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QUARTERLY ECONOMIC NEWS

Fourth Quarter 2013

Looking back on 2013, the U.S. bond market experienced a greater level of volatility than in previous years. Much of this volatility was caused by the Federal Reserve's lack of a clear explanation of the difference between the eventual tapering of their quantitative easing program, and actual tightening of monetary policy. With many analysts expecting a continuation of expansionary monetary policy for an extended period, June's Fed meeting brought heightened anxiety to both the stock and bond market. From mid-May through June, the S&P 500 experienced its largest drop of the year, albeit only a pullback of roughly 5.5%. The bond market on the other hand faced volatility that continued for much of the year. Investors continued to be concerned about how quickly the Federal Reserve would exit their bond buying program (used to keep borrowing rates low), and what that would mean for long-term interest rates. In addition, worries persisted on how the Fed might adjust the Federal Funds Rate (used to set short-term rates). As a result of increased selling pressure, the yield on the benchmark 10-year Treasury spiked nearly 130 basis points, from a 52-week low of 1.62% in April to nearly 2.9% by mid-summer, ultimately finishing the year at nearly 3%. According to Bloomberg, the spread between yields on 2-year and 10-year Treasury notes reached its widest level in more than two years by the end of December, as an improving economy bolstered speculation that the Federal Reserve will not only taper but end bond purchases entirely in 2014. This volatility, and rise in longer term rates, carried over to nearly all sectors of the fixed income markets. Rate sensitive areas, such as Treasuries and investment grade bonds, posted negative returns with longer duration bonds feeling the brunt of rising rates. Credit sensitive sectors, including corporate high-yield and floating rate bank loans, posted gains for the year as the outlook for the U.S. economy continued to show strength and equity markets continued to rise. With an outlook of rising interest rates, investors have been rotating out of interest rate sensitive areas of the fixed income market in search of ways to lower their duration risk. The Federal Reserve's scaling back of its $85 billion-a-month purchases of longer dated Treasuries and mortgage-backed securities has investors worried that a drop in demand may translate to a rise in longer term yields and a softening in prices.

The following table highlights the average annual returns for various indices:

Index	4th Qtr	1 Year	5 Year	10 Year
S&P 500 (Composite Total Return)	10.51%	32.41%	17.94%	7.40%
Russell 2000	8.72%	38.82%	20.08%	9.07%
MSCI EAFE (Price)	5.36%	19.43%	9.13%	4.04%
Barclays Aggregate Bond Price	-1.41%	-3.75%	0.73%	0.22%

The S&P 500 is a commonly used measure of common stock total return performance, the Russell 2000 is a commonly used measure of small capitalization stocks, the MSCI EAFE is a commonly used measure of common stock total return performance of international markets, and the Barclay's Aggregate Bond Price Index is a commonly used measure of the bond market. All referenced indices are unmanaged and not available for direct investment. Past performance is not a guarantee of future results.

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That's the Spirit!

Just in time to close out 2013, a holiday miracle occurred: a two-year bipartisan budget agreement overwhelmingly passed the House vote (December 12) and then cleared the Senate hurdle shortly thereafter (December 18). Spearheaded by Rep. Paul Ryan (R-WI) and Sen. Patty Murray (D-WA), the Bipartisan Budget Act of 2013 is lauded by many as paving the way for more bipartisan cooperation in Washington. That remains to be seen; no "grand bargain" negotiations, in which Democrats would agree to cut safety-net spending in exchange for Republican concessions on taxes, were attempted in this round. In an article in the Washington Post, Paul Ryan was quoted as saying "[...] we have to focus on common ground... to get some minimal accomplishments."

The executive summary of the two-year agreement published by the House Budget Committee details the following provisions:

- For fiscal 2014, overall discretionary spending will be set at $520.5 billion (defense) and $491.8 billion (non-defense).
- $63 billion in sequester relief over two years, split evenly between defense and non-defense programs. According to the budget architects, the sequester relief is fully offset by savings elsewhere in the budget.
- Specific deficit-reduction provisions (such as prevention of waste, fraud, and abuse in government-sponsored programs) with mandatory savings and non-tax revenue totaling approximately $85 billion.
- Reduction of the deficit by $20 to $23 billion.

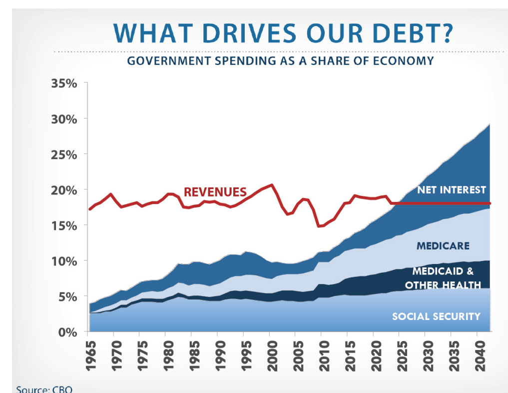
Fed Tapers QE3

On December 18, the Federal Reserve announced plans to begin tapering their bond-buying program, known as QE3, in January 2014. With annualized GDP growth at 4.1% in the third quarter, and November unemployment reflecting a 5-year low of 7%, the Federal Open Market Committee (FOMC) felt it was an appropriate environment to initiate the cutbacks. Chairman Bernanke outlined an initial reduction of $10 billion per month for the next 7 months with flexibility depending on prevailing economic conditions. For instance, if unemployment figures were to rise or GDP growth to fall to 2%, the Fed could skip several rounds of tapering in an effort to alleviate pressure. The FOMC's press release ended months of speculation on the timing and scale of the Fed's exit from unprecedented levels of asset purchases. Proponents of this strategy cite the record highs experienced in the stock market and the Fed's $4 trillion balance sheet while hawks point to sluggish expansion and low inflation. Newly confirmed chairwoman Janet Yellen, who served as an architect for the quantitative easing program, will have her work cut out for her as she carefully unwinds the asset purchases. Following the market's volatile reaction to Mr. Bernanke's summer intimation that a tightening was in the works, the latest decision was accompanied by a renewed commitment to keep interest rates low in an attempt to soften the impact. Keeping the pace of asset purchases and outlook of interest rates separate will remain a crucial factor in maintaining the faith of financial markets going forward. As early as November, Mrs. Yellen admitted that "[QE] can't continue indefinitely" while also praising the positive impact on the country. The turnaround in the economy cannot be denied; however it remains important to examine some of the potential risks involved with reducing asset purchases. Runaway interest rates could be an issue with 30-year mortgage rates creeping up since the announcement. Financial markets have held steady for the time being, but the long-term reaction to the Fed's tightening policy is difficult to predict. And while it is true the unemployment rate is at a 5-year low, the labor force participation rate, a measure of workers who have or are actively looking for work, is also falling. With inflation continuing to run below the Fed's 2% target, a rise in the Federal Funds Rate is not forecasted until early 2015. As Mr. Bernanke's 8 years at the helm come to a close, the woman who championed many of the Fed's current strategies will be left to guide the central bank into a new policy era.

Shop 'Til You Drop

Consumer spending is generally considered by economists to be a leading indicator of the health of the economy. The fourth quarter is a critical time for consumer spending; according to the National Retail Federation, the holiday season accounts for 20 to 40% of retailers' annual sales, with 10 to 15% of those holiday sales occurring over Thanksgiving weekend. With Thanksgiving arriving late in 2013 (November 28), and the ever-increasing efforts of retailers to push forward holiday offers and capture those initial holiday dollars, the fourth quarter showed both positive and negative movement relative to the previous year's spending patterns. Holiday spending over Black Friday weekend fell $1.7 billion compared to the same weekend in 2012. ShopperTrak reported that sales were down 13.2% on Black Friday, a decrease that was somewhat softened by increased shopping activity on Thanksgiving Day itself. According to ShopperTrak, sales on Thanksgiving Day accounted for 1% of the total holiday shopping in 2013; this was an all-time high for the day. Despite the decline in activity over Black Friday weekend, ShopperTrak indicated that total national holiday sales remained up 2.7% for the year, compared to the same time last year. The decline of Black Friday weekend activity and overall increase in holiday shopping can largely be attributed to changing timelines. The National Retail Federation surveyed shoppers in the first week of November and found that 53.8% of them had already started their holiday shopping. On a more personal level, a recent Gallup poll found that Americans spent an average of $96 per day (excluding normal household bills and major durables such as homes or cars) in the month of December. This daily average of discretionary spending was the highest since September 2008, when the recession and news of the economic crisis began to spread. While this figure remains below the May 2008 high of $114 per day, it is nevertheless a positive indication that discretionary consumer spending is on the rise.

That's The Spirit! (continued)



Economic News (continued)

10-Year Treasury Note Yield, dated January 3, 2014

Perspective Financial Group
22 Cassatt Avenue
Suite 100
Berwyn, PA 19312
Phone: 610-854-0035
Fax: 610-854-0042

www.pfg1976.com

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