Timmons Wealth Management

Client Newsletter – Third Quarter 2013

Key Market Data

TWM Client Benchmarks	3Q2013
Aggressive Growth Strategy	6.26%
Capital Appreciation Strategy	5.12%
Balanced Return Strategy	3.96%
Broad Market Benchmarks	**3Q2013**
S&P500	5.24%
FTSE Global All-Cap ex-US	10.32%
Barclays US Aggregate Bond Index	0.57%
Barclays US Treasury Bill 1-3 Months	0.01%

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Timmons Wealth Management is a Registered Investment Advisor offering independent investment management and financial planning services to clients.

Putting the Recent Quarter in Perspective

A prominent investor and academic Robert Arnott once said *"In investing, what is comfortable is rarely profitable."* Investors are often unduly influenced by events in the immediate past and the latest news headlines. This tendency leads to investment decisions that are predicated more on fear than the achievement of long term goals. Though this mindset often serves to provide some level of comfort in the short term, it rarely leads to acceptable rates of return over the longer term. The second quarter of 2013 witnessed a sharp reversal of investor confidence as fears mounted in the face of pending Federal Reserve actions surrounding the tapering of its bond buying program. Bond and equity markets experienced selling pressure heading into the end of the quarter as a flight from risky assets ensued. Heading into the third quarter, it would not have been unreasonable to assume that these same worries that drove relatively weak returns in the second quarter would persist leading to additional market declines in the third quarter.

Yet despite these worries, the third quarter rewarded investors that were able to live with the temporary discomfort of staying invested and focused on the fundamentals that drive market returns over the long term. Strong returns across equity markets and improved returns in the bond market reinforced the benefit of a diversified approach to investing and sticking to a carefully formulated investment strategy. As the budget and debt ceiling battles in Washington continue to contribute to nervous markets and sporadic and indiscriminate selling, we encourage clients to remain confident in their long term investment strategies, ignore the short term noise and understand that ***in investing, what is comfortable is rarely profitable***.

Market Overview for the Third Quarter 2013

The financial markets faced numerous headwinds throughout the third quarter. Threats of military action in Syria, uncertainty surrounding the timing of the Federal Reserve's tapering of QE and continued dysfunction in Congress regarding the budget and debt ceiling all served to add to investor uncertainty. Despite these challenges, the US equity markets proved resilient with the S&P 500 posting strong total returns of +5.24%.[i] Value investing strategies underperformed growth strategies in the US, with small capitalization stocks continuing their YTD outperformance. In the wake of improving economic data throughout the Eurozone and China, international equity markets outperformed the US with a quarterly return of +10.32% as measured by the FTSE Global AC ex-US Index.[ii] Similarly, bond markets benefitted from the temporary reprieve provided by the Federal Reserve's decision to postpone tapering with the Barclays US Aggregate Bond Index posting a positive return of +0.57% for the quarter, the first quarter of positive returns for the index in 2013.[iii]

At the September FOMC meeting, the Federal Reserve surprised investors by delaying what was viewed by many as the inevitable start of its tapering program. Fed officials viewed incoming economic growth progressing at a moderate rate but requiring additional confirmation of its strength and sustainability prior to pulling additional stimulus from the economy. In addition, the Fed remained concerned about the fiscal deadlock in Washington and ongoing brinkmanship surrounding the budget and debt ceiling debates which could act as a drag on economic growth going forward. As if these challenges weren't enough, the sharp rise in yields and mortgage rates following the Fed's introduction of its tapering plans in May threatened the recovery in interest-rate sensitive areas of the economy like housing. As noted in previous newsletters, the yield on the 10 Year Treasury rose from 1.63% on May 2nd to 2.97% on September 5th, an increase of more than 82% in less than five months.[iv] Related to the spike in bond yields, mortgage rates increased from a national average of 3.29% on May 5th to a high of 4.51% on August 25th.[v] Though these rates still represent significant discounts to historical interest rate levels, the speed of the increase in rates was unexpected and negatively impacted consumer decisions to refinance while making new home purchases less attractive than even five months ago. The Fed's decision to delay tapering should have served as a poignant message to the markets about potential risks going forward, however the financial markets largely cheered the decision resulting in higher stock and bond prices. As the end of the third quarter approached, the markets once again focused on the looming US budget deadline of September 30th and debt ceiling deadline of October 17th. As reality set in that a quick-fix was less likely given Republican demands focused on defunding the Affordable Care Act and lack of any evidence of substantive negotiations, the US and international equity markets experienced selling pressures heading into the end of the quarter.

Though concerns about Washington seemed to dominate the discussion for the latter part of the quarter, the economic news emerging from the US was largely positive. US economic growth as measured by GDP was revised upwards to a positive +2.5% for the second quarter

2013 driven by strong gains in net exports and housing. Though the growth rate of GDP remains below the 20 year average of +2.6%, it did show marked improvement vs. the first quarter 2013.[vi] On the labor market front, the US unemployment rate fell from 7.6% in June to 7.3% in August continuing the downward trend albeit at a slower rate than many hoped.[vii] A key statistic that remains in focus is the labor force participation rate which has declined from above 66% in 2007 to 63.2% as of August 2013.[viii] For many economists, this declining participation rate is a worrisome sign of the volume of disenchanted job-seekers choosing to permanently leave the workforce as similar jobs and benefits to the ones lost have failed to materialize. In addition, many workers continue to be underemployed and job gains have been heavily weighted towards part-time employment. However, net job gains from August 2012 to July 2013 remain positive with average hourly earnings growth on a year-over-year basis increasing +2.2% as of August 2013.[ix] The question that emerges from these figures is if the long term unemployed are still employable particularly in the face of their apparent declining relevancy in setting wage rates. We expect these and other concerns to be at the forefront of future Fed discussions when the new Federal Reserve President Janet Yellen takes office in 2014.

Looking beyond the labor markets, the US economy continued to demonstrate promising advancements in the third quarter particularly in the areas of consumer health, housing and business activity. Household net worth rose to $76.4T in the third quarter 2013 vs. $69T in the third quarter 2007 driven by gains in the financial markets, rising home values and improving labor markets.[x] The housing market has played a critical role in the US economic recovery, with home inventories declining over the past year and housing prices increasing as measured by the S&P/Case Shiller Home Price Index. Household debt has continued to decline, with the percentage of disposable personal income required to service debt declining from 14% in the 3Q2007 to 10.4% at the end of the most recent quarter.[xi] Inflation, as measured by CPI, remains muted with prices increasing at a low annual rate of +1.5% in August, well below the 50 year average of +4.2%. Lower fuel prices have also provided a welcome boost to consumers with gasoline prices reversing from a peak of $4.00+ p/gallon in 2012 to a market average of $3.55 p/gallon in the third quarter. From a business standpoint, corporate revenue and profits have continued to rise as measured by the S&P 500, with profit margins near all-time highs, levels of leverage continuing to fall, increasing cash balances in company bank accounts and rising levels of dividend payments and share buybacks.[xii] All these factors continue to give us confidence in the future of the US economy and the valuation levels we see in the US markets today.

In a sharp rebound following multiple quarters of weak relative returns vs. the US markets, international equity markets produced the strongest quarterly gain seen since the first quarter of 2012 as measured by the FTSE Global AC ex-US Index. International market returns were driven by strong stock performance across European markets in places such as Germany, Spain, Italy and the UK. The economic data emerging from Europe during the third quarter was largely positive, with consumer sentiment improving and the Eurozone emerging from recession after 18 months with GDP growth of +0.3% in the second quarter

2013.[xiii] With Eurozone inflation coming in at +1.1% in September, the European Central Bank continues to have significant flexibility to supply additional stimulus should it be needed. Other leading indicators such as the European purchasing manufacturer's index (PMI) reflected positive growth for the first time in six quarters, providing additional evidence that the worst may be over for Europe. International equity markets also benefitted from improvements in the Chinese economy, with signs that industrial production hit a 6-month high in September. After initiating tighter lending controls earlier in the year to stem the expansion of credit, the Chinese government once again resorted to "old faithful" by initiating new credit-driven investments focused on large infrastructure programs domestically.[xiv] Though the recent bounce in economic conditions in China bodes well for the immediate future, some investors (us included) question the sustainability and costs of these actions over the longer term. Similarly, the emerging markets as measured by the MSCI Emerging Market Index recovered from the lows set earlier this year with a +5% return in the third quarter, still underperforming the broader international index and US equity markets.[xv] Though the short term rally was welcome to many investors who were caught unprepared and overexposed to the emerging markets earlier this year, we believe longer term structural issues remain intact which will likely continue to challenge emerging market economies over the next several years.

Despite a steady rise in rates during the early part of the third quarter, bonds benefitted disproportionately from the Fed's decision in September to keep its bond-buying program intact. Bond yields declined sharply after the September Fed meeting and investors exposed to longer term, more interest-rate sensitive holdings benefitted from the rise in bond prices. Similar to the reaction seen in emerging market stocks, emerging market bonds rallied as lower interest rates led to greater risk-taking by investors. Opinions continue to vary on the short term direction of rates from here, with some strategists arguing that rates may decline further as the Fed is forced again to delay tapering of its QE program in the face of weaker economic data caused by the ongoing government shutdown. Though yields may remain lower for a longer period of time than originally expected, we believe the "shot across the bow" seen in the summer bond selloff is a clear argument for prioritizing safety of principal over the reach for yield as many investors are currently inclined to pursue.

Outlook

As we look out to the fourth quarter, we remain largely constructive on the US equity markets despite the government shutdown and the rise in valuations vs. even nine months ago. We do not disagree that the US equity markets seem more fairly valued today at 14.3x forward earnings as of 09/30/2013, though these valuation levels remain below historical market peaks seen in March 2000 and October 2007 and below the 15 year average of 16.3x forward earnings.[xvi] In an October research report published by Yardeni Research, Dr. Ed

Yardeni notes that 2014 and 2015 analyst estimates for US companies continue to forecast growth for both corporate revenues and profits.[xvii] Should these estimates come to pass, increasing revenues and further margin expansion should aid earnings growth and lead to increased valuations for stocks translating into higher share prices.

Despite our relative optimism about the longer term prospects for the US economy, we would be remiss to avoid speaking about the risks that currently face the economy – namely Washington DC. The prolonged budget debate and government shutdown in the US will likely have a negative impact on the fourth quarter's GDP growth rate. A recent analysis performed by Guggenheim Investments noted that a week-long shutdown of the US government could cut annualized GDP growth by approximately 0.25% in the fourth quarter.[xviii] Though this temporary setback would be unlikely to derail the longer term recovery in the US economy, it could serve to push much needed growth out into the 2014 timeframe. Perhaps the greater threat facing both the US and global economy is the ongoing brinkmanship surrounding the debt ceiling debate. Though careless remarks have been made about the ability of the Treasury to prioritize US debt payments should the debt ceiling fail to be raised in time, any attempt to circumvent the debt ceiling would likely be viewed as a default under another name with severe market consequences. We remain confident that our Congressional leaders will avoid a debt default, though the solution may be nothing more than once again kicking the problem down the road by raising the debt ceiling for another couple of months.

From a global allocation perspective, we continue to maintain a larger allocation to the US equity markets vs. international equity markets, a positioning that detracted from performance during the third quarter yet has benefitted clients over the past 12 months. Though the news emerging from Europe is promising, we remain wary given the many challenges that continue to threaten Europe's recovery. With Angela Merkel's party once again winning the majority vote in the recent German elections, the Christian Democrats must build a coalition to ensure stability to arguably Europe's most important economy. Italy continues to face numerous challenges with the size of its public debt, weak economic growth, high levels of unemployment and poor business environment. Similarly, Greece continues to struggle and the debate surrounding additional bailout measures will likely continue to be a source of concern to the European markets. In terms of the emerging markets, we continue to maintain a small allocation to a diversified group of emerging economies but believe the recent rally in emerging market stocks largely ignores some serious challenges ahead. When the Federal Reserve does begin tapering, emerging market economies will face the challenge of higher interest rates at a time when many of these same economies are attempting to combat high levels of inflation and weakening economic growth. Heavy reliance by many of these economies on strong commodity prices and export driven demand by China has added to their challenges as Chinese commodity demand has ebbed and commodity prices have plummeted. Current account deficits and emergency actions to stabilize currencies as seen during the most recent emerging market selloff will likely continue to persist for a number of these same countries going forward. More

concerning, the future of China's economy remains a major question to us despite recent signs of improvement. China's credit bubble continues to grow with the Chinese government appearing unwilling or unable to mount a serious offensive to control the growth of credit and address China's housing bubble. Numerous Chinese industries continue to receive massive government subsidies for businesses that are not viable on their own, calling into question the effectiveness of Chinese government investment and its allocation of capital. We believe China remains a key longer term risk to the global economy, and continue to track developments in the country while minimizing direct investment exposure to China in client portfolios.

Our positioning across fixed income investments for client portfolios has remained largely consistent over the last several quarters. Earlier this year, we began making minor adjustments to reduce our intermediate term bond exposure while adding additional short term high yield and bank loan investments. We continue to favor capital preservation while focusing on identifying flexible solutions that can adjust when rates begin to rise while cushioning the blow caused by falling bond prices. Though this more defensive posturing may lead to temporarily underperforming more interest rate sensitive bond investments should rates decline further, we believe a more defensive positioning is warranted for clients with fixed income allocations given our expectation that the question is no longer if interest rates will rise, but when.

As always, we encourage our clients to maintain a long term perspective as investors and realize the inevitability of bumps along the way. We continue to believe the key to wealth accumulation and preservation is shunning the short term thinking and associated emotional tendencies that might sell newspapers and commercials but rarely lead to sound investment decisions. We encourage clients to reach out to us with any questions or concerns.

Operational Items for Clients

We hope you have received your **Third Quarter 2013 Portfolio Review** package via your secure web portal. If for any reason you have not been able to access the website or reports please contact our office for assistance. Your secure web portal can be accessed via our company site at **www.TWealthManagement.com** and going to **Client Center** tab.

Are we missing cost basis for holdings in your taxable brokerage account? If we have notified you of this previously, please work on obtaining the missing costs basis information prior to November 30th. We plan to contact clients again within the next several weeks to ensure all data is updated at Scottrade prior to the deadline.

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Wondering about Required Minimum Distributions? If you are over the age of 70 ½ or have an Inherited IRA currently receiving distributions, we will be processing RMD's for your accounts during the 4Q13. Please expect to be contacted with the appropriate paperwork in early November to ensure everything is in place prior to the year-end deadline.

Have you made your IRA Contributions for 2013? If you have earned income for 2013, you are likely eligible to make 2013 IRA contributions. Clients often max out on 401k contributions early in the year, and an IRA offers the opportunity to put an additional $5,500 p/year away for retirement ($6,500 if you are over the age of 50). If you have any questions about eligibility or your options, please let us know and we would be happy to discuss.

Did you know it is time to start thinking about tax planning? With investors experiencing strong returns in the market this year, it is time to start planning for capital gains. Please review your 2012 tax return to determine if you have carry-forward losses that might be used to offset gains. If you have any other questions about your potential tax liability as it relates to your portfolio please contact our office.

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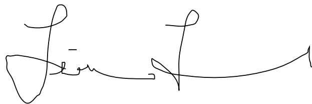
On behalf of Timmons Wealth Management, we would like to thank you for your continued trust in our firm. If there is anything we can do to help you please do not hesitate to contact our office.

Sincerely,



Liam Timmons, President

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References

[i] Source: Morningstar Office Index Return Data
[ii] Source: Morningstar Office Index Return Data
[iii] Source: Morningstar Office Index Return Data
[iv] Source: WSJ Market Data, Yahoo Finance
[v] Source: Zillow Mortgage Marketplace Rates
[vi] Source: Bureau of Economic Analysis
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[viii] JP Morgan, 4Q2013 Guide To the Markets
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[x] Source: JP Morgan Estimates, Bloomberg
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[xiii] Source: http://www.bbc.co.uk/news/business-23692102
[xiv] Source: WSJ, "Doubts Rise as China Touts Upturn," 09/13/13
[xv] Source: Morningstar Office Index Return Data
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[xvii] Source: Yardeni Research
[xviii] Source: Guggenheim Investments