WealthHealth
Personal Wealth Management

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Market Review

The third quarter ended on a down note as global stock markets declined in September, leaving most broad market indices with losses for the quarter overall, as shown in the chart below.

In the United States, larger company stocks managed a slight gain for the quarter whereas smaller company stocks, which have had a challenging year so far, plunged 7.4% for the quarter. Year to date large caps have gained over 8% versus smaller cap stocks which are down over 4% for the year. Some of this can be explained by the overvaluation of small caps relative to larger cap stocks which make them more vulnerable to market sell offs. Our portfolios are tactically underweight small caps—a beneficial stance given this year's performance divergence between the two asset classes.

Global stock markets generally fell in the third quarter. In the United States, larger-company stocks dominated, with the S&P 500 gaining 1.1% while smaller-company stocks were down 7.4%.

Index Returns *Through 9/30/2014*

Index	QTD	YTD	Annualized Returns 1-Year	3-Year	5-Year
S&P 500	1.13%	8.34%	19.73%	22.99%	15.70%
Russell 2000	-7.36%	-4.41%	3.93%	21.26%	14.29%
MSCI EAFE	-5.88%	-1.38%	4.25%	13.65%	6.56%
MSCI All Country World Index	-2.85%	3.21%	10.68%	16.73%	10.33%
MSCI Emerging Markets Index	-3.49%	2.43%	4.30%	7.19%	4.42%
Barclay Capital US Aggregate Bond	0.17%	4.10%	3.96%	2.43%	4.12%
Barclay Capital Municipals	1.49%	7.58%	7.93%	4.56%	4.67%
Dow Jones UBS Commodity	-11.83%	-5.59%	-6.58%	-5.34%	-1.37%
HFRI Fund of Funds Composite Index	0.33%	2.38%	6.14%	5.17%	3.40%

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Developed international and emerging markets stocks fell during the quarter, particularly in dollar terms as the U.S. dollar rose against other currencies, thereby reducing returns on investments denominated in foreign currencies. As we write this newsletter in early October, we have experienced greater volatility with the focus on slow growth in Europe and China, a strengthening dollar, and an Ebola panic globally, all of which are negative factors for the markets, especially large U.S. exporting companies. However, a continued reduction in oil prices and positive earnings growth accompanied by positive forward guidance is providing an offset to the negative news and creating a renewed life to the volatility index which we expect to continue.

In the absence of major market developments, our outlook for individual asset classes has not changed materially from last quarter.

In the bond market, yields rose slightly at the prospect of the Federal Reserve's exit from its bond buying program and eventual rate hikes (likely in 2015). The core bond benchmark was flat for the quarter. The focus however, is on the statements and actions of global central bankers, as they continue to exert a powerful influence on financial markets. As a result, we have found ourselves more attuned to monetary policy in recent years than in times past. Monetary policy remains one of the largest unknowns and risk factors as we look forward.

We look forward to a change in the environment (i.e., market volatility) that presents us with opportunities.

At their latest meeting in mid-September, the Fed continued on its course of ending quantitative easing bond purchases in October, as expected. The Fed also did nothing to dispel market expectations that they are likely to start raising the federal funds rate around mid-2015, given the current trajectory of economic growth and unemployment.

Federal Reserve Board Chair Janet Yellen again reiterated, however, that all of their decisions will be data dependent, not calendar driven. While the market and the Fed are now in line in terms of the likely timing of the first rate hike, the market still does not expect the pace of rate hikes to

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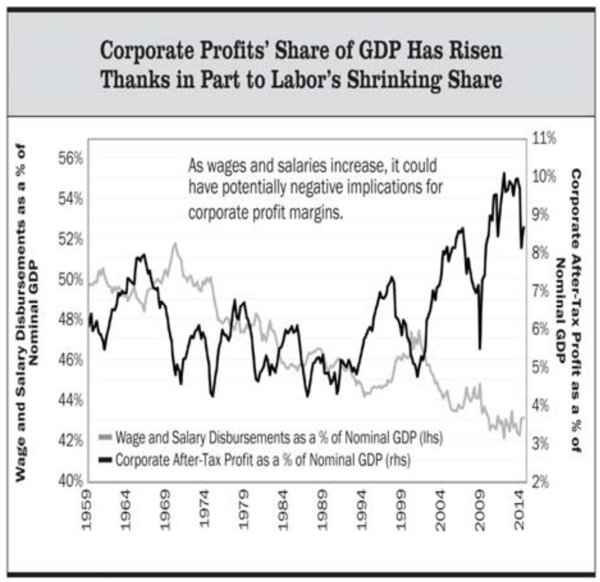
be as aggressive as current Fed forecasts imply, using the median forecast of the FOMC members. So the potential for a market surprise in terms of higher and sooner rate increases exists.

Key to the Fed's monetary policy decisions is the outlook for U.S. inflation, wages, and employment. We provide short updates on recent developments for each of these variables below.

Inflation: In the most recent three months, the inflation rate ticked back down or stabilized at levels below the Fed's long-term target of 2%. Inflation expectations remained relatively stable as well. With this inflation backdrop, the Fed has more leeway to remain accommodative and core bond interest rates are unlikely to move sharply higher. Extremely low rates in Europe and other developed economies also should contribute to keeping a lid on Treasury bond yields (i.e., Treasuries should remain in demand among global bond investors due to their relatively attractive yields as well as a strengthening U.S. dollar).

Wages: Both average hourly earnings and real (inflation-adjusted) hourly earnings increased slightly over the past three months. But they remain well below what Yellen has said she wants to see as evidence of a healthy labor market—probably at least 3% nominal wage growth and 1% real wage growth. Broader indicators of labor's share of the economy also suggest we are still early in the cycle of wage gains. While additional wage growth and a rising labor income would be healthy for the economy, it has potentially negative implications for corporate profit margins (which remain around historical highs) and, therefore, earnings growth and stock market valuations.



Data as of 6/30/14. Source: U.S. Department of Commerce.

Employment: On the employment front, despite a disappointing August number, job gains (U.S. nonfarm payrolls) continued to be reasonably strong—averaging 207,000 per month over the past three months through August. For the first eight months of the year, job growth has averaged 215,000 per month, the highest rate since 1999. However, the recovery in jobs following the 2008 financial crisis continues to lag what is typical after previous U.S. recessions. The unemployment rate dropped slightly to 6.1% in August, still well above the Fed's estimate of "full employment" in the low-5% range. However, the labor force participation rate remains stuck at a 36-year low, exerting a downward bias to the unemployment rate. Taking these and other employment indicators into account, the Fed reiterated its view that "there remains significant underutilization of labor resources."

The news from the European Central Bank during the quarter was perhaps more meaningful and highlighted the divergence among global central bank policies. In early September, ECB president Mario Draghi announced additional stimulative monetary policy actions in response to worsening Eurozone economic data and deflationary indicators. The ECB not only cut rates but also announced its plans to buy private sector asset-backed securities and certain types of bonds backed by loans from banks, with the aim of increasing the flow of credit to the real

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economy (particularly to small- to medium-sized businesses). More broadly, Draghi said the "aim is to steer, significantly steer, the size of our [ECB] balance sheet towards the dimensions it used to have at the beginning of 2012." This could imply roughly one trillion Euros of additional asset purchases over the next 12 months.

The ECB will essentially "print euros" to buy the securities, so it's similar to QE (where the Fed bought government bonds) but on a much smaller scale. In theory, buying the securities from banks will free up capital enabling banks to make new loans to businesses, stimulating growth. But the actual magnitude of these purchases remains to be seen. There are reasons to be skeptical it will have much impact given the small size of the ABS market, and that the ECB will only be buying the highest-quality tiers of the securities at this point.

If the ECB's latest steps don't do enough to move the economic needle, it may ultimately have to engage in large-scale QE—as the Fed, Bank of England, and Bank of Japan have done—in order to try to prevent deflation from taking hold in the Eurozone. Deflation in Europe would obviously have very negative consequences for the global economy and equity markets. On the other hand, a strong shot of QE liquidity from the ECB could give a boost to global stock markets just as the Fed is starting to tighten U.S. monetary policy.

As we noted at the outset of this commentary, our macro view has not changed over the course of the quarter. We continue to see the United States on a slow path of recovery with very gradual improvement in growth and employment. Much of the developed world is in worse shape, facing slower growth, higher unemployment, and worrisome deflationary trends. The role of monetary policy—specifically the timing and impact of the Fed's gradual winding down of its stimulative policies—is a major unknown. In addition, we continue to monitor the risk of a greater slowdown in China's economic growth, a risk factor that also hasn't changed meaningfully over the past three months.

Current Views and Portfolio Positioning

In the absence of major market developments, our outlook for individual asset classes has not changed materially from last quarter. The overall environment still seems supportive of higher equity prices due to mild but positive economic growth, low inflation, accommodative Fed policy, and weak "competition" for stocks from bonds and other asset classes. This may continue to be the case in the near term.

These same issues have shaped markets over the course of the year. They include divergent economic outlooks around the globe, with the United States seemingly on a path of modest recovery, Europe facing stalled growth and potential deflation, and China continuing to seek a balance between maintaining sufficient economic growth on the one hand versus slowing credit growth and implementing economic reform on the other. Geopolitical issues, most recently with the escalation of U.S. military action in the Middle East, the Ebola scare and concern about high stock prices in the United States are other current concerns investors are weighing.

Ultimately, in our investment analysis and decision-making we try to focus on what is knowable with a reasonable degree of certainty or within a reasonable range of outcomes and probabilities. There are times when what we determine is right for our clients' long-term benefit is at odds with what the markets are doing in the short term. However, we believe our discipline in adhering to our circle of competence—our expertise as asset class analysts, fund manager analysts, and portfolio (risk) managers—gives us an edge that has enabled us to meet our clients' investment objectives over time.