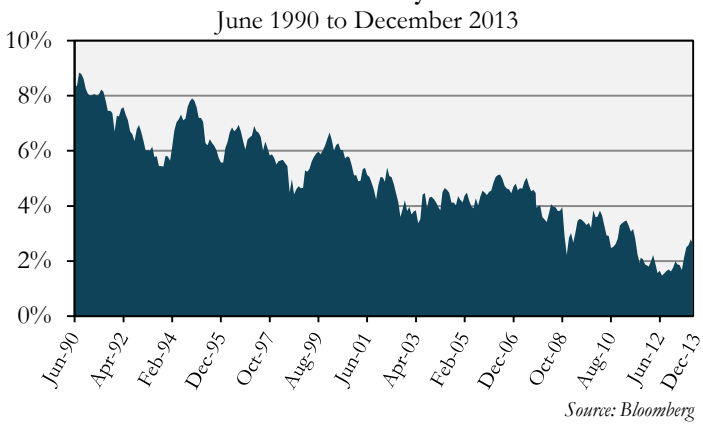
FIRSTwestern
CAPITAL MANAGEMENT

DECEMBER 2013 QUARTERLY REVIEW & OUTLOOK
"IN WITH THE NEW"

The annual ritual of turning the calendar to a new year is usually accompanied with reflection on the past and optimistic prognostications. The past has been overwhelmingly fruitful for many investors as financial markets produced generous returns. Soaring equity prices led the way even as benchmark interest rates rose. While some of the riskier sectors of the bond market performed well, the significant increase in rates pressured more traditional parts of the fixed income world. In sum, though, a well-diversified portfolio generated very healthy gains. Thus, rather than closing the book on 2013, many investors might cheer for an encore performance.

The Federal Reserve, however, may be eager to turn the page after a rather bumpy twelve months. Though markets did well, economic conditions remain disappointing to most. Growth is sluggish, unemployment remains above target, and inflation hovers dangerously low. Importantly, the adjustment from massive quantitative easing to initiating tapering of the Fed's bond buying program was fraught with miscues. The first missive, in May, inflicted severe damage to the market psyche as rates rocketed and risky assets plummeted. The Fed communiqués that followed did little to alleviate investor fears. Hardest hit were emerging markets as levered investors unwound positions to reduce exposure.

10 Year Treasury Rates
June 1990 to December 2013



Source: Bloomberg

The Fed's miscalculation of the market excesses and confusing messaging made for a very messy preliminary step. While equities and other risk assets rebounded, rates remained under pressure. When the actual announcement of tapering finally occurred in December, a $10 billion reduction to bring down the monthly bond purchases to $75 billion, it did little to derail the rally. During the fourth quarter, with the 10-year Treasury nearing a 3% yield, equities approached a very impressive 30% year as measured by the S&P 500.

> ***"The first missive, in May, inflicted severe damage to the market psyche as rates rocketed…"***

2014 will witness the "out with the old" Fed leadership as Chairman Ben Bernanke retires and an "in with the new" Janet Yellen regime. Since Fed policy lags make one unable to complete the concluding chapter of Bernanke's legacy, the next few years will influence his final grade. History should illustrate the depth and complexity of the Great Recession, realizing the limited power of monetary tools, and should note the success that many initiatives achieved. Free market proponents may argue that the sluggish recovery was a result of government programs which never enabled the economy to hit rock bottom and find equilibrium. Perhaps this alternate path would have engendered a more robust recovery, but it likely would have resulted in a much more brutal recession, perhaps even a depression, and risked the collapse of our financial system. Fault can be found in allowing the reckless lending and poor oversight of the financial industry, but many of the early responses should be viewed favorably and Bernanke's final marks should be relatively strong.

Many year-end reviews will focus on "what's hot and what's not" in fashion, food, technology, and media. In these sectors, there are always late adopters that are just catching on to the past trend. Be it gluten-free foods, Instagram, or Breaking Bad, some hot things in 2013 will fade while others may continue to draw interest. In the financial world, investors must determine if trends from the prior year will continue or if new investment opportunities look attractive. Ascertaining the optimal risk levels, asset classes, sectors, and securities based

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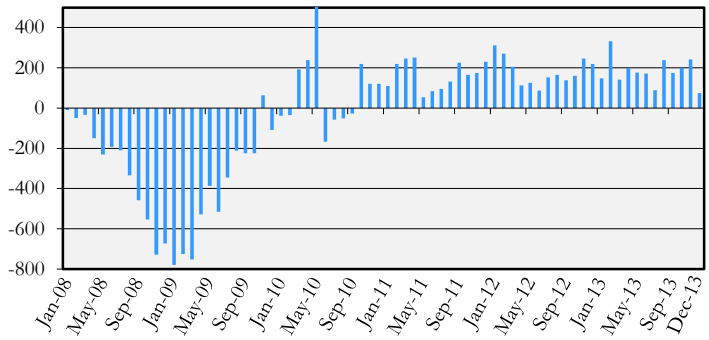
upon one's 2014 outlook is a formidable challenge. While some may see the eye-popping equity returns and rotate money into that area, others will become more conservative following those gains and reallocate elsewhere. Most market strategists remain optimistic that equities can continue to rally, though others argue that P/E ratios have expanded significantly and stocks are no longer cheap. Bonds, on the other hand, experienced sizeable outflows and negative returns in most sectors. While this may prompt some further rotation out of bonds, others may see the fixed income market as more attractive at these higher yields.

NON FARM PAYROLLS (thousands)
January 2008 to December 2013



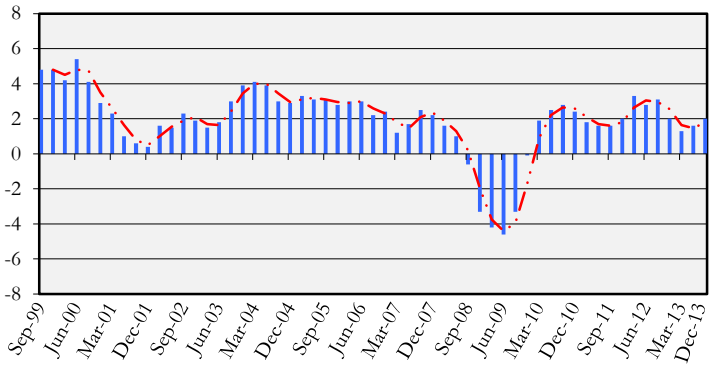
Source: Bloomberg

Prior to making these asset allocation decisions, the broader macroeconomic environment needs to be carefully analyzed. This outlook will enable one to develop expectations for upcoming central bank policies. To start, and without figures yet for the fourth quarter, the U.S. has likely grown at around a 2% pace during the past year. As the year progressed, growth accelerated and the unemployment rate dropped. While initial improvement in the unemployment rate was more a result of a declining participation rate (workers were dropping out of the workforce), recent months showed healthy gains in new jobs and brought down the jobless rate to 7.0%. Inflation has yet to rear its ugly head. Years of injecting liquidity into the system has done little to prop up goods prices, though it has done quite a number on asset prices. Barely topping 1% per year, the Consumer Price Inflation index is below the Fed's 2% target. Some are more concerned about disinflation, or even outright deflation, as opposed to inflation in the upcoming quarters. Though we differ in many ways from Japan, it should be noted that deflation did not commence until seven years after their bubble had burst. Other important measures, such as consumer confidence and manufacturing indices, point to solid growth in the months ahead. Furthermore, the S&P/Case-Shiller index of home prices reported a 13.3% increase in the year ended September, the highest year-over-year figure since February 2006. Thus, with most signs pointing to at least modest growth with a potential for some strengthening, the Federal Reserve finally felt comfortable enough to initiate tapering.

In an environment that has been driven by central bank policies for several years, an investor must have a thorough understanding of monetary tools and develop expectations for future modifications. At some point in time, the market may adjust its thinking and place a much greater importance on economic and company fundamentals, downplaying the influence of central bank policy. Weaning market participants off Fed largesse may prove difficult, as indicated by its opening attempt. However, markets do adjust and these past few months were considerably smoother, including the actual mid-December announcement of the $10 billion in tapering.

Back to our "what's hot and what's not" list, central bank policy will usher out its reliance on quantitative easing and increase the popularity of forward rate guidance. Incoming Federal Reserve Chairperson Janet Yellen, while sharing a dovish monetary policy philosophy with exiting Bernanke, has advocated a greater reliance on the policy of providing a long-term outlook on Fed rate guidance. Thus, the Fed has gone to great lengths to differentiate between tapering QE and an actual increase in short-term rates. The latter, as the Fed under Yellen will continue to contend, is quite far off with the majority of Fed voting members expecting 2015 to be an appropriate time. Yellen summed it up best: "By lowering private sector expectations of the future path of short-term rates, this guidance can reduce longer-term interest rates and also raise asset prices, in turn, stimulating aggregate demand."

GDP Year over Year
September 1999 to December 2013



Source: Bloomberg

The clarity of central bank policy, be it easing or tightening, enhances financial stability and enables improved business planning. However, promoting an underpinning on short rates for too long can lead to unwanted consequences. Already, the bond market has observed a noticeable steepening of the yield curve. With 2-year Treasury yields barely budging, longer rates have moved considerably higher. From a May low of

2.6%, the spread between 30-year Treasury yields and 2-year Treasury yields climbed to 3.6% by year end. While this does impact home mortgage rates and other important lending rates, it is usually indicative of higher inflation down the road. As we alluded to earlier, that is not yet evident in consumer prices, nor has it been seen earlier in the production cycle through producer prices or commodity indices. However, the Fed manipulation of bond yields for the past several years has made the job of the analyst more difficult. When the 10-year Treasury yield was at 1.6% in early May, most would have agreed that bond prices were well above fair market valuation (and yields well below). At today's approximately 3% yield, however, intermediate rates appear to be closer to fair value. If GDP were to be only 2% and inflation remains near 1%, current rates make sense. Most project stronger growth and inflation, but unless one is extremely bullish on global and domestic prospects and quite fearful of near-term inflation, upward rate pressure may persist but the severity of future moves will likely be reduced.

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Fortunately, the Bernanke term ushered in a new era of Fed transparency. Gone are the days of attempting to decipher the convoluted utterings of Fed Chairman Greenspan. Today's Fed has adopted the use of clear language and established question and answer sessions. For our benefit, incoming Chairperson Yellen has published many articles and given numerous speeches throughout recent years, providing ample insight into her thinking. She has spoken about the fragility of this recovery and how it differs from others due to consumers having sharply revised down their expectations for future income growth. She has voiced concern over the absence of stimulative fiscal policy, including the drag from the sequester. In addition, Yellen has weighed in on the timely issue of a decline in the unemployment rate that is not accompanied by sufficient strong growth. She notes that this declining rate "may not indicate substantial improvement in the labor market outlook", providing further evidence that the Fed may not incorporate a hard rule for the unemployment rate. She has favored the quantitative easing programs, primarily due to their ability to promote prudent risk-taking. As discussed earlier, Yellen has long been a proponent of forward guidance as it clearly signals a commitment to boost economic activity. Thus, there seems little risk of a drastic change in Fed policy, although monetary accommodation will shift from a reliance on QE to a reliance on forward rate guidance. An extension of the zero interest rate policy, however, increases the potential for the Fed to fall behind the curve when inflation resurfaces. Moreover, the continuation of low rates may further encourage inappropriate risk-taking. As has been argued in previous letters, monetary stimulus and the ensuing low rate environment has compelled yield-hungry investors to allocate capital to areas with much more risk than the more traditional financial assets. These risks are usually no longer incompatible with their tolerance levels, probably exacerbated now that risk premiums have been reduced following the market rally. The implication is that prolonging the misallocation of capital may lead to a deeper correction down the road as the short-lived investors bail out of these higher-risk assets.

Fed continuity should foster a modest and improving economy with continuation of healthy demand for risk assets during 2014. Valuation, as we alluded to, has become less appealing for some of these risk assets. Following the twenty-percent expansion of P/E multiples to 17.4 times reported earnings, this valuation metric hit its high since 2010. Expanding valuations further, in the face of the eventual elimination of QE and higher expected benchmark interest rates, may prove difficult. For the equity rally to endure, earnings will have to be the primary driver. After years of cost efficiencies, top-line revenue growth may be necessary to grow profits in the quarters ahead. Moderate net income growth and stable to slightly increased multiples may enable another solid year for stocks, albeit high single digit returns.

Potential returns from fixed income will vary greatly depending upon maturity, sector, and risk. Corporate bonds have long been the leader, and the scenario of modest growth along with Fed accommodation bodes well for this to persist. Yield spreads are no longer as attractive as they had been, so one must uncover relative values among different issuers and securities across various industries. Mortgage-backed securities will benefit from stronger housing prices and tend to perform well in a flat or reasonable move higher in rates. Shorter bonds should fare better than longer ones, but eventually the pendulum could begin to swing. At some point, for example 4% on the 10-year Treasury, investors would be able to construct an investment grade bond portfolio with an average yield above 5%. Many might consider this attractive…certainly a far cry from average yields in the 2% range earlier this year. This could act to both limit the upward movement of yields as investors rotate back into less risky fixed income sectors and could impact high yield bonds, emerging markets, and equities.

Therefore, while some changes may occur as the Fed leadership changes and the monetary accommodation relies less upon QE and more upon forward rate

guidance, the direction of markets may follow a similar path as 2013 with much more subdued returns. While upward pressure on interest rates may remain, the median estimate of 64 economists surveyed by Bloomberg is for the 10-year Treasury to climb to only 3.4% by year end. In this environment, assuming a continuation of moderate economic growth, intermediate-maturity fixed income investors should be able to generate positive returns. This modest rate move and economic backdrop would also be supportive to equity prices, though gains may be partially mitigated by tapering and current valuations. Although change is often viewed negatively in financial markets, a judicious and transparent modification to policy can be surmountable as long as consumer and investor confidence can be sustained. History shows that it would be rare to avoid bouts of volatility, but underlying fundamentals should remain supportive and the turning of the calendar can be viewed as a positive event.

Market Snapshots

Equities

The year went out with a bang as a very final quarter enabled the market to generate extremely healthy gains for the year. A return of 10% for the S&P 500 during Q4 brought the annual gain to an impressive 30%. With the Dow Jones Industrial Average topping 26% for the year and the Nasdaq turning in a 38% increase, equity investors have been the prime beneficiaries of the Fed's largesse and their improved wealth may help drive consumer confidence. Share buybacks and decent revenue growth should help earnings, and strong capital inflows into equities will provide additional assistance. Should rates rise too rapidly, investors may begin to question valuations.

Bonds

The long-anticipated reversal in bonds hit investors in 2013, with the last leg in the fourth quarter bringing the benchmark 10-year Treasury above a 3% yield. While sizeable mutual fund outflows were commonplace, yield spreads behaved rather well. Investment grade bond market indices were mildly negative in Q4 and fell 2% for the year, most managers minimized the losses with heavy allocations to corporate bonds and mortgage-backed securities. High yield investors fared better as the primary index gained 3.5% for the quarter and over 7% for the year. Municipal bonds eked out small gains and peripheral European bond markets improved noticeably.

Commodities

The potential for Iranian supply to re-enter the market pulled oil prices down during the quarter, though partially offset by expectations for stronger growth. Natural gas prices, fueled by frigid temperatures across much of the U.S., spiked over 10% during the quarter and closed at $4.23 per BTU. As investors grew more comfortable with global growth prospects and financial market stability, the demand for gold lessened and prices ended just above $1,200 per ounce.

Currencies

In an effort to support growth in the region, European Central Bank President Mario Draghi strengthened his pledge to keep rates low for an extended period. The perceived beginnings of a turnaround in Europe lead to gains for the shared euro currency. Weakness in emerging markets and the expectation for accelerating U.S. growth has benefitted the U.S. dollar, although bond weakness stemming from QE tapering offset other factors and resulted in very little change in the dollar relative to a basket of major currencies.

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MARKET RECAP							
Index	**9/30/13**	**12/31/13**	**% Change**		**Treasury**	**9/30/13**	**12/31/13**
DJIA	15129.67	16588.25	9.64%		3 Month	0.01%	0.07%
S&P 500	1681.55	1848.36	9.92%		2 Year	0.32%	0.38%
S&P Elec. Util.	213.50	215.55	0.96%		5 Year	1.38%	1.74%
Nasdaq	3771.48	4176.59	10.74%		10 Year	2.61%	3.03%
Crude Oil	102.33	98.42	-3.82%		30 Year	3.67%	3.97%