Tarheel Advisors LLC

Tarheel Advisors Newsletter

Volume 6, Issue 1

January 2014

2014 Investment Outlook

Who knew '13 would be so lucky for equities? In spite of numerous potential causes of an election year hangover, stock indices around the world enjoyed historically good returns. Perhaps more of the same is on tap for this year, but we'll cut through the froth later. Let's first take a look at how our 2013 predictions panned out.

Year in Review–Most of our predictions for 2013 were on the mark but were off by an order of magnitude. It would have been nice to foresee 30% domestic stock market returns, but better to be surprised to the upside than the downside. As predicted, the Market continued its momentum out of the gates earning 12% in the first quarter despite the political commotion around the debt ceiling, fiscal cliff, and the arrival of Obamacare. Even though we were correct about the intense focus surrounding the debt ceiling debate, we were incorrect in our assumption that it would create a 10%-20% correction as it did in the previous Summer; instead, the biggest correction we saw in 2013 was a 5% retracement in June when the Federal Reserve mentioned the word "taper". As it turns out, tapering was put off until December after briefly rattling the Markets, and the surge in value over growth stocks in the first half of the year was reversed by the threat of rising interest rates and its relative affect on dividends. At the end of the year, growth companies slightly outpaced value, but it's hard to feel bad when both styles were up close to 30%.

Our bond market predictions were spot-on as historically low interest rates reversed course mid-year and made for one of the worst years for bond investors in a decade. However, most of the damage in the bond markets was in long maturity government bonds. Our prognosis to over-weight high-yield and international bonds was correct with these asset classes providing significant relative out-performance.

2014 Predictions–Will our cup continue to runneth over in 2014? Against conventional wisdom, there is a good statistical chance that stocks once again will produce positive returns. In fact, roughly 75% of calendar years end with stocks in the black. Certainly there is a strong chance of reversion to the long-term stock market averages of 8-10% annualized returns, but we wouldn't bet against the open spigot monetary policy still flowing throughout the world which makes it very uncomfortable for investors to sit in cash or own bonds still at historically paltry yields. To put it in perspective, stocks have only averaged a 3.3% annualized return since 2000. An investor would have realized much better returns over the last 13 years investing in US Treasuries. From that standpoint, it is tough to conclude that stocks must end their run higher in the near-term.

We're encouraging investors to embrace the easy money policy a little longer and are expecting equity returns of around 10% in 2014 for both domestic and international stocks. We see the momentum for this forecast driven by the long overdue expansion of the U.S. economy. With the recent third quarter revision to GDP growth exceeding 4%, it is quite possible that we are finally growing out of the economic malaise of the past 5 years and are on the path toward a

2013 Score Card

Big Returns Early in Year	A
Debt Ceiling Calamity	B+
10% or Greater Correction later in Year	D
Poor Year For Bonds	A
High Yield Bond Outperformance	A

2013 Market Update

S&P 500	+32.4%
DOW	+29.7%
NASDAQ	+38.3%
MSCI World	+22.8%
BONDS	-2.5%
GOLD	-28.6%

Mortgage Rates

15-Year	3.57%
30-Year	4.54%
5/1 ARM	3.69%

Did You Know?

*Federal Reserve Chairman, Ben Bernanke, will step down on January 31st after serving 2 four-year terms. He will be replaced by Janet Yellen, the Fed Vice-Chair.

*At one point in December the market capitalization of Twitter exceeded that of Target.

*Historically, the year following 20%+ US stock market gains has produced an average of just over 11%.

* As part of the agreement to end the Government shutdown in the Fall, the US debt ceiling was raised until February 7th.

modest yet stimulative 3% growth rate.

Generally, with economic growth comes expansion of corporate revenue and profits. If investor confidence remains stable, earnings can drive price appreciation without the aid of a less accommodative and / or tapering Federal Reserve.

Economic growth can also be a good thing for bond markets moving forward as interest rates begin to normalize and artificial monetary ceilings are removed. We expect the balance of low inflation and monetary policy maneuvers to hold the yield curve in the same territory for 2014, thus providing bond investors with better yet unspectacular returns of around 3-5%.

Aside from the two main asset classes, we feel that 2014 could be a banner year for alternative investments. With the most well known barometer, gold, losing 28.6% in 2013, we anticipate double digit upside from here. Given that gold is now hovering around its production cost, reduced supply by producers and the continued demand by consumers to protect against fiat currency expansion should put a floor under the yellow metal. Additionally, we feel that the 2013 mid-year 20% sell-off in income producing assets like REITs and MLPs was overdone. We think both look attractive in 2014 as they attempt to regain momentum with solid risk / reward dynamics.

While we feel the short-term prospects for the stock market are positive, we still encourage investors to approach portfolio allocation in an extremely diversified fashion. Despite the abnormally high returns of domestic equities in the past 5 years, the U.S. entered a cyclical bear market in 2000, and 14 years later its hard to say whether we have exited. The average cyclical bear market lasts 17 years, so hopefully, we are at least getting close to the cusp of a new long term bull market that we can all believe in. However, with government intervention and easy money at record levels, our bet is on one more bump in the road before investors can ride the bull.

-Ryan Glover, CFP®

New Year — New Tax Laws

As we celebrate the big ball (or acorn) drop and the beginning of a new year, taxpayers are in for quite a surprise in 2014. Notwithstanding the recent federal tax law changes, many of which stem from the national healthcare overhaul, several states have undertaken extensive tax reform as well. According to the National Conference of State Legislatures, five states: Alaska, Minnesota, North Carolina, Ohio, and Virginia, enacted major tax reforms. At least four more states are scheduled to vote on tax reform early in 2014. These reforms are certainly all different in many aspects, but the common trend appears to be an effort to simplify the tax code by lowering state income tax rates in exchange for limiting or eliminating certain deductions or exclusions.

Our home state of North Carolina is a good example of the typical overhaul, and some of the changes may surprise you. These changes will likely have a major impact on your tax planning for 2014, so here are the highlights of what did and did not change for 2014.

For individuals, the previous three-tier (6, 7, 7.75%) progressive income tax is replaced by a flat tax rate of 5.8% in 2014 and 5.75% in 2015 and beyond. To offset the revenue impact of this reduction, individuals stand to lose several state income tax deductions and exemptions, including the personal exemption, earned income tax credit, energy star credits, and deductions for making contributions to a NC 529 plan. Perhaps the most consequential change for our readers is the elimination of the $50,000 per taxpayer state income tax deduction for net self-employed income.

On the corporate side, businesses can also expect to see a reduction in the income tax rate from 6.9% to 6% in 2014 and down to 5% in 2015. Further rate reductions in subsequent years will depend on whether revenue targets are met in 2016 and 2017. In exchange for this reduction, almost all of the various other business tax credits will be allowed to expire as scheduled under the current law, with the exception of the tax credit for research and development, which continues through 2016.

Some of the other notable tax code tweaks in NC involve various sales tax nuances. The overall state rate will not change, but some of the modifications will definitely affect your purchasing power and buying decisions. For instance, the "back-to-school" sales tax holiday is eliminated, and movie tickets and other amusements will now be subject to full sales tax rates instead of the reduced privileged rate of 1-3%. Another pseudo-tax increase will come mid-year as a result of the legislature vote to enact electricity rate increases as of July 1st.

As you can see, there are numerous changes that will affect all of us in different ways, both positive and negative. Be sure to consider and plan for your own situation as the new calendar year begins.

-Walter Hinson, CFP®

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