Rebalance Commentary

For the first time since the financial crisis in 2008, the US economy has a compelling growth story that is unrelated to external support from the government or central bank. Consumers are nearing the end of the long and painful deleveraging process. In 2009, Americans owned less than 40% of the equity in their homes and at the end of 2013 they owned more than 50%, for the first time since 2009, households are borrowing money again. Net worth is at an all-time high and the unemployment rate has plummeted from a high of 10% to 6.7%. The energy renaissance is keeping prices low, creating jobs and bringing outsourced manufacturing back from overseas. The budget deal reduced the impact of the sequester and showed that Congress is more willing to work together. The Fed clarified the taper and confirmed a new chair, Janet Yellen.

There are several key factors we will be monitoring to determine if the US can stay on its growth track. Consumer expectations of wage growth are low and that has kept them from spending. The drop in the labor force participation rate makes us skeptical about the reality of the improvement in the unemployment rate. Corporations have taken advantage of low interest rates and stagnant wages to hoard cash and buy back shares but haven't raised salaries or invested in their aging equipment. It will be a delicate balance because capital investments and hiring are good for the economy in the long run but may hurt profit margins in the short run. The US equity markets weathered the volatility of 2013 and generated double digit returns for the last 2 years therefore we're increasing our allocation to US equities by adding to small cap growth, which tends to outperform in growth periods, and large cap growth, which has lower volatility than our small cap allocation.

Internationally, we are increasing our allocation to developed markets and are decreasing but not eliminating our emerging markets exposure. For many years, emerging markets have been the engine of growth for the world economy while Europe has suffered from severe recession, high unemployment, and repeated crises from countries like Spain and Greece. We believe Europe may have turned a corner in 2013. The European Central Bank (ECB) guaranteed in 2012 that it would do "whatever it takes" to prevent a crisis in one country from spreading to the rest of the Eurozone. Their promise was tested in 2013 as Cyprus neared catastrophe and, for the first time, markets did not panic. Since then, we have seen the first signs of tepid growth from several major European economies. While Europe is not yet booming, we want to participate if the market has bottomed. Conversely, emerging markets have been weaker than expected. China has slowed and may be experiencing a credit bubble. The threat of the US Fed taper damaged the accounts of the so-called "Fragile Five" (Brazil, Indonesia, South Africa, India and Turkey). Emerging Market growth forecasts have been revised downward as increases in labor costs and the flip side of the US energy renaissance make them less competitive. The underlying fundamentals are there for the long run, including favorable demographics and higher growth than developed markets, but we are concerned about shorter term risks.

Ahead of the Fed's tapering decision in December, we sold approximately 10% of our longer duration fixed income and are now deploying that cash in strategic bond funds, shorter maturity corporate bonds, and US/developed market equity. Bonds have been in a bull market for 30 years and bond funds have been on the receiving end of massive investor inflows since the crisis of 2008. Following Bernanke's May 2013 taper talks, interest rates spiked and many traditional bond investments finished 2013 with negative total returns and significant outflows. Liquidity in the bond market has deteriorated as regulations have led to banks being less willing to buy the bonds that funds are selling, resulting in volatility. While nobody can predict where rates will go, we think the downside risks are greater than the upside potential of a rate decrease.

Our alternative allocation is designed as a hedge against equity and fixed income risks and so we are adding to both our MLP and our managed futures allocations. MLPs generate yield and the move is intended to offset any loss in yield from reducing our fixed income allocation. Managed futures have low correlation to equities during market downturns and the goal is to offset some of the risk created by adding to equities if stock markets decline. •

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