Investment Tally & Perspective

From Financial Crisis to Record High Stock Prices

The Past - Five years ago, as we experienced a breakdown in the financial system and the most severe financial crisis since the Depression, market psychology was extremely negative toward stocks, which was understandable after market indices had declined over 50% from their peak in 2007. At that time, when fear was the dominant emotion, we stated that "stock prices are undervalued by many measures, and recent market weakness will eventually be viewed as an exceptional buying opportunity". From their lowest level in March 2009, the current bull market has produced a total return that exceeds 200% (including dividends). During this time period, we have managed portfolios with a positive long term bias towards stocks, though we had several short term periods of concern for a significant pullback or market correction.

In October 2012, when the S&P 500 stock index was trading around 1,450, we offered the view that stock indices were likely to reach new high levels in the years ahead, which was achieved last year (the closing price for the S&P 500 stock index at the end of 2013 was 1,848). Last year, we maintained a positive view on stocks (with our normal anxieties and concerns), and we were delighted with returns that exceeded our expectations (thanks to the Fed), though we are fully cognizant of the wisdom in "Don't confuse genius with a bull market".

Elsewhere in 2013, we anticipated a choppy bond market, and returns for the broad bond market were slightly negative, and we did not anticipate the broad decline in precious metal securities, as commodities in general were subject to selling pressure.

The Investment Outlook

While it is common for investment strategists at the beginning of each year to issue their predictions for market performance, we find more value from focusing efforts on the major factors that may impact account strategies and performance.

Accordingly, what follows on pages three and four are our economic and market views, as well as highlighted points worth noting in recent reports from several investment firms, including BCA Research, Schwab, Ned Davis Research, Merrill Lynch, and Nuveen.

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Volume 23, Issue 1

January, 2014

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MAJOR INDUSTRIALIZED COUNTRIES

	2013 Est. GDP	Unemployment	Consumer Prices	Budget Balance	Interest Rate, %
Britain	1.4%	7.4%	2.6%	-6.7%	3.29%
Canada	1.7%	6.9%	1.0%	-3.0%	2.77%
France	0.2%	10.9%	1.0%	**-4.1%**	2.43%
Germany	0.5%	6.9%	1.6%	**0.1%**	1.94%
Italy	-1.8%	12.5%	1.3%	**-3.2%**	4.09%
Japan	1.8%	4.0%	0.3%	-8.2%	0.74%
Spain	-1.3%	26.7%	1.5%	**-7.1%**	4.22
Switzerland	1.8%	3.2%	-0.1%	0.2%	1.25%
United States	1.7%	7.0%	1.5%	-4.1%	3.03%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, January 4, 2014

EQUITY INDEX RETURNS—QUARTERLY AND ANNUALLY FOR 2013

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	2013
S&P Index	10.61%	2.91%	5.24%	10.51%	32.39%
NASDAQ Composite	8.52%	4.52%	11.19%	10.74%	40.12%
Dow Jones Ind. Average	11.93%	2.92%	2.12%	10.11%	29.65%
Russell 2000	12.39%	3.08%	10.21%	8.37%	38.82%
MSCI EAFE	5.13%	-0.98%	11.56%	5.72%	22.78%

Data from Morningstar

EQUITY INDEX RETURNS

Period Ending December 31, 2013

				Average Annual Returns		
	2013	2012	2011	3 Year	5 Year	10 Year
S&P 500	32.39%	16.00%	2.11%	16.18%	17.94%	7.41%
NASDAQ Composite	40.12%	17.45%	-0.83%	17.74%	22.86%	—
Dow Jones Ind. Average	29.65%	10.24%	8.38%	15.71%	16.74%	7.44%
Russell 2000	38.82%	16.35%	-4.18%	15.67%	20.08%	9.07%
MSCI EAFE (Foreign Index)	22.78%	17.32%	-12.14%	8.17%	12.44%	6.91%

Data from Morningstar

LINCOLN CAPITAL – OBSERVATIONS AND VIEWS

We have a high degree of conviction that 2014 will prove to be markedly different than 2013.

- Global growth will accelerate during this election year, which is normally supportive of stock prices (higher revenues and earnings). Yet increased economic activity may raise fears of a Fed policy change sooner than currently expected.
- The rate of technological changes that impact lives around the globe is accelerating and, for the U.S., two interrelated developments are very significant - moving towards being energy independent, and the notable increase in domestic manufacturing.
- On the negative side, the odds of a significant external geopolitical event or shock (Iran, Syria, Russia, al Qaeda), with cyber-attacks being a major threat, have increased.
- The new Fed chairperson will most likely feel increasing pressures to reduce monetary stimulus during this election year, with interest rates rising further and faster than generally expected.
- **Bottom Line** – Strategically, from our three main portfolio allocations – aggressive, neutral, and defensive – we remain neutral at the present time and continue to view stocks as the preferred asset class in 2014. Tactically, with valuations at the high end of historical averages, if the market moves sharply higher in the near term, then the probability of a market correction would increase, which would prompt a reevaluation of our strategy. Looking longer term, the prospects for global growth remain positive, as do the prospects for higher equity valuations in the years ahead. Bond portfolios are being managed with expectations for short term interest rates remaining low, while intermediate and long term interest rates gradually move higher.

BCA Research – US Investment Strategy 2014: Proceed With Caution – January 6, 2014

- We remain constructive on equities because of the interaction between an improving economy and far-easier-than-normal policy settings. Economic data received before and after the holidays support a sense of optimism about the fundamentals.
- **Bottom Line**: Economic data support our accelerating-growth call, but signs of froth are emerging in sentiment, household participation and equity valuation measures. We think these series have farther to run but investors should monitor them closely to make sure they are not caught overstaying their welcome.

Ned Davis Research – Market Digest – December 13, 2013

- After nearly five years of modest growth, the U.S. economy appears ready to gain some mo mentum in 2014. Nevertheless, several headwinds remain, particularly with respect to fiscal policy, which could increase economic uncertainty and hamper growth.
- The bottom line is that the potential exists for the biggest correction since at least 2011. As long as the economy avoids a recession, the odds of a severe bear market remain low.

Liz Ann Sonders, Chief Investment Officer, Charles Schwab – Outlook for Economy/Stocks in 2014 – January 6, 2014

- We expect an acceleration in economic growth, as the expansion becomes powered by consumer spending, business investment, housing and job growth
- We remain optimistic about the market but it would also be foolish not to be mindful of complacency, given that valuations moved sharply higher over the past two years, and investor sentiment is showing elevated optimism (a contrarian indicator).
- **Bottom Line**: The secular bull market in US stocks is intact, but there remains a risk of a cor rection in the near-term; especially if the market moves into melt-up mode (they don't end well). Other risks are the four-year presidential cycle and the possibility that the Fed has to become more aggressive if economic growth, inflation or employment surprise on the upside. A correc tion, which would be increasingly likely—especially if sentiment becomes overly frothy—could be nasty. But it would likely be a nice buying opportunity in the context of this ongoing secular bull market.

James Paulson, Wells Capital Management – Economic & Market Perspective – January 2, 2013

- We expect a volatile but essentially flat year for stocks in 2014, but also believe the bull market is likely to last several more years.
- Most importantly, investors should avoid getting too cute attempting to time the volatility this year less they miss what will likely prove only a pause in an ongoing bull market during the next several years. If inflation spirals out of control (not our forecast), the Fed and bond vigilantes would aggressively increase interest rates and prematurely abort both the recovery and the stock market run. However, should inflation remain reasonably contained, the economic recovery will most likely last several more years, and while certainly not in a straight line, the ultimate peak of the contemporary stock market bull should prove considerably higher.

Nuveen Investments – 2014 Ten Predictions from Bob Doll – January 1, 2014

- We expect economic growth will be broader and stronger yet remain moderate for the United States and around the world.
- We anticipate the bond market will continue to experience a gradual climb in interest rates which should not be a headwind for equities if economic conditions continue to improve.
- The U.S. equity market should continue to grind higher as a result of central bank liquidity, modest economic acceleration, quiet inflation and an improving fiscal situation. Even though equities may still advance, run-ups since 2009 and throughout 2013 have reduced our forward view for annual returns to mid- to high-single digits.