

To: Aequitas Client

From: Warner A. Henderson, ChFC

Subject: Farewell Ben, Hello Janet

At the time Ben Bernanke was sworn-in as Chairperson of the Federal Reserve in February of 2006, the US economy was expanding at a robust annual rate of 5%, the unemployment rate stood at a healthy 4.7%, housing prices were at an all-time high and the stock market had finally regained all of its loss from the Tech Wreck stock crash of 2000. In short, the economy was humming along, consumer confidence was strong and asset values were at all-time highs. Chairperson Bernanke was considered an able and bright economist; an excellent appointment to fill the shoes of his predecessor, Alan Greenspan. Listed on Bernanke's resume was his academic research on the nature and causes of the Great Depression; scholarly work which many viewed as immaterial to his role as Fed Chair in 2006. After all, hadn't economists learned the lessons of the Great Depression? Apparently not; for over the next three years the housing bubble burst, the stock market crashed, eight million people lost their jobs and the economy was on the brink of another Great Depression. At that most challenging time, the lessons Bernanke learned from his past academic research provided him and two Secretaries of the Treasury with guidance that helped steer our economy out of the abyss toward a path of recovery. While his policies might be subject to criticism today (in hindsight), most observers feel that Bernanke was the right person at the right time to guide the Federal Reserve.

Enter Janet Yellen; another bright, thoughtful and highly respected economist coming into office under vastly different circumstances. Today the economy has *mostly* recovered from the Great Recession, but substantial challenges remain. While the housing market has significantly improved and stock prices have fully recovered, economic growth is sub-par at 2.8% and the unemployment rate remains high at 6.7%. The Fed's stimulus policies have most certainly helped to inflate asset values as designed, but those same policies

have been much less effective in solving the unemployment problem and generating stronger economic growth. Furthermore, Janet Yellen's Fed is saddled with the responsibility of unwinding the stimulus which Bernanke's Fed deployed (i.e., tapering back on bond buying, reducing the size of the Fed's balance sheet and eventually raising interest rates). All of this unwinding must be done while at the same time attempting to maintain or even strengthen economic growth, improve the employment picture and keep inflation low; a herculean task indeed. Former President and CEO at the Federal Reserve Bank of Boston and a friend of Janet's, Cathy Minehan, said at the time of her appointment that Janet was the perfect choice for the job. She went on to say, that the Fed's ".....high wire act of keeping the economy moving with less and less monetary support without creating financial volatility that works to damage prospects for growth will be one of the most difficult challenges ever faced by a Fed chairman...."

The challenges facing Chairperson Yellen are unprecedented and there are no comparable lessons from history she can draw on in contrast with Bernanke's situation in 2008-09. So we're heading into uncharted waters with lots of speculation. Some economists feel that unless the Fed unwinds its stimulus in a timely manner, we run the risk of much higher inflation in the future and possibly stagflation (i.e., high inflation and slow growth). Others feel that if the unwinding is done too rapidly, we run the risk of sparking another recession which would only make matters worse. Clearly, the key to a successful outcome will be the pace of economic growth over the next few years (probably longer). If growth accelerates, the economy will then be in a stronger position to absorb the negative impact of the Fed's cutting back on stimulus. Fortunately for Yellen (and the rest of us), economists are now forecasting stronger growth in the US over the next twelve months with unemployment gradually falling to 5.5% to 6%. The improved outlook extends around the globe, as well, with Europe coming out of recession and China's growth



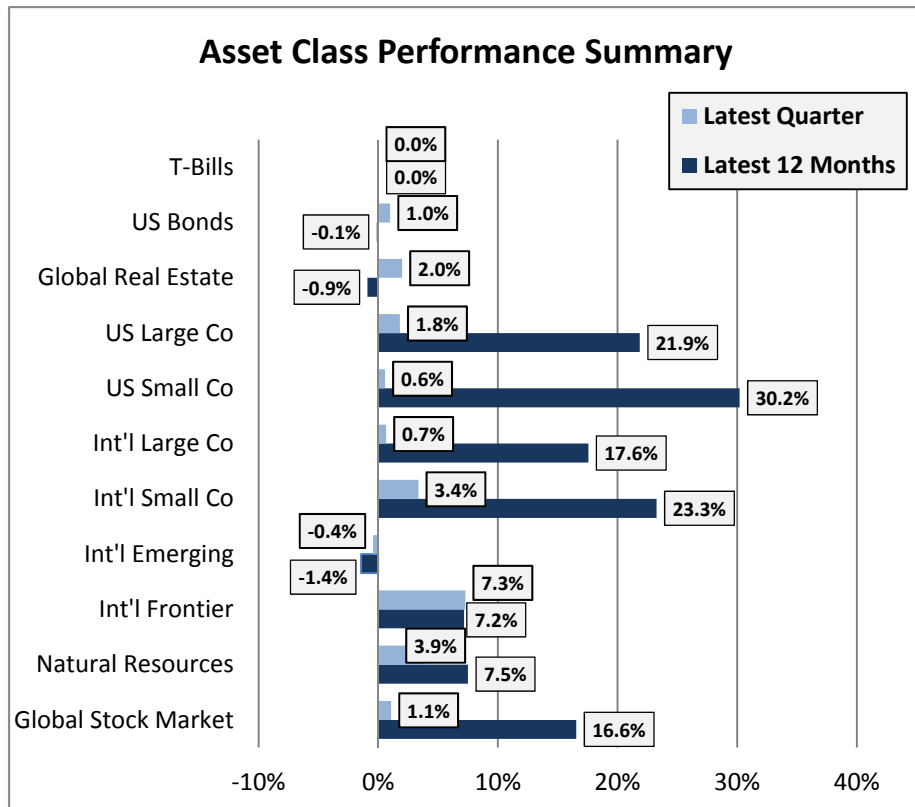
appearing to stabilize. This week, the International Monetary Fund published a revised forecast indicating stronger global growth over the next twelve months (rising from 3.6% to 3.9%) and a near zero probability of a global recession. The direction of the forecasts is encouraging and should allow Janet Yellen some breathing room (she needs it).

Asset Class Performance Review

For the latest quarter, all of the major asset class returns were positive with the lone exception of the Emerging Markets (EM). Given the prospect of improving growth in the Developed Markets (DM), there have been significant outflows of capital from the EM economies toward the US and Europe. Some see this trend continuing for a while which puts the yellow flag up on EM stocks; others see this as a temporary adjustment and interpret the lower prices of EM stocks as an opportunity to find bargains (we're cautiously optimistic

about EM stocks, especially the non-BRIC countries and the Frontier Markets). Speaking of Frontier Markets, they had the highest gain for the quarter (+7.3%), followed by Natural Resources (+3.9%), Int'l Small Co's (3.4%), Global Real Estate (+2.0%), US Large Co's (+1.8%), US Bonds (1.0%), Int'l Large (+0.7%), US Small Co's (+0.6%) and, lastly once again, US T-Bills (0.0%). Bonds were given a reprieve following Janet Yellen's recent statements suggesting that the Fed will likely not be raising interest rates until the economy displays stronger growth.

For the latest twelve months, stocks in the Developed Markets posted the strongest returns given more favorable economic outlooks for the US and Europe. Small Cap stocks led the way, with gains of 30.2% and 23.3% for US Small and Int'l Small respectively. Not far behind were US Large (+21.9%) and Int'l Large Co's (+17.6%). The entire Global Stock Market gained 16.6% which is close to twice its expected return. Natural Resources (+7.5%) and Frontier Markets (+7.2%) came in at close to a tie. The laggards were T-Bills (0.0%), US Bonds (-0.1%), Global Real Estate (-0.9%) and Emerging Markets (-1.4%). All in all, a terrific twelve months for stocks.



Has the Anticipated Stock Market Correction Begun?

For several months, or more, strategists have been anticipating a stock market correction following well-above average returns over the past two-plus years (a correction is defined as a 10% pullback in stock prices). Sooner or later, of course, the law of averages catches up; and as I wrote in our last quarterly letter, we shouldn't be surprised to see a 10%, or more, correction during 2014. We almost got there in late January and early February when stocks fell by 6%, but stocks quickly recovered as positive economic news in the US, UK and Europe apparently outweighed growing concerns in the developing world, including the Ukrainian crisis and slowing growth in China. Over the past few days, stocks have retreated once again leading some to believe the anticipated correction is now underway. From our perspective, as long as the global economic outlook remains positive, as it appears so today, we believe a stock market correction, whenever it occurs, should be viewed as an opportunity to buy stocks at lower prices through portfolio rebalancing. One of the benefits of having a balanced portfolio (i.e., owning a combination of stocks and short-term bonds) is that one is always in a position to take advantage of corrections. Should stock prices fall, short-term bonds not only lessen the downside impact, they also provide a source of liquidity to purchase more stocks at a relative discount.

Closing Comments on Corrections & the Price of Hamburgers

One of the reasons Warren Buffett has been such a successful investor over the years is his understanding that common stocks represent ownership in operating companies. By studying a company's assets and liabilities, its management team and its future earnings potential, he is better able to judge whether that company's stock is over-valued or under-valued based upon its current price. Buffett loves bargains and is generally happier when stock prices are depressed rather than when they're too high (which is why he usually keeps a considerable amount of cash on the sidelines). A number of years ago, Buffett reflected upon his penchant for hamburgers as a way to illustrate how emotions can interfere

with disciplined investing when it comes to the stock market. "To refer to a personal taste of mine, I'm going to buy hamburgers the rest of my life. When hamburgers go down in price, we sing the 'Hallelujah Chorus' in the Buffett household. When hamburgers go up in price, we weep. For most people, it's the same with everything in life they will be buying -- *except stocks*. When stocks go down and you can get more for your money, people don't like them anymore." (Except for people like Warren Buffett and other value stock investors.)

In closing, here's to the advent of spring (*finally*) and a time to renew hope for the future!

