



**Artemis**

FINANCIAL ADVISORS LLC

# Market Outlook & Strategy

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### *Executive Summary*

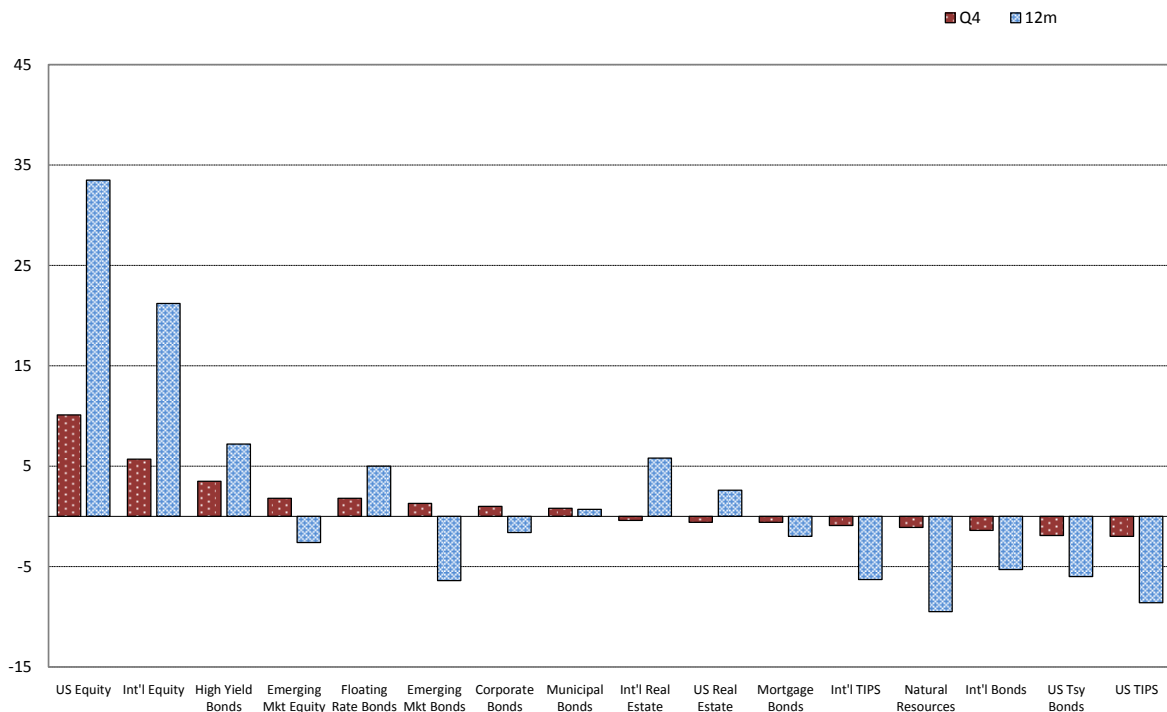
- **Equity markets continued their march upward in Q4, with the U.S. market up a very impressive +10.1% and international developed markets up +9.3%.** In contrast, emerging markets fell further behind, delivering only +1.8%. All of this came after a shaky start to the quarter with the U.S. government in shutdown for the first 16 days of October.
- **In contrast, returns in most segments of the bond market resumed their downward trajectory in Q4** and by the end of the quarter, the U.S. 10-year Treasury yield had risen to 3.03% from 2.61%.
- **On a total calendar year basis, the U.S. market had its best year since 1997, increasing +32%, and Europe wasn't far behind at +25.2%.** In contrast, emerging market equity returns were highly disappointing at -2.6%, and gold got crushed, falling -30%.
- **Taking a retrospective look at the year, Artemis got most of its calls right, except for emerging markets, where we thought growth would accelerate and lead to equity market momentum.** Following the Fed's misstep in late May, we not only cut our losses but moved into an underweight position in both emerging market equity and bonds. **In total, Artemis portfolios performed extremely well in 2014, handily beating their benchmarks.**
- **Artemis is taking a positive view on 2014 and is positioning its portfolios accordingly.** We think U.S. economic growth may accelerate this year (much of which is already priced into the market, given the run up in 2013), and Europe will continue to recover. We also expect that the overall stance of the Federal Reserve will remain highly stimulative, despite its planned tapering.
- **In contrast, we are not bullish on emerging market stock and bonds.** For a variety of reasons, we believe that emerging markets are still vulnerable in the short term and, therefore, are likely to continue to underperform their developed market counterparts.
- We have no immediate plans to adjust our fixed income strategy, which served us well in 2013.



**Markets in Review**

Equity markets continued their march upward in Q4, with the U.S. market up a very impressive +10.1% and international developed markets up +5.7%. In contrast, emerging markets fell further behind, delivering only +1.8%. All of this came after a shaky start to the quarter with the U.S. government in shutdown for the first 16 days of October.

Figure 1: Asset Class Performance in Q4 2013 (percentage points)



The markets were underpinned by some strong economic data from the U.S. Data released throughout the quarter showed the U.S. economic backdrop looking ever more robust, with the third quarter GDP growth figure of 4.1% comfortably outstripping the previous estimate of 3.6%.

The strong macroeconomic data helped to convince the U.S. Federal Reserve to begin tapering its quantitative easing program in January, although strongly emphasizing that short-term interest rates would remain low “well past the time that the unemployment rates declines below 6.5%.” The tapering news was interpreted as a sign the U.S. economy



was strong and getting stronger, and added further impetus to the stock market. By the end of the quarter, the S&P 500 hit an all-time high, culminating in the best calendar year for U.S. stocks since 1997.

European markets continued to show strength, helped by accommodative monetary policy from the European Central Bank (ECB). However, data showed that euro zone growth slowed to 0.1% in the third quarter after posting an increase of 0.3% in the second quarter. German economic data continued to be very strong, and the Dax ended the quarter up +13.3% in USD, beating every other major global market.

Asian equities also posted positive returns in Q4 as the stronger global outlook boosted sentiment in the region. Markets appeared to take heart from the outcome of China's Third Plenum of the country's leaders, which saw a raft of reforms and policies outlined for implementation; some analysts hailed it as historically important, comparable to Deng Xiaoping's opening up of the Chinese economy in 1978. Other emerging markets largely underperformed, with problems coming from Turkey, Russia, Brazil and several other Latin American countries.

After a reprieve in Q3, returns in most segments of the bond market resumed their downward trajectory in Q4 as the prospect of the Fed tapering its asset purchases continued to weigh negatively. By the end of the quarter, the U.S. 10-year Treasury yield rose from 2.61% to 3.03%. As in other recent quarters, corporate bonds outperformed government bonds, with high-yield debt posting a solid +3.5% gain during the quarter.

In summary, 2013 appears to be one for the record books, with the U.S. market up just over +32%. Small-company stocks did particularly well (our favorite small-cap value fund gained +42.3% for the year), and European equity gained +25.2%. Among the worst-performing assets were those of emerging markets, which suffered from investors' worries about structural imbalances and the impact of any reduction in the Federal Reserve's asset purchase program. Commodities did not fare much better, continuing their downward descent, and gold got crushed, declining almost 30% in its worst year since 1981.

Finally, most fixed income sectors were dragged down by the "taper tantrum" that occurred in May-June. But it should be noted that apart from 30-year Treasuries (down -15.0% for the year); TIPs (down -8.7% for the year), and 10-year Treasuries (down -.7.8%), most other sectors returns were in the -1%-3% range, reminding us that a bad year in bonds isn't so bad. In the U.S., only high yield and floating rate bonds turned in positive returns at +7.4% and +2.4% respectively. (See Figure 1.)



## **2013 Retrospective**

Before looking forward to next year, it is always useful – and sometimes humbling – to take a look back at how we thought the prior year would evolve and how the investments we made (or didn't make) performed. Coming into 2013, we were less concerned than many that the fiscal drag associated with tax and spending reforms would derail the U.S. economy. Instead, we expected the economy to be supported by continuing housing market recovery, relatively low energy prices, and employment growth.

In addition, we expected emerging market growth to accelerate, especially in the Asian emerging economies, benefiting from renewed growth in China. We believed that both European and emerging market returns had a fighting chance of outpacing U.S. returns, as valuations in both areas were compelling. We were particularly bullish on Germany because we felt the German economy was best positioned to take advantage of a resumption in global trade. We also felt investing in Germany would be a less risky way to rebuild our position in Europe. We also expected the euro to remain intact, but did not expect to see much growth from the region.

Finally, as for fixed income, we believed short-term rates would stay at zero through 2013 at least (due to very unambiguous signals from the Fed) and did not foresee a tapering of quantitative easing. Nevertheless, we were concerned about the interest-rate sensitivity of bonds and were also worried that the rally in high-yield bonds in 2012 was looking long in the tooth.

With a notable exception, we were largely right in 2013. The U.S. continued to be the growth leader in the developed world, and Europe muddled through and stabilized somewhat.

The surprising outcome for us was how poorly emerging markets performed, due in part to capital flight engendered by the Fed's tapering announcement in May, but also to increased political instability in several countries (Turkey, Iraq, Egypt, Thailand, to name a few) and a cyclical decline in corporate productivity and profitability (more on this in the next section). Of course, it was also surprising to see the U.S. post +32% equity returns -- as virtually no one was predicting results anywhere close.

Our investment stance reflected our views: we increased our overweight equity exposure in the U.S. (largely by not rebalancing), and we steadily increased our exposure to Europe (with a large overweight in Germany) and other international developed markets



throughout the year. Our focus on Germany proved to be a strong winner, as the index return for Germany was +31.3% for the year.

In contrast, we modestly increased our exposure to emerging market equities early in the year, which did not perform as hoped. Following the Fed's ill-fated tempering announcement in May, we not only cut our losses but changed course and went to an underweight position in both emerging market equity and debt. This released more funds for increasing our exposure to Europe, which has paid off handsomely.

We also seemed to make some good calls on the fixed income front, staying with our overweight position in high-yield debt (despite concerns the asset class was overbought) and initiating a fairly robust tactical position in floating-rate bonds.

Finally, as before, we were proactive about getting all cash to work, as we continued to believe the opportunity costs of letting cash sit idle "waiting for better opportunities" was too high. We still think so.

In summary, Artemis portfolios performed very well in 2013, handily beating our benchmarks.

### **Outlook for 2014**

Around this time last year, I wrote to all Artemis clients to explain why I did not think U.S. equity was overvalued and, therefore, why I was not planning to reduce the overweight position in virtually all client portfolios. I still believe this to be the case for 2014.

It is true that U.S. market has gotten more expensive over the last year, particularly in light of slowing earnings growth. Still, the current forward P/E on the S&P index is only at 15.4, below its 15-year average of 16.2, and many other conventional measures of valuation are also still reasonable (Figure 2).



Figure 2: S&P 500 Index: Stock Valuation Measures

S&P 500 Index: Valuation Measures		Historical Averages					
Valuation Measure	Description	Latest*	1-year ago	3-year avg.	5-year avg.	10-year avg.	15-year avg.
P/E	Price to Earnings	15.4x	12.6x	13.0x	13.1x	13.9x	16.2x
P/B	Price to Book	2.7	2.1	2.2	2.2	2.5	2.9
P/CF	Price to Cash Flow	10.6	8.7	8.9	8.6	9.5	10.8
P/S	Price to Sales	1.6	1.2	1.3	1.2	1.3	1.5
PEG	Price/Earnings to Growth	1.5	1.3	1.2	2.1	1.7	1.6
Div. Yield	Dividend Yield	2.1%	2.4%	2.2%	2.2%	2.1%	1.9%

Source: JP Morgan

Of note, however, is that stock valuation alone is not the only determinant of equity returns, and, indeed, is a rather poor predictor of returns over short time frames (Figure 3 next page). With earnings growth slowing in 2013, however, and margins at very elevated levels, **it will be critical for earnings and, thus, the stock market for economic growth to pick up steam in 2014.**

Fortunately, we do expect U.S. growth to accelerate this year (as do most economists) to a 3%-3.5% range. This is a good bit faster than in recent years, but it is important to note that the economy has been held back by significant fiscal drag, and this will become a diminishing problem. According to IMF estimates, fiscal restraint knocked 1.3 percentage points off the 2013 U.S. growth rate. This suggests that growth would have been around 3% in 2013 in the absence of any fiscal drag. And the fiscal effect is about to go into reverse due to the latest budget deal, which could add more than 1 percentage point to the growth rate in 2014 and a further modest amount in 2015.

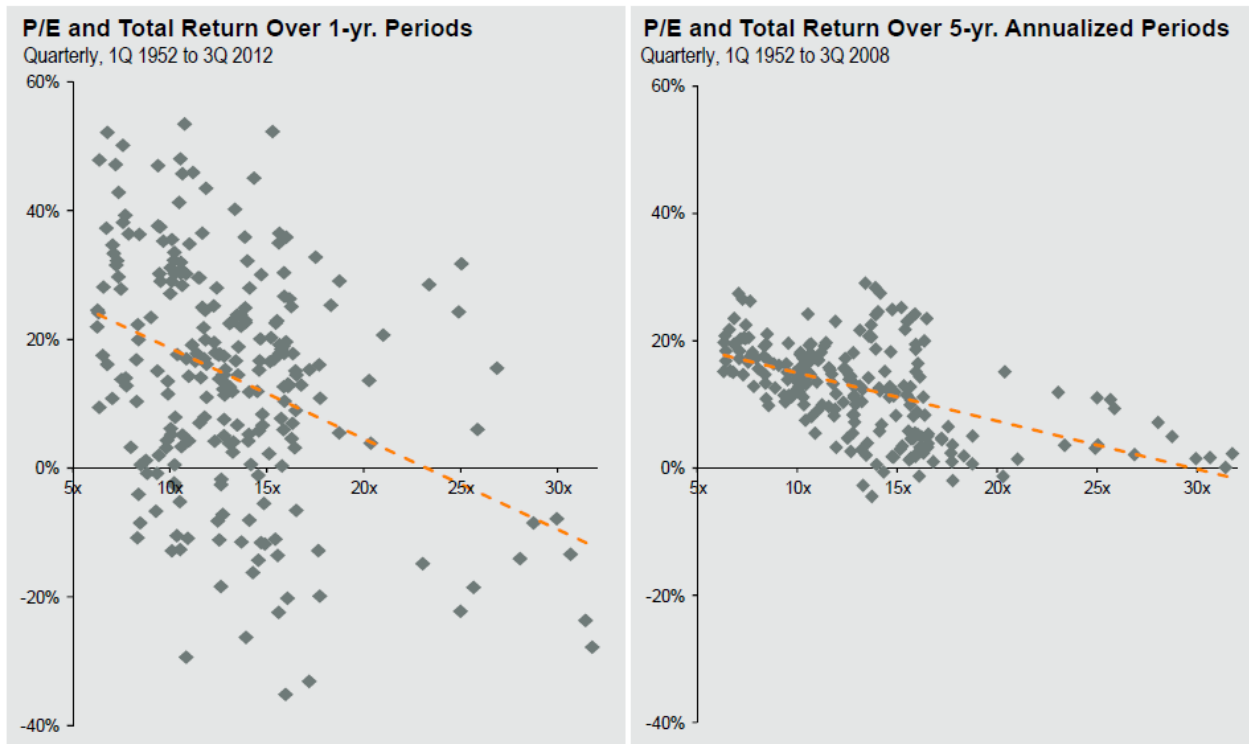
Other likely positive contributors to growth in 2014 include increased consumer spending due to the so-called “wealth effect” (the tendency for consumers to spend more when they are feeling more wealthy due to rising home prices and rising stock markets). Household net worth has increased sharply in recent years, and with an improving job market and projections for continued housing appreciation in 2014, household net worth should continue to rise in 2014. Also, 2014 may well be the year that companies start spending on capital goods again to meet growing consumer demand.

The final expected contributor to growth in 2014 is a nascent synchronous global expansion taking root. For the first time since the 2008 Great Recession, 2014 may be the year in which we see all major global economic blocs (U.S., Europe, China and Japan) expanding



simultaneously, which would increase global trade and demand. As highlighted previously, the eurozone has stopped contracting, and Japan should see a continuation of the positive momentum from last year. Finally, China's supply side reforms mean that growth will not surge back quickly, but the cyclical trough was likely reached several months ago.

Figure 3: P/E Ratios and Equity Returns



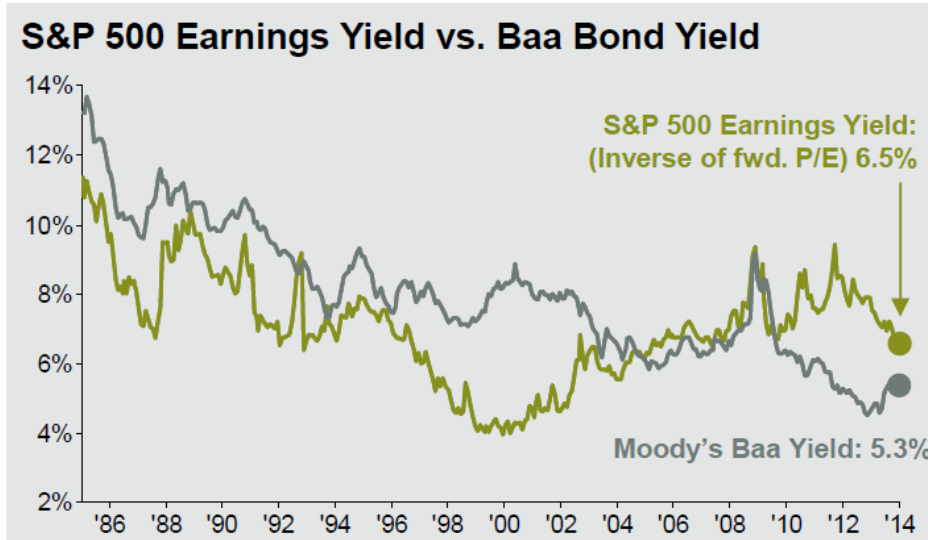
Source: JP Morgan

And let's not forget the Fed. While the Fed is likely to continue the slow tapering of asset purchases in 2014, the overall stance of the Fed will remain highly stimulative, and interest rates will remain low. As a result, while U.S. stocks are no longer cheap on an absolute basis, they will continue to be cheap relative to bonds (Figure 4).





Figure 4: Equity vs. Bond Yield

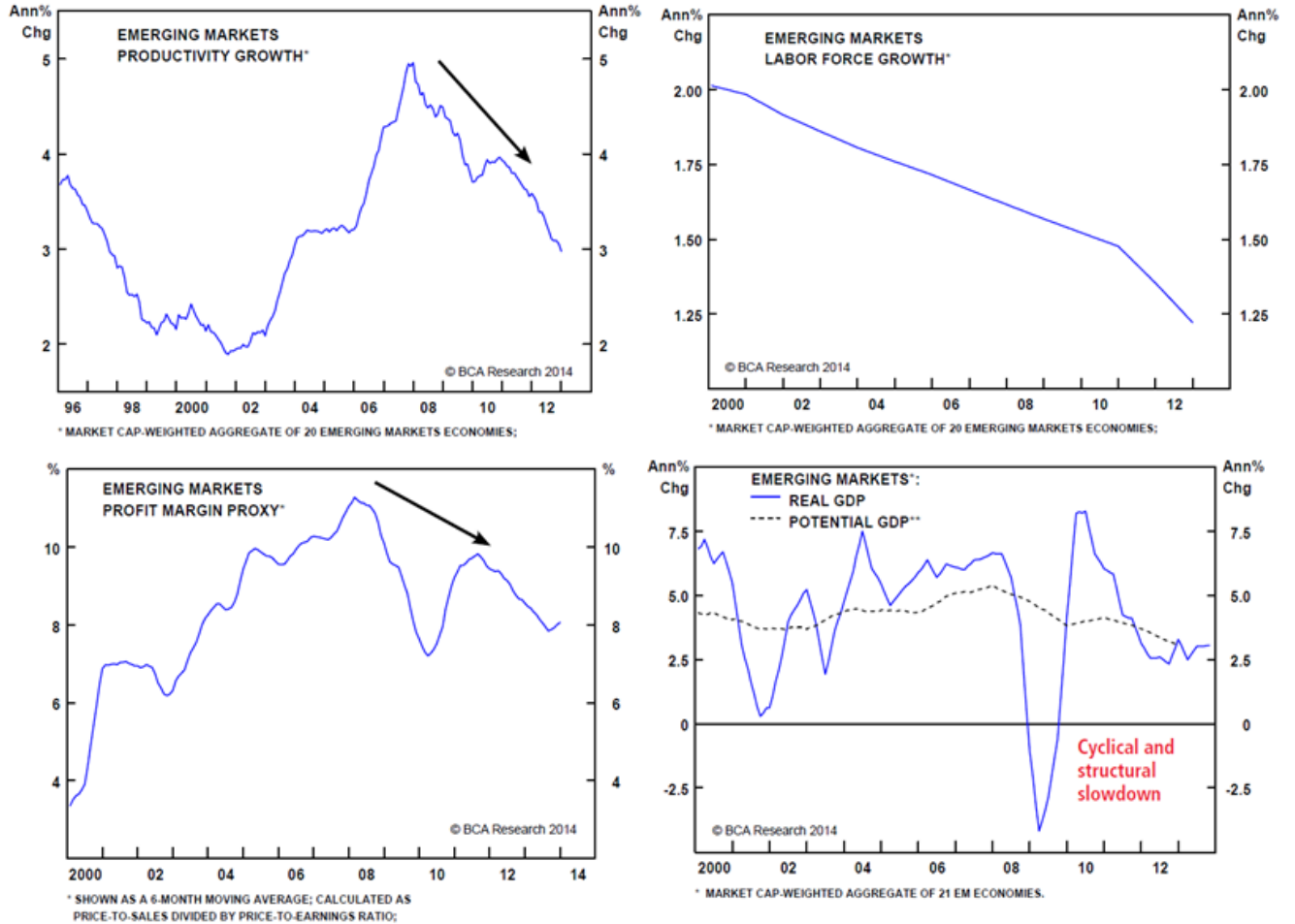


Source: JP Morgan

What about emerging markets? As we know, the gap between growth in the emerging and advanced economies widened significantly in the 2000s, fueled by a booming China and rising commodity prices. Also, many countries had adopted pro-growth reforms after the 1990s Asian crisis. But the rapid growth was unsustainable and exaggerated the emerging economies' underlying performance. Worrying trends have included a marked deterioration in corporate productivity and profitability and a slowdown in labor force growth in recent years (Figure 5). These have led to a slowing of growth resulting in poor equity returns. Combined with the fact that foreign capital is not likely to rush back in in 2014, and the fact that valuations are not as attractive as they appear, these developments suggest that emerging markets are still vulnerable. We are concerned that they are likely to continue to underperform their developed market counterparts in the near term.



Figure 5: Emerging Markets: The Bear Market Story



Source: Courtesy of BCA Research

The outlook for fixed income in 2014 is muted at best. A reasonable expectation for nominal 10-year yields on Treasuries is to move to about 4% (yield is 2.85% as of this writing) within the next two or three years. On that basis, they are not a very appealing investment. With high-yield debt, there appears to be some evidence of an overshoot. However, as long as the Fed continues to hold short-term interest rates at zero, high-yield will continue to do well.

Finally, inflation and interest rates will remain low. Inflation will be muted because there is still plenty of spare capacity across much of the developed world and virtually no sign of



wage pressures. Interest rates will remain low because the Fed has committed to keep interest rates low “for the foreseeable future.”

## **Risks to the Outlook**

Given the strong consensus that bonds are going to have another tough year (although unlikely to be as tough as last year), why own much fixed income right now? The short answer is, of course, that something could go wrong and send equity markets into a tailspin. We always face geopolitical risk, and that’s hardly different this year (e.g., the daily news out of the Middle East presently is downright grim) than in the recent past. But what is different this year is the lack of major macroeconomic risks, which, in and of itself, can help to propel equity markets.

This is not to say there aren’t any risks out there. The IMF, for example, is becoming increasingly worried about the prospect of deflation in Europe, which would derail Europe’s nascent growth trajectory. With deflation, consumers and businesses would be all too happy to delay spending on the prospect that prices will be lower in the future. Deflation would also make it more difficult for peripheral countries in Europe to pay off their debts, as debt would become more expensive. We remain hopeful, however, that the European Central Bank (ECB) would take timely action to further stimulate to ensure this doesn’t happen.

Another risk worth paying attention to is Japan. Japan has embarked upon an aggressive monetary policy designed to bring back inflation, and we still do not know whether the experiment is going to be successful. The worst-case scenario is the policy stokes high inflation without growth. If so, then this hugely indebted country could see a collapse of confidence in its bonds. A crisis in the world’s third biggest economy would certainly reverberate across global equity markets.

Finally, some economists are worrying about the risk of too much growth in the U.S. They say it might rekindle inflation fears and lead to a major spike in bond yields that would undermine the stock market. A variant of this risk is that we are currently overestimating the true output gap (i.e., the amount of currently unused capacity in the economy) so that inflation pressures might emerge even without accelerated growth. This could be the case if the often-noted decline in the labor participation rate is structural (i.e., due to folks voluntarily leaving the labor force) and not temporary. If the decline is structural, there are actually fewer folks looking for a job, and so wages will accelerate sooner than anticipated.

These are the risks we will be monitoring this year as we move forward with our strategy.



## **Artemis Strategy**

For all of the reasons we have discussed, we believe that equity is going to outperform fixed income again this year, so we are staying modestly overweight in risk assets (stocks and real estate). We dispute the notion that the U.S. market is in bubble territory and extremely vulnerable. This does not mean we might not see a correction this year (defined as a 10% decline in the market); in fact, a correction is overdue, based on history. But these corrections typically come with little warning and don't last for long.

In the U.S., this essentially means not rebalancing to last year's targets. As for other international developed markets, we have already been steadily rebuilding our clients' positions and are content with our current exposure. We are strongly overweight Europe (especially Germany) and plan to stick with this posture a while longer. We are not diving into Japan, even though Japan may have another good year.

As highlighted previously, we have been underweight emerging market equity and fixed income since last spring and are not yet ready to jump back in. We have already referred to a deterioration in emerging market profitability and productivity, and this has been a factor in driving emerging market bond underperformance relative to U.S. counterparts. We are waiting for leaders in emerging markets to implement critical structural reforms before we adjust our stance.

On the fixed income side, we think our current strategy of underweighting duration (i.e., underweighting long-maturity bonds whose prices decline more rapidly when interest rates rise) and overweighting credit-sensitive bonds has not run its course. We do not currently subscribe to the increasingly popular view that the new so-called liquid alternatives (hedge funds in a mutual fund format) are a suitable substitute for bonds, although this is an area of current research, and we will be reporting on our findings next quarter.