ECONOMIC & MARKET REVIEW

Third Quarter 2013

Through three quarters of 2013 the equity markets continued to impress. The S&P 500 was up 5.2% for the third quarter and up 17.9% year to date. Again this quarter the Federal Reserve played a key role, surprising the markets by refusing to taper the bond buying program called quantitative easing. The Barclays Aggregate Bond Index was up 0.57% for the quarter but down 1.89% year to date.

I want to start with the most important economic yardstick: employment. Through August the monthly unemployment rate had declined to 7.3%. The decline from the recession–induced monthly high of 10% in October, 2009 has been painfully slow, but steady.

ANNUAL UNEMPLOYMENT RATES THROUGH THE RECESSION

2007	4.6%
2008	5.8%
2009	9.3%
2010	9.6%
2011	8.9%
2012	8.1%
2013	7.6% (YTD)

So, we will likely end the calendar year 2013 with an annualized unemployment rate of just under 7.5%. The trend has been established and confirmed by the weekly unemployment claims data, which continued to improve through the month of September. The list of better economic releases is a long one: unemployment rate, unemployment claims, non-farm payrolls, leading indicators, manufacturer's capital goods orders, purchasing managers index, retail sales, and home and auto sales. All of these are indicating that the recovery is sustaining itself and recently gaining some momentum.

The better economic news is not just a U.S.–based case. Internationally, the news has turned brighter. You can see the better economic news being picked up in the quarterly performance of many international indices.

THIRD QUARTER PRICE CHANGE

IBEX- Spain	18.3%
CAC 40 France	10.8%
Bovespa Brazil	10.3%
Shanghai A China	9.9%
DAX Germany	8.0%

Remember that the international equity markets had severely underperformed the U.S. equity market in recent periods, so they have a long way to go. But my point is that markets around the world are feeling more positive about the global economic outlook. Another way of looking at the improved international activity is by seeing the vastly improved performance of the Baltic Dry Index. While a bit esoteric, it is an assessment of the price of shipping major raw materials by sea. Commodities like coal, iron ore and grain make up the items shipped. It is viewed as a way to assess the demand for shipping versus the supply of carriers.

Anything that is up 161.5% catches my eye. The index is coming off a very low reading, so it has a long way to go to get back to normal…whatever normal looks like in today's economic world. This index is not a perfect indicator for international trade, but clearly activity has picked up.

However, one of the more concerning aspects of today's economy is the lack of loan demand. Nationally, loan demand has been slow to come back post the recession. If the economic recovery were really beginning to pick up momentum, loan demand would show that. If we do see improvement from today's levels, that would be one more confirmation that the recovery is for real.

The Federal Reserve's decision not to begin tapering their quantitative easing program was surprising. After the Chairman had set up the markets to expect a reduction in asset purchases, the Open Market Committee decided no change was warranted. This is a program that was at first described as a temporary emergency program. At this point it seems something more than that. The sooner they can begin removing themselves from the markets the better, from my perspective. Also, the question of what the Fed does with a balance sheet bloated with newly purchased securities is something else to ponder. Does it sit on the bonds, waiting for them to mature? Does it begin a selling program? What is the impact on the markets and our economy of either option?

Now for the U.S. government shutdown. Impact on the markets depends on the length of the closure. Anything around a week or two would probably not create much of an economic impact. More than two weeks, draws the lack of a budget agreement headlong into the debt ceiling debate. Both of these issues should be discussed in tandem. Instead we will hop from one problem to the next, lengthening the pain. Not raising the debt ceiling would likely cause the U.S. government to fail to make debt payments that come due… a default. I can't imagine a more debilitating event that would shake domestic and international markets to their core than the U.S. defaulting on its debt. Even without such a calamitous outcome, the standoff in Washington will no doubt cause a decline in both consumer and business confidence.

If you can see past the three ring circus in Washington, both the U.S. and international economies are improving. The Federal Reserve will remain incredibly loose with monetary policy, providing ample liquidity and keeping short rates at zero. In this environment I think the equity market still represents value. Bonds a little less so, but the rate increase I expect would be slow and driven more by greater demand for money, not higher inflation.

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Disclosures

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