The Return of Fear & Volatility

Global geopolitical tensions and concerns about slowing growth outside the United States took center stage throughout the third quarter. The rise of ISIS sent tremors throughout the Middle East while Russia's economy continued to soften in light of increased sanctions. The emergence of a Scottish referendum on independence, uncertainty about future Federal Reserve actions and an Ebola outbreak served to add additional fuel to the fire, bringing an end to the complacency which had settled over the markets in the first half of the year and the return of volatility.

Though low in absolute terms, large US companies were the strongest performers in the third quarter rising +1.13%.[i] Small companies performed poorly declining -7.36%[ii] as fears over valuations and the impact of rising rates on small company financing led investors to exit positions. In the face of weak economic data, European stocks declined -7.0%[iii], on par with international small and mid-sized stocks which declined -7.55%.[iv] Emerging Market stocks fell -3.49%[v], modestly outperforming other international developed markets. A moderate decline in bond yields and a growing aversion to risk during the quarter helped domestic bond markets produce a small yet positive return of +0.17%[vi], while commodities plummeted amidst waning global growth and falling inflation.

US Economy Improves as Recession Fears Fade

The US economy rebounded strongly in the second quarter with GDP growing +4.6%. Amidst actions by the Federal Reserve to wind down its bond buying program, unemployment levels fell to new lows of 5.9% in September, with the US economy adding an average of 224,000 jobs over the previous three months.[vii] Wage growth has begun to pick up (albeit slowly), while inflation remains subdued at +1.5%[viii] as of August. Auto sales have strengthened and are now above their longer term average. Lower oil prices will result in lower fuel costs for consumers, with Deutsche Bank estimating each -$0.01 decline in gasoline equates to $1B in annual savings for American households.[ix] Retail sales figures have continued to improve, driven by improving consumer confidence and healthier household balance sheets.

With US economic data showing signs of improvement, concerns have returned related to the Federal Reserve's plans for rate increases. The exact timing of rate increases remains unknown, though most would agree that a rate increase is likely at some point in 2015. Ironically, unexpected improvements in the US economy have begun to be viewed negatively, as stronger than expected growth could mean an earlier start to rate increases. Despite these worries, we view a gradual increase in rates as a welcome development which would indicate stronger US growth while increasing the availability of credit to homebuyers and simultaneously offering savers a better return on cash.

US Market is Fairly Valued but Still Attractive

As of the end of the third quarter, the US market[x] was trading at 15.2x forward earnings, in-line with longer term averages. From this perspective, the US market is fairly valued on absolute basis. However, on a relative basis, the US stock market is still attractive when comparing the potential total return of US stocks (dividends + earnings growth) to that available from other asset classes such as bonds or cash. Given low interest rates available on high quality bonds and negative real rates on cash, we believe the best option for longer term investors is having broad exposure to US stocks, particularly those that pay dividends and have the ability to grow earnings and dividends at a rate faster than inflation for the foreseeable future.

Europe - Waiting for Godot?

A strengthening US dollar was a key factor behind weak international stock market returns in the third quarter. The US dollar appreciated significantly vs. the Euro and other currencies hurting US investors with non-dollar denominated investments. Fears of deflation and slowing growth across the Eurozone have led to calls for the European Central Bank to take more aggressive action to boost the European economy. Eurozone GDP grew +0.2% in the second quarter reflecting a deceleration in growth, while inflation data across the Eurozone weakened to +0.3% in August. Europe continues to struggle with high levels of unemployment, anemic credit growth, Russian sanctions which are hurting the European economy as well as the growth-depressing impact of attempted deleveraging via budget cuts and higher taxes.

The European Central Bank has announced a number of new initiatives to boost growth including a new 250B EUR lending program, additional cuts to policy rates, and a new "QE-Lite" program targeting the purchase of asset-backed securities designed to drive higher the prices of real assets. The impact of these actions on the European economy remains to be seen. ECB governor Mario Draghi has commented that monetary policy alone is not enough and has called for Eurozone governments to engage in structural reforms necessary to revive confidence and investment.[xi] Germany has remained highly critical of ECB actions, fearing an emphasis on short term growth initiatives over necessary longer term fiscal reforms to address budget imbalances.

We continue to monitor the developments across Europe closely, and will adjust our investment allocations accordingly for clients. Our international investments remain broadly diversified and focused on high quality companies trading at reasonable valuations relative to longer term growth potential.

Divergent Stories across Emerging Markets

Returns across the Emerging Markets were highly varied throughout the third quarter. Russia and Brazil were among the worst performers, as both economies continued to contract amid rising inflation and further currency devaluation. A stronger US dollar and soft global growth has pushed commodity prices lower hurting commodity producing and exporting nations such as Russia and Brazil.

China has continued to battle slower growth favoring mini-stimulus plans while attempting to push through required reforms. Though it is apparent that in this tug-of-war the Chinese government will prioritize growth over reform, stock valuations across Chinese stocks have fallen significantly and many investors are now betting that pessimism has overshot on the downside. Other than India and Mexico, China was one of the few major emerging market countries to post positive stock market returns in dollar-terms during the third quarter.[xii]

Low Rates Persist for Bond Investors

Global Interest rates remained depressed throughout the third quarter, with bond yields across Europe touching new lows. With Germany's 10 Year Sovereign Bond paying a measly 0.93%, [xiii] it is not difficult to ascertain why the 2.51% yield on the 10 Year US Treasury is attractive for foreign investors who will also benefit from a rising dollar. Despite lower levels of Federal Reserve purchases of Treasuries, foreign demand along with a falling supply of Treasuries served to depress interest rates in the US bond market regardless of improving US economic conditions. It is now clear that this outside influence may remain for some time, particularly as long as the US bond market continues to offer attractive yields vs. foreign markets.

With long term bonds posting some of the biggest returns in the quarter, we see investors tempted to ignore risks and chase yields at any cost. We believe the minimal additional yield gained from extending duration (the sensitivity of a bond to interest rate moves) is insufficient to compensate investors from principal losses when rates eventually increase. We maintain our cautious positioning in our bond allocations across client portfolios, favoring shorter term bonds and alternative investment strategies that offer bond-like levels of volatility with the ability to better withstand a rising rate environment.

Current Portfolio Positioning & Outlook

- Portfolios remain in-line with long term allocation targets. Stock allocations are tilted towards large companies with an emphasis on valuations, cash flow, dividends and growth potential.
- We continued to reduce our below-average exposure to small companies during the quarter, while maintaining a small core positon for diversification purposes.
- For less risk-averse clients, we added a targeted Emerging Markets ETF during quarter to supplement client exposure to international stocks.
- We eliminated our small position in precious metal miners at the end of the quarter in the face of a strengthening US dollar and falling metals prices.
- Bond investments continue to position portfolios for an eventual rise in rates, and will likely lag longer term bond strategies as long as rates remain low or decline further. We view these lower relative returns today as a down payment on principal protection in the future.
- We believe the increase in volatility across global stock and bond markets is here to stay. We continue to emphasize the need to remain focused on longer term investment objectives as outlined in each client's Investment Policy Statement and to ignore the short term noise that crowds media outlets.

Did You Know?

- The Social Security Administration will release the 2015 COLA (cost of living adjustment) for social security benefits on October 22nd. The AIER estimates benefits will increase 1.6%-1.8% in 2015.
- If you were considering refinancing and missed the window last year, now might be a great time to apply for a lower mortgage. The 30 year fixed mortgage rate hit 3.97% on 10/16/14, the lowest level since mid-2013.
- The sudden resignation of legendary bond fund manager Bill Gross from PIMCO rocked the bond world in late September. Bill Gross ran PIMCO's flagship fund PIMCO Total Return, amassing one of the best performance track records of any bond fund manager. Though we have limited exposure to the fund across client accounts, we are currently evaluating our existing holdings and will make any changes we deem necessary.

Market Return Data for 3Q2014

Broad Market Benchmarks	3Q2014
S&P500	1.13%
DJIA	1.87%
Russell 2000	-7.36%
FTSE Global All-Cap ex-US	-5.27%
MSCI Europe	-7.00%
S&P Developed Ex US Small Cap	-7.55%
MSCI Emerging Markets	-3.49%
Barclays US Aggregate Bond Index	0.17%
Barclays US Treasury Bill 1-3 Months	0.01%
Bloomberg Commodity Index	-11.83%
CBOE Interest Rate 10 Yr Treasury	2.51%
Consumer Price Index (CPI-U) 12 Month	1.70%
TWM Client Benchmarks	**3Q2014**
Aggressive Growth Strategy	-0.17%
Capital Appreciation Strategy	-0.09%
Balanced Return Strategy	-0.03%

Disclosures

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i S&P500 Total Return
ii Russell 2000 Total Return
iii MSCI Europe NR USD
iv S&P Developed Ex US Small Cap
v MSCI Emerging Markets
vi Barclays US Aggregate Bond Index
vii US Bureau of Labor Statistics, September 2014
viii August PCE Index year over year change
ix Brett Ryan, US Economist at Deutsche Bank
x S&P500
xi http://www.reuters.com/article/2014/10/01/us-ecb-draghi-idUSKCN0HQ4XB20141001
xii MSCI China NR US, MSCI India NR USD, MSCI Mexico NR USD
xiii European Sovereign Yields, 9/26/14, JPM Market Insights