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Financial Market Commentary: 3rd Quarter 2013

Despite Robust 3rd Quarter Gains Politics Remain the Center of Attention

Markets performed reasonably well across the board in the quarter with most equity asset classes showing strong returns. However, reading signals out of Washington, D.C. has become more difficult. Over the past several weeks the United States has gone from being on the brink of a military strike on Syria to cooperating with the Russians on a diplomatic solution regarding Syrian President Bashar al-Assad's chemical weapons arsenal. Former US Treasury Secretary Lawrence Summers was the White House's first choice to assume the US Federal Reserve Chair, but surprisingly his appointment was opposed by many in the Democratic Party. Having become conditioned to expect eleventh-hour deals to avert a crisis, lawmakers were unable to strike a deal to keep the government running and, a partial government shutdown is occurring. Finally, the US Federal Reserve (Fed) decided to postpone the inevitable "tapering" of its bond-buying activities at its recent meeting when it had previously signaled to the world that it was highly likely to slow down the bond-buying.

Strength in the Real Economy Continues

The rise in U.S. equity markets during the quarter was driven in part by continuing improvements in the real economy. Initial unemployment claims dropped to a multiyear low early in September despite worries that the improvement was a result of data issues; later reports substantiated the good news. The unemployment rate ticked down from 7.4 percent to 7.3 percent in August. These factors combined to increase real disposable income by the largest amount since March of this year, enabling consumers to spend more.

Good news also happened outside of the U.S. The Eurozone showed improvement, emerging from six quarters of economic contraction. Germany led, but the improvement was widespread. China also showed better economic results, which helped the emerging market space as a whole. Part of what drove the general improvement in the U.S. was manufacturing, which benefited from increased exports on the back of higher demand from Europe and China. The housing market continued to do well, as rising prices up 12.4 percent year-over-year in July for existing homes created a positive wealth effect for homeowners. In response to the general improvement, consumer confidence reports were up at the end of September. The index of leading economic indicators ticked up as well, suggesting that, absent the effects of politics, the recovery in the real economy was continuing.

As Referenced, Politics Remain the Center of Attention

Better economic trends notwithstanding, the primary market movers in September was the Fed and the Federal Government. The Fed, against expectations, decided not to start reducing the bond-buying program it had implemented to keep interest rates low and stimulate the economy. It did so in the face of a general sense that the requirements for such a reduction had been met.

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At his press conference after the announcement, Chairman Ben Bernanke said that the Federal Open Market Committee (FOMC) believed that, among other things, employment gains were uncertain and that the political risk of the pending government funding and debt ceiling debates justified continued easing.

Markets initially celebrated the continuation of the stimulus program, but they reversed on worries that the economy might be weaker than anticipated. These declines prompted further selling because of concerns about the potential government shutdown, as Congress proved unable to agree on a budget to fund the federal government into October.

The pending debt ceiling negotiations also moved into focus as a risk. The fact that the U.S. hit the debt ceiling last May, and is likely to run out of accounting tricks in late October, brings back memories of 2011, when the market slid by double digits on a combination of debt ceiling concerns and a downgrade of U.S. debt by Standard & Poor's. The solution, sequestration, has already been implemented and is not available this time around. The debate also appears to be ideological, with mutually beneficial compromise less attainable.

Although the domestic focus has been on U.S. politics, other governments have also shifted. The German election went off well from the perspective of European stability, with Angela Merkel's party winning re-election. But the unexpected elimination of Merkel's coalition partner party from the legislature has led to uncertainty as to the actual makeup of the next government. In addition, Italy nearly returned to political crisis mode at month-end, as five ministers resigned in protest of a tax hike. Finally, Greece moved closer to needing an additional bailout and debt forgiveness. Just as with the U.S., a European recovery remains at risk due to political factors.

An Uncertain Outlook Ahead

Times like these are a reminder that it pays to have a balanced portfolio allocation and a long term view as an investor. Those with an eye to the short-term have recently been whipsawed by unsuccessfully trying to guess what politicians and the US Federal Reserve's next steps will be. Looking ahead one can expect the economy to continue to face uncertainty and headwinds from fiscal policymaker decisions. These come at a time when the economy is in a modest economic expansion but not fully recovered from the severe financial crisis. Assuming the U.S. government chooses to not default on its debt, expect the economy to continue to post sub-trend growth rates with low inflation and an improving but soft labor market.

If Janet Yellen is nominated and confirmed as the next chair of the FOMC, expect monetary policy to continue on the same course set under Mr. Bernanke. Given the outlook for the economy and restrictive and uncertain fiscal policy, expect the Fed to taper QE3 on a longer timeframe than had been expected. The first taper may not occur until 2014 or the Fed may guide the markets to not expect a hike in the policy target rates until at least later in 2015.

The ten-year T-note 3% yield level reached in September may function as a cap for at least the next few months. At 2.60% currently, the yield may possibly go lower if the self-induced crisis in D.C. is not resolved fairly soon sparking a bond market rally. Once the debt ceiling crisis has passed, however, it is likely that risk assets should stage a relief rally with lower volatility and Treasury yields drifting higher.

Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moodys, Fitch, and S&P is Ba1/BB+/BB+ or below.

Equity Performance

Equity Index	Style	YTD Return As of 9/30/2013	1 Year Return As of 9/30/2013	3 Year Return As of 9/30/2013	5 Year Return As of 9/30/2013	10 Year Return As of 9/30/2013
Russell 1000 TR	U.S. Large Cap Stocks	20.76%	20.91%	16.64%	10.53%	7.98%
Russell MidCap TR	U.S. Mid Cap Stocks	24.34%	27.91%	17.53%	12.97%	10.78%
Russell 2000 TR	U.S. Small Cap Stocks	27.69%	30.06%	18.29%	11.15%	9.64%
MSCI EAFE NR	Foreign Developed Stocks	16.14%	23.77%	8.47%	6.35%	8.01%
MSCI EM NR	Foreign Emerging Stocks	-4.35%	0.98%	-0.33%	7.22%	12.80%
DJ US Real Estate TR	Real Estate	1.83%	3.85%	11.17%	5.56%	8.45%
DJ UBS Commodity TR	Commodities	-8.56%	-14.35%	-3.16%	-5.29%	2.14%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 9/30/2013	1 Year Return As of 9/30/2013	3 Year Return As of 9/30/2013	5 Year Return As of 9/30/2013	10 Year Return As of 9/30/2013
BarClays US Aggregate Bond TR	U.S. Core Bonds	-1.89%	-1.68%	2.86%	5.41%	4.59%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	3.73%	7.14%	9.19%	13.53%	8.86%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	-2.17%	-2.64%	2.09%	5.07%	4.92%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	-3.96%	-1.35%	4.24%	10.78%	8.32%
CitiGroup 3-Month T-Bill	Cash	0.04%	0.07%	0.08%	0.15%	1.61%

Source: Morningstar®

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