Perspective

At a Glance...

2014: A Third Quarter Update

A quick summary of economies & markets for you.

Announcement:

Stocks ultimately advanced across Q3 2014 with the S&P 500 closing at a new peak of 2,011.36 on September 18. Still, the 3-month gain of the index was minor at 0.62%. A raft of indicators showed the economy in reasonable health, but not so healthy that the Federal Reserve was motivated to alter its exit plan for QE3. Home sales were up and down in the quarter; prices of key commodities fell. Overseas manufacturing gauges left Wall Street unimpressed; performance of foreign stock indices varied greatly. Questions emerged about how well the aging bull market might fare with oncoming shifts in U.S. monetary policy.[1,2]

Domestic economic health. The Federal Reserve described the interval between the end of easing and the eventual alteration of the benchmark interest rate as a "considerable" time. "No news" at the Fed was good news for stocks.[3]

Household confidence surveys were in disagreement. The University of Michigan's consumer sentiment index advanced from 82.5 at the end of June to 84.6 as September wrapped up; the Conference Board's consumer confidence index went from a (revised) June mark of 86.4 to 86.0 in September.[4]

By September, the jobless rate was down to 5.9%, 0.2% beneath where it was in June. Employers added 243,000 new workers in July, 180,000 in August, and another 248,000 for September. The U-6 rate (unemployed + underemployed) had dipped to 11.8% by the end of the quarter.[5]

Retail sales were up a healthy 0.6% in August, and the Commerce Department revised July's headline number to show a 0.3% gain. Households didn't have to contend with sudden inflationary pressures – the year-over-year rise in the headline and core Consumer Price Index was just 1.7% in August. In July, the headline CPI had shown a yearly gain of 2.0% and the core CPI a 12-month gain

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of 1.9%. (Both the headline and core Producer Price Index showed 1.8% annualized inflation by August.)[4]

Summer brought huge fluctuations in headline durable goods orders: +22.5% for July and -18.2% for August. Core hard goods orders, minus aircraft, were simply down 0.5% for July and up 0.7% in August. Amid all this, the influential purchasing manager indices maintained by the Institute for Supply Management approached the 60 mark – the factory PMI went 57.1, 59.0 and 56.6 across the quarter, while the services PMI went 58.7, 59.6 and 58.6. In sum, solid expansion. Looking back a bit further, the federal government concluded that America experienced 4.6% growth in Q2.[4]

In Washington, the Federal Reserve gradually tapered QE3 on schedule; the final cut was still slated to occur at the October policy meeting. The Federal Open Market Committee's rather dovish September statement was a bit more optimistic than its previous assessment of U.S. economic conditions, citing a "moderate" pace of growth.[3]

Global economic health. As Q3 ended, a shaky truce signed on September 5 between Russia and Ukraine threatened to collapse with Russian separatists again inflicting casualties on Ukraine's military and civilians. Meanwhile, Ukrainians were facing the prospect of a wintertime natural gas cutoff from Gazprom (Russia's natural gas supplier), even with the European Union trying to broker a deal. With 15% of the natgas Europe uses traveling through Ukrainian pipelines, the EU feared interruptions in supplies to Ukraine might also impact other eastern European economies.[6,7]

Speaking of disruption to energy supplies, the ISIS threat did not send NYMEX crude prices soaring in Q3 – even though ISIS was reaping as much as $3 million a day smuggling fuel from Syrian oil refineries it had captured by the end of the quarter. September ended with U.S.-led air strikes on these facilities.[8]

Manufacturing abroad wasn't quite as robust as it was in America. By September, China's official PMI was at 51.1, little changed from the 51.0 reading for June. HSBC's private sector China PMI drifted downward from 50.7 at the end of June to a barely expansionary 50.2 at the end of September. The quarter ended with the eurozone manufacturing PMI showing tepid growth at 50.3 for September, which was a 14-month low; Markit manufacturing PMIs for Germany, France, Austria and Greece were all below 50 as Q3 concluded. Eurozone inflation diminished to 0.3% for September, a 5-year low.[4,9]

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World markets. Some of Asia's stock markets did very well in Q3: Shanghai Composite, +15.40%; Sensex, +4.79%; Nikkei 225, +6.67%; Manila Composite (PSE), +6.41%. In troubled Hong Kong, the Hang Seng fell only 1.11% on the quarter; Australia's ASX 200 lost 1.91%, the Asia Dow 5.80%. In Europe, the DAX lost 3.65% for Q3, the CAC 40 0.15%, the FTSE 100 1.80%, the Europe Dow 8.23% and the RTS a dismal 17.74%; the STOXX 600 eked out a Q3 gain of 0.36%. As for various North American and South American stock markets, the TSX Composite went -1.22%, the IPC All-Share +5.26%, the Bovespa +1.78% and the Dow Jones Americas -0.78%. How about the MSCI World Index? It dipped 2.58%. The MSCI Emerging Markets Index fell 4.33%. As for the Global Dow, it gave back 2.73% for the quarter.[2,10]

Commodities markets. Between June 30 and September 30, the U.S. Dollar Index advanced 7.72%. With a gain like that, commodities were in for an awful quarter. Metals plummeted. Gold took an 8.4% drop and settled at its YTD low of $1,211.60 on September 30. Silver sank 19.0%, wrapping up Q3 at $17.06. Platinum lost 12.3% for the quarter, palladium 8.1%. (Even so, palladium ended Q3 at +7.9% YTD; gold finished the quarter at +0.8% YTD.)[11,12]

Ag futures were all over the board – for example, cotton lost 17% across the quarter, sugar 8.7% and orange juice 1.3%, but cocoa rose 5.5% in Q3 and coffee advanced 10%. Oil lost 13% to settle at $91.16 a barrel on September 30 (which was its worst day on the NYMEX in nearly two years); that was the cheapest price for WTI crude seen since May 2013. There was just too much supply sitting around. RBOB gasoline futures sank 16% for the quarter.[13,14]

Real estate. Resales? Up 2.2% for July, down 1.8% for August by the estimation of the National Association of Realtors. New home buying increased 18.0% in August according to the Commerce Department, on the heels of a 1.9% improvement in July. Subsequent revisions may even the ups and downs out; the takeaway was that the housing market was still reasonably healthy, though the August dip in existing home sales was unexpected.[4]

The pace of annual home price gains moderated – at least according to the S&P/Case-Shiller home price index. The overall July index (measuring annual and monthly price differences over 20 metro areas) showed home values up 6.7% over the past 12 months compared to the double-digit annualized gains of 2013.[4]

Mortgage rates crept up across Q3. Back on June 26, Freddie Mac's Primary Mortgage Market Survey noted an average rate of 4.14% on the 30-year FRM. At

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that date, rates on 15-year FRMs were averaging 3.22%; the average interest rate on the 5/1-year ARM was 2.98%, the mean interest rate for the 1-year ARM 2.40%. On September 25, the averages were noted as follows: 30-year fixed, 4.20%; 15-year fixed, 3.36%; 5/1-year ARM, 3.08%; 1-year ARM, 2.43%.[15]

Looking back … looking forward. The Dow and Nasdaq also notched record settlements in Q3. The blue chips closed at 17,279.74 on September 19, while the Nasdaq ended the September 2 trading day at 4,598.19. By the end of the quarter, the S&P 500 was on its fifth-longest stretch without a correction since 1928. The Russell 2000 (which began the fourth quarter with a correction) closed at 1,101.68 on September 30 and sank 7.65% for Q3. The "fear index" – the CBOE VIX – rose 40.97% across Q3 to 16.31.[1,2]

Quarter-ending closes for the big three were as follows: S&P, 1,972.29; DJIA, 17,042.90; NASDAQ, 4,493.39. At +32.75% YTD, the NYSE Arca Biotechnology index led all U.S. equity indices after three quarters.[2]

% CHANGE	Y-T-D	Q3 CHG	1-YR CHG	10-YR AVG
DJIA	+2.81	+1.29	+12.65	+6.91
NASDAQ	+7.59	+1.93	+19.14	+13.69
S&P 500	+6.70	+0.62	+17.29	+7.70
REAL YIELD	9/30 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	0.55%	0.45%	1.56%	1.77%

Sources: online.wsj.com, bigcharts.com, treasury.gov – 9/30/14[2,16,17]
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

Could the fourth quarter bring a pronounced rally? There is that possibility, but several looming concerns need to be addressed before it does, including Ebola containment, lack of growth in Europe and China, US' involvement in Iraq and Syria, and Russia's stance on Ukraine. The domestic economy remains a bright spot with unemployment at pre-recession lows, corporate earnings growth, and fundamental valuations at 25 year historical averages. With interest rates at 30 year lows, you might argue equity valuations are on the low side. Also, some recent Q4 history is reassuring: in the past five fourth quarters (2009-13), just 3 of 15 months have been negative for the S&P 500. During 2007-13, its median compounded yearly return for Q4 was 24%.[18]

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Hopefully, question marks about the fourth quarter will gradually fade with renewed enthusiasm trumping any uneasiness about the economy and the market climate. Still, some major ups and downs may be in store before 2015 arrives, so brace for additional volatility.

Hopefully, Q4 will see stocks exceed expectations. Perhaps this earnings season will provide a lift. We'll recap this quarter in January; you may, of course, call us at 425.455.6623 with any questions or concerns you have in the interim.

Sincerely yours,
Lars Knudsen/Dan Stober/Randy Williams-Gurian

companies in the region. The MSCI World Index is a free-float weighted equity index that includes developed world markets, and does not include emerging markets. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The Global Dow (GDOW) is a 150-stock index of corporations from around the world, created by Dow Jones & Company. The US Dollar Index measures the performance of the U.S. dollar against a basket of six currencies. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. Past performance is no guarantee of future results. Investments will fluctuate and when redeemed may be worth more or less than when originally invested. All information is believed to be from reliable sources; however we make no representation as to its completeness or accuracy. All economic and performance data is historical and not indicative of future results. Market indices discussed are unmanaged. Investors cannot invest in unmanaged indices. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional.

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