Market Update: 2013 Winds Down
December 2013
By Tim Courtney

We anticipated good performance this year from U.S. stocks based on last year's record breaking earnings levels. This gave us confidence that they would at least deliver returns in line with their historical range. But we have been pleasantly surprised by 25 percent gains.

The market is more often a tug-of-war between acceleration and underperformance than a smooth or predictable trajectory. That said, U.S. stocks have broken earnings records again this year, so continued price appreciation would certainly be warranted, though probably not to the degree we experienced this year.

Bonds, in our view, were not in position to reward investors this year. Overall, they behaved a lot like an expensive low volatility asset class should be expected. We feel validated on that stance, but it is worth noting that bonds did not have a deeply negative impact on investor portfolios either.

Looking to the New Year, our bond outlook remains close to a zero real return target when factoring for inflation. As an asset class, they still serve as an income source and provide essential stability and portfolio diversification, so we will continue to own bonds. Due to their costliness, however, we do not expect to commit much new capital here at these price levels.

Real estate has delivered 2013 returns in the 5 percent range thus far, solidifying the perception that it has recovered as an asset class. We would venture to guess that its 2014 returns will be similar and in line with its historical norm.

There is a possibility that Federal Reserve policy tightening actions could weigh negatively on real estate investments. Mortgage rates are still low by historical standards, and they stand to rise when the Fed begins unwinding, which would decrease the appeal to investors of housing and commercial property.

International stocks have been a source of above historical average performance this year as well, though to a considerably lesser degree than their U.S. counterparts. This was somewhat surprising – we thought they would be performance leaders given how inexpensively they are priced.

We view this as a positive since investors can still purchase these stocks cheaply, which means they can improve their future expected returns for next year and beyond. We think that would be a smart use of capital given the alternatives.

Fundamentally, if company profits keep growing, even at a slow pace, stock prices should keep rising in response. This, coupled with the lack of attractive alternatives, gives us confidence that U.S. and international stocks will continue to reward investors over time.

Of course, we have progressed more than two years without a meaningful stock market pullback, which is far past the average annual 10 percent correction. Investors should understand that the absence of a meaningful correction – perhaps even more than 2013's impressive performance – is truly atypical. But a significant price drop would only make stocks more attractive to buyers, so we would look at the event as a potential rebalancing opportunity.

Keep in mind, there is a precedent for this type of extreme positive performance after a severe decline like 2008-2009. Stocks have a major drop and spend several years recovering alongside the economy. We wrote earlier about the acceleration-underperformance tug-of-war, and even that can look smooth if the camera lens pulls back far enough. Believe it or not, some day we will look back and the average performance over the past decade will look pretty normal.

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