1st Quarter 2014

American business will do fine over time. And stocks will do well just as certainly, since their fate is tied to business performance. Periodic setbacks will occur, yes, but investors and managers are in a game that is heavily stacked in their favor. (The Dow Jones Industrials advanced from 66 to 11,497 in the 20th Century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression and many recessions. And don't forget that shareholders received substantial dividends throughout the century as well.)

Since the basic game is so favorable, Charlie and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of "experts," the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it.

Warren Buffet

We could not say it better ourselves! Although equity markets have increased and the Federal Reserve's policy could change by year end, there could still be room for the market to end the year higher. Could we have a bumpy ride? We absolutely think we could.

Where are interest rates going?- Flat, Down or Up

Flat: In our last newsletter, we mentioned the uncertainty of Ben Bernanke's replacement. Now we know that Janet Yellen has been confirmed and that the market is comforted by the fact that she is unlikely to increase interest rates as long as inflation is held in check and the economy slowly improves. That would suggest rates will be stable.

Down: We are part of a global economy. Government bond yields in other developed countries matter. As the dollar increases against other currencies, we would expect to see the demand for US Treasuries to increase. This could dampen rates for some time to come since demand pushes prices up and inversely lowers yields. So, rates could go down.

Up: Human behavior is part of the equation, as well. If the economy and unemployment continue to improve, there could be pressure from investors to sell bonds and chase higher yields. We have certainly witnessed that behavior before. What was the result? Go back to the spring and summer when we saw a sharp increase in rates even though the Fed did not change its policy.

So, which is it - stable, down or up? It is clear that with this backdrop, staying on the short end of the interest rate curve, allows us to protect on the downside and take advantage if rates increase.

Good news or bad news?

We do see good news for the US. Trade deficits are shrinking as we become more competitive and bring jobs back home; and we are making progress at becoming energy independent. This could be a source of additional jobs, as well. However, this is not so good for China which has provided cheaper labor or for OPEC countries that have been our energy suppliers. Slower growth in China could mean lower commodity prices and a stronger dollar. Bad news since a stronger dollar has a negative impact on US exports.

Consumer confidence is returning as is corporate confidence. Good news. Not a surprise, though. With an increase in the market and 401K statements showing an increase in value, everyone feels better. With consumer spending, corporations continue to be profitable and to increase already large cash balances. So where is the bad news? Increasing government debt in this country worries many. When we factor in the fact that the cost of borrowing money has been so low, just think what happens as interest rates increase and individuals, corporations and governments have much larger payments for that borrowing.

And geopolitical events play into everything. There is hardly a day that we do not turn on the television to hear bad news. Continued strife in the Middle East and unrest in the Russian Caucauses reminds us of the myriad of potential global threats. None of us want to see another terrorist attack, especially with our athletes traveling to Sochi.

Back to Warren Buffet's quote: In looking to the future, there are many variables, as we have stated in the few last paragraphs. That is why we do not try to time the market. We construct portfolios based on risk tolerance, time frame and liquidity needs. We rebalance as asset classes increase in value and extend beyond our allocation range. We use satellite investments to complement our core investments so we can deploy assets to areas we feel are able to benefit from the economic environment over the shorter term. We focus on correlation of assets. We want investments that respond differently to movements in the markets. This is so important in protecting on the downside.

From our Family to yours

We hope that you all had a wonderful holiday season and that the New Year brings good health, happiness and peace to you and your family!. As always, we appreciate your trust and look forward to a wonderful 2014.

12021 SUNSET HILLS ROAD • SUITE 300 • RESTON VIRGINIA 20190
TEL: (703) 796-0800 • FAX: (703) 796-0990 • TOLL FREE: (866) 796-HFRG • WEB: www.houlihanfinancial.com