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Third Quarter 2014

Fig. 1 – S&P 500

Fig. 2 – 10 Year U.S. Treasury Yield

World markets posted mixed returns in the third quarter. The large cap U.S. S&P 500 posted a total return of 1.1%, and has now gained 8.3% in 2014 (**Figure 1**). By contrast, international indices dropped sharply. The MSCI Europe, Australia and Far East Index lost 3.8% in the quarter, and is now down 1.4% for the year. The MSCI Emerging Markets Index also fell, losing 4.3%, but is still marginally positive (+0.3%) year to date.

U.S. companies generally continued to grow profitably. According to Factset, 74% of S&P 500 companies reporting during the quarter beat earnings expectations while 64% topped revenue estimates. The positive revenue surprises are indicative of the snapback in the economy following the first quarter's cold-induced slowdown. Earnings grew for the sixth consecutive quarter, rising 7.7% after gaining 2.1% in the first quarter. These successes have raised the bar for the upcoming earnings season. Wall Street analysts now expect third quarter earnings growth of 6.5%. However, this projection is down from the +8.9% expected on June 30th.

The third quarter was marked by troubles overseas, which weighed on investor sentiment. In early July, Portugal was forced to bail out one of their largest banks, which was beset with bad loan issues. This was followed by further conflict in the Ukraine, and subsequent economic sanctions against Russia by the U.S. and European Union. Negative headlines during the quarter also included armed conflict in Israel and Gaza, the rise of the Islamic State of Syria and Iraq (ISIS), and the outbreak of the Ebola virus in Liberia. The quarter ended with protests for democracy in Hong Kong.

All of this weighed on investor sentiment, sending foreign shares lower. (**Figure 3**) European economies remained in a state of stagnation, either contracting or registering minimal growth. In September, Eurozone inflation was only 0.3%, well below the European Central Bank's (ECB) long term target of 2%. The ECB has pledged to do whatever is necessary to combat deflation, including asset purchases similar to the Federal Reserve's quantitative easing. Similarly, Japan's central bank has been pumping money into their banking system, trying to ease the flow of credit and end years of deflation. As a result, U.S. bonds, even at the historically low 10 year Treasury rate of 2.5% (**Figure 2**), have seen steady buying as a relatively attractive yield play. This demand is likely to keep domestic interest rates from

Index returns taken from Morningstar.com rising very rapidly, which will provide a floor for U.S. bond prices. The U.S. dollar has also been a beneficiary of this buying, and the dollar index rose to a four year high against foreign currencies.

Fig. 3 – European Monetary Union Index

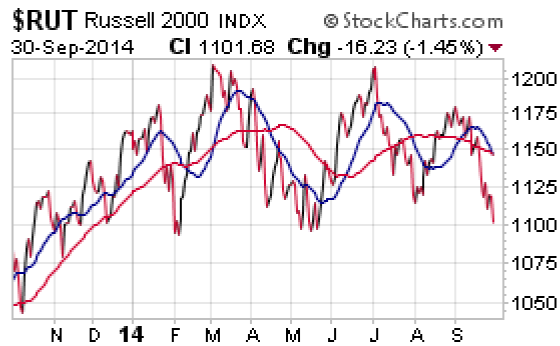

Fig. 4 – Russell 2000 Small Cap Index

The U.S. economy, in contrast, continued to grow steadily in the last quarter. Manufacturing and services surveys showed increases in production and new orders, and new job creation continued at roughly the same pace as earlier in the year. Housing activity was mixed: existing home sales were strong, but new home sales slowed. Consumer credit expanded at the fastest rate since 2006, while overall debt levels and debt expense remained well below 2008 financial crisis levels.

This environment has led to solid returns for U.S. large cap stocks, but smaller issues have suffered modest losses this year (**Figure 4**). There are a number of reasons for this. First, investors may perceive that after leading the market rally in 2012 and 2013, some small caps may be overvalued. Second, to the extent that headline news has increased investor uncertainty, smaller, less liquid issues are usually the first to be sold. Finally, with interest rates expected to rise, investors may be worrying that credit may be more difficult to obtain for smaller borrowers. Historically, there have been many periods in which large company stocks outperformed smaller stocks. If economic expansion continues, it seems likely that small caps will recover and earn solid returns. The current underperformance may provide attractive buying opportunities for watchful investors.

We hope that all is well with you, and look forward to speaking with you soon.

Sincerely,

Kenneth M. Bernard, CFA