

Investment Update

Third Quarter, 2014

Markets Summary

Equities

The broad markets continued to move ahead during the third quarter, although at a much reduced pace from the S&P 500's advance of 5.2% during the second quarter. For most of the quarter, issues that had been simmering for some time did not seem to matter as the market shrugged its shoulders at the Ukraine, the Middle East and weak European economic growth, but in the final two weeks attention appeared to turn back to them and the S&P 500 declined 1.9% in the final 10 trading days of September from a record high on the 18th.

<u>Total Returns</u>	<u>1q 2014</u>	<u>2q 2014</u>	<u>3q 2014</u>	<u>2014</u>
Dow Jones Industrials	-0.1%	2.8%	1.9%	4.6%
S&P 500	1.8%	5.2%	1.1%	8.3%
S&P Mid Cap	3.0%	4.3%	-4.0%	3.2%
S&P Small Cap	1.1%	2.1%	-6.7%	-3.7%
MSCI All Country World	0.8%	4.2%	-2.6%	2.3%
MSCI EAFE Developed Markets	0.0%	3.0%	-6.4%	-3.6%
MSCI Emerging Markets	-0.8%	5.6%	-4.3%	0.3%

The apparent unresponsiveness of much of continental Europe to several rounds of interest rate cuts could be the primary culprit for this change in sentiment. Economic growth there has been anemic and made worse by rising tensions with Russia and slower growth in China, both major trade partners.

Bonds

As seen below, rates remained relatively unchanged during the third quarter, with a slight decline for both the benchmark 10-year and 30-year government bonds. There were several factors, including Ukrainian sparring and the other issues mentioned above, that could have led to a greater rally (reduction in rates), and several factors including improving US GDP growth (revised from 4.0% real to 4.6% real for the second quarter, a significant revision by historical standards) and continuing improvement on the labor front that could have led to a greater sell-off (rise in rates), but they appear to have largely offset each other.

<u>US Treasury Yields</u>	<u>30-Jun-14</u>	<u>30-Jun-14</u>	<u>30-Sep-14</u>
10-year	2.64%	2.53%	2.49%
30-year	3.69%	3.36%	3.18%

Interestingly, not only has the US bond market remained calm, but rates in Western Europe have also remained very low, in many cases well below rates on comparable maturities in the US Treasury market.

The bond buying programs (the QE's) to inject liquidity into the economy are expected to end this quarter; inflation remains low; government deficits are shrinking at a hefty clip; and job creation, while not robust, has been pretty steady over the past 12-18 months after adjusting for cold winters and other abnormalities. All things considered the overwhelming consensus is that a rate increase or possibly a series of rate increases will start in mid-2015. Of note, we have been thinking this would happen for the last couple of years, and it has not.

If employment levels remain the key variable for interest rate policy, then some consideration should be given to the possibility that the significant increase in the use of technology in all industries, especially manufacturing and healthcare, is causing a structural increase in unemployment that will not change through monetary policy. This summer some of us at the BFO delved into an interesting book called *The Second Machine Age* by Erik Brynjolfsson and Andrew McAfee, two MIT professors, which details the technology of (un)employment and the resulting opportunities and the challenges being created by the second machine age. Change now occurs much more rapidly and dramatically than before the first machine age at the end of the 19th century, something affecting many Americans whose manufacturing jobs have been eliminated. The MIT professors offer a few obvious solutions to the problem, faster economic growth and public education reform.

Outlook

We think the fourth quarter is likely to be more like the end of the third than the first half of the year with some increase in volatility given that the exogenous issues mentioned above do matter, there are Congressional elections in four weeks and the third quarter earnings season commences in the second week of October. The weakness in Europe and slower growth in China are likely to have some adverse impact on many US businesses. We remain positive on equity markets longer term even though there seems to be more uncertainty creeping into the shorter term. As for bond markets we continue to feel that yields do not offer compelling enough value to warrant shifting money into bonds at the margin, unless there are other good reasons for such a move.