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RDM CAPITAL ASSOCIATES
WEALTH MANAGEMENT

THIRD QUARTER MARKET COMMENTARY
October 2013

EXECUTIVE SUMMARY

In the Third Quarter 2013, uncertainty reigned in the markets as the U.S. government threatened military action in Syria and the Fed sent conflicting signals regarding its "quantitative easing" asset purchase program. Despite these headwinds, the equity markets proved to be surprisingly resilient. The S&P 500 gained 4.69% in the Third Quarter, bringing its year-to-date return to 17.9%, as investor confidence was bolstered by a slowly improving economy in the U.S. and stabilizing economic conditions in Europe. RDM Capital's composite equity portfolio of client accounts has returned 6.29% in the Third Quarter and 24.74% year-to-date, with its out-performance due in part to strong allocations in healthcare and financials, two of the top performing sectors in the S&P 500 this year. Our decision to minimize allocations to fixed income in 2013 has proven to be prudent as bond prices have begun to recede as interest rates have risen since May. For example, the Fidelity Balanced Fund – a mutual fund invested 60% in equities and the remainder in bonds and other debt securities – has returned less than 12% for the year.

We are cautious in our outlook for the markets in the Fourth Quarter, as the strong rally in 2013 will face headwinds in coming months. In particular, Third Quarter earnings to be reported in the Fourth Quarter are expected to be relatively lower than previous quarters. The political dysfunction in Washington also threatens to weigh on the market, as politicians posture for yet another budget and debt ceiling clash that will heat up in the Fourth Quarter. Yet, we believe that over a longer time frame, U.S. equities are the best place for our clients to invest relative to other asset classes. Equity markets will continue to be supported over the long term by a slow and steady U.S. economic expansion, accommodative monetary policy at home, and economic stabilization abroad. While the U.S. equity markets are currently fairly valued, we see upside in keeping a significant allocation to equities through both increased capital gains into 2014 and, for many of our clients, healthy dividend income compared to other asset classes.

We intend to maintain our over-weight equity positions in financials, energy, materials and healthcare/pharmaceuticals into the Fourth Quarter and 2014. For fixed income portfolios, we intend to maintain a very short duration given the expectation of rising interest rates in the future.

2013 Gross Performance
as of 9/30/13

RDM Capital:	24.74%
Dow Jones:	15.46%
S&P 500:	17.90%
Russell 1000 Value:	18.37%

Five Years After the Lehman Bankruptcy, the U.S. Economy is Still Inhibited by Fiscal and Regulatory Uncertainty

The Third Quarter 2013 saw the fifth anniversary of the collapse of Lehman Brothers, which filed for bankruptcy on September 15, 2008 and accelerated the worst financial crisis since the Great Depression. Five years later, our economy is still held hostage by fiscal and regulatory uncertainty, in part due to the financial crisis. The domestic banking sector remains in a state of transition and regulatory scrutiny as the myriad provisions of the Dodd-Frank bill are slowly implemented. While the U.S. economy is far less leveraged than it was five years ago thanks to caps on leverage imposed on systemically important banks (13% Tier 1 bank capital as a percentage of assets versus 10% in 2008), and corporations with record cash levels on their balance sheet (nearly $2 trillion), not enough of this additional capital has been deployed to stimulate the economy past a middling sub-2% GDP growth rate. Finally, Washington politicians continue to battle over the proper role of government in the private sector.

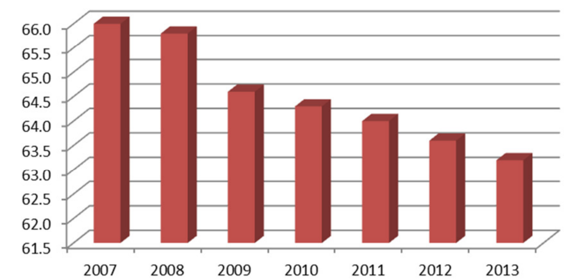
Over the past couple of years, these battles have been waged at the end of the Third Quarter and into the Fourth Quarter as Congress is consumed with budget and debt ceiling negotiations at the end of the government's fiscal year. This Fall should be no different and the markets will likely endure increased volatility in coming months as the political theatrics continue.

The Fed Sends Conflicting Signals on the End of QE as the Economy Muddles On

The Federal Reserve surprised many observers after the September FOMC meeting when Chairman Ben Bernanke announced that there would be no "tapering" of bond purchases by the Fed. Currently, the Federal Reserve is purchasing approximately $85 billion in mortgage backed securities and U.S. treasuries in an effort to lower long term interest rates and stimulate investment in the economy, which would lead to lower unemployment and faster economic growth. The jury is still out as to whether these purchases (dubbed "quantitative easing" or "QE", for short) have had the intended impact on the economy – a point we have called into question in several recent market commentaries.

The unemployment rate remains elevated at 7.3%. While the rate has ticked down from its high of 10% in the middle of the financial crisis, some of this decline is due to a decrease in the labor force participation rate (*see chart, right*), which is a measure of all employed and unemployed Americans as a percentage of the civilian population. This means that employment growth has been more anemic than it would appear on the face of each labor report and is declining partially for the wrong reason: i.e., many unemployed workers are discouraged and have simply dropped out of the labor force. Further contributing to the decline is an aging population with many baby boomers retiring – many likely forced into early retirement after becoming discouraged with the job market.

US Labor Force Participation Rate
(source: US Department of Labor)



Due to the slowly improving economic picture, the Fed signaled in June that it would consider reducing its purchases after the next FOMC meeting in September. Many observers speculated that the Fed would taper its purchases by $10 - $15 billion per month. The Fed's comments caused interest rates to jump and the stock market to decline in August, in part due to investor expectations that the Fed would soon announce a tapering of its quantitative easing program. However, after the September FOMC meeting, Bernanke announced that there would be no changes to the quantitative easing program for now.

One of the main reasons for the Fed electing not to taper its asset purchases was the relatively quick rise in interest rates after its June announcement, which in part caused mortgage rates to jump nearly 1% since May. The Fed feared that any additional spike in mortgage rates due to tapering would jeopardize the economic recovery, which had already contributed to some slowdown in the growth of home prices. Nevertheless, it is likely that the Fed will begin winding down QE in 2014, if not sooner. When this occurs, many bond investors and near-retirees will feel the pain of capital depreciation on their bond funds as interest rates rise, a topic we explored in a recent blog post (www.rdmcapital.com/wealthmanagementblog).

The Fed continuing its asset purchases unabated (for now) has several implications for the markets:

First, in the short term, bond prices will continue to receive support from the historic amount of artificial demand for treasuries and mortgage-backed securities created by the Fed, while correspondingly interest rates will likely drop closer to pre-June levels. Additionally, both the fixed income and equity markets received a short-lived trading boost from increased investor confidence due to the Fed's continued willingness to support the economic recovery with accommodative monetary policy.

Second, in the medium term, the stock market will be supported by a historically accommodative monetary policy environment. Quantitative easing is viewed by investors as a positive for the economy and, relatedly, the stock market, because it lowers interest rates for corporate borrowing and theoretically stimulates investment in businesses by flooding the market with cheap capital. It also bolsters investor confidence when the Fed communicates openly that it will extend or increase its quantitative easing indefinitely if economic data should weaken, thereby providing a strong backstop for the economic recovery. It is important for investors to remember that the Fed has made a long term and indefinite commitment to a low interest rate policy. Undoubtedly, there will come a time when the Fed will need to reduce its bond buying from the current pace of ~ $1 trillion per year. However, any tapering of bond purchases does not mean that the Fed has changed its indefinite commitment to near-zero short term interest rates nor its willingness to intervene in the bond markets should longer-term interest rates rise to a level that hurts the economic recovery. The equity markets will continue to benefit from the Fed's low interest rate commitment, regardless of tapering.

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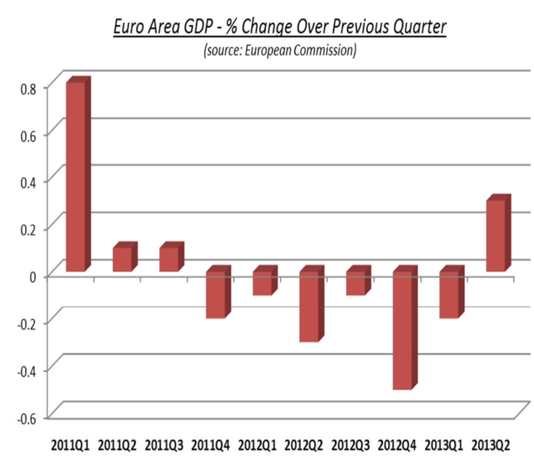
Last, over the long term, the impact of such a massive amount of extra dollars in the economy is uncertain. Should the economy ever pick up full steam, along with renewed growth in Europe and a re-strengthening in emerging markets, inflation will likely become a problem domestically as the prices of goods and services could soar due to the trillions of extra dollars injected into the financial system trickling from the financial markets to commodities, manufacturing and other areas of economic output. Future administrations and Fed bankers will face this problem down the road. They will be faced with the difficult task of tightening the reigns of inflation by raising interest rates – the trick is timing any interest rate hike after the economy is self-sustaining and not a moment sooner.

European Economies are Showing Signs of Stabilization

While the U.S. economic recovery muddles on, the Third Quarter saw some signs of economic stabilization in the Eurozone. Indeed, the seemingly endless Eurozone crisis headlines have faded somewhat this year. In past quarterly market commentaries, we have discussed at length the European debt crisis, particularly as it pertained to the potential for Greece to exit the Euro and/or European Union. We stated then that we thought it was extremely unlikely that Greece would be forced out of the Euro, and it appears more likely as time passes that Greece's debt restructuring will be enough to avoid a forced exit that would threaten the future of the entire European monetary union. Greece is currently in talks to secure its third bailout to run through 2016, which will likely be secured due to the Greeks' progress in adhering to to the austerity conditions imposed by its Eurozone creditors in previous bailouts. Further, economic data out of Europe in recent months signals that the European recession may have bottomed and the start of an economic recovery may be showing its first "green shoots". The Eurozone produced its first quarterly increase in gross domestic product in the Second Quarter 2013, as reported in the Third Quarter, after six straight previous quarterly declines (*see chart, right*). While growth remains tepid and unemployment is elevated, there is hope that developed European economies are turning the corner after the sovereign debt crisis that gripped the continent since 2011.



However, delaying the European recovery is the fact that the European banking sector is far behind its American competitors. Whereas the government aggressively forced American banks to recapitalize during the financial crisis, European banks have been allowed to muddle their way out of the European financial crisis through earnings – a process that will take longer than the American strategy. This exemplifies the overall approach of European economic leaders in dealing with their crisis - it has been more passive and austerity-focused when compared to the American strategy. From its passive stance towards the banking sector to its avoidance of monetary accommodation akin to QE, Europe has been far more cautious in employing available tools to combat its economic crisis. This is partly due to Europe's past history of hyper-inflation, especially in Germany where a great deal of European economic power currently resides. Therefore, while the Eurozone is showing signs of economic stabilization, European economies (especially on the periphery of Europe) are still years away from catching up with the U.S. recovery. Future years of economic recovery out of Europe will be a positive for the equity markets over the medium to long term.

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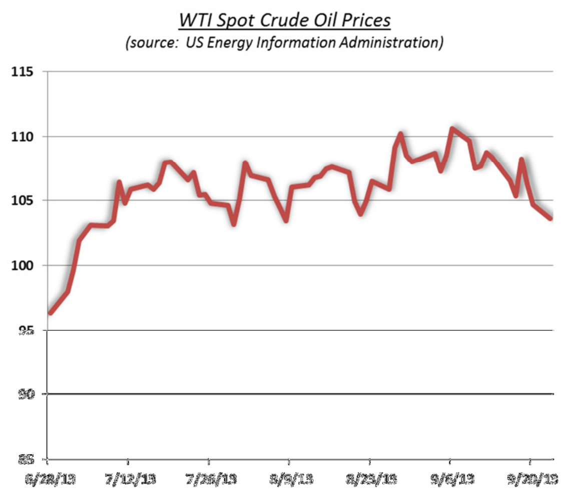
Middle East Turmoil Fuels Investor Anxiety

The Third Quarter saw renewed turmoil in the Middle East, particularly in Syria. The U.S. government threatened military action against Syria due to its use of chemical weapons on its own citizens, but ultimately backed down in favor of a diplomatic solution. The Obama administration's diplomatic solution ultimately was the best possible outcome for the economy and markets in the short term. Americans have grown war-weary after over a decade of conflict in Iraq and Afghanistan and polls indicated that there was little domestic support for a military intervention in Syria. From an economic standpoint, military intervention in the Middle East is rarely ever a positive for the U.S. as the cost of waging war greatly outweighs any benefits in the short term. This can be seen most readily by considering the spike in crude oil prices while the risk of U.S. military intervention in Syria grew. On August 28th, as the world waited for U.S. to begin air strikes on Syria, crude oil pushed to a two-year high of $112 per barrel, after only surpassing the $100 mark a month earlier (*see chart, right*). Oil prices have since retreated closer to $100 per barrel in the month of September, as it became clear that no military strike was imminent.



Military intervention in Syria would be dangerous for the fledgling U.S. economic recovery. The uncertainty and fear of a prolonged military campaign, along with potential disruptions in the oil supply raising prices for gasoline domestically, could have significantly damaged consumer confidence. As the consumer and the housing market rebound are major catalysts for the economic recovery, a military strike in Syria that scares consumers into chilling their investment or spending activities would have negative implications for housing, retailers, and the global economy in general. Further, the rise of Al Qaeda backed militants fighting the Syrian regime complicates America's role in the conflict – the civil war has become a lose-lose proposition for the U.S. politically. While a military strike in Syria is not completely off the table, it seems likely that the Obama administration's reluctance to intervene coupled with a diplomatic escape route through Syria's "surrender" of its chemical weapons stockpile to the international community will provide enough impetus for the U.S. to stay out of the conflict for now.

Conclusion

Overall, the Third Quarter was positive for the markets and for our clients. RDM out-performed the markets and maintained its focus on long term fundamentals-based equity investing through temporary periods of market volatility. We expect the equity markets to become more volatile in the near term as debt ceiling and budget negotiations in Washington heat up and the markets react to any policy changes announced by the Fed. We plan on posting any analysis of significant political developments to our blog (www.rdmcapital.com/wealthmanagementblog) and circulating the analysis to our clients. However, we believe that these political machinations create a lot of short term noise for traders to digest without significantly impacting the markets over the longer term. Therefore, we do not intend to trade significantly around news items related to the political negotiations in Washington. Ultimately, the U.S. is unlikely to default on its obligations to creditors and any government "shutdown" will be limited in duration and will have little effect on long term economic fundamentals. Further, continued economic growth domestically and economic stabilization in Europe, along with a historically accommodative Federal Reserve, will likely support corporate earnings and maintain investor confidence to justify current stock valuations going forward.

As usual, all comments are welcome.

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