

## Global Economic and Financial Markets Summary

### Inside this issue:

<b><u>Financial Markets Performance</u></b>	<b>2</b>
<b><u>Global Economic Outlook</u></b>	<b>4</b>
<b><u>Investment Strategy</u></b>	<b>6</b>
<b><u>In Closing</u></b>	<b>8</b>
<b><u>Appendices</u></b>	<b>8</b>

During the fourth quarter of 2013, the world's financial markets delivered uneven performance, with some markets experiencing strong returns and others flat to slightly negative. The mixed results were even more pronounced for the full year. US equities generated exceptional gains in 2013, and developed market equities also performed extremely well. In contrast, many sectors of the global bond market posted negative returns, as did emerging market equities.

In diversified portfolios, the strong results from developed market equities were tempered by allocations to asset classes that lagged. Our positioning within the weaker asset classes helped minimize their impact on overall portfolio performance. Our fixed-income exposure was tilted toward opportunistic strategies and high yield that were less sensitive to interest rates. In addition, where appropriate, we have allocated capital to absolute return strategies that have risk characteristics similar to fixed income but perform independently of rates. This positioning was helpful in 2013, as longer-term interest rates rose over the course of the year (Interest rates move inversely with bond prices.). In emerging markets, our emphasis on regions exhibiting the strongest fundamentals benefited portfolio performance.

Despite the cautious mentality of many investors since the 2008 financial crisis,

stocks have produced substantial gains. While each of the last several years has started with expectations for weak results, the market has largely defied those expectations. The one exception was 2011, when the S&P 500 Index rose just 2.1%. Heading into 2013, many investors were concerned that tax increases and government spending cuts would derail the US economy and, in turn, the stock market. However, those worries turned out to be unwarranted, and estimates suggest that GDP increased by nearly 2% in 2013. We think this is very solid growth, particularly since the fiscal drag of higher taxes and lower spending likely shaved at least 1% off of GDP growth.

The positive momentum in the US economy has been recognized by the Federal Reserve, which announced in December that it would start tapering its bond purchases in January. Nonetheless, we believe that many investors continue to underestimate the economic progress being made in this country, and that the economy could pleasantly surprise them in the months ahead. However, even if it does, the US stock market might take a breather following its remarkable performance over the past five years. Going forward, we expect to see US equities produce lower returns and higher levels of volatility that are more consistent with long-term averages.

## Financial Markets Performance

### Equities

Equity markets in developed countries closed out an exceptional year with strong performance in the fourth quarter; see [Exhibit 1](#). Emerging market equities remained weak, both for the quarter and 2013.

Among developed markets, the United States had a particularly strong fourth quarter. The main driver of the positive results was better-than-expected economic performance, including key cyclical sectors, which gave the Fed an opportunity to begin tapering in 2014. The gains in US equities were widespread across market capitalization ranges and

economic sectors, with small caps and health care stocks leading the way. For the year, the S&P 500 Index returned 32.4%—its best annual showing since 1997.

After lagging somewhat in the first half of 2013, stocks in developed European markets had a strong finish. Investor sentiment improved as the European economy showed signs that it was finally emerging from a long recession. Monetary easing by the European Central Bank (ECB) was another positive catalyst. The ECB cut its main policy rate to a record low of 0.25% in November in an effort to support the region's economy and counter the threat of deflation. In Japan, "Abenomics"—the bold stimulus policies of Prime Minister Shinzo

**“The gains in US equities were widespread across market capitalization ranges and economic sectors, with small caps and health care stocks leading the way.”**

**Exhibit 1**

**Total Return\* for Selected Equity, Fixed Income, and Hedge Fund Indices**

	4th Quarter (9/30/13 to 12/31/13)	Year to Date (12/31/12 to 12/31/13)
<b>Major Equity Indices</b>	<b>%</b>	<b>%</b>
S&P 500 Index	10.5	32.4
Russell 3000 Index (Total US market)	10.1	33.6
Russell 2000 Index	8.7	38.8
MSCI All Country Ex-US Index (Net)	4.8	15.3
MSCI EAFE International Index (Net)	5.7	22.8
MSCI Emerging Markets (Net)	1.8	-2.6
<i>Source: Bloomberg, MSCI</i>		
<b>Major Fixed Income and Hedge Fund Indices</b>	<b>%</b>	<b>%</b>
Barclays Capital US Aggregate Bond Index	-0.1	-2.0
Barclays Capital U.S. Credit Index	0.0	-2.4
Merrill Lynch US High Yield BB-B Bond Index	9.6	6.3
JPMorgan Non-US Global Hedged Index	0.4	1.4
JP Morgan EMBI Global Index in USD (Emerging markets)	0.9	-6.6
HFRX Equal Weighted Strategies Index (Hedge Funds)	1.7	6.2
<i>Source: Bloomberg, MSCI, PIMCO</i>		

\* Includes price appreciation plus dividends and/or interest.

## Financial Markets Performance Cont.

Abe—continued to push Japanese stocks higher, although a weakening yen significantly eroded returns in dollar terms for US-based investors.

Equity performance in emerging markets was mixed during the year. Several markets posted gains, including China. However, falling commodity prices, sluggish economic growth, and weakening government balance sheets pushed stocks lower in other markets, including Turkey, Brazil, and Indonesia with an overall negative result for emerging markets as an asset class.

### Fixed Income

As previously noted the Fed announced in December that it would begin tapering in January 2014. However, the modest size of the taper and assurances from the central bank that it was in no hurry to raise short-term interest rates helped bond investors cope with the news. The Barclays Capital US Aggregate Bond Index (a benchmark of the broad US fixed-income market) fell just slightly in the fourth quarter. Combined with earlier losses, 2013 marked the first year since 1999 that the Index generated a loss. Treasuries with shorter maturities managed modest quarterly and annual gains, but longer-dated securities fell sharply. For example, 10-year Treasury notes, Treasury inflation-protected securities (as measured by the Barclays Capital US TIPS Index), and 30-year Treasury bonds declined 7.8%, 8.6%, and 15.0%, respectively, for the year. In the credit markets, demand for yield

in the low-yield environment was a tailwind for riskier securities, driving solid fourth quarter and annual gains in the high-yield bond and bank loan markets.

Globally, developed sovereign debt markets delivered uneven performance, despite the synchronized economic expansion underway in the United States, Europe, and Japan. Risk-taking was generally well compensated during the quarter and the year. Government bond markets in Ireland, Spain, and Italy led in both periods, while Germany, the United Kingdom, and the United States lagged. Returns on global investment-grade bonds were also mixed for the quarter, with lower-grade paper tending to outperform higher-quality issues. In 2013, investors favored European corporate debt over US corporate debt and higher-risk securities over higher quality bonds.

During the fourth quarter, emerging market debt managed to erase some of its losses from the first half of the year but still ended 2013 in negative territory (down 6.6% in USD). The first-half decline was due to comments from Fed Chairman Ben Bernanke, who said in both May and June that the central bank might soon start tapering its bond purchases. For some time, given the easy monetary environment, the sector had attracted strong flows from investors seeking higher yield. Bernanke's remarks affected investor sentiment and the expectation of higher US interest rates made the asset class less attractive, thereby reversing flows.

**“In the credit markets, demand for yield in the low-yield environment was a tailwind for riskier securities...”**

## Global Economic Outlook

### United States

Data suggest that the US economy expanded at an approximately 3% annual rate in the fourth quarter, putting GDP growth at just under 2% for the year. GDP growth is expected to be around 3.3% in 2014 (see Exhibit 2), which is slightly above the average growth rate seen in the years leading up to the financial crisis.

We expect the housing sector to make a strong contribution to economic growth in the year ahead. While rising mortgage rates have fueled concerns that the pace of home price increases might slow down, rates are still very attractive. Additionally, housing affordability is good, and the inventory of homes for sale is low; see [Appendix A](#). In 2014, we expect to see a significant increase in construction activity. This would positively impact the job market, as many of the currently unemployed used to work in

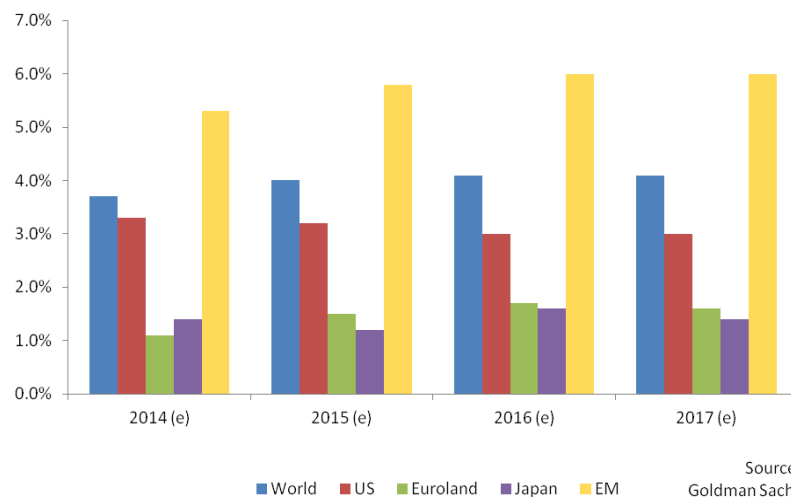
the construction industry.

Across the economy, the job market improved in 2013, with unemployment falling and wages and salaries rising; see [Appendices B and C](#). Furthermore, the number of discouraged workers peaked in 2012 (see [Appendix D](#)), although we may continue to see lower-than-average participation rates going forward given the aging US population (The participation rate measures the percentage of working-age Americans who are either employed or actively seeking work.). In the coming months, we expect the unemployment rate to continue to fall, which should increase demand for office space and capital equipment and boost private consumption. Private consumption should further benefit from the wealth effect created by rising home prices and growing investment portfolios.

We believe US fiscal and monetary policy will also be supportive of growth in the year ahead. The fiscal drag of the 2013

**“We expect the housing sector to make a strong contribution to economic growth in the year ahead.”**

Exhibit 2  
Real GDP Growth Estimates



## Global Economic Outlook Cont.

tax increases and government spending cuts is fading, and rising revenues should allow many state and local governments to increase spending. Although the Fed will likely continue tapering its bond purchases over the course of 2014, we think it will hold short-term interest rates very low. In addition, Janet Yellen, the new Fed chairperson, is generally considered to be more “dovish” than Ben Bernanke, meaning she is perceived as being more concerned about stimulating job growth than the potential inflationary effects of monetary stimulus. Inflation was subdued in 2013 and is expected to remain so in 2014 amid restrained commodity prices and unused productive capacity in developed economies. If anything, deflationary forces overseas (especially in Europe) and a lower Japanese yen could help the US consumer by making imported goods less expensive.

### Europe

The euro zone emerged from recession in 2013 and is expected to grow by just over 1% in 2014. It is likely that German GDP will increase by roughly 2%, while growth in Italy, France, and Spain will be below 1%. We think anemic credit growth will remain a material headwind for the region, particularly as European banks support their balance sheets ahead of a comprehensive asset-quality review being conducted by the ECB. Of more lasting concern are the labor policies in peripheral European countries that are hampering employment growth. In light of these challenges, we believe the ECB

will have to ease monetary policy further to combat deflationary forces. Deflation is a real risk, especially for weaker economies that are more vulnerable to waning demand should businesses and consumers postpone spending.

### Japan

Japan’s economy appears on track for a 1.7% GDP growth in 2013 and is forecast to grow by approximately 1.4% in 2014. The country is raising its sales tax in April, which will likely increase first-quarter consumption but could subsequently disrupt the positive momentum created by “Abenomics”. This would be reminiscent of what happened in 1997, when a similar tax went into effect and caused consumption to spike and then plummet; see [Appendix E](#). In December, the Japanese government unveiled a spending package that should help soften the fiscal drag of the tax increase, and the Bank of Japan has indicated its willingness to add more stimulus as necessary. The central bank is implementing unprecedented easing measures in an attempt to import inflation and export deflation to Japan’s trading partners, including Europe. Its efforts are being accompanied by fiscal stimulus, in the form of the recently announced spending packages, as well as structural reforms. These reforms, which are slated for 2014, will deal

**“Although the Fed will likely continue tapering its bond purchases over the course of 2014, we think it will hold short-term interest rates very low.”**

*(Continued on page 6)*

## Global Economic Outlook Cont.

*(Continued from page 5)*

with a variety of issues, including tax policy, trade, and business regulation.

### Emerging Markets

**M**ost emerging economies slowed in 2013 and are expected to grow at below-average rates in 2014. Nonetheless, they will likely continue to expand at a robust rate overall and grow much faster than their developed counterparts.

China is likely to post below-trend growth in 2014. However, tightening financial conditions in China suggest that policymakers are willing to tolerate slower growth in order to address structural problems, such as the need to become less dependent on exports and investment for economic growth. China's large amount of leverage is also a concern—its debt-to-GDP ratio recently exceeded 200%. This is a substantial increase over the last six years and leaves China more heavily indebted than a number of its emerging market peers.

The slowdown in China will create economic headwinds for many other

emerging countries, including Brazil and South Africa, which supply China with raw materials. Brazil and South Africa, along with Turkey, Indonesia, and Russia, face the additional challenge of higher inflation and persistent current-account deficits (i.e., the value of the goods and services they import consistently exceeds the value of the goods and services they export). Higher levels of inflation in these countries make it more difficult for them to rectify their trade imbalances by allowing their currencies to depreciate, as currency weakness stokes inflation. Upcoming elections in many of these countries create political uncertainty that further clouds the outlook for their economies.

Mexico is one of the emerging markets where we believe growth could accelerate in 2014. The country's economy is poised to benefit from several favorable developments, including faster US GDP growth and new laws that allow private-sector participation in the underinvested oil and gas sectors. In addition, lawmakers recently came to agreement on a highly-contested tax reform, and Mexico is recovering from the effects of last September's hurricanes. South Korea, another exporter to the United States, is also expected to gain from faster US growth.

**“Mexico is one of the few emerging markets where we believe growth could accelerate in 2014.”**

## Investment Strategy

### Equities

**W**e believe US equities are fairly valued following several years of

very strong performance. Although returns may be positive in 2014, we do not expect to see a repeat of 2013. A more likely scenario would be a year of

## Investment Strategy Cont.

normal, more subdued returns with a return to normal levels of volatility.

Other than large, high-quality multinationals, which appear fairly valued, valuations are more attractive in developed international countries; see [Appendix F](#). Consequently, we are finding more opportunities in these markets than in the United States. Valuations in emerging markets are also generally attractive and we are tactically overweighting areas that offer better valuations relative to their growth prospects. Emerging market equities struggled in 2013. However, we believe an allocation to the asset class makes sense in a diversified portfolio, where appropriate, given the positive long-term growth outlook for many emerging countries and companies in these markets.

Despite fuller valuations in the United States, we continue to find some opportunities within the US stock market and continue to have exposure to the broad US stock market. That said, we have been selectively reducing our US equity exposure and reallocating funds to assets with more attractive valuations, where appropriate.

### Fixed Income

**W**e expect the fixed-income market to remain challenging

in 2014. We believe short-term interest rates will remain anchored near current levels but that long-term rates will continue to rise. The threat of rising rates and very low credit spreads (i.e., the differences between corporate bond yields and yields on similar-maturity Treasuries) will likely put pressure on government and corporate bonds. Higher-yielding securities should continue to benefit from investors' search for yield and a low-default environment.

Given the headwinds we anticipate for the bond market, we continue to pursue opportunistic fixed-income strategies that have relatively low sensitivity to long-term interest rates, as well as the flexibility to avoid overvalued sectors of the credit markets. Where appropriate, we also continue to employ absolute return strategies with conservative risks profiles similar to fixed income but whose performance is less sensitive to changes in rates.

Opportunities may be harder to come by in the bond market. However, if the global economy maintains its low-but-sustainable growth rate, and inflation remains subdued, fixed income could fulfill its normal role within a diversified portfolio—namely, providing some growth and adequate liquidity while reducing volatility.

**“Despite fuller valuations in the United States, we continue to find some opportunities within the US stock market...”**



**“...we are focused on maintaining broad diversification by asset class, geographic market, asset size, and investment style as a means to best protect against market volatility and permanent loss of capital.”**

## In Closing

2013 was a year of transition. The US economy seemed to have hit its stride, and the Fed decided to begin withdrawing stimulus. US interest rates started to rise from historical lows, and US equities reached unprecedented heights. Furthermore, returns among asset classes and within asset classes began to diverge.

Achieving attractive returns will be more difficult given fair valuations in equities and elevated valuations in fixed income. As always, we are focused on maintaining broad diversification by asset class, geographic market, asset size, and investment style as a means to best protect against market volatility and permanent loss of capital.

We are also searching for opportunities in out-of-favor asset classes and market segments which can incrementally benefit your portfolio. In addition, we continue to thoughtfully rebalance portfolios being mindful of the geopolitical and macroeconomic environment.

As always, we remain committed to meeting your long-term investment goals, within your risk profile, and funding your future liquidity needs. Please call us at 301.881.3727 with any question or concerns about your portfolio.

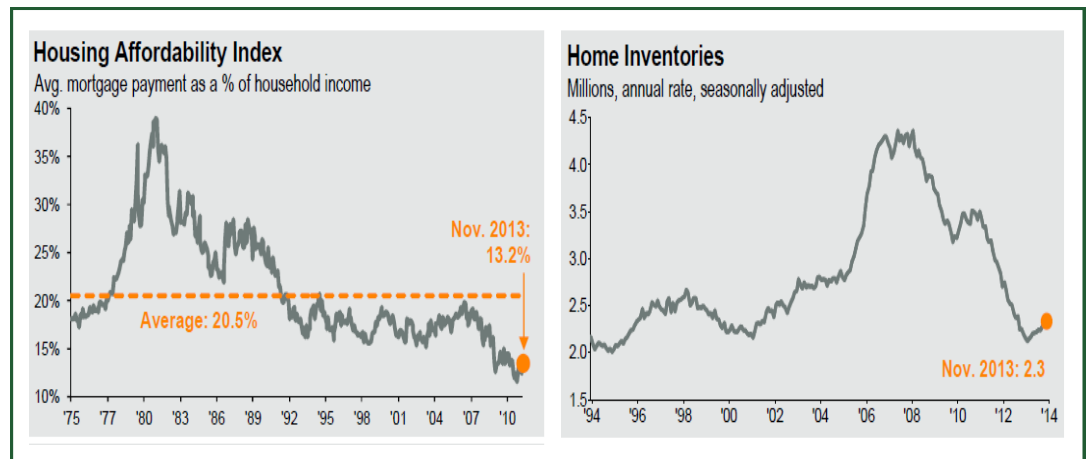
Sincerely,

The SOL Capital Management Team

## Appendices

### Appendix A

### Housing Affordability and Home Inventories



Source: (Left) Census Bureau, J.P. Morgan Asset Management. Monthly mortgage payment assumes the prevailing 30-year fixed-rate mortgage rates and average new home prices excluding a 20% down payment. (Right) Census Bureau, National Association of Realtors, J.P. Morgan Asset Management. Data are as of 12/31/13.

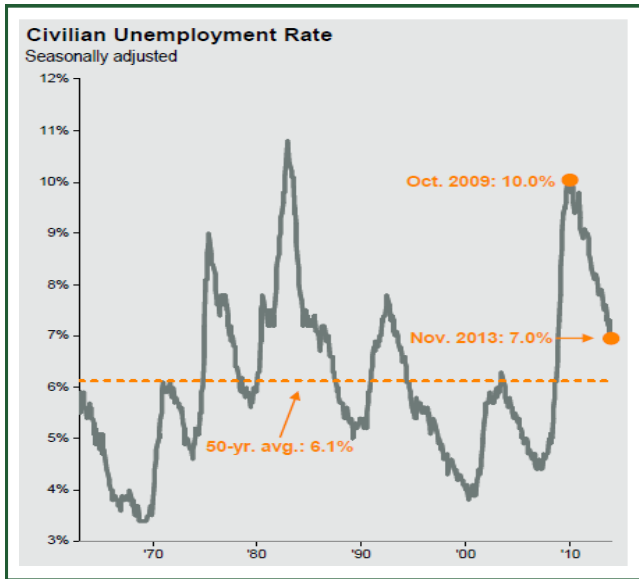
Source: “Housing Affordability Index” and “Home Inventories,” *Guide to the Markets 1Q 2014*, J.P. Morgan Asset Management, page 20

**Please note that past performance is neither an indication nor a guarantee of future returns and that diversification does not ensure profits or guarantee against a loss.**



## Appendices Cont.

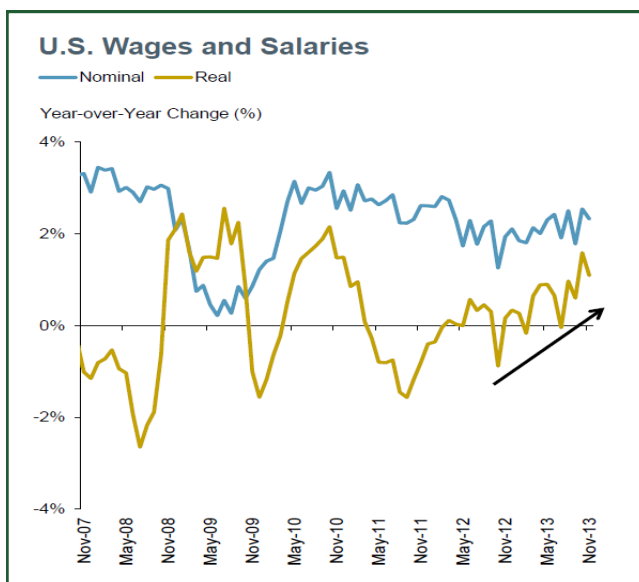
### Appendix B Civilian Unemployment Rate



Source: BLS, FactSet, J.P. Morgan Asset Management. Data are as of 12/31/13.

Source: "Civilian Unemployment Rate," *Guide to the Markets 1Q 2014*, J.P. Morgan Asset Management, page 23

### Appendix C US Wages and Salaries



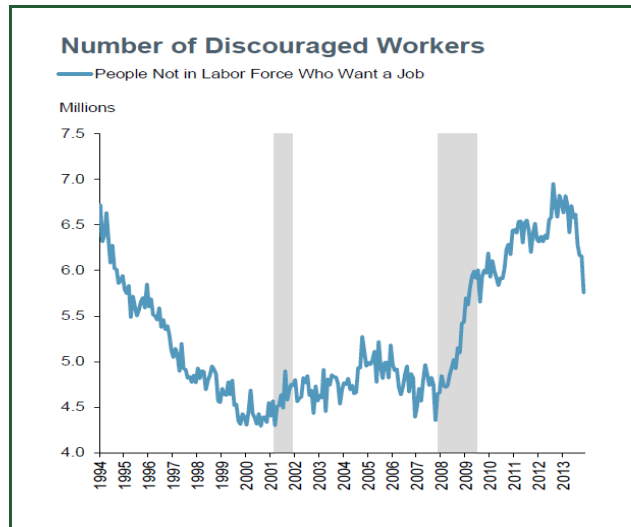
Source: Bureau of Labor Statistics, Fidelity Investments (AART) as of 11/30/13.

Source: "US Wages and Salaries," *First Quarter 2014 Quarterly Market Update*, Fidelity Investments, page 12

## Appendices Cont.

### Appendix D

#### Number of Discouraged Workers

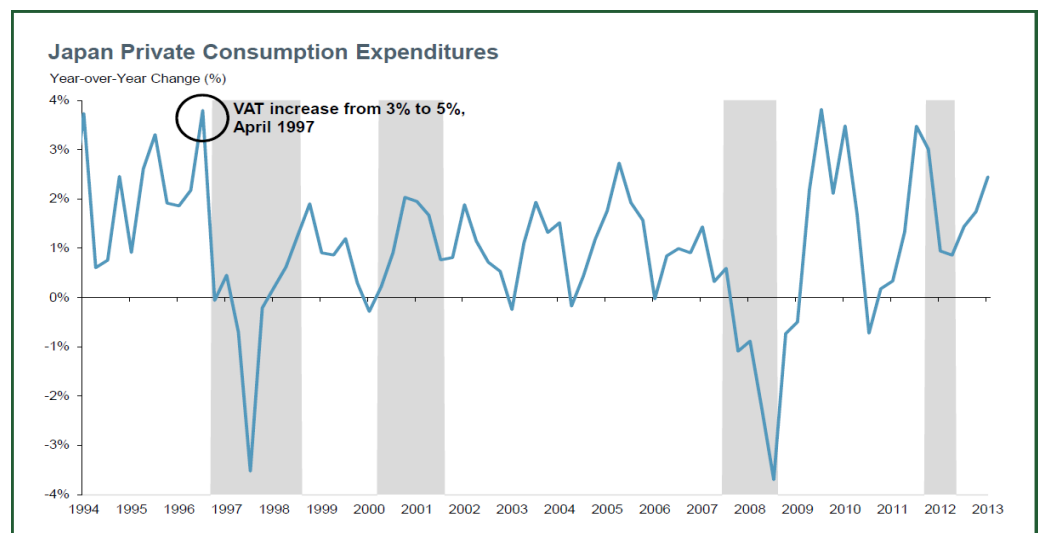


Source: Bureau of Labor Statistics, Haver Analytics, Fidelity Investments (AART) as of 12/31/13. Shaded areas are US recessions, as defined by the National Bureau of Economic Research.

Source: “Number of Discouraged Workers,” *First Quarter 2014 Quarterly Market Update*, Fidelity Investments, page 13

### Appendix E

#### Japan Private Consumption Expenditures



Source: Cabinet Office of Japan, Haver Analytics, Fidelity Investments (AART) through 9/30/13. Shaded regions indicate recessions, as defined by the Cabinet Office of Japan.

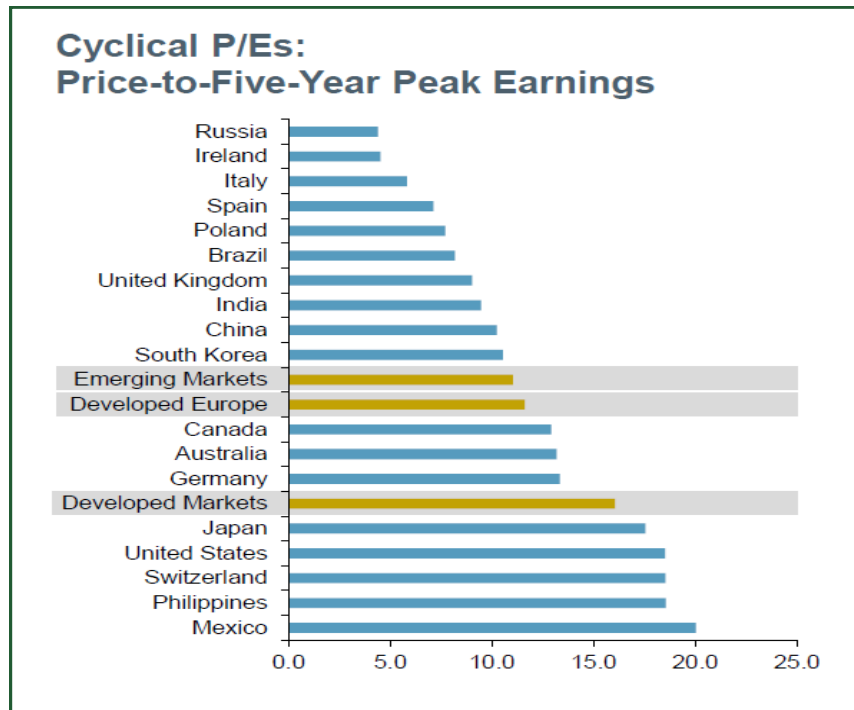
Source: “Japan Private Consumption Expenditures,” *First Quarter 2014 Quarterly Market Update*, Fidelity Investments, page 9

## Appendices Cont.

### Appendix F

#### Cyclical P/Es: Price-to-Five-Year Peak Earnings

Using peak earnings to calculate a cyclical P/E, non-US markets are relatively inexpensive.



Source: FactSet, country statistical organizations, Haver Analytics, Fidelity Investments (AART) as of 12/31/13. Five-year peak earnings are adjusted for inflation.

Source: "Cyclical P/Es: Price-to-Five-Year Peak Earnings," *First Quarter 2014 Quarterly Market Update*, Fidelity Investments, page 21

SOL CAPITAL MANAGEMENT COMPANY

111 Rockville Pike, Suite 750  
 Rockville, MD 20850  
 Phone: 301.881.3727  
 Fax: 301.770.5346

75 Rockefeller Plaza, 18th Floor  
 New York, NY 10019  
 Phone: 212.710.4698

[www.sol-capital.com](http://www.sol-capital.com)

E-mail: [sol@sol-capital.com](mailto:sol@sol-capital.com)

