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Third Quarter 2013

Fig. 1 – S&P 500

Fig. 2 – 10 Year U.S. Treasury Yield

U.S. stocks moved higher again in the third quarter. The large cap S&P 500 rose 5.2%, and is now up 19.8% in 2013 (**Figure 1**). Stocks overseas played catch-up after lagging in the first half of the year. The MSCI Europe, Australia and Far East Index gained 11.6%, and MSCI's Emerging Markets Index added 5.8%.

According to Factset, 72% of S&P 500 companies topped second quarter earnings expectations while only 52% beat revenue estimates. Earnings grew for the third straight quarter, rising 2.1% after gaining 3.3% in the first quarter of 2013. Analysts currently expect growth of 3.2% in the third quarter. It is worth noting that one month ago, growth was expected to be 6.5%.

Overall, the economy displayed signs of modest growth in the third quarter. However, housing starts and builder surveys indicated growth over last year, but failed to meet analyst expectations. Mortgage originations dropped significantly and large banks announced job cuts, as long-term interest rates rose (**Figure 2**). In contrast, manufacturing surveys showed increased momentum through the quarter: the Institute of Supply Management's widely followed purchasing manager survey forecast acceleration in the manufacturing sector, topping analyst expectations each of the past three months. At the same time, the Federal Reserve's regional reports portrayed weakness in much of the country in mid-quarter before rebounding somewhat in September. The service sector maintained its steady pace of expansion, and consumer spending also appeared to grow over last year. Private employment continued to grow, and the unemployment rate ticked lower to 7.3%, but this was at least in part due to more people exiting the labor force.

The Federal Reserve remained at center stage in the third quarter. Market watchers waited anxiously after the Fed appeared to signal that they would begin to reduce the monthly bond purchases that have helped keep long-term interest rates low. **Figure 2** shows the rise of the 10 Year Treasury yield starting in May, which caused bond prices to fall sharply. Stocks fell through most of August as well, as concerns over higher future interest rates weighed on investor sentiment. This waiting proved to be in vain, as the Fed elected to stay the course after their September meeting. Bond yields fell on this announcement, and both stocks and bonds rallied. Federal Reserve governors may be worried that higher interest rates would further crimp housing activity, and unemployment does remain higher

Index returns taken from Morningstar.com and MSCI.com

than their target for raising interest rates. The delay may be short lived. Fed governors have noted in subsequent speeches that tapering may begin as early as October.

Most international equity markets also rose in the quarter, with particular strength in developed countries (**Figure 4**). European economies, led by Germany, may be moving out of their recessionary malaise. Similar to the U.S., purchasing manager surveys there show increased activity, particularly with respect to new orders. The current situation in emerging markets, on the other hand, remains tenuous. As noted last quarter, rising interest rates in the U.S. were a factor in driving down developing economy stocks, as capital left those economies for higher yields in more stable and liquid U.S. securities. Emerging market stocks did bounce back late in the quarter (**Figure 3**), but growth estimates for those countries have been lowered repeatedly, most recently by the Asian Development Bank, which revised its growth estimate for 2013 for developing Asia down from 6.6% to 6%. While that may seem attractive (or ***exciting***) when U.S. growth is barely staying above 2%, a declining growth rate is a very tough environment for stocks.

Fig. 3 – iShares MSCI Emerging Markets

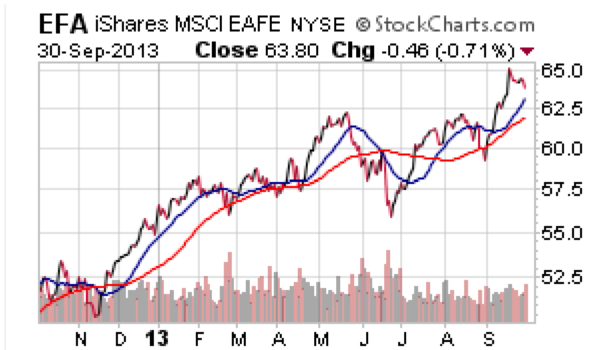

Fig. 4 – iShares Europe Far East & Australia

As of this writing, the U.S. legislature has been unable to agree on a budget, and our federal government has effectively been shut down. In addition, a struggle over the national debt ceiling looms. These are serious concerns, as a lengthy impasse over the budget would curtail growth, and failure to raise the debt limit would result in default, which would have widespread consequences for the world economy. We expect that our lawmakers will effect a compromise, as they have in past. Previous shutdowns – there have been 17 since 1977 – have not caused more than very temporary stock market setbacks. Thus, any pronounced weakness may provide a buying opportunity for alert investors.

An important part of our work is to stay abreast of changes in your financial circumstances. If you have anything you wish to discuss, please contact us at any time.

Sincerely,

Kenneth M. Bernard, CFA