Timmons Wealth Management

First Quarter 2014

First Quarter 2014 Review & Outlook

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Despite positive absolute returns across equity and bond markets in the first quarter, investors witnessed a return of volatility during the first three months of the year. Surprising many investors, interest rates fell during the quarter leading bonds to outperform equities on a relative basis. Political turmoil in the Ukraine, disappointing economic data out of China and bad weather across the US led to a shift in risk-aversion among investors. Momentum names across internet and biotech sectors, among the biggest gainers in 2013, experienced sharp corrections as investors took profits and reassessed risk amidst sky-high valuations across many of these "market darlings." Mid-Cap stocks outperformed Large Cap and Small Cap stocks, while growth-focused strategies underperformed value strategies. Our firm's focus on fund strategies with higher quality, more valuation sensitive biases held up better during the market turmoil in the first quarter as investors began to shift allocations towards mature, dividend paying companies and investments with more attractive valuations. As noted in our previous letter, many of the fund strategies we invest in began building cash stakes in the 4Q13 as the number of attractive investment opportunities receded. As correlations have continued to fall between stocks across various sectors since the beginning of the year, we may be entering a new phase of the market which will benefit stock-pickers and lead to greater value differentiation for certain actively managed funds.

For the first quarter, the S&P500 produced a total return of +1.81%. The US economy has reached the 58th month of expansion leading many observers to believe that we are entering into the later stages of the US equity bull market. The US economic recovery has continued to proceed slowly with the economy growing +2.4% in the fourth quarter 2013. Despite Federal Reserve projections for GDP growth in the range of 2.8%-3.2% for 2014, estimates for 1Q14 GDP growth have continued to be revised down in the face of bad weather which stunted economic growth throughout the first two months of the year. The US unemployment rate has remained steady at 6.7% as of March 2014, with the private sector having replaced most jobs lost during the great recession outside of manufacturing. Despite falling unemployment levels, the number of underemployed in the US remains elevated and the labor force participation rate stands well below long term averages. The Federal Reserve continues to view deflation and slack in the labor market as two key issues facing the US economy today, and despite the Fed's continued actions to reduce its bond buying program, monetary policy will likely remain highly accommodative for an extended period of time. Low interest rates have continued to benefit corporate borrowers by reducing interest costs while punishing savers via lost income. In the face of these challenges, future equity market returns in the US will need to be driven by improving economic fundamentals and growth across corporate revenues and earnings. Outside of momentum stocks focused on biotechnology and the internet, valuations for the US market remain reasonable with the S&P500 trading at a forward P/E of 15.2x as of the end of March, roughly in-line with the 30 year average of 14.9x. We continue to expect US equity returns to be positive for 2014 but significantly below 2013 levels.

International equity markets, as measured by the FTSE Global AC-ex US Index, posted a moderate return of +0.98% in the first quarter. Europe continues to face a variety of challenges and is much further behind the US in its recovery cycle, in part driven by the 2011 recession resulting from the European debt crisis. Fears of the Euro currency breakup have subsided, and sovereign bond yields across the continent have fallen and stabilized. We would argue that despite high levels of unemployment (which tends to be a lagging indicator), the potential for earnings growth recovery across European companies is significantly greater than that of the US going forward. For the quarter, Italy and Spain experienced some of the strongest market returns earning +14.6% and 4.8% respectively. The UK has continued to lead the economic recovery across Europe with the Bank of England remaining highly accommodative. Outside of Europe, Japan and its leaders now face the "moment of truth." Actions by the Bank of Japan over the past year have served to weaken its currency, increase stock prices, expand exports and fight deflation. However, in the first quarter, the Japanese Yen began to strengthen with inflation picking up modestly but without the much needed wage growth component. The consumer tax hike scheduled for April 1st remains a big unknown, as it served to boost consumer spending ahead of its implementation while simultaneously reducing industrial production. Rising current account deficits in Japan could have long term ramifications on the country's ability to issue debt given its high current debt levels. In the first quarter, Japanese equity markets fell -5.6%. As of the end of the first quarter, we continue to maintain our long term target allocation to diversified international markets, with an emphasis on high quality investments across Europe.

After a very difficult year in 2013, emerging markets produced a -0.43% return for the first quarter as measured by the MSCI Emerging Market Index. Emerging market central banks have continued to take aggressive actions to stabilize currencies, fight inflation and boost growth. Investor outflows began to stabilize in the first quarter leading to rallies across various emerging market countries facing political elections and moderate economic improvements including India, Turkey and Brazil. Though the rebound in stock prices was a welcome development, we do not believe the investment attractiveness of emerging markets has improved by any considerable measure. Brazil and Argentina continue to battle high inflation, declining growth as well as civil unrest. Similar challenges continue to exist across Egypt, Thailand and Turkey with relatively limited progress. Among the hardest hit markets during the quarter were Russia (-14.5%), Mexico (-5.0%) and China (-5.9%). As we have discussed in previous letters, all signs continue to point towards an economic slowdown in China. GDP growth estimates for China continue to be revised down below the 7.5% target originally established for 2014. While inflation pressures remain modest across China, government officials have continued to delay making substantial long term changes related to rising debt levels, inefficient allocation of capital and transitioning away from its reliance on exports. We continue to view China as a significant risk to the global economy should the necessary changes fail to materialize. Given the risks we see throughout the emerging markets, we continue to maintain a low direct allocation to emerging market investments.

The first quarter provided a welcome relief for bond investors, as the 10 Year US Treasury yield fell -9% from its peak of 3.02% on December 31st to 2.72% on March 31st. For the quarter, bonds earned a return of +1.84% as measured by the Barclays US Aggregate Bond Index, outperforming broad equity market indices in the US and abroad. Though the fall in interest rates and subsequent rise in bond prices during the quarter surprised many, the yield curve has continued to steepen over the past year indicating the increasing likelihood of rising interest rates over the next several years. International bonds and emerging market bonds were the top performers during the first quarter, outperforming global high yield and corporate bonds. Despite continued actions by the Federal Reserve to reign in its bond buying program, commentary from the Federal Reserve over the past several months leads us to believe that the Fed will not begin to raise short term interest rates until the middle of 2015 or later. Given the difficulty predicting short term interest rate moves, we remain conservatively positioned in terms of bond allocations in client portfolios.

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We continue to favor short duration bond strategies and high quality intermediate term bonds that provide a favorable mix of income and protection against rising rates.

Market Data

Broad Market Benchmarks	**1Q2014**
S&P500	1.81%
FTSE Global All-Cap ex-US	0.98%
Barclays US Aggregate Bond Index	1.84%
Barclays US Treasury Bill 1-3 Months	0.01%
TWM Client Benchmarks	**1Q2014**
Aggressive Growth Strategy	1.64%
Capital Appreciation Strategy	1.72%
Balanced Return Strategy	1.68%
Disclosure: Historical performance results for investment indices and/or benchmarks have been provided for general comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. You cannot directly invest in an index.	

As always, we encourage our clients to contact our office with any questions or to discuss our market outlook and strategy in greater detail. On behalf of Timmons Wealth Management, I want to wish you a very happy and prosperous spring!

Sincerely,

Liam Timmons, President

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