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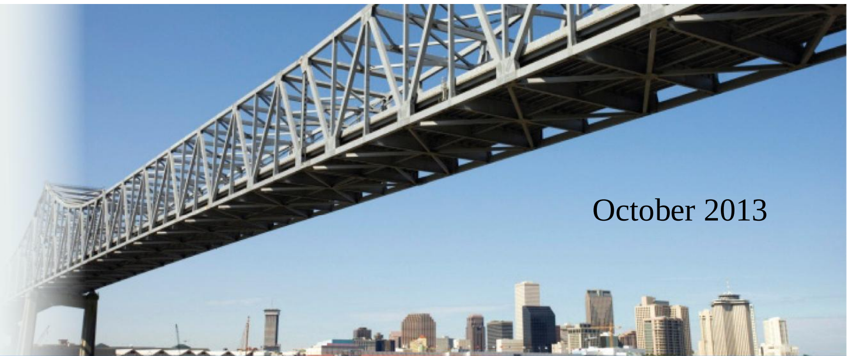

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Economic Comments

As we go to press, the ineptitude of our nation’s legislative and executive branches has reached new lows with the dual prong fiscal showdown occurring in Washington, D.C. The federal government has been forced to shut down for the first time in 17 years. Rather than agreeing to a new fiscal year budget (the shutdown of the government by the Republicans) or agree to make good on the nation’s existing debt obligations (the debt ceiling fight by the Democrats), our lawmakers are playing an enormously dangerous game of Russian roulette with the country’s future.

The federal government’s shutdown is quickly merging into the related, and even more pressing, debt ceiling crisis which will reach its climax by October 17th. On this date, the U.S. Treasury will have exhausted all possible tricks to avoid exceeding the nation’s Congressionally authorized debt limit. The only sure answer is that there will be no winners from this fight and one loser - the American people who will be hurt in both the near and the long term from the irrational actions of our so-called leaders. So far, the financial markets have remained highly complacent about the current turmoil as investors are convinced that a resolution will be achieved before October 17th. The very complacency of the markets, however, is encouraging even greater levels of brinkmanship by politicos as neither party feels much pressure from the financial markets, or their increasingly radicalized political bases, to resolve the issue.

Almost lost among the political turmoil of Capitol Hill and Pennsylvania Avenue was the Federal Reserve's mid September decision to NOT start unwinding its loose monetary policies. While Fed Chairman Bernanke had not promised a tapering of the current $85 billion/month bond buying program, he had managed expectations to suggest that this action was on the imminent horizon. Although the decision to continue the key bond buying program created new uncertainties for analysts, initial reaction from the bond and stock markets was very positive with both arenas rallying sharply in the immediate aftermath of the announcement. In support of the decision to continue the existing bond buying program, Chairman Bernanke alluded to some slackening of the economy in recent months. That being said, the deciding factor in sustaining the bond purchases was the threat to the economy of the fiscal showdown now playing out in Washington.

A bit of good news, however, was recently revealed by the country’s energy sector - the U.S.’s daily energy output (courtesy of new fracking technology) recently surged to the equivalent of 22 million barrels - greater than the world’s prior leading energy producer, Russia, at 21.5 million barrels/day. In the past five years, as the implementation of the technology has become more wide spread, U.S. imports of natural gas and petroleum have declined by 32% and 15%, respectively with a commiserate reduction in the U.S.’s trade deficit. Longer term, we believe that this trend will provide both improved stability and increased strength to the nation’s economic output.

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Economic Comments continued from cover

Prior to the September 30th federal shutdown, the economic data was still mixed. The nationõs factories showed increased activity as the September reading from the Institute for Supply Managements' manufacturing index rose to 56.2ð the highest level in almost 2 1/2 years. Also on a positive vein, last monthõs average income grew at its most rapid pace in 6 months. Further good news was evidenced by the number of people seeking new unemployment benefits sinking to its lowest level in six years, as fewer companies are laying off staff. Despite this upbeat news, and after peaking in July at a six year high, Septemberõs consumer sentiment index declined for the 2nd straight month.

While we remain cautiously optimistic about the intermediate term, the near term remains an area of appreciable concern. The one certainty coming from the current political stalemate is that Congress and the President are playing with fire as they continue with their recent bouts of economic brinkmanship. Both the near and longer term ramifications of this fight could be enormous. By some estimates, 4th quarter economic growth will be reduced by as much as 0.3 percentage points for each week that the government remains shut down. With the economy currently growing at an approximate 2.0% annual rate, a 2-3 week shut down could reduce the quarterõs growth by as much as 45%!

Meanwhile, the longer term ramifications of the government shut down/debt ceiling fight could be even more severe if, by even creating the real concern that the U.S. could actually default on its debt, investors start to question the hereto undisputed safe haven status of the dollar and U.S. debt. The result would be a sharp increase in the risk premium required by investors to purchase the U.S.õs debt and an enormous increase in the interest costs on the nationõs borrowings.

The crux of the matter is that our nationõs politicians must somehow work together and chart out a sustainable AND affordable level of government. In recent months, the White House has been touting the substantial reduction in the annual federal deficit. The problem is that even the non-partisan Congressional Budget Office projects that deficits are going to sharply increase starting in 2016. Recent budget reducing efforts have been focused on domestic programs and military spending. The real object of concern should be the dramatically increasing costs of our entitlement programs. As the Baby Boomer generation starts to retire over the next several years, these costs are anticipated to explode. Our nationõs politicians must find the strength of will to act as leaders to do what the public needs rather than as enablers only providing what the public wants.

What the U.S. needs, and has not had for almost 15 years, is spending matched with a sustainable level of tax collections. Until the big picture is resolved, bouts of frightening economic brinkmanship will only continue.

Analyst Corner

At an accelerating pace since the end of World War 2, the worldõs economy has become increasingly interconnected. A primary beneficiary of this rising level of global trade has been transportation facilitators such as third party logistics company C.H. Robinson (*NDQ: CHRW).* Operating with a vast network of transportation companies, CHRW has an ñasset liteò model which allows it to operate with relatively little fixed assets as well as minimal debt. This business model has allowed the company to navigate the slowdown in the global economy easily with per share earnings advancing almost 50% since 2008. As importantly, management maintains a sharp eye on shareholder value with an above average dividend that has been rapidly growing. While not appropriate for all investors, given the vagaries of international trade, shares of C.H. Robinson could be a worthwhile addition to the appropriate account.

Market Comments

Looking at the stock market versus the bond market this year, it has been a tale of two very different cities. While the bond markets are showing year-to-date losses in the face of increasingly eminent removal of the Federal Reserveôs monetary stimulus, the stock market has been partying like itôs 1999. At Septemberôs close, the S&P 500 had advanced almost 6% during the last quarter and almost 20% for the year to date. With the pending start of Obamacare, healthcare has led the market up, more than 28%, with the interest rate sensitive utility sector playing caboose with a gain of only 6%.

Prior to the Fedôs September announcement, the bond market had already pulled back appreciably in anticipation of the Fedôs reduced bond purchases. Although the fixed income market surged following the release of the September meetingôs minutes, bond prices remain substantially lower for the year. More importantly, if the Fed was right in its decision to reduce growth forecasts (and continue to delay the tapering of the bond buying program), this could foreshadow disappointments in 3rd quarter earnings reports.

Along with the upcoming earnings announcements, investors are primarily focused on Washingtonôs budgetary and debt ceiling issues. The key drivers for 3rd quarter earnings will be rising interest rates, the strengthening dollar, higher oil prices and the weaker than expected 2nd quarter GDP growth. In total, corporate earnings are projected to only grow 3.2% over 2012ôs performance. In fact, in advance of October earnings releases, a near record number of companies have made negative pre-announcements in an effort to lower investor expectations.

In gauging the overall strength of the market, additional concern comes from the continued tepid earnings growth - increasing by only low to mid single digits since the summer of 2012. While the stock marketsô performance has been strong this year, clearly gains have appreciably out-paced profits. After surging in the early part of the recovery from the Financial Crisis, earnings growth for the S&P 500 have come close to stalling recently with earnings for the 2nd quarter increasing by 3.8% and expectations for the 3rd quarter being slightly lower - for a 3.5% increase. With trailing 12 month price to earnings ratio now in excess of 19.0, the market is valued a third higher than its long term average. Moreover, on a 10-year adjusted basis, the marketôs valuation is almost 50% above average.

We are not necessarily forecasting that the market cannot chalk another gain in the 4th quarter, but rather stating if the market is to continue its recent advance, it will likely need the support of more robust earnings growth. A key tenet that we subscribe to is that the current relatively low interest rate environment has made stocks more attractive than bonds even if interest rates rise over the next few years. Even in the face of the recent divergence between stock valuations and earnings growth, we continue to view stocks favorably over the next several years. Shorter term risks like the fiscal showdown in Washington or the acquisition of nuclear weapons of Iran can certainly create near term market volatility. These are the types of risks that long term investors should be prepared to ride out and from which they will profit.

Performance as of 9/30/13

	Close	Month	YTD	1 Year
DJIA	15,129.67	2.27%	17.64%	15.59%
S & P 500	1681.55	3.14%	19.81%	19.35%
NASDAQ Comp.	3771.48	5.06%	24.90%	21.03%

	Quarter end yield	Prior Year end yield	Yield 1 year ago
10 yr. U.S. Treasury	2.62%	1.76%	1.64%

Planning Thoughts

Despite the last minute efforts of House Republicans, the first major phase of Obamacare rolled out on October 1st. Under the new law, and effective January 1st, individuals will be able to obtain health coverage from competing private health care providers. Central to the proposition is that health insurance acquired through these providers will have no exclusions for pre-existing medical conditions and that these policies will offer substantial subsidies for lower income individuals and families.

For those individuals who do currently have health coverage, and yet do not qualify for the health insurance subsidies, it could still make sense to spend time exploring the options available in your state. Depending upon your current health situation and medical needs, a more attractive health insurance option could now be available. A great starting point for this assessment is www.healthcare.gov. As always, in assessing any type of insurance, you should make sure that your unique needs and risks are identified and met through your proposed insurance coverage.

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