Over the next three months, we expect that both stock and bond markets will be somewhat more volatile, and we may see additional short term weakness in stock market prices. However, we remain focused on the positive economic outlook for the U.S. over the next twelve months.

The U.S. economy, after a surprisingly weak first quarter, has steadily improved through the year, in line with our expectations. Unemployment has dropped to 5.9%. Home prices are up about 24% from the low reached in February 2012, although still below the 2006-2007 levels as measured by the Case-Shiller index. Rates for 30 year fixed rate mortgages recently moved below 4%, which should continue to boost sales of both new and existing homes. Oil prices have fallen by 20% since the Spring, a positive for both consumers and businesses.

Following returns of 1.8% in the first quarter and 5.2% in the second quarter, the S&P 500 returned just 1.1% in the third quarter, after notching up an all time high on September 18. Between September 30 and October 15, the U.S. stock market lost 5.5%, bringing the total return for the year-to-date to just 2.3%. Small and mid-sized stocks have fared much worse, with the Russell 2000 index losing 7.4% during the quarter, a loss of 4.4% for the first three quarters, and 6.9% for the year through October 15.

We have positioned our stock sector holdings for increasing economic strength, with slightly higher exposures to more cyclical sectors that do better when the economy is strengthening, and away from more stable sectors. This sector positioning hurt in the first quarter, helped in the second quarter and through mid-September, and has hurt since mid-September. As in the first quarter, since mid-September, stable sectors such as utilities and healthcare did significantly better than the more cyclical sectors.

After U.S. stock markets hit an all-time new high in mid-September, both stock and bond markets began to evince signs of financial distress. U.S. Treasury bond yields rose modestly in early September, from two years to thirty years, as the Federal Reserve continued to signal that it would begin to raise short term interest rates in mid-2015. Following the 8.8% market appreciation from January 1 through September 18, the S&P 500 index started falling. At the same time, U.S. Treasury bond yields started falling, and have fell sharply through mid-October. So what changed since mid-September? Briefly, the outlook for global growth has diminished, and investors have reduced their evaluation of the probable success of policy-makers ability to stimulate growth.

Fundamentals versus Feelings. Our positive case for the stock market rests on fundamentals: the strength of the U.S. economy, improved consumer balance sheets, a stronger U.S. dollar, extremely low interest rates, and growing corporate earnings — the Earnings from the Price/Earnings ratio. But, stock market returns combine both fundamentals and feelings: the earnings multiple that investors are willing to pay for expected corporate earnings depends as much upon investors subjective evaluation, or feelings, as it does on factors such as the rate of inflation and the level of interest rates. Last quarter, we noted that the primary risks to our generally positive outlook were global and geopolitical; these continue to be the major sources of risk. Since mid-September, both stock and bond market investors are increasingly focusing their worry on international economic conditions and on international political concerns — and there have been plenty of events and risks to worry about, which cumulatively have lowered the earnings multiple that investors are willing to pay.

Numerous factors have increased concerns about global growth. Japan is struggling to balance an aging population and persistent economic stagnation with high budget deficits. While the Abe government has pledged to follow expansionary policies, a 60% increase in the value added tax rate in April has complicated the economic picture and created sticker shock for consumers, leading to slower growth. Another 25% hike in the Japanese value added tax rate is scheduled for 2015.

Fears about global recession are also focused on Europe. Sanctions on Russia and uncertainties about Russia's next move have materially slowed European economies. On its own, Russia is just 2% of global real GDP. However, the economic sanctions put in place after the Russian annexation of the Crimea have affected not only the Russian economy but also its Eurozone trading partners, especially Germany. Exacerbating the fears about European growth, conflict between the German government and the European Central Bank (ECB) over Germany's unwillingness to provide fiscal stimulation to support the ECB's monetary stimulus is increasingly vocal and open.

After decades of investment-driven economic growth, the Chinese government is attempting to increase the proportion of the economy related to consumption. This has led to a slowing in economic growth to approximately 7.5%, and downward pressure on commodity prices, as China's decreasing infrastructure spending removes the marginal pressure on commodity prices.

Underscoring the concern about global growth, the price of oil has fallen by over 22% from this year's high. Decreases in the price of oil are generally a positive for consumers. However, such a significant decline over a short time period has a negative impact on some sectors and geographic regions, such as the areas of the U.S. that have been experiencing an energy boom, such as North Dakota, Texas, and Oklahoma, and the industrial companies that have been suppliers to the energy sector.

Against this backdrop of concern about global growth and possible deflation, very real fears about terrorism, global unrest in the form of ISIS, and a fear of a spreading worldwide Ebola epidemic also weigh on investors' minds.

U.S. Stock Valuation. Since the significant pullbacks in stock prices and bond yields, we believe that the market is appropriately valued. The price/earnings ratio, or the S&P 500 index divided by the expected earnings of S&P 500 companies over the next year, is a moderate 14.7, below the June 2014 level of 15.6, and below the 25 year historic average of 15.5. Other measures of valuation, including Robert Shiller's CAPE, which measures the ratio of prices to the ten year historic average of inflation-adjusted earnings, are also in line with the 25 year average, with the current CAPE at 24.7 and the 25 year average at 25.1. In addition, we note that lower levels of inflation have historically supported higher P/E ratios, as investors are willing to pay more per dollar of corporate earnings when they do not expect high inflation to erode the future value of earnings. With the 10 Year Treasury yield at 2.23% and the 10 Year Treasury Inflation Protected Securities (TIPS) yield at 0.28%, we estimate that stocks should return about 6.5% more than intermediate term bonds over the next twelve months.

Bonds. Not only do short term interest rates remain extraordinarily low, but longer term rates are falling again as well. Under the leadership of Federal Reserve Chair Janet Yellen, the Fed has been slowly and carefully shifting its language, trying to prepare the financial markets for the eventual start of a rising interest rate cycle while also communicating that upcoming interest rate increases are likely to be extremely gradual, and that they will be calibrated to the strength of the U.S. economy.

This raises an interesting question and concern, about the ability of the U.S. to pursue an independent monetary policy in an increasingly interdependent and interconnected world economy. The expansionary monetary policy followed by the U.S. since mid-2008 led to extraordinarily and persistently low interest rates. As the Federal Reserve began to position for a less expansionary monetary policy, U.S. interest rates rose relative to Eurodollar rates, and short term investment capital has flowed into the U.S. and out of other currencies, raising the value of the U.S. dollar versus other currencies. Tapering in the United States translated into tighter credit in both developed and emerging economies.

Since mid-September, we have seen sharp declines in short and long term interest rates. Generally, this would be interpreted as an indication of expected declining economic growth in the U.S. This time, however, falling U.S. interest rates are resulting from low interest rates abroad. U.S. tapering, and an increase in U.S. interest rates has drawn short term investment funds from Europe, slowing European economies. As the ECB expanded its quantitative easing program, interest rates in Europe fell. As a result, short term investment funds have flowed into the U.S., leading to a surging value of the dollar and falling U.S. Treasury yields. Yields on 10 Year and 30 Year U.S. Treasury bonds have fallen back to the levels seen in 2011 and 2012. It is rather stunning to think that yields of just 0.34% on the U.S. Treasury 2 Year note and 2.2% on the Treasury 10 Year note are attractive enough to be pulling investment capital from across the world.

Outlook. We expect continued slow, gradual recovery and expansion in the U.S. economy, weak to zero growth in the Euro zone and Japan, and significantly slower growth in China. Given our outlook for a strengthening U.S. economy, reasonable equity valuations, and the subdued expectations for bond returns, we are maintaining our overweight allocation to equities relative to bonds and cash. Fundamentals, the U.S. economy and positive corporate earnings growth, support stock market returns. Feelings, or sentiment, is currently very negative. In our judgment this negative sentiment is excessive and overdone. We expect that stock market returns will soon begin to reflect the fundamentals, and we are therefore maintaining our overweight allocation to stocks. At current valuations, we expect equities to return about 6.5% more than bonds over the next year. We are emphasizing more cyclical sectors such as information technology, financial services, and industrials. In the short term, we expect that both stock and bond markets will be somewhat more volatile, and we may see additional short term weakness in stock market prices. However, we remain focused on the positive economic outlook for the U.S. over the next twelve months. As before, the primary risks to our outlook are political. We will be monitoring closely the rising violence throughout the Middle East and any further moves by Russia to annex territory. Significant further spread of the Ebola virus would be likely to slow worldwide trade and commercial activity, and we will continue to monitor efforts to contain the virus.