WEEKLY MARKET COMMENTARY **December 30, 2013**

The Markets

Like the mother of a bride reviewing flower arrangements and fretting that a brilliantly sunny day could be marred by dark clouds hidden just beyond the horizon, pundits have been parsing the exceptional year-to-date performance of U.S. stock markets and fussing over the future.

It's true. U.S. stock markets look like they may be headed toward a fizzy champagne finish even after retreating a bit last Friday. Through Thursday, the Dow Jones Industrial Index had closed at record highs 50 times this year and the Standard & Poor's 500 Index wasn't far behind with 44 record high closes, according to NASDAQ.

U.S. stocks aren't the only markets analysts are stewing over. They're also pondering the potential effects of higher interest rates. Last week, the yield on benchmark 10-year Treasury notes ascended beyond 3 percent for the first time since 2011. It's possible higher yields (and a potential drop in bond values) will cause investors to seek out better performing assets next year, but that may not be all bad, according to *Barron's*.

> "IS TOPPING 3% A BAD THING? Not necessarily, considering the reason for the 10-year yield's march higher: the Federal Reserve's decision to taper $85 billion a month in Treasury purchases, starting with $10 billion less in January. It's a small paring, but sends a big message: Maybe – just maybe – after years of recovery, the U.S. economy is returning to normal."

Returning to normal in the United States may not prove to be any easier than seeking a new normal in China. Top communist party leaders in China recently implemented policies that give markets a more significant role in the country's economic development. Concern that high levels of local government debt could pose a risk to ongoing economic growth has the People's Bank of China (PBOC) employing some unconventional measures to manage interest rates.

Last week, those actions caused China's seven-day repurchase rate to rise precipitously which triggered the worst case of interbank jitters since June's liquidity crunch in China. The PBOC "injected fresh money into the markets on Tuesday, easing the pressure on the financial system and quelling fears about a credit crisis."

As an investor, it's important to remember that no one knows what the future holds or how central banks and markets will respond.

Data as of 12/27/13	**1-Week**	**Y-T-D**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Standard & Poor's 500	1.3%	29.1%	29.9%	13.6%	16.2%	5.3%
10-year Treasury Note (Yield Only)	3.0	NA	1.7	3.4	2.1	4.2
Gold (per ounce)	1.6	-28.3	-26.6	-4.9	6.7	11.4
DJ-UBS Commodity Index	0.0	-8.2	-8.3	-7.1	2.4	-0.6
DJ Equity All REIT TR Index	0.4	2.8	3.3	10.0	19.0	8.6

Notes: S&P 500, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods. Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable.

WHAT'S THE DIFFERENCE BETWEEN A BULL AND A BUBBLE? During 2013, stock markets in the United States and Europe generally delivered very attractive returns so it's not all surprising that talk of market bubbles fills the air. After all, bubbles are not a new phenomenon and they've done some damage in the past.

In the 1800s Charles Mackay penned *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds*. The book chronicled some of the earliest bubbles, including Holland's Tulipmania of 1624 during which tulip bulbs were valued more highly than gold. He also describes the popularity of the South Seas Corporation whose shares traded higher and higher (on little more than word of mouth) until the stock crashed. More recently, we've experienced bubbles in stock markets, real estate, technology stocks, and other types of assets.

So, how do we tell the difference between a bull market and a bubble? According to *The Economist*, Nobel Laureate Robert Shiller of Yale University, "Describes a bubble as 'a psycho-economic phenomenon. It's like a mental illness. It is marked by excessive enthusiasm, participation of the news media, and feelings of regret among people who weren't in the bubble.' They are often enlarged by an expansion of credit."

Shiller measures valuation levels using cyclically-adjusted price-to-earning ratios (CAPEs). According to *Barron's*, the Shiller CAPE for the S&P 500 Index was at 21 in January of 2013. That was higher than its long-term average and lower than its recent trend so U.S. equities were somewhere between neutral and significantly over valued. Since January 2013, some U.S. stock markets have delivered returns in the double digits, pushing the Shiller CAPE toward 25. On the face of it, U.S. equities appear to be highly valued.

However, in early December, *The Economist* reported Shiller was "not yet ready to declare a bubble in American equities… There is nothing like the same excitement about shares that was seen in the late 1990s; net flows into mutual funds only just turned positive this year. Another measure of public indifference is CNBC, a television station that tracks the financial markets, suffered its lowest ratings since 2005 in the third quarter."

So, is this a bubble or a bull market? The experts aren't certain. Keep your eyes peeled for signs of irrational exuberance.

Weekly Focus – Think About It

Every day of the week, *The Economist* explains a new topic on its website. The most popular explanations during 2013 included:

- What is the difference between Sunni and Shia Muslims?
- How does copyright work in space?
- Why are your friends more popular than you?
- How did Estonia become a leader in technology?
- Why are there so many tunnels under London?
- Why don't Americans ride trains?
- How might your choice of browser affect your job prospects?

Financial Factoid - The size of the US economy was $16.9 trillion as of 9/30/13, an all-time record. The size of the national debt was $16.7 trillion as of 9/30/13 (source: Commerce Department, Treasury Department).

Epic Humor - What happened to the Irish man who thought about the evils of drinking in the New Year?

He gave up thinking.

Have a great week!

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
* The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices.
* The 10-year Treasury note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market
* Gold represents the London afternoon gold price fix as reported by the London Bullion Market Association.
* The DJ Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.
* The DJ Equity All REIT TR Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.
* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods
* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
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* Consult your financial professional before making any investment decision