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Economic Outlook 2014

A Long-Range Economic Look at the Year 2014

Economic *Outlook*

Economy

POSITIVES

- Low cost energy, cheaper commodities
- World leading technology will help U.S. economy outperform other Organisation for Economic Co-operation and Development (OECD) countries
- Today's pockets of strength: homes, autos, consumer goods
- Continued FED stimulus, low short term rates
- Deficit spending drives artificial demand for a limited time

NEGATIVES

- Higher taxes hurt growth
- Increasing regulations hamper GDP expansion
- Government actions ineffective and inefficient

The implementation of the Affordable Care Act has created confusion, lowered confidence and hurt business prospects. The economy has difficulty absorbing new regulatory initiatives and health care mandates without a negative impact on GDP growth. These programs offset the natural recovery which capitalistic systems enjoy after recessions. They increase dropouts from the labor force and foster a belief among many of Washington's hostility toward business. It is hard to see a sharp advance in U.S. economic growth in 2014.

All around the world, especially the developed world, economic slowdowns are the norm. World economic growth has been estimated to be only 0.5% in the second quarter and 0% in the third (OECD data). The United States has a leadership position but has limited success in correcting worldwide economic weakness. FED actions have made it increasingly difficult to achieve strong growth in poorer countries, leading to unemployment and unrest, which some call the "Arab Spring."

Stocks

POSITIVES

- Growth in capital goods helps Industrials
- Strong shipping demand benefits stocks
- Rising orders helps Manufacturing

NEGATIVES

- Mid-term election years generally have poor returns
- Historically, a new FED Chair is not favorable for stocks
- Excessive margin debt makes stocks riskier
- Valuations extended

The elephant in the room remains the tapering schedule of the Federal Reserve regarding Quantitative Easing (QE). This will likely be a case of "selling on the rumor" and may enable buying opportunities after tapering.

When tapering begins, those companies unloved by Wall Street (such as those with sell recommendations or with low estimated growth) tend to perform better than Wall Street's "darlings."

With energy prices likely to head lower (along with other commodities), the better industry plays will be refiners, energy service and energy transport companies. We would underweight oil exploration.

Homebuilders should provide opportunities so as long as traffic remains robust.

Initial Public Offerings (IPOs) are a risky investment as they typically lose money their first year. Technology stocks are pricey and speculative stocks are extended. We recommend excellent diversification by size and sector in view of the generous level of stock prices.

Following significant advances in 2013, it would not be surprising for equities to undergo limited corrections the next year, but we nevertheless anticipate 2014 to offer positive, not spectacular, returns.

Bonds

POSITIVES

- Inflation to remain stable
- New FED Chair's policies likely accommodative
- FED Funds Rate to remain low
- Municipal Bonds offer higher relative value today

NEGATIVES

- Historically low rates cause investors to "reach for yield" and incur higher credit risk
- QE Taper may shock longer term bonds
- Debt Ceiling issues delayed, not solved
- Price volatility is here to stay

Janet Yellen will become the new FED Chairwoman in early 2014. Judging from her writings, employment will be her major theme for the FED. The FED Funds Rate will remain low since unemployment is still elevated while inflation remains low.

On the other hand, the issue of tapering Quantitative Easing will greatly affect markets. Since 2008, cessations of QE have tended to cause interest rates to decline, not rise. But should the FED pull back too soon or too strongly, longer term interest rates could jump dramatically and would likely signal the end of our 30-year bond bull market.

To reduce volatility and preserve capital in the fixed income area, new strategies should be implemented in 2014. Investors should consider positioning portfolios with lower durations than in the past. New types of securities, such as Floating Rate Notes could be added. In order to earn income, investors may look to bonds with higher coupons. Many highly rated Municipal Bonds offer yields superior to that of an equivalent Treasury while their tax free income is an added plus. 2014 will likely prove to be a challenging year for bond investors.

International

POSITIVES

- Favor Taiwan, Thailand, Singapore, Hong Kong stock markets
- Chinese stocks to prosper if Xi Jinping's reforms are implemented
- Favor U.K. stocks
- Some foreign markets have attractive earnings yield along with GDP growth
- Volatile African stocks show potential

NEGATIVES

- Global growth hampered by austerity measures, high taxes, excessive regulations
- Commodity prices still correcting, pressuring many Latin American stocks
- Japan's Quantitative Easing creates huge risks for the global economy – avoid
- Euro zone recovery is very sluggish, hampering some emerging markets
- Rising external financing costs slow emerging market growth

The global economy is expanding, but the growth rate remains sub-par. Euro zone technocrats, ever-willing to sacrifice proven capitalist economics, push for higher taxes and excessive regulations that enshrine bureaucracy. However, this swamps economic revitalization. Meanwhile, China's reform-minded leaders fight epic battles to make China more competitive and productive. Japan embarks on a very risky course of Quantitative Easing and excessive sales taxes without any real economic reforms. Latin America faces a raft of problems: low commodity prices, protective practices and a return of socialist programs.

Taiwan, Thailand, Singapore, Hong Kong and other Asian countries have strong current account surpluses, high literacy rates and growing productivity. We see opportunities in emerging markets that have been unduly punished in 2013 and are at bargain prices. The United Kingdom has surprised many, at least the social-democrats on the European continent, with stronger than expected growth and offers some opportunity. Ireland's low tax rates continue to pay off.

Conclusions *for* 2014

For Business Executives

- Make capital investments now: Most firms enjoy abundant cash reserves
- Financing is available for sound ventures at attractive rates
- Heavy regulations favor limited and flexible workforce
- New technology can provide productivity gains
- Cheap energy supports the general economy and manufacturing

For Investors

- Positive but lackluster returns in stocks and bonds are likely
- Stocks will have higher volatility than 2013
- Opportunities in some developing Asian countries and Europe
- Bonds will be challenging
- Quality Municipal Bonds look relatively attractive today

For The Future

For our nation, there are too many positives to be pessimistic long term. Under our system, changes in government direction occur with some frequency and tend to reverse unproductive initiatives. The United States leads in technology and we have competitive advantages in raw materials. We don't expect early improvements, but after a time America will use its cheap, abundant energy, our leading technologies, and our natural bent for entrepreneurial action to move ahead and generate the kind of business opportunities that will lead to higher corporate profits and greater employment for our citizens.

- James Philosophy: To grow our clients' funds while stressing the preservation of capital
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