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MARKET PERSPECTIVES

While there were plenty of things for investors to worry about during the quarter, many of the issues that dominated headlines just a few weeks ago failed to come to fruition. The threat of confrontation with Syria has been defused; the Federal Reserve opted not to taper its quantitative easing program; and the hawkish Lawrence Summers bowed out from the competition to succeed Ben Bernanke as Fed Chairman. All of these events were interpreted as bullish for the market, leading the S&P 500 and the Dow Jones Industrial Average to once again eclipse all-time highs.

After experiencing massive outflows and negative returns for most of the year, bond indices largely turned a corner after the Federal Reserve surprised markets by announcing they had no plans to unwind quantitative easing. Domestic investment grade bonds, as measured by the Barclays US Aggregate Bond Index, returned 0.57% — marking the first positive quarter for the index since the fourth quarter of 2012. Riskier segments of the bond market, such as high yield bonds and emerging markets debt, pushed higher as well — returning 2.29% and 1.19% respectively.

Domestic equities, which had been on a steady climb, closed at a new high following the Fed's announcement. Since then, domestic stocks declined across the board, driven in part by fears of a government shutdown. For the quarter, domestic large cap stocks, as measured by the S&P 500 Index, returned 5.24% while small cap stocks, as measured by the Russell 2000 Index, returned 10.21%. Growth stocks outpaced value stocks by a wide margin.

Looking abroad, international developed markets and emerging markets stocks posted positive gains on a dovish Fed, a strengthening world economy and a stabilizing Chinese economy. For the quarter, the MSCI EAFE Index clocked in a gain of 11.56% while the MSCI Emerging Markets Index returned 5.77%.

At the beginning of the quarter, interest-rate risk was often noted as the number one concern of investors. Now U.S. fiscal policy and the potential debt ceiling crisis has taken center stage. The near-term risk to the economy of a continued political standoff is concerning, and Congress will need to come together at some point to solve our longer-term fiscal challenges. The nonpartisan Congressional Budget Office (CBO) warned in a report published on September 17 that under its "alternative fiscal scenario" federal debt is projected to grow at 190% of annual economic output by 2038, from an "already quite high 73% today." From a fiscal standpoint, that figure would put the U.S. a step behind where Greece is today within 25 years. While the current standoff in Congress over the budget is concerning, longer-term, it is a dialogue that needs to take place.

The real fight is likely to be over the debt ceiling, which the Treasury says it will hit on October 17. That is the date on which the federal government will have to decide which obligations to honor: debt payments or other bills. We believe the probability of a technical default on Treasury securities is very low; however, if it does occur, there would be a market disruption. Defaulted securities can't be used in repurchase agreements. The repo market is the lifeline of the debt market, and as such, the seizing of this market could cause widespread shocks to the financial system—something that both political parties will want to avoid.

Fortunately, there is good reason to think that despite the political near-term risks, growth will likely pick up next year. Housing construction should continue to trend higher, household finances are improving, and as long as the government shutdown is short-lived, the drag from fiscal policy should slowly diminish.

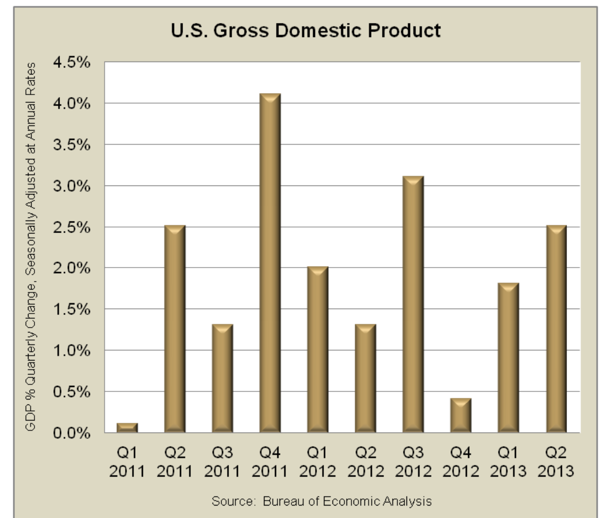
From an investment perspective, we continue to advocate maintaining exposure to assets that can perform well in different economic environments. Poorly diversified portfolios or asset allocations that are structured to perform well in only one scenario have often led to poor performance. We will continue to assess the risks that any political solution, or inaction, may have on investors and will make changes to investment portfolios as warranted.

The Economy at a Glance

Economic Growth & Profits

- The final estimate for second quarter 2013 gross domestic product (GDP) was 2.5%. Economic growth was more solid than the first quarter's 1.1% pace due to stronger business spending, inventories and trade.[1] Growth is likely to pick up next year on the heels of continued positive trends in both leading and coincident economic indicators.

- Corporate profits rose 3.3% in the second quarter after slipping 1.3% in the first quarter.[1] U.S. operating earnings are still expanding but at a reduced pace. In Europe, corporate profits have made what technical analysts call a "double bottom" and should soon recover.



- As of the date of this commentary, there has been no meaningful progress in Washington regarding negotiations to either pass a budget resolution or raise the debt ceiling. A continued stalemate presents risks to near-term economic growth.

Interest Rates

- Going into the third quarter, the Federal Open Market Committee (FOMC) had conditioned financial markets to expect tapering of its quantitative easing program. To the surprise of many, the FOMC decided to hold off for a few reasons:

  1. The economic data, especially on the jobs front, had not been strong enough to convince the majority of policymakers that the recovery has reached a self-reinforcing stage.

  2. Inflation is still well within the FOMC's target range and is unlikely to trend higher in the near term.

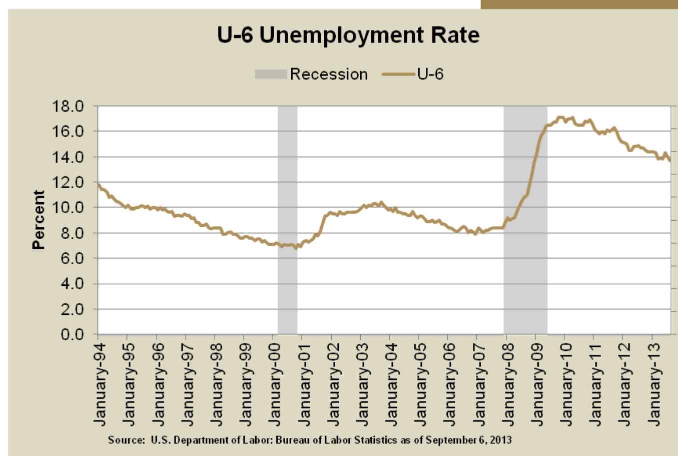
  3. Interest rates rose in June on the premise that the FOMC would begin tapering in September. This led to a rise in mortgage rates and tightened financial conditions, which could be a headwind to the economy and labor market.

  4. Budget battles are looming in Congress, which could generate volatility.

- Chairman Ben Bernanke emphasized that the fed funds rate will stay close to zero well after the 6 1/2% unemployment threshold is reached, and the pace of rate *hikes* will be modest once tightening begins.[2] However, the FOMC's timetable for *tapering* will be "data dependent" and could occur later this year.

Employment

- While the unemployment rate decreased to 7.3% in August, this decrease was due to a decline in the labor force rather than a strong increase in hiring. The labor force participation rate fell to 63.2%, a new post-recession low.[3] This once again underscores that the unemployment rate misses a lot of under-employment, which has been particularly high in this cycle. The U-6 unemployment rate, which includes marginally-attached workers and people who are working part time but would like full-time jobs, remains six percentage points above pre-recession levels. At this point in the recovery, labor force participation typically rises. Given the current rate of payroll growth and the state of the unemployment picture, the Federal Reserve is likely to delay increasing interest rates for some time.



Inflation

- In August, the cost of living in the U.S. increased 0.1%, (up 1.5% year-over-year) which was less than expected on falling energy prices. Core prices firmed slightly, rising only 0.1% (up 1.8% year-over-year).[4]
- The avoidance of a military conflict in Syria has calmed oil prices for now—bringing down commodity prices and inflationary pressures. Slower global growth, especially within the emerging countries, has removed much of the inflationary pressure outside of the U.S.
- Overall, inflation remains well below the Fed's 2% target. As long as labor utilization stays depressed, inflation will remain a distant threat. This implies that the Fed will be in no rush to raise rates.

Risks

- The Federal Reserve's monetary policies may pose a long-term threat to bond investors.
- Credit conditions remain challenging for individuals and small businesses.
- Oil prices may trend higher due to turmoil in the Middle East.
- Government-induced fiscal drag could subdue economic growth.
- The debt ceiling debate could increase volatility over the near-term.

Benchmark Performance Table

	Total Return 3 Months	Total Return 1 Year	Total Return Annlzd. 3 Year	Total Return Annlzd. 5 Year	Total Return Annlzd. 10 Year
Barclays Aggregate Bond	0.57	-1.68	2.86	5.41	4.59
US High Yield Master II Bond	2.29	7.14	8.87	13.35	8.71
Barclays Municipal Bond	-0.19	-2.21	3.24	5.98	4.40
S&P 500	5.24	19.34	16.27	10.02	7.57
Russell 2000	10.21	30.06	18.29	11.15	9.64
MSCI EAFE	11.56	23.77	8.47	6.35	8.01
MSCI EM NR USD	5.77	0.98	-0.33	7.22	12.80
DJ UBS Commodity Idx.	2.13	-14.35	-3.16	-5.29	2.14
DJ US Select REIT	-3.15	4.70	12.09	5.30	9.29
Source: Morningstar® as of September 30, 2013					

Disclaimer

The BarCap Aggregate Bond Index (Barclays Aggregate Bond) is a market-capitalization weighted index that is considered to be representative of U.S. traded investment grade bonds. The Bank of America Merrill Lynch High Yield Master Index (US High Yield Master Bond) is a market-capitalization weighted index that tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market. The BarCap Municipal Index (Barclays Municipal Bond) is a market-capitalization weighted index that is considered to be representative of U.S. traded investment grade municipal bonds. The Standard & Poor’s 500 (S&P 500) is a market capitalization free-float adjusted index of the prices of 500 large capitalization common stocks traded in the United States.. The Russell 2000 Index is a market capitalization free-float adjusted index that is considered to be representative of the small cap segment of the U.S. equity universe. The MSCI EAFE Index is a market capitalization weighted index and is designed to measure the equity market performance of developed markets (Europe, Australasia, and Far East) excluding the U.S. and Canada. The MSCI EM NR USD Index is a free-float adjusted market capitalization index that is designed to measure the equity market performance in the global emerging markets. The Dow Jones UBS Commodity Index is a price weighted index composed of futures contracts on physical commodities. The Dow Jones US Select REIT Index is a market capitalization free-float adjusted index that measures the performance of the Real Estate Investment Trust (REIT) Industry. The market indices referenced are unmanaged. You cannot invest directly in an index.

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Sources:

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3. United States Bureau of Labor Statistics, Economic News Release, Employment Situation Summary, September 6, 2013
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