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2013 FALL INVESTMENT OUTLOOK

Over the last three months the United States has experienced many conditions that existed during the first half of the year including moderate but subpar economic growth, modest improvements in the job market, easy money policies by the Federal Reserve and rising stock prices. Second quarter GDP growth was reported to be 2.5% which followed quarters of 1.1%, 0.1% and 2.8% in the preceding three quarters, respectively. All these figures are well below the long term average of 3.4% going back to 1930 and continue a trend of steady but unexceptional improvement since the 2008 financial crisis. The substandard economic recovery has resulted in only gradual improvement in the job market. Job gains have averaged approximately 180K per month thus far in 2013 which is not sufficient to keep up with an expanding population and slightly below the average for all of 2012. While it’s true that the unemployment rate has continued to decline, much of this improvement has come from a shrinking labor force as discouraged workers have simply stopped looking for work and are therefore no longer considered unemployed.

One side effect of the uninspiring progress in the economy and job picture is that the Federal Reserve has continued its extraordinary efforts to stimulate growth. This December will mark the fifth anniversary of the Fed’s zero interest rate policy. It has also employed other tactics to aid the recovery including bond purchases intended to depress longer term interest rates and drive asset prices higher. Commitment to these efforts was reiterated last week when the Fed announced a continuation of current interest rate policy and surprised the market by also agreeing to continue to purchase $85 billion per month of treasury and mortgage securities. Whatever the unintended consequences of this policy goal to inflate asset prices may be, there is no doubt that it has been successful in achieving its aims. The broad housing market has experienced a notable improvement while U.S. stock prices have recently hit record high levels. For now, investors are satisfied that the interim solution in Syria will defuse those tensions and that pending difficult debates in Washington regarding funding the government and the debt ceiling will be solved. As shown below, domestic year to date stock returns have been exceptional with gains far in excess of historical averages. Meanwhile, international equity returns as measured by the MSCI index have lagged due to several challenges facing those economies, particularly in several emerging market countries.

Year-to-Date Market Returns (excluding income)

	9/20/13 Price	Change From Year-End
Dow 30 Industrials	15,451	+17.9%
S&P 500	1,710	+19.9
NASDAQ Composite	3,775	+25.0
MSCI ACWI-exUS*	273	+8.9

**MSCI All Country World Index excluding U.S.*

Near and Intermediate Term Outlook

The resilience of the U.S. economy has been on full display this year. Despite the sequester which curtailed federal government spending and a meaningful tax increase on individuals since the beginning of the year, economic progress continues to be made. Notwithstanding weak overseas growth, talk of Fed tapering and unrest in the Middle East, modest GDP growth has contributed to a decline in the unemployment rate from a peak of 10.0% in October 2009 to a recent figure of 7.3%. Other data points also indicate fresh signs of strength. The Institute for Supply Management recently reported that service firms, which employ almost 90% of the U.S. workforce, expanded at their fastest pace in eight years last month while factory output grew the most in two years. On balance, recent statistics indicate that the housing market recovery remains on track while automobile sales were up 17% last month versus one year ago and enjoyed their fastest rate of gain since late 2007. Courtesy of the gradually improving job market (42 consecutive months of private sector job gains) and the continued low interest rate environment which eases the burden of servicing debt, consumers remain in decent shape. In fact, Americans' total debt service ratio recently hit 10.49% which is the second lowest quarterly figure on record since the Fed began tracking this measure in 1980. Meanwhile, overall consumer debt is 12% lower than it was at its peak in fall of 2008, delinquency rates are falling and banks are more willing to lend putting consumers in a better position to contribute to economic growth.

Consumers do face some headwinds, however. The falling unemployment rate may be masking underlying weakness in the job market. Currently, just under 59% of American adults have jobs versus the 63% who did prior to the last recession. Moreover, the improving unemployment rate has come largely from discouraged workers leaving the labor force defined as those working or actively seeking employment. The labor force participation rate declined to 63.2% in August which is the lowest figure since 1978 and well below the 65.7% level reported when the recession ended. In a typical recovery the participation rate increases as the economy expands encouraging people to again seek work. Another point of caution relates to the types of jobs being created. Some of the fastest rates of gains have been in the retail, food services and temporary industries where wages are generally lower and benefits often nonexistent.

Adjusted for inflation, average hourly wages remain below levels of four years ago when the recession officially ended. In a normal recovery, wages would be picking up at this point but due to the substantial number of people either out of work or underemployed, employers are not under significant pressure to raise wages to attract and retain workers. Similarly, the Census Bureau recently reported that inflation adjusted median household income for 2012 was essentially flat with the prior year after falling 1.5% in 2011 and 2.0% in 2010. The current figure of $51,017 is well below the all-time peak of $56,080 achieved in 1999 and still well below 2007's level of $55,627 indicating that employees have benefited less than their employers in the current recovery.

From a stock market investor's point of view, one near term benefit of the above trends is that the relatively weak bargaining position of employees has contributed to record high profits and margins for corporate America. Corporate profit margins were 9.3% in the first quarter of 2013, roughly 50% higher than the long term average of approximately 6%. To be sure, other factors have influenced margins such as globalization, lower corporate taxes and record low interest rates. Regarding this last point, a recent study found that interest expense for S&P 500 companies was 1.8% of sales in 2012 which compares favorably to the 15 year average of 3.9%. The fact remains, though, that while U.S. businesses are in excellent shape, progress for U.S. workers continues to lag behind.

Investors rewarded corporate America's strength by pushing stock prices to record high levels last week. In addition to benefiting from higher stock prices, investors are also enjoying record high dividend payments. Aggregate shareholder dividends for the S&P 500 companies are on track to hit $300 billion this year, up from an all-time high of $282 billion in 2012. While stock market fundamentals remain sound, there are signs that exuberance is returning to the capital markets. Margin debt is approaching record high levels, junk bond issuance is at its highest level ever and private equity firms are adding debt at a record pace. These are all trends which merit close attention as they historically have been harbingers of more challenging times ahead for investors.

The aforementioned trends have been aided by the continued low interest rate environment which encourages debt financing often emboldening investors to finance speculations that they will later regret. While interest rates have risen since early May when the Fed first hinted that it may pull back from its expansionary policy actions, rates remain historically very low. The benchmark 10 year Treasury bond rose to nearly 3.00% earlier this month up from 1.63% roughly four months ago and as of this writing stood at 2.71%. As noted earlier, the Fed announced its intention last week to maintain its easy money policies, a decision that was welcomed by the markets. Long term investors would be wise to keep in mind, however, that Fed policy will have to be tightened eventually. When this occurs there is likely to be increased volatility in many of the asset classes that have benefitted from the unprecedented easy policies of recent years. Fed Chairman Bernanke's term is set to expire at the end of January 2014 and the process to name his successor, as well as the successor's learning curve once on the job, could add a source of uncertainty that might be unsettling to investors in the coming months.

Two other developments that bear watching are the state of events in international economies and the pending debt ceiling debate in this country. Regarding the latter, rhetoric from both sides of the political aisle has increased in recent weeks as an October deadline to fund the government looms. It is unlikely that either political party will gain from a government shutdown or a default on our debt so a solution should be identified in the coming weeks. The statutory limit on the federal debt has been raised 73 times since 1954 and we expect a 74th increase this fall though the road to that agreement could be a difficult one which results in some uncertainly for investors.

For a variety of different reasons, many foreign economies are facing challenges today. The major developed markets of Europe and Japan are more rigid than the U.S. economy and have recovered more slowly. Fortunately, the recession in Europe officially ended in the second quarter. The road to recovery will be a long one, however, as unemployment is over 12% in the overall Euro zone and certain economies within the region continue to face severe hardship. Over one quarter of the Greek and Spanish populations remain unemployed while it is likely that Greece will need a third bailout in the coming months. Japan has shown better growth recently but a proposal to raise the national sales tax to help pay for its ballooning debt load could deal a setback to economic growth much as it did in 1997. Back then the sales tax was raised from 3% to 5% contributing to the onset of a recession soon thereafter. Recent growth in emerging markets has come in well below expectations with important implications for investors. Several big themes have been working against many of those economies including rising wage pressures and other inflationary trends, global supply chain issues and lower domestic energy prices which have caused corporate America to shift manufacturing back to the U.S., and rising U.S. interest rates which have caused global investors to reallocate funds away from many developing economies. Too often this reallocation happens far too quickly for those nations to adjust causing significant economic disruptions and capital market impacts including disruptive currency swings that can make foreign denominated debt more difficult to repay.

Investment Conclusions

2013 is shaping up to be the fifth consecutive calendar year of S&P 500 stock market gains. Thus far this year the broad market has enjoyed a total return of over 21% and since the bear market low in March 2009 annualized returns have averaged almost 23%. These are unusually high figures and are more than double the roughly 10% long term total return the market has averaged since 1926. While corporate fundamentals remain satisfactory, recent stock price movements have been unduly influenced by the Federal Reserve's unprecedented policies. Investors are cautioned to keep in mind the extent to which aggressively easy monetary policy has bolstered stocks in the current upturn. Indeed, one of the Fed's stated goals has been to inflate asset prices, specifically those of equities and houses, and it has been successful in this regard. Longer term, however, asset prices are driven by fundamental factors and those factors may have little room for improvement from current levels in the near to intermediate term. Corporate profits are still growing though the rate of growth has slowed dramatically while corporate profit margins remain near peak levels so the path of least resistance will be lower. Overall equity valuations remain reasonable although it is important to remember that current valuations rely in part on the current easy money policies.

As long term investors, we are keenly aware that success depends on the ability to manage client portfolios *through a full market cycle*. This requires a patience and discipline to allow clients to benefit during market expansions while also being mindful to manage downside risks *before* the inevitable downturns arrive. The past four and one half years during which time the broad market has risen nearly 155% have been great for investors. This period represents only one phase of the market, however. We believe that the so called "easy money' has been made in the current cycle and going forward individual stock selection and asset allocation will become increasingly important. At some point, the Federal Reserve will begin to tighten policy and it is likely that this process will lead to challenges for stock investors. Bond holders, too, should be especially careful in the current environment as yields remain historically low from both a credit quality and maturity perspective. Short to intermediate term high quality bonds remain our vehicle of choice as these securities can be expected to better protect investor capital in a rising interest rate environment. While select opportunities exist today to invest new money in both the stock and bond markets, it remains our view that patient investors with suitable cash reserves will have even greater opportunities in the future to invest that capital more broadly and with higher expected returns.

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