OVERVIEW

Economic Analysis and Market Review Q3—2013

Third quarter headwinds:

- Syria
- Shutdown
- Debt ceiling

The third quarter didn't come in on little cat feet. We entered the second half of 2013 with some formidable, disruptive challenges to the economy and the markets:

1. The conflict in Syria was up front with Obama's statement that any use of chemical weapons was a "line in the sand" that shouldn't be crossed. Well, Assad did use chemical weapons on his citizens and that opened up a big debate on whether the U.S. should get involved with missile strikes on their weapons depots or put "boots on the ground". Wars are not good for markets.

2. Domestically, the Tea Party threatened to de-fund Obamacare to prevent its roll out in 2014. Ted Cruz, the Tea Partyist supreme, filibustered for 21 hours with a threat of a government shutdown if Democrats and the President didn't go along with their demands.

3. Along with the threat of a government shutdown, was the always problematic debate over the debt ceiling. Another debt ceiling imbroglio in 2011 caused turmoil in the stock markets even after it was avoided. The solution then was to "kick the can down the road" and as that is the most politically expedient solution, this will be a recurring event for quite a while. If the debt ceiling isn't resolved before October 17, Treasury Secretary Lew has stated that the U.S. government will be unable to borrow and there will be a default on our debt—a no-win situation for all concerned—Americans, investors, global economies and every politician in D.C. Even if by some chance the debt ceiling isn't raised, a default isn't a certainty. The U.S. government brings in approximately $250 Billion in tax revenue every month and the debt payment is roughly $30 billion every month. In September the government took in $239 billion in tax revenue while bond interest in fiscal 2013 totaled $224 billion—more in one month than total debt service for the entire year. The probability of default seems highly unlikely.

Third quarter headwinds:

- Bernanke's replacement
- Tapering QE3
- Recoveries everywhere
- A friendly market

4. Ben Bernanke's term is ending and concern swirls around what the new Fed chairman will do about the on-going quantitative easing program. Larry Summers, a monetary policy hawk, was the lead candidate and he is known to criticize the policy and would probably cut the current $85 billion per month program. Mr. Summers pulled his name from consideration which brought Janet Yellen's name to the fore. From all accounts, she is the most qualified candidate for the position and her confirmation should be quick. She will likely continue QE3 for the time being.

5. The "taper" or curbing the QE3 program will cause disruptions to the markets, but perhaps not for long. There are some who believe that any tapering of the $85 Billion would be a positive sign that the Fed sees an economy that can continue the recovery on its own. Janet Yellen is known for her accurate economic forecasts so this should lend credence to a sustainable recovery when tapering begins.

The third quarter did arrive with some very positive data, however, from Europe of all places. Their debt problems have been front page news for the last year—Greece, Spain, Italy—all swamped with excessive debt, slow growth and high unemployment. In July, Eurozone business activity expanded for the first time in 18 months as reflected in the purchasing managers index (PMI). In July the composite index increased to 50.5 from 48.7. Above 50 is positive. Germany's recovery gained momentum and the downturns in major economies such as France, Italy and Spain eased further with manufacturing leading the way. Mario Draghi, the president of the European Central Bank, remains very cautious on the recovery, however, he has stated that he will do whatever is necessary to ensure the survival of the banking sector, the euro and the smooth operation of the economy. The Eurozone is one of our biggest markets so their recovery is a plus and should be less of a headwind.

As for the markets, in the words of Sir John Templeton, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell." The University of Michigan's Consumer Sentiment survey has improved but it is still below its historical average so we haven't hit maximum optimism yet even as the stock market climbs to new highs.

While the U.S. stock market works its way higher, finding attractive areas of investment becomes more difficult but there are areas of strong interest. U.S. banks are healthy, with strong balance sheets and rising profits. The U. S. is producing its own energy resources and could become energy independent due to new technologies in oil extraction and our huge supply of natural gas. Corporate profits are at all-time highs and continue to rise. For a long term investor, stocks are still an attractive place to park some money. What else is there? Money market funds pay no interest and bond rates are at historic lows with the likelihood of higher rates around the corner as the Fed removes itself from its current activity in the bond market. The talk of the taper caused billions of dollars—$60 billion according to the Investment Company Institute—to exit bond funds in June, the biggest monthly withdrawal in records going back to 1961. To be sure, a lot of this money is going into the stock market.

Outside the U.S. markets, emerging markets currently have attractive valuations. Many of these countries have price-to-earnings ratios in the single digits. Additionally, emerging markets generally have large and growing foreign exchange reserves that are far greater than developed markets. They have room for fiscal and monetary stimulus if needed and their debt level relative to their GDP is also much lower than developed markets. Asian emerging markets look particularly good as the International Monetary Fund (IMF) predicted their economies will grow 6.9% this year compared to 1.7% for the U.S. All in all, there will be hiccups along the way caused by various sources, but until there are signs of a recession, we should see more of the same.

Market Indexes
Third Quarter, 2013

INDEX	Q3'13	YTD	3 YEAR RET.	10 YEAR RET.
S&P 500	5.24%	19.79%	16.26%	7.56%
Russell 2000	10.21%	27.69%	18.28%	9.64%
Europe, Aust., Far East	11.56%	16.14%	8.47%	8.01%
Barclays Agg. Bond	0.57%	-1.89%	2.86%	4.59%
Dow Jones Real Estate	-3.15%	2.33%	12.09%	9.29%
Dow Jones Real Estate	0.02%	0.06%	0.10%	0.00%

- The S&P 500 is an index of large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties