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MARKET COMMENTARY

Although more volatile during the quarter, stocks finished the period mostly flat. After a 5% pullback in January, stocks in the S&P 500 finished the quarter with a 1.8% gain. The DJIA was just slightly negative with a -0.1% return. Small cap stocks in the Russell 2000 had a 1.1% return while mid cap stocks in the S&P 400 posted the best returns with a 3.0% gain. International stocks didn't fare any better than US stocks. The developed foreign markets were up 0.7% and emerging markets were down -0.8%. The Aggregate Bond Index which was down -2.0% last year, was up 1.8% this quarter.

US GDP growth slowed from the 4.1% pace of the third quarter to 2.6% in the fourth quarter. During the quarter, consumer spending rose at the fastest pace in three years at an annual rate of 3.3%. Since consumer spending accounts for about 70% of GDP, the strong number is a good sign. Many analysts believe the first quarter GDP growth will be around 2% due to bad weather that disrupted factory production and home building and kept people home rather than out spending money. They are hopeful that as the weather warms, consumer spending will pick up again and builders will be back to work. Currently, economists are still forecasting around 3% GDP growth for the entire year. If that figure is reached, the economy will have its best year since 2005.

Europe is also expected to see its strongest growth since 2011. However, forecasts for the Eurozone which includes the European Union plus countries like Switzerland and the UK are for 1.1% annual GDP growth. This growth is much slower than the US. Their recovery out of recession is not as strong and their unemployment rate is still above 10%. On the other side of the world, Japan's reforms resulted in 2013 GDP growth of 1.5% and economists recognize that the challenges ahead may result in uneven growth in 2014.

The S&P 500 Stock Index recovered its losses from the 2008-2009 bear market and is now almost 19% above the 2007 high. Its PE ratio is at its high for the last 5 years and is even slightly above the level it was at the previous peak in 2007. Meanwhile, the MSCI EAFE Index of international stocks has not yet recovered its previous losses. It is still about 20% below its previous peak. The PE ratio on the MSCI EAFE of 13.9 times is also below its level at the peak of stock prices. It's also below the S&P 500's current 15.4 level. The dividend yield on the MSCI EAFE is also 1% higher at 2.9% versus 1.9% for US stocks. With their more conservative valuations, international stocks may have higher growth potential than US stocks this year if their economic recovery continues and investor confidence can be regained enticing investors.

Emerging markets are expecting higher GDP growth than the developed world. The Asian Development Bank is projecting 6.2% growth for developing countries in Asia. This is about the same as last year even though China's growth is slowing. Russia and its actions with Crimea have added to uncertainty. Although emerging markets have higher GDP growth expected and their stocks have not participated in the rally the rest of the world has had, the added political risks may continue to weigh on investors minds. Longer-term, we may see that this is a buying opportunity as issues are resolved.

Yields on the 10-year Treasury retracted this quarter from 3.0% to 2.7%. The safety of bonds was sought after stocks were more volatile reminding investors of the risks involved. The Barclays Aggregate Bond Index was up 1.8% during the quarter. Analysts expect the 10-year yield will start to rise again in 2014 and continue climbing into 2015 but at a slower pace than in 2013.

We continue to believe diversification is a prudent strategy and can help reduce risk and smooth out total returns over the long term. Just as stock portfolios can be diversified across large and small cap, US and international, bond portfolios can be diversified across government, and corporate, US and international as well as including high yield, convertibles, and floating rate securities. Investment in real assets like real estate, gold, and other commodities can also reduce portfolio volatility.

2014 BENCHMARK RATES OF RETURN

INDEX	FIRST QUARTER	YTD
S&P 500	1.8%	1.8%
DJIA	-0.1%	-0.1%
NASDAQ	0.5%	0.5%
Russell 2000	1.1%	1.1%
International	0.7%	0.7%
Fixed Income	1.8%	1.8%

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MARKET COMMENTARY

The new Fed Chairman

After eight years as the chairman of the Federal Reserve, Ben Bernanke retired on February first. Taking office in 2006, he endured some of the toughest times and was the focus of much attention as the country struggled through the Great Recession. Under his leadership, the Fed's actions of Quantitative Easing have garnered much discussion as to whether it was too much for too long, but most people credit QE with supporting the stock market rally over the past five years.

Now, the Fed has a new chairman. Janet Yellen took over the reigns in February as the first woman to hold the position in its 100 year history. Change normally is accompanied by fear of what will happen under new leadership. Yellen has eased some of the fears by indicating her intentions to stay accommodative and not pull support unless the economy is strong enough. She's also followed Bernanke's plan to taper QE by steadily reducing the Fed's new bond purchases.

The stock market had been down during the first month of the year, but in February—just shortly after the time Yellen took office—stocks began to rally again and the S&P 500 Index rose 8% over the next month. Interestingly, Philip Orlando of Federated Funds points out that a stock market rally has been consistent during the initial period when leadership at the Fed has changed. He says "first, the S&P 500 historically has enjoyed a honeymoon period that lasts for about a quarter or so with stocks rallying by about 8% to 9%."

So what happens after the honeymoon? Orlando says, "Next, investors become temporarily concerned about some aspect of the transition and stocks have tended to consolidate over the next quarter or two by about 10% to 15%." That doesn't necessarily mean we would end the year in negative territory, though. "Finally, investors come to realize that the new chairman is just as capable as the previous chairman, and stocks have tended to rally from oversold levels by about 15% to 20%."

Of course there are other factors at play and correlation does not equal causation. However, if we do follow this pattern, stocks will have more volatility than they have had the past year or so and investors will need to stay focused on the long term. On the bright side, those who hold on to their stocks and do not panic during periods of volatility could see positive stock returns by year end. Furthermore, investors who have been waiting for a better opportunity to put money to work in the market, may find it in the summer.

QUESTION: *With the run-up in stock prices over the past 5 years, should we be concerned about a "bubble"?*

ANSWER: In the tech boom of the late 1990's, stock prices appreciated rapidly—sometimes even when companies had negative or very minimal earnings. Even non-tech companies experienced strong appreciation. Often, stock prices were rising faster than earnings and price/earnings ratios (PEs) increased above historical averages. At the stock market peak in March 2000, the PE for the S&P 500 Index topped out at 25.6 time earnings. Since March 2009 when stock prices bottomed, the S&P 500 Index is up more than 175%.

The especially strong 32% return of last year has some observers voicing concerns that stocks may be in or near a bubble. The PE multiple on the S&P 500 Index one year ago was at 12.6 times earnings. Over the last 5 years, it has averaged 13.1 times earnings. Currently, the PE is 15.4 time earnings—the highest it's been for the last 5 years. Even the 10-year average PE was only 13.9 times earnings. The 15-year average PE (which includes the time period when PEs were spiking) is 16.2 times, only slightly above current levels.

Valuations as measured by PE ratios are definitely higher than they have been recently. However, it may be too early to sound the panic alarms. Historically, during times of low inflation like we are in now, PE multiples have generally been higher. In addition, with bond returns expected to be low, stocks have been more in demand. As long as earnings continue to grow and prices don't appreciate as quickly as 2013, current PE levels may be sustainable and not indicative of a looming bubble.

CAMBRIDGE ADVISORS NEWS

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Also, we recently mailed a letter explaining how we have partnered with Broadridge Financial to offer an automated claims filing service for securities class action lawsuits. More information regarding this service can be found on our blog. If you have questions or would like to opt out, please let us know.

Serious about your future