Investment Watch

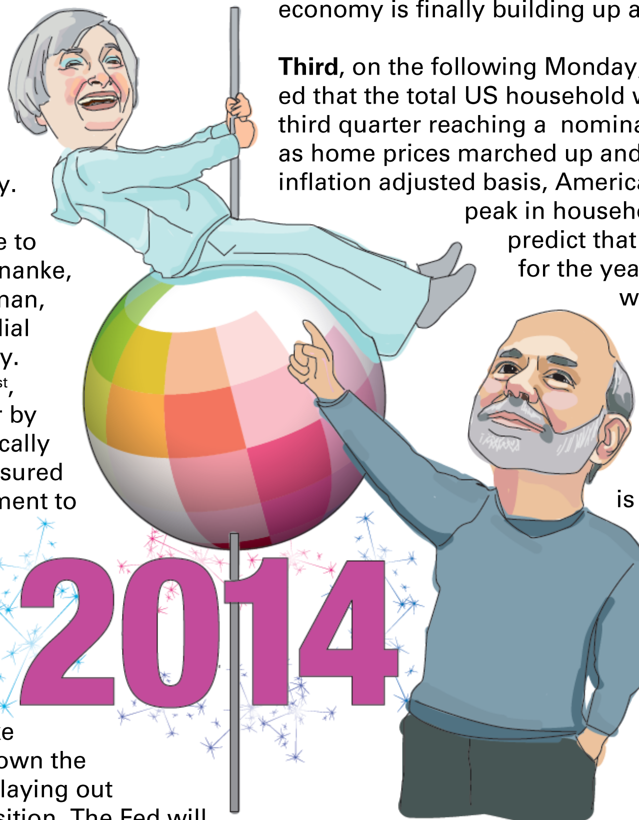
4th Quarter, 2013

Out with a Bang!

2013 went out with a bang! At least for the stock markets, which posted their best returns in over a decade. Both the S&P 500 and the DOW Jones Industrial Average hit all-time record highs for the year. Bonds, on the other hand, had a dismal year. After bottoming out at an artificially assisted, historic low of 1.4% last year, the yield on the 10 year treasury note shot up to just over 3.0% and bond values, which move in the opposite direction as yields, tumbled.

The Federal Reserve's third version and most massive bond buying stimulus ever, **QE3**, drove longer-term bond yields below any preconceived nadir to unseen, historic lows. Everyone knew, not only that bond yields were pushed below realistic levels, but also that the Fed's bond buying binge had to be curtailed as their balance sheet had ballooned to nearly $4 trillion. Back in May, Fed Chairman Bernanke merely hinted that the Central Bank could begin scaling back **QE3**'s bond buying which sent bonds into a tailspin, ending an unprecedented over thirty year bull run. But two weeks ago, the announcement of the Fed's decision to actually start unwinding **QE3** was met by investors with a bang that sparked a global rally, an exact opposite to the negative reaction last May.

In keeping with his self-imposed mandate to help the Fed speak more clearly, Ben Bernanke, in his last news conference as Fed Chairman, surprised most pundits by beginning to dial back the bond-buying program in January. But Bernanke, who retires on January 31st, wanted to pave the way for his successor by outlining the Fed's intention to systematically reduce the bond purchases while he reassured Wall Street of the central bank's commitment to keep the benchmark short term rate near zero long after the end of **QE3**.



Investors rejoiced sending the DOW to its third-biggest rally of the year, while the bond market held up fairly well in light of the probable consequence of rising longer-term interest rates. Bernanke eased the new Fed Chair, Janet Yellen, down the Times Square pole into the New Year by laying out the Fed plan affording her a smooth transition. The Fed will reduce the $85 billion/month bond purchases by $10 billion in January with additional $10 billion cuts at each subsequent meeting based on the economy's strength.

In this unusually uncertain world, the Fed's clearly defined plan to methodically remove **QE3**'s bond buying stimulus provided a degree of certainty that the Fed will maintain this economic support "well past the time when the unemployment rate falls below 6.5%." Yellen, who has been Vice-Chair since 2010, is expected to continue the Bernanke's Fed easy-money policies. In fact, many have referred to Yellen as Bernanke without a beard.

This Fed certainty was accompanied by three other stabilizing economic surprises in rapid succession in late December. **First**, and the most shocking of which was the Senate approval of a bipartisan budget deal coincidently on the same day the Fed announced their promising plan. For the first time in what seems ages, Congress passed a bipartisan spending plan without resorting to last-minute political brinkmanship and midnight negotiations. This budget deal, which guides government spending through 2015, hopefully portends less of the political posturing and gridlock that has sickened the American public over the past few years.

Second, two days later, the Bureau of Economic Analysis announced that the US economy grew at an unexpectedly robust annual rate of 4.1% in the third quarter. This was the fastest pace in two years and only the second time over 4% since the Great Recession, fueling hopes that this time the economy is finally building up a head of steam.

Third, on the following Monday, the Federal Reserve reported that the total US household wealth increased 2.6% in the third quarter reaching a nominal record high of $77.3 trillion as home prices marched up and stocks rallied. On a real inflation adjusted basis, Americans were still shy of the 2007 peak in household wealth, but many pundits predict that once the data is crunched for the yearend, US household wealth will reach an all-time high due to the steady increase in home values and a surge in stocks and mutual funds in the fourth quarter.

70% of our economic output is driven by the consumer and the American consumer is getting in better and better shape. The Great Recession devastated US household net worth with the stock market crash and tumbling home values. It's been a long, difficult road back, but the 2013 mega-rally marked all-time highs in the stock markets and the housing recovery hit a higher gear.

2014 likely won't be as exciting. But there's a global sense of a New Year renewal with a vision of more stability and certainty, making us feel more optimistic about our future.

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