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QUARTERLY ECONOMIC NEWS

Third Quarter 2013

The war in Syria and the possibility of a military intervention by the United States gripped the world's attention in the third quarter. According to many public opinion surveys conducted in September, a majority of Americans did not favor U.S. involvement for reasons ranging from ideological considerations to economic concerns. Military spending is a big line item in the federal budget; a budget that has undergone tremendous scrutiny in the past few months. By the end of quarter, many Americans had shifted their attention to a more domestic issue: the looming government shutdown. The shutdown, which went into effect on October 1, remains unresolved at time of press. It is plain to see that the government shutdown has "thrown a monkey wrench in the works". The September employment report from the Bureau of Labor Statistics was not released because Bureau employees are not there to crunch the numbers, and many government services have been suspended for lack of personnel. And don't plan on visiting a National Park or applying for a passport until the situation is resolved. It is also expected that the government shutdown will impact the fourth quarter's GDP because compensation of federal employees is treated as GDP produced by the federal government.

Economic News

According to the third estimate released by the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.5 percent in the second quarter of 2013 (compared to 1.1 percent in the first quarter). Consumer sentiment rose early in the third quarter amid higher home and stock prices, improving labor markets, and better credit availability, but slipped in September as worries about fiscal policy, legislative gridlock and sluggish economic growth were renewed. Although economic growth overall has been slow and steady, the challenges facing the economy in the upcoming months weigh heavily on investors' minds. U.S. stocks posted modest gains during the third quarter, but rising interest rates and widening credit spreads negatively impacted bond markets. Increasing investor confidence that the worse of the recessionary conditions had come to pass in Europe helped drive returns for international markets. The following table highlights the average annual returns for various indices:

Index	3rd Qtr	1 Year	5 Year	10 Year
S&P 500 (Composite Total Return)	5.25%	19.35%	10.02%	7.56%
Russell 2000	10.21%	30.06%	11.15%	9.64%
MSCI EAFE (Price)	10.94%	20.35%	3.20%	5.12%
Barclays Aggregate Bond Price	0.93%	-2.69%	1.66%	0.28%

The S&P 500 is a commonly used measure of common stock total return performance, the Russell 2000 is a commonly used measure of small capitalization stocks, the MSCI EAFE is a commonly used measure of common stock total return performance of international markets, and the Barclay's Aggregate Bond Price Index is a commonly used measure of the bond market. All referenced indices are unmanaged and not available for direct investment. Past performance is not a guarantee of future results.

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We Can't Work It Out

Political posturing in Congress has wreaked havoc yet again... a missed deadline on budget appropriations sent the federal government into partial shutdown on October 1. What does "partial" mean exactly? Mandatory spending—Social Security, Medicare, food stamps and unemployment insurance, for example—is exempt from a shutdown, as is spending for active duty military, and spending for which a suspension would threaten human life (air traffic controllers) or the protection of property (Border Patrol). All government employees categorized as essential personnel (members of Congress fall in this category) still go to work and receive a paycheck. The situation is not so rosy for those "non-essential" employees: according to the Wall Street Journal, an estimated 800,000 federal workers are temporarily furloughed. While both the President and Republican leaders in Congress argue that their showdown was based on conviction and principle, Americans seem to disagree. According to a Gallup poll conducted in the last week of September, Americans were more likely to believe the budget debate between the President and the Republicans in Congress was an attempt by both sides to gain political advantage rather than an important battle over principles and the future direction of government. Most news media outlets have called the government shutdown "messy and disruptive", but have not been able to articulate in specific terms the impact on the economy. With the different parties in Washington remaining at odds, it is difficult to predict when the shutdown will end. The last government shutdown occurred during Bill Clinton's presidency in 1996, and lasted approximately three weeks.

Financial Burden of Intervention in Syria

Since the August 21 chemical weapons attack near the Syrian capital city of Damascus, U.S. political leaders have debated the appropriateness, as well as the effectiveness, of military intervention. Among other considerations has been the potential financial burden of leading the charge. Despite the prospect of a diplomatic resolution—with Syria agreeing to turn over its supply of chemical weapons—military-related costs have already started to accumulate.

The U.S. Navy initially deployed at least five destroyers, a cruiser, and a nuclear-powered aircraft carrier (USS Nimitz) to the Red Sea in anticipation of a possible intervention in Syria. According to Admiral Jonathan Greenert, the top U.S. Navy officer, supporting a carrier strike group in routine operations costs about \$25 million per week, and up to \$40 million per week during military operations. However, these costs are not inclusive of any missiles launched, which may represent the highest cost to American taxpayers in the event of an intervention; Tomahawk missiles cost approximately \$1.5 million a piece. According to Reuters, over 100 Tomahawk missiles were launched in one day in a 2011 air strike on Libya. Considering this staggering number, it is difficult to predict the cost of extended military involvement in Syria.

Americans are likely to bear the burden of an intervention beyond just taxes. Many expect the global price of oil to increase if outside forces get involved. While this may be welcome news for some investors, it is unlikely to please the general public. Syria produces less than 1 percent of the global oil supply; however, foreign intervention in their civil war may invoke skepticism on the stability of the region in general. The country's close proximity to pipelines and sea routes used for transporting a much more significant portion of the global oil supply further explains the concern.

The U.S. military has a history of exceeding cost estimates. Under the George W. Bush administration Congress estimated the cost of the wars in Afghanistan and Iraq to be between \$50 and \$60 billion; revised estimates now show that costs are expected to surpass \$1.7 trillion by the end of 2013, with approximately \$500 billion in future costs. With so much scrutiny on the budget, it appears imperative that the federal government consider both direct and indirect costs of intervention before making any commitments.

Fed Maintains QE3

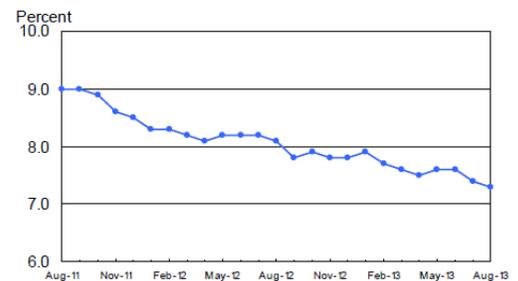
The September 18 meeting of the Federal Open Market Committee (FOMC) was penciled in by many economists as the moment the Federal Reserve would begin tapering its quantitative easing policy that has been in place for the past few years. It was truly a surprise when the Fed announced it was maintaining the current pace of its monthly bond-buying program. According to the press release published after the meeting, a conservative growth outlook, stagnant labor market conditions, and a lack of congressional action all contributed to continued quantitative easing.

Earlier this year, the FOMC felt unemployment levels around 7 percent would signal an end to quantitative easing while a further drop to 6.5 percent would serve as a precursor to rising interest rates. While unemployment figures fell from 8.1 percent in August 2012 to 7.3 percent in August 2013, these figures were inflated by the number of people no longer looking for work. According to *The*

Economist, the labor market participation rate sank to a 35-year low in August 2013.

The Fed will continue to evaluate their current monetary policy while weighing investor reactions both domestically and abroad. Chairman Bernanke de-emphasized a concrete timeframe: "Subsequent steps will be dependent on the continued progress of the economy. So we are tied to the data. We don't have a fixed calendar schedule." Where and when the data triggers further action from the Fed remains to be seen.

Unemployment Rate (seasonally adjusted), August 2011 to August 2013



Conclusion

The third quarter was witness to volatility on many fronts. Legislative gridlock seems to be the continued theme looking forward. Fiscal policy, or the lack of agreement on what the policy should be, remains a downside risk to the U.S. economy. The government shutdown may have been just a prelude to the upcoming debt ceiling battle. Many economists agree that the fallout from failing to raise the debt ceiling by October 17 could be much more far-reaching than that of the government shutdown. In a September speech to The Economic Club of Washington, D.C., Treasury Secretary Jack Lew cautioned that failing to extend the debt limit could once again disrupt financial markets and roll back economic progress. All eyes are on Congress for the upcoming negotiations that will determine the nation's credit.

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