WealthHealth
Personal Wealth Management

January 2014

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 866.734.4227

www.wealthhealthllc.com
info@wealthhealthllc.com

Market Review

As we begin a new year, we find ourselves with a more sanguine big-picture view, at least over the nearer term, than we have had in some time. U.S. and global economic fundamentals gradually improved over the past year across a number of dimensions, and seem poised for continued improvement or at least stability in 2014. Unfortunately, the risks related to excessive global debt, subpar growth, and unprecedented government policy that we have worried about since the aftermath of the 2008 financial crisis still remain largely unresolved. But before we revisit our concerns, let's quickly run through some of the key positives and examine the returns of 2013 shown below.

At the broadest level, the growth rate for the global economy (which the International Monetary Fund estimates at 2.9% for 2013) improved in spots over the year and seems set to increase at least modestly next year. On a year-over-year basis, the U.S. economy grew at a real (i.e., inflation-adjusted) rate of around 2% in 2013 (through the third quarter), Europe finally emerged from recession, and the United Kingdom (2.6%) and Japan (2.1%) also generated modest but positive growth. Emerging-markets' growth was disappointing overall in 2013, but they should benefit from improved export demand in developed markets next year.

Index Returns *Through 12/31/2013*

			Annualized Returns		
Index	**QTD**	**YTD**	**1-Year**	**3-Year**	**5-Year**
S&P 500	10.51%	32.39%	32.39%	16.18%	17.94%
Russell 2000	8.72%	38.82%	38.82%	15.67%	20.08%
MSCI EAFE	5.71%	22.78%	22.78%	8.17%	12.44%
MSCI All Country World Index	7.31%	22.80%	22.80%	9.73%	14.92%
MSCI Emerging Markets Index	1.83%	-2.60%	-2.60%	-2.07%	14.79%
Barclay Capital US Aggregate Bond	-0.14%	-2.02%	-2.02%	3.26%	4.40%
Barclay Capital Municipals	0.33%	-2.55%	-2.55%	4.83%	5.89%
Dow Jones UBS Commodity	-1.05%	-9.52%	-9.52%	-8.11%	1.51%
HFRI Fund of Funds Composite Index	3.53%	8.79%	8.79%	2.43%	4.84%

The U.S. housing market continues to improve. For example, the S&P/Case-Shiller Home Price Index was up 11% from a year earlier, and CoreLogic reports the percentage of homeowners who owe more than their homes are worth fell to 13% (as of the third quarter) compared to 22% a year ago. Along with the surging U.S. stock market, the strengthening housing market boosted household net worth to new highs.

The U.S. labor market continues to gradually improve. Nonfarm payrolls (the net new jobs created in the economy each month) averaged a solid rate of nearly 200,000 per month during 2013 (although that is still below the pace of job growth during a typical economic recovery), and the unemployment rate dropped to 7% in November. Of course, much of the decline in the unemployment rate has been driven by a drop in the labor participation rate to 30-year lows (December Jobs Report only increased by 74,000 but the unemployment rate fell even further to 6.7%).

An improved debt and credit picture bodes well for consumer spending. The household debt/income ratio, a measure of the willingness and ability of consumers to increase their

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 866.734.4227

www.wealthhealthllc.com
info@wealthhealthllc.com

borrowing, has dropped 20% from its peak in 2007, and is now back where it was in 2003 and in line with its long-term historical trend. Meanwhile, household debt service and financial obligations ratios remain at historically low levels thanks to extraordinarily low interest rates engineered by the Federal Reserve, along with modest income growth. Furthermore, credit conditions (i.e., credit availability and cost), as measured by a variety of indicators, also continue to improve and remain relatively loose.

Inflation in the United States (and globally) is low and remains well-contained due to subpar growth and significant slack (excess capacity) in the economy.

Related to the inflation picture, developed country central banks are likely to remain highly accommodative at least over the next year or two in terms of holding short-term interest rates at extremely low levels, and in some cases also providing additional liquidity via quantitative easing bond purchases.

The U.S. federal budget deficit has come down sharply over the past year, and, with the recent bipartisan two-year budget agreement, the drag on GDP growth from fiscal policy tightening will be reduced in 2014. The two-year budget deal also greatly reduces the threat of another government shutdown during that span. However, another political fight over the debt ceiling remains a possibility later in the first quarter of 2014, and the need for a credible medium- to longer-term plan for government deficit and debt reduction remains.

While there are many macro positives that should not be ignored, it is important to remember that just because economic fundamentals are improving doesn't necessarily imply a strong year for the stock market. Valuations, earnings growth, interest rates, and overall investor sentiment/psychology (to name a few) are likely to be much more important drivers of market returns. The stock market is a discounting mechanism, so presumably it already incorporates positives like stronger economic fundamentals as this evidence comes out. There also remain significant macro risks and uncertainties that continue to influence our investment outlook and portfolio positioning as we look out over the next five years.

Wage growth and income growth in the United States remain subpar, although both have been increasing since late 2012. Weak income growth implies that consumer spending is likely to be subdued even as consumer deleveraging becomes less of a headwind. With consumption accounting for roughly 70% of U.S. GDP, this suggests a continued drag on economic growth absent a significant increase in consumer borrowing or reduced saving.

Overall U.S. debt levels remain very high and the projected growth in government debt and entitlement spending relative to GDP is still too high to be sustainable over the very long term.

Fed monetary policy is still far from normal and, although the QE taper has begun, there remains a great deal of uncertainty as to how the Fed will exit from its zero fed-funds rate policy and unwind its huge balance sheet without causing an economic or market shock. We think it's more likely than not that the Fed will err on the side of tightening monetary policy (raising rates) too late rather than too early, and that inflation will become an issue for the financial markets, which would be a negative for both stocks and bonds. But, given the Fed's policy pronouncements as well as their unpleasant experience with the market's reaction to last summer's "taper talk," we'd put a low probability on the Fed tapering or tightening too aggressively. But policy errors in either direction are certainly possible.

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 866.734.4227

www.wealthhealthllc.com
info@wealthhealthllc.com

Despite exiting recession in 2013, the Eurozone economy remains very weak, with structural imbalances between creditor and debtor countries that are still far from resolved. There remains a meaningful risk of deflation and a debt crisis stemming from the weaker peripheral countries. The banking system is undercapitalized and still in need of a credible region-wide banking union backstop. Meanwhile, Eurozone unemployment climbed to more than 12% in 2013 and is at much higher levels in the periphery, causing social unrest with the potential to spiral into a more serious crisis.

Risks in the financial system related to China's debt/infrastructure spending bubble remain. While it is encouraging to see China's new leadership acknowledging and addressing the economy's cyclical and structural imbalances, it is no guarantee they can successfully manage them without a major disruption.

Japan is the world's third largest economy, so the success or failure of "Abenomics" (prime minister Shinzō Abe's wide-ranging plan for reinvigorating Japan's economy) is a wild card that will have important global economic and market implications. We don't have a high-conviction opinion as to its ultimate outcome—just recognition that it's another manifestation of an unbalanced and weak global economy, and the extremely aggressive and unconventional policies that are being undertaken to try to turn things around.

Our Positioning and Outlook

The biggest contributor to our 2013 performance was our tactical underweight in core fixed-income, which we are maintaining heading into 2014. Our analysis continues to show that core bonds are likely to provide low single-digit annualized returns over the next five years. Therefore, we have a portion of our bond exposure to tactical positions in several non-core flexible and absolute-return-oriented fixed-income funds that have more flexibility to generate higher returns and navigate a challenging interest-rate environment.

Our actively managed growth stock funds were also significant positive contributors to performance in 2013. While we can never predict how our active managers will perform from one year to the next, we do intensive and ongoing qualitative due diligence to gain a high level of confidence in their ability to outperform over the longer term.

A contributing headwind to performance was our under-allocation to U.S. and developed market international equities. Our exposure to emerging-markets stocks and emerging-markets local-currency bonds also detracted from returns.

The degree by which U.S. stocks outperformed emerging-markets stocks and emerging-markets local-currency bonds in 2013 was unusual. We believe it was largely an overreaction to shorter-term factors and is not justified by longer-term fundamentals or valuations. Over the next five years, we believe that emerging-markets stocks are likely to generate better returns than U.S. stock across most scenarios. Therefore, we are maintaining our emerging-markets' stock exposure.

We are also maintaining our small position in emerging-markets local-currency bonds in our portfolio strategies because we expect mid-to high-single-digit returns from this asset class over the next five years. These bonds also provide some insurance against a decline in the U.S. dollar.

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 866.734.4227

www.wealthhealthllc.com
info@wealthhealthllc.com

Our alternative investment strategies are positioned to outperform core bonds with lower downside risk and volatility than stocks and low correlation to stocks and bonds. While full-year returns were no match for the 25%-plus returns from stocks, we continue to believe our alternative strategies can generate returns at least comparable to stocks over our tactical investment horizon and with much less risk.

Parting Thoughts

Looking ahead to 2014 and beyond, it appears that the economy is getting stronger. However most asset classes are currently priced for just fair or subpar longer-term returns in our view, and stock market sentiment in the United States is reaching optimistic extremes, suggesting vulnerability to a pullback. The timing of a pullback is not something we can predict, and with hugely accommodative monetary policies still in place against a backdrop of tame inflation and gradually improving global growth, stocks could continue to climb for a number of months. In this environment, we believe patience and a long-term perspective are especially critical. Investment opportunities are currently few and far between and big-picture headwinds remain and we believe this is not the time to be aggressively investing.

We appreciate your confidence and trust, and share our best wishes for a happy, healthy, and prosperous new year.

Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Wealth Health LLC with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.