--Economy and Market Review--

A snapshot and commentary about the economy, stock & bond markets and how they are affecting your investments

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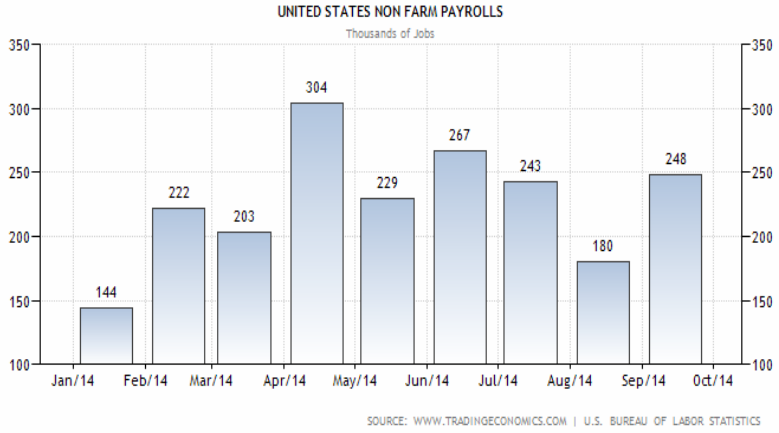
Quarterly Review - October 2014

Reflecting on the first three-fourths of 2014, the U.S economy and the U.S. stock market have, to a large degree, gone in very different directions. The economy has made positive progress on many fronts: gross domestic product (GDP) growth, job creation / reduction in the unemployment rate, etc. U.S. stock market indices, on the other hand, have turned in a disappointing year and have sold off sharply starting in late September. Most U.S. stock indices are now in negative territory for the year after posting huge gains last year.

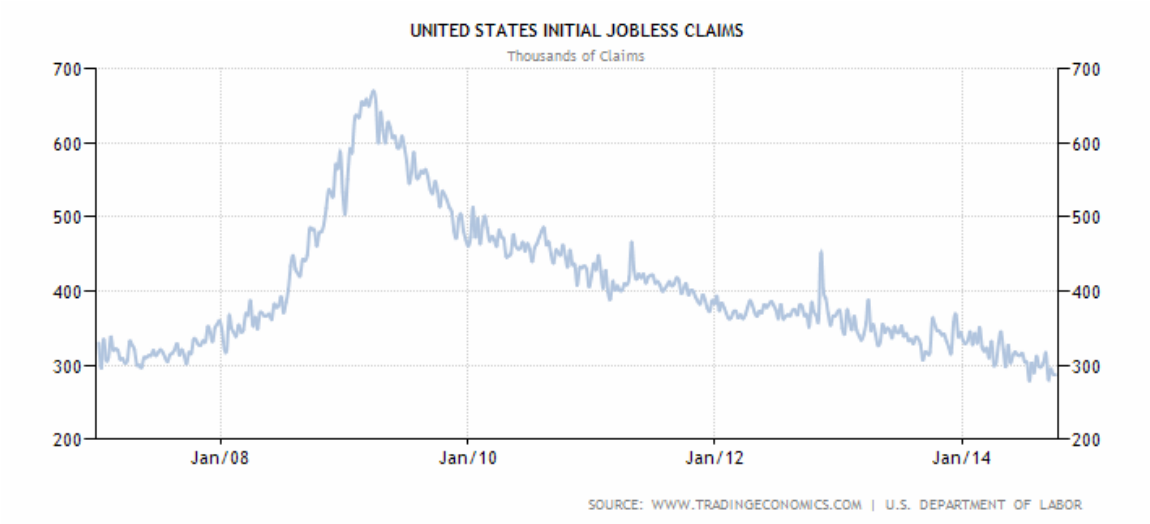
U.S. Economy Continues to Show Slow, Steady Progress

Just last month, the U-3 unemployment rate dipped below 6% for the first time since July 2008. The number of unemployed persons is down by 329,000 to 9.3 million over the past year. The number of long-term unemployed (those unemployed for 27 weeks or more) is down by 1.2 million over the past year.

After severe weather dampened hiring early in the year, hiring has been solid. Monthly non-farm payroll jobs have been added at a healthy pace, though slightly below the 250K - 300K per month pace that most economists would consider robust at this point in a recovery from a recession.



Initial filings for unemployment benefits have dipped below 300,000 for the first time since 2007.



Perhaps the most important indicator of how the U.S. economy is doing is measured in gross domestic product (GDP) growth, the increase in value of all goods and services produced by the economy. The past 12 months have seen fairly robust quarterly gains with the exception of the first quarter of this year, which was impacted by severe weather. We will get an initial reading on the third quarter in early November. Overall, GDP has grown 2.6% year-over-year (compared to its reading 12 months ago). Economists would like to see consistent GDP growth of +3.0 - 3.5%.

The U.S. story is largely positive, but Europe's growth story is fading. The Euro zone saw 0.0% GDP growth last quarter and just 0.7% GDP growth over the past year, and recent readings were a contributor to the fear that spread to global stock markets over the past month. The area's unemployment rate stands at 11.5%.

China's growth story has slowed considerably as well. Annual GDP growth has slowed to the mid-7% range, a large decline from the double-digit growth years the country enjoyed as recently as 2010.

A last point of interest: you have undoubtedly noticed that gas prices have fallen somewhat dramatically over the past several months, and oil prices are at their lowest level in almost four years. Saudi Arabia recently indicated it would not cut production in an effort to raise prices, and continued booming production in the U.S. would mean lower gas prices for an extended period of time.

U.S. Stock Market Indices Turning in a Disappointing 2014

2013 saw the S&P 500 index return over +30%, and it wasn't surprising to see some of that momentum carried into 2014. The index gained +7% in first half of 2014, however it has given up all of those gains year-to-date. The second half of the year saw a divergence between the large cap indices (S&P 500, Dow Jones Industrial Average) and small company index, the Russell 2000. This index set its high for the year way back in March, and as of October 13th had already fallen over 13% from that high. Many sub-categories - economically-sensitive stocks, cyclical stocks, growth stocks, turnaround / value stocks, and stocks that did particularly well in 2013 have been punished over the past few weeks. We've seen 20-35+% declines in many of these stocks in a short period of time. At the moment, the broader market S&P 500 index has shed roughly 8% of its value since mid-September. Other global stock indices have done worse, including the FTSE 100 (Europe), which is down 10% from recent highs.

The pace and depth of this sell-off is by no means unprecedented (which I'll discuss momentarily), however it has been over two years since we've experienced a decline of this magnitude. Late January, early April and late July/early August of this year saw some fairly rapid sell-offs, resulting in 4-6% declines. These declines were very short-lived, as it turned out, with the market recovering those declines and reaching new highs within a matter of weeks. Investors who check their statements once per month may not have even realized any significant decline had taken place. With this current market decline, this will not be the case. The current sell-off started in mid-September and is already over a month old, and the level of daily volatility still present in the market suggests it is not over yet.

Will this current market decline will be limit itself to a 8-13% decline among domestic stock indices, or will this be a deeper, more prolonged decline? There is, of course, no way to predict, but I think some perspective will be helpful here.

The first point that needs to be made is that a market sell-off at the present time should not be terribly surprising for a number of reasons:

1) We are in year 6 of the current bull market that started in March 2009, the low point of the large cap U.S. stock indices during the "Great Recession." We are already well past the length of the average bull market (62 months since 1921).

2) During the five years following the March 2009 lows, there were frequent pullbacks. 2010-2012 saw deeper, 10-20% corrections where fear and panic were the dominant sentiment. The first two months of 2009 saw stocks shed 22% in just 2 months, as measured by the S&P 500 index. 2013, however, was different. There were no intra-year drops of 10% or more. Individual investors - long scared out of the market after the psychological wounds of 2007-08, actually began to put money back into stocks, and market sentiment was largely positive during the past year and a half. The market seems overdue for a deeper correction at this point.

Source: Forbes

3) On a fundamental level, stocks had gotten expensive. The S&P 500 index was trading at roughly 19 times its previous 12-month earnings. This ratio is known as price-earnings ratio, price-earnings multiple, or simply P/E ratio for short. The historical average is 15.5 and median is 14.6. To be fair, this ratio was well above average for all of 2013 as well, but it is worth noting.

4) It has been over 2 years since we have seen a market decline of 10% or more, and roughly 3 years since we have seen a decline of near 20%. Historically, we were overdue for a pullback since these 10-20% declines are normal, and not just in the wake of financial crises. Since the end of WWII in 1945, there have been 27 declines of 10% or more (known as corrections) and 12 declines of 20% or more (known as bear markets). This equates to a correction or bear market once every 20 months. The average decline has been 13%, and the decline from peak to trough has lasted 71 days on average.

One other important event worth mentioning is recent comments by the Federal Reserve regarding the timing of an interest rate hike. The Fed has held rates near zero for an extended period of time, and the availability of "cheap money" has been a boon for most businesses. The ability to borrow at low interest rates has been reality for so long that comments suggesting a first rate hike in mid-2015 spooked some market participants. We have witnessed market drops over similar comments during the past couple of years, but strong economic data have more people believing that a rate hike will become a reality this time.

All of these are reasons to not be surprised by the current stock market decline. Do any of these points make experiencing pullbacks such as the one we are experiencing now any easier? That is debatable, but for most investors, the answer is probably "no." It is never fun to see account balances and individual investments decline by 10-30+% no matter how strongly historical data suggests that the decline will be temporary. So - what is the best course of action at this point?

What Action, If Any, Should Be Taken Now?

For most long-term investors simply staying the course and riding out decline such as the one we are experiencing now is likely the best course of action. I believe this to be the case for several reasons.

-First - numerous studies show that trying to "time the market" and side-step these declines is notoriously difficult to do. Individual investors who attempt to do so are pitting themselves against trading firms, hedge funds and other professional traders who make a living exploiting short-term market moves. Though market pundits often apply reasons to and rationalize these declines after the fact, predicting the beginning and end of these declines with any degree of accuracy is extremely difficult if not impossible, even for professional traders and investors.

-Second - historical long-term returns, particularly those seen in markets over the past 5-6 years, show that solid returns are achievable despite riding out these temporary declines. Many great investors and firms have achieved outstanding long-term returns without attempting to time these short-term market gyrations. I do not personally try to sell stocks to avoid declines, nor do I do so for clients. I simply do not believe I can consistently add value or returns by doing so.

-Lastly, current data seems to suggest that the U.S. economy is fairly robust, and there are no signs pointing to the beginning of a recession here in the U.S. For these reasons, I believe maintaining ones long-term investment strategy and not overreacting to what have historically been temporary declines is the proper course of action.

This not to say that market declines like the one we are experiencing now should be ignored. For long-term investors who have excess cash in their accounts - either from recent sales or new contributions - these market declines present a potential opportunity. I found myself using similar declines in 2010, 2011 and 2012 to make the majority of my new purchases of stocks and stock mutual funds for clients, and I will be looking to make similar purchases this time around. It is times like these when many stocks "go on sale" and are available for 10-40+% less than they were trading just weeks prior. Such declines in the value of these businesses defy rationality, but we know the stock market is anything but rational during times like these. Fundamentals go out of the window during these selloffs, and all stocks - regardless of future business prospects - decline in value indiscriminately, and emotion takes over. Legendary investor Warren Buffett has famously said that broad market declines are "falling tides that take down all boats" and advises long-term investors to "buy when there is blood in the streets" for this reason. Long-term minded investors who can avoid the panic and fear associated with these declines can profit handsomely by "being greedy when others are fearful" (another Buffett-ism), trusting their analysis associated with stock purchases, and having a willingness to "buy low" when there is an air of uncertainty in the market place. Buffett's results speak for themselves, and long-term investors would be wise to take his advice.

I have no idea how long this market sell off will last or how deep it will go, but - as I have done in the past - I will be looking to add to existing stock positions clients already own and to open new positions that have been indiscriminately punished and that represent what I believe to be a good long-term value. "Buying low" is much easier to do during times like this, and though doing so is often accompanied by some anxiety over the uncertainty of the timing and depth of such market declines, I believe historical data suggests it is the right course of action.

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