Quarterly Newsletter

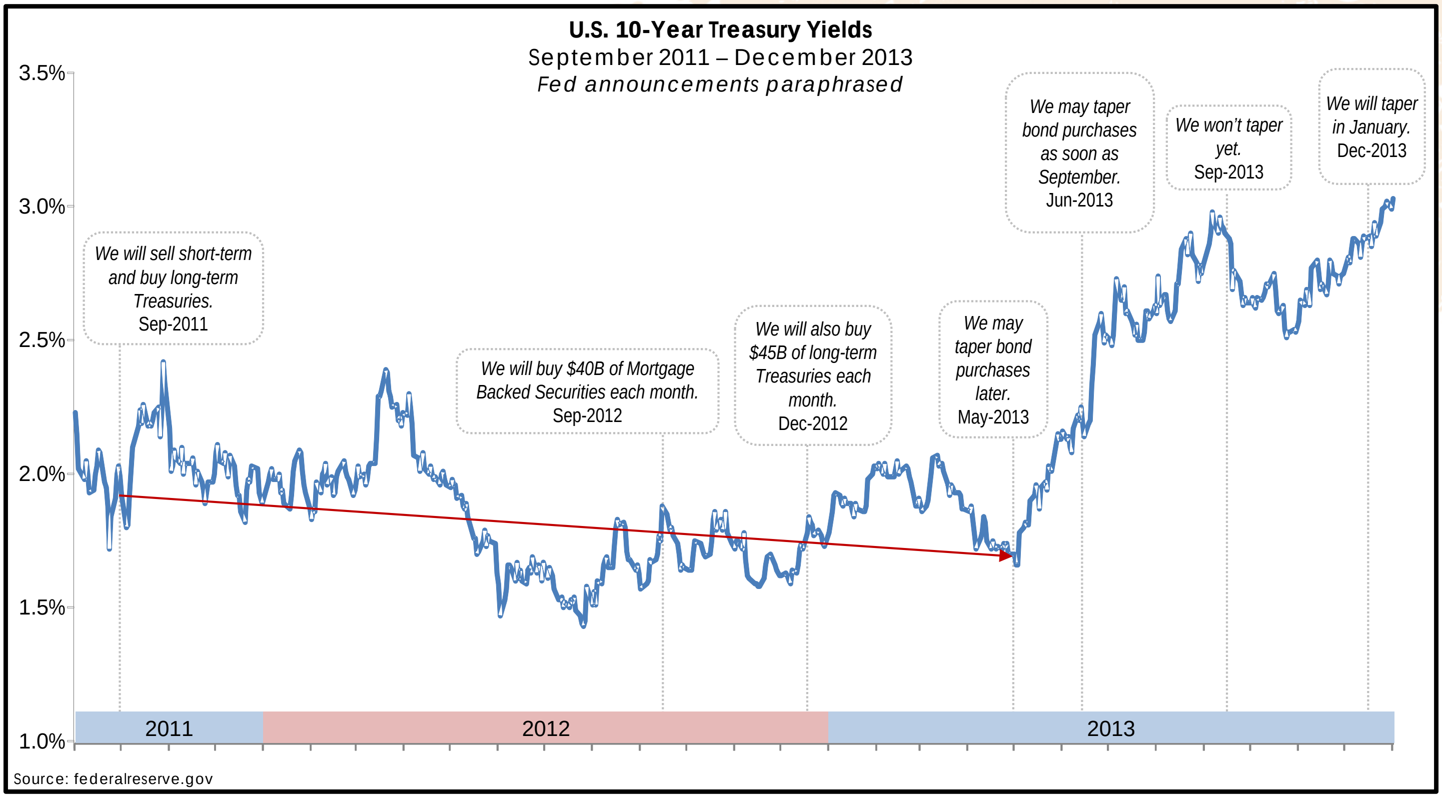
JANUARY 2014

CAPITAL MARKETS UPDATE | Domestic equity markets vaulted higher in 2013 (Large Cap +32.4%, Small Cap +38.8%) as the S&P 500 and Russell 2000 both set new all-time highs. International equities (+22.8%) performed well while Emerging Markets (-2.6%) and Commodities (-9.5%) both struggled as the U.S. dollar strengthened. The U.S. bond market posted a modest loss (-2.0%) as yields moved higher across all maturities. Major central banks in the developed countries continue to be active in markets and target low short-term rates though the U.S. Fed announced plans to reduce the pace of its bond purchase programs.

A NEW YEAR, A NEW FED | Three key changes at the Federal Reserve come with the New Year:

1. New Leadership—At the end of January, Janet Yellen will succeed Ben Bernanke as Chairperson of the Federal Open Market Committee (FOMC), which sets monetary policy for the Fed. Most pundits expect a smooth transition as Ms. Yellen has served as Vice Chair for three years and shares Bernanke's dovish tilt (favors continuing accommodative monetary policy support).
2. Changing Composition—The FOMC makes decisions based on a majority vote. As many as seven of the twelve voting members may turnover in 2014. It is possible the direction of FOMC policy will morph with the changes in its members.
3. New Policy Direction—In January, the Fed will begin to "taper" its monthly purchases of Mortgage Backed Securities and Treasuries (collectively Quantitative Easing or QE) from $85 billion to $75 billion. Additionally, the Fed now expects to keep short-term interest rates pegged at 0.00% to 0.25% even longer. Many expect rock bottom short-term rates will remain through at least 2015.

WHAT IS THE LIKELY IMPACT OF FED TAPERING? | If the Fed continues to reduce its monthly bond purchases by $10 billion each FOMC meeting, QE should conclude by the end of 2014. How will long-term interest rates react? It is instructive to review the path of interest rates since the Fed explicitly targeted lower long-term rates in September 2011. The chart below illustrates the U.S. Ten Year Treasury Yield over the last 28 months. Paraphrased on the chart are major Fed announcements.



Source: federalreserve.gov

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The red arrow on the chart highlights the point to point trend in the Ten Year Yield during the Fed's intense focus on long-term rates. The yield stood at 1.95% before the Fed announced its Maturity Extension Program in which it would sell short-term Treasuries and buy long-term Treasuries. One year later, the Fed announced its plan to purchase $40 billion of Mortgage Backed Securities each month. In December 2012 the Fed added $45 billion per month of long-term Treasuries to its purchase plan. In May 2013, the Fed first discussed a potential change in these latter two programs. Prior to this announcement, the yield was 1.70%. Interestingly, the U.S. Ten Year Treasury Yield only declined a scant 25 basis points from September 2011 through April 2013. Since Chairman Bernanke's May 2013 initial suggestion of future tapering, the Ten Year Yield increased over 1.30% to close the year above 3%.

Of course, we can't know what yields might have done if the Fed had not purchased large quantities of bonds over this period. **The impact of QE on bond yields and the broader economy is unclear.** Given that U.S. Treasuries have been a safe haven, the path of the Ten Year Yield may have more to do with the level of global financial stress. Indeed, the Ten Year Yield plumbed its all-time low of 1.39% in July 2012 as Spanish government bond yields spiked to all-time highs. As fears subsided in Europe, the Ten Year Yield moved higher. We should also expect bond yields to reflect market expectations for growth and inflation. So what is next?

A quote from former Defense Secretary Donald Rumsfeld provides a sound framework for organizing our thinking about risk and uncertainty in the investment arena:

> *"…there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."*

Below are some thoughts for each category.

KNOWN KNOWNS

- In the developed world, tepid growth and subdued inflation define the current environment.
- While it has decelerated from higher levels, growth in the emerging market countries is materially higher than that in the developed nations.
- Yields on stocks and bonds in the U.S. are close to historic lows.
- Total debt in the G20 countries is over 30% higher today than the pre-crisis level.
- Economic cycles are here to stay—central bank activism has not repealed the natural business cycle of expansions and recessions.
- With short-term rates at zero and a mixed report card on the efficacy of QE, central banks do not have traditional tools available to combat the next adverse unknown.

KNOWN UNKNOWNS

- Will global growth surprise on the upside or downside?
- Will inflation remain subdued, go negative or move higher?
- What will be the timing, direction, magnitude and speed of bond yield adjustments going forward?
- Will the Euro currency survive?
- Will Abenomics (aggressive monetary policy + aggressive fiscal stimulus + structural reforms) restart growth and create inflation in Japan?
- Will recent reforms in China and Mexico serve as the template for the rest of the emerging market countries?
- Will geopolitical tensions wane or intensify in the Middle East and East Asia?

UNKNOWN UNKNOWNS | By definition, a list is impossible. We all want to predict the future with accuracy, especially as investors. With unknown unknowns, we can't know the catalyst for change in key markets until after the fact. Otherwise, market prices would already reflect that information. A recession started in the U.S. less than three months after the S&P 500 reached a new peak in October 2007. The stock market doesn't predict what lies ahead either. As disciplined investors, we can only inventory known knowns and known unknowns and use balanced judgment to match investment strategy with an appropriate risk budget.

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INVESTMENT IMPLICATIONS | Managing our emotions is one of the most difficult elements of sound investing. The competitive spirit thrives in all of us; we not only want to win, we want to win by a large margin. Equity heavy portfolios concentrated in U.S. companies were the clear winners in 2013 while diversified portfolios naturally lagged the S&P 500 and Dow Jones Industrial Average that dominate the headlines of The Wall Street Journal. While we continue to like U.S. equities in client portfolios, we also advocate International and Emerging Market equities, alternative investments and favor portions of global fixed income. By definition, **diversification** will always detract from performance relative to the top performing asset class, but history tells us it is a prudent long-term discipline.

Ben Inker, head of asset allocation strategy for globally respected Grantham Mayo, reminds us, "If you don't know what is going to happen, don't structure your portfolio as though you do." The key to successful long-term investing is to respect the unknowns and follow a disciplined approach that sets emotion to the side: determine an appropriate risk budget, align the asset allocation with the global investment opportunity set, rebalance to long-term targets, prudently manage investment expenses and minimize fees and taxes.

TAX ITEMS | Tax time is here again. Fidelity expects to post online and mail its annual Tax Reporting Statement on or before February 18th. This statement will provide information that you will need for your 2013 tax return including Form 1099 Dividends and Distributions, Interest Income, Realized Gains and Losses and Arbor's Investment Management Fees that are debited from taxable accounts. Some clients will also receive Form(s) 1099-R summarizing certain IRA activity. Separately, we will send you a summary of any charitable gifts of appreciated stock. Please let us know if you have any questions, thank you.