The Colony Group

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This Goldilocks economy – that is not so hot that it causes inflation and not so cold that it causes a recession – is a favorable environment for risk assets.

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Q3 2014 Market Update and Economic Review

Introduction: Five years into the recovery following the Great Recession, economic conditions finally appear to be normalizing. Despite a weather-induced slowdown during the first quarter of this year, the U.S. economy is expected to grow at a 3% seasonally adjusted annualized rate during the second half, as employment, manufacturing, and consumer confidence are all showing signs of improvement.

The improved economic performance reflects the effects of stronger job and income growth and, more recently, lower gasoline prices. Business fixed investment spending also appears to be strengthening. Additionally, the housing market has gotten back on track, though the pace of growth is below where it was earlier in the recovery. Lastly, government spending is switching from a headwind to a tailwind as tax revenues continue to improve.

Despite stronger economic growth, the Federal Reserve has been able to remove its accommodative monetary policy over time. This is because inflation remains tamed. Additionally, modest U.S. economic growth is being offset by slower growth outside the U.S. and falling commodity prices. This Goldilocks economy – that is not so hot that it causes inflation and not so cold that it causes a recession – is a favorable environment for risk assets.

Inside This Issue

Capital Markets Update

Global equity markets were broadly challenged during the quarter, with many regions posting negative returns. In the U.S., large-cap stocks saw small gains while small-cap names declined sharply. The growing dispersion between large-cap and small-cap stock performance has left many questioning when the relationship might reverse course. Since small companies are generally more economically sensitive, it appears that investors have taken some risk off the table while waiting for greater conviction on economic growth and the Federal Reserve's interest rate policies. With continued geopolitical unrest in Russia/Ukraine, Iraq/Syria, and Israel/Palestine, international equity markets were hard pressed for gains. China and India posted advances despite continued concerns over the impact to the Asian region from a slowdown in China's growth and Japan's struggling economic reforms.

S&P 500 sector performance was also mixed for the quarter. Growth-oriented Health Care and Technology stocks were leaders, rising 5.5% and 4.8%, respectively. Telecommunications, Financial Services, and Consumer Staples also did well (+2-3%). However, Energy stocks declined sharply (-8.6%) as prices for West Texas Intermediate crude oil fell over $10 to approximately $91 per barrel at quarter's end. The rising dollar undoubtedly contributed to this decline. In general, growth outperformed value across all market capitalizations in the quarter.

U.S. bonds generally outperformed their international counterparts. Most strategists were predicting that interest rates would rise this year, but the markets have confounded them. The yield on 10-year U.S. Treasury bonds has gradually declined over the year, trading between 3% in January and 2.4% at September's end. Municipal bonds continued to see strong demand, advancing 1.5% for the third quarter and 7.6% year-to-date. High-yield bonds experienced some selling pressure as investors became concerned about valuation. TIPS declined over the quarter as the risk of inflation appeared low, with lower commodity prices and economic weakness in Europe and Japan. Foreign and emerging markets debt declined 5.4% and 7.4%, respectively.

Within the non-traditional asset class, returns were largely negative. Commodity prices for agricultural goods, livestock, and energy fell, leading many benchmarks to double-digit declines. The REIT space took a bit of a breather during the quarter (-3%) but remains up about 14% for the year. Hedge fund strategies generally were weak, particularly given the performance of the equity, fixed-income, and commodities markets.

Economic Review

Inflation: The headline consumer price index increased by 1.7% year-over-year in August. Excluding food and energy, core prices also rose by 1.7% year-over-year. On a month-over-month basis, the headline index fell by 0.2%, the first decline since April 2013, while the core index remained unchanged. For the second consecutive month, falling energy prices were largely responsible for the pullback in the headline CPI.

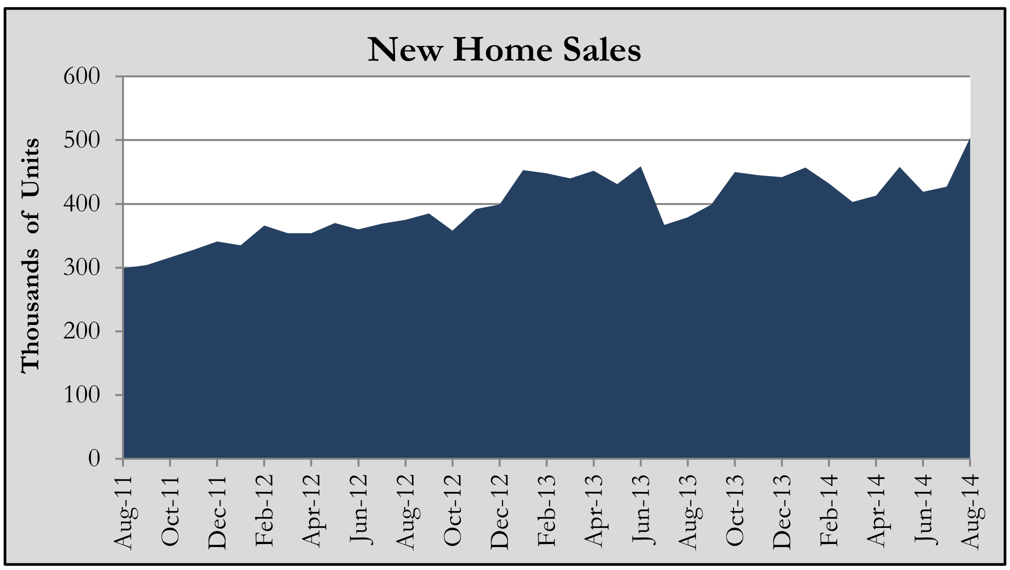
Although energy prices have played a key role in moderating headline inflation, a more fundamental factor has been the notable absence of accelerating wage growth. The shift from moderate to robust job gains over the past year has not caused average hourly earnings to accelerate. Historically, wage gains have preceded material changes in prices for goods and services.

The inflationary backdrop remains benign and is enabling the Federal Reserve to be deliberate with the timing of the first interest rate hike. We believe they will likely remain on hold until at least 2015.

Housing: On balance, the data on housing has been mixed. Existing home sales have languished in recent months. Moreover, attitudes toward home buying remained depressed according to the consumer confidence survey, which asks whether participants plan to buy a new home in the next six months.

Conversely, August new home sales jumped 18%. The increase was largely due to sizeable gains in the Northeast and West, which increased 29% and 50%, respectively. Moreover, data for the previous three months were revised higher. This corroborates the solid gains in builder sentiment over the past three months. Lastly, average home prices increased during the month. We expect a continued slow and gradual improvement in the housing market, with activity likely to pick-up in the coming months.

Federal Reserve: The Federal Open Market Committee (FOMC) announced that it would end the bond-buying program known as Quantitative Easing in October, but it reaffirmed guidance that short-term interest rates would remain near zero for a "considerable time" after that program ends. Under the plan, the Federal Reserve will purchase $15 billion of mortgage and Treasury bonds this month and then stop the purchases.



Source: Federal Reserve Bank of St. Louis

This statement, following the FOMC meeting in September, alleviated market concerns that the central bank might be warming up to the prospect of an earlier than expected interest rate increase.

ECB: The European Central Bank (ECB) lowered its main lending rate to 0.05% from 0.15%. In addition, the ECB increased the rate it charges on overnight bank funds parked at the central bank to 0.2% from 0.1%. Recall that in June the ECB became the largest central bank to experiment with a negative rate on bank deposits, a measure aimed at encouraging banks to lend surplus funds to other financial institutions rather than paying to park them at the ECB.

In a somewhat surprising move, the ECB announced an asset-backed securities and covered bond purchase program. This is an indication that officials are growing increasingly concerned that the recent period of very low inflation could persist longer than expected and may threaten the currency bloc's economic recovery. This first attempt at quantitative easing is expected to lower borrowing costs and weaken the euro, making exports more competitive in overseas markets.

Global Economy: As the U.S. economy continues to grow, some larger foreign economies are experiencing challenges that are limiting their contributions to global economic growth. The aforementioned moves by the European Central Bank (ECB) underscore the weak economic environment in the region. Meanwhile, Japan is struggling to find the right balance between its reform efforts.

On the other hand, the Chinese economy, which had been weakening over the past several quarters, is showing early signs of strengthening. Better performance from the Chinese economy would be welcome news by the global economy. Indeed, many emerging market countries, which depend on China's growth, have struggled. One of the few emerging market countries that bucked this trend was India, which posted a stronger-than-expected growth rate in the second quarter.

Outlook: Many investors and economists have criticized the pace of the U.S. economic recovery since it started five years ago. Indeed, growth has been subpar compared with some past recoveries. This phenomenon has its advantages, however. Inflation remains constrained, allowing the Federal Reserve to maintain accommodative monetary policy for longer than expected. Now that the economy appears to be on sounder footing, the Federal Reserve is removing some of its reflationary policies. Nevertheless, we expect the U.S. economy to continue to grow moderately for the foreseeable future.

Outside the U.S., conditions are not as sublime. Japan is struggling to gain traction with its economic reforms. China's growth is decelerating, although it is showing some signs of bottoming. Finally, policymakers in Europe remain reactive and seem unable to get ahead of the region's economic challenges. More will need to be done by these countries before the existing trends reverse.

Sources: Capital Market Consultants, Department of Commerce, The Conference Board, Institute for Supply Management, Department of Labor, Bureau of Labor Statistics, National Federation of Independent Business

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Index Performance as of: 9/30/2014	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	-1.00	-2.43	-0.87	-0.87	7.01	17.67	23.67	15.09
3000	-0.60	-2.08	0.01	0.01	6.95	17.77	23.07	15.78
3000 Growth	-0.22	-1.75	0.88	0.88	6.91	17.89	22.40	16.43
1000 Value	-0.91	-2.06	-0.19	-0.19	8.07	18.90	23.93	15.26
1000	-0.53	-1.75	0.65	0.65	7.97	19.02	23.23	15.90
1000 Growth	-0.17	-1.45	1.49	1.49	7.89	19.16	22.44	16.51
Mid Cap Value	-0.98	-3.80	-2.65	-2.65	8.20	17.47	24.71	17.24
Mid Cap	-0.74	-3.34	-1.66	-1.66	6.87	15.84	23.78	17.19
Mid Cap Growth	-0.51	-2.90	-0.73	-0.73	5.73	14.44	22.73	17.13
2000 Value	-2.05	-6.75	-8.58	-8.58	-4.74	4.13	20.60	13.03
2000	-1.46	-6.05	-7.36	-7.36	-4.41	3.93	21.25	14.29
2000 Growth	-0.86	-5.35	-6.13	-6.13	-4.05	3.80	21.90	15.51
Standard & Poors								
S&P 500	-0.49	-1.40	1.13	1.13	8.34	19.75	22.99	15.70
Consumer Disc	-0.44	-2.76	0.26	0.26	0.86	11.78	26.27	21.46
Consumer Staples	0.31	0.63	1.95	1.95	7.23	16.54	18.21	15.40
Energy	-1.83	-7.55	-8.62	-8.62	3.24	11.87	16.87	12.46
Financials	-0.66	-0.39	2.33	2.33	7.42	18.53	27.64	11.03
Health Care	-0.39	0.43	5.46	5.46	16.62	28.45	28.83	19.74
Industrials	-0.45	-1.08	-1.09	-1.09	2.87	16.79	24.82	17.25
Information Technology	-0.26	-0.68	4.77	4.77	14.13	29.29	22.31	16.03
Materials	-1.10	-1.54	0.22	0.22	8.87	20.49	21.95	13.23
Telecom Services	0.06	0.41	3.07	3.07	7.47	13.36	15.21	14.00
Utilities	0.08	-1.86	-3.96	-3.96	13.95	17.14	12.26	12.13
Other U.S. Equity								
Dow Jones Industrial Avg.	-0.07	-0.23	1.87	1.87	4.60	15.30	19.02	14.85
MSCI USA	-0.49	-1.56	0.95	0.95	8.16	19.32	23.00	15.77
Wilshire 5000 (Full Cap)	-0.52	-2.09	-0.02	-0.02	6.85	17.68	23.01	15.88
International Equity - Broad Market								
MSCI EAFE	-1.45	-3.81	-5.83	-5.83	-0.99	4.71	14.16	7.04
MSCI Emerging Markets	-2.63	-7.39	-3.36	-3.36	2.75	4.66	7.55	4.76
MSCI Frontier Markets	-0.27	0.73	1.57	1.57	22.44	30.52	18.34	9.14
MSCI AC World	-1.13	-3.20	-2.20	-2.20	4.16	11.90	17.24	10.65
MSCI AC World ex USA	-1.78	-4.81	-5.19	-5.19	0.39	5.23	12.29	6.50
MSCI AC Asia ex Japan	-2.35	-5.86	-1.54	-1.54	4.93	8.52	11.18	7.12
International Equity - Country Region								
MSCI Brazil	-6.04	-19.21	-8.58	-8.58	1.23	-4.31	-2.33	-4.13
MSCI BRIC	-3.54	-9.12	-3.14	-3.14	1.55	3.28	5.63	1.16
MSCI China	-3.04	-6.34	1.53	1.53	1.02	4.87	11.80	3.96
MSCI Europe	-1.49	-3.74	-6.98	-6.98	-1.44	6.37	16.22	7.54
MSCI India	-1.07	-1.42	2.34	2.34	24.71	37.64	9.01	4.34
MSCI Japan	-0.42	-0.60	-2.19	-2.19	-1.36	0.93	9.39	5.60
MSCI EM Latin America	-3.88	-13.33	-5.44	-5.44	1.56	-0.74	1.48	0.08
MSCI Russia	-3.53	-5.81	-15.07	-15.07	-19.46	-19.19	-0.28	-0.12
Fixed Income								
Barclays U.S. Aggregate	0.00	-0.68	0.17	0.17	4.10	3.96	2.43	4.12
BofA Merrill Lynch 3-Month T-Bill	0.00	0.00	0.01	0.01	0.03	0.05	0.07	0.10
Barclays U.S. Government	0.10	-0.52	0.32	0.32	3.00	2.29	1.06	3.11
Barclays U.S. Credit	-0.24	-1.41	-0.03	-0.03	5.67	6.65	4.82	6.10
Barclays High Yield Corporate Bond	-0.91	-2.09	-1.87	-1.87	3.49	7.20	11.09	10.57
Barclays Municipal	0.22	0.10	1.49	1.49	7.58	7.93	4.56	4.67
Barclays TIPS	-0.26	-2.50	-2.04	-2.04	3.67	1.59	1.34	4.48
Barclays Global Aggregate ex US	-1.10	-4.25	-5.38	-5.38	-0.09	-0.81	0.14	1.68
Barclays Global Aggregate	-0.65	-2.79	-3.14	-3.14	1.64	1.19	1.16	2.69
BofA Merrill Lynch Emerg. Mkt. Credit	-0.69	-4.09	-7.37	-7.37	2.29	4.54	11.87	11.76
Alternative Investments								
Alerian MLP	1.49	-1.56	2.73	2.73	19.48	25.81	22.94	23.58
Bloomberg Commodity	0.08	-6.23	-11.83	-11.83	-5.59	-6.59	-5.34	-1.37
FTSE NAREIT Equity REIT	0.06	-5.95	-3.14	-3.14	13.96	13.15	16.67	15.89
S&P Global Natural Resources	-2.14	-7.05	-7.76	-7.76	-1.41	3.08	4.96	2.33
S&P North American Natural Resources	-1.86	-8.81	-10.03	-10.03	4.75	10.28	12.52	8.82

Sources: MPI, Morningstar, Barclays, HFR