

The CMC Efficient Frontier

CAPITAL MARKET CONSULTANTS, INC

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Q3 2014 ECONOMIC AND CAPITAL MARKET COMMENTARY

OCTOBER 2014

Recap: With five years of GDP growth on the books since the end of the Great Recession, conditions finally appeared to be returning to something closer to normal. While nonfarm employment growth fell short of expectations in August, the economy performed better in the second half of the year as international trade, the ISM survey results, construction spending and consumer confidence all showed improvement. Real GDP should see growth of 3.0% in the third quarter.

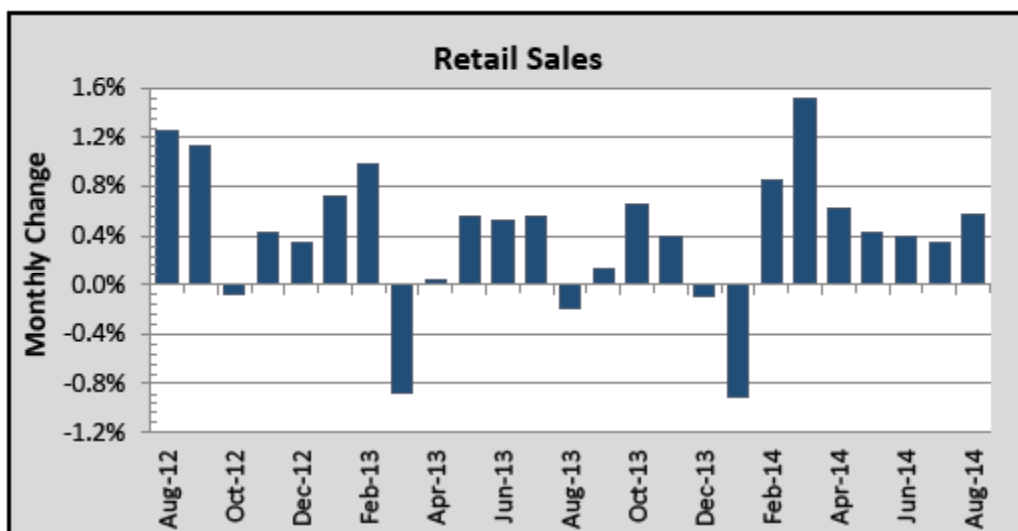
This improved economic performance will reflect the delayed effects of stronger job and income growth, and recently lower gasoline prices which have kept the consumer spending. Business fixed investment spending also looked stronger and the economy has seen a big lift from increased energy production. Even the housing recovery has gotten back on track a bit, though at a slower rate. The age of fiscal restraint is about to come to an end, as improved tax revenues have allowed government spending to increase.

Stronger economic growth has also pulled inflation and longer term interest rates a *little* higher in recent weeks. However, with the global economy struggling and commodity prices soft, inflation has remained modest and given the Fed flexibility to move cautiously and incrementally.



Abdur Chowdhury, Ph.D.
Chief Economist

Retail Sales: U.S. retail sales grew by 0.6% month-over-month in August. The gain came on top of strong positive revisions to both July and June figures. Core retail sales (i.e. ex-autos, ex-gasoline) came in at 0.5% month-over-month in August with gains in 11 of 13 subcomponents. Of these, the largest gains were in general merchandise stores, motor vehicles and parts, building materials, and sporting goods/books/music stores.



Positive revisions to prior months helped allay some of the mystery surrounding the U.S. consumer. While prior reports pointed to decelerating consumer spending amidst otherwise strong economic growth, these revisions paint a much brighter picture. With consumer confidence sitting at a post-crisis high, sustained job gains (e.g. unemployment now at 5.9%), and wage growth set to pick up later this year, the next several months of sales bode well for retailers. This also points to stronger consumer spending in the third quarter. Markets would appear to be reflecting this upward bias to economic growth.



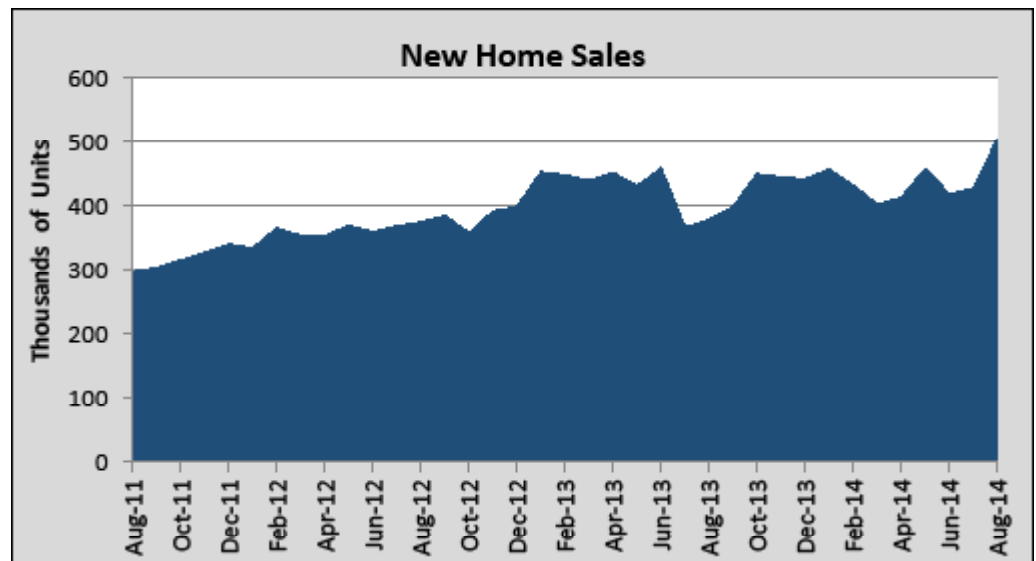
Inflation: The headline consumer price index increased by 1.7% (annualized) in August. Excluding food and energy, core prices also rose by 1.7% year-over-year. On a month-over-month basis, the headline index fell by 0.2%, the first decline since April 2013, while the core index remained unchanged. For the second consecutive month, falling energy prices were largely responsible for the pullback in the headline CPI.

Although energy prices have played a key role in moderating headline inflation, a more fundamental factor has been the notable absence of an acceleration in wage growth. The shift from moderate to robust job gains over the last year or so has not come with the same acceleration in average hourly earnings, where gains have remained limited and remarkably stable since the recovery began.

All said, the inflationary backdrop remains benign at this point and is not likely to force the Fed's hand in pulling forward the timing of their first rate hike. The Fed likely will remain on hold until at least mid-2015.

Housing: On balance, the data on housing has been disappointing. Existing home sales have languished in recent months and the months' supply of new homes has returned to its historical norm, even though the absolute level of inventories has remained low. Attitudes toward home buying also remained depressed, at least as measured by the consumer confidence survey. Both housing starts and building permits fell in August.

Conversely, in August new home sales jumped 18.0%. The increase was largely due to sizeable gains in the Northeast and West, which increased 29% and 50%, respectively. Data for the previous three months were also upwardly revised. This would corroborate the solid gains in builder sentiment over the past three months. Inventories of new homes for sale are up 16% over the past year. With sales showing strong gains in the highly-priced Northeast and West, average home prices increased during the month.



A continued slow and gradual improvement in the housing market with activity likely to pick-up in the coming months is expected, as builders' confidence has surged to late 2005 levels. Builders are likely to break ground on projects before the winter arrives. While credit conditions on prime residential mortgages have eased over the first half of 2014, they still remained relatively tight by historical standards and have been a constraining factor in this sector's response to economic growth.

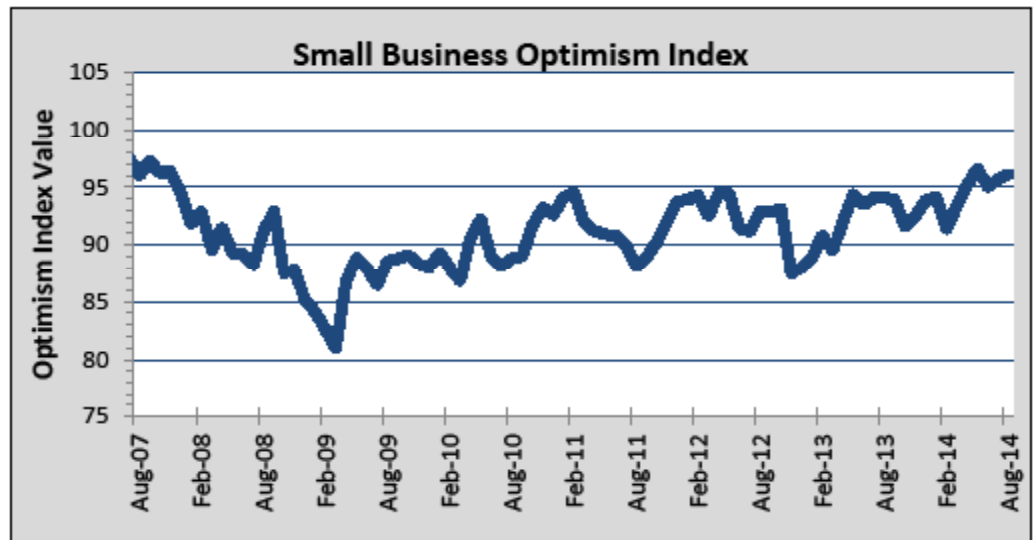
Trade: Net exports remained a downside risk, but should not take anywhere near the toll on growth that they did during the first half of this year. Earlier timing of the Chinese New Year and harsh winter weather likely hurt the trade numbers; however trade is expected to be essentially neutral during the second half. The risk is that Europe's economic troubles will cut demand for exports, while stronger U.S. growth pulls in imports. That has not appeared to be the case so far in the third quarter. Surging oil and natural gas production has curbed demand for imported crude,



and exports of petroleum products are surging.

Small Business Optimism Index: The NFIB's Small Business Optimism Index rose 0.4 points in August to 96.1. Gains were led by "plans to make capital outlays." The percentage of firms expecting the economy to improve rose 3 percentage points.

Small business confidence has continued to inch ahead although the gains among components continued to be a bit shaky. However, the directional change in the index has been consistent with the ongoing improvement in the pace of small business growth. The rise in plans for capital outlays was encouraging as the share of businesses planning to increase investment now sit at the highest level of recovery to date. It also gives support to the expectation for business investment to be an important contributor to economic growth in the second half of 2014.



Fed: The Federal Reserve recently announced it would end the bond-buying program known as Quantitative Easing in October, but retained its guidance that short-term interest rates would remain near zero for a "considerable time" after that program ends. Under the plan, the Fed will purchase \$15 billion of mortgage and Treasury bonds this month and then stop the purchases.

Their statement, following the FOMC meeting on September 17th, has alleviated earlier market concerns that the central bank might be warming up to the prospect of a March interest rate increase.

For the first time, the central bank released policy makers' predictions for interest rates in 2017. Those showed most officials see short-term rates above 3% – and somewhere near what officials consider the long-run normal rate – around three years from now. The new projections show officials expect their benchmark short-term rate, the federal funds rate, to be between 1.25% and 1.50% in late 2015 and between 2.75% and 3.0% in late 2016.

The Fed also formalized and stated its stimulus exit strategy. The interest it pays banks to park excess reserves at the central bank will be the primary tool used to "move the federal funds rate into the target range" set by the FOMC. Other facilities, like overnight reverse repurchase agreements, will also be used as supplemental tools during an eventual exit.

ECB: The European Central Bank's (ECB) main lending rate was lowered to 0.05% from 0.15%. The ECB also lowered the rate on overnight bank funds parked at the central bank to -0.2% from -0.1%. The ECB in June became the largest central bank to experiment with a negative rate on bank deposits, a measure aimed at encouraging banks to lend surplus funds to other financial institutions rather than paying to park them at the ECB. It also cut the rate it charges on overnight loans to 0.30% from 0.40%.



While the ECB was considering an ABS purchase program in recent months, the rate cuts plus a recently announced \$1 trillion covered bond buying and asset backed securities buying program was a surprise. This was an indication that officials have grown increasingly concerned that the recent period of very low inflation could persist longer than first thought and may threaten the currency area's economic recovery. This announcement was a positive for risk assets. Because of these actions, European stocks and bonds are expected to go higher and the euro should fall. Many Eurozone companies should benefit from ECB efforts to lower borrowing costs, and a weaker currency should make products manufactured in the Eurozone and shipped abroad, cheaper for foreign buyers.

However, it is not expected the ECB will be able to successfully fight low inflation all by itself; governments in the Eurozone need to do more to boost growth by loosening fiscal policy and introducing structural reforms.

Euro: In late September, the euro fell below \$1.28 to the dollar for the first time in more than a year, making its losses against the dollar since the start of July, to 6.6%; that would put it on course for its steepest quarterly fall since late 2011.

The depreciation follows the radical steps taken by the European Central Bank to loosen monetary policy since June, including September's cuts in interest rates and the announcement that it would start buying private sector assets. But it also reflected a rally in the dollar that has gained momentum in recent weeks as the U.S. Federal Reserve neared the end of its quantitative easing program and investors have looked ahead to the prospect of U.S. interest rates rising in 2015.

The fall in the euro will have a rapid effect in raising import prices for non-Eurozone goods and services, and should boost exports from Europe. To drive it yet lower, the ECB could embark on a program of quantitative easing involving large-scale government bond purchases. A drop in the value of the euro should also boost Eurozone corporate earnings. A recent study by Swiss Bank UBS estimated that a 10% depreciation in the euro would raise Eurozone non-financial corporate earnings (before interest and taxation) by 3% on average – a significant boost, given single-digit earnings growth at present.

Global Economy: As the U.S. economy has continued to grow at a relatively strong pace, some large foreign economies have continued to experience important challenges that will limit their contribution to worldwide economic growth. The recent move by the European Central Bank (ECB) to further reduce interest rates and to start an asset purchase program underscored the weak economic environment in the region.

On the other hand, the Chinese economy, which had been weakening over the past several quarters, seemed to have accelerated a bit during the past several months. A better performance by the Chinese economy has been welcome news for the global economy even if the improvement was not enough to alter the growth rates expected for some of the largest emerging markets that are dependent on Chinese growth. Perhaps one of the few emerging markets that surprised on the upside was the Indian economy, which posted a stronger-than-expected growth rate in the second quarter.

Outlook: Real GDP is expected to grow close to 3.0% in 2014. This forecast will rely on continued gains in household finances, further improvement in housing and, importantly, less fiscal drag from Washington. Stronger demand and a tighter labor market will allow pricing power to gain some traction. Consumer prices should increase by 2% in 2014, putting the inflation rate right at the Federal Reserve's target. Lower unemployment and inflation at goal will allow the Fed to maintain its current policy stance.

Internationally, downside risks remain for the global economy if China experiences a further economic slowdown, the deflationary trend in the euro zone continues and finally if Japan's economic reforms fail. The Emerging Market



economies have been facing more restrictive financial conditions recently and this could also slow global growth and trade flows.

Index Performance as of: 9/30/2014

	<u>1 Week</u>	<u>1 Month</u>	<u>QTD</u>	<u>3 Month</u>	<u>YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
Russell								
3000 Value	-1.00	-2.43	-0.87	-0.87	7.01	17.67	23.67	15.09
3000	-0.60	-2.08	0.01	0.01	6.95	17.77	23.07	15.78
3000 Growth	-0.22	-1.75	0.88	0.88	6.91	17.89	22.40	16.43
1000 Value	-0.91	-2.06	-0.19	-0.19	8.07	18.90	23.93	15.26
1000	-0.53	-1.75	0.65	0.65	7.97	19.02	23.23	15.90
1000 Growth	-0.17	-1.45	1.49	1.49	7.89	19.16	22.44	16.51
Mid Cap Value	-0.98	-3.80	-2.65	-2.65	8.20	17.47	24.71	17.24
Mid Cap	-0.74	-3.34	-1.66	-1.66	6.87	15.84	23.78	17.19
Mid Cap Growth	-0.51	-2.90	-0.73	-0.73	5.73	14.44	22.73	17.13
2000 Value	-2.05	-6.75	-8.58	-8.58	-4.74	4.13	20.60	13.03
2000	-1.46	-6.05	-7.36	-7.36	-4.41	3.93	21.25	14.29
2000 Growth	-0.86	-5.35	-6.13	-6.13	-4.05	3.80	21.90	15.51
Standard & Poors								
S&P 500	-0.49	-1.40	1.13	1.13	8.34	19.75	22.99	15.70
Consumer Disc	-0.44	-2.76	0.26	0.26	0.86	11.78	26.27	21.46
Consumer Staples	0.31	0.63	1.95	1.95	7.23	16.54	18.21	15.40
Energy	-1.83	-7.55	-8.62	-8.62	3.24	11.87	16.87	12.46
Financials	-0.66	-0.39	2.33	2.33	7.42	18.53	27.64	11.03
Health Care	-0.39	0.43	5.46	5.46	16.62	28.45	28.83	19.74
Industrials	-0.45	-1.08	-1.09	-1.09	2.87	16.79	24.82	17.25
Information Technology	-0.26	-0.68	4.77	4.77	14.13	29.29	22.31	16.03
Materials	-1.10	-1.54	0.22	0.22	8.87	20.49	21.95	13.23
Telecom Services	0.06	0.41	3.07	3.07	7.47	13.36	15.21	14.00
Utilities	0.08	-1.86	-3.96	-3.96	13.95	17.14	12.26	12.13
Other U.S. Equity								
Dow Jones Industrial Avg.	-0.07	-0.23	1.87	1.87	4.60	15.30	19.02	14.85
MSCI USA	-0.49	-1.56	0.95	0.95	8.16	19.32	23.00	15.77
Wilshire 5000 (Full Cap)	-0.52	-2.09	-0.02	-0.02	6.85	17.68	23.01	15.88
International Equity - Broad Market								
MSCI EAFE	-1.45	-3.81	-5.83	-5.83	-0.99	4.71	14.16	7.04
MSCI Emerging Markets	-2.63	-7.39	-3.36	-3.36	2.75	4.66	7.55	4.76
MSCI Frontier Markets	-0.27	0.73	1.57	1.57	22.44	30.52	18.34	9.14
MSCI AC World	-1.13	-3.20	-2.20	-2.20	4.16	11.90	17.24	10.65
MSCI AC World ex USA	-1.78	-4.81	-5.19	-5.19	0.39	5.23	12.29	6.50
MSCI AC Asia ex Japan	-2.35	-5.86	-1.54	-1.54	4.93	8.52	11.18	7.12



	<u>1 Week</u>	<u>1 Month</u>	<u>QTD</u>	<u>3 Month</u>	<u>YTD</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
International Equity - Country Region								
MSCI Brazil	-6.04	-19.21	-8.58	-8.58	1.23	-4.31	-2.33	-4.13
MSCI BRIC	-3.54	-9.12	-3.14	-3.14	1.55	3.28	5.63	1.16
MSCI China	-3.04	-6.34	1.53	1.53	1.02	4.87	11.80	3.96
MSCI Europe	-1.49	-3.74	-6.98	-6.98	-1.44	6.37	16.22	7.54
MSCI India	-1.07	-1.42	2.34	2.34	24.71	37.64	9.01	4.34
MSCI Japan	-0.42	-0.60	-2.19	-2.19	-1.36	0.93	9.39	5.60
MSCI EM Latin America	-3.88	-13.33	-5.44	-5.44	1.56	-0.74	1.48	0.08
MSCI Russia	-3.53	-5.81	-15.07	-15.07	-19.46	-19.19	-0.28	-0.12
Fixed Income								
Barclays U.S. Aggregate	0.00	-0.68	0.17	0.17	4.10	3.96	2.43	4.12
BofA Merrill Lynch 3-Month T-Bill	0.00	0.00	0.01	0.01	0.03	0.05	0.07	0.10
Barclays U.S. Government	0.10	-0.52	0.32	0.32	3.00	2.29	1.06	3.11
Barclays U.S. Credit	-0.24	-1.41	-0.03	-0.03	5.67	6.65	4.82	6.10
Barclays High Yield Corporate Bond	-0.91	-2.09	-1.87	-1.87	3.49	7.20	11.09	10.57
Barclays Municipal	0.22	0.10	1.49	1.49	7.58	7.93	4.56	4.67
Barclays TIPS	-0.26	-2.50	-2.04	-2.04	3.67	1.59	1.34	4.48
Barclays Global Aggregate ex US	-1.10	-4.25	-5.38	-5.38	-0.09	-0.81	0.14	1.68
Barclays Global Aggregate	-0.65	-2.79	-3.14	-3.14	1.64	1.19	1.16	2.69
BofA Merrill Lynch Emerg. Mkt. Credit	-0.69	-4.09	-7.37	-7.37	2.29	4.54	11.87	11.76
Alternative Investments								
Alerian MLP	1.49	-1.56	2.73	2.73	19.48	25.81	22.94	23.58
Bloomberg Commodity	0.08	-6.23	-11.83	-11.83	-5.59	-6.59	-5.34	-1.37
FTSE NAREIT Equity REIT	0.06	-5.95	-3.14	-3.14	13.96	13.15	16.67	15.89
S&P Global Natural Resources	-2.14	-7.05	-7.76	-7.76	-1.41	3.08	4.96	2.33
S&P North American Natural Resources	-1.86	-8.81	-10.03	-10.03	4.75	10.28	12.52	8.82

Capital Market Update:

Global equity markets were broadly challenged during the quarter, with many regions posting negative returns. In the United States, large-cap stocks saw small gains while small-cap names declined sharply. The growing dispersion between large and small stock performance has left many questioning when the relationship might reverse course. Since small companies are generally more economically sensitive, it appears that investors have taken some risk off the table while waiting for greater conviction on economic growth and the Federal Reserve's interest rate policies. With geopolitical unrest in Russia/Ukraine, Iraq/Syria, and Israel/Palestine continuing, international equities markets were hard pressed for gains. However, China and India posted advances despite continued concerns around a slowdown in Chinese growth and Japan's struggling economic reforms, and their impacts on the Asian region.

S&P 500 sector performance was also mixed for the quarter. Growth oriented Health Care and Technology stocks were leaders, rising 5.5% and 4.8%, respectively. Telecommunications, Financial Services, and Consumer Staples also did well (+2-3%). However, Energy stocks declined sharply (-8.6%) as oil prices for West Texas Intermediate Crude fell over \$10 to approximately \$91 per barrel at quarter's end; the rising dollar undoubtedly helped feed the decline. Utilities stocks also struggled - falling almost 4%, but remain one of the top-performing sectors for the year (+14%) as



investors search for income from dividends. In general, growth outperformed value across all market capitalizations in the quarter.

U.S. bonds outperformed their international counterparts. Most strategists had predicted rates to climb this year, but markets have confounded them with a declining trend. Interest rates in the U.S. have gradually declined over the year, trading between 3% in January and 2.4% at September's end. Municipal bonds continued to see strong demand, advancing 1.5% for the quarter and 7.6% so far for the year. High yield bonds experienced some selling pressure as investors anticipated higher rates down the road. TIPS also declined over the quarter as the risk of inflation appeared low with lower commodity prices and economic weakness in Europe and Japan. Foreign and emerging markets debt declined 5.4% and 7.4%, respectively.

In the alternative spectrum, returns were largely negative. MLPs (+2.7%) performed well despite the decline in energy prices and stocks. MLPs have been the top-performer in the alternatives space year-to-date, climbing over 19%. Commodity prices for agricultural goods, livestock, and natural gas declined, leading many benchmarks to double digit declines. The REIT space took a bit of a breather during the quarter (-3%), but remains up about 14% for the year. Hedge fund strategies were weak, not all that surprising given the performance of the equity, fixed income, and commodities markets.

Sources: Department of Commerce, the Conference Board, Department of Labor, Bureau of Labor Statistics, National Federation of Independent Business, National Association of Home Builders, Federal Reserve Board.

What's New @ CMC?

We are pleased to announce the arrival of our new Chief Investment Officer **Rob Cummisford, CFA**. Rob will have a leadership role in serving our institutional clients and formulating the firm's investment policy reflected in our model portfolio strategies. We welcome Highwater Wealth Management in Denver, CO as a new client of the firm.

Manager visits included: Harding Loevner, Skyline Asset Management, Ge Capital, Brown Advisory, John Hancock, Todd Investment Management, Brown Capital, Twin Rivers, Windhaven, Steinberg Asset Management.

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CMC's actively managed multi-asset class, multi-manager model portfolios are available on all major independent custodial platforms, selected variable annuity platforms and through selected overlay portfolio managers.

For more information on CMC services or strategies contact one of the following:

Banks, Insurance, Multi-Family Office, Wealth Management firms:
Barry Mendelson, CIMA, 414-727-7995; barry@cmarkc.com

Broker-dealers, Registered Investment Advisors and Wealth Management firms:
George Patten, 414-7233-2682; george@cmarkc.com, or
Alex Powell, 414-727-7990; alex@cmarkc.com