Fed's Decision to Taper Affects Bonds, Mortgages

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Review of 4Q 2013

2013 was the best year for equity investors since 1997. The Nasdaq led the way, up 40.11 percent, followed by the S&P 500, which was up 32.32 percent, and the Dow Jones, up 29.58 percent. The robust returns of 2013 allowed investors to erase memories of the 2007-2009 recession, and stocks rocketed 20 percent above the previous 2007 highs.

The combination of steady growth in the economy and continued monetary accommodation by the Federal Open Market Committee (FOMC) drove stocks to new highs. Despite the fiscal drag from Washington, we believe that the growth the economy experienced in 2013 sets the stage for a sustained GDP pickup in 2014 (Chart 1).

Chart 1: U.S. GDP Estimates

'11 Act.	'12 Act.	'13 Est.	1Q '14E	2Q '14E	3Q '14E	4Q '14E	'14 Est.
1.8%	2.2%	2.0%	3.3%	2.8%	2.5%	2.8%	2.8%

Source: Pinnacle Trust and Investment Advisory

While GDP growth was lower in 2013 than in 2012, GDP accelerated to 4.1 percent in the third quarter due to an inventory build driven by the robust sales of durable goods related to the automobile and the housing industry.

As we discussed in our last letter, we had expected the FOMC to begin tapering bond purchases in the first half of 2014. Because of improving economic conditions, the FOMC began the taper at their December meeting. Its action, a surprise to many, will lead the Fed to exit its purchase of Treasuries by the June meeting.

The effect of this early tapering was a prompt sell-off in bonds, and we believe that the yield curve will begin to flatten as we move into the year. As you can see in Chart 2, the 10-year bond yield finished the year around 3 percent.

Chart 2: 10-year Bond Yield for 2013

Source: Bloomberg

Housing

The housing recovery continued in the fourth quarter but at a slower pace. Prices have risen substantially in many markets. We expect home prices to grow 2-5 percent in 2014 vs. a 13.6 percent gain in 2013. The 30-year mortgage rate has risen from 3.7 percent in January 2013 to 4.6 percent today. We believe that if the GDP growth we discussed materializes, the 30-year mortgage rate will be well above 5 percent by the end of 2014. As the Fed continues to taper, we think that rising mortgage rates will be a headwind for home prices. The result will be a slower rate of growth, thus limiting consumers' purchasing power.

Chart 3: U.S. Housing Starts

'12 Act.	'13 Act.	1Q '14E	2Q '14E	3Q '14E	4Q '14E	'14 Est.	'15 Est.
783	918	957	869	901	945	1,075	1,254

In thousands seasonally adjusted

Source: Pinnacle Trust and Investment Advisory

Chart 4: Case-Shiller Home Price Index

Source: Bloomberg

Unemployment

Job creation continues to increase steadily in the U.S. Job creation accelerated in the second half of 2013, bringing the unemployment rate down to 7.4 percent in December (Chart 5). While we have been negative on the unemployment trends for some time because of the low-quality jobs that are being created, progress is being made.

We expect the unemployment rate to fall below the FOMC's 6.5 percent threshold by the end of 2014, setting the stage for an additional unwinding of the FOMC's $3.9 trillion balance sheet.

Chart 5: U.S. Unemployment Rate

'12 Act.	'13 Est.	1Q '14E	2Q '14E	3Q '14E	4Q '14E	'14 Est.	'15 Est.
8.1%	7.4%	7.6%	7.6%	7.2%	7.1%	6.7%	6.0%

Source: Pinnacle Trust and Investment Advisory

Chart 6: U.S. Labor Participation Rate

Source: Bloomberg

Chart 7: U.S. Full-time Employment

Source: Bloomberg

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Outlook

2014 will be driven by better GDP growth and the FOMC's move to a more balanced approach. With the increasing probability of the FOMC conducting additional tapering and rising interest rates in the bond market, we expect the S&P 500 to be up 6-8 percent in 2014. As the bond market trades on its own and the FOMC withdraws its stimulus, bond returns will be negative in 2014. However, the silver lining is that as yields rise in the bond market, investors will be able to buy bonds with higher yields to maturity down the road.

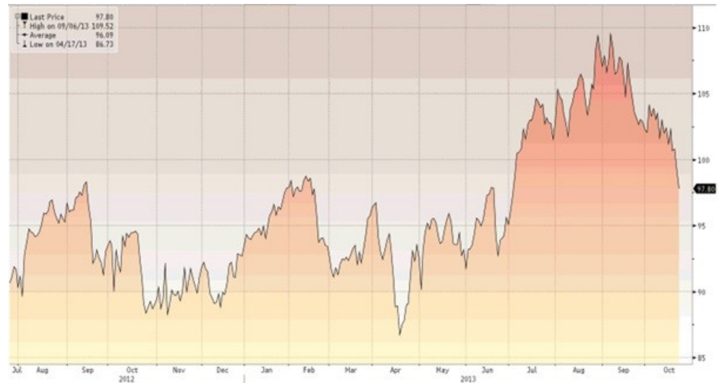
We expect world GDP to accelerate from 2.9 percent in 2013 to 3.5 percent by year-end 2014. What is behind this rapid acceleration in global GDP? Europe had GDP growth of -0.5 percent in 2013 and is expected to be at a 1.4 percent rate by 2015. The low inflation numbers we have seen over the last two years have been driven by a glut of commodities, lackluster growth in the U.S., the recession in Europe and low single-digit growth in Asia. The effect of the global GDP growth will be a slow build in commodity prices as we move forward over the next three years.

Chart 8: Consumer Price Index Estimates

'12 Act.	'13 Act.	1Q '14E	2Q '14E	3Q '14E	4Q '14E	'14 Est.	'15 Est.
2.1%	1.5%	1.0%	2.4%	1.7%	1.8%	1.7%	2.2%

Source: Pinnacle Trust and Investment Advisory

Chart 9: U.S. Crude Oil Price YTD



Source: Bloomberg

Portfolio Strategy

We remain bullish on technology, healthcare, financials and industrials. We are negative on utilities and consumer staples. The best-performing sectors for the fourth quarter were consumer discretionary, up 42.74 percent; healthcare, up 41.40 percent; and industrial, up 40.54. The worst-performing sectors for the quarter were utilities, up 13.05 percent; materials, up 25.99 percent; energy, up 26.25 percent; and consumer staples, up 26.30 percent.

Our portfolios are currently:

- Overweight: Technology, financials and industrials
- Underweight: Healthcare, consumer staples and consumer discretionary
- Recent sells: Allergan Inc.
- Recent purchases: Added to our position of IBM Corp., Apple Inc. and eBay Inc.