Research (quoted in Barron's), profits are expected to grow by about 8%. FactSet goes on to note, however, that analysts' earnings estimates tend to change throughout a given year, increasing in a period immediately following a recession and decreasing in more mature markets. It's the more mature market we are in today, so we might expect earnings estimates to decline during 2014. David Rosenberg of Gluskin, Sheff noted last month that a record 94 S&P 500 companies issued earnings downgrades for Q4 while only 12 have had positive pre-announcements. The key will be what Q4 earnings will look like and that won't be finalized for a couple of months yet. From some of what I've read recently, 2013 earnings growth might not exceed 5%, all-in. With the above estimates for 2014 at twice that level, this is going to be a critical area to watch.
- P/E ratio. There are several variations of this ratio depending on whether trailing earnings, leading earnings estimates or inflation-adjusted earnings are used (among other definitions). I'm going to base my comments on trailing earnings. Again according to S&P Dow Jones, the P/E ratio from last September (the latest date of available earnings information) was 17.8 and little change is estimated for 12 months hence. Over the recent 20-year period, the average P/E ratio has been about 26 or, if outlier recessionary months are excluded, about 21, so the current P/E doesn't seem so out of line.

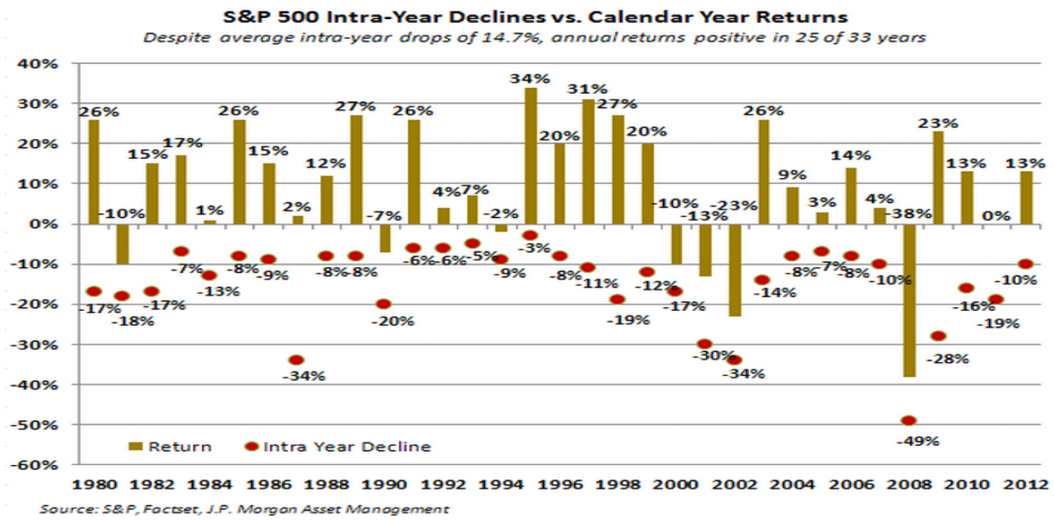
Above, from multpl.com is an historical chart of the P/E ratio that goes back to 1880. While the current ratio is looking on the high side at 19.4, this is overstated on account of using earnings from Q3 and the current price of the S&P 500 index. Make that adjustment and the current P/E ratio based on

trailing earnings doesn't look quite so excessive.

Dividend yield. This is another factor that is a component of total return. The chart below, prepared by David Bianco at Deutsche Bank, shows the total return contributed by each component element (dividend yield, earnings growth, and change in the P/E ratio). This chart suggests to me that, given the historical pattern and today's P/E ratio, the opportunity for an expansion of the ratio over the next 12 months is limited but hardly impossible.



- Analyst estimates. According to BusinessInsider.com, 14 "top" stock market forecasters expressed an average expected return for the S&P 500 index of about 9.5%. If dividends running just under 2% are added to that, this would suggest these analysts are expecting upwards of 11.5% total return for the S&P 500 in 2014.
- To be sure, there are those who have a very different view. One is John Hussman of Hussman Funds. His view is that the market is extremely overvalued and overbought, and that the expectations for corporate earnings are unrealistically high. He makes a strong case for a substantial correction (over 30%) . The problem is, he's been saying that for over a year. That said, he's worth reading for the bear case (http://www.hussmanfunds.com/weeklyMarketComment.html).
- International. By one estimate I've read, 30-35% of large cap corporate earnings come from abroad. So, global growth is an important contributor to the S&P 500. According to PIMCO, Goldman Sachs, and BofA Merrill Lynch, among others, global growth, currently below the long term trend, is expected to improve in 2014, though modestly and still below the long term trend.
- Economic Factors. To a certain extent, discussing economic factors is just the other side of the coin of discussing the prospects for corporate earnings and stock market returns. Nevertheless, there are certain factors we should keep in mind that influence expectations for 2014. Key among these are expected improvements in employment, housing, industrial production, and consumer spending. Also, increased federal and local government spending (caused in part by the recent budget agreement in Washington), continued bond buying by the Fed (even if winding down), and maintenance of the zero bound Fed funds rate, will all contribute to equity market improvement.
- Headwinds. There are risks to the market, there always are. For 2014, they could include a faster than expected increase in interest rates, a political stalemate in Washington that adversely impacts government spending, a reversal of market sentiment, an unexpected disappointment on 2014 corporate earnings growth, a major growth disappointment in Europe, China or Japan, or a flare-up in some region of the world.
- Hiccups. The chart on the next page, assembled by David Templeton of Horan Capital Advisors, shows that every year since 1980, there has been an intra-year decline in the S&P 500. The average decline (including 2013 though not included in this chart) was over 14%. If we exclude the years of negative total returns as outliers, the average intra-year decline has been about 10.8%. In the last two years, the decline has also been about 10% (even though we "eeked out" our total 35% gain in 2013). In fact, multiple intra-year declines are not unusual with 2013 being only one of two years in the



last ten with only one meaningful hiccup. So, regardless of the expected S&P 500 return for 2014, it would be unrealistic to assume that it will come without a significant hiccup (defined as over 10%) sometime during the year, if not more than one.

Of course, the timing of the hiccup is important in estimating calendar year returns. Interestingly, the S&P 500 index has been running from 0 to 2 standard deviations above its 50 day moving average (50DMA) since the beginning of 2013. Two standard deviations, using a 50DMA base, is roughly equivalent to 10 percentage points of movement. Since 2013 escaped a second hiccup and we've gone 6 months since the last one, my suspicion is that we will experience another one in the first half of next year and it will be at least a 10 percentage point move.

So, this has been a long-winded way of reaching my estimate for 2014's total return for the S&P 500. If I'm right about an above average hiccup in the first half of 2014 and if the prior pattern of declining analysts' earnings estimates throughout the year holds for 2014, reaching the consensus total return for the S&P 500 of 11.5% could be a challenge. Therefore, I'm going to shave the consensus estimate a bit by saying my expectation for 2014 is for a total return of 8%. Of course, I hope I'm on the low side, and will be happy to adjust during the year as conditions warrant.

On last thought relates to asset allocation. This will be addressed on page 10.

International Equities

There's less available data on which to base an estimate for international equities (thank goodness, you say, as this is getting long). Here is a summary of comments picked up from different sources embellished with a few of my own thoughts. The key here is to recognize that international equity performance is not uniform. It varies greatly by region and even country within region. Therefore, any investment theme including international equities should be country specific if outperformance is a goal.

- Eurozone. PIMCO sees the EZ emerging from recession in 2014 but growth to be anemic, less than 1%. For an economic area to be in recession and still turn in a return, according to the Dow Jones European index, of over 22% for 2013, all of which occurred in the last 6 months of the year, says something about market expectations. My forecast is that the EZ will parallel the U.S. in 2014 but lag behind. Let's call it S&P 500 minus 1%. On the other hand, sticking with my country-specific theme, I believe Germany and Belgium will outperform the U.S., if only by a little bit.
- Great Britain. Despite a 9% lag compared to the EZ and over 11% lag vs. the U.S., Great Britain still had a decent year with a 13% return in 2013, despite being very volatile. My estimate for Great Britain in 2014 is to be roughly comparable to the Eurozone.
- Emerging Markets. This group, comprised primarily of developing countries in Asia, Latin America (including Mexico) and Russia, swamped the U.S. in 2009, roughly equaled the U.S. in 2010, and has underperformed the U.S. ever since with the entire sector having a negative return over the last 3 years. But again, it's necessary to drill down to see where the performance has been and where it might go. As it turns out, there were no countries that I

saw as standouts, but several that were worse performers than the others, including all of Latin America (especially Brazil but not including Mexico), and India. On the positive side were Mexico, South Korea, Malaysia, and Singapore. My view is that emerging markets will have another struggling year and one with high volatility.

- Japan: Japan is pulling out the stops on monetary and fiscal policy resulting, according to Forbes, in deterioration of the yen against the dollar and an exit from the deflation of the last 5 years. Forbes also notes that Japanese stocks are cheap compared to the U.S. and that Japanese companies are cash-rich and looking to increase share buybacks. Although volatile, total return on Japanese stocks ended up a strong 27% for 2013 and remain in an uptrend. My outlook for Japanese stock in 2014 is to actually outpace the U.S. since there is still a lot of catching up to do relative to the last 5 years.

Bonds and Other "Fixed" Income:

After sulking below 3% since July 2011, the 10-year U.S. Treasury bond yield skyrocketed with Fed Chairman Bernanke's May 2013 comments suggesting the beginning of tapering (reduced bond purchases), nearly doubling from its then level of 1.66% to 3.0% today. That said, investment grade corporate bonds enjoyed steady growth in total return through 2012 and early 2013 despite the low level of interest rates and the certain knowledge of eventual interest rate increases. Once Bernanke spoke about tapering, however, the prospect of rising rates became a reality in the mind of investors and IG bonds haven't fully recovered since. With an expectation that 10-year Treasury rates will increase in 2014 to 3.5% or better, my outlook for IG bonds is for a year of less than 2% total return.

That said, I do see some opportunities to balance equities in 2014 with the best options being short duration, high yield bonds and floating rate notes. Convertible bonds that benefit from lowered rates, should they occur, and rising stock prices, should they occur, will also provide balance to equities.

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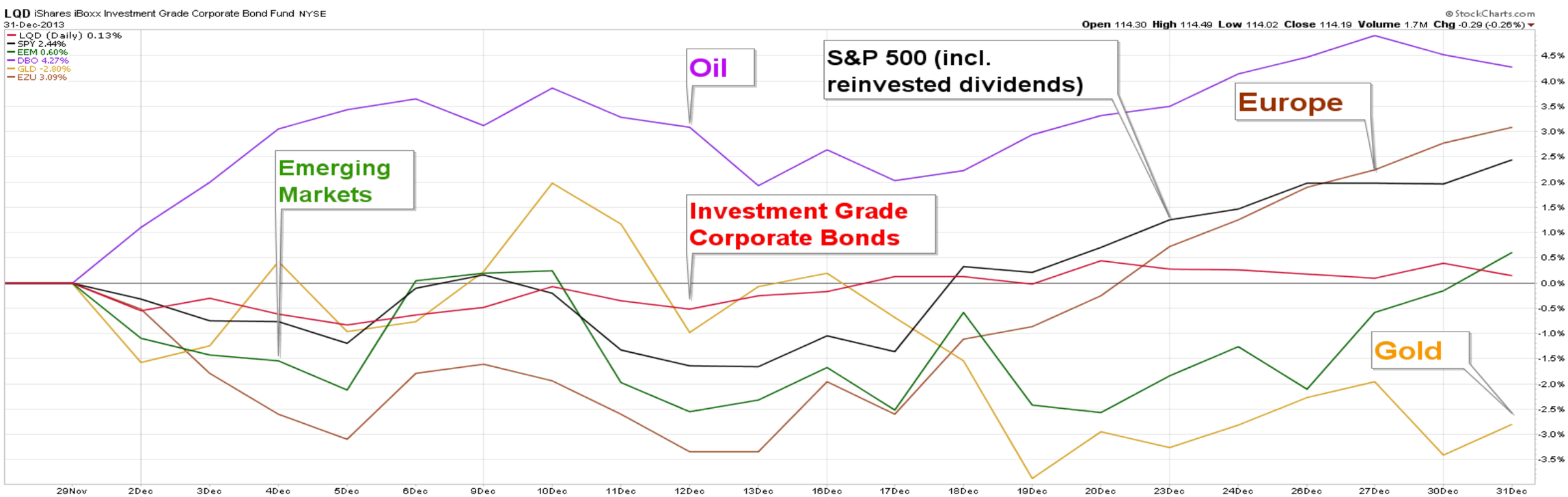

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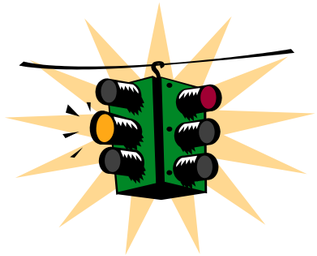
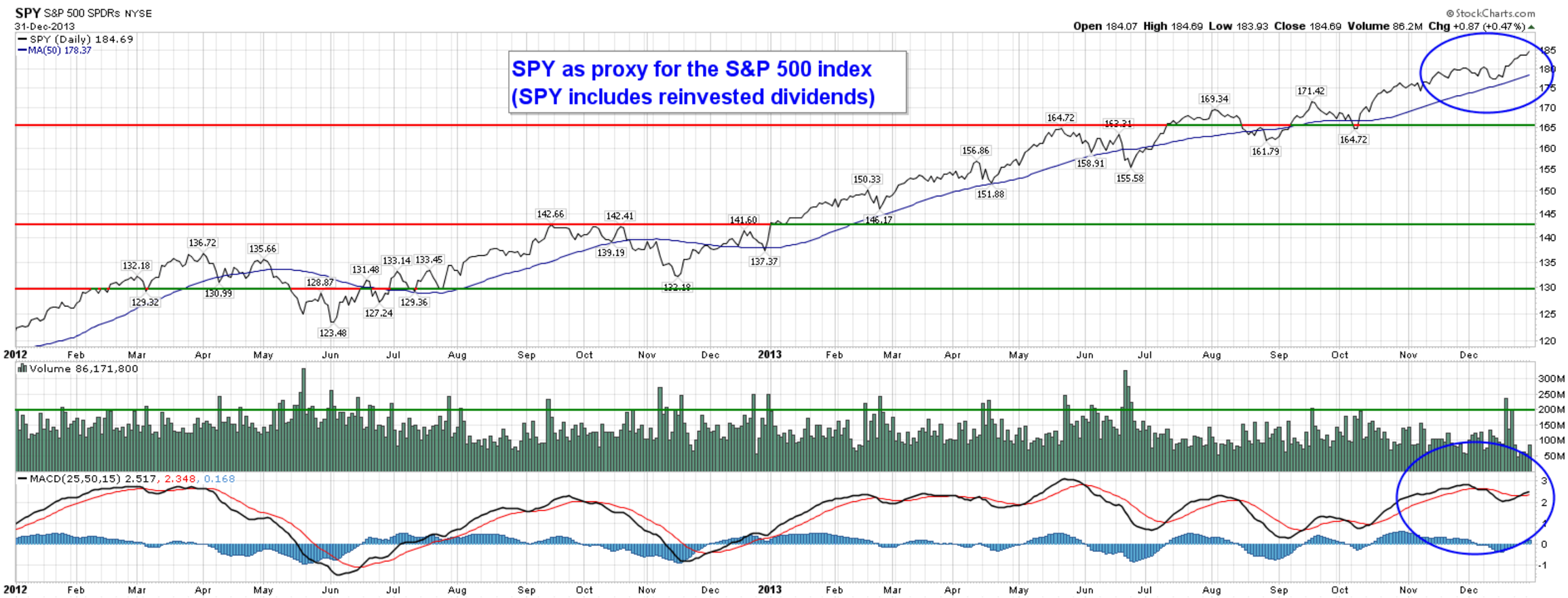
S&P 500



Last month, I said the flattening momentum "could be the beginning of a mild correction in light of the rich market valuation and relatively strong performance over the (previous) 8 weeks. Therefore, I am going to maintain my cautious yellow light stance." Well, the mild correction was more mild than I had in mind and the S&P (SPY) moved into new territory, ending the year at its highest point ever and closing out the year with a gain of nearly 35%. Examining the chart below, one could conclude "it's all systems go," with a rising trend in the 50-day moving average (50DMA) and recovering momentum in the MACD. If it weren't for my concerns about a market correction (see pages 4-5), I would have to give an unqualified green light to investing in SPY at this time. But I can't get the potential of that correction out of my mind, so I have to advise some caution in terms of increasing exposure to the broad equity index. If a correction does occur, as my longer term outlook remains constructive, I would look upon that as a buying opportunity.



SPY is an exchange-traded fund designed to match the experience of the S&P 500 index adjusted for dividend reinvestment. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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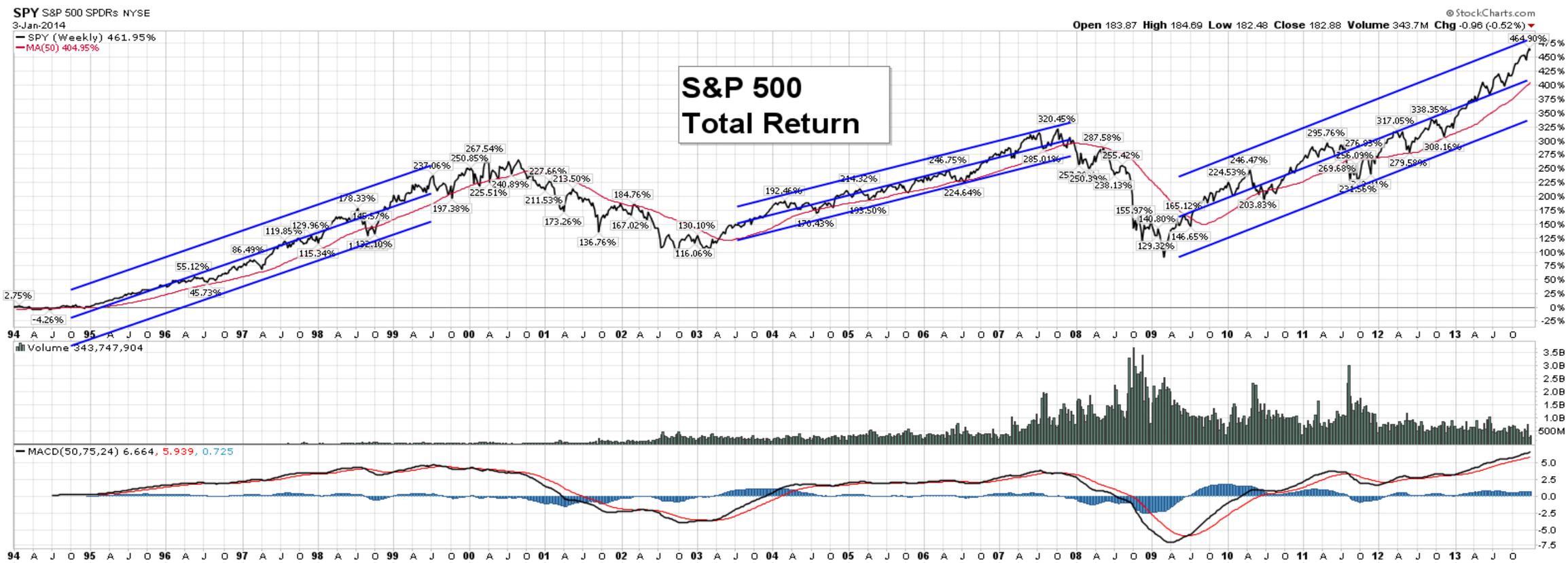
S&P 500—The Longer Trend

Below is a 20-year weekly chart of the total return for the S&P 500 with a 50-week moving average trend line (50WMA) and the momentum indicator MACD. It might seem obvious, but it is on the basis of this chart that I am optimistic about equities on a longer term basis.

In 2000-2003, the market corrected for an overblown valuation of technology (the NASDAQ still has not fully recovered from the height of its value in early 2000). In 2008, the market corrected once again, this time for an overblown reliance on credit. While we will certainly see another bubble/recession sometime in our future, there's almost no evidence that such an event in on the horizon. Yes, the S&P 500 valuation is on the high side, but not in bubble territory in my view. Moreover, neither the U.S. nor the global economy is anywhere near being overheated. From this perspective, the slow but steady economic recovery may be a more acceptable long term investing environment. This is not to say that corrections won't occur—one is likely in the coming months. This should be viewed, however, as a normal cyclical pattern (observe the last 20 years) and taken as an opportunity to modify a long term asset allocation.



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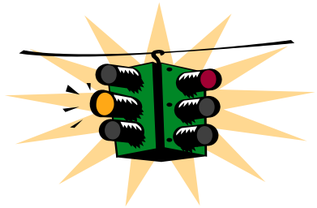
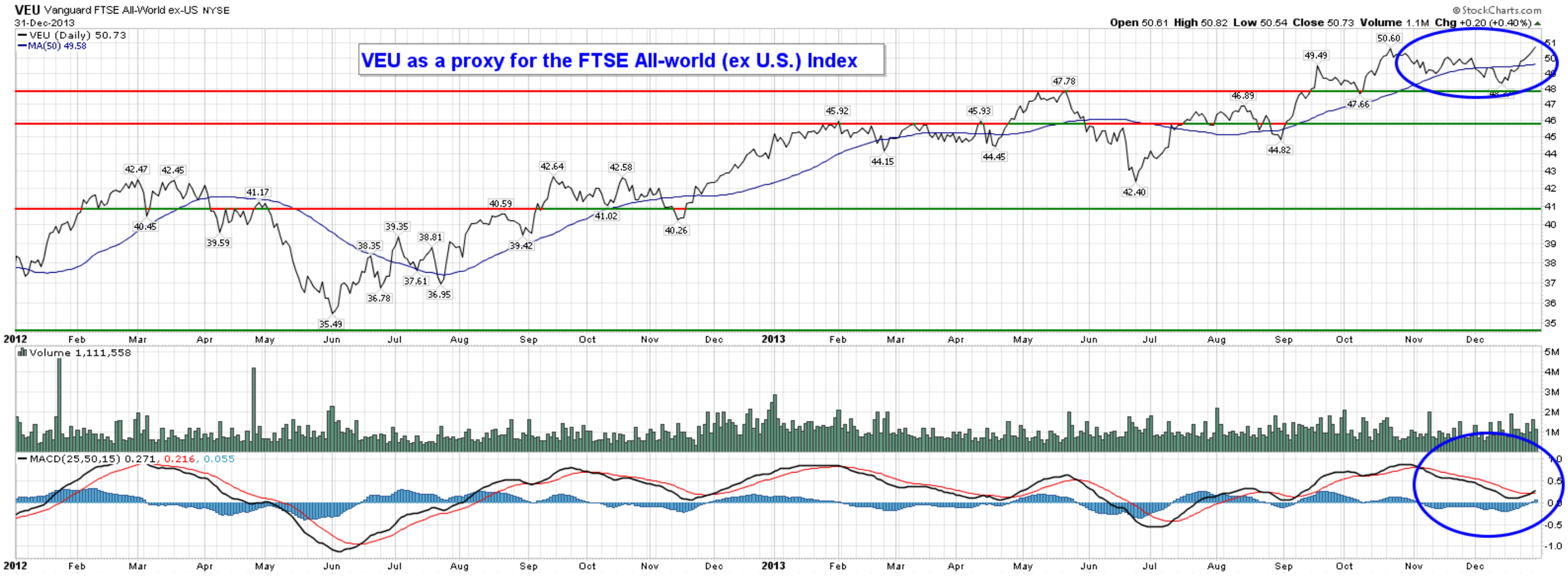
All-world (ex U.S.)



International equities, represented here by VEU, tested support at $48.10 and the 50DMA during December and ended the month and the year on a high note with price above the trend line and a reversal in momentum (MACD) to the good.

As I've mentioned in the past, international equity performance can be very localized. Currently, Germany and Belgium are outperforming the broader index, but not much else. Most of the emerging market countries are running behind VEU. Remembering that maybe 33% of the revenue of the S&P 500 come from overseas, significant international exposure can be had through a domestic allocation in large cap equities like the S&P 500. Accordingly, I believe better opportunities for equity performance lie within the U.S. (see also page 10). On the other hand, one thing to keep in mind is the view by some strategists that international equity valuations are more attractive than for the U.S. If this view prevails, it could mean a shift in investor preferences. When that happens, it will show up in the relative performance chart on the next page and I'll adjust my thinking accordingly.



VEU is an exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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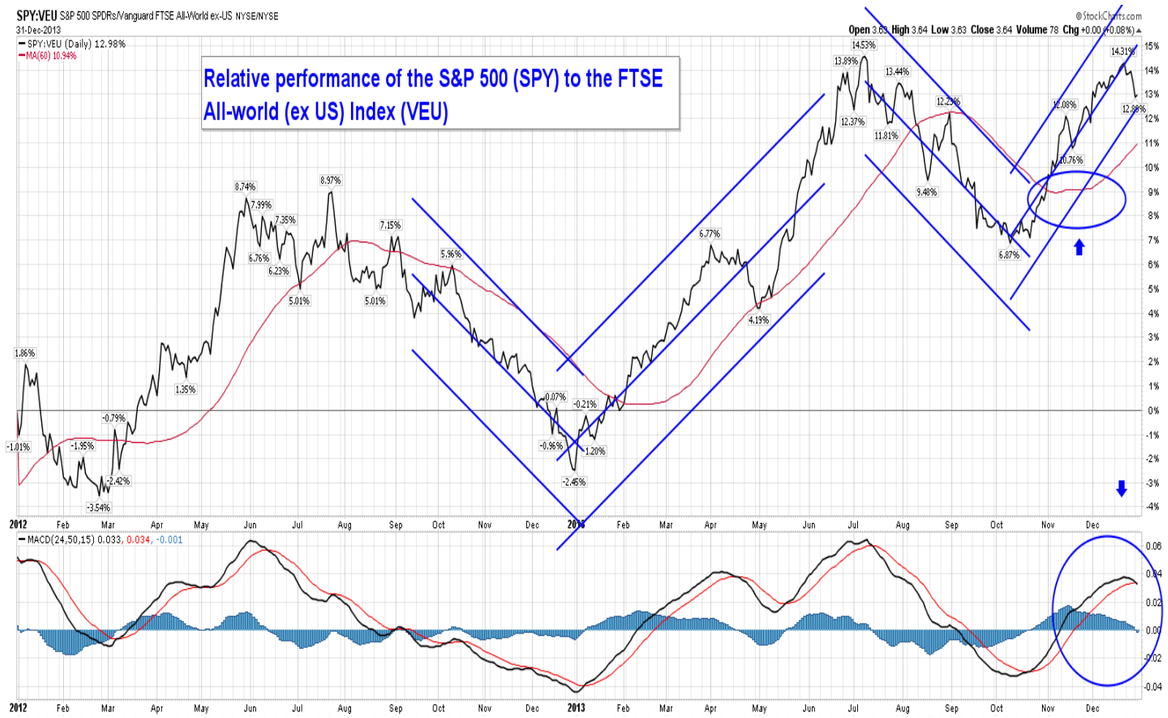
Asset Allocation and Relative Performance

Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. Commonly, investors choose an allocation that reflects their risk tolerance and reallocate at prescribed times, say, semi-annually, or when the actual percentage allocation deviates from the longer-term strategic plan. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show the relative performance of the S&P 500 (SPY) to an investment grade corporate (IGC) bond index (LQD) on the left, and to the Vanguard All-world (ex U.S.) index fund (VEU) on the right.

Bouncing off of support in early October, equities remain in an up channel relative to IGC bonds and the relationship is still on trend. Despite the initially weakening momentum in December, I suspect equities will retain their relative strength for the foreseeable future even if there are a few hiccups along the way. On the right, domestic equities retained control over the broad international index even though the last week of December looked like the situation was about to reverse. That said, I'm not yet ready to give up on my relative support for U.S. and, noting how the relative strength of the U.S. persisted through several prior moments of weakening momentum, I probably won't change my view while the trend in the relationship is rising.



SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**

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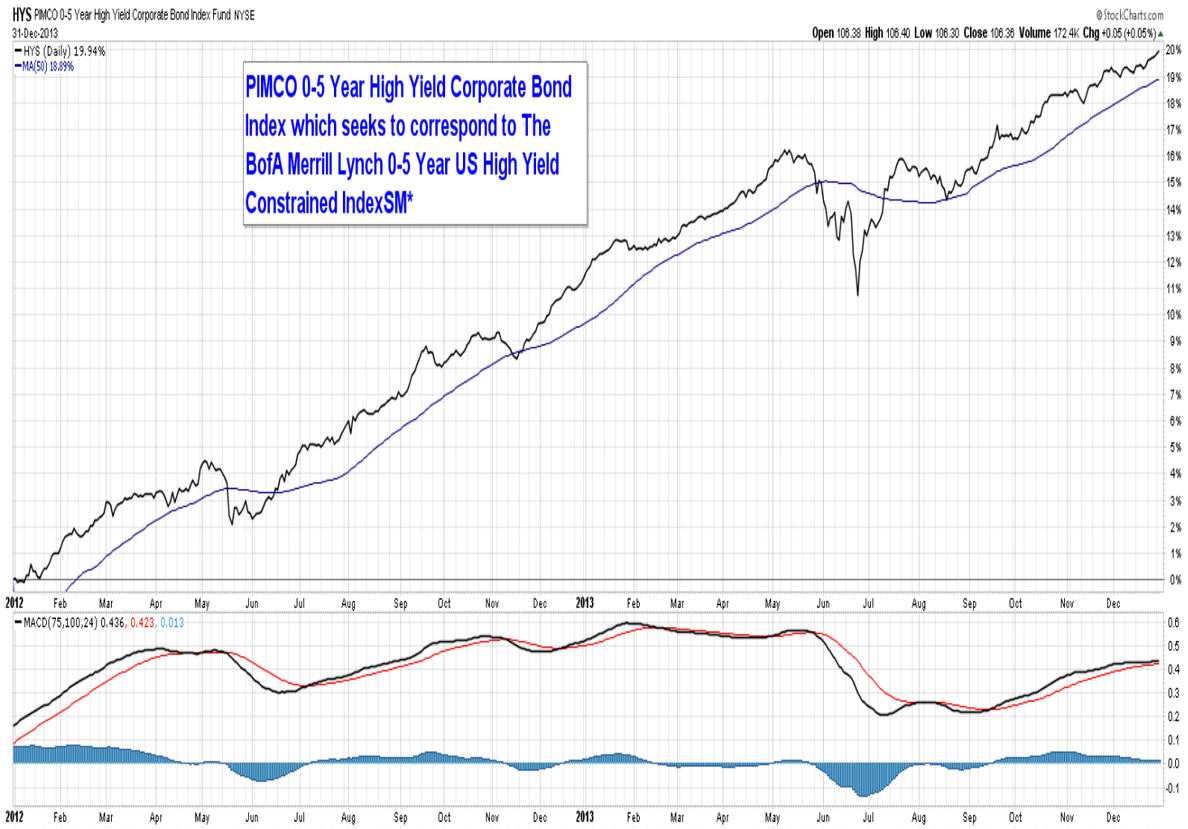
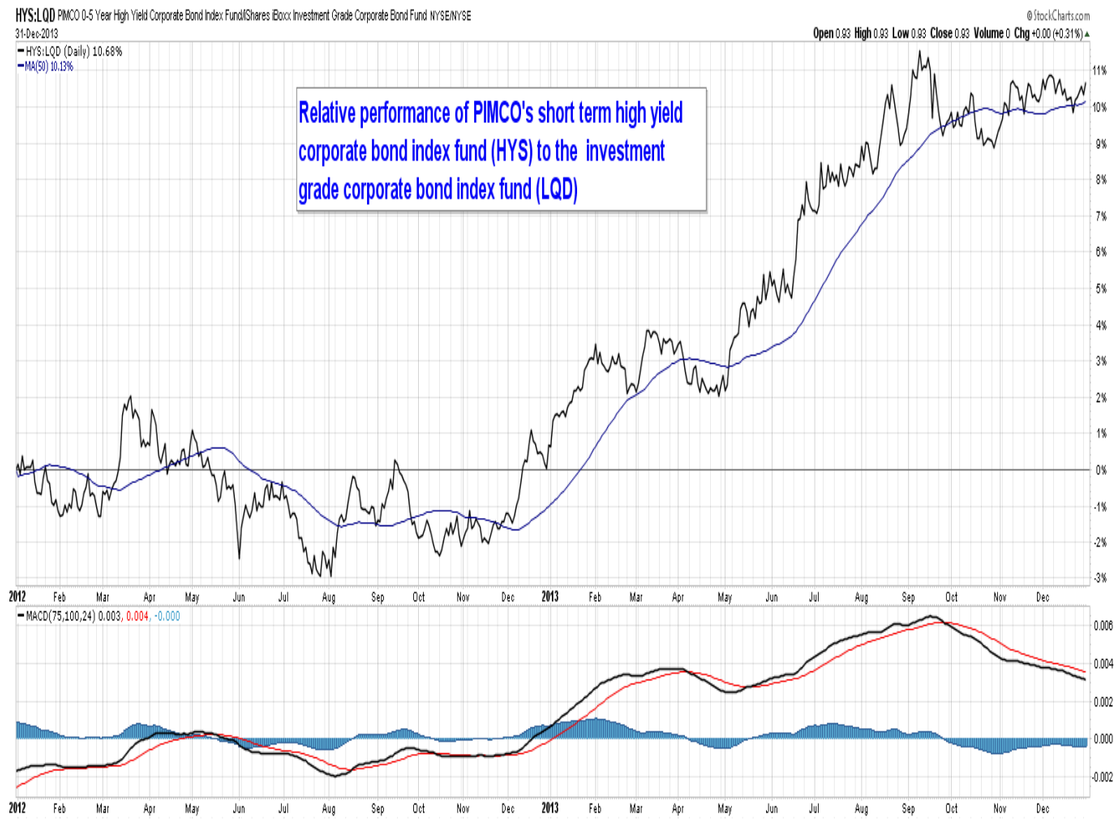
Income Investing

While income investing has gotten a bad name in the last few months as the reaction to the Fed's contemplation of "tapering" its bond purchase program in May resulted in a spike in interest rates, that does not mean the sector should be abandoned altogether. In prior months, I spoke of the outperformance of preferred stocks to investment grade corporate bonds. As in recent months, I draw attention to short term high yield corporate bonds represented here by PIMCO's exchange-traded fund HYS.

On the left below is a 2-year chart of total return for HYS. Over the last 2 years, the annualized gain has been about 9.5%; about 8.0% over the last 12 months. The chart on the right below contains the relative performance for HYS vs. investment grade corporate bond index fund (LQD) showing their similarity of performance during a period when LQD was rising last year, but significant outperformance during 2013 through September. Although the relationship has been basically flat since then, I believe the long term interest rate outlook continues to favor the short duration, high yield bond.





HYS is the PIMCO 0-5 Year High Yield Corporate Bond Index which seeks to correspond to The BofA Merrill Lynch 0-5 Year US High Yield Constrained Index^{SM}*. LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. **<u>Past performance is no guarantee of future results.</u>**

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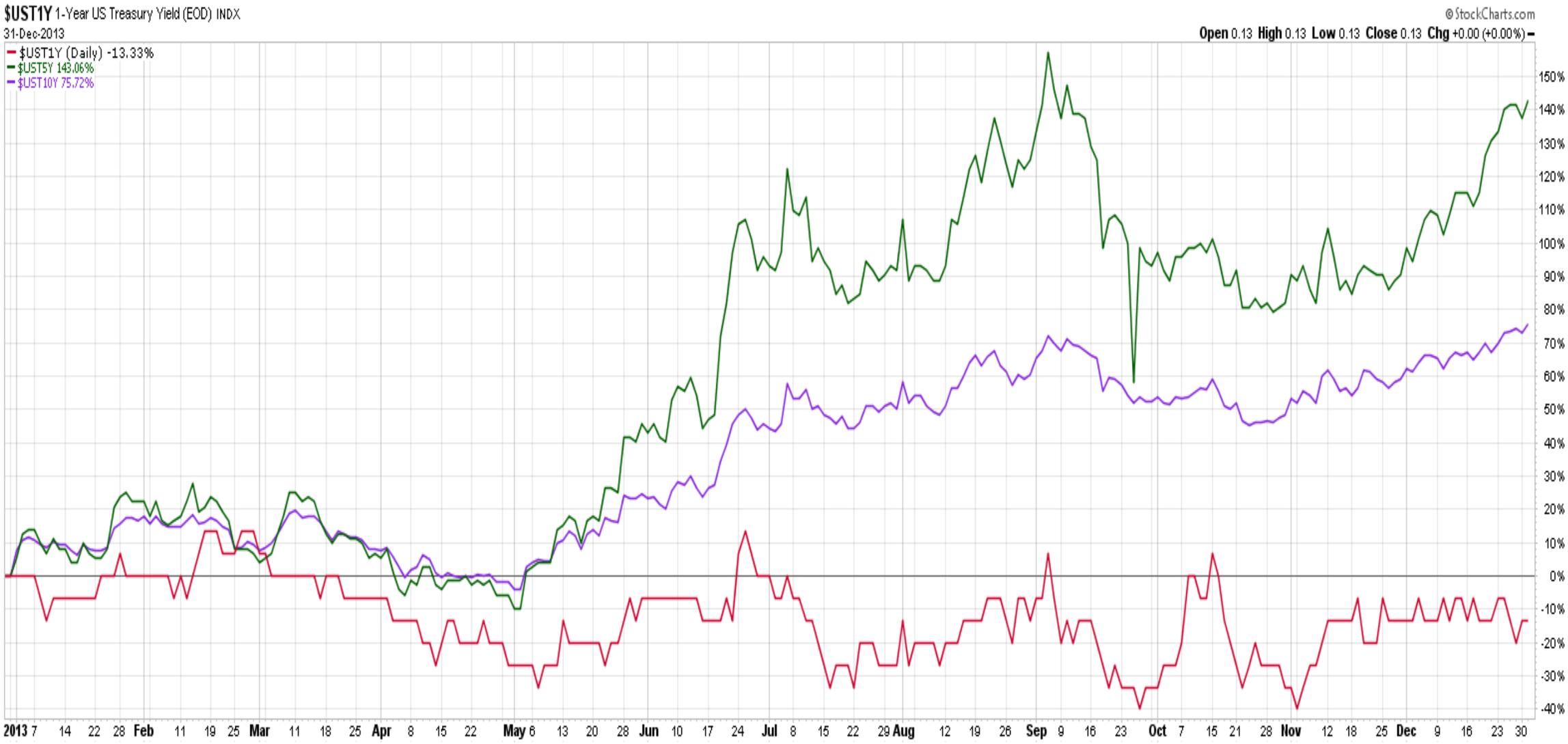
Treasury Rates

This chart shows the percentage increase in 1, 5, and 10-year Treasury rates over the last year. December saw the 10-year rise back to 3%, just short of its 2013 peak in September. While it's probably true that this recent increase was spurred by anticipation of the beginning of Fed tapering (that actually came to pass in mid-December), I see this as really a continuation of the increase that began in May with an adjustment in September-November as the market rested in the wake of the non-taper in September. In other words, I have a sense that the 10-year rate has seen the bottom and is likely to rise throughout 2014, albeit with some volatility. With the current yield at 3%, I'm expecting a year-end rate above 3.5%.



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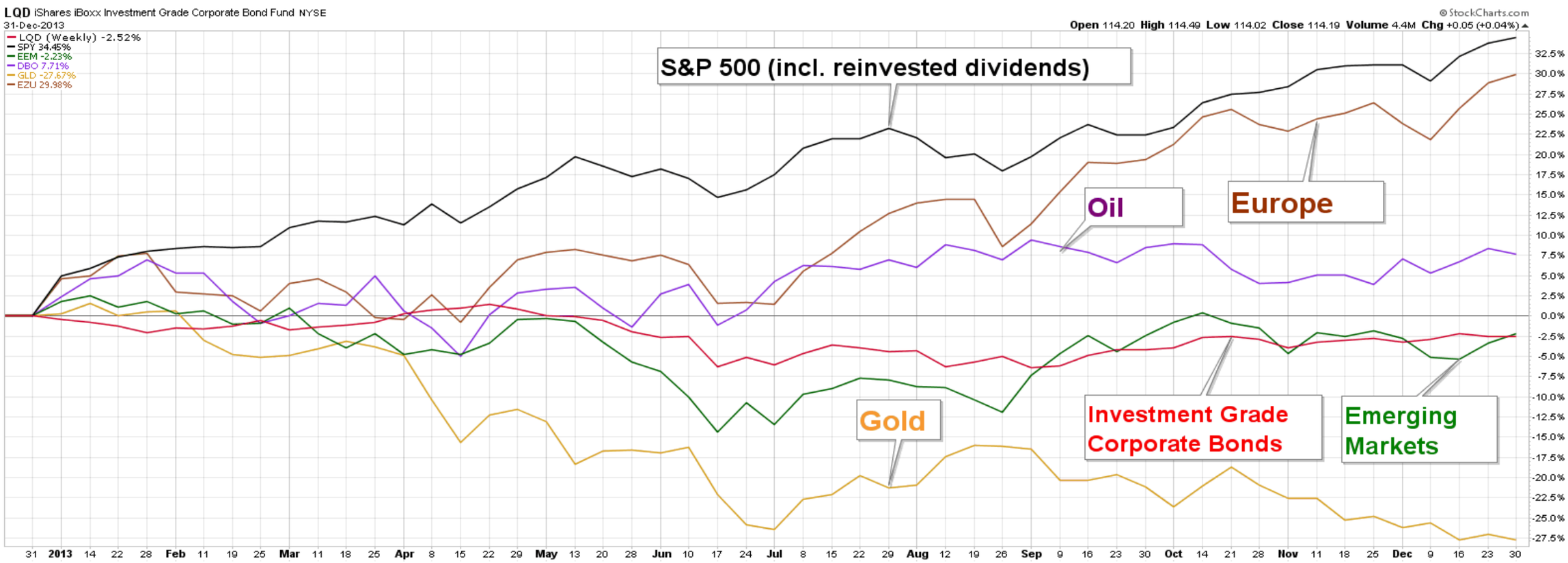
12-Month Performance

The chart below shows the last 12-month performance of the indicated ETFs, the same ones that are on page 1.

- **Large cap domestic equities (SPY) notched another gain in December and put up an impressive 12-month performance of nearly 35%.**
- **The Euro Zone (EZU) paralleled the S&P 500 in December and closed out the year with a nearly 30% gain — impressive given the challenging economic environment in the EZ, but reflective of an improving situation. Note that the broader international index VEU (not shown) remains well below SPY and EZU for the 12 months, highlighting the outperformance of EZU over the broader index by over 15 percentage points for the period and the region/country-specific returns in the international equity space.**
- **Gold (GLD) continues to languish. If gold represents the fear trade, there's not much of that evident and, I suspect, that will continue.**
- **Oil (DBO) had a small gain in December as global economic activity picked up and the forecast for 2014 is for additional improvement.**
- **Emerging market equities (EEM) had another flat month in December, pulled down by China and Brazil, among others.**
- **Investment grade corporate bonds (LQD) continue to struggle as investors anticipate rising rates. Eventually, turnover in the underlying bonds and stabilization in rate expectations will lead to some recovery in LQD, but that doesn't seem to be on the near term horizon.**



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Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

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