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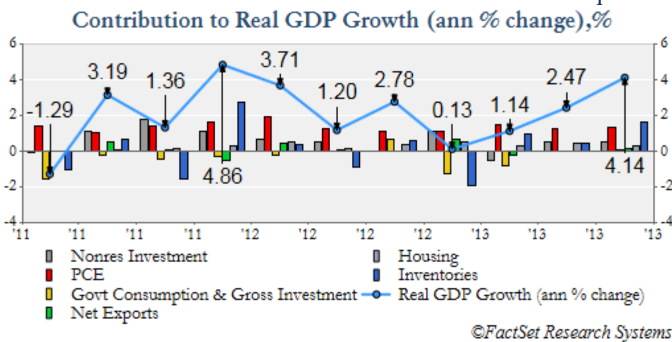
Market Review

December 2013

Economic Review

In December, the final estimate of U.S. third quarter real GDP was revised to a 4.1% annualized pace, up from an estimate of 3.6% in November. The results reflect a gain over the second quarter growth of 2.5%. The increase in the latest estimate was almost entirely due to further growth in private inventory investment. Additions to inventory added 1.67% to the change in real GDP, after having added 0.41% in the previous quarter. Gross domestic income was a drag on GDP, only rising 1.8% after a 3.2% increase in the second quarter.

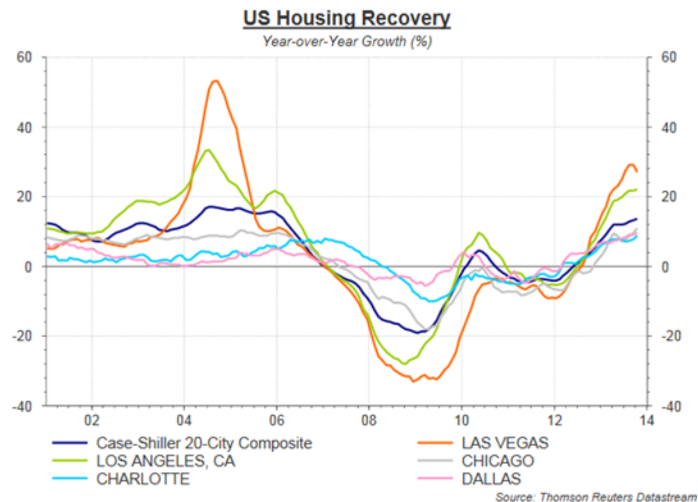


Nonfarm payroll grew by 203,000 during November and the unemployment rate declined to 7.0%. Both figures were positive surprises, as the consensus estimates called for 180,000 jobs added and a 7.2% unemployment rate. The ranks of the frictionally unemployed, persons unemployed less than 5 weeks, declined by 300,000 in November. The reduction in short-term unemployment was affected by the return to work of federal employees that had been furloughed during the government shutdown in October. The long-term unemployed, those jobless for 27 weeks or more, remained unchanged at 4.1 million people or roughly 37% of unemployed workers.

The headline Consumer Price Index (CPI) remained unchanged in November after a drop of 0.1% in October. Year-over-year, prices have increased by 1.2%, which is higher than the 1.0% year-over-year increase reported in October, but still below the Fed's stated target for 2% annual inflation. Lower energy prices have been a drag on inflation, as gasoline prices dropped 5.4% year-over-year through November and energy costs are down 2.4% overall. Core CPI, which excludes food and energy costs, increased 0.2% over the previous month and is up 1.7% year-over-year. Medical care costs remained unchanged in November, registering zero growth for the second consecutive month. The Medical Care Index has increased 2.2% year-over-year.

The U.S. Consumer Confidence Index registered 78.1 in December, rising sharply from a reading of 72 in November and returning to pre-government shutdown levels. The November Index value was revised up to 72 from 70.4. The increase was due primarily to increasing optimism relating to economic growth and hiring; optimism about the job-market registered a 5-year high. The Confidence Index has averaged 73.3 this year, the highest since 2007. In 2009, a year that included recession and a bottoming of the stock market, it averaged 45.2. Confidence remains below the five-year high of 82.1 reached in June 2013. A reading of 90 is consistent with a healthy economy.

The S&P/Case-Shiller 20-City Composite report for October showed a 13.6% increase over the prior year, showing signs of accelerated growth after a 13.3% reading during the previous month. The 13.6% annual increase was the largest increase since February 2006. The U.S. housing market is now only 20% from the 2006 peak of the housing bubble. Las Vegas and Los Angeles continue to lead the index higher with 27.1% and 24.6% growth, respectively. These two cities, which have 10% and 13% unemployment, continue to benefit from heavy investor activity. Chicago recorded a 10.9% growth, the highest annual rate for the city since December 1988. Charlotte and Dallas increased 8.8% and 9.7%, respectively, the highest readings for those cities since the inception of their indices in 1987 and 2000. The S&P commentary attached to the report delivered cautious guidance moving forward, citing the tapering of quantitative easing (and subsequent impact on mortgage rates) as a potential future headwind.



The Federal Reserve announced a modest tapering of its accommodative monetary policy in December. The committee cited improving labor market conditions and broader economic fundamentals as reasons to begin the tapering process. The Fed will initially reduce monthly purchases from $85 billion to $75 billion, with equal portions of the reduction from U.S. Treasury and mortgage

bonds. In addition, the Fed indicated the intention to keep short-term interest rates low until the labor market shows substantial improvements. The Fed has specified a 6.5% unemployment rate as a benchmark for labor market progress, signaling a long-term commitment to sustained accommodative policy from Janet Yellen.

The European Union lost its AAA rating from S&P, which cited deteriorating creditworthiness. S&P cut its long-term rating on the EU to AA+, with stable outlook. The European Central Bank kept its key interest rate on hold, as widely expected by the markets. President Draghi cited anemic growth and the threat of deflation behind the decision. Though the unorthodox policy measures may have helped the Eurozone avoid a financial crisis so far, growth continues to remain elusive. The ECB forecasts for Eurozone growth is just 1.1% in 2014 and 1.5% in 2015, while inflation is expected to be slightly north of 1%. Eurozone manufacturing PMI rose 1.1 pts to 52.7 while the services PMI fell 0.2 pts to 51. German industrial production fell 1.2% versus an expectation of a 0.7% increase.

The Bank of England's Monetary Policy Committee left the £375 billion quantitative easing program intact and left the Bank rate at 0.5%. Inflation in the UK reached a four-year low of +2.1% year-over-year. The Bank of Canada surprised markets by staying dovish and keeping key interest rates on hold while citing inflation concerns. The Canadian Dollar weakened on the news.

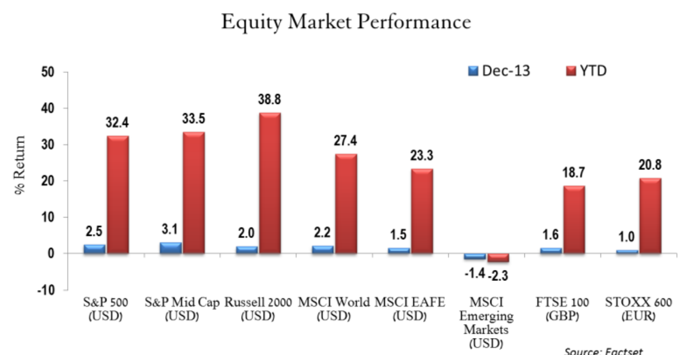
Moving to Asia-Pacific, Japan's third quarter real GDP was revised downward to +0.3%. while its current account surplus narrowed to ¥128 billion in October. Japanese Prime Minister Abe's cabinet approved a ¥5.5 trillion package to cushion the economy. The aggressive policies being pursued by Japan seem to be bearing some fruit as inflation in Japan reached a five-year high, as consumer prices increased 1.5% year-over-year in November.

The Reserve Bank of Australia (RBA) kept key interest rates on hold citing the Australian Dollar as being "uncomfortably high". RBA's Governor Stevens called for a weaker currency as he viewed AUD over 90 US cents as unsuitable for the economy. The Reserve Bank of India (RBI) kept key interest rates unchanged at 7.75%, despite expectations of a hike to contain rising inflation. Wholesale inflation surged to 7.5%, well above the RBI's comfort zone of 5%.

Equity Markets

Equity markets rallied to another record high in December and 2013 was the strongest year for global equities, as measured by the MSCI World Index, in 14 years. The MSCI World Index rallied 2.2% in December, finishing the year up 27.4%. Domestic stocks performed even better: large-caps (S&P 500) gained 32.4%, mid-caps (S&P 400) added 33.5%, and small-caps (Russell 2000) rose 38.8% in 2013. Emerging Markets lost -1.4% in December, and was the only equity class to post a negative return in 2013, losing -2.3% for the year. The headline indices for Europe (STOXX 600) and the UK (FTSE 100) gained 1.0% and 1.6% in December, respectively. These European indices lagged the U.S. and broader international markets in 2013, gaining 20.8% and 18.7% for the year in their local currency.

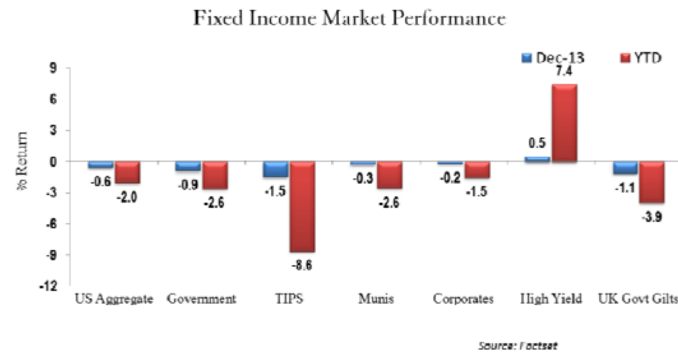
The U.S. equity market began December weakly, dropping over 1% in two different periods through mid-month. The market then rallied through the end of the month after the Federal Reserve announced a modest tapering of bond purchases. The CBOE Market Volatility Index (VIX), a measure of expected future volatility, peaked above 16 before the announcement and then fell to below 12 in the days following. The VIX ended the month at 13.72, capping a year of low implied volatility and historically low realized volatility in equity markets. The highest reading for the VIX in 2013 was 21.91, the lowest number since 2005; the lowest VIX reading of 2013 was 11.05, the lowest since the 2007 low of 9.70.



Bond Markets

Treasury yields climbed while credit spreads tightened during December on better than anticipated economic data and the long-anticipated announcement of tapering by the Fed. The intermediate portion of the yield curve (5-10 year) saw a pronounced sell off, with a modest sell off in longer term notes (30 year). Short term bills and notes (less than 2 years) were largely unchanged. The U.S. Bond market, as

measured by Barclays U.S. Aggregate, declined 0.6% during December and was down 2% for 2013. Credit spreads measured by Barclay's option adjusted spread on the full credit index, narrowed by 9 bps to 1.11%, the tightest month-end level of the year.



The 10-year and 30-year U.S. Treasury bond yields reached two–and-a-half-year highs by the month end. The 10-year bond yield increased 26 bps to close at 3.01% while the 30-year bond increased 16 bps to close at 3.97%. The yield on German 10-year benchmark bonds increased 25 bps, ending December at 1.94%. The yield on UK 10-year benchmark bonds increased 40 bps to close at 3.0%.

Commodities

The S&P GSCI Total Return Index, a headline index of 24 commodities, gained 1.92% in December but finished 2013 down -1.28%. The Index was led higher by the Industrial Metals sub-index, which gained over 4%, and the Energy and Petroleum sub-indices, which each gained over 3%. Precious Metals (down -3.8%) and Agriculture (down -3.5%) continued to drag on the index. These sub-indices were also the worst performers in 2013, losing -29.8% and -18.1%, respectively.

Zinc led the Industrial Metals sub-index higher, gaining 9.2% in December, after several mining companies delayed or cancelled mining projects in Canada and Australia. These measures are estimated to reduce the global supply of zinc by 1.7 million metric tons, tightening supply by 13%. Natural Gas prices also rose sharply, up 7.1% on the month, due primarily to forecasts for a continuation of an unusually cold winter in the United States.

Gold and Silver each lost more than -3% in December and were among the worst performing commodities in 2013. Gold lost -28.7% on the year and Silver was down -36.7%, as expectations of Fed tapering against a backdrop of already-low inflation dragged the Precious Metals lower. Corn fell by more than -30% in 2013, as the U.S. market delivered better than expected supply, while demand for Corn for the production of ethanol and livestock feed reached a low. Similar market conditions, marked by massive increases in supply, have rocked the Coffee market. Coffee lost -30.6% in 2013, and is down nearly -50% since 2011.

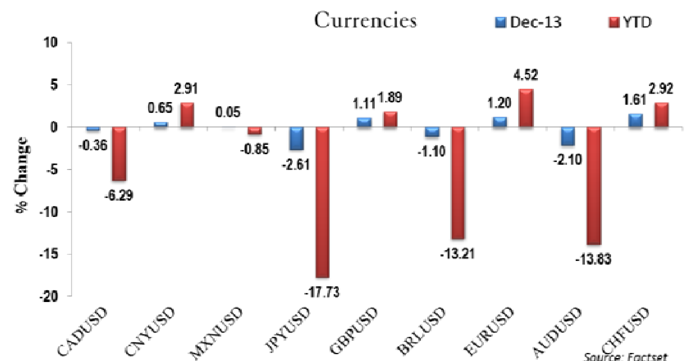
Currency

Global currency movement during most of 2013 was dominated by expectations of a modest pull back of monetary easing by the Federal Reserve. The US Dollar Index, a measure of the Dollar against six trading partners, weakened during the month. The Index declined 0.8% during December. It is up a modest +0.3% in 2013, closing at 80.03.

The Euro gained 1.2% in December, despite the European Union losing its AAA credit rating from S&P. The Euro rallied 4.5% during 2013 against the US Dollar, the biggest gain amongst the sixteen heavily traded currencies. The European Central Bank's balance sheet shrank while the Federal Reserve expanded its holdings in 2013.

The Yen fell 17.7% against the US Dollar during 2013, to reach a five-year low of 105.1 Yen/USD, amid unprecedented polices from Japan's government and central bank to boost economic growth and ward off deflation.

In the emerging markets, the Chinese Yuan rose nearly 3% during 2013 while the most of its peers depreciated on concerns of domestic economic problems and a poor global liquidity outlook.



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