Tradition Capital Management, LLC

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Economic & Market Commentary

Equity investors had a lot to be thankful for as 2013 ended. At the beginning of 2013, we avoided falling over the fiscal cliff, while the impact of the government spending "sequester" and a tax increase on the wealthy proved less deleterious to economic growth than feared. Later, we survived a three week government shut down and avoided a U.S. debt default, in spite of a totally dysfunctional group of legislators. Inflation stayed well controlled, while long-term interest rates increased about 75%, admittedly from historically low levels. Outside our borders, the Eurozone avoided another crisis, China's economy stayed on the rails, Japan opted for Abenomics, the West did not escalate involvement in the Middle East, and Iran made overtures to mollify relations with the U.S. In spite of this lengthy list of potential negatives, the U.S. stock market (S&P500) turned in its best performance since 1997 and its 19th best in the past 85 years. It produced a total return of +32.4% for the full year, gaining 10.5% in the final quarter. Other indices were in the same area, ranging between +30% - 40%, depending on your choice. The U.S. outperformed most other global markets, with emerging markets at the bottom of the pile. U.S. stocks outperformed bonds and gold, which both produced negative returns, and most other asset classes as well.

Small and mid-cap stocks outdid large cap for the year, although the reverse was true in the final quarter. Growth had a slight edge over value for both the year and final quarter. Lower quality issues continued their superior showing for both periods, as they have for some time. The narrowness of the stock market, which we have noted in the past, continued for the full year, with only 4 of the 10 S&P industry sectors providing superior results. The consumer discretionary, healthcare, industrials and financials were the strongest sectors for the year, while utilities, telecom, energy and consumer staples advanced less. In the final period, technology came to life and healthcare began to fade. As has been the case since last year, high dividend payers were definite laggards. The increase in interest rates seems to have deflated some of the recent impetus in the search for income.

Like the stock market, the U.S. economy withstood the spate of negatives throughout the year, and turned in what can be considered a good performance. Third quarter real GDP was revised upward to a strong +4.1%, due in part to strength in anticipation of the three week government shut down. Fourth quarter economic growth is estimated at +2% plus, which will bring the full year in at about +2.5%. The various components of economic growth contributed about as expected. Consumer spending, housing and exports were all decent, while capital spending disappointed and government spending was a drag. Job creation has been fairly strong; notwithstanding the recently released anemic December report of 74,000 jobs (this has many nonrecurring factors and is expected to be revised upward). Inflation was well under control and liquidity remained abundant. All in all, it was a year in which the economy developed about as we expected.

The outlook for the current year is good as well. The U.S. consumer will benefit from a better jobs outlook, which should have a salutary impact on disposable income, while the effects of tax increases wane and the past year's fiscal drag diminishes. In addition, household balance sheets have been significantly repaired by the deleveraging that has taken place over the past couple of years (although primarily the result of mortgage defaults, not debt pay down), and the appreciation in both the housing and financial markets. The result of this has been an estimated $8 trillion increase in household wealth in the past year. Housing is expected to continue its rebound, probably at a slower pace than the most recent past, as interest rates begin to edge up increasing the cost of mortgage financing. Federal government spending will cease being the drag of the past few years, and state and local governments are in decidedly better shape. With a synchronized global upswing and an attractively priced dollar, exports should be another positive. The other major component that is important is business spending on capital equipment, which has not been as buoyant as we had expected; we do think this is about to change for the better. Business fixed investment

has not been strong during this recovery. The change in the real capital stock of the country has been close to 50 year lows, leading to an average age of plant close to 50 year highs. As long as consumers continue to spend, business spending should follow and add to the equation. With inflation not an issue and the Federal Reserve Board's promise of ample liquidity, we should have the ingredients that allow the U.S. economy to show the best growth in several years. The view of most economic observers is that we will experience real growth in the area of 3-3.5%, the best since 2005.

We have long held the view that the U.S. was in for a period of subpar growth in the range of 2-2.5% for a period of several years after the Great Recession. We are now in the fifth year of recovery from that event, and while we continue to feel the premise is valid, there can be cyclical improvement from that path. 2014 could well be an example. The case for prolonged subdued growth has been the subject of some recent discussion when Larry Summers, the Harvard guru and former Treasury Secretary, spoke at the IMF's annual research conference. He floated the idea that the U.S. economy could be in a period of "secular stagnation" that prevents the absorption of the economy's full capacity, restraining growth well below the 3.5% the U.S. enjoyed between WWII and 2000. The case for subpar growth after financial crises is also discussed in Rogoff and Reinhart's seminal book This Time is Different, laying the cause at the feet of the severe financial shocks and strains that economies sometimes go through. The case was advanced further in a Barron's cover story "Slowing to a Crawl" (October 20, 2013), which looks at our dwindling demographic profile and diminishing labor productivity, the two essential components of economic growth, and concludes we are in for a longer period of subpar growth than the 5-7 years that Rogoff and Reinhart suggest. The original secular stagnationist was economist Alvin Hansen - "the American Keynes" - who in 1938 pronounced that the U.S. was stuck in a period of profoundly slow growth, which he dubbed "secular stagnation."

In any case, there is room for cyclical ups and downs in any of these theories, and a cyclical boost is what most economic observers expect in the coming year. We share that view, as discussed earlier. Whether we resume a period of subpar activity remains to be seen. It is a reasonable conclusion given the facts as they look today; however like Hansen, it could be proved wrong due to technological advancement and the ingenuity of man.

If the expected scenario plays out as described, we should have another positive year for stocks. Accelerating growth, both here and across the globe, with low inflation and friendly central banks should be a good environment in which to be an equity investor. While we certainly do not expect a reoccurrence of last year, we do expect an acceptable result. Last year, we posited that stocks could provide a return in the 6% area, and of course, we were wrong. For the second consecutive year, price/earnings multiple expansion exceeded earnings growth and was responsible for well over half the market's return. In our last quarterly outlook, we outlined our best case for earnings growth for the market (as measured by the S&P500). We concluded that growth of about 6% could be expected. We are in the final quarter's earnings season now, and the consensus expectation is that the S&P500 will close the year with earnings of $110-$111 per share, a gain of close to 6%. The base case discussed last time is still valid with the only adjustment being a better rate of expected global economic growth, which should translate into a slight increase in bottom line growth, say +7% (but not the +10-11% expected by some).

At the close of the year the S&P500 was at 1848, or close to 16.5x expected 2013 earnings. While not stretched, this valuation is not cheap, and in fact is a full multiple higher than three months ago. This level is not yet at the point where we would want to reduce exposure, but it does underscore the need to have conviction about our investment assumptions. We would not expect much help from a reduction in the

equity risk premium (higher P/E's), which is still above its average level. We believe the primary driver of equity prices this year will be earnings, and therefore there will be a premium on being right on these.

Three months ago we also discussed our portfolio structuring approach to the environment at that time. We explained that because of the improving environment we wanted more offense and less defense. This meant more emphasis on economic sensitivity in our sector selection (industrials, technology and financials) and less emphasis on consumer staples and some parts of healthcare. These moves have been beneficial, and we will continue their emphasis. It also happens that these moves are in keeping with going from more expensive valuations to cheaper valuations, which gives us greater confidence in such a strategy. We also spoke about searching for businesses that have specific catalysts, which are independent of the broader macro influences. We have added several holdings with these characteristics and will continue the effort going forward.

The problem with the views stated above is that they are almost universal, which is to say we are part of the consensus. This puts us in an uncomfortable position, as the consensus is often wrong, but more importantly, when reality is different than the consensus financial markets can adjust sharply or even violently. So, we must ask ourselves what could throw sand in the gears and derail the scenario. In our last outlook, we pointed to several factors that could be problems as we go through 2014. There is no need to repeat all of them, but it is important to point out a few things that are on our watch list.

- Europe continues to have problems. At the moment it looks like Europe is in the early stages of recovery. However, deflation is still on the minds of Europe's central bankers. A deflationary spiral causing a run on European banks could endanger the Euro and lead to another crisis.

- China slips into decline. Quite to the contrary, China looks like it has negotiated the transition well, and is on the way to resumed growth in the +7% area.

- Interest rates could spike. Our view is that the normalized rate for 10 year Treasuries is 4-5%. Last year, the 10 year went from 1.76% to 3.03%. If rates were to exceed the normalized rate and did so rapidly, it would pose a problem for equities. The Federal Reserve has signaled moderation, but this will need to be watched closely

- Profit margins are close to record levels and could decline, creating a problem for earnings. While this is true, and we expect earnings to be the primary driver of stock returns this year, we think there are enough factors to mitigate this potential problem. Foreign sourced earnings are increasing and these carry higher margins than domestic. Also, the returns to capital have been greater than the returns to labor for several years. With unemployment remaining high, there is little reason to expect this to change in the near term.

- Dysfunction in Washington rears its head again. Deeply held partisanship is not going away, and we do have issues to deal with in the first quarter. The budget and debt ceiling were merely kicked down the road last fall, and will come up again soon. Also, the important issue of income inequality has risen in the political discourse to the point where it may demand to be addressed. This is sticky as the solutions are not easy and could raise very basic differences in political viewpoints, throwing gasoline on the partisanship fire. The issues of equality of opportunity versus equality of outcome and the absence

of a growth agenda are central to this issue, and potentially divisive.

- Finally, the possibility of a 1987 like event is always lurking. The Bank Credit Analyst recently raised the thought, and pointed out similarities between then and now. There are some (stocks getting expensive, interest rates rising, a weakened dollar, and general bullishness on the part of investors), but not enough substance to call for action.

Putting all of these together and adding the others mentioned last time, it is evident that we will have to remain alert for any negatives that could derail what could be a decent outcome. Having negotiated last year without a decline in the equity market of more than 6%, it is evident that we are overdue for a steeper "correction". At this stage, we think the chances of this happening are high, but the exact timing and cause are impossible to predict with accuracy.

Fixed Income Review and Outlook

Unlike equity investors, bond managers weren't sorry to see 2013 end. The suggestion by Fed Chairman Ben Bernanke in May and again in June, that the Federal Reserve would not buy Treasuries and Mortgages forever sent 10 year bond yields up almost 100 basis points (one percentage point) in a few months' time. The 3.03% yield on the 10 year Treasury on December 31, was the highest daily closing level of 2013. Bond volatility returned to levels not seen since late 2011 and companies rediscovered that they could issue bonds at historically low interest rate levels and use the cash to reward the equity holders with higher dividends and share repurchases.

Bonds produced a small negative return for the quarter. Overall, the Barclay's Aggregate Bond Index generated a -0.14% return for the three months ending in December and returned -2.02% for the year. This was the first negative annual return for the Aggregate since 1999 and only the third in the last twenty years.

Treasuries lagged the overall market with a -0.75% return, bringing the YTD total to -2.75%.

The Fed's decision to pass on tapering (reducing bond purchases) in September came as a surprise to most of the market. Similarly, market participants (ourselves included) expected the Fed to delay tapering until March 2014. We thought Bernanke would prefer not to set Janet Yellen, the next Fed Chair, on a course with which she potentially did not agree. On December 18, the Fed started the process of exiting the latest round of QE. Starting in January, the Fed will purchase $75 billion bonds per month; $40 billion Treasuries and $35 billion Mortgages. Consensus says the Fed will reduce purchases by $10 billion over the next six meetings and by $15 billion at the October meeting. Consensus also said taper in September and no taper in December so let's see what evolves, but "Don't Fight the Fed".

The December press release that announced the taper decision noted that the "sizable and still increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates" which will "support mortgage markets". Let's assume for the sake of argument that the Fed tapers at the consensus speed this year. What does that mean? It means that the Fed will buy more than $200 billion Treasuries and more than $150 billion Mortgages in 2014.

Does that matter? The obvious answer is yes. That's a lot of supply being taken out of the market. But the Fed is taking out a smaller piece of a dwindling pie. In the fiscal year that ended in September 2013, the Federal deficit was $680.28 billion, the lowest since 2008 and down from $1.089 trillion in fiscal 2012. It's Treasury issuance that funds the deficit spending. A lower deficit means less need for new Treasuries. We

can argue that there were some unique circumstances in last year's budget. For example, Fannie Mae and Freddie Mac repaid over $80 billion in total to the Government. That goes directly to deficit reduction and won't be repeated. But with the S&P up more than 30% in 2013, surely there will be some capital gains to be paid. Treasury issuance is set to fall.

To go off on a tangent for a minute, you may remember that in the late 1990's, when the Federal Government was projecting surpluses as far as the eye could see and some talking heads had the Dow going to 36,000, there was some concern in the bond market that Treasuries would be issued too infrequently to serve as a benchmark off which to price bonds. Not to worry, one corporation replied, you can benchmark off us. That corporation was reduced to non-investment grade just eight years later. We are back to being wary of the consensus.

The composition of the voting members of the Fed Board of Governors changes in January. Yellen will be sworn in February 1 as the new Fed Chair. She will lead a Fed with voting members more divided philosophically than those that have gone before. Noted inflation hawks Plosser and Fisher vote this year, as does the dovish Kocherlakota. It is uncertain how Stanley Fischer, the presumptive Vice-Chair, will lean, though some consider him hawkish. That would put the voting members at a near 50/50 split philosophically with few members, if any, taking a more neutral stance. It's expected that, like previous Fed's, the Board will follow the Chair's lead in voting. Yellen is considered a dove. Large dissents during the voting are possible if the hawks perceive too little concern about inflation or too little efficacy of the slow taper. In that event, expect bond volatility to rise.

At current levels, Treasury yields represent fair value. We are maintaining duration of about 90% of our target, with less exposure to the longer end of the Treasury curve, based on the expectation of higher rates once the taper does begin. We take most of our interest rate exposure using the three to ten year part of the curve. We are watching the TIPS market in anticipation of an overly bearish view on inflation for an opportunity to add inflation protection. We would look for breakeven yields, the rate at which you are indifferent to holding a nominal Treasury or a TIP, to fall about 20 basis points from current levels before taking a position.

Agencies returned -.06% for the quarter and -1.58% YTD. We like callable Agencies that have coupons that step-up, as they have an increased probability of being called. The rise in interest rates since the end of April has pushed the prices of many callable bonds below par, $100, making them eligible for both capital appreciation and income.

Investment grade corporate bonds outperformed the market with a 1.11% return, bringing the YTD total to -1.53%. Longer bonds outperformed shorter bonds, as spreads compressed dramatically in December and financials continued to best both utilities and industrials.

Corporate issuance set another record in 2013. $1.106 trillion new investment grade corporate bonds were sold according to Barclays Capital. That is only what was issued in US dollars and in size big enough to be included in the Barclays Aggregate Index; there was certainly a lot more. Net issuance, new bonds less maturities and redemptions, totaled $665 billion, the second largest year behind 2009. We will probably still see $1 trillion in issuance this year, though the net figure may be lower as bonds issued in 2009 start to mature.

We intend to remain overweight corporate bonds. In a low yield environment, the carry trade (owning spread to capture extra yield) is a good way to outperform the market. Following the strong performance of credit

relative to other fixed income offerings late in the year, we expect to lighten up on the corporate holdings that don't offer enough yield to compensate owning the bond. We also plan to exit some bonds that have rolled down the curve and find bonds in the same names with longer maturities that will roll down as 2014 progresses. We continue to prefer credits with the ability to raise prices or those engaged in ongoing balance sheet repair. We tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

Mortgages fell in the fourth quarter, returning -0.42% and -1.41% for 2013. This was only year mortgages failed to deliver a positive return in more than 25 years. We reduced our mortgage positions in late 2013 and expect to look for opportunities to continue to do so in the first quarter. There is a lot of noise in the market and spreads, in our opinion, do not reflect all the negatives for holding the bonds. For example, banks facing regulatory changes have reduced their MBS allocation. Money managers, facing redemptions, will often sell what is liquid and sizable; mortgages tend to fit the bill. Mortgages provide a higher yielding alternative to Agencies. We intend to look to add mortgage exposure on weakness later in the year but, for now, are more comfortable sitting on the sidelines.