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Economic & Market Summary
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While it doesn't make for exciting headlines and it could be much better, the U.S. economy has now clearly achieved a state of stabilization and modest growth. Fears of a return to the Great Recession of 2008-09 are finally receding, confidence is improving, and equity markets have been strong. Residential investment and consumer spending have remained bright spots. Business investment has been uneven, reflecting cautious leadership and regulatory headwinds, but is still contributing positively, driven primarily by reductions in financing and operating costs. To understand potential risks to continuing GDP growth, the salient question becomes, where are excesses in the economy? Government spending and debt are the most obvious answers. While a collapse of housing activity in the previous economic cycle ultimately led to a deep recession, a reduction in government expenditures won't derail GDP growth. Contributions to the previous 12 months' 1.6% GDP growth have been personal consumption (+1.3), residential investment (+0.4), business investment (+0.3), inventories (0.0), net exports (+0.1), and government spending (-0.4). Concerns about the sequester's detrimental effects on the private economy appear exaggerated. A certain level of government spending is rational, but government debt approaching ~100% of GDP is problematic and is why the U.S. budget debate has returned to the spotlight. Our 2013 GDP growth estimate remains 2% and it would not be surprising if 2014 growth were similar.

Without fanfare, the Euro Zone has likely eclipsed the nadir of its recession with Germany, UK, Portugal, Italy, and Spain reporting positive and/or accelerating GDP growth. Ireland and Greece have improved to a lesser degree. Emerging economies are mixed with acceleration in Brazil and positive but decelerating growth in India, China, Russia, and Mexico. Japan's economy accelerated in the second quarter with annualized GDP growth of 3.8%, one year after emerging from recession. Unsurprisingly, geopolitical tempers are flaring in the Middle East, presenting a near-term risk.

Late in Q3, the Federal Reserve unexpectedly delayed reducing its QE program, with gridlock in Washington likely a contributing factor. Another likely consideration is the expectation that Fed Chairman Ben Bernanke will retire at the end of his term on January 31, and that he will be replaced by Janet Yellen, the current Vice Chairman. Dr. Yellen should provide a smooth transition given her extensive experience in the Federal Reserve System, although we fear she may favor unnecessarily extending QE. Economic data since May, when the Fed first discussed reducing QE, would seem to support a tapering of the program. Core inflation has increased to 1.8% from 1.7% and the unemployment rate has declined from 7.6% to 7.3%. To be clear, with a falling U.S. deficit, not reducing QE is equivalent to expanding it. The 10-year Treasury yield increased from 1.6% in May to a high of 3% in September, settling at 2.6%. We anticipate yields will rise unevenly creating dislocations in fixed income and to a lesser degree equities. These moments should be viewed as opportunities.

The S&P 500 currently trades at 16x 2013 EPS estimates and 15x 2014 after a year-to-date return of 19.8%. Profit growth is estimated to decline from 8.4% in 2013 to 5.7% in 2014. Our valuation models show the stock market approaching fair value, although with interest rates remaining historically low and with the economy continuing to recover from an unusually deep recession, it is hard not to remain bullish on the stock market generally. Within the universe of equities, through diligent research and analysis, we continue to find attractive values in high-quality businesses with clearly identifiable competitive advantages.

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To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address above.