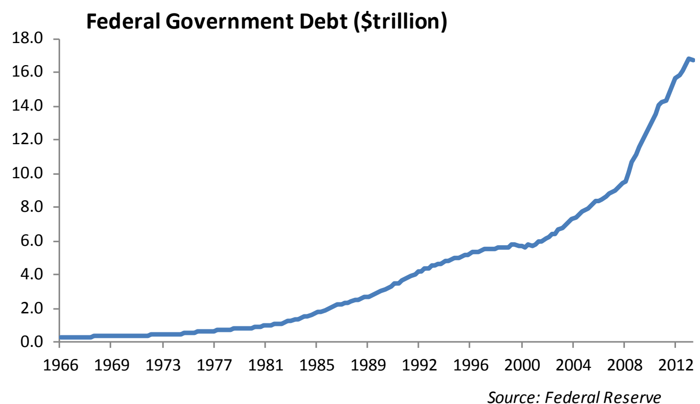
It has been five years since the Financial Crisis wreaked havoc on the economy and capital markets. With equity markets trading near record highs and new issue corporate bonds coming to market regularly, the capital markets have largely recovered. However, we are concerned that the economic recovery is just an illusion that exists in spite of the efforts in Washington D.C. to kill it. Aggressive Federal Reserve monetary policies have been successful in maintaining commerce and increasing equity prices; however, economic growth is well below the pace necessary to allow the Fed to begin to taper its asset purchase program. In addition, economic growth is impeded by structural problems which are negatively impacting job growth, fixed investment, business formation, risk taking and private credit expansion. Without more thoughtful fiscal policy, monetary policy can only sustain the economy for a period of time. Since the Financial Crisis, we have endured a painfully dysfunctional Congress which has struggled to balance a budget, initiate tax reform, and control the level of debt it has incurred without any accountability over its spending.

We all mark time in different ways. My wife recently moved her father into an assisted living facility. It was time. Now, as she and her sisters clean out the large two story colonial house, they are finding a treasure trove of family memorabilia that goes back three generations. This weekend she pulled out from a trunk in the basement an old flag with 48 stars. Think for a minute what Congress in 1959 wrestled with when they made the decision to incorporate Alaska and Hawaii into the union of states that is America. Today, our current Congress has proven incapable of coming together to promote an agenda for America. Today, we mark time with the hope that Congress will come together in a spirit of leadership and approve a budget, control expenses, finish financial regulatory reform, and reduce the debt. We don't expect that will happen.

Last week, Congress passed an increase to the debt ceiling which allowed Federal workers to go back to work. The federal debt limit was increased to $16.7 trillion and effectively delayed until January 2014 the time to deal with the political agenda of reducing the deficit and our massive spending programs. While Washington DC wants to celebrate as if they have passed a major piece of legislation, we are once again disappointed at the lack of responsibility that is being taken to control the level of spending. Our country is void of leadership and disconnected with the business constituency that has the capacity to provide jobs, capital and economic growth. It is no surprise that Congress has not passed a budget in four years and racked up $5.0 trillion in debt over the same period.

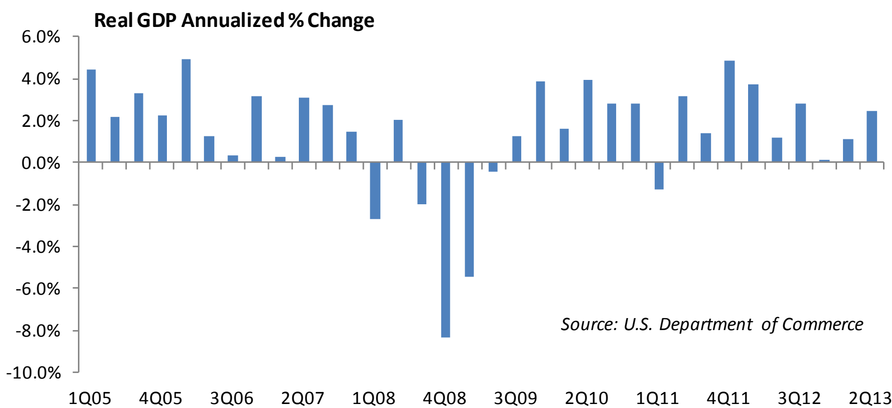


To be clear, our country's total debt burden rested at a mere $9.0 trillion in 2007. *In the past five years we have accumulated over $7.0 trillion in debt largely due to massive deficit spending. It only took our country 227 years to accumulate the first $7 trillion in debt.* History shows that when a country accumulates massive debt at such a rapid rate, the economy ultimately languishes. We are a society that is living beyond our means and there is no end in sight. *Spending is paid for through either increased taxes or borrowing. In order to experience sustained economic growth, we believe that spending levels need to be reduced.*

We mark time, but we have not changed our views on expected returns for financial assets over the near term. At the end of last year, we indicated that the S&P 500 could reach 1620 this year which would provide investors with returns in excess of 15%. *With the S&P 500 index now resting at historic high level of 1740, operating margins near the peak levels of 2007, and no real catalyst for revenue growth, we expect equities will move sideways over the near term. And, with muted economic growth, we believe we have seen the high levels in interest rates for the time being.*

The Economy

The U.S. economy currently is estimated to be $16.7 trillion in total size. *One of our investment themes is that there are structural barriers that exist in our economy and capital markets, which include uncertainty over healthcare reform, financial regulatory reform, and higher capital requirements in the banking sector. Those structural problems act as impediments to sustained growth.* GDP grew at 2.25% in the second quarter and we expect the second half of 2013 that growth is between 1.0% and 1.8%.



Five years after the Financial Crisis and with the aggressive monetary stimulus from the Fed, we still do not have sustained economic growth. The hope of our policy makers is that, by some miracle, the economy will grow into the current debt level thus justifying that it was appropriate fiscal policy. By our calculations, the economy would have to grow by 5.0% over the next consecutive five years in order for the country's debt burden to be normalized. Their other hope is that they get re-elected. The sad truth is that, in spite of the massive debt financed spending programs and the Federal Reserve's massive quantitative easing program, the economy is barely growing. *We are stuck between trying to grow the economy so that the Fed can reduce its stimulus and the increased burden of higher interest costs if the economy does accelerate.*

We expected the economy to slow during the second half of 2013. However, after Congressional dithering over the debt ceiling and shutting down the federal government, we expect the two week government shutdown will reduce GDP by 0.5%. The consumer sector is benefiting from a decline in household debt service as a percentage of disposable income. However, we are unsettled by the rapid increase in household debt after the recession. We expect a mixed holiday shopping season with heavy discounting which may end up to be milder than the previous year.

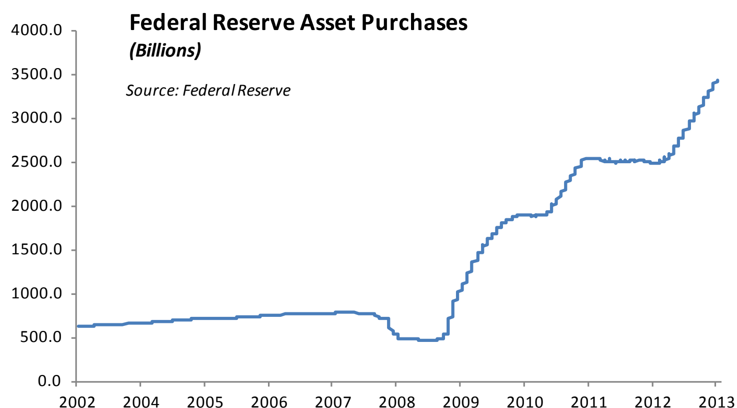
We are seeing an increase in housing starts; however, the rate of change is decelerating. This slowing suggests that economic activity will slow in early 2014. Overall, construction is growing but at a slower rate. While this has a multiplier effect on the economy, it supports our view that we will continue to muddle through 2014 with benign growth. Manufacturing remains a bright spot in the economy and has the potential to be a bigger impact on economic growth over the next decade. We expect the airline sector to help drive manufacturing through 2014. With auto sales approaching a five year high, we expect we are near the peak. However, we do not expect any decline in domestic auto sales to be catastrophic.

The ability for the economy to produce jobs remains a concern. As much as we would want to paint a pretty picture, the number of jobs being created in this economy is less than what is necessary to put the 5 million people who want to work back to work. The real unemployment rate is closer to 13.6% and the labor participation rate has declined to 63.2%. While this has helped to support operating margins in the corporate sector, it will likely have a negative impact on consumption next year.

Monetary Policy

This past month, Eugene Fama was given the Nobel Prize in economics (along with Robert Shiller and Lars Hansen) for his work on asset pricing models. His work at the University of Chicago laid the foundation for the belief that markets are efficient and, thus it is difficult to predict price movements of publicly traded stocks in the short term. His research is foundational to capital asset pricing models that we use in our own research at Winthrop Capital Management. While we do not mean to denigrate the importance of his work and contribution to the economic and financial world, it seems ironic the award comes at a time of severe direct manipulation by the Federal Reserve in our capital markets, which has the effect of distorting the price of risk in the market.

During the Financial Crisis, the Federal Reserve embarked on a huge experiment in central bank policy by directly investing in the capital markets through programs called *quantitative easing*. The first program was directed at purchasing $600 billion in mortgage-backed securities. The second program, implemented in 2010 was directed at purchasing $700 billion in US Treasury securities. In 2012, with the economy showing lackluster growth and Congress unable to pass a budget and fiscal reforms, the Fed embarked on its third program, known as *QE3*. Under QE3, the Fed targets open market purchases of Treasury and MBS of $85 billion per month. As a result of these combined quantitative easing programs, the Federal Reserve holds over $3.6 trillion in assets on its balance sheet.



With interbank lending rates at zero and banks unable to make loans and expand credit, the Fed is attempting to increase the money supply through open market purchases of securities. The effect is to lower interest rates further out the term structure and free up capacity at the banks to continue to lend.

The liquidity to purchase these assets is derived from two main sources. First banks hold excess reserves on deposit at the Federal Reserve which amount to over $1.5 trillion. In addition, the Fed borrows money from the US Treasury on a short term basis under the Supplemental Financing Program which was set up during the financial crisis in 2008.

Without sustained economic growth in the first half of 2014, any reduction to the Fed's asset purchase program is not likely until the middle of 2014. This aggressive monetary policy is designed to help capital markets function in the absence of targeted fiscal policies. With all 435 seats in the House of Representatives and 33 Senate seats up for election in 2014, we expect nothing to happen in Congress next year as more time is spent campaigning. *Any reduction in QE3 purchases is likely to be symbolic and will not have much impact on the level of interest rates and the economy. We expect that by the end of next year, the Federal Reserve's balance sheet will be over $4.5 trillion in total assets.*

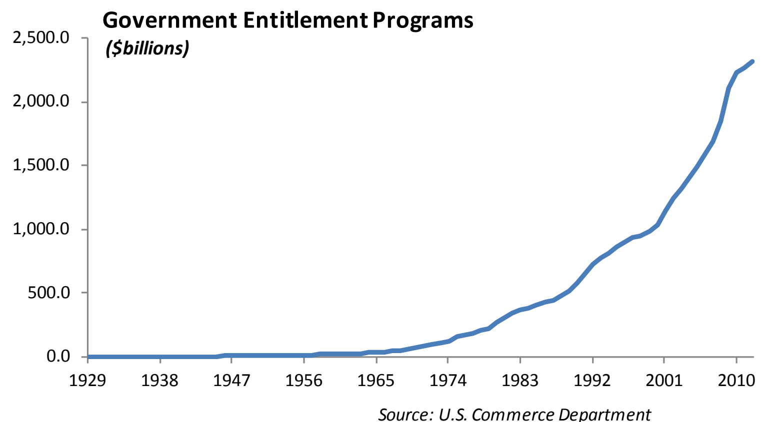
We know there will be progress toward sustained economic growth when private credit expansion accelerates. The journey toward higher capital levels coupled with a more stringent regulatory environment has restricted loan growth for the domestic banks. The bank's legal problems have compounded the current lending environment. J.P. Morgan, for example, has set aside $18 billion in legal reserves since the financial crisis. It is hard to make loans when you're constantly being sued.

Fiscal Policy is More Than Just Federal Spending

After the tremendous contraction in credit resulting from the Financial Crisis in 2008 and 2009, we experienced a severe recession which was compounded by financial regulatory reform, stiffer capital requirements for the banks and uncertainty over healthcare reform. Typically during a recession, slack resources in the economy increase and demand declines. The financial system feels pressure as the rate of defaults and problem loans increase. In addition, unemployment rises as companies try to preserve profits in the face of declining revenues. With the increase in unemployment, consumption and savings decline. Dramatic monetary and fiscal policies helped to keep capitalism moving and stabilize the economy. *Unfortunately, fiscal policy has turned into big spending on social programs that has largely gone unchecked, and there is no political will to come together to discuss solutions and put controls in place.*

Increasing federal spending during an economic downturn can help to stimulate the economy. This is known as *fiscal policy*. Fiscal policy attempts to impact economic growth either through altering tax revenues or expenditures of the government. What we would expect is that after the economic downturn, there would be incentives for established businesses to create jobs, make fixed investment in property and equipment and banks to lend money to small businesses. Assuming there was some recognition in Washington D.C. of these needs, fiscal policy initiatives would be initiated to help spur economic activity. These might include a tax credit for businesses that purchase computers and other equipment, or an incentive for small businesses to hire full time employees.

Unfortunately, healthcare reform has had the opposite effect and actually acted as a deterrent to job creation and economic progress. We believe the process of creating and implementing healthcare reform has been destructive to the economy in two ways. First, corporate America has postponed hiring over the past three years as the uncertainty of how Healthcare reform would impact expenses. And, secondly businesses have brushed over men over 45 preferring to hire younger employees who are cheaper and not a burden for the group insurance plans.



Deficit spending is clearly a part of fiscal policy. However, simply keeping our expenditures in place without any review of effectiveness ignores the many years of neglect to the stewardship over where Congress spends our tax revenues. *Here is the troubling part: federal entitlement programs are the largest catalyst for this spending growth. In total our entitlement programs, lead by Medicare, Medicaid, and Social Security, cost over $2.0 trillion in 2012 and account for 62% of total government spending. In 1963, entitlement programs represented 25.4% of the total spending.* The rapid rate of growth can be seen in the chart on the right.

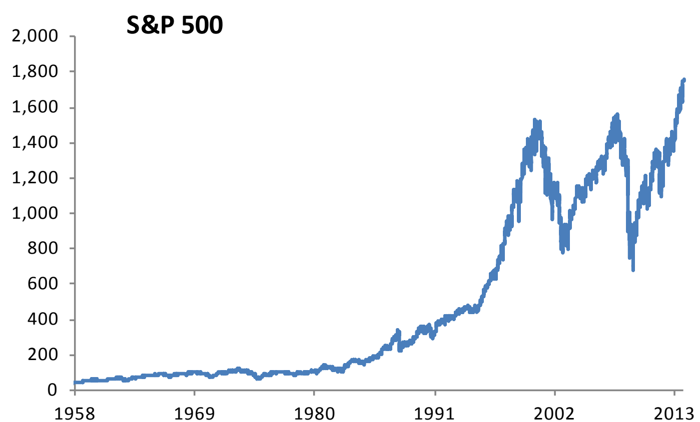
Unless there is strong fiscal policy initiatives implemented in the near future that are targeted at jumpstarting job growth and incentivizing risk taking, the Fed will not be in a position to begin its taper for a long time. The economy is simply not strong enough to grow at a pace to allow for diminished support. We do not believe that will happen under this administration and this Congress. *Unfortunately, we are stuck between trying to grow the economy to a pace that the Fed can reduce its stimulus and absorbing the increased burden of higher interest costs if the economy does accelerate.*

Investment Strategy

We mark time with every recommendation of caution we have made to investors since the Financial Crisis. *The number one rule of investing is to make sure you are adequately compensated for the risk you are taking. There appears to be a disconnect in the market between fundamental valuation and market sentiment.* With the S&P 500 at a record high level 1740, the markets appear gleeful with every incremental layer of stimulus. Yet, we see deterioration in operating margins over the next year as the added costs of healthcare reform, compliance, regulation and higher borrowing costs are factored in. While there are examples of companies that are growing revenues, we see more challenges in top line growth given weak global demand.

From a valuation standpoint, we believe the trend in top line revenues is flat and operating margins are near peak levels of 2007. With 2014 S&P earnings around $108 to $115 per share and a forward P/E multiple in the 15 to 16 range, we view the market fairly valued in the 1680 to 1730 range. Without a strong catalyst for revenue growth, we expect earnings growth will experience pressure. Thus, our expected returns for equities are in the mid-single digit area. At the same time, there is so much stimulus in the system that downside risk, while very real, is limited. We still believe there is opportunity in the industrial, technology and consumer discretionary sectors. Earnings for large banks will be challenged as profits are squeezed in a higher interest rate environment.

We are early in the recovery in Europe and we expect it to be weak. The EU has yet to deal with their structural problems and we would prefer to take a wait and see attitude before making a tactical allocation. We don't believe the numbers coming out of China, but remain constructive in the Pacific Rim as part of our international allocation.



With the spike in US Treasury yields last quarter, preferred stocks sold off. We see excellent value in the Bank sector preferred stocks where yields have increased to the 6% to 7% range. With the change in leadership at the Federal Reserve and the modest outlook for economic growth, the Fed will be challenged to reduce its stimulus in a meaningful way over the next year. While there will be volatility in interest rates, we expect to see only modest pressure upward on interest rates over the near term. This will give time for businesses and consumers to adjust and policy makers to assess the impact of higher rates on economic growth, particularly in the mortgage origination and commercial development areas. With the default of the city of Detroit and concern over Puerto Rico, the municipal bond sector cheapened up significantly during the third quarter. There is wonderful value in the 15 to 20 year maturity range for income oriented buyers in high quality general obligation and revenue issuers.

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