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Market Commentary
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Overview

After years of government and fiscal stimulus following the credit crisis, 2013 may well be remembered as the year the US economy proved that it could again stand on its own two feet. The sequester, payroll tax cut expirations, Obamacare rollout, government shutdown, and yet another debt ceiling debate are estimated to have taken as much as 1.5% from GDP growth. Despite all these headwinds, the US economy began to grow at a reasonable rate, driven by potential game changers like the surge in domestic manufacturing and the energy renaissance. Unemployment ended the year at 7.0% (down from 7.8% a year ago) and third quarter GDP growth defied expectations at 4.1%. While there are ongoing concerns such as still high unemployment, the ending of government stimulus, and annual GDP growth below historical average, the equity markets showed strong gains for 2013 while bonds posted their first negative year in 10 years. Overall our portfolios remained conservatively invested in equities and short duration fixed income in order to be prudent about risks in the market while still capturing sizeable gains.

Domestic Equity

Due to the headwinds mentioned above, we started the year with a cautious outlook on US equities. Many speculated that the equity rally was Fed-driven, but improving economic data has been constructive for equities. Following a 16% gain in 2012, the S&P ended the year up over 32% supported by strong corporate earnings and the improvement in the US economy. Investors looking for substantial selloffs as buying opportunities were out of luck, as the nearly uninterrupted rally never lost more than 6% in a single decline. To take advantage of the improving US economy, we increased our equity exposure by allocating to US small cap growth stocks and increased our overall tilt to growth stocks. Small caps outperformed large caps, for the first time since 2010, by over 5%. Growth stocks outperformed value stocks across all market cap spectrums and particularly in the small cap space, in which growth stocks outperformed value by just under 9%. Looking ahead, data out of the housing, industrial, labor, and business sectors have been surprising to the upside, but we would like to see consumer and sales data improve to be confident that such a considerable equity rally can be sustained. The underlying economic story of the US seems stronger than a year ago, especially compared to the rest of the world, but it remains to be seen if equity markets have gone too far too fast and may face volatility in 2014.

International Equity

Although International Developed Equities lagged US Equities, the MSCI EAFE returned over 23%, mainly due to the improving sentiment in Europe and Japan's loose monetary policy. Despite high unemployment and severe austerity, Europe's GDP growth was positive for the 2nd and 3rd quarters for the first time since 2011 and it seems that a major collapse is unlikely. Japan implemented extreme monetary stimulus that included aggressive quantitative easing, increased public infrastructure spending, and yen devaluation in order to pull Japan out of its decade long economic malaise. Emerging markets had a difficult year largely driven by the slowdown in China's economic growth, with the MSCI EM Index down -2.3%. As a result, EM stocks are cheap on a relative basis but sentiment has turned negative. Unlike Emerging Markets, Frontier Markets continued to surge, posting returns of nearly 26%. Many Frontier Market countries are in earlier stages of development than Emerging Markets and have more favorable demographics, growth rates and infrastructure spending.

Fixed Income

Bond markets experienced turmoil following Ben Bernanke's initial comments in May about reducing the $85 billion bond buying program known as QE3 that many believed was suppressing interest rates and keeping bond prices high. From early May through September, the yield on the 10-year Treasury nearly doubled from 1.63% to just under 3% in an unprecedented move. Bond investments are typically considered to be safe havens but are also vulnerable to losing value when interest rates rise. Fixed income investments, especially those with high credit quality and higher sensitivity to interest rate movements (as measured by a longer duration), lost value sharply over the summer. Emerging market debt, longer maturity Treasuries, TIPS, and municipal bonds were especially hard hit by the combination of rising rates and liquidity issues as investors rushed to the exits. The Barclays Aggregate Index, a broad measure of US fixed income, was down -1.4% and 7-10 year maturity Treasuries were down over -4%. Prior to the Bernanke comments, we had positioned our portfolios to have shorter maturities and be more exposed to credit risk (via high yield and floating rate funds) which enabled us to achieve positive total return across our fixed income allocations despite the difficult environment. Strategic bond funds provided both alpha generation and downside protection during the fixed income selloff, as an example, the Goldman Sachs Strategic Income fund (GSZIX) generated a 6.43% total return.

On a positive note, when the Fed surprised markets and announced a taper in December, the volatility we had seen over the summer did not reemerge despite a modest rise in rates. That said, with yields still low on a historic basis and reduced liquidity in the fixed income market, we remain concerned that the upside in bonds is limited compared to the downside risk.

Alternatives

The alternative investments that we include in our portfolios are not meant to behave like either equities or fixed income but to act as shock absorbers and diversifiers against risks. While they can sometimes be a drag on performance when markets rally, alternatives have proven their value in the past when markets have turned. Managed futures have low correlation to both bonds and equities and were one of the few areas to see a positive return during the crash of 2008. While the asset class as a whole was essentially flat in 2013 as trend-following strategies underperformed, LTAM's fund selection process chose the AQR Managed Futures Fund (AQMIX) which was up 9.40% this year. Master limited partnerships (MLPs), which aim to provide both appreciation and income by investing in companies involved in natural gas pipelines, were up nearly 30% in 2013. The energy renaissance has lowered the cost of energy and made the US more competitive relative to the rest of the world. After a decades long trend in outsourcing of our manufacturing and labor, we are beginning to see a reversal as jobs and production move back to the US.

Real Estate

One of the Fed's concerns about tapering quantitative easing was its potential impact on mortgage rates and, thus, on the uncertain housing market recovery. Despite a substantial rise in mortgage rates, the housing market continued to show improvement through 2013. Home prices were up 13.3% year over year and housing starts jumped to 1.1 million, the highest annualized rate since 2008. Continued improvement in the housing market is a vital underpinning to future expansion as it drives construction and job growth.

Conclusion

Even with rising corporate profits and manufacturing growth, the resurgent American consumer is the missing piece in the US economic recovery. Since the Great Recession, companies have raised record amounts of cash but have been reluctant to use it to hire and invest due to uncertainty. As the labor market recovers, we are looking for the consumer to improve and believe the potential is there in the form of the energy renaissance, housing, and eventual wage growth. A "Year of the Consumer" would mean another positive year for US equities. Bonds may have seen the end of their 30 year rally, but still, along with alternatives, provide diversification and protection if the US economy fails to live up to its potential. LTAM has cautiously adjusted the portfolios as macro-economic improvements are recognized but, being mindful of all factors, we maintain a diversified portfolio to manage the unknown risks.