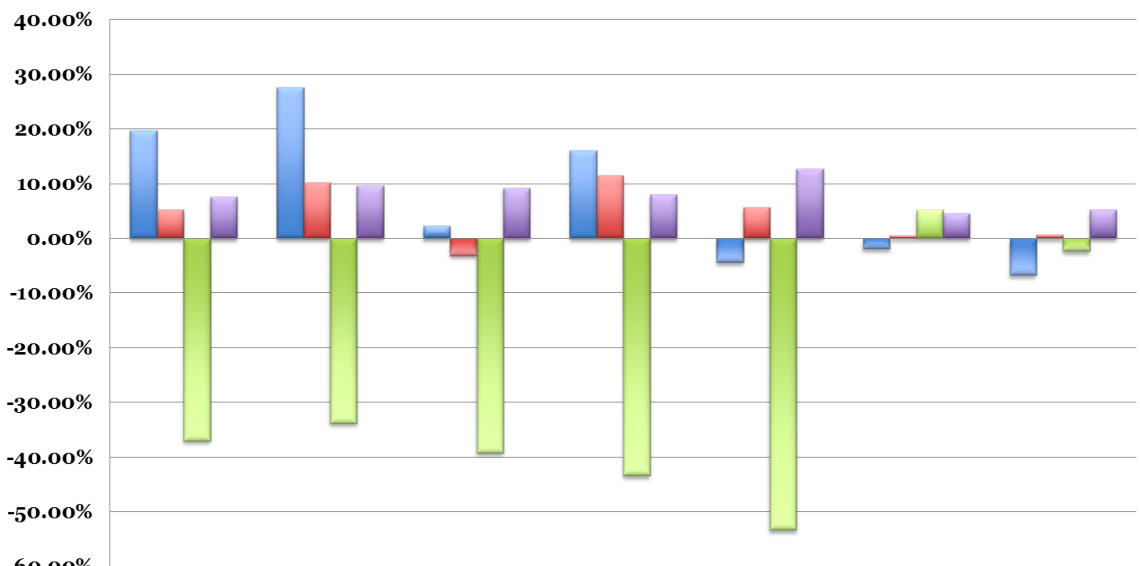
Market Summary and Outlook 3rd Quarter 2013

Despite entering the third quarter with tremendous uncertainty following a significant rise in Treasury rates in May and June, US equity markets flirted with all time highs before retreating slightly from those highs at the end of September. Bonds recouped some of their losses from the second quarter. The markets rebounded in spite of continued uncertainty over Federal Reserve policy, a potential government shutdown and the debt ceiling battle as we head into the 4th quarter.

In the chart below, we compare the major markets and asset classes year-to-date and for the 3rd quarter. You will note US equities (both large cap and small cap) are the strongest performers. Developed foreign markets also had a great quarter as much of Europe seems to be exiting recession. We are including the 2008 and 10-year annualized numbers in this chart as a reminder of why we think high quality bonds and emerging markets are an important part of a diversified portfolio with a long term focus.

Major Benchmark Performance through 9/30/2013



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds	TIPS
YTD	19.79%	27.69%	2.33%	16.14%	-4.35%	-1.89%	-6.74%
3Q13	5.24%	10.21%	-3.15%	11.56%	5.77%	0.57%	0.70%
2008	-37.00%	-33.79%	-39.20%	-43.38%	-53.33%	5.24%	-2.35%
10 Year (ann.)	7.57%	9.64%	9.29%	8.01%	12.80%	4.59%	5.24%

Source: DFA

Congressional Dysfunction

We do want to acknowledge the seriousness of the twin crises that are coming to a head this month.

As of midnight September 30, the end of the federal government's fiscal year, the government shut down because Congress could not agree on how to fund federal agencies for the upcoming fiscal year.

The Republicans, who control the House of Representatives, have tried to tie passage of the budget to defunding the Affordable Care Act (also known as Obamacare). The Democrats who control the Senate and the President refuse to include ACA in budget negotiations.

The other and much more serious Congressional debate will be over the need to raise the debt ceiling, most likely by mid-October, when the Treasury may not have enough money to meet all its obligations, including interest on Treasury debt, Social Security, and Medicare checks. Government leaders this week are discussing whether and how to prioritize these payments, if there is a default.

From an investor's perspective, this could signal a period of uncertainty ahead, as the markets have been largely dependent on the US government for the past couple of years, rising and falling with every congressional and presidential skirmish. The volatility has occurred despite steadily (although slowly) improving economic data.

Equity markets tend to respond negatively to uncertainty and each Congressional battle has created volatility. We don't see the current impasse any differently. Volatility has historically led to a surge in US Treasury bonds since they are perceived as the safest investment. They probably still are; however, one point of contention in this impasse is whether Congress will raise the debt ceiling in time to allow the government to continue to meet all its obligations, including interest payments to Treasury holders. Congress narrowly missed a default in 2011. Ironically, Treasury bonds appreciated despite Standard & Poors' downgrading of the United States credit rating at that time. The US equity markets suffered in 2011 only to rebound after resolution of that debt crisis. We see this current battle as a manufactured crisis and our advice is to remain focused on your long-term goals and stay diversified.

The other significant government player affecting the markets is the Federal Reserve. For the past year, as part of their economic stimulus program, the Fed has been buying $85 billion of bonds per month to keep rates low. Starting this past spring, Chairman Ben Bernanke announced the US economy was improving enough that in the near future, the Fed would start to cut back (taper) its bond purchases. The markets reacted poorly to 1) the idea of easy money being taken away and 2) the lack of a specific date when the tapering would start which resulted in the significant decline in June Q213 Newsletter. The yield on the 10 year Treasury bond started the quarter at 2.5%. In early September when the markets thought the Fed was about to announce the first of the tapering steps, the 10 year Treasury yield increased to a high of 3%. When the Fed declined to start the tapering in September (which was a surprise to most investors, including us), the yield dropped to 2.6%. While the yield did not change much in the 3rd quarter, it is still significantly higher than the 1.6% yield that was in place at the beginning of May.

Perhaps the Fed anticipated the shutdown and debt ceiling battles coming to a head in October as reasons to not begin tapering in September.

Economic Data

A positive result of the dysfunction from earlier this year is a short term drop in the federal **budget deficit**. It decreased from over 6% of GDP in 2012 to an estimated 3.9% in 2013 (source: Congressional

Budget Office). CBO predicts the budget deficit will bottom out at 2.1% in 2015 but is concerned the deficit will rise again after 2016 due to strain by the Baby Boomer generation on the entitlement programs such as Social Security, Medicare, and Medicaid. The sequester from last March and tax increases from January so far have not adversely impacted GDP growth. Unfortunately, CBO says the recent cuts have been in areas that are not responsible for the projections of increasing debt, i.e. entitlement programs.

The last **unemployment** data released indicates a rate of 7.2%. The trend shows a steady decline from the peak of 10% in October 2009. 8.8M jobs were lost during the crisis and 7.5M have been gained post-crisis. We obviously have not recouped what was lost in the last recession but the trends indicate we are still gaining.

Housing starts and the shadow housing market (foreclosures) have dropped which has lowered inventory. Since mortgage rates at less than 5% are still reasonable compared with historical rates, we do not predict a reverse of the housing market recovery. The low inventory should keep existing home prices from dropping.

There are many different ways to look at **stock valuations**. If we look at the Shiller cyclically (10 year) adjusted price/earnings ratio, we are above the 60 year average. However, if we look at JP Morgan's forward P/E estimates, we are right in line with the P/E average that goes back 30 years. Corporate leverage has steadily declined, corporate cash as a percent of current assets has steadily increased, and consumer sentiment is still trending upward (although this may change if the shutdown lasts for an extended period of time). Also, the US has posted another record setting quarter of corporate profits. Bottom line is we think stocks are fairly valued.

US GDP is slowly trending upward. The most recent estimate of 2nd quarter GDP is a respectable although not spectacular 2.5%.

Fixed Income Diversification

Despite the increase in yields (bond prices are inversely related to yields) earlier this year, we strongly believe fixed income plays an important role in a diversified portfolio. As with equities, we prefer to maximize the diversification of bond holdings. Below are the broad categories we include:

- **High quality US** (corporates, Treasurys, agencies, municipals where appropriate)
- **Foreign bonds** (governments, corporates)
- **Treasury Inflation Protected Securities**
- **Non-core bonds** – we limit this category but think it is important to have some bond funds that construct their portfolios with wide discretion over the universe of allowable bonds to include. Correlation is an important statistical term and goal we are always striving for. These funds have maintained their value or even appreciated in an increasing interest rate environment

Looking Forward

When both the stock and bond markets are volatile, it is tempting to make changes to the portfolio that may make you feel better or more in control in the short term. However, since we do not know where markets will go short term, we continue to recommend staying focused on:

1) What you can control
2) Your long term goals
3) Staying diversified

We don't feel like we are going out on a limb by predicting markets will drop further before resolution of the current government-driven crises. However, we also fully believe "this too shall pass" and that long term the markets will revert to their upward trend.

This month marks the 5 – year anniversary of the financial collapse. While there are significant current and future problems to worry over, our markets and economy have come a long way since those dark days.

We appreciate your continued confidence in us and encourage you to call anytime.

Janet & Barry

Sources: DFA, JP Morgan, Morningstar, WSJ, PIMCO, BlackRock, Congressional Budget Office, New York Times