

# Investment Outlook Report

## The 2014 Outlook: Cooking Up an Even Stronger Comeback

The strangest ingredients can come together to create some of the most delicious meals. The Food Network's popular reality TV show "Chopped" makes this case by pitting professional chefs against a basket of random ingredients and asking them to make gourmet meals. While there is the occasional snafu, the chefs tend to produce some very tasty-looking results because they're experts at teasing out flavors from ingredients that run the gamut from mundane to extraordinary.

In a lot of ways, we view the CEOs of large companies as very similar to the chefs on "Chopped." Like the pressured chefs on the show, CEOs must operate within the economic environment available to them, not the economy they necessarily want. Their jobs, then, are to tease out as much profitability as possible from any set of economic events that come their way. Their success in doing so is what drives their companies to profitability and what may have driven last year's amazing market returns.

### 2013: Second - Rate Ingredients, Delicious Results

The economic "ingredients" of 2013 did not resemble gourmet fixings at all. Some of the headwinds businesses and the overall economy fought last year included tax hikes enacted in January, sequestration and budget cuts in the spring, and a standoff over the government's ability to borrow paired up with a governmental shutdown in the fall. In many ways, 2013 was the year when anything could have gone wrong, and yet the economy and markets turned out well anyway.

As you know, the companies of the S&P 500, representing America's largest public corporations, posted their first year of significant profit growth since 2011. They watched their stock prices rise by more than 30% in just one year. There were other gourmet results from these ingredients as well, and we believe they set a much better economic tone for entering 2014.

### 2014: A Better Set of Ingredients

We have come a long way since the economy bottomed out in mid-2009. One of the most important yardsticks of our progress is the federal budget deficit. The government responded to the 2009 financial crisis by funding large spending programs with borrowed money, running a deficit that was as large as 10% of our economy during parts of 2009 and 2010. This spending was designed to stimulate our weak economy. However, a deficit at those levels was not sustainable and required immediate action on the part of Washington.

## Federal Budget Defecit as % GDP

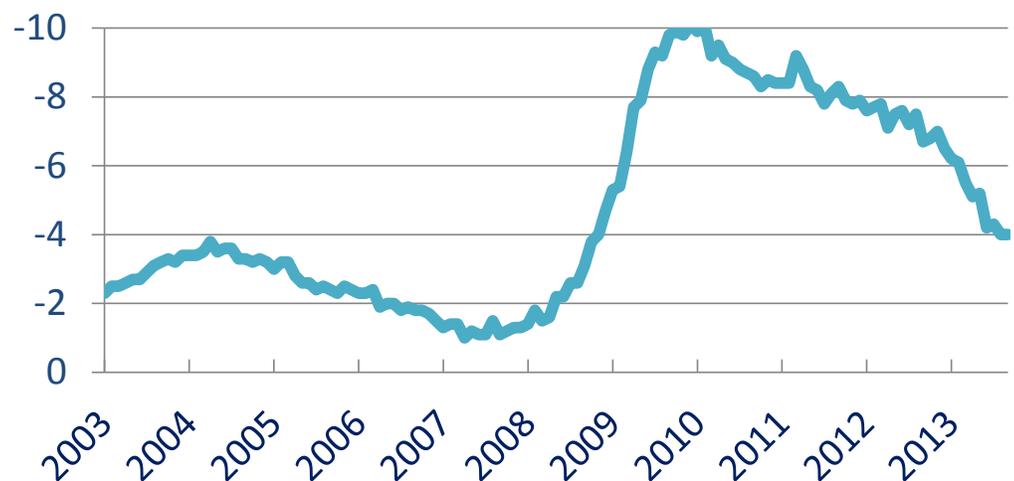


Chart Source: Bloomberg

Perhaps one of the most encouraging developments of 2014, we think, will be a more cooperative environment in Congress. The reduction of the deficit to 4% of GDP could make the required cost cuts/tax hikes less extreme and increase the scope for compromise.

The business sector has done a lot of belt-tightening as well. As measured by the companies in the S&P 500 Index, debt as a percentage of total equity has been cut in half since 2008. This change has two big potential benefits. The first is that running a business on borrowed money carries additional risk; small declines in profit could make it impossible to pay off a debt burden, potentially leading to bankruptcy. With debt levels now much lower, this sort of risk is less of a problem. The second benefit is that low debt is actually a potential opportunity. Businesses that start out with low debt levels may, over time, feel more comfortable borrowing to finance new capital projects and hire more employees.

Consumers are the biggest segment of the U.S. economy, so their state of mind can also play a disproportionately large role in our country's economic health. Beat down by falling home prices, tumbling stock markets, and an unemployment rate that rose over 10% at one point, consumer confidence plummeted in 2008 and 2009. Because they were not confident in their job security or their own financial health, many consumers delayed big-ticket purchases like cars and new homes, adding to an already deep recession. Fortunately, consumer confidence has risen steadily over the past several years. In fact, 2013 posted the biggest increase in home values since 2005.

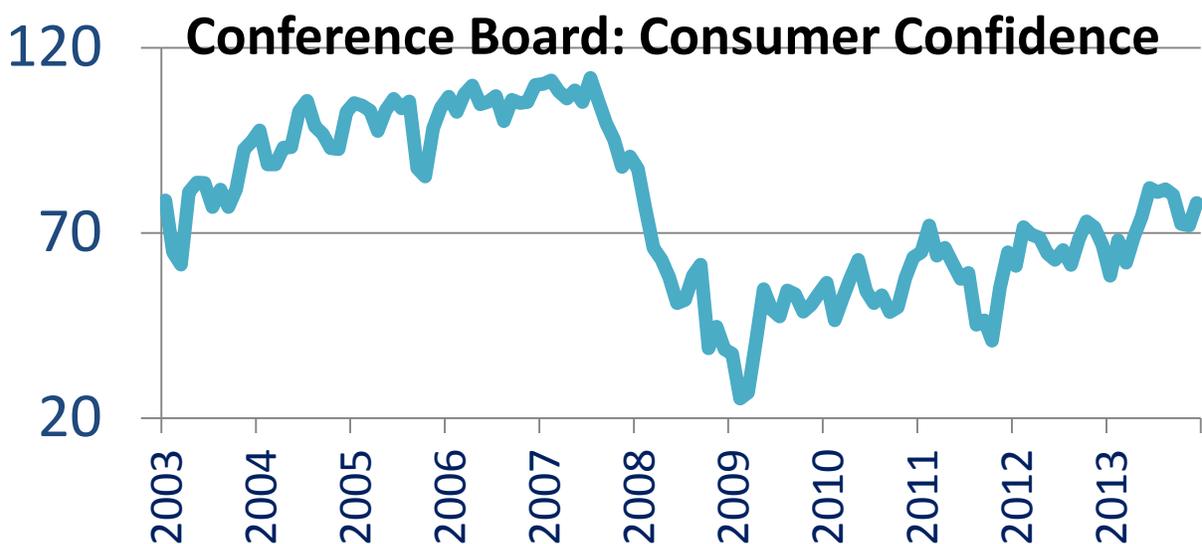


Chart Source: Bloomberg

To recap, 2013 was the year that had just about everything going against it—from policy uncertainty to government shutdowns. Even so, the economy and America's CEOs were able to turn these ingredients into a "gourmet meal" for investors. The good news is that we believe the basket of ingredients we have for 2014 is shaping up to be much tastier, with the government, business, and consumers all on much stronger footing in our economic "kitchen" than they have been in recent years. Bon appétit!



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