

# QUARTERLY ECONOMIC UPDATE

A review of 3Q 2014

## QUOTE OF THE QUARTER

“Plans are only good intentions unless they immediately degenerate into hard work.”

– Peter Drucker

## QUARTERLY TIP

Paying off your home loan or other major consumer debt before you retire leaves you with less pressure to sell assets or make unexpectedly large withdrawals from retirement accounts in the future.

## THE QUARTER IN BRIEF

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.<sup>1,2</sup>

## 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.<sup>3</sup>

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.<sup>4</sup>

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.<sup>5</sup>

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 of 1.9%. (Both the headline and core Producer Price Index showed 1.8% annualized inflation by August.)<sup>4</sup>

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.<sup>4</sup>

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.<sup>3</sup>

## 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.<sup>6,7</sup>

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.<sup>8</sup>

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.<sup>4,9</sup>

## **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.<sup>2,10</sup>

## **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.)<sup>11,12</sup>

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.<sup>13,14</sup>

## **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.<sup>4</sup>

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.<sup>4</sup>

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 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%.<sup>15</sup>

## 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. 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.<sup>1,2</sup>

% 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<sup>2,16,17</sup>  
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, even with the Fed about to wrap up its easing effort. Generally speaking, the benchmarks are notably outpacing managed money (according to Fundstrat Global Advisors, only 6% of large-cap fund managers were beating their benchmark by 2.5% or better in the last week of September). Under that kind of pressure, managers tend to grow increasingly bullish and chase beta. 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%. 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.<sup>18</sup>

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The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is not possible to invest directly in an index. NYSE Group, Inc. (NYSE:NYX) operates two securities exchanges: the New York Stock Exchange (the "NYSE") and NYSE Arca (formerly known as the Archipelago Exchange, or ArcaEx®, and the Pacific Exchange). NYSE Group is a leading provider of securities listing, trading and market data products and services. The New York Mercantile Exchange, Inc. (NYMEX) is the world's largest physical commodity futures exchange and the preeminent trading forum for energy and precious metals, with trading conducted through two divisions – the NYMEX Division, home to the energy, platinum, and palladium markets, and the COMEX Division, on which all other metals trade. The SSE Composite Index is an index of all stocks (A and B shares) that are traded at the Shanghai Stock Exchange. BSE Sensex or Bombay Stock Exchange Sensitivity Index is a value-weighted index composed of 30 stocks that started January 1, 1986. Nikkei 225 (Ticker: ^N225) is a stock market index for the Tokyo Stock Exchange (TSE). The Nikkei average is the most watched index of Asian stocks. The Philippine Stock Exchange PSEi Index is a capitalization-weighted index composed of stocks representative of the Industrial, Properties, Services, Holding Firms, Financial and Mining & Oil Sectors of the PSE; it was formerly named the PSE Composite. The Hang Seng Index is a freefloat-adjusted market capitalization-weighted stock market index that is the main indicator of the overall market performance in Hong Kong. The S&P/ASX 200 is Australia's "premier" share market index. The Asia Dow measures the Asia equity markets by tracking 30 leading blue-chip companies in the region. The DAX 30 is a Blue Chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. The FTSE 100 Index is a share index of the 100 most highly capitalized companies listed on the London Stock Exchange. The Europe Dow measures the European equity markets by tracking 30 leading blue-chip companies in the region. The RTS Index (abbreviated: RTSI, Russian: Индекс РТС) is a free-float capitalization-weighted index of 50 Russian stocks traded on the Moscow Exchange. The Dow Jones STOXX 600 Index captures more than 90% of the aggregate market cap of European-based companies. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. The Mexican IPC index (Indice de Precios y Cotizaciones) is a capitalization-weighted index of the leading stocks traded on the Mexican Stock Exchange. The Bovespa Index is a gross total return index weighted by traded volume & is comprised of the most liquid stocks traded on the Sao Paulo Stock Exchange. The Dow Jones Americas Index measures the Latin American equity markets by tracking 30 leading blue-chip 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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