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Market Commentary
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Introduction

In the third quarter of 2014, volatility made a comeback as the US diverged from the rest of the world by showing economic improvement in the face of international challenges. As we expected, 2nd quarter GDP came in well above market forecasts at 4.6%, the largest quarterly gain since the 4th quarter of 2011. US growth was spurred by an awakening consumer, coupled with stronger business spending. We believe the consumer will continue to strengthen, as energy costs decline due to the US Energy Renaissance. Lower gas prices have had a real impact on the consumer since it is estimated that every 1 cent-per-gallon decrease in the price of gas translates to a $1 billion decrease in household energy spending. Globally, the economic news and market performance was less positive. An uptick in geopolitical tensions, contentious elections in several emerging markets, continued weak growth and an unproven stimulus plan in Europe weighed on developed and emerging markets alike. We believe these factors will drive investments into US equities and fixed income, while continuing to strengthen the US dollar over other currencies.

US Equities

The S&P 500 ended the quarter higher, up 1.13%, marking the seventh consecutive quarter of gains for the index despite some rockiness in July and September. Growth stocks outperformed value stocks, reversing a trend we had seen in the first half of the year. Despite mixed US economic data throughout the quarter, concerns overseas have highlighted the strength and stability of the US economy. Weaker than expected housing data and wage growth this quarter were met by positive data from US corporations as second quarter earnings continued to reach record highs. This was driven by better than expected sales rather than the cost cutting we've seen over the last several years. The market was also supported by positive labor market news that should provide a tailwind for the consumer and prop up future earnings. The unemployment rate dropped to 5.9% and the number of people filing for unemployment dropped to the lowest level since 2001. Although large-caps are our largest equity allocations, diversification into other US equities did not prove to be beneficial, since the S&P 500 was the clear winner. The S&P is up more than 9% year to date; the Russell Midcap Index was down -2.04% and the Russell 2000 Index, which tracks small cap companies, was down -7.65% as investors bet that they had become overvalued.

International Equities

Nearly all international equities faced a difficult quarter as the rest of the world underwhelmed in comparison to the positive news in the US. This has caused the US dollar to strengthen against most international and Emerging Market currencies. The MSCI EAFE Index, which tracks developed market stocks, was down -5.48% over the quarter and is now negative so far this year. European Central Bank President Mario Draghi announced plans to step up stimulus, consisting of cheap loans to banks and purchases of bank loans, in response to the slow growth, high unemployment, and risk of deflation in Europe. Questions remain about the size and effectiveness of the stimulus. Sanctions on Russia, a slowing German economy, and a weakening euro were also drags on European equities. Following a strong rally to start the year, the MSCI Emerging Market Index lost -3.39% in the third quarter as investors grew concerned that weaker commodity prices, a stronger dollar and rising rates in the US following the end of the taper may lead to trouble ahead for emerging countries. Worries about China's economy worsened following declines in imports, foreign investment, domestic loans and manufacturing. Frontier Markets were the only bright spot internationally, up 0.51% during the quarter, the sixth consecutive quarterly gain. Due to the weakness in commodity prices globally, we are beginning to worry about the impact these lower prices will have on both Frontier and Emerging Markets. Many of these countries are commodity export driven economies that could experience heightened volatility if commodity prices sustain these low levels.

Fixed Income

For the third consecutive quarter, bond prices increased as rates declined, with the 10 year Treasury yield falling from 2.53% to 2.49%. Unlike the first half of the year, we saw much more volatility in the fixed income market. The Barclays Aggregate Bond Index rose 0.17%, but other areas of the fixed income market struggled, with the Barclays High Yield Corporate Index down -1.87% and the Barclays Global Aggregate ex US down -4.83%. We believe external factors are contributing to the continued low interest rates within the US, despite the strong 2nd quarter GDP, further reduction of Quantitative Easing and expected rate increase by the Federal Reserve. The US Treasury yields, although at historically low levels, are high compared to European bonds, which are being driven down by weak economic fundamentals and aggressive monetary policy by the European Central Bank. European investors are choosing US bonds since they are yielding higher than the 10 Year German government bond near 1%. Furthermore, while the Federal Reserve is buying fewer Treasuries, other central banks like the Bank of Japan are stepping up purchases to fill the void. We continue to believe interest rates will eventually rise due to the improving US economy and Federal Reserve tightening, but our forecasts have been pushed out further because of the external forces at work.

Alternatives

In a quarter in which there was a lot of volatility within both the fixed income and equity markets, our alternative allocations played a key role in diversification. We continue to position our alternative allocation with two diversifying strategies, Market Neutral and Managed Futures, and one alpha generating strategy, Master Limited Partnerships. For the quarter, each asset class posted positive returns, with the Alerian MLP Index up 2.73%, Credit Suisse Managed Futures Index up 5.12% and market neutral strategies, represented by the Credit Suisse Long/Short Liquid Index, up 0.85%. MLPs have been our top performing investment for the year (+19.48% YTD Alerian MLP Index) and we still believe in the asset class, as the North American Energy Revolution continues to strengthen. The US recently surpassed Saudi Arabia as the largest oil producer in the world and is already the largest producer of natural gas.

Real Estate

Poor housing data coupled with volatility in interest rates hampered the real estate market this quarter. The Dow Jones US Real Estate Index was down -2.67% this quarter, but is still up 13.32% YTD. After a strong rebound in the second quarter, new housing starts tumbled in August, falling below a 1 million annualized rate and well below the 1.5 million rate that is considered normal. Home price growth slowed, with the S&P/Case-Shiller Home Price Index up 5.6% in July compared to 6.3% in June. We believe the high student loan debt is prohibitive for first time homebuyers and higher lending standards by banks have led to the slower than expected housing recovery.

Conclusion

As we mentioned in our previous commentary, this is now the fourth largest bull market in US history. Some investors may be questioning how long this run can continue, but we still feel confident the rally is being driven by strong economic data and rising corporate profits. With the strengthening US dollar and rising geopolitical risk, we believe US equities will remain attractive compared to their global counterparts. While markets may need to adjust to new Federal Reserve policy, historically rallies can continue long past the time when the Fed begins to raise rates. Despite our mostly optimistic views on domestic equities, fixed income and alternatives will continue to play a key role of diversification in the event of added volatility from speculation surrounding the Federal Reserve's tightening and this year's midterm election.