Market Commentary
October 2013

Overview

While most of the news this quarter has focused on what the Federal Reserve will do and its effects on interest rates, the highlight of 2013 so far has been the strength of US equity markets. Manufacturing has steadily improved as the US energy renaissance creates jobs and lowers costs, making it more attractive for companies to produce domestically rather than overseas. Unemployment has shown continued improvement but there are concerns over wages and the number of adults who have left the workforce. Additionally, while earnings came in at record levels again this season, the growth in earnings continues to be driven more by reduction in costs than increased sales. Much of the volatility seen in the third quarter was driven by uncertainty surrounding how the Federal Reserve would proceed with quantitative easing. Many investors anticipated the Federal Reserve would begin tapering during the September Federal Reserve meeting, but instead Ben Bernanke held steady and continued purchasing $85 million a month of mortgage backed securities and treasuries which has caused interest rates to fall and markets to calm going into the fourth quarter. We took advantage of a mid quarter pullback to increase our equity allocations by adding small caps but overall we are still defensively postured as growth remains disappointing and debt levels in both the developed and emerging world are a headwind. Overall, the biggest concern is the lack of clarity from the Federal Reserve, making it difficult for investors and individual business owners alike to plan accordingly for the future.

Domestic Equities

The S&P 500 rallied 5.25% in the third quarter, returning 19.79% YTD. Manufacturing continues to drive the US economy, which expanded in September for the fourth consecutive month, coming in at 56.2 (levels higher than 50 signal expansion). The resurgence of the US manufacturing, housing and energy sectors have boosted earnings to record levels. For this to continue we will need to see a pickup in wage growth and top line sales, as both have been modest. A continued drop in unemployment would help facilitate higher wages and in turn, higher sales growth, but may put pressure on earnings. For the first time in a few years, small caps showed significant outperformance over less volatile asset classes such as large and mid caps. Small caps returned 10.25% for the quarter, and are up 28.69% YTD (Russell 2000 Index). After lagging for the first two quarters of the year, Growth stocks outperformed Value stocks by 4.26% for the quarter, and now lead by 1.07% YTD (Russell 3000 Index). While Fed actions may drive the media headlines and increase volatility, we believe the improved economic data and strong US consumer may continue to lead this equity rally.

International Equities

For the first time this year, both International Developed and Emerging Market equities outperformed domestic equities. In the 3rd quarter, International Developed returned 11.56% (MSCI EAFE Index) and Emerging Markets returned 5.77% (MSCI Emerging Markets Index). Although international developed economies are still facing many economic challenges, we saw a somewhat unexpected recovery in Europe, driven by the stronger economic growth out of the UK and the possibility that Greece emerges from a six-year recession. Greece posted a positive surplus in the 3rd quarter and is expected to grow by 0.6% in 2014 vs. -4% this year. Emerging Markets posted its first positive quarter of the year, but is still lagging both domestic and international markets. It seems that improving fundamentals, coupled with attractive prices have overshadowed the continued negative sentiment on China. The World Bank recently forecasted China to expand by 7.5%, which was revised down from its April estimate of 8.3%. Frontier markets posted modest returns for the quarter, up slightly above 2%, but are still outpacing Emerging markets due to increasing exports to the rest of the world.

Fixed Income

The 10-year Treasury rate spent July, August, and the first half of September continuing the rise that began in the second quarter with Bernanke's taper comments, rising from 2.52% to a high of nearly 3% on September 6th. Following the Fed's surprise announcement on September 18th that they would not begin a taper until they saw further improvement in the economy and the employment situation, the 10 year reversed course and fell to 2.62% by the end of September (when yields decline, prices of bonds increase). Volatility in the bond market appears to be driven more by concerns of Fed decisions than reaction to any real economic improvement. The municipal bond market was impacted by the bankruptcy in Detroit and concerns about risks in other locations, particularly Puerto Rico. Both US corporate high yield and floating rate (bank loans) had a positive quarter as default rates remained historically low and investors looked to reduce their exposure to interest rate risk in exchange for credit risk. We continue to maintain a lower than usual duration (aiming to be less sensitive to interest rate movements) in our portfolios by investing in shorter-term bonds and floating rate securities.

Alternatives
The role of alternatives in a portfolio is primarily to provide diversification and protection when other asset classes experience volatility. Master Limited Partnerships (MLPs), which are partnerships in the oil & gas industry that make regular cash distributions, lost 0.73% this quarter (Alerian MLP Index) but are up 21.18% year to date on the still-developing renaissance in US energy production. Due to technological advances in horizontal drilling and fracking the US is currently second in country oil production and is projected to overtake Saudi Arabia as the number one producer as early as 2020. Managed futures were essentially flat for the quarter, with the Credit Suisse Managed Futures Index up 0.20%, but displayed extremely low volatility and functioned as a protection against downside risk. Finally, unconstrained bond funds, which have the ability to invest across and outside the fixed income spectrum, were flat for the quarter but provided protection when other fixed income assets sold off in response to the Fed and rate movements. In a market environment such as what we have experienced lately, when traditionally safe fixed income investments like Treasuries, munis, and TIPS experience sharp selloffs, alternatives like MLPs, managed futures, and nontraditional bond funds have helped to stabilize the portfolio.

Real Estate
Increasing mortgage rates, which peaked at 4.67% in September, lead to mixed data in the housing market. The Case-Schiller index of home prices is up about 12.4% this year but mortgage applications were volatile week-to-week through the quarter with a large part of the declines driven by a reduction in refinancing as rates went higher. Sales for existing homes were higher in both July and August while new home sales were mixed. There are still fewer homes being built than we need just to keep up with population growth and this limited supply of houses may keep home prices rising even if mortgages become more expensive. Overall, the housing market should benefit from improving demand, lower supply from reduced inventories, and improving credit conditions but the impact of a further rise in interest rates is unclear.

Conclusion
This quarter delivered more signs of a modest recovery both in the US and globally but the outlook has been clouded by uncertainty over decisions made in Washington. Markets have been turbulent but we are looking forward to a resolution in Washington and clarity from the Fed to enable markets to trade more off of economic fundamentals instead of headlines**.** We have moved to be slightly more aggressive over the last quarter in terms of equity exposure but will continue to maintain our mostly defensive stance until we get past these external risks and begin to see market volatility subside.

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