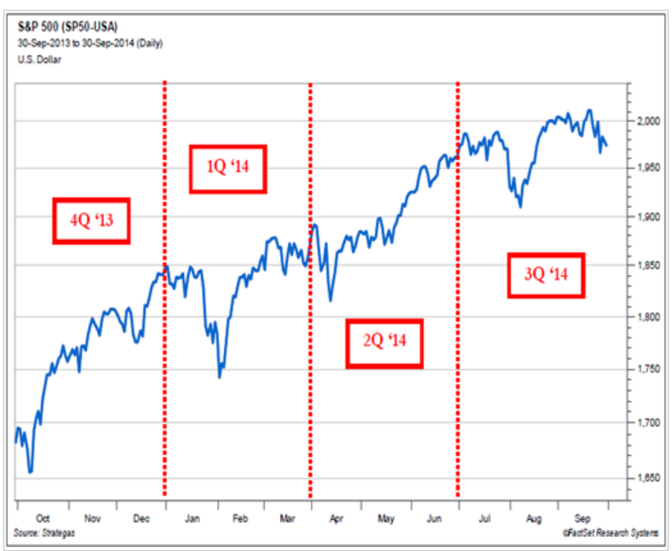
ECONOMIC & MARKET REVIEW

Third Quarter 2014

The third quarter made no one happy. Bonds were basically unchanged for the quarter up +0.1% (Barclays Aggregate), larger cap U.S. equities were up +1.1% (S&P 500), U.S. small caps were down -7.4% (Russell 2000), international developed markets fell -5.9% (EAFE), and emerging markets were down -3.5% (EM). Bulls ran out of steam after a good start to the year and bears wanted more of a correction than they got.

Updated performance year-to-date, through September 30, 2014:

S&P 500	*8.30%*
Russell 2000	*-4.40%*
Barclays Agg.	*4.10%*
MSCI EAFE	*-1.40%*
MSCI EM	*2.40%*



A very noticeable change in direction has taken place this year within the U.S. equity markets. With small caps down -4.4% vs. large caps up +8.3%, this 12.7% difference has some believing that small caps are indicating trouble ahead for the whole market. I don't think so. It is true that higher interest rates would fall disproportionately harder on small companies. But rates are low and will stay low for quite a while. Also, in past periods of a strong dollar, small caps have performed very well. In addition, don't forget that in 2013 small caps were up nearly 40%, so some give back seems normal. Finally, during a period of weak/no growth in Europe, small caps are only modestly exposed to those markets as their revenues are primarily U.S. based.

Second quarter 2014 real GDP was +4.6%. This follows the weather-influenced first quarter of -2.1%. While 4.6% is not sustainable given current conditions, it does show that the U.S is on solid footing as it relates to economic growth. Estimates for GDP growth in the third and fourth quarters are between 3.0% and 3.2%. So the nature of the economic recovery remains the same in America – long, slow, and sustainable. Leading indicators for the quarter also lead to the conclusion that growth should continue. Weekly unemployment claims are now under 300,000 and monthly payroll job growth has averaged 226,000 through the end of the quarter. Again- reinforcing the idea of a long, slow, steady economic recovery.

We could publish a world history text book with just the events from 2014, and there is still three months to go. No doubt, the turmoil internationally has had a negative effect on equity markets, and a positive effect on bonds. Only the continent of Antarctica has escaped war, political turmoil, epidemic, and terrorism.

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The Fed is getting ready to close out quantitative easing and set the stage for slightly higher short term interest rates, probably beginning in the summer of 2015. Leaving the “emergency” policy response to the economic meltdown of 2008-2009 is a good thing. Markets will need to adjust to a slightly tighter Federal Reserve. However, the Fed will not move too quickly or raise rates too much to cause a negative reaction in the economy. Not that the onset of tightening won’t cause volatility, but I’m confident markets will quickly adjust and accept the normalization of interest rate as a sign of economic strength.

Europe has a much different economic environment than we do. Growth rates are slightly negative to very modestly positive. German PMI (Germany Manufacturing Purchasing Managers’ Index) slipped below the neutral 50.0 threshold in September to, 49.9, down from 51.4 in August. This indicator is designed so that 50 is the point of demarcation between growth and contraction. European challenges fall mostly on the fact that their economies need major structural reform, especially in the labor markets. Mario Draghi, President of the European Central Bank, has encouraged member countries to make reform a cornerstone of growth. Understanding that without reform economic progress will be difficult to achieve. Only Spain has done much reform, and their economy has started to respond with 2nd quarter GDP +0.6%. The rest of Europe has a long way to go.

So, while the U.S. economy is doing ok, Europe represents a potential road block to sustainable global growth. The European Central Bank appears to be behind the curve. They will need to find a way to become more aggressive, while appeasing the Germans who want no part of it. The situation in Europe affects both the U.S. equity markets – less risk taking – and the bond market – lower interest rates – than would otherwise be occurring domestically.

A Letter From Camp
“Hello Muddah, hello Fadduh,
Here I am at, Camp Granada.
Camp is very entertaining,
And they say we'll have some fun if it stops raining”.

Let’s hope the Europeans can find a way to stop the rain.

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