

ECONOMIC OUTLOOK

Summary

The economy showed signs of slowing during the latter part of the third quarter. The headwinds of a slower labor market, combined with rhetoric surrounding the debt ceiling crisis and the potential, and then realized, government shutdown, appear to have affected the consumer. The Conference Board's consumer confidence index fell in September to its lowest level since May. The consumer seems more cautious in spending.

The ISM manufacturing index rose slightly in September, although the component for new orders indicated a slowing of underlying growth. The more important ISM non-manufacturing index, which represents the large majority of the economy, went the other direction and declined in September. Although there was some growth in the new orders component, the majority of other components was soft and indicated slowing growth. This softness was especially bad for the health of the labor market. In addition to the Federal Reserve's focus on the labor market as a determinant of when to change its interest rate policy, the condition of the labor market has a significant impact on the consumer. The better the consumer feels about job prospects and future wage increases, the more the consumer is willing to spend. The housing market continues to show higher sales, but the increase in interest rates has caused borrowing costs to increase and may affect future sales.

The government shutdown has created issues in the labor market, and not just with government jobs. Ancillary impacts have caused issues in the private sector as well. The length of the shutdown will be the key to determining how much of an impact there is on economic growth. The slowdown in the labor market, the issues in Washington and the resulting cautious approach from the consumer appear to have led to slower

growth in the third quarter, and it is expected to continue into the fourth quarter. We do not anticipate anything greater than a slowdown. Until there are signs of an improvement, the Fed will most likely continue with its current policy, which could then lead to better times in the new year.

Positives

ISM manufacturing index rose again in September

Housing market continues to show positives, with an increase in existing home sales

The Conference Board's Leading Economic Index rose in August to its highest level since April 2008

Negatives

The Conference Board's consumer confidence index declined in September

ISM non-manufacturing index fell in September, indicating slowing growth

An increase in interest rates has led to higher borrowing costs

Unknowns

Ultimate impact on the economy of the government shutdown and debt limit debate

EQUITY OUTLOOK

Summary

Equity markets recorded broad-based gains in September, with international stocks leading the way as the MSCI EAFE gained 7.1%. Domestically, the S&P 500 rose 2.97%, while the NASDAQ charged ahead 5% (absolute price returns).

The industrials and discretionary sectors rose 5.5% and 5.3%, respectively. Both the utilities (+0.7%) and telecommunications sectors (-0.6%) – considered bond substitutes – lagged considerably.

Most important, year-to-date the S&P 500 is up 17.9% and the NASDAQ has jumped 24.9%.

Last month, we wondered whether the Federal Reserve would stand firm with its monthly asset-purchase program, since vital readings on unemployment and inflation were well off target. In mid-September, the Fed reaffirmed its commitment to the current program, at least until the next FOMC meeting.

Markets hate uncertainty. Unfortunately, with the liquidity crisis at least temporarily behind us, we find ourselves in the middle of a federal budget impasse and an ongoing government shutdown, and the looming fight over raising the debt ceiling is right around the corner in mid-October.

If that weren't enough, the Affordable Care Act is now open for business, and several high-profile corporations already have announced plans to shift large segments of employee coverage – most notably retirees – to the public exchanges.

We expect such disruptions will have a negative impact on both GDP and corporate earnings estimates for this quarter. Consumer confidence, which held up remarkably well

throughout the summer, is not immune to all the uncertainty emanating from Washington. Indeed, Fed Chairman Ben Bernanke cited such political friction as one factor that influenced the Fed's decision to hold fast on its current path of monetary accommodation.

With markets at all-time highs and plenty of capital gains inside portfolios, we believe we could see a rough patch for the markets near term as uncertainty drives short-term traders to the sidelines.

Positives

Housing and auto sales robust

Northern Europe appears to be bottoming

Monetary policy steady

Negatives

Washington, D.C. gridlock

Probability of earnings disappointments increased

Unknowns

Syria/Iran

FIXED INCOME OUTLOOK

Summary

September brought a reversal in interest rates and sparked a bond rally across all major sectors. Finishing at 2.61%, the 10-year Treasury rallied 17 basis points and beat returns on shorter maturity bonds, but underperformed 2- to 7-year maturity Treasuries on a duration-adjusted basis. The 3-year Treasury was the best performer on the yield curve, dropping a whopping 21% in yield, from 0.78% to 0.61%. Mortgages and TIPS were the top-performing sectors this month, while corporate bond spreads finished unchanged, resulting in a slight underperformance to Treasuries and the Aggregate Index.

The Fed surprised the markets during the month by backing away from an expected announcement regarding a reduction in its bond-buying program. This was a marked reversal from statements made by the Fed since early May, seemingly preparing the markets for the dreaded tapering. Its reluctance to taper probably stemmed from market rates being substantially higher than in the spring. The 10-year Treasury yields finished the month about 1.00% above May levels, and 30-year mortgage rates – at 4.50% – have created headwinds for the fragile housing recovery.

Also notable during the month was Verizon's \$49 billion bond issuance, the largest corporate issuance ever. This type of opportunistic debt issuance will likely continue as rates remain low and companies seek to leverage balance sheets by buying back stock or funding M&A transactions. This transaction blew away Apple's previous record issuance of \$16 billion earlier this year. With corporate spreads near post-crisis lows, company-specific credit events must be monitored closely because shareholder-friendly announcements often lead to painful moments for bond investors.

Markets remain on edge with a government shutdown under way, a debt ceiling fight around the corner and a new Fed chairperson nomination forthcoming. It would not surprise us to see tapering postponed until 2014, and the new Fed chairperson push the ultimate wind-down into 2015. Those conditions would be consistent with a range-bound Treasury market for the remainder of the year.

Positives

Inflation expectations remain contained and well below Fed targets; lowered 2014 Fed inflation projections

Steep yield curve provides increased return potential from rolling to lower yields

Negatives

Ever-increasing Fed balance sheet risks a disorderly bond market unwind

Retail inflows to bonds are still weak; Treasury market volatility is lower, but still elevated

Unknowns

U.S. fiscal policy battles; geopolitics: Egypt, Syria, Iran

Degree and timing of Fed security purchases tapering; appointment of FOMC chairperson
