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"I can't change the direction of the wind, but I can adjust my sails to always reach my destination." –Jimmy Dean

Despite the recent turmoil in Washington, the S&P 500 posted another strong quarter rising 5.2% for an impressive 19.8% year-to-date return. Following a weaker start to the year on a relative basis, the international markets staged a strong comeback with the MSCI EAFE index jumping 11.6% this quarter for a 16.1% year-to-date return. The Russell 2000 small cap index also posted robust returns gaining 10.2% in the quarter (+27.7% YTD), while the Russell Mid Cap index was up 7.7% (+24.3% YTD). The Russell 3000 Growth index outperformed with a +8.5% Q3 rise (+21.8% YTD) versus the Russell 3000 Value index's +4.2% gain (+20.7% YTD). We use this quarter's commentary as an opportunity to discuss a rare surprise move by the Federal Reserve, the U.S. Government shutdown and market valuations following this year's robust stock market rally.

Who's the boss?

In an attempt to help stimulate economic growth by keeping longer term interest rates low, the Federal Reserve is purchasing a total of $85 billion of Treasury and Mortgage backed securities per month as part of its third round of Quantitative Easing known as QE3. In a move that surprised investors, the Federal Open Market Committee (FOMC) made the decision not to slow (taper) the rate of bond purchases at its August meeting. At the time of the announcement, the 10 Year U.S. Treasury Yield was near 2.90% and dropped back down to around 2.60%. Many investors expected the Fed to begin tapering their bond-buying program to $75 billion a month, so the decision not to adjust QE3 was a strong reminder that the FOMC will adjust the rate of bond purchases on an as needed basis. One has to wonder if FOMC Chairman Ben Bernanke decided not to begin the taper of QE3 in anticipation of the budget fight in Washington, which has now led to a government shutdown.

Out to Lunch, Back In 10 Days…

In yet another example of profound brinkmanship in Washington, the folks in Congress were unable to reach an agreement on a spending bill and the U.S. Government was shut down on October 1st. Under the Constitution, Congress must pass laws to spend money so, without a spending bill, the government does not have legal authority to continue spending money. Goldman Sachs estimates that this creates downside risk of 0.25% to 0.50% to their Q4 GDP growth estimate of 2.5% depending on how long the shutdown lasts, but they acknowledge growth would bounce back in Q1 2014.[1] They also estimate that for every day of shutdown, federal compensation is reduced by $400 million, but Congress has approved retroactive pay for federal workers.[1]

Since 1970, there have been a total of 17 government shutdowns that have lasted 6.4 days on average with the longest, and most recent, in 1996, which lasted 21 days.[2] Additionally, The Chartist points out that, on average, stocks were lower by 0.8% from the beginning to the end of the shutdown, but were up one month and six months later and with average 11.9% return one year after the shutdown.[2]

It is important to note that this impasse is occurring at the same time that the U.S. Treasury will reach its borrowing capacity (the debt ceiling) on October 17th. As such, these two discussions are likely to converge because the consequences of reaching the debt ceiling are far more severe than a temporary government shutdown. Goldman Sachs envisions one of three outcomes with the following probabilities:

1) The shutdown ends prior to October 17th as Congress feels pressure to resolve it (10% probability)[3]
2) The shutdown and debt limit are dealt with together near the October 17th deadline (60% probability)[3]
3) The debt limit is increased while the shutdown continues beyond October 17th (30% probability)[3]

While the circumstances surrounding each shutdown and the external forces on the markets have been different each time, historically there has been no major impact or trend regarding the markets during these periods.[4] We would note that the alignment of the budget and debt ceiling negotiations is an important factor that raises the stakes during this shutdown. We continue to monitor the situation but do not believe any radical change in investment strategy is appropriate at this time.

A word on valuations

We have received numerous questions about a market crash now that the S&P 500 is back near record highs. Generally speaking, we are not in the business of predicting short term market movements and we believe that all stock market investors must be prepared for the market gyrations that are part and parcel to investing. We would like to provide an update about market valuations following the dramatic recovery from the 2008 financial crisis. To bring perspective to this analysis, we will look at multiple valuation methodologies in comparison to historical averages. The Shiller Cyclically Adjusted P/E Ratio looks at the trailing average 10-year inflation adjusted price/earnings ratio on the S&P 500 and is considered a very conservative estimate of market valuation. On this metric, the S&P 500 is trading at 24.3x earnings and is above the historical average of 19x earnings. On a Trailing P/E Ratio, the S&P 500 is trading at 17x trailing earnings versus a 20-year historical average of 19x. Finally, on a forward looking price/earnings ratio, the S&P 500 is trading at 14.3x forward earnings estimates versus a 15-year average of 16.3x. The table below samples numerous additional valuation measures which are all near historical averages.

As the Price-to-Earnings measure below shows, much of the market rally over the past year has been driven by expansion of the P/E multiple, but we do not believe the markets are overvalued versus the long-term averages. It is worth noting that corporate profit margins are currently high as a result of the cost cutting measures undertaken during the financial crisis. Historically, profit margins have a tendency to revert to the mean (return to normalized levels) and this does pose a risk to future earnings growth in such a slow growing economy. Unlike 2007, the U.S. financial system is well capitalized, corporations have significant amounts of cash on their balance sheets, and the Federal Reserve is taking unprecedented actions to stimulate economic growth. This is not to say that the market will not correct at some point, because it always does, but we are not anticipating a market crash like the Dot-Com bust in 2000 or Financial Crisis of 2008.

S&P 500 Index: Valuation Measures

Valuation Meaure	Description	Latest*	1-Year Ago	10-Year Avg.	15-Year Avg.
P/E	Price to Earnings	14.3x	12.9x	14.0x	16.3x
P/B	Price to Book	2.5	2.2	2.5	2.9
P/CF	Price to Cash Flow	9.9	8.9	9.6	10.9
P/S	Price to Sales	1.4	1.3	1.3	1.5
PEG	Price/Earnings to Growth	1.4	1.3	1.7	1.6
Div. Yield	Dividend Yield	2.2%	2.3%	2.1%	1.9%

Source: (Top) Standard & Poor's, FactSet, Robert Shiller Data, J.P. Morgan Asset Management.
Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Price to Book is price divided by book value per share. Data post-1992 include intangibles and are provided by Standard & Poor's. Price to Cash Flow is price divided by consensus analyst estimates of cash flow per share for the next 12 months. Price to Sales is calculated as price divided by consensus analyst estimates of sales per share for the next 12 months. PEG Ratio is calculated as NTM P/E divided by NTM earnings growth. Dividend Yield is calculated as consensus analyst estimates of dividends for the next 12 months divided by price. All consensus analyst estimates are provided by FactSet. (Bottom left) Cyclically adjusted P/E uses as reported earnings throughout. *Latest reflects data as of 9/30/2013.

PRISM℠

We are often asked about investment strategy during times of stress in the markets. As we referenced in our opening quote, despite our many years of collective investment experience, we are unable to control the outcomes of the markets. Instead, we focus our efforts on trying to maximize the probability of achieving a good outcome with our investments by following what we believe is the right process, our **P**roprietary **R**anking and **I**nvestment **S**election **M**odel - **PRISM℠**. Unfortunately, a good process cannot negate all bad outcomes, but it should try to mitigate them. Allowing the winds to change your sails will only lead to misdirection and missed opportunities because that type of decision is often driven by emotion, not process. We quote the commentary from Mairs & Power Funds in which they quoted Sanibel Captiva Investment Advisors: "Courage to do nothing when emotions run high and market volatility spikes is the wiser choice than trying to game the stock markets unpredictable gyrations." We believe it is important to have a well-developed process for making long-term investment decisions. Importantly, by incorporating risk assessment into PRISM, we try to avoid situations where market timing is required to achieve a good outcome. This is not to say that we simply buy and hold investments, rather we prefer to buy and monitor our investments and PRISM is our process for this analysis. Should the winds of the markets change, we will continue to use PRISM to set our sails.

Did you know?

We have had growing interest from clients about the services now available to them from Guaranty Bank and Trust. As a client of Private Capital Management, you have access to the Private Banking and Trust services offered through Guaranty Bank and Trust. Services include personal banking, jumbo mortgages, lines of credit, business loans, estate administration and settlement, and personal trust services. If you have any questions about Guaranty Bank and Trust, or their services, please do not hesitate to call us.

Reflecting on a trying summer

As we reflect on the past few months, our thoughts and prayers go out to our family, friends, colleagues, clients and neighbors who were affected by the severe flooding in Colorado. This has been a challenging time for our community following the devastating fires earlier in the summer and last year.

We want to congratulate Justin Apt on his completion of the Chartered Financial Analyst (CFA) program this year. This is a difficult designation to attain and we commend his personal commitment to achieving this goal. Giles R.A Fox and Justin Apt are both Chartered Financial Analyst Charterholders.

We would also like to take this opportunity to express how grateful we are for such a wonderful group of clients who have entrusted us with their wealth management needs. Thank you.

By the numbers…

Index	Close	3rd Quarter	Year to Date
S&P 500	1,681	+5.2%	+19.8%
Dow Jones Industrial Average	15,129	+2.1%	+17.6%
MSCI EAFE	1,818	+11.6%	+16.1%
MSCI Emerging Markets	987	+5.8%	-4.4%
Barclay's U.S. Aggregate Bond	-	+0.6%	-1.9%
DJ|UBS Commodity	127	+2.1%	-8.6%

Data provided by Morningstar as of 9/30/2013

1 Phillips, Alex. "US Daily: Updated Thoughts on the Federal Shutdown and Its Implications (Phillips)." Goldman 360. Goldman Sachs, 02 Oct 2013. Web. 5 Oct 2013. <https://360.gs.com>.
2 Sullivan, Dan, and Steve Mais. "The Chartist Newsletter." The Chartist. The Chartist, 03 Oct 2013. Web. 8 Oct 2013. <http://www.thechartist.com>.
3 Phillips, Alex. "US Daily: Will the Federal Shutdown End with a Debt Ceiling Increase? (Phillips) ." Goldman 360. Goldman Sachs, 04 Oct 2013. Web. 5 Oct 2013. <https://360.gs.com>.
4 "Daily Equity Report: Were You Aware...?." Dorsey Wright & Associates. Dorsey Wright & Associates, 02 Oct 2013. Web. 5 Oct 2013. <http://dorseywright.com/>.