American Heritage Financial

February Update

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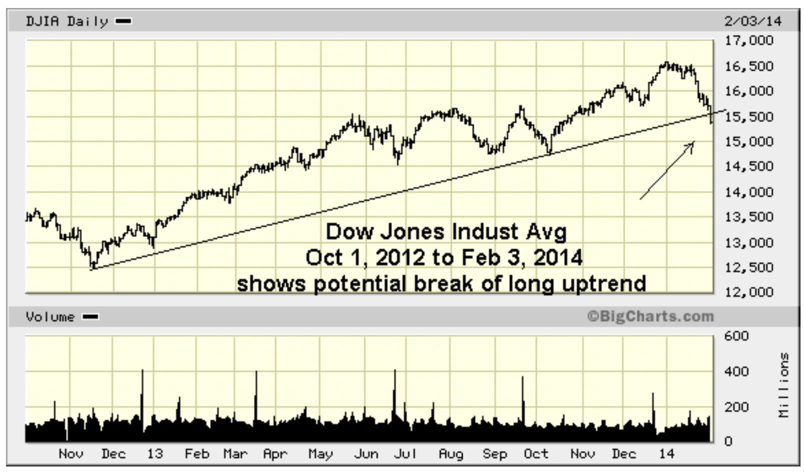
Will the 2014 Market be as Brutal as the Weather?

A Return to Normal: The New Year feels like a whole new world to investors. After the amazing run from November 2012 through the end of 2013—that finished with a four month 12% cruise from September through December—the stock market has turned as cold as the weather. And like the weather, declining prices are brutal and those of us who grew comfortable with mild conditions are finding it difficult to adapt.

The first month of 2014 saw the Dow skid 5.3% while the S&P 500 lost 3.6%, the worst monthly percentage declines since May 2012. And February, so far, is escalating the pain! What is the cause of the sudden reversal in stock prices? Let's start with the simple fact that a straight-up market such as we enjoyed over the final months of 2013 is unsustainable. Stocks rarely travel a steady course, either up or down. The final quarter of 2013 was an amazing *"everything that could go right…went right"* environment that drove stocks higher. We could even argue that the sharp, scary move toward a correction in early 2014 is an extension of the *"everything right"* environment—the market needs some correction to remain healthy.



The important change affecting stocks in 2014 is new concerns about the developing or emerging economies around the world. Similar to 2011 and mid-2013, concerns about liquidity and money fleeing many of the less stable economies of the world are having ripple effects on our market. An ebb and flow of foreign capital is normal, but the latest rush for the exits from some of the more vulnerable countries has meant sizable currency adjustments. Turkey, India and South Africa have reacted by raising interest rates, hoping to entice foreign capital to stick around and stem outflows, but markets have failed to respond positively. Policymakers will need to take bigger, bolder, and more permanent steps to convince investors that they are responsible enough to preserve the value of their currencies. Currency unrest is one of those potentially huge risks which investors with any memory of recent crises are not willing to bear.

It's tempting to believe that U.S. stocks are an antidote for this pain, or at least a safe haven. But the reality is that when emerging markets swoon, U.S. stocks decline as well, just not as much. Still, we believe global economies passed their nadir with the crises of the past few years and the recent aftershocks will pass.

Meanwhile, there remain other concerns which may provide headwinds for the market in the short term. The biggest of these is the changing of the guard at the Federal Reserve. Not that Janet Yellen has any less credibility than her predecessor, but the Fed is at a critical stage where it must continue to make progress reining in its massive stimulus programs while doing it in a way which does not disrupt the economy (and by extension the market). Secondly, investors are catching their breath at the same time the anxiety level concerning corporate earnings is extremely elevated. The endless argument about an expensive or cheap market has taken on greater urgency with stocks still near record highs, corporate margins at record levels and sales ever so hard to grow. In a twist of the conditions of late 2013 we are at a point where *"any little thing that can go wrong could turn into a big thing."*

Our advice to investors at this point is to reassess your long-term goals and objectives. If you are in the market for the long term to benefit from the resilient growth of capitalism, you should likely stay the course through the current turbulence. Certainly it is ok to lock in some outsized gains and rebalancing back to your established asset allocation is always prudent. However, the current anxiety in the market—as well as declining prices—is simply a **return to normal** after an exceptionally sublime period. While we may be in the early stage of a real correction (i.e. at least a 10% drop), conditions still look good for net gains in 2014, and the long-term bull market appears far from finished.

For those currently fully invested in stocks, with your appropriate asset allocation, the risk in taking dramatic defensive action at this time (i.e. trying to time the market by selling stocks) is that you could end up like those who held too much cash (or bonds) in 2013. You could be under-invested and miss out on the next strong up-leg. For anyone who is still under-invested, this potential correction is a true buying opportunity.

Best regards,
Your Advisory Team
EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments? Email us at: ahs@egifinancial.com or call 330-535-0881.

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