Economic & Market Commentary

Just as earlier in the year, politics failed to derail the financial markets during the past quarter. Early in the year we had the specter of the "fiscal cliff" followed by sequester. In the second quarter, we were propelled by massive global liquidity injections followed by "taper on". In the most recent period, we had "taper off" fears followed by the dysfunction of a government shut down and the debt ceiling fiasco with the threat of a U.S. default. In spite of these Washington shenanigans, stocks sailed through the period on waves of liquidity and finished another remarkably good quarter. The S&P 500 produced a total return of 5.2%, with other indices in the +2% to +12% range, leaving the year to date +18% to +30% depending on the index. Dysfunctional politics seem to have left equity investors unfazed and attention was more focused on the prospects for synchronized global growth.

These sentiments also influenced global equity investors, as most global markets produced similar returns for both the quarter and nine months. The exception was the emerging market index, which turned in a negative return for the year to date, in spite of showing positive signs of life in the quarter. Bonds were a different story, as the broadly held belief that rates would rise was reinforced by taper fears, and most fixed income instruments turned in negative or, at best, meagerly positive result for all periods.

The character of the equity market was, for the most part, a continuation of the previous quarters. Small capitalization stocks outperformed large and low quality outperformed high. In a reversal, growth outperformed value, equalizing their year to date returns. Market breadth was somewhat better as five of the ten S&P sectors outpaced the index, resulting in four sectors doing so for the nine months. The latest period saw materials, industrials, consumer discretionary, information technology, and healthcare in the positive column, with industrials, consumer discretionary, financials, and healthcare there for the nine months. For the past several months, the defensive, less economically sensitive groups (consumer staples, telecom, and utilities) have lagged, and this continues to be the case. In a trend that began last quarter, high dividend payers have produced weak returns, and were at the bottom of the heap this quarter.

As this is being written, politics has again been injected into the economic equation. The federal government shutdown ended in its third week, and we were hours away from reaching the federal borrowing limit ("debt ceiling"). The Senate has reached an agreement, which the House has ratified, that will allow Uncle Sam to pay his bills and avoid an American default. The financial markets breathed a giant sigh of relief and stocks have been up strongly. The federal shutdown is a relatively small matter, compared to the unimaginably harmful effect of a default on our debts. The shutdown is estimated to cost 0.1% - 0.2% of GDP per week, or a roughly 0.5% hit to Q4 GDP (now estimated at 2.0%). On the other hand, Goldman Sachs reckoned that a default would cost 4.0% of GDP, potentially wiping out economic growth in the fourth quarter. In addition, the chaos caused by the questionable nature of U.S. Treasury securities would wreak havoc on the world's financial markets. For example, the $2 trillion tri-party repurchase market, where financial institutions raise cash for short-term financing, is largely based on the use of Treasuries as collateral. So it looks like we may have dodged another bullet, but the dodging is only temporary, as the agreement appears to merely postpone dealing with the brunt of the issues until early 2014. Our Washington representatives have again simply kicked the can down the road. This breathing spell does, however, allow investors to focus on the economic fundamentals at hand.

And without political interference the economic fundamentals are decent. Our viewpoint is the same as it has been for some time. We wrote last time: "we have been in the +2.0% growth camp for the past several years, and see no reason to change that view." Consensus estimates for the third and fourth quarter GDP are +1.9% and +2.4%. After adjusting Q4 for the effects of the government shut down (-0.5%) the result would bring the year close to +2%. The support for our point of view has been enumerated in previous commentaries, so there is no need to go into those details again. Suffice it to say they remain the same (improvements in housing, capital expenditures, employment, state and local government positions, etc.), and in fact, are all showing favorable trends. The consensus view of most economic observers is that growth will accelerate into 2014, as many of these trends continue to pick up steam. This, of course, assumes no political interference. Important to this view is the notion that the world economy is slowly moving into a synchronized growth phase. A year ago there were concerns about Eurozone risks, a China hard landing, and U.S. growth itself. Anecdotal evidence and many economic indicators now point to a much better framework for a return to worldwide growth. The Fed's decision to renege on beginning to taper bond purchases in September, and the outlook for benign inflation, signal no monetary interference until well into 2014 (at the earliest), assuring ample liquidity and low rates to satisfy investor's craving. What this could result in is real GDP growth of 2% to 3% for the next couple of years. This is our base case. In rough terms what this implies for stocks (S&P 500) is:

- Nominal GDP growth of about 4%
- Aggregate revenue growth of about 5% (foreign sales begin to kick in)
- Margins, which are close to peak levels, don't decline, and in fact could increase marginally (foreign revenues generally carry better margins.)
- Corporate balance sheets remain flush allowing share repurchase and dividend payouts to continue.

All of this translates into earnings growth in the +6% area for the market, slower than the last five years, but adequate to make stocks interesting.

At today's prices (S&P 500 close to 1750 an all time high) stocks are at the upper end of a fair value (more than 15x current year earnings) range. Over the past couple of years, stocks have outpaced earnings, as the equity risk premium has come down and the price/earnings ratio has increased. We had felt that there was further room for P/E expansion, as worldwide risks continued to diminish. We are now less sure of that position over the near term, largely due to the dysfunction in Washington and the fact that the budgetary issues must be dealt with again during the first quarter of 2014. Not surprisingly, with the market at fair value, we find many of the ideas we look at also at fair value. Which is to say, it's not as easy to find compelling things to buy. We find our clients' portfolios populated with a handful of issues that are not overly expensive, but nor are they cheap. However, if we are right about earnings progress, we can grow with them and achieve superior returns. To further adapt to this environment, we need to pay greater attention to the various economic sectors of the broad market, as not all will perform equally well. In a positively growing environment, which is hopefully accelerating and global in nature, we want more cyclical economic exposure – i.e. more offense and less defense. Defensive sectors (staples, telecom, utilities, etc.) have done their job over the past 7 years and are no longer cheap. At this stage, we have been adding exposure to industrials, technology, and financials. Energy, which has been a drag in the past, largely due to weak natural gas prices, remains a very cheap sector. Finally, in an environment where the broad market is at the upper end of fair value, and individual ideas are hard to come by, we think it is important to look for businesses that have specific catalysts which are independent of the macro influences that may surround them. Restructuring, new products, share buybacks, or other important capital allocation activity can often lead to significant price appreciation. Finding businesses with these characteristics, and building the necessary level of confidence in their execution, is a process that we are actively engaged in, with the objective of adding incremental return to client portfolios. If we successfully execute this strategy, we believe our clients' portfolios will perform well.

The risks to this scenario include the usual political and geopolitical outcomes which we can't handicap:

- Further severe dysfunction in Washington as we revisit the budget and debt issues in the first quarter
- The always present geopolitical risk in the Mideast or Europe

Closer to home are a few risks to economic fundamentals that could upset the applecart:

- Economic activity could be either too hot or too cold:
    a. If growth accelerates to the 4-5% GDP range, the Fed would re-enter the picture and a monetary tightening phase could begin. Given the economic slack in the system and the current pace of growth, we put a low probability on this.

    b. If growth decelerates and we approach another recession, deflationary forces could come into play. At this stage, we think we are at an accelerating inflection point, and put an even lower probability on a tip over.

- Once the Federal Reserve's taper begins, the pace could cause rates to accelerate upward beyond what we consider a normalized level (as discussed in our last commentary), having a negative impact on stocks and bonds. With the current make-up of the Federal Reserve Board, and the prospect of new members joining, we remain hopeful that the process will be measured.

None of these are enough to cause us to alter our strategy, although they all bear watching.

Fixed Income Review and Outlook

As mentioned previously, bonds took a different path than stocks. They barely eked out a positive return for the quarter. Overall the Barclay's Aggregate Bond Index generated a 0.57% return for the three months and a return of -1.89% for the year to date. We noted in last quarter's commentary, that the Barclay's Aggregate has not had three consecutive negative quarters since 1990, and the streak remains intact.

Treasuries lagged the overall market with a 0.50% return, bringing the year to date total to -1.52%. No discussion of the Treasury market in the last quarter would be complete without some context about the Fed action regarding the taper. The decision by the Fed NOT to taper came as a surprise to most of the investing world. Some pundits have opined, and we agree, that the Fed had missed an opportunity to slow the purchase program, the efficacy of which has been questioned by some Fed governors themselves. There's an old Wall Street maxim, "When they pass out free cookies, take some". The Fed passed on the cookie plate this time. Market expectations, influenced by Fed communication, had clearly anticipated some action that would remove stimulus and return monetary operations to "normal". Fed Fund rates as measured by futures contracts in mid-May had priced a 76% chance that Fed Funds would remain between 0-0.25% until December 2014 with only a 4% chance of the target rate being greater than 0.50%. Those figures had decreased to 49% and 15%, respectively by August. So, clearly, the market thought there would be action by the Fed.

Part of the Fed's rationale not to taper was the "tightening of financial conditions observed in recent months, if sustained, could slow the pace of the improvement in the economy and the labor market". For example the rate on a 30 year fixed mortgage rose approximately 1.00% from May to August. A consumer taking out

$200,000 loan would have to pay about $115, or 12%, more per month in order to afford the same house in August as opposed to May. We would argue that the tightening of conditions was in large part a result of garbled or inconsistent communications from the Fed, rather than any fundamental actions by the Board.

So the question now is: when will the taper begin? We think it has been deferred into 2014 for a number of reasons:

The full effects from the 16 day shutdown of the Federal Government won't be known for some time. We can say with a good deal of confidence that the growth the Fed had expected in May for all of 2013 will not be met and the Fed will take that into account at its October and December meetings.

Prior to the shutdown, growth estimates had been falling with little likelihood of a repeat of 2Q's 2.5% growth rate in 3Q. 2.0% is the current estimate.

The composition of the voting members of the Fed Board of Governors changes in January. While the number of inflation hawks is set to rise by one, the number of dovish member remains in the majority. Dovish-leaning 2014 voters, Elizabeth Raskin and Sandra Pianalto, are set to leave in 2014. We would expect them to follow the lead of the dovish Fed Chair nominee, Janet Yellen, until their departure in mid-year.

We think the Fed is not likely to begin the taper until the March meeting, at the earliest, and we hope for better communication from the Fed prior to the outset, so that the market's reaction will not be violent.

At current levels, Treasury yields represent fair value. We are maintaining a duration of about 90% of our target, with less exposure to the longer end of the Treasury curve in the expectation of higher rates once the taper does begin. We take most of our interest rate exposure using the three to ten year part of the curve. We are watching the Treasury Inflation Protected Securities (TIPS) market in anticipation of an overly bearish view on inflation for an opportunity to add inflation protection.

Agencies returned 0.44% for the quarter and -1.51% YTD. We currently like callable Agencies that have coupons that step-up, as they have an increased probability of being called. The rise in interest rates since the end of April has pushed the prices of many callable bonds below par, making them eligible for both capital appreciation and income.

Investment grade corporate bonds outperformed the market with a 0.82% return, bringing the YTD total to -2.62%. Lower quality outperformed higher quality and financials continued to best both utilities and industrials.

Corporate issuance has remained robust in 2013. Through September 30, new issuance as tracked by Barclay's Capital is running ahead of 2012's record pace. To date, $852 billion new investment grade corporate bonds have been issued. Verizon brought the largest deal ever, $49 billion, in early September to secure financing to buy Vodafone out of its stake in Verizon Wireless. That deal was almost three times the next biggest corporate bond issue ever. Unlike the Verizon offering, which was designed for mergers and acquisitions activity, it is becoming more common for corporations to issue debt to buy back stock or pay special dividends. Witness Apple's decision to bring a $17 billion deal, the second biggest ever, in late April, with the proceeds slated for share buybacks and a dividend increase. This trend toward re-levering the balance sheets has not had a material effect on the overall quality of the sector but bears watching.

We intend to remain overweight corporate bonds; however we have reduced some of the overweight due to relatively expensive valuations of some corporate sectors and concerns about the re-levering trend. We prefer corporate issuers with the ability to raise prices or those engaged in ongoing balance sheet repair. We tend to avoid those companies that issue debt in order to pay dividends or buy back shares.

Mortgage-backed securities (MBS) led the market higher in the third quarter, returning 1.03% and -1.00% so far in 2013, and they rallied following the decision by the Fed to continue monthly purchases unabated. Given the importance of the housing market to the recovery, we think the Fed, once it begins to taper, will target Treasuries first and provide support via mortgage purchases.

In light of our expectation that Fed mortgage purchases will continue at least into mid-2014, we will use mortgages as a high quality alternative to Agencies. The increase in interest rates has slowed prepayment activity and, with some MBS prices below par, investor prepayment concerns have subsided. In the face of investor demand for high quality assets with an attractive yield over Treasuries, MBS should continue to do well.