HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET April 2014

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Often we must use these quarterly commentaries to modify our prognosis and forecasts from previous commentaries. But not this time around. Our January newsletter seems highly prescient about how the market would behave in 2014. We read the analytic tea leaves correctly and we do not have much different to say. As the old phrase goes: "That is our story and we are sticking to it."

Let us recap. We thought the run-up of the stock market in 2013 got ahead of the economy. Some stocks were clearly in "frothy" territory. We expected the market to take time for reassessment and pause in early 2014. But the period of adjustment would pass and the bull market would continue – albeit at a much slower pace than 2013. The year 2014 would be moderately positive.

Well, even if you just follow the market news occasionally, that scenario is playing itself out as we scripted. The first quarter saw the market indexes decline, then recover, and end on March 31 close to where they started the year. After some volatility this earnings season and summer, we expect the equity markets to end the year positive. We are calm in this environment. There is nothing in the big picture that makes us too anxious or concerned. However, we expect to work hard for our clients this year. We cannot ride the indexes higher as was possible in 2013. Some stocks are clearly too expensive. Other stocks still have good value and future opportunity. It will take analysis and diligence to find good picks for our clients.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first quarter of 2014. As predicted, the stock market took a pause after the dramatic expansion seen in 2013. Meanwhile, the bond market showed unexpected gains after its losses last year.

Equity Markets: The line graph of the Dow Jones Industrial Average in the first quarter has a distinct V-shape pattern. Starting at nearly the 16,500 level, it lost almost 1,000 points in the first five weeks of the year as investors pulled back over concerns about high prices and the direction of interest rates. Then confidence rebounded and the Dow spent the next seven weeks recovering its initial losses. Overall, it ended the quarter down just .15%. The pattern was basically similar in S&P 500 index with reversals and then recoveries. The S&P 500 squeaked out a 1.81% gain for the quarter. The story was similar with the other indexes. The Russell 2000 managed a 1.12% gain for the quarter and the Nasdaq Composite was ahead by .8%. The new Federal Reserve chair, Janet Yellen, seemed to help at the end of the quarter with calming remarks about the slow adjustment to the policy of low interest rates.

Fixed Income Market: Most analysts – including us at Hudson Advisors – had expected the bond market to continue the decline that marked 2013. Instead, the Barclays U.S. Aggregate Bond Index – the broad measure of bond prices – gained 1.34% in the quarter. This result seemed to come largely from the Federal Reserve's expressed intent to move gradually to taper its program of bond buying that supports the underlying credit markets. The yield on the 10-Year U.S. Treasury, which moves opposite to prices, fell to 2.776% on March 31 from 3.030% on December 31.

MAJOR MARKET INDEXES

	1Q Total Return
Dow Jones Industrials	-0.15
S&P 500 Index	1.81
Russell 2000 Index	1.12
NASDAQ Index	0.83
EAFE Index	0.00
Barclays Aggregate Bond Index	1.34

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: The gradual economic recovery in the U.S. is the spur for the positive view of equities. Despite impact of a harsh winter, annual GDP growth is forecast in the 3% range. While less robust than most of us would prefer, the recovery is at least broadly based. It is reflected in rise of housing prices, improved employment numbers, better consumer confidence, strengthened business investment, and subdued inflation. In order not choke off this recovery, as indicated above, the Federal Reserve seems inclined to keep interest rates low for the remainder of 2014.

Beyond the U.S., the economy in Europe is slowly mending. Growth in China is slowing – but the government there is acting to stimulate both industrial output and consumer demand. Much of the focus on emerging markets is on the so-called "fragile five" – India, Indonesia, Turkey, South Africa, and Brazil. But the central banks in those countries are seeking to stabilize their currencies. Nothing on the international economic front is a major threat to U.S. recovery. Most important, we do not see any imminent geo-political risk to the economy or the market. The current tensions with Russia are disturbing – but we do not see escalation that would disrupt international trade flows. As stated, we are relatively calm when we look at the "macro picture."

The Market: Stocks in the S&P 500 on average are trading about 15.2 times the next 12 months expected earnings. That compares to 13.8 as the average in the last 10 years. So, yes, stocks are somewhat expensive – but not to a level of excess. We do not subscribe to the "bubble territory" view of this market. The current P/E ratio is about the same as 2007 before the fiscal meltdown. The so-called "frothiness" is prevalent in some areas such as small cap stocks, recent IPOs, and certain tech stocks including social media. In addition private equity seems eager to sell portfolio companies and leverage their balance sheets for special dividends. But many large cap companies have good value remaining.

Of course, corporate earnings are the key to stock prices. We are encouraged by the trends. Earnings in the S&P 500 companies grew by over 10% in the last quarter of 2013 – in comparison to a year previous. We will be watching for earnings reports on first quarter performance. Less weather sensitive sectors, the news should be overall encouraging, given the broad base of economic recovery. Thus, on balance, relatively high value of stocks will restrict market expansion compared to 2013. But that situation is countered by the constructive outlook for earnings. Given these forces, we expect the major indexes to end in a positive range.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 55% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We suggest fully invested clients to trim equities to 55-65% depending on the client's investment time horizon and goals.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy.

We are cautious now on the consumer staple companies that have done so well in the last year. Their stocks are expensive. Instead, our focus is on other sectors where prices are still reasonable and growth opportunities exist. We like selected companies in the financial, health care, energy, materials, technology, and industrials sectors. Many of these stocks will see a rotation of investor interest – and we want to buy before prices are driven higher. But the key word here is "selected." No single sector is a panacea. We must look within each sector to find companies with value for our clients.

Fixed Income: We think the first quarter rebound in bond prices was a fluke. The trend of decline seen in 2013 is likely to resume. At some point, interest rates will rise and inflation will resume. The risk to holders of longer maturities is substantial. Our viewpoint on this issue is well-known to our clients and it is another area where we stick to our story. Instead, for the non-equity portion of client portfolios, we utilize cash, short bond instruments, and alternative investments like municipal tax lien programs.

Dow Jones U.S. Sectors
(Percent Change for YTD, Ending March 31, 2014)

Oil & Gas	**1.39**	**Consumer Services**	**-0.87**
Basic Materials	**2.60**	**Telecommunications**	**0.36**
Industrials	**-0.07**	**Utilities**	**9.60**
Consumer Goods	**0.10**	**Financials**	**2.38**
Health Care	**5.91**	**Technology**	**3.25**

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