Actuarial Consulting Group

Quarterly Update & Economic Commentary - December 31, 2013

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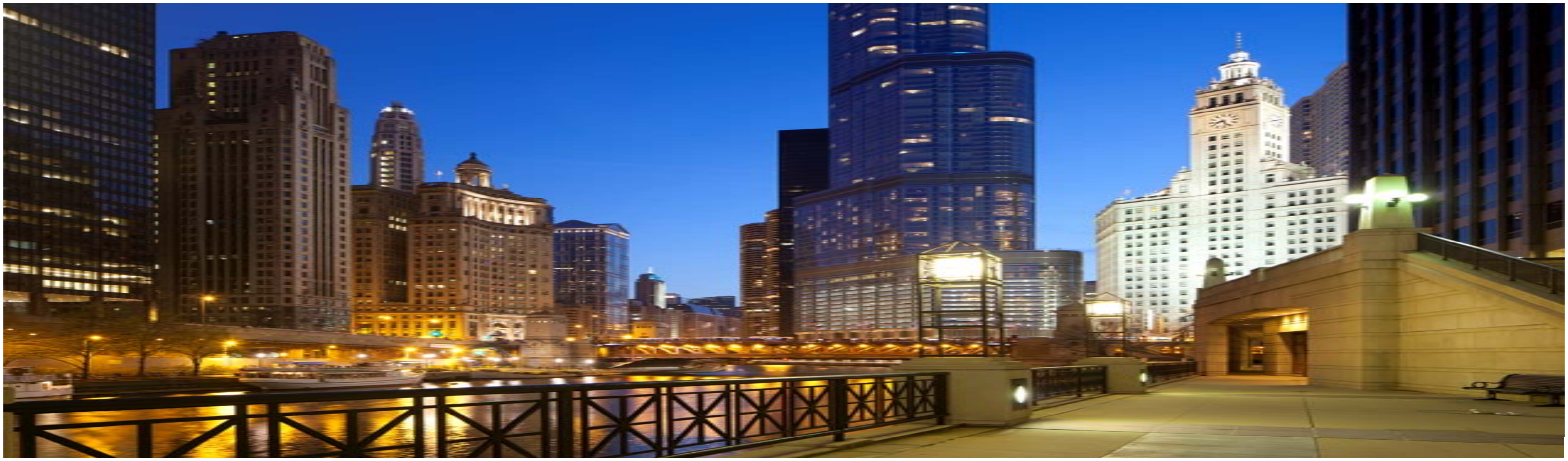

Economic Environment During the Past Quarter

Equity market investors had a great year in 2013. The S&P 500 and Dow Industrial Average both traded at all-time highs. The S&P 500 returned over 32 percent, its best calendar year return since 1997 and the Dow returned over 29 percent, its best return since 1995. All sectors in the S&P 500 returned over 10 percent for the year led by Consumer Discretionary (43 percent), Health Care (41 percent) and Industrials (40 percent.) The laggards came from the more defensive, interest-rate sensitive sectors, Utilities (13 percent) and Telecom (11 percent.) Smaller cap companies performed even better, with the S&P SmallCap 600 returning over 41 percent while the S&P MidCap 400 returned over 33 percent.

Performance in foreign markets was much more sporadic. The developed markets had a decent year, finishing positive by 22.78 percent, as represented by the MSCI EAFE, but emerging markets struggled finishing the year slightly negative, -2.60 percent, as represented by the MSCI Emerging Markets Index. There were pockets of exuberance, like Japan, which returned over 50 percent in local currency terms, its strongest calendar year gain in 41 years. Ireland's 33 percent return was a leading performer in Europe. The poor performance from lesser-developed countries, often referred to as emerging markets, can be attributable to a number of factors, including falling commodity prices, currency devaluation and growing current account deficits.

As many had expected, interest rates rose in 2013, the widely followed 10-year treasury bond began the year yielding 1.78 percent and finished the year yielding 3.03 percent. The rise in rates caused bond prices to fall leading to negative performance for many bond indexes. Fixed income investments that had a lower duration or took more credit risk were able to buck the trend and earn a positive return for the year. The Barclays Capital High Yield Index returned over seven percent for the year, while the Barclays Capital Aggregate Index lost approximately two percent of its value.

In general, commodities did not perform well in 2013. Gold broke a 12-year calendar streak of positive returns, falling over 28 percent; this was its worst return in 28 years. Agriculture prices fell throughout the year. Oil and natural gas were bright spots for the commodity sector as prices rose throughout the year.

The major headlines during the fourth quarter came courtesy of the U.S. Government. The quarter started with a government shutdown, which curtailed many routine government operations and furloughed around 800,000 government workers. The shutdown was the result of Congress's inability to enact legislation appropriating funds for fiscal year 2014. An appropriations bill was signed into law, re-opening the government on October 17.

The beginning of the quarter also marked the opening of President Obama's healthcare exchanges, the rollout was embarrassing as many would be enrollees could not register as a result of a poorly constructed and managed web site. In addition to the website issues, there were other problems related to the specifics of the law that caused Republicans to criticize and Democrats attempt to distance themselves from the law all together.

The government's fiscal year ended on September 30, with a $680 billion deficit, which on the surface looks bad, and it is, but was the lowest annual deficit since 2008. The previous five years saw deficits over $1 trillion which were the highest five deficits in the history of the U.S. Unfortunately, the factors contributing to the smaller deficit are not a result of a long-term, sustainable policy change. On a positive note, Congress did pass a "bi-partisan" budget deal in December. The deal was far from a grand bargain but did remove the possibility of another government shutdown in January or next October.

The Federal Reserve surprised many by announcing their intent to taper their monthly purchases during its December meeting after failing to announce a taper when many expected during the September meeting. Pleasingly, the market reacted to the taper in a positive manner. The positive tone can be attributed to Chairman Bernanke's emphasis that short-term rates will remain low well into the future; additionally, many believe the Fed made its decision based on data suggesting the economy is strengthening and not reliant on extraordinary monetary policies, like quantitative easing. The Fed will start the year purchasing $75 billion a month in treasury and mortgage-backed securities.

Outside of the news out of Washington, the fundamentals of the economy continued to show signs of improvement. The biggest surprise during the quarter came from the final real Gross Domestic Product (GDP) reading for the third quarter, which showed the economy growing at an annual rate above four percent. We believe a large component of this number is from inventory build-up, which could affect future readings, but nonetheless, it is a great number. The unemployment rate continued its downward trend, finishing the year at seven percent. We are not advocating that the jobs market is strong but data is indicating that it is improving.

We continue to see strong demand in larger purchases, like automobiles and housing. Light vehicle auto sales reached an annualized rate north of 16 million in November. Prior to this year, we have not seen an annualized rate above 16 million since 2007. Seasonally adjusted annual housing starts increased to over one million, which is the highest reading since early 2008. Strong and improving housing and auto markets imply consumers are getting more confident and willing to take on debt. Additionally, big-ticket items like homes and autos tend to help other areas of the economy due to the number of inputs necessary to reach the final product.

The European Central Bank (ECB) cut rates to record lows in November as policy makers attack the increasing risk of deflation. The Euro Zone is no longer in a recession but continues to suffer from a record high unemployment rate above 12 percent and has recently seen economic data disappoint. The ECB will continue to be accommodative and make policy decisions in an effort to avoid any disturbance to the little momentum they have seen. The United Kingdom is having the opposite problem; their economy is improving and their unemployment rate is dropping which may cause them to tighten quicker than they might otherwise feel comfortable. In other global news, Iran struck a deal with the U.S. and five other world leaders, to curb Iran's nuclear activities in exchange for limited and gradual sanctions relief.

A Look At The Numbers

Index	4th Quarter 2013 (%)	Year to Date (%)
Dow Jones Industrial Total Return	10.22	29.65
S&P 500 (Large Cap) TR	10.51	32.39
S&P 400 (Mid Cap) TR	8.33	33.50
S&P 600 (Small Cap) TR	9.83	41.31
NASDAQ	11.10	40.12
MSCI EAFE (International) TR USD	5.71	22.78
BarCap U.S. Aggregate Bond Index	-0.14	-2.02
Wilshire US REIT (Real Estate)	-0.83	1.86
US 30-Day Treasury Bill	0.01	0.02

The Forecast in Brief

We continue to believe that domestic equities are an attractive asset class. The economy looks as if it will continue to grow and strengthen in the year ahead. We believe the housing market remains strong as demand is increasing from consumers that are more confident and interest rates are still at historically low levels. With the risk of prices rising because of demand, low inventory levels and rising interest rates, buyers are also feeling a sense of urgency to buy now instead of waiting.

From a valuation perspective, the market appears to be reaching a point of being fairly valued; however, we do not believe this will translate into a top in the equity markets. Markets can often trade at or above fair value for an extended period. We also believe that as time passes from the 2008 crisis, investors will be less concerned with risk, allowing valuations to expand without a major correction. It is also possible that earnings can grow at a faster rate than prices rise, which could effectively make valuations cheap without markets falling. It is also important to point out that the market by itself may be fair-valued, but when compared to other investable asset classes, it is attractive.

Chairman Ben Bernanke will hand over his duties to incoming Fed Chair Janet Yellen, assuming Congress confirms her, which is expected. Chairman Bernanke initiated his fair share of controversial monetary programs, many of which we applaud and a few we disagree with, but we find it hard not to appreciate his efforts throughout the financial crisis and during the recovery. Although we believe Ms. Yellen is intelligent, well qualified and the right person for the job, we believe, having a new Fed Chairperson could cause some uncertainties or anxiety to the markets. Our concerns are from a communication perspective not from a policy perspective. We do not believe this risk is specific to Ms. Yellen but to any incoming Chairperson.

In past years, political uncertainty has acted as a headwind for the stock market. We believe many of these types of political risks that hurt the markets in the past will not be headlines this year. The debt ceiling debate will heat up during the first quarter; Republicans are expected to ask for concessions but the President and other Democrats insist that there will be no negotiating. Although this is a risk, we do not expect Republicans to push the issue given the potential negative backlash that may transpire this close to the mid-term elections. Obamacare may continue to be discussed in the media but we do not believe any intended or unintended consequences will impact market performance this year.

In addition to the strengthening of the U.S. economy, we also believe many global economies will strengthen, especially in developed countries, like Europe and Japan. Europe has trailed the U.S. in terms of strength of recovery but signs are beginning to show sustainable growth may be nearing. The Euro Zone climbed out of a recession in 2013. As the U.S. central bank is expected to become less accommodating, the ECB (European Central Bank) is expected to continue with loose monetary policy to promote growth, lower unemployment and promote inflation. The Euro, which strengthened relative to the dollar in 2013, may see a reversal this year as both central banks could be making countering policy decisions. A cheaper Euro can assist in the recovery, as European produced goods would be cheaper for other countries to import.

Japan, the turnaround story of 2013, has momentum on its side but challenges will continue. There does not appear to be any end to the bold policies Prime Minister Shinzo Abe initiated in 2013, referred to as "Abenomics." The monetary policies assisted in depreciating the Yen by almost 25 percent against the dollar during 2013. It is difficult to tell if the growth can continue. Some of the threats that could slow the recovery are sales tax increases, which will go into effect in April, and rising tensions with China that could end with military action. Although these are concerns, Abe has demonstrated his willingness to be bold and aggressive to fight a weak economy.

Emerging markets, arguably the most disappointing equity asset class of last year, may continue to have headwinds as an asset class but we believe there is value in selective areas. There are a group of countries being identified as the "Fragile 5" that will face significant headwinds because of important political elections and unstable currencies. The "Fragile 5" consists of Turkey, South Africa, India, Brazil and Indonesia. We expect to see countries like Poland and Greece benefit from an improving economy in Europe. Mexico may see considerable improvement from 2013 as significant reforms, most notably in the energy sector, could be the catalyst for significant upside. Mexico will also benefit from their proximity to the U.S. and our improving economy. As labor costs in China and other historically low-wage countries rise, U.S. corporations will look to Mexico as a potential location for new manufacturing plants.

As the market moves higher, it is important to remember the goals and objectives of your investments. Although we believe that in the current environment equities are an attractive asset class, we believe most of our clients should own some fixed income or other asset classes besides equities in order to manage portfolio risk. For current clients, if there have been any material changes in your financial life that may require a change in investment strategy please contact us so we can orchestrate necessary adjustments. If you are not a current client but would like to learn about how our expertise can help you meet your financial goals, please contact us to set-up a meeting.

— Robert Moyer, CFA, CFP®
Director of Research