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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

There is an old saying in the investment industry, "Sell in May and go away." The origins of the saying date back to when our economy was dominated by manufacturing, and during summer months economic activity would slow due to vacations and factory maintenance. Since this slowdown complicated analysts' efforts to evaluate their companies' prospects, the preferred strategy was to wait out the summer doldrums and revisit their recommendations in the fall. The new recommendations would sometimes incorporate dramatic revisions as the result of changes which might occur during the summer.

Clearly, such a strategy would have proven disappointing this year; not that economic activity was particularly robust; it wasn't. Instead, businesses and investors spent the summer in almost universal anticipation of "tapering." Tapering is the term which describes the action the Federal Reserve Bank will use to reduce and eventually remove the monetary stimulus it has provided since the financial crisis began. In general, investors fear the uncertainty of a Federal Reserve Bank move toward tighter monetary policy. However, this time, **instead of being subdued by the prospect of tightening, the stock markets rose to new heights, in a continuation of a market run which began a year ago.**

Indeed, this rapid rise in stock prices has been a source of concern for many strategists who feel that the market is poised for a correction. Some think that the rise in equity prices is a function of Quantitative Easing (QE), attributing a direct cause and effect between stimulus and the rise in stock prices. **While we won't deny that easy money probably helped the economy as well as stock prices, in the near term, it appears that monetary easing has been less effective during this cycle than at any time in recent memory.** Besides, the stock market should not have appreciated to the extent it did this past summer unless it saw an end to the current monetary policy and a return to less intervention as a long term positive for the economy.

Others have noted that stock prices have appreciated much faster than earnings have grown, giving rise to the notion that price/earnings (P/E) multiples are at historically high levels. While we understand the attraction of an apparently simplistic metric for valuing stocks, it is worth noting that this ratio is anything but simple. Earnings can be derived from the past, normalized, or future estimates. The price an investor is willing to pay for a stock should reflect the expected future stream of earnings, discounted to a present value by a rate which is a hybrid of current or future interest rates and/or current or expected inflation. **It should be easy to see how an apparently objective comparison of a simple ratio to historical measures can be anything but simple or objective.**

Instead we would characterize the market move over the past year as a move toward the restoration of equilibrium between stocks and bonds. Last fall, the stock market was significantly undervalued due to a number of reasons. On a fundamental basis was the fear that the fiscal cliff would be sufficient to push an anemic recovery into recession. The consensus at the time was that we would be in a mild recession during the first half of 2013. Instead, **companies have streamlined their operations and have been able to eke profits out of an otherwise weak economy in each quarter of this year.**

Fixed income markets have effectively been subsidized by QE since the fiscal crisis began in 2008. An unintended consequence of this, combined with an irrational distrust of stocks, has resulted in the sale of stocks and purchase of bonds since the crisis began. This year the trend seems to have reversed. **With the realization that interest rates will rise, resulting in a decline in bond prices, investors have begun to sell bonds and buy stocks. This is a trend which could provide upward pressure for stock prices for some time to come.**

The initial move in stock prices, much of it due to a broad-based reallocation of funds from bonds to stocks, has resulted in a compression of stock valuations. Investors wanted to invest in stocks and reduce their exposure to long bonds, so they participated broadly, using index and quasi index funds. As a consequence, the difference in valuation between the stocks of companies with great prospects is very close to the valuation of companies with much more limited prospects. **We think that companies with good operating leverage, companies which can bring most of an increase in revenues to the bottom line, will continue to outperform and their stock prices will begin to reflect their superior prospects.**

Finally, in most recent Federal Reserve Board releases, they make the point that even after they begin removing stimulus, they will not let the economy slide into recession. **So while a correction in the longer term trend is always possible, the Fed has effectively put a floor on economic growth, as well as stock prices, for the foreseeable future.**

Fixed Income Market

All eyes were on the Fed at its September 17-18th meeting as investors awaited the decision on a "tapering" action for the $85 billion monthly QE policy. **In a surprise to market expectations, the Federal Open Market Committee decided to maintain their current bond purchasing pace because the economic data didn't support tapering at this time.** Chairman Bernanke reiterated that the decision would be data driven and dependent on an employment rate below 6.50% (currently 7.30%) and inflation consistently above 2.00% (currently 1.50%). Additionally, the Fed provided slower growth projections for the economy and implied that short term rates could remain at or near zero through 2015. Bond market prices reacted positively resulting in the 10-year Treasury yield falling from a high of 2.98% to 2.61% in September.

Although the interest rate drop was a welcome respite from the dismal returns of recent months, it is doubtful that QE purchase activity or low interest rates are sustainable for the long term. **It is apparent in the markets that the Fed's bond buying program is experiencing diminishing efficacy in keeping rates low and spurring growth**. In fact much of the injected liquidity remains on the sidelines, with excess reserves at the banks increasing to over $2.1 trillion in August 2013 from $1.4 trillion at the end of 2012.

We see further evidence of anticipation for higher interest rates in bond issuance activity in recent quarters. Recent notable examples include the Verizon deal which amounted to $49 billion in September and Apple's $17 billion in April, the two largest corporate bond offerings of all time. **Companies continue to take advantage of the low interest rate environment by issuing debt when they do not have an immediate need for the funds**.

The only area of the fixed income market which showed lower issuance was the municipal bond market. This decline can be attributed to factors including the increasing interest rates from prior quarters and fears for lower demand due to the Detroit default. **Although the constrained supply of new municipal offerings was somewhat offset by the reduced demand from muni bond fund outflows, there are still attractive yields for our higher income tax bracket clients focused on capital preservation.**

The implications for this interest rate environment remain simple; with rates increasing in the near future it is important to keep durations low and to ladder the maturities on any bond holdings in the investment portfolio. To attain the best yields, credit spreads for corporate bonds continue to provide upside opportunities when moving to the lower end of the investment grade spectrum with the spread between BBB and AAA bonds at over 1.7%. **We continue to prudently add high quality corporate and municipal bonds where appropriate in our client portfolios.**

International Market

The use of chemical weapons by Bashar al-Assad's forces almost led to a U.S. military strike on Syria. For some time, geopolitical uncertainty has been a major downside market driver, with investors especially concerned about the potential impact on the oil market. Unfortunately, the outbreak of war was not the greatest threat to the emerging markets. **Excessive inflation plagues the developing markets, and the situation continues to deteriorate**.

Over recent years, as the cheap credit environment created by QE drove "hot money" (investment cash seeking higher returns) into emerging markets, these countries put up little resistance. The inflow of hot money not only generated growth for the local economies, but also obscured weaknesses such as political instability, corruption, budget deficits, current account deficits, and poor public financial management.

However, the inflows also opened the door for inflation. Hot money stays only as long as excess returns can be made, measured not in the local currency but in the home currency from which it originated. **Once inflation devalues local currencies to a point of no additional returns, hot money leaves as quickly as it came.** The cash-infused growth evaporates, but all the structural weaknesses remain, if not worsen, and inflation continues to erode the local economies.

Currently in many emerging economies, slowing growth, together with the prospect of tighter U.S. monetary policy and the accompanying increase in global bond yields, has brought additional issues such as currency depreciation and rising financing costs. The problem is most pronounced where governments have depended on hot money to finance a current account deficit. Brazil's real has dropped to the weakest level since December 2008; the Indian rupee has plunged nearly 20% since early May; and Indonesia's rupiah has fallen to the lowest level since April 2009. Most developing markets are likely to see their economic growth further depressed by increases in funding costs.

Unlike emerging markets now suffering from the consequences of ultra easy monetary policies, developed economies such as the U.S., Japan, and some European countries have actually seen their prospects improve. Similar to the case in the U.S., bond purchases by the Japanese Central Bank have been exerting strong downward pressure on nominal interest rates. The push has helped boost stock prices and restrain bond yields, while also supporting bank lending and bolstering confidence among consumers and businesses. The euro zone's business activity is also growing at its fastest pace since the spring of 2011. This acceleration has been attributed to Mario Draghi, head of the European Central Bank, who has stated his commitment to maintain low interest rates into the foreseeable future, so long as inflation remains subdued. In addition, German Chancellor Angela Merkel won an historic election victory as her conservative party achieved their best results since reunification. It is expected that forming a grand coalition with the Social Democratic Party not only will ensure continuity in Europe's most powerful economy, but will also allow Merkel to put greater emphasis on stimulating economic growth and curbing unemployment in the euro zone.

While the situation in emerging economies appears less promising, the once troubled Europe and Japan, stalled for more than a decade, seem to have weathered the decline and are beginning to show evidence of renewed growth. **Thus, for now, we are comfortable over-weighing developed markets while under-weighing emerging markets.** However, with China starting to show early signs of stabilization, it is only a matter of time until investment opportunities in the developing world become sufficiently attractive to again participate in emerging markets.