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Financial Market Commentary: 3rd Quarter 2014

The First Three Quarters of 2014 Have Baffled Many Investors

Following a strong finish in 2013, many expected the New Year to extend the bull market cycle. Several favorable economic factors fueled the optimism: continued low interest rates and low inflation; signs of improvements among the world's major economies; and the energy revolution in the U.S. Yet, not surprisingly, the year has progressed differently from what both market bulls and bears predicted. The continued divergence between economic conditions in the U.S. and the rest of the world was prominent again during the third quarter.

For the quarter, the Standard and Poor's (S&P) 500, Russell 1000, Russell 2000, MSCI EAFE, and MSCI Emerging Markets Indices returned 1.13%, 0.65%, -7.36%, -5.88%, and -3.49%, respectively.

Mixed Signals

The Dow Jones Industrial Average and S&P 500 have achieved new highs in the 3rd Quarter while the Russell 2000 of small companies has struggled; currently, the Russell 2000 is negative for the year. During several periods of market volatility, each of the indices went into negative territory; earlier in the spring, technology oriented companies (in social media, internet and biotechnology) sold off sharply. The struggling small cap area supports those who believe that the equity markets are overvalued. Still, larger company stocks, which are well represented in the Dow and the S&P 500, have driven these indices higher.

This year's performance gap could reflect investor anxiety over the end of the Fed's accommodative monetary policies; investors may be favoring the "safety" large cap stocks over "risky" small cap stocks. Small cap underperformance is inconsistent with the strengthening domestic economy; in general, small cap companies generate most of their revenues and earnings in the U.S.; a strengthening domestic economy should benefit small caps more than their globally diversified large cap counterparts.

Fed Tapering Continues

The U.S. Federal Reserve (the Fed) continued its tapering pace during the quarter but chose to maintain existing accommodative language suggesting that short-term interest rates would remain low for a considerable period of time even after the bond buying program winds down. This seems to further fuel the disconnect between the Fed's tightening outlook and the more dovish view of forward rates reflected by market participants, though the looming prospect of rate increases was cited as one reason for increased volatility at the end of the quarter.

Economic Growth outside the U.S. Weakens Further

The U.S. economy has assumed a global leadership position and relative stability continues to offer attractive investment opportunities. Meanwhile, the growth rates in the other major economies remain somewhat lackluster. Both Europe and Japan need structural reforms to create the conditions for sustainable, long-term growth. For now, though, their central banks seek to improve economic growth with programs similar to the Fed's. These solutions are not ideal but they may spur risk-taking activities which lead to economic growth. Similarly, China is also looking to strike a balance between reform and growth; still, state-directed investment will continue to play an important role in the economy. Anticipate the Chinese government will implement the necessary adjustments to meet its 7.5% medium-to-longer term growth target.

Geopolitical Turmoil Remains on Investor Minds but Not a Major Driver of Markets

Geopolitical concerns are always a wild card for investors. Yet, the tepid market response to recent events in the Middle East and Ukraine suggests that these conflicts do not threaten the U.S. economy. These issues may contribute to increased market volatility but, unless matters escalate, they are unlikely to represent more than a modest risk. Indeed, the political upheaval in the Ukraine may actually provide a significant boost for the U.S. economy; Washington is considering a policy change to lift the government's long-standing restrictions on exporting domestic oil and natural gas to Europe and Asia. Thus, geopolitical headlines may provide investment opportunities related to oil and gas exports.

While geopolitical tensions in oil supplying countries and regions have historically produced spikes in oil prices, some of which have been significant, the opposite has been observed recently as oil prices continued to decline despite the geopolitical conflicts in much of the Middle East and Russia. In the current environment, a combination of additional oil supply from North America, and global demand constrained by weak growth, has helped push oil prices down. If this is the beginning of a new trend in lower hydrocarbon-based energy prices it could provide significant support for global economic growth and help keep the lid on inflation globally for some time.

In Closing

As we head into the 4th Quarter of 2014, global economic growth is likely to move ahead slowly, with the U.S. in the lead. More turbulence looks quite possible; however, the U.S. remains exceptionally well positioned for the future, and U.S. investors should continue to participate in the growth. Historically, the markets have generally performed well in the 4th Quarter however geopolitical events and the actions of the central banks will continue to influence the markets. As headline issues subside, performance disparity should narrow as investors focus on the earnings growth potential of stocks.

Although market price adjustments are never pleasant, they are an inevitable result of investors adjusting risk exposures and in the long term are usually not significant. Those with properly diversified portfolios have enjoyed the market run-up in the past several years and should be prepared to take an inevitable downturn in stride.

Equity Performance

Equity Index	Style	YTD Return As of 9/30/2014	1 Year Return As of 9/30/2014	3 Year Return As of 9/30/2014	5 Year Return As of 9/30/2014	10 Year Return As of 9/30/2014
Russell 1000 TR	U.S. Large Cap Stocks	7.97%	19.01%	23.23%	15.90%	8.46%
Russell MidCap TR	U.S. Mid Cap Stocks	6.87%	15.83%	23.79%	17.19%	10.34%
Russell 2000 TR	U.S. Small Cap Stocks	-4.41%	3.93%	21.26%	14.29%	8.19%
MSCI EAFE NR	Foreign Develop Stocks	-1.38%	4.25%	13.65%	6.56%	6.32%
MSCI EM NR	Foreign Emerging Stocks	2.43%	4.30%	7.19%	4.42%	10.68%
DJ US Real Estate TR	Real Estate	13.32%	13.25%	15.99%	15.00%	7.33%
Bloomberg Commodity TR	Commodities	-5.59%	-6.58%	-5.34%	-1.37%	-1.04%

Fixed Income Performance

Fixed Income Index	Style	YTD Return As of 9/30/2014	1 Year Return As of 9/30/2014	3 Year Return As of 9/30/2014	5 Year Return As of 9/30/2014	10 Year Return As of 9/30/2014
BarClays US Aggregate Bond TR	U.S. Core Bonds	4.10%	3.96%	2.43%	4.12%	4.62%
BarClays US Corporate High Yield Bond TR	U.S. High Yield Bonds	3.49%	7.20%	11.09%	10.57%	8.33%
BarClays Global Aggregate Bond TR	Foreign Developed Bonds	1.64%	1.19%	1.16%	2.69%	4.38%
Morningstar Emerging Market Bond	Foreign Emerging Bonds	5.90%	7.16%	8.08%	8.34%	7.77%
CitiGroup 3-Month T-Bill	Cash	0.03%	0.04%	0.05%	0.08%	1.51%

Source: Morningstar®