Market Commentary

Third Quarter 2013

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The third quarter of 2013 continued the upwards rise in US equity markets. The benchmark S&P 500 index rose by 5.2% during the quarter on a total return basis. This brings the total return on the S&P 500 to 19.8% for the first nine months of 2013. Shaking off any concerns about higher interest rates as well as a dysfunctional Congress, equity markets have marked time since mid-May, rising about 1% over that time period. The benchmark 10-year US Treasury note yielded 2.64% at the end of the third quarter, modestly higher than the 2.5% three months earlier. In early September, the yield on the benchmark security did briefly surpass 3.0% before declining for the remainder of the quarter as fears of an imminent tapering in Quantitative Easing (QE) subsided.

Economic Outlook

In our last Commentary we highlighted that Federal Reserve Bank Chairman Bernanke had stated "the Fed was looking to begin *tapering its bond purchases* in coming months *if the expected economic growth continues to improve."* Clearly, investors believed that marked an irreversible commitment to tapering. However, at the September meeting the Fed chose to continue purchasing $85 billion a month in US and mortgage securities, confounding many investors. While pundits have been blaring that the Fed has lost credibility, we argue the exact opposite. The Fed had always said it was "data dependent" and would base its decisions on economic reports. We have long believed that the vast amounts of quantitative easing were distorting money flows and interest rates. At the mid-September meeting, the Fed lowered its GDP forecasts for 2013 and 2014. The Fed also noted that while the unemployment rate had declined from 8.1% to 7.3% during the current round of QE, the bulk of this rate decline came from a significant reduction in the workforce, rather than in people finding jobs. Thus, tapering QE while at the same time acknowledging the economy was doing worse than expected would have cost the Fed some credibility in our eyes.

Bernanke often discusses "stocks" versus "flows". By stocks, he explains that the Fed will be holding over $4 trillion in Treasuries and mortgage bonds by the time QE ends. Flows are the amount of securities purchased each month. Clearly, market participants have been focused on a gradual decline in flows while ignoring the stocks – $4 trillion of securities that will take decades to run off the Fed's balance sheet. There is simply no way the Fed can sell a meaningful amount of these securities without spiking rates higher. What the Fed has done is caused investors to now focus in microscopic detail on every economic report. If the Fed is truly "data dependent", each economic release will be analyzed in depth and will likely cause higher than normal levels of volatility in the financial markets every time data is reported. Global growth is slowly, yet unevenly improving. Europe appears to have broken out of the latest recession and fiscal policies in Japan are quite encouraging. If Japan can break out of its 20+ year cycle of stagnation and deflation, global growth would get a much needed boost.

The dysfunction in Washington is disconcerting. While a temporary government shutdown is not something to be concerned over, (there have been 17 prior government shutdowns since 1976 ranging in length from 1 to 21 days with none of them causing a significant decline in the equity markets), the complete inability of government to do anything more than stagger from one crisis to the next is beyond frustrating. The fiscal cliff drama of late 2012 merely pushed the day of reckoning to the current moment when we are in the midst of a government shutdown and facing an imminent debt ceiling crisis. Lost in the Washington squabbling is better news on the US budget. Improvements in housing and consumer spending have increased tax revenues and helped lower the projected deficits for both 2013 and 2014. While still large on a historical basis, as a percentage of GDP, the deficits are much lower than those of the past four years. The budget deficit peaked in fiscal 2009 at $1.4 trillion which was 10.1% of GDP. The deficit for fiscal 2014 is projected at $744 billion, or approximately 4.5% of estimated GDP. Further true deficit reduction will have to focus on entitlement spending as there is very little discretionary spending that could be cut to meaningfully reduce spending growth.

Portfolio Positioning

In client portfolios, we moved to further shorten durations in fixed income, believing that interest rates have begun a slow, but uneven move higher. This will likely play out over several years; and rates will not move higher in a straight line. However, the economy continues to grow in fits and starts and we are 17 quarters removed from negative GDP growth. This means the generational lows in yields are ending and we need to protect principal in fixed income portfolios. Equity portfolios have seen minimal changes, as we believe global growth is improving and will continue to support equity prices. We believe economic growth will accelerate modestly in 2014 as budget deficits continue to decline, interest rates remain low on a historical basis and we anniversary the effects of both the budget sequester and the January 2013 tax hikes. We continue to focus on companies and sectors that are showing positive growth in cash flow along with those areas that can most benefit from the current economic environment such as healthcare and industrials, along with companies that have shown the ability to grow earnings in challenging economic environments.

Conclusion

As we write this, the US Federal Government is in the midst of a shutdown. We believe this only serves to delay any tapering plans by the Fed, causing QE to remain at current levels longer than would otherwise be the case. We always counsel long-term planning and investing and thus do not expect this shutdown to meaningfully impact our investment outlook. However, the looming debt ceiling showdown (mid-October) could be much more protracted and cause increased volatility in the debt and equity markets. The US has never defaulted on its debt in its 237 year history. While not many are currently expecting a default, we believe that a default would cause significantly negative effects that would be felt globally. We do not advise changing asset allocations due to very short-term circumstances, as this has proven to be a fool's game time and again. Barring any meaningfully bad news out of Washington, we expect equity markets to grow in line with earnings over the next 12-18 months, meaning high single-digit returns. If we see an unexpected swing in asset prices, we will evaluate client holdings to determine if a shift is warranted.

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