

# HUDSON ADVISOR SERVICES, INC

## OUR VIEW OF THE MARKET

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The year-end headline in *The Wall Street Journal* concluded: “Winners of 2013: Boring Investors.” The point of the article was that last year’s best-rewarded investors were those with plain-vanilla holdings of U.S. stocks. It was not a year to be engaged in esoteric trading strategies or exotic product investing. It was the year to be concentrated – as indeed we are – in stable, productive large-cap companies.

Yes, it was a stupendous year – and we certainly did enjoy the ride. We did not anticipate the extent or the endurance of the stock market boom. At the outset of 2013, and throughout the year, we expressed concerns about government dysfunction, mixed signals from the Federal Reserve, and Middle East instability. We were surprised, although not unhappy, to see the market shrug off those concerns and push the indexes to record highs.

But 2013 is over – and new years bring reassessment and pause. We expect a bit of reality to take hold. Put simply, the market got ahead of the economy in 2013. The months ahead will see adjustment. We expect a modest correction in the first half of the year as investors revise strategies and re-balance portfolios. The pull back from the frothiness of recent months will be healthy – and will lay groundwork for reasonable and sustained future growth.

We are positive on 2014. Despite the anticipated correction, the overall investment climate looks good. The economy grows stronger, interest rates remain low, and inflation is subdued. The market will move past the correction and expansion will resume – albeit more slowly than 2013. We expect the major indexes to show 2014 percentage gains in the mid to high single digits.

### MARKET TRENDS

The accompanying chart summarizes stock and bond market results for full year 2013. The stock market virtually soared with the major indexes showing the best results in over 15 years. Meanwhile, the decade-long bull market in bonds finally ended – with overall bond prices actually declining for the first time since 1999.

**Equity Markets:** Nothing seemed to deter the hunger of investors to buy stocks in 2013. The market did experience five setbacks during the course of the year as Federal Reserve announcements seemed ambiguous and the Washington politicians shut down the Government. But those setbacks were short-lived. The economic news seemed somehow positive enough to keep U.S. equity markets humming right through the fourth quarter.

Volume 58 January 2014

The Dow Jones Industrial was up 9.6% for the quarter and 26.5% for the year – its best performance since 1995. Similarly, the S&P 500 rose 10.5% for the quarter and 32.39% for the year – its best since 1997. All 10 sectors of the index posted gains. The Nasdaq Composite was even stronger with a gain of 12.03% for the quarter and 36.9% for the year. The Russell 2000 index of small companies was also impressive, increasing 8.7% for the quarter and 38.8% for the year. However, material stocks and commodities produced sharply negative returns. The MSCI EAFE increased 5.4% for the quarter and 19.4% for the year.

**Fixed Income Market:** As our clients know, we have been skeptical avoiders of long-term bonds at Hudson Advisors for many years. That viewpoint has been sometimes difficult to explain and, yes, occasionally frustrating when bond investors came out winners year after year. Well, in 2013, our viewpoint finally was verified. Investors belatedly recognized that yields are too low to compensate for the interest rate and inflation risk. The yield on the benchmark 10-Year U.S. Treasury, which moves opposite price, ended just over 3% -- versus 1.7% at the outset of the year. The Barclays U.S. Aggregate Bond Index – a broad measure of bond prices – was down 2.75% for the year, its first annual decline since 1999.

### THE OUTLOOK

**The Economy :** Much of the market enthusiasm is rooted in the fundamentals of the economy. After years of sluggish recovery, signs point to more healthy economic growth. The U.S. GDP was reported to expand at an annualized rate of 4.1% in the third quarter. The consensus forecast is for growth of 2.8 to 3.2% in 2014. The driving forces are recovery of housing prices, strong auto sales, and business capital investment. Consumer confidence is improved even though unemployment is still historically high at about 7%.

### MAJOR MARKET INDEXES

	4Q Return	YTD Total Return
Dow Jones Industrials	9.56	26.5
S&P 500 Index*	10.51	32.39
Russell 2000 Index*	8.72	38.82
NASDAQ Index*	12.03	36.92
MSCI EAFE	5.36	19.43
Barclays U.S. Aggregate Bond	-0.75	-2.75

\*Total Return Includes Reinvested Dividends.

Other macro trends are essentially positive. The Federal Reserve has articulated a plan that will adjust monetary policy gradually – as evidence warrants – and not so abruptly so as to threaten recovery. While long-term fiscal solutions are evasive, the Washington political crowd seems willing to avoid renewed budget drama in the year ahead. Europe has stabilized and China indicates willingness to address its economic and credit issues. More broadly, there is no looming geo-political crisis that threatens global economic activity.

**The Market:** So, as summarized above, the proverbial Wall Street “wall of worry” seems manageable. We do not see any forces that would compel major retreat in the stock market. In fact, small investors have gained confidence and they should invest cash that has been sidelined in recent years.

With all that, 2014 will be a good year, but certainly not the great 2013 year. We do think investors acted in anticipation of economic growth. Stocks are now priced pretty richly. Prices rose from about 13 times earnings a year ago to 17 times earnings currently. This P/E ratio is close to historic norms. Corporate earnings are not expected to change these valuations much in the year ahead.

Thus, we do anticipate some market correction in coming months. Investors are likely to pause, evaluate, and reduce holdings in stocks that seem too highly valued. This period of adjustment will be calm, even healthy – not volatile and dramatic. In the second half of the year, we expect market expansion to resume. Overall, by the end of 2014, we forecast stock indexes to show gains in the 4-to-8% range.

## OUR STRATEGIES

**Asset Allocation:** For clients investing new money, we are reducing our recommended allocation to equities from 60% to 55%. This adjustment is made in light of the likely market correction. The remaining portion of client

portfolios are dedicated to cash, bonds with maturities under two years, and alternative investments.

**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 use covered call writing to improve dividend payments. We note that total return calculated to include dividends was 29% for the Dow Jones and 32% for the S&P 500 in 2013. Those extra percentage points will be more important in 2014. Sectors we like include:

**CONSUMER DISCRETIONARY:** This sector did well in 2013 as consumers seemed more willing to open their wallets. Growth opportunity still exists in areas such as online retail.

**HEALTH CARE:** The effects of Obamacare call for careful stock picking in this sector. But we think that some drug makers and biotechnology companies remain attractive and pay healthy dividends.

**FINANCIALS:** Increased Net Interest margins and loan growth should help both domestic and international banks.

**INDUSTRIALS:** This sector also did well last year – and we think values here are solid and can expand higher.

**TECHNOLOGY:** Businesses are expected to increase capital spending and that will be good for the old-line names in this sector.

**Fixed Income:** Having been finally vindicated, our aversion to long-term bonds is firm and strengthened. We think 2014 will not be kind to all the money that flowed into fixed income in recent years. We believe the yield on the 10-year Treasury will likely surpass 4%. To protect our clients, we keep the non-equity of their portfolios in cash and short-term bonds. We also try some alternatives such as municipal tax lien programs.

Dow Jones U.S. Sectors (Percent Change for YTD, Ending December 31, 2013)			
Oil & Gas	26.14	Consumer Services	42.17
Basic Materials	20.38	Telecommunications	14.13
Industrials	41.00	Utilities	15.20
Consumer Goods	30.55	Financials	34.22
Health Care	41.98	Technology	26.96

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