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JANUARY UPDATE

January 6, 2014

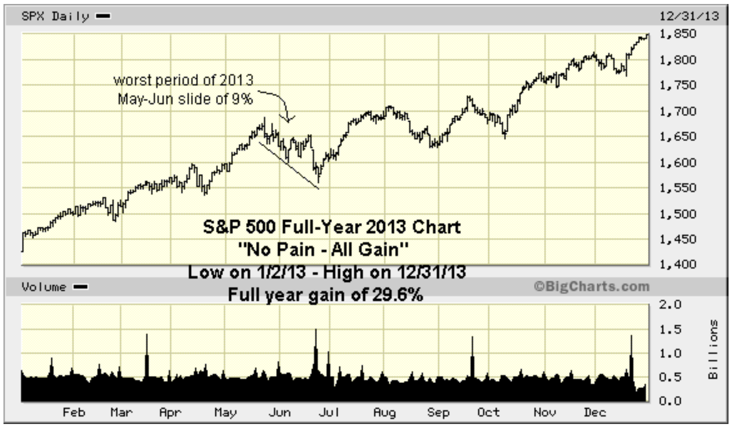
What Created the Great Gains of 2013?

All Gain, No Pain: There is no doubt about it, 2013 will go down as a great year for the market. Stocks finished with average gains near 30%, as shown in the accompanying table. It was the best performance for the S&P 500 in 16 years. Not only were gains extremely strong, they were consistent; there were only two months in 2013 which did not produce positive gains and the worst slide in stock prices was when taper-fever inflicted the market in the spring; resulting in a 9.4% drop from May 20 to June 24.

Market Returns **Full Year 2013**	% **YTD Chg**
DOW JONES IND AVG	26.50%
S&P 500	29.60%
NASDAQ COMPOSITE	38.32%
DOW TRANSPORTS	39.46%
DOW UTILITIES	8.27%
NYSE COMPOSITE	23.18%
MSCI EAFE	19.41%
MSCI EMERGING	−4.95%

So returns were great and gains were consistent, but what investors should really be thankful for is what ***drove*** the returns of 2013. Simply stated, market gains were the result of a steady ***reduction in uncertainty*** that accelerated into the final months of 2013. To understand this, think back to how bad it was in the beginning of the year—you could cut the uncertainty with a knife! In January 2013 many investors were still convinced that the November elections would lead to a dramatic decline in U.S. prestige, power and economic health. Critical political questions such as imminent tax hikes, spending (sequester) cuts and threats of another U.S. debt downgrade were conveniently packaged into an easy to hype term, the **"fiscal cliff."** The high anxiety and multiple fiscal issues created huge *un*certainty that threatened to snuff out the nascent economic recovery and tank the market. Nervous investors, still shell shocked from the 2008 financial crisis weren't helping as they jumped on a couple of widely publicized gloom and doom studies. One study showed that stocks produce below average returns in the first year of a presidential cycle, and especially poor returns in the first year for an incumbent—an average of negative 0.3%. More chilling was a study that suggested 2013 could be similar to 1973—a year which produced a 17.4% decline in the S&P 500.

The market began to harden to the fiscal cliff hype as politicians found ways to continuously kick the can down the road over the early months of '13. Meanwhile, the economy refused to buckle even in the face of the headwinds



blowing from Washington. Stocks suffered briefly in the spring when *"taper"* replaced *"fiscal cliff"* as the worry de jour. Investors reluctantly accepted the inevitability of "taper"—or the Fed withdrawing its stimulus programs—and thus removed one of the last major uncertainties smothering the market. Investors realized the economy and market could still function with higher interest rates (the 10 year Treasury rose from 1.6% to 3.0% in 2013). Then, the Fed announced in November that it would reduce bond purchases in December and the market responded extremely positively to the ***certainty*** that the massive stimulus programs were finally going to be unwound.

Added to the reduction of uncertainty concerning Fed policy and fiscal issues, investors questions about future leadership of the Fed were answered with the appointment of Janet Yellen—a dovish but well respected financial scholar—as new Fed Chairperson (beginning February 1, 2014). Finally, Congress even helped the market with a bipartisan agreement on a two year budget deal in late December. Although no one has any illusions that our budget problems have been resolved, the market took comfort in knowing Congress and the President were actually able to work together to create an appearance of function.

So if a reduction of uncertainty propelled returns in 2013, what is left for 2014? Considering that the market is 30% higher than a year ago, is it too expensive? We begin by looking at valuation. Based on 2013 earning estimates, stocks are currently selling at slightly less than 17 times earning. With earnings expected to grow another 10%+ in 2014, the market is at 15 times future earnings. Stocks are not cheap at these levels and the market is definitely overdue for some kind of pullback. On the other hand, the public has reawakened to the merits of equity investing and money flows typical of a mature bull market could drive stock valuations (P/E ratios) much higher in 2014.

So continued earnings growth should motivate investors to drive stock prices higher—but can we depend on the economy to be strong enough to produce that expected 10% earnings growth in 2014? Estimates of economic growth have been tamped down recently but most economists still expect 2.5% to 3% expansion in 2014. Some even believe a boost resulting from improvements in global economies could push U.S. growth close to 4%. Unlike recent year's headwinds, 2014 could actually be boosted by tailwinds which could create upside surprises. One tailwind is the **ongoing energy boom**, reducing energy costs and creating new jobs and industries in its wake. A second is an **extension of the housing recovery**—which has sputtered in recent months but housing prices are still 7.9%, or $1.9 trillion higher than at the end of 2012 and demand is firm. Add in the **U.S. manufacturing renaissance**—fueled by low energy costs, technological superiority and skilled labor. A potential positive is improving, although still tentative, global economies. Another reversal in fortunes is the U.S. **budget deficit**—which is actually declining. One of the biggest positives is **consumer confidence**—as Americans benefit from the **lowest household debt burdens** in a decade as well as the **wealth effect** of the $19 trillion dollar value of the stock market, compared to a low of just $7 trillion in early 2009 lows.

All this does not mean that we expect to party again like it is 2013, but it does suggest our investment strategies in 2014 will look much like they did last year. Stocks should continue to be a rewarding asset class but can't sustain the energy of the past year and will require a more selective approach. We expect to stay focused on the highest quality stocks within a well diversified portfolio with emphasis on industrial, technology, health care and financial industries. One change this year will be an increased exposure to foreign markets. Meanwhile, bonds continue to hold risk of loss of principle due to higher interest rates and commodities will remain depressed until emerging economies gain strength. We hope to add it all together to again help you achieve reasonable gains—with limited pain—as we assist you in achieving your financial and life goals!

Best regards,

Your Advisory Team

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