Altamont Wealth Management

Third Quarter 2013 Performance

“The individual investor should act consistently as an investor and not as a speculator.” *Benjamin Graham*

Third Quarter 2013 Benchmark Index Returns	Third Quarter	Year- to-Date
Large-Cap Benchmarks		
S&P 500 iShares	5.5%	19.7%
S&P 500 Growth iShares	6.8%	19.4%
S&P 500 Value iShares	4.0%	19.9%
Mid-Cap Benchmarks		
S&P 400 Midcap iShares	7.9%	23.4%
S&P 400 Mid Growth iShares	8.2%	22.5%
S&P 400 Midcap Value iShares	7.1%	24.0%
Small-Cap Benchmarks		
S&P 600 iShares	10.8%	28.8%
S&P 600 Growth iShares	12.1%	29.6%
S&P 600 Value iShares	9.7%	27.5%
Other Benchmarks		
MSCI EAFE Int’l iShares	11.4%	14.5%
MSCI EM Int’l iShares	5.8%	-6.9%
Vanguard Total Bond ETF	0.6%	-2.0%
DJ-UBS Commodities iPath ETF	2.1%	-9.9%

Sometimes the never ending soap opera (vis-à-vis the government, the markets, businesses and consumers) borders on the absurd. The markets respond to the tune played by the Federal Reserve as well as to the collective actions of businesses and consumers. Usually the rules of engagement between the Fed and other entities is clear and the rules are followed, but every once in a while there’s a glitch. When the Federal Reserve deviates from its standard methods of communicating and surprises the markets with unexpected comments at unanticipated times, the results can be unexpected.

So in May when Bernanke, Federal Reserve Chairman, hinted during a speech that the Fed would be considering scaling back its massive Quantitative Easing (QE) program due to the improving economy, the markets were surprised. Instead of a moderate decline the markets became volatile and triggered a global sell-off. Interest rates began to rise and the stock and bond markets fell through June. At the end of the Second Quarter the stock market had backed off its highs and the bond market had fallen as well. Especially hard hit were emerging markets and TIPS (Treasury Inflation Protected Securities).

So this takes us to the Third Quarter where the Fed’s surprise guidance led to a surprise policy clarification. The Fed surprised the markets by reversing its May guidance; stating it would not start easing off the current Quantitative Easing (QE) program and that it would keep rates steady at current lows. The decision to maintain its $85 billion a month purchase of bonds reflects the continued sluggishness of the U.S. economic recovery and concerns about the fiscal uncertainty in Washington. This all conspired to increase market volatility, making the markets unstable and prone to over react to any changes or uncertainties.

After a bumpy summer, bond markets improved. The bond market is still negative for the year but due to revised Fed guidance rates fell and bond market recovered some of its losses. The Vanguard Total Bond ETF rose almost 1% in the Third Quarter, recovering a third of the losses experienced in the Second Quarter.

The U.S. stock markets rallied strongly with the riskiest parts of the market performing the strongest. So the more volatile S&P 600 Small Cap index rose 10.8% while the S&P500

Large Cap index increased a more sedate 5.5%. U.S. Growth also trumped Value stocks consistently across all sectors of the market. S&P500 Growth gained 6.8% while the S&P500 Value index rose a more temperate 4.0%.

International stock markets recovered in the Third Quarter after an unfortunate first half of the year. Developed markets (MSCI EAFE) were up over 11%, outperforming emerging markets (MSCI EM) which grew 5.8%.

The Trap of a Luke Warm Economy

Why is the Federal Reserve having trouble deciding when the economy is strong enough to handle tapering the market support they have been providing? Because though the economy is growing it is not growing strongly. It is just doing OK at best. Economic growth on many fronts is respectable but just not gathering any steam. The economy is like a car that is going a consistent 15mph in a 50mph zone and shows no inclination to speed up.

The reason; we are in a self-actuating cycle of stagnating demand and supply. Companies are not hiring unless in dire need. They are also not expanding and reinvesting. Interviewed CEOs are consistently saying they do not see an increase in demand to justify risking additional capital associated with hiring more workers and investing more capital. They want to avoid a repeat of 2008 when demand for their goods disappeared and they were unable to raise new capital. Without the guarantee that demand is increasing CEOs do not want to bet additional capital and then get caught short.

Why isn't demand increasing? Well, due to uncertainty companies are only purchasing the goods and services that are absolutely necessary. The Government is surly not spending more, and in fact is purchasing less every time it shuts down. That leaves consumers to pull us out of these morasses. Consumer demand has increased but has lately stalled because the unemployment rate is still high (because companies and the government are not hiring). Third Quarter unemployment rate stubbornly hoovers around 7.3%. Consumer spending in the Third Quarter increased 1.5%, but that is well below the pace set in the First Quarter of 2.3%. So consumer demand alone will not be enough to pull us out of this sluggish growth cycle.

The gist of it is that everyone is standing around waiting for everyone else to make the first move. Hence the self-actuating cycle of stagnating growth.

This is why the government shutdown, sequestration and threatened default is so destructive. It further exacerbates the current economic morass. It adds more uncertainty for businesses and consumers. The financial ratings agency Standard & Poor's stated that the shutdown "to-date has taken $24 billion out of the economy," and "shaved at least 0.6 percent off annualized fourth-quarter GDP growth. The country's Gross Domestic Product is the sum total of all goods and services. These estimates are for the overall economy, taking into account not just federal wages and productivity, but all the ripple effects and costs as well. So just the physical shutdown significantly hurt the growth rate and this doesn't even include the cost associated with added uncertainty of further cuts and shutdowns. It's like our politicians are playing Russian roulette with our economy. If they play long enough they might just shoot a bullet that could really damage this fledgling economy.

The one part of the economy that is showing promise is the housing sector. It has been a bright spot, strengthening consistently over the last twelve months in an otherwise fitful recovery. Residential housing rose 14.6% in the Third Quarter. This is a slight pickup from the gains of the first half of the year. Experts are concerned that the gains in the housing markets are unsustainable. They worry that the Housing market could cool as interest rates rise further causing, mortgages to become more expensive. The Federal Reserve is still keeping interest rates low at least for the near term. So five years after leading the economy down, the housing sector is helping to keep it afloat.

This is not a "Feel Good" economy. Growth remains sluggish and economic news mixed. The degree of uncertainty among economists and market experts is unusually high. Businesses continue to be conservative and the Government shenanigans haven't helped. Guidance from the Federal Reserve has been muddled by the looming change of leadership. Fed Chairman Bernanke is retiring in January and Janet Yellen is taking the reins (that is if Congress approves her appointment). Yellen and the Fed Board will decide when the Federal Reserve will begin weaning the economy and markets from all the support the Fed has provided. It will be a tricky process that will require delicate balance to avoid economic turbulence.