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Annual Market Review 2013



Overview

Standoffs, sequestration, shutdown, and suspense in Washington supplied the wall of worry that equities markets are said to be so fond of climbing. And climb it they did. The Dow, S&P 500, and small-cap Russell 2000 explored record territory for much of the year. Investors spent most of 2013 toggling between rejoicing at the lack of bad economic news and worrying that good news would prompt the Federal Reserve to start cutting its support. However, the Fed delayed action, first to assess the economic impact of the sequester budget cuts imposed by 2012's fiscal-cliff detour, and then to avoid aggravating concerns over the U.S. debt ceiling showdown and the 16-day government shutdown.

All the uncertainty rattled markets worldwide, particularly emerging markets, during the summer. However, headlines about potential sovereign default abroad became more scarce as the eurozone emerged from the longest recession in its history despite record 12% unemployment. Meanwhile, China announced plans for economic reforms designed to reduce state monopolies and open up the banking system. In the United States, regulators finally adopted the Volcker rule, which will limit Wall Street banks' ability to speculate with their own money, and Janet Yellen prepared to replace Ben Bernanke as Fed chairman. Meanwhile, despite the confusion in Washington, solid corporate profits helped reassure investors.

By year's end, the S&P 500 had nearly tripled since its March 2009 low. However, financial markets must now begin navigating unfamiliar terrain as the Fed begins to taper its support. With a fresh round of debt ceiling debates on the horizon, that wall of worry isn't likely to shrink in 2014; the question is whether investors will be willing to climb it--and if they are, how far they might go.

Snapshot 2013

The Markets

- **Equities:** The Dow industrials spent 52 days--one-fifth of the year's 252 trading days--setting fresh all-time closing highs, while the S&P 500 had its best annual percentage gain (+29%) since 1997. However, neither came close to matching the spectacular performances of the Nasdaq and the Russell 2000. The Russell's 37% increase gave the small caps their fourth best year ever, while the Nasdaq did even better. The Global Dow was hampered by the impact of anxiety about Federal Reserve tightening on the global economy, especially emerging markets which posted a -2% return for 2013.
- **Bonds:** Bond investors were haunted by two specters for much of the year: possible reductions in the Fed bond purchases that have helped support the bond market, and the potential for an unprecedented default on U.S. debt. Neither of those materialized in 2013, but the brinksmanship over the debt ceiling briefly sent short-term Treasury yields higher than those of the one-year note in October. The flight from bonds left the benchmark 10-year Treasury yield at roughly 3% by year's end as prices fell.
- **Oil:** A resolution to a global standoff over Syria helped oil prices retreat from late-summer highs over \$100 a barrel. However, despite increased U.S. production, oil prices ended the year up almost 6% from December 2012, at roughly \$98 a barrel.
- **Currencies:** The U.S. dollar made a round trip during the year, ending 2013 at roughly the same value against a basket of six other major currencies as it began. Between January and July, the dollar gained more than 5% on anticipation of potential Fed action, only to see those gains vanish during the year's second half as tapering failed to materialize.
- **Gold:** Gold lost much of its luster in 2013, falling from just under \$1,700 an ounce in January to just over \$1,200 by year's end. Despite a few bounces along the way, especially in late summer, 2013's 28%



decline was fairly relentless. Low inflation reduced gold's traditional value as a hedge against higher prices, and global economic recovery undercut the perceived need for safe havens as investors bet on a stronger U.S. dollar resulting from any Fed tapering.

The Economy

- **Unemployment:** The employment picture continued to improve slowly. The unemployment rate ended the year at 7%, its lowest level in more than five years and an improvement from last December's 7.8%. According to the Bureau of Labor Statistics, the unemployment rate has now fallen 3 percentage points from its October 2009 high of 10%.
- **GDP:** U.S. economic growth accelerated throughout the year. The sluggish 1.1% expansion seen in the first quarter rose to 4.1% by Q3--the fastest economic expansion since Q4 2011. And though the Bureau of Economic Analysis said after-tax corporate profits were stronger in the second quarter than the third, they were still a dramatic 8.6% higher in Q3 than a year earlier.
- **Federal Reserve:** After keeping the world in suspense much of the year, the Fed finally announced it will begin gradually reducing bond purchases in January 2014. Members of the Fed's monetary policy committee anticipate its target interest rate could remain at its current low level into 2015, even if unemployment falls to 6.5%, as long as inflation remains low.
- **Inflation:** Inflation remained well under historical averages, allowing the Fed to begin tapering its bond purchases. By December, the Bureau of Labor Statistics said consumer inflation had fallen to an annual rate of 1.2% from the previous December's 1.8%, while wholesale prices gained a mere 0.7% over the same time--half the inflation rate of a year earlier. Despite heavy discounting and a shortened holiday shopping season, retail sales showed improvement over the course of the year, and consumer spending was up 2.6% from a year earlier.
- **Housing:** Despite being hampered by higher mortgage rates and low housing inventories, the housing market demonstrated resilience. The 13.6% year-over-year average price gain in the S&P/Case-Shiller 20-City Composite Index was the strongest since February 2006, putting home prices back at mid-2004 levels. New-home sales rebounded from a summer slump and by November were 16.6% ahead of the previous year, though the National Association of Realtors® said sales of existing homes showed signs of slowing by year's end. Meanwhile, the Commerce Department said a 23% jump in housing starts in November put them almost 30% ahead of a year earlier.
- **Manufacturing:** By the end of the year, businesses seemed confident enough about the future to increase spending on equipment. The Commerce Department said even aside from the strong but volatile aircraft sector, durable goods orders showed signs of improvement in December, while monthly readings on the Institute for Supply Management's manufacturing index rose every month in the second half of the year.

*Data sources: Economic: Based on data from U.S. Bureau of Labor Statistics (unemployment, inflation); U.S. Department of Commerce (GDP, corporate profits, retail sales, housing); S&P/Case-Shiller 20-City Composite Index (home prices); Institute for Supply Management (manufacturing/services). Performance: Based on data reported in WSJ Market Data Center (indexes); U.S. Treasury (Treasury yields); U.S. Energy Information Administration/Bloomberg.com Market Data (oil spot price, WTI Cushing, OK); www.goldprices.org (spot gold/silver); Oanda/FX Street (currency exchange rates). All information is based on sources deemed reliable, but no warranty or guarantee is made as to its accuracy or completeness. Neither the information nor any opinion expressed herein constitutes a solicitation for the purchase or sale of any securities, and should not be relied on as financial advice. Past performance is no guarantee of future results. *Based on data from the "Stock Trader's Almanac 2014."*

The Dow Jones Industrial Average (DJIA) is a price-weighted index composed of 30 widely traded blue-chip U.S. common stocks. The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. The NASDAQ Composite Index is a market-value weighted index of all common stocks listed on the NASDAQ stock exchange. The Russell 2000 is a market-cap weighted index composed of 2000 U.S. small-cap common stocks. The Global Dow is an equally weighted index of 150 widely traded blue-chip common stocks worldwide. The U.S. Dollar Index is a geometrically weighted index of the value of the U.S. dollar relative to six foreign currencies. Market indices listed are unmanaged and are not available for direct investment.

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