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Fourth Quarter 2013

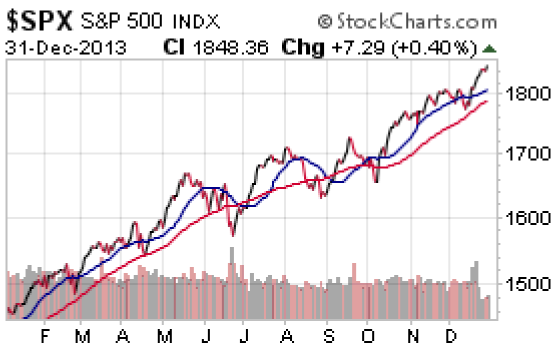

Fig. 1 – S&P 500

Fig. 2 – 10 Year U.S. Treasury Yield

U.S. stocks again posted strong gains in the fourth quarter. The large cap S&P 500 rose 10.5%, finishing 2013 up 32.4%, in a year marked by steady gains and few pullbacks (**Figure 1**). Outside the U.S. the picture was mixed. The MSCI Europe, Australia and Far East Index gained 22.7% in 2013 as investors favored developed country markets and stocks. Emerging economies generally lagged, with the MSCI Emerging Markets Index falling 2.6%.

According to Factset, 73% of S&P 500 companies topped third quarter earnings expectations while 53% beat revenue estimates. Earnings grew for the fourth straight quarter, rising 3.5% after gaining 2.1% in the second quarter of 2013. At this time, analysts expect earnings growth of 6.3% in the fourth quarter. This anticipated acceleration in earnings growth may be partly responsible for the strong equity returns in the fourth quarter.

The U.S. economy began the quarter with the continued modest growth seen earlier in the year. As in the previous quarter, housing data showed solid annual growth, but often failed to meet analyst expectations. Interest rates dipped slightly mid-quarter (**Figure 2**), but not enough to stimulate home sales and mortgage refinancing. However, other areas of the economy appeared to strengthen throughout the quarter. Purchasing manager surveys in both the manufacturing and service sectors indicated continued growth, particularly with respect to new orders.

The employment picture in the U.S. also improved in the quarter. The unemployment rate dropped from 7.3% in October to 7.0% in November, the lowest in five years. Improvement in this closely watched statistic has been identified by the Federal Reserve as a trigger for reducing their monthly bond purchases and eventually raising interest rates. In December, in his last press conference as Chairman of the Federal Reserve, Ben Bernanke announced that the Fed would begin to taper bond purchases. This news was welcomed by equity markets. Stocks rallied as investors perceived the tapering as a show of confidence in the economy.

After such a strong year for U.S. stocks, and double-digit increases in four of the last five years, investors may well worry whether the market can continue to rise in 2014. Previous bull market returns may provide some useful perspective. In 1997, the S&P 500 rose 33.4%. This was followed by gains of 28.6% in 1998 and 21.0% in 1999. Similarly, the market gained 31.7% in 1950, and then rose 24.0% in 1951 and 18.4% in 1952. These historical examples are not provided to predict that the market will have a strong year in 2014. However, the data does imply that it is

Index returns taken from Morningstar.com and iShares.com possible for stocks to follow very strong years with additional gains, as economic and earnings momentum may continue longer than investors expect.

As the new year begins, there are reasons for optimism regarding the economic recovery, which may also fuel further equity market gains. Oil and natural gas reserves and production in the U.S. have increased significantly, offering the potential for lower gasoline and heating costs. This also provides U.S. industrial and basic materials companies with lower input costs, a significant competitive advantage. At the same time, world-wide demand growth for oil and other commodities has slowed, partly due to China's reduced emphasis on new construction. The previous decade was marked by rising commodity costs and tepid or negative stock returns. This was also true during the Seventies, another long bear market. Higher commodity costs serve as a tax on corporations and individuals, squeezing profits and consumption. By contrast, today's lower cost environment may provide a subsidy of sorts, boosting earnings growth in many industries. Moreover, falling commodity prices may stimulate further demand for the U.S. dollar and dollar-denominated assets, again supporting stock prices.

On a more local note, the Michigan economy has steadily strengthened since bottoming in 2009. According to United Van Lines, migration from Michigan halted in 2013 after sixteen years of net outbound moves. Furthermore, the population of Michigan grew for the second consecutive year, following seven years of declines. In a clear sign of the changing commodity picture, DTE Energy will be decreasing costs for customers for the first time in five years. All of this is supported by renewed strength in the auto industry, which, historically, has promoted growth in the whole U.S. economy.

While we have some optimism for the coming year, we are mindful that, after a 166% increase from the lows of 2009, some stocks may not be as attractively valued as at the start of 2013. By some valuation measures though, stocks appear to have further upside. Morningstar reports that valuations of stocks in their coverage have risen from fairly valued at the beginning of 2013 to just 2% over fair value today. Forward price-to-earnings multiples for U.S. indices have risen, but do not appear to be at bubble levels. In this environment, we will continue to search for attractively priced investments while maintaining a careful watch on economic developments.

We wish you a happy, healthy and prosperous new year.

Sincerely,

Kenneth M. Bernard, CFA