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EXECUTIVE SUMMARY

Thanks to steady growth in the U.S. economy and corporate earnings, accommodative monetary policy, and a resurgent housing market, 2013 was a great year to be invested in U.S. equities. The S&P 500 and Dow Jones gained 29.6% and 26.5%, respectively. The composite of RDM client accounts with RDM's equity strategy earned a 34.31% net return.

As we've forecasted in prior market commentaries, the Federal Reserve's decision to begin tapering its bond purchases was well received by the equity markets, largely because the tapering will be in small amounts commensurate with the moderately stronger U.S. economy. Additionally, corporate earnings achieved their forecasted growth in 2013 with U.S. companies continuing to maintain strong balance sheets first crafted in the early stages of the financial crisis recovery. Finally, the equity markets have seen a return of investor confidence, after several years of crises both domestically and abroad.

In 2014, we project that the U.S. equity markets should outperform other asset classes, while fixed income will underperform due to a rising interest rate environment. Historically, periods of moderate economic growth, slowly rising interest rates and strong corporate earnings have led to positive returns in the equity markets. After years of middling returns due to the financial crisis and economic and regulatory uncertainties created largely by political ineptitude, negative economic and political headlines have dissipated in recent months. We expect this trend to continue in 2014 in the lead up to the mid-term Congressional elections in November. Finally, we believe that gains in the housing sector and, relatedly, the labor market will pick up steam in 2014. With the Fed no longer serving as investors' primary focus, the markets will be much more dependent on the fundamentals of our economy, which we believe will continue to improve.

We do not expect the great returns of 2013 to be duplicated next year, but we still expect the equity markets to achieve returns in 2014 at least consistent with historical averages, if not better. Specifically, we predict the S&P 500 will be about 9% higher next year, based on our projected price-to-earnings (P/E) ratio of 16.5, in line with historical P/Es, and earnings of $121.71, consistent with consensus analyst estimates.

Within the equity markets, we favor those sectors that tend to outperform in periods of economic growth, such as the industrial, energy, materials and financial sectors. We particularly like the financial sector going into 2014. Financials tend to outperform in higher interest rate environments thanks to their ability, as interest rates rise, to widen the net interest margin between the interest that banks charge on loans and the interest that banks must pay depositors for their savings. With banks finally moving past much of the damage caused by the financial crises, we see this sector as most likely to outperform in 2014.

Our Forecast for 2014

As noted above, we expect the equity markets to approach or exceed historical averages, with gains of 7%-12% across the three major indices.

Figure 1. 2014 Projections	
S&P 500	2,008*
Dow Jones Industrial Average	17,737
Nasdaq	4,677
Inflation	1.8 – 2.0%
Ten Year Treasury Rates	3.5%
GDP	2.7 – 3.0%
Oil	$105 / barrel

*based on projected 2014 P/E of 16.5 and projected 2014 S&P 500 earnings of $121.71

S&P 500 aggregate corporate earnings are expected to grow approximately 11% to $121.71 per share in 2014, according to the consensus estimate of Wall Street analysts. Assuming the S&P 500 price-to-earnings multiple in 2014 settles around 16.5, which is closer to its historical average than the multiples reached in 2013, we project a 2014 S&P 500 target of 2,008. This represents approximately a 9% gain in the S&P 500. Given the likelihood of rising interest rates, which should hurt higher dividend stocks more than others, we project a slightly lower return of 7% for the Dow Jones Industrial Average, because of the higher concentration of defensive stocks in the Dow. Conversely, due to the higher concentration of technology and growth equities with less interest rate sensitivity in the NASDAQ, we project a slightly higher return of 12% for the NASDAQ. Figure 1 summarizes our projections for the equity markets and economic drivers in 2014.

Equities Outperformed in 2013 but Are Not in Bubble Territory

The equity market's performance in 2013 was exceptional by any measure. The S&P 500 and Dow both had their best performances in over a decade, setting 45 and 52 new highs, respectively, during the year. Even on the basis of inflation-adjusted performance – a more telling indicator of market performance – 2013 was a historic year, as the Dow surpassed its inflation-adjusted peak set in January 2000. While the S&P is still below its inflation-adjusted peak, it has more than doubled since the lows of the recession. All S&P 500 sectors were positive for the year, with two of our preferred sectors – financials and health care – among the leaders.

2013 was a strong year for the equity markets due to rising corporate earnings and increased investor confidence, exemplified by significant price-to-earnings multiple expansion over last year. In total, earnings for S&P 500 companies were up about an estimated 6% this year, due in large part to companies cutting costs and becoming more efficient (as opposed to strong revenue growth). Third-quarter corporate profits on an after-tax basis were a record 11.1% as a share of GDP, according to the U.S. Department of Commerce. In other words, while overall growth remained tepid, companies still found a way to squeeze out profits. Companies will need to increase top line growth for this bull market to continue, but in 2013, increased bottom line growth was sufficient to drive the market to record highs.

While strong corporate earnings growth this past year was not entirely surprising given underlying economic growth in the U.S., the multiple expansion caught many by surprise and significantly contributed to the outperformance of the S&P 500 compared to analyst estimates at the beginning of the year. Some of the main reasons for this P/E expansion are optimism for continued economic recovery and rising demand for equities due in part to the Fed's easy money policies, as we discuss below.

The market's strong performance led to increasing questions about whether equities are currently overvalued. We acknowledge that these concerns are valid, as the market did not suffer any significant corrections in 2013. But, we believe equities are fairly priced based on 2013 corporate earnings, and valuations are reasonable when viewed in a historical context and in the context of growing corporate earnings. For example, the forward S&P 500 PEG ratio, or the ratio of the S&P 500's forward P/E

multiple to projected future corporate earnings growth, currently sits under 2.0. This is one of the lowest forward PEG ratios over the past two years. Further, in actual stock bubbles, such as the tech bubble in the early 2000s, P/E multiples were significantly higher than at the end of 2013.

In short, we continue to believe that equities are the best place to invest, with fixed income likely to continue to suffer from a rotation towards equities.

A Review of Significant Events Affecting the U.S. Equity Markets in 2013

Despite the strong market performance, the U.S. and world economies were in many ways a mixed bag in the Fourth Quarter and in 2013 as whole.

1. **The Fed announced a tapering of its $85 billion monthly bond buying program.**

The Fed's monetary policy dominated the financial news in 2013. In an effort to lower interest rates and reduce unemployment, the Fed had been buying $85 billion of U.S. Treasuries and mortgage bonds per month throughout 2013. However, in December 2013, the Federal Open Market Committee announced it would reduce its asset purchases by $10 billion per month beginning in January 2014. The immediate impact was not the market correction that some had feared – instead, the equity markets soared after the announcement. The reaction was a result of two factors: the market was prepared for a moderate slowdown in the Fed's bond buying and the Fed committed to keeping short-term rates near zero until the jobless rate is "well past" 6.5%. The Fed clearly believes that *deflation* and stagnant growth are far bigger concerns than the *inflation* that could result from its easy money policies. The net result is that the Fed's easy money is here to stay until well into 2015.

We are pleased that the Fed is slowing its bond buying program and that the market responded favorably to the Fed's announcement. We prefer stock price to be driven by earnings and fundamentals, not speculation on Fed policy. And, while inflation does not appear imminent, we believe that at some point all of the cash injected into the system and sitting as commercial bank reserves at the Fed will have to be reinvested into the economy. When the U.S. and world economy truly begin moving on all cylinders, the continued use of easy money policies throughout the world could be the fuel for crippling inflation down the road. Beginning to slow (albeit slightly) the money printing machines now ultimately is in the best interests of the economy going forward.

Now that the Fed is slowly taking its foot off the accelerator, the bigger question is whether the Fed's quantitative easing (QE) has had a significant positive impact on the economy as a whole. The housing market no doubt benefited from lower interest rates. The stock market also benefitted both from lower interest rates and from the influx of cash, much of which was returned to shareholders in the form of dividends and stock buybacks. The wealthy – who are more likely to own homes and equities – likely reaped the biggest benefits from QE, at least in the short term. However, unemployment is still high and GDP is sluggish, so an argument could be made that QE failed to significantly stimulate the economy. (Of course we cannot know what unemployment and GDP would have looked like without QE.) Ultimately, a final analysis of QE can only be made years from now with the benefit of hindsight: QE may be seen as a necessary step to save the economy from going into another Great Depression and/or as the cause of inflation years down the road.

2. **Congress finally reached a budget deal but regulatory uncertainty remains.**

The end of 2013 also saw a budget deal for the first time in years – and without the last minute theatrics that have become common in Washington. In a nutshell, the budget deal reduces the automatic spending cuts that were set to take effect next year as a result of the sequestration by $62 billion, paying for those additional costs by raising $85 billion through higher security fees for airline passengers and less generous retirement benefits for federal workers, among other things. The deal is small: it raises spending from $967 billion to $1.012 trillion in fiscal 2014 and $1.014 in fiscal 2015. And, it does nothing to address the larger issue of spending cuts for Social Security, Medicare and other entitlements.

It does have at least two positive effects, however.

First, the deal may have a small impact on economic growth in 2014 by reducing the fiscal drag caused by sequestration. Many economists believe that U.S fiscal policy – both spending cuts and increased taxes – cut as much as 1.5% from the U.S. growth rate in 2013. With no new taxes scheduled for 2014, the drag from fiscal policy was expected to decline to .5%. Now, some economists believe the new budget deal actually will boost growth by .25% in 2014 – a small bump, but maybe all that can be expected from Congress under the current divided government.

Second, it suggests that Democrats and Republicans can work together on fiscal policy. The increasingly bitter and personal disputes between Democrats and Republicans in Washington are a hindrance to the U.S. economy. Indeed, a major reason the Fed did not act earlier to reduce its easy money policies was to compensate for Congress' inability to agree on any tough fiscal policy decisions to grow the economy. The budget deal is thus a small step in the right direction.

While the budget deal was a rare positive development out of Washington, regulatory uncertainty continues to hamper the markets. We have noted before that the political dysfunction in Washington has a negative effect on the market and the economy as a whole. The impact is felt not just through ill-advised legislation, but also through regulatory uncertainty. Businesses are reluctant to hire workers and increase capital expenditures if they are not confident about the direction of the economy and the rules that will be governing their businesses. A perfect example of this is Obamacare. Confusion over the Obamacare mandate has led many employers to hire part-time, rather than full-time, workers; at one point this past summer, three out of every four new hires were on a part-time basis. According to media reports, some businesses held their headcount below 50 and others cut back their work week for current employees to under 30 hours to avoid providing health insurance for employees. Our intent is not to take a political stance on the controversial issue of Obamacare, but only to note that Obamacare is a major distraction for government and business from the important task of growing the economy.

Regulatory claims and lawsuits arising from the financial crisis also made headlines in 2013. JP Morgan in particular often was on the receiving end, culminating with a $13 billion settlement in November to resolve the government's claims arising from the bank's mortgage bond sales prior to the financial crisis. According to Bloomberg, the six biggest U.S. banks, led by JPMorgan and Bank of America, have incurred more than $100 billion in legal costs since the financial crisis – more than all of the dividends paid to shareholders by these banks in the past five years. This stat highlights that the government's pursuit of the big banks in many ways represents a large wealth transfer from bank shareholders to the government and political cronies. Going into 2014, the government will continue to play an even more prominent role in our banking system with the implementation of the Volker Rule, which bans certain proprietary trading by the banks.

We do not dispute that regulation of banks is needed and acknowledge that excessive risk taking by some financial institutions helped fuel the financial crises. But, we believe the time for demonizing the

big banks is over and that the focus should be on growing our financial system going forward. A strong financial system is the cornerstone of a vibrant economy.

3. **U.S. GDP continues to expand, while the world economy stagnates.**

The U.S. economy continued to grow at a moderate pace in 2013. GDP is estimated to have risen between 2%-3% in 2013, due largely to 4.1% annualized growth in the third quarter, which was the fastest pace in two years. Much of this third quarter growth was due to increasing inventories, which accounted for nearly 40% of the GDP growth rate. Growth from expanding inventories is transient, as businesses have to sell off these inventories, and thus this growth is not expected to continue in the fourth quarter.

However, some of the growth was due to increased consumer spending, which rose 2% in the third quarter, 0.4% in October and 0.5% in November, despite stagnant wages. This is good news as more than two-thirds of GDP comes from consumer spending. Consumers are increasing their spending due in large part to the "wealth effect" created by rising housing and stock markets. There is thus a positive feedback loop, with increasing consumption leading to a growing economy, which in turn benefits the stock and housing markets, leading to more consumption. Indeed, one of the sectors that benefitted most from the uptick in consumer confidence and spending was the Consumer Discretionary sector, which was a top sector in the S&P 500 in 2013.

While GDP, driven by consumer spending, is increasing, employment remains a mixed picture. On the one hand, the unemployment rate ticked down to 7%, a five year low. Yet, there is significant concern that much of this drop is due to workers leaving the labor force – either because of early retirement or because unemployed workers have given up looking for work. The civilian participation rate is now at 63%, near a 35 year low. The U6 unemployment rate, which includes people who recently gave up looking for work as well as those who can only find part-time positions, is at 13.2%.

For the employed, wages remain stagnant as companies are reluctant to raise salaries when the labor market is relatively weak and employees have few places to go or lack the confidence to look for new jobs. Personal income rose just 0.2% in November after falling 0.1% in October. While companies are sitting on high levels of cash, they are increasing returning money to shareholders through dividends and stock buybacks, rather than raising salaries or investing in activities that would create new jobs. Share buybacks and dividends totaled $207 billion in the third quarter, the highest level since the end of 2007. The return of cash to shareholders boosts share prices and is a big reason for the stock market performance this year. But, for long term growth to truly accelerate, companies will need to begin spending more on capital improvements, research and development, and hiring.

The rest of the world is doing little to help U.S. economic growth. For example, the Euro zone economy remains stuck in neutral. The region officially exited from recession in the second quarter and is now in a very early expansionary phase, with the major countries in the region growing at less than 1%. The stabilization of the Euro zone is a positive for the U.S. and world economy, but growth at such anemic rates has almost no impact on U.S. GDP. In fact, one study concluded that growth in the Eurozone at a rate of 1% would have only a .3% impact on U.S. GDP.

Similarly, China, the world's second-largest economy, grew at around 7.6% in 2013, which is .1% ahead of the government's target but near the weakest pace since the Asian financial crisis in 1997-1998. The Chinese government likely will keep its 7.5% target for GDP growth in 2014. Exports to China account for only about .7% of U.S. GDP so, again, China GDP growth would have to return to the double-digit rates of prior years to have any meaningful impact on U.S. GDP.

Stay Bullish on Equities in 2014 but Do Not Expect a Repeat of 2013 Returns

We believe that several factors that contributed to the strong equity returns in 2013 should persist in 2014:

1. **The Fed will continue its accommodative monetary policy in 2014 despite tapering its quantitative easing program.**

As discussed above, the Fed has provided forward guidance that it will continue to reduce its bond purchases slowly in 2014, assuming the economy continues to improve as projected. The Fed's tapering of bond buying does not mean that the Fed is ending its accommodative policy stance. Rather, the Fed will maintain near-zero short-term interest rates until at least 2015 and continue to utilize quantitative easing as necessary to depress long-term interest rates. The Fed's decision to taper its bond purchases should be viewed by long-term investors as a reflection of the economy's improvement and self-sufficiency. In 2014, economic fundamentals will increasingly be responsible for market returns, as the Fed's bond buying program slowly, and predictably, fades from the market picture.

2. **Popular outrage over the political dysfunction in Washington during 2012 and 2013 will cause both parties to retreat from crisis negotiating tactics.**

Political dysfunction between the Obama administration and Republican congressional leaders has been a major hindrance to market confidence since at least 2012. From the debt ceiling to the Fiscal Cliff to the government shutdown, the country has been run on a crisis by crisis basis over the past two years. This experiment in government by crisis has undoubtedly hurt both political parties in the polls ahead of the 2014 mid-term congressional elections – while many Americans blame the Republicans for the government shutdown, President Obama's approval ratings sunk in 2013. In 2014, both parties will likely do their best to avoid major crises in the run up to the November elections.

3. **The U.S. economy will continue to experience moderate growth while the Eurozone will embark on an economic recovery of its own.**

We expect the U.S. economy to continue its moderate growth into 2014. The U.S. corporate sector remains healthy, with less leverage and stronger balance sheets than before the financial crisis, while U.S. consumer spending will be buoyed by increased household wealth thanks to gains in equities and housing. The improving housing sector will also continue to support the economy by supporting employment growth in 2014, causing the unemployment rate to tick below 7% during the year. The consensus analyst forecast for 2014 is around 2.5% GDP growth, lower than the Federal Reserve's projection of 2.8 – 3.2%, but comparing favorably to 2013 growth of just over 2%.

Despite the positive support for the equity markets in 2014, there are several factors that could cause the markets to achieve lower returns than 2013:

1. **The Fed may become over-aggressive in reducing its quantitative easing purchases.**

Assuming the Fed continues tapering its purchases at a moderate rate, the markets should handle it in stride. Under this scenario, interest rates would slowly rise, yet they would remain low enough to stimulate economic growth by benefitting the housing market (via low mortgage rates) and corporate borrowing. However, acceleration in the rate of tapering or a pre-mature hike in short-term interest rates could spook the markets in 2014 and potentially stall economic growth.

2. **The 2014 mid-term Congressional elections could be received unfavorably by the markets, particularly if the outcome signals greater political dysfunction in the future.**

While the political dysfunction in Washington has eased somewhat towards the end of 2013, there is no guarantee that all will remain calm after the 2014 mid-term congressional elections. Specifically, if candidates viewed as extremists perform surprisingly well in the elections, the markets may react negatively in expectation of renewed brinkmanship for the remainder of President Obama's term. Victories by more moderate candidates would likely support more Congressional harmony.

3. **Congress will need to agree on a solution for the debt ceiling, which must be raised by February 7.**

While Congress passed the Ryan-Murray budget compromise at the end of 2013, ostensibly averting a government shutdown for the next two years, Congress did not resolve the upcoming debt ceiling deadline. By February 7th, Congress will need to agree on whether to raise the debt ceiling and by how much. Already, some Republicans have signaled that they will seek tax and entitlement reforms in exchange for agreeing to raise the debt ceiling, topics that President Obama has previously asserted he will not negotiate over. A new debt ceiling crisis in 2014 will be received poorly by the markets and could dampen confidence in Washington's ability to maintain the nation's credit rating and stay out of the way of the economic recovery.

4. **U.S. companies' earnings may suffer from lack of top line growth.**

U.S. companies have been slashing costs and operating more efficiently since the financial crisis. At some point, though, these measures will be insufficient to drive earnings, and companies will have to rely more on revenue growth. There is a downside risk that 2014 earnings will suffer because revenue growth slows and companies are unable to find additional ways to cut costs. If so, our predictions for 2014 returns may be overly optimistic.

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Finally, and most importantly, we would like to thank our clients for your continued trust and confidence in RDM Capital. We wish all clients and friends a very happy and prosperous New Year!!!

As usual, all comments are welcome.

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