



Fourth Quarter Investment Commentary

2013

Rife with anger and strife

Today the world is rife with anger and strife. The situations are deteriorating in Iraq and Afghanistan. Civil war continues undeterred in Syria. Terrorist attacks are plaguing Russia in the days leading up to the Winter Olympics. The Japanese Prime Minister is warning the world in Davos Switzerland that the Chinese are not to be trusted, as those two nations battle over the sovereignty of some disputed islands. Strikes are occurring in South Africa's mining community, closing the world's largest mines. Turkey's Prime Minister is embroiled in a corruption investigation. Deadly protests in the Ukraine and Thailand are eroding confidence in the political stability of those developing nations. Argentina and Venezuela are devaluing their currencies. The net effect of all these conflicts is a loss of confidence in the Emerging Markets of the world and now once again the United States, despite our own internal struggles, appears to be the safe haven of choice for the world's capital.

The U.S. stock market, as measured by the S&P 500 Index, finished 2013 with a total return of just over 32%, including dividends. Some of this impressive return is the result of strong corporate earnings. Other likely catalysts included a strengthening Labor market and an increase in Industrial Production.

A considerable amount of the gain though, in my opinion, is artificial and the result of the massive oversupply of easy money that the Federal Reserve continues to pump into the economy. Although the Federal Reserve has begun to "taper" its third round of Quantitative Easing, its balance sheet still continues to climb. The rate of growth is just not as steep. The balance sheet stands at \$4.14 trillion on January 22nd 2014, up from \$3.886 trillion as of October 19th, 2013.

It was a strong year across the board for domestic equity returns. All ten sectors of the S&P 500 posted double-digit gains. However, there was a significant spread between the best performing sector, Consumer Discretionary (+43.1 %) and the worst performing sector, Telecommunications (+11.5 %). Following is a table of the S&P 500 returns by sector:

2013 Performance Summary by Sector

Sector	Return
Consumer Discretionary	43.1 %
Health Care	41.5 %
Industrials	40.6 %
Financials	35.6 %
Information Technology	28.4 %
Consumer Staples	26.1 %
Materials	25.9 %
Energy	24.8 %
Utilities	13.2 %
Telecommunications	11.5 %

In comparison, here are how some of our more widely held securities performed over the calendar year:

Accenture (ACN)	26.4 %
Baker Hughes (BHI)	37.0 %
Conoco Phillips (COP)	27.0 %
Dominion Resources (D)	29.7 %
DuPont (DD)	49.1 %
Intel (INTC)	30.8 %
Johnson & Johnson (JNJ)	34.6 %
Lockheed Martin (LMT)	67.7 %
Microsoft (MSFT)	44.3 %
Norfolk Southern (NSC)	54.0 %
Raytheon (RTN)	62.1 %
Spectra Energy (SE)	35.1 %
Verizon (VZ)	18.4 %
Walgreen (WAG)	58.9 %

With those historic sector and individual stock returns for 2013 in mind, I thought it would be insightful to see where ten of the top Wall Street strategists expect the market to go in 2014. (Information from marketwatch.com)

Strategist	Firm	S&P 500 Index Year-end 2014	% up
David Bianco	Deutsche Bank	1,850	0.2 %

Brian Belski	BMO Capital	1,900	2.9 %
Barry Knapp	Barclays	1,900	2.9 %
David Kostin	Goldman Sachs	1,900	2.9 %
Jonathan Golub	RBC Capital Markets	1,950	5.6 %
Andrew Garthwaite	Credit Suisse	1,960	6.1 %
Tobias Levkovich	Citi Research	1,975	6.9 %
Savita Subramanian	Bank of America/ML	2,000	8.3 %
Adam Parker	Morgan Stanley	2,014	9.0 %
Thomas Lee	J. P. Morgan	2,075	12.3 %

Is another year of positive returns possible for the S&P 500? If the Federal Reserve continues with its artificial stimulation, while even at a lesser rate, I assume that it is.

For an historical perspective, here are the market returns for the years that follow a year in which the S&P 500 gained more than 25% (Information from Strategas):

Year	Price Return	Following Year's Return
1928	38 %	- 12 %
1933	44 %	- 5 %
1935	41 %	28 %
1936	28 %	- 39 %
1945	31 %	- 12 %
1954	45 %	26 %
1955	26 %	3 %
1958	38 %	8 %
1975	32 %	19 %
1980	26 %	- 10 %
1985	26 %	15 %
1989	27 %	- 7 %
1991	26 %	4 %
1995	34 %	20 %
1997	31 %	27 %
1998	27 %	20 %
2003	26 %	9 %
2013	30 %	??
Average	32 %	6 %

In these seventeen instances, there were only six years in which the price return for the Index went down the following year. On average, the return was actually 6%. Is this what we should expect to see in 2014?

Can we anticipate Single Digit Returns?

The S&P 500 has had an average annual price return of 5.6% since 1927 and so something in that neighborhood is often cited as a reasonable expectation for any one year's return. In reality, the often predicted mid-single digit return year does not really happen all that often. Calendar year returns of greater than 20 %, while they seem unusual, aren't really that rare and they have occurred in more years since 1926 than have returns of single digit years and years of 10 to 20 % return combined. There are 32 instances of a return greater than 20 % since 1926:

Returns	Years
Lower than - 20% (6):	1930, 1931, 1937, 1974, 2002, 2008
Minus 20 % to minus 10 % (5):	1941, 1957, 1966, 1973, 2001
Minus 10 % to Zero (13):	1929, 1932, 1934, 1939, 1940, 1946, 1953, 1962, 1969, 1977, 1981, 1990, 2000
Zero to 10 % (13):	1947, 1948, 1956, 1960, 1970, 1978, 1984, 1987, 1992, 1994, 2005, 2007, 2011
Ten % to 20 % (18):	1926, 1944, 1949, 1952, 1959, 1964, 1965, 1968, 1971, 1972, 1979, 1986, 1988, 1993, 2004, 2006, 2010, 2012
Greater than 20 % (32):	1927, 1928, 1933, 1935, 1936, 1938, 1942, 1943, 1945, 1950, 1951, 1954, 1955, 1958, 1961, 1963, 1967, 1975, 1976, 1980, 1982, 1983, 1985, 1989, 1991, 1995, 1996, 1997, 1998, 1999, 2003, 2009

Tough Year for Bonds

Although the stock market ended up having a strong performance in 2013, such was not the case for the bond market. For the year, rates rose for treasuries with maturities of two years or longer on the yield curve. In particular, the rates for seven and ten year treasuries rose 1.27%, finishing the year at 2.452% and 3.029%,

respectively. This increase was unusual as it occurred in the face of more than a trillion dollars worth of artificial demand for treasuries and mortgage backed securities from the Federal Reserve. The purchasing of these bonds was, among other things, intended to keep interest rates from rising.

Bond mutual funds in the U.S. posted record net withdrawals of \$80 billion in 2013, mostly in the third and fourth quarters, as investors shunned fixed income in anticipation that interest rates will continue to rise even further. According to the Investment Company Institute, net redemptions for the year represented 2.3% of bond fund assets. The previous record for net redemptions from bond funds was in 1994, when investors pulled approximately \$62 billion.

Redemptions from bond funds were felt most severely by Bill Gross's Pimco Total Return Fund, which lost its title as the world's largest mutual fund in October. That one bond fund alone had net redemptions of \$41.1 billion for the year, according to Morningstar estimates. In the month of December alone, investors redeemed approximately \$4.2 billion from the Total Return Fund, marking its eighth straight month of withdrawals. Still, according to Morningstar, the fund ended the year with \$237 billion in assets. The Pimco Total Return Fund fell 1.9% in 2013, which was its biggest loss since 1994.

Industrial Production

Industrial production rose for a fifth month in December. Industrial output rose at 6.8% annual rate for the fourth quarter of 2013, the most since the second quarter of 2010. Manufacturing, which makes up approximately 75% of total production, rose 0.4% after a gain of 0.6% in both October and November. Factory output of automobiles, home appliances, furniture, electronics and clothing all increased in December. Mining production, which includes drilling, increased 0.8% in the last month of the year. Particularly strong in the fourth quarter was the production of automobiles and automobile parts, which increased 1.6% in December following a 3.6% increase in November. (Carmakers also had their best year for sales since 2007.) Ford plans to add 5,000 jobs in the U.S. as it introduces 16 new vehicles in North America in the year ahead. The only down note to these strong Production numbers was a soft month in Utility production. Utility output dropped 1.4% in December but we should expect to see a strong rebound in the current month as the nation is experiencing one of the coldest Januarys in nearly a century.

All of this news has Economists raising their projections for growth in 2014. According to the median estimate of 79 economists in a Bloomberg survey, our economy should expand at a 2.8% rate in 2014.

Social Security and the C.O.L.A.

Social Security benefits are adjusting upward this year for nearly 58 million people who receive the benefit. The annual cost of living adjustment, or COLA, is based on a government measure of inflation and this year it amounts to an increase of 1.5%. Last year the increase was 1.7%. There were no increases in 2010 and 2011 because inflation in those years was too low.

The amount of wages subject to Social Security taxes is also going up. The wage threshold has increased from \$113,700 last year to \$117,000 this year. Wages above that threshold are not subject to Social Security taxes. About 165 million workers pay Social Security taxes and about 10 million of those earn wages above the threshold. Perhaps we should see some legislation that raises that threshold at a rate in excess of the calculated COLA rate.

The cost of living adjustment is based on the consumer price index for urban wage earners and clerical workers, as measured by the Bureau of Labor Statistics. It measures price changes for food, housing, clothing, transportation, energy, medical care, recreation and education. The COLA is calculated by comparing consumer prices in July, August and September each year to prices in the same three months the prior year. Among some of those components, last year food and beverage costs were up 1.4%, housing costs were up 2.3%, clothing was up 0.7%, transportation costs dropped 2% and medical costs were up 2.4%, according to the Bureau of Labor Statistics.

The COLA will affect the benefits for more than one fifth of the country. In addition to Social Security benefits, it also affects benefits for disabled veterans, federal retirees and people who get Supplemental Security Income, a disability program for the poor.

Ballooning Debt

In the days ahead we will be hearing again about the nation's debt ceiling and the battle over raising it. You see, our debts are coming due and we will need to borrow even more money to pay for the money that we have already borrowed. Or at least just to pay for the interest on the money that we have already borrowed. While the debt ceiling is surely a worthy topic of debate, it is still only a second order issue to the more important issue of the underlying debt itself.

According to www.usdebtclock.org the total debt of the United States is \$17,336,154,944,609 and climbing rapidly, as I write this commentary on Sunday January 26th, 2014. That's \$300,000,000,000 more than when I wrote my last

commentary just three months ago. (That's an accumulation of One Hundred Billion dollars of debt per month.) I encourage everyone to check out this website because it is loaded with everything you need to know about our escalating debt problem.

If \$17.34 trillion is a number that is just too big for you to comprehend, then let me break it down for you into something a little easier to handle: that much debt amounts to \$54,616 for every citizen. Since most of you who are reading this note are also paying taxes, \$17.34 trillion represents \$150,516 of debt for each taxpaying citizen.

This website also shows rolling tallies of our largest budget items, including Medicare and Medicaid, Social Security and Defense. An even more staggering number shown there are the nation's unfunded liabilities. They are in excess of \$127.5 trillion, or a liability per taxpayer of \$1,107,772. Please check out this website and share it with everyone you know. Our collective attention must be on this first order problem or ultimately our debts will sink us and we will go down with the ship.

A New Captain at the Helm

On Monday January 6th, the Senate voted 56 – 26 to confirm Janet Yellen as the 15th Chairman of the Federal Reserve. She will be the first woman to lead the Federal Reserve in its 100 year history. A former University of California at Berkeley professor, Yellen was a Fed Governor from 1994 to 1997, Chairman of President Clinton's Council of Economic Advisers from 1997 to 1999, and San Francisco Fed President from 2004 to 2010. Since 2010 she has been serving in the position of Vice-Chairman of the Federal Reserve, second to Ben Bernanke.

Although very well qualified for the position, her confirmation vote was not lacking for controversy. Senate opponents, already skeptical of the current Fed Chairman's policies of easy money, expressed concerns that Mrs. Yellen would only continue down the very same path. She has been a consistent supporter of the current policy. To compound their discontent, Yellen was among the first nominees considered under newly altered Senate rules adopted in November that now deny a single Senator the right to demand a 60 vote threshold to confirm a candidate. With rules now only requiring a simple majority, Yellen was confirmed with only 56 votes. By comparison, during his second confirmation, Chairman Bernanke only garnered 70 votes, which at the time was the narrowest confirmation vote on record for a Federal Reserve Chairman since the Senate started confirming the position in 1978. The Federal Reserve will meet next on January 28th and 29th. This will be the last meeting for Chairman Bernanke. Chairwoman Yellen will take the helm of the Federal Reserve on February 1st and we all wish her Godspeed in her new position at the helm.

Now That's a Lot of Ship!

Royal Dutch Shell recently completed building the hull of the world's largest floating vessel. Dubbed "Prelude", the 1,600 foot long hull was floated out of the dry dock of the Samsung Heavy Industries shipyard in Geoje, South Korea. The vessel has been constructed to process natural gas off of the coast of Western Australia and is the world's first ocean-based LNG plant. When operational in 2017, the vessel will float above a gas field named Prelude and will take in the equivalent of 110,000 barrels of oil per day in natural gas. It will then cool that natural gas into liquefied natural gas.

At an estimated cost of \$12 billion, Shell is attempting to consolidate its advantage as the first mover in Floating Liquefied Natural Gas (FLNG) facilities. Anchored about 125 miles off of the Australian coast, "Prelude" will chill the natural gas to reduce its volume by a factor of 600 and will then load it onto specialized LNG tankers for transit and later sale in Asia. Shell says the vessel is designed to remain in place, even in the face of gales from a category 5 cyclone. This is a potential game changer for the Natural Gas industry and even larger floating facilities are already on the drawing board.

Gravity

The Federal Reserve's stimulus program and its rate of reduction will remain the major wild card for the markets in 2014. Will the party continue with a \$5 trillion balance sheet and a 20% plus return for stocks in the year ahead? Perhaps. Are the Wall Street strategist's sober predictions of a more historic mid-single-digit return what will become of the markets in 2014? That's what the averages would suggest. Or will this be a year when we are finally reminded of the gravity of run-away borrowing, creating trillions of dollars of liquidity out of thin air and the need to pay down our corpulent bills before they burst? That's hard to imagine, isn't it?

Although the market may have a swinging time in the process, I think I will go with the more historic mid-single-digit return scenario myself.

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