Third Quarter 2014 Market Review

October 2014

Economic Summary

Economic Data September 30, 2014			
Global Growth	**3Q14**	**2Q14**	**1Q14**
U.S. GDP [1]	3.2%[E]	4.6%	-2.1%
Eurozone GDP [1]	0.1%[E]	0.0%	0.2%
Japan GDP [1]	0.2%[E]	-7.1%	6.0%
China GDP [2]	7.3%	7.5%	7.4%
U.S. Inflation	**9/14**	**8/14**	**YoY**
Consumer Price Index	0.1%	-0.2%	1.7%
Core	0.1%	0.0%	1.7%
Key U.S. Economic Data	**9/14**	**8/14**	**9/13**
Leading Economic Index	0.8%[E]	0.2%	1.0%
Durable Goods Orders	0.7%[E]	-18.4%	0.4%
ISM Manufacturing	56.6	59.0	56.0
ISM Service	58.6	59.6	54.5
Consumer Confidence	86.0	93.4	80.2
Auto Sales (millions) [3]	16.3	17.4	15.3
Retail Sales	-0.3%	0.6%	0.1%
New Home Sales (millions) [3]	0.47[E]	0.50	0.39
Existing Home Sales (millions) [3]	5.17	5.05	5.26
Unemployment Rate	5.9%	6.1%	7.2%
Underemployment Rate	11.8%	12.0%	13.6%
Labor Force Participation Rate	62.7%	62.8%	63.2%

[E] Investing.com Estimate, [1] Annualized Q/Q % Change, [2] Y/Y % Change, [3] Annualized M/M change

Federal Open Market Committee (FOMC)
The FOMC made few changes during the third quarter other than further reductions in its asset purchase program. Fed officials have become concerned that weak overseas growth and a strengthening U.S. dollar will crimp the domestic economy and hold down inflation. This outlook has made the Fed more inclined to maintain low interest rates.

Gross Domestic Product (GDP)
The economy strengthened significantly since the beginning of the year when GDP declined -2.1%. The Bureau of Economic Analysis raised its third estimate of second quarter GDP to +4.6% reflecting broad-based growth in many areas of the economy including consumer spending and business investment. Economists expect GDP growth to moderate to 3% for the balance of the year.

Inflation
Domestic inflation remained relatively benign with the consumer price index (CPI) gaining 1.7% year-over-year through September. The recent slowdown in global economic growth coupled with a strong dollar has brought commodity prices in line with fundamentals and should keep inflation in check.

Business
For the quarter, the Institute for Supply Management Manufacturing survey increased from 55.3 to 56.6, while the Services survey increased from 56.0 to 58.6. Both readings indicate an increase in business activity. Respondents to both surveys cited improving business conditions in the third quarter.

Consumer
For the quarter, consumer confidence increased from 86.4 to 93.4 before falling to 86.0 points in September. The increase was driven by improving expectations on the general economy and job prospects; however consumers continue to remain less upbeat about income growth. Retail sales dropped -0.3% in September following a +0.6% gain in August. Economists are predicting the recent drop in gasoline prices will give consumers incentive to purchase goods and services in coming months.

Housing
The housing market continued its trend of modest improvement. Existing-home sales in September were reported at an annualized rate of 5.17 million units. This is up slightly from August's 5.05 million unit rate, and off about 1.7% from September 2013. Economists believe a continued rebound in housing is likely, primarily as a result of attractive mortgage rates and the improvement in employment.

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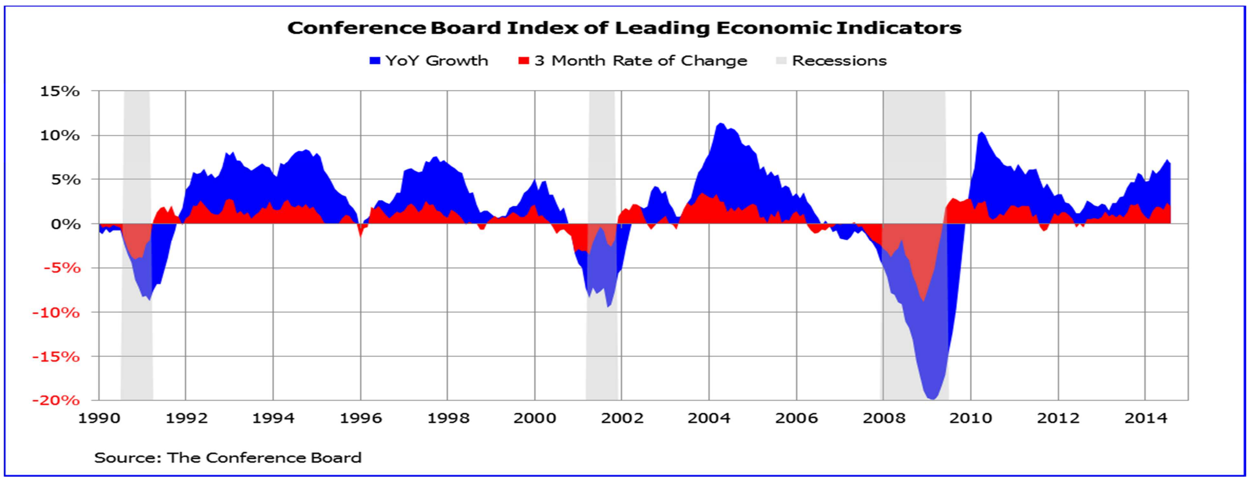
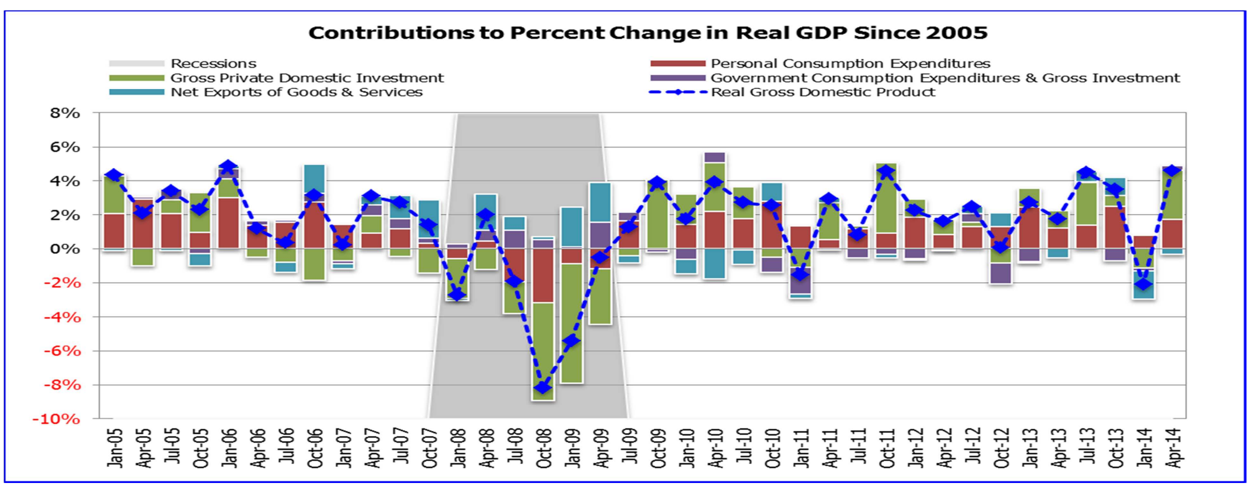
Employment
The employment situation continued its trend of modest improvement, with an average of 224,000 jobs added each month during the quarter. As a result, the unemployment rate in September fell to 5.9% down from June's 6.1%. However, the labor force participation rate fell to 62.7% in September down from June's 62.8% reading indicating the rate of new jobs added will need to accelerate going forward in order to keep pace with the growth in the working-age population.

The view forward
Second quarter GDP data indicates improving strength in the U.S. economy. The 4.6 % growth reflected growing personal consumption, private inventory investment, exports and both residential and nonresidential investments. Economists are hoping that stronger employment growth and rebounding housing values will give consumers confidence to increase discretionary spending.

Potential risks to continued improvement in the economy include further slowing in China's growth, a monetary policy misstep by the Fed, an inability of the Eurozone policymakers to jump-start the region's growth and an escalation in geopolitical tensions.





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Equity Summary

Volatility returns to the equity market
The third quarter started on a sour note, with performance in July negative across each market cap and style. August saw positive returns across each market cap and style thanks to encouraging domestic economic reports. However, September saw negative returns across each market cap and style as investors grappled with dueling concerns about the Fed raising interest rates sooner than anticipated in light of stronger domestic economic data; slowing growth in the Eurozone and Asia; and an unexpected military campaign against ISIS. As a result, volatility reentered the equity market and appears poised to remain for the foreseeable future. Despite the increased volatility, the S&P 500 advanced +1.1% for the quarter. On a year-to-date basis, the index is up a respectable +8.3%.

Domestic Equity	Total Return September 30, 2014			
	QTD	YTD	2013	2012
Major Indices				
DJIA	1.9%	4.6%	29.7%	10.2%
S&P 500	1.1%	8.3%	32.4%	16.0%
Nasdaq	2.2%	8.6%	40.2%	17.7%
Market Cap				
Large	0.7%	8.0%	33.1%	16.4%
Mid	-1.7%	6.9%	34.8%	17.3%
Small	-7.4%	-4.4%	38.8%	16.3%
Style (Growth)				
Large	1.5%	7.9%	33.5%	15.3%
Mid	-0.7%	5.7%	35.8%	15.8%
Small	-6.1%	-4.0%	43.3%	14.6%
Style (Value)				
Large	-0.2%	8.1%	32.5%	17.5%
Mid	-2.6%	8.2%	33.5%	18.5%
Small	-8.6%	-4.7%	34.5%	18.1%

Market Cap and Style
U.S. small-cap stocks suffered a -7.4% decline in the third quarter, continuing their year-long divergence from large-cap and mid-cap stocks. Small-cap stocks are now down -4.4% year-to-date while large-cap and mid-cap stocks are up +8.0% and +6.9%, respectively. For the quarter, growth outperformed value across the each market cap although year-to-date there is a negligible difference between these styles.

Sectors
The third quarter saw a broad dispersion in returns among the ten economic sectors in the S&P 500 index, indicating that sector selection is becoming more important. The health care sector was the top performer for the quarter, posting a gain of +5.5%; the health care sector is also the top performer year-to-date with a gain of +16.6%. Information technology also posted good results for the quarter with a gain of +4.8%. The energy sector was the worst performing sector for the quarter declining -8.6% as a result of reduced demand for oil. Utilities also struggled this quarter posting a loss of -4.0%.

Corporate earnings and revenue
According to FactSet, 73% of companies in the S&P 500 reported earnings above estimates in the second quarter and 65% of companies reported revenues above estimates. Second quarter earnings growth came in at 7.5% and revenue growth at 4.4%. Both readings are slightly ahead of first quarter results. Third quarter projected earnings growth is 4.7% and projected revenue growth is 3.7%.

The bull market takes a breather
As noted in our second quarter commentary, we don't expect to see a repeat of the expansion in price/earnings multiples that drove stocks higher in 2013. Instead, stocks are most likely to be influenced by corporate earnings growth, which we think will continue at a moderate pace through the rest of the year. With this thesis in mind, we will continue to watch global economic activity since companies in the S&P 500 index generate 68% of their revenue in North America, 11% in the European Union and 10% in Asia. A stronger U.S. dollar and weakening economic activity in the European Union and Asia have the potential to place pressure on corporate earnings for the balance of this year.

The view forward
We view the overall environment as supportive of stock prices through year-end. We continue to favor dividend paying large-cap and mid-cap stocks.

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Taxable Bond Summary

U.S. Treasury Yield Curve (%)				
	Sep14	Jun14	Dec13	Dec12
6 Month	0.03%	0.07%	0.10%	0.11%
2 Year	0.58%	0.47%	0.38%	0.25%
5 Year	1.78%	1.62%	1.75%	0.72%
10 Year	2.52%	2.53%	3.04%	1.78%
30 Year	3.31%	3.34%	3.96%	2.95%

Treasury yields react to economic data

The yield curve continued to flatten as short term rates rose, intermediate rates remained unchanged and long term rates declined. There was increased volatility in Treasury yields during the quarter as evidenced by the yield on the 10 year Treasury fluctuating between 2.63% and 2.34% before finally settling unchanged at 2.52%. Improving U.S. economic data led to expectations of the Fed increasing interest rates sooner than anticipated and this put upward pressure on yields. At the same time, Treasury securities were sought for their safe haven status as geopolitical concerns mounted during the quarter and this put downward pressure on yields. Globally, the 2.52% yield on our 10 year Treasury bond continues to be an attractive alternative when compared to the yield on 10 year government issues in Germany (0.9%), Japan (0.5%) and the U.K. (2.4%).

Domestic Taxable Bonds	Return September 30, 2014			
	QTD	YTD	2013	2012
Index				
Barclays Aggregate	0.2%	4.1%	-2.0%	4.2%
Index Sectors				
Treasury	0.3%	3.1%	-2.8%	2.0%
Agency	0.1%	2.9%	-1.6%	3.0%
Corporate	-0.1%	5.6%	-1.5%	9.8%
Industrial	-0.2%	6.0%	-2.6%	7.6%
Utility	0.5%	7.8%	-3.2%	7.5%
Finance	-0.1%	4.3%	0.9%	14.7%
Securitized	0.1%	4.1%	-1.3%	3.0%
ABS	0.0%	1.3%	-0.3%	3.7%
MBS	0.2%	4.2%	-1.4%	2.6%
CMBS	-0.2%	2.4%	0.2%	9.7%
Index Quality				
Aaa	0.2%	3.5%	-2.1%	2.4%
Aa	0.3%	4.2%	-2.0%	5.4%
A	0.0%	5.2%	-1.9%	9.9%
Baa	-0.2%	6.9%	-2.0%	11.5%
< Baa	-1.9%	3.5%	7.4%	15.8%
Index Maturity				
1-3 Year	0.0%	0.6%	0.6%	1.3%
3-5 Year	-0.1%	1.9%	-0.1%	3.0%
5-7 Year	0.0%	3.5%	-1.6%	4.8%
7-10 Year	0.2%	5.3%	-3.9%	7.3%
10+ Year	1.0%	11.5%	-8.6%	8.8%

Taxable bond market treads water

Taxable bond returns were subdued this quarter as the Barclays Aggregate Bond Index only managed a return of +0.2%. However, the journey to this muted return was full of ups and downs as Barclays Aggregate Index was down -0.25% in July, up +1.1% in August and down -0.7% in September. Investors are patiently trying to sort out a mixed bag of weak global economic data and U.S. interest rate uncertainty due to an improving domestic economy. Investors continue to absorb all new debt issues with $230 billion in new investment grade issues and $68 billion in new high yield issues being oversubscribed during the quarter.

Within the Barclays Aggregate Index, the Treasury sector was the top performer for the quarter posting a gain of +0.3% while the Corporate sector maintained the lead on a year-to-date basis with a +5.6% return. High yield bonds were the weakest component in the index with a return of -1.9% for the quarter. Angst over rising interest rates caused investors to demand increased yield for the credit risk associated with high yield issuers as evident by spreads widening 87 basis points (0.87%) during the quarter. Bonds with greater than ten years to maturity outperformed as investors continued their search for yield.

Investors absorb securitized bond issuance

Investors absorbed $352 billion of new issue mortgage-backed securities (Securitized) this quarter which lends support to our thesis that the Feds tapering of MBS purchases will ultimately balance the mismatch between new issuance and demand and bring the securitized market back to a more normalized spread and trading environment.

The view forward

We continue to underweight Treasury and Agency bonds in favor of Corporate and Securitized bonds. As market conditions allow, and as appropriate for each client, we will look to shorten duration, improve credit quality and increase coupons in anticipation of rising interest rates in 2015.

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Municipal Bond Summary

Municipal bonds once again deliver solid results
Municipal bonds produced another quarter of solid performance as measured by the +1.5% return of the Barclays Municipal Bond Index. Overall, municipal bonds outperformed Treasury, Agency, Corporate and Securitized debt. From a technical standpoint, municipal bond issuance continues to run below its five year average while demand remains robust leading to upward price pressure and lower yields. The municipal yield curve flattened as longer-maturity municipal bonds experienced the most significant price increases and yield declines.

Municipal bonds nationwide have returned above 7% this year, ahead of most of their taxable counterparts. Credit conditions for most municipalities continue to improve with rising tax receipts. Municipal credit upgrades continue to outnumber downgrades by a wide margin.

While investor demand for yield generally meant that lower-rated credits outperformed, high-yield debt results were skewed by Puerto Rico, which comprised nearly one-third of the high-yield index. Puerto Rico bonds within the high-yield index rose +10.6% during the quarter.

Puerto Rico
On June 28th, Puerto Rico's governor signed into law the Puerto Rico Corporation Debt Enforcement and Recovery Act. This Act creates a legal mechanism for certain of Puerto Rico's public corporations, including the Puerto Rico Electric Power Authority (PREPA), the Puerto Rico Aqueduct and Sewer Authority (PRASA), and the Puerto Rico Highways and Transportation Authority (PRHTA) to restructure financial obligations. Investors expected PREPA would be the first of the public corporations to default in August but were surprised when PREPA reached a forbearance agreement with bondholders and obtained an extension of credit from Citibank and Scotiabank. PREPA now appears to have time to pursue a more orderly debt restructuring with creditors.

Domestic Municipal Bonds	Return September 30, 2014			
	QTD	YTD	2013	2012
Index				
Barclays Muni Bond	1.5%	7.6%	-2.6%	6.8%
Index Bond Type				
General Obligation	1.3%	6.7%	-2.3%	5.6%
Revenue	1.7%	8.4%	-2.9%	7.8%
Index Largest Issuers				
California	1.7%	8.5%	-1.8%	8.2%
Florida	1.5%	7.3%	-1.5%	7.5%
Illinois	1.3%	8.2%	-3.0%	8.1%
New York	1.7%	7.3%	-2.2%	6.2%
Texas	1.6%	7.9%	-2.1%	7.3%
Index Quality				
Aaa	1.1%	5.4%	-1.6%	4.5%
Aa	1.4%	6.9%	-2.1%	6.2%
A	1.6%	8.7%	-2.6%	8.2%
Baa	2.2%	12.1%	-7.2%	9.8%
<Baa	4.6%	12.5%	-5.5%	18.1%
Index Maturity				
1 Year (1-2)	0.1%	0.5%	0.8%	0.8%
3 Year (2-4)	0.3%	1.4%	1.3%	1.9%
5 Year (4-6)	0.8%	3.1%	0.8%	3.0%
7 Year (6-8)	1.0%	5.2%	-1.0%	4.2%
10 Year (8-12)	1.5%	7.2%	-2.2%	5.7%
15 Year (12-17)	2.0%	9.6%	-3.3%	8.5%
20 Year (17-22)	2.1%	10.6%	-4.4%	10.0%
Long (22+)	2.3%	12.7%	-6.0%	11.3%

Detroit, MI and Stockton, CA
On September 10, Detroit reached a deal with three Michigan counties that removed $5.4 billion in water and sewer service system bonds from the bankruptcy proceedings. The water and sewer system deal was crucial to adjusting the city's $18 billion of debt and exit the biggest-ever municipal bankruptcy. Meanwhile, the judge overseeing the Stockton, California bankruptcy ruled that the City's relationship with CalPERS is contractual, and that the contract can be impaired in bankruptcy. Thus, CalPERS cannot be treated differently than similarly positioned creditors. The city had planned to pay pension obligation expenses owed to CalPERS in full while substantially discounting payments to bondholders.

The view forward
We continue to favor A-rated general obligation and essential service revenue bonds in the intermediate part of the curve. As market conditions allow, and as appropriate for each client, we will look to shorten duration, improve credit quality an increase coupons in anticipation of rising interest rates in 2015.

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