TFC FINANCIAL
The Financial Counselors

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Equity Markets Slide (Confirming the "Black October Hypothesis"?) - Volatility Returns, Hedge Funds and Traders Party Again

After more than three years without a US stock market correction exceeding 10%, meaningful price adjustments are under way. Readers of these letters may recall our concerns, voiced throughout the summer, about investor complacency, apparent speculative activity (e.g., last month's Alibaba IPO), and relatively expensive small company P/E levels. As corrections of this nature develop, the cognoscenti emerge from their lairs with headline-grabbing explanations, economists provide one-liner pronouncements for the media to recycle, and portfolio strategists rationalize the obvious. After sifting through all the noise, it seems that this year's Nobel Laureate in Economics, Robert Shiller, gets us back to first principles:

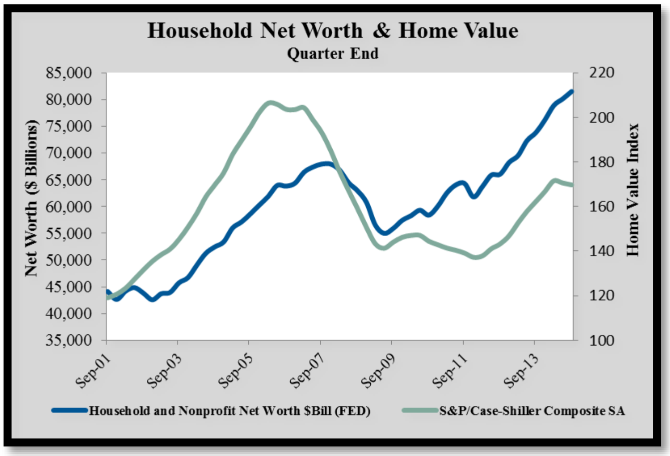
> "The market is supposed to estimate the value of earnings (i.e., P/E), but the value of earnings depends on people's perception of what they can sell it again for" (to other investors).*

We don't disagree, but Shiller appears to be somewhat conflicted in prescribing a behavioral metric to unravel the decline in stock prices currently under way. On the one hand, he earned his Nobel Prize because of his research devising a precise set of ratios by which to statistically measure the relative valuation levels of the housing and stock markets. And yet, at the moment, he suggests that valuations in the end rest on investor perception. Shiller's dilemma, no doubt, reflects the conflicting mental state prevailing today of most investors. But it still remains that in the relatively free financial markets in which capital is risked daily with an infinite variety of motives driving investor activity, stock prices in the long run are determined by the direction, quality and amount of corporate earnings. (More on this later.)

Can (Should) Central Bankers Take a Victory Lap?

In the US at least, recently the tendency for investors had been to exhale, sit back, open a bottle of Chablis and credit the Federal Reserve Bank (Fed) with rescuing the global financial markets from the cataclysm of 2008-2009. Indeed, by printing dollars without restraint, the Fed has succeeded in its goal of reinflating the housing market and rebuilding collective household net worth back to pre-crisis

*Jason Zweig, *Wall Street Journal*, October 11-12, 2014 levels (see exhibit "Household Net Worth & Home Value" below).



Source: TFC Chart, Bloomberg Data

But the result, which policy wonks and pundits failed to anticipate, and the media bleats incessantly, has been that those who own financial assets have benefitted from the Fed's money supply inflation at the expense of the average worker. Worse, as equity markets moved up into what had been new high ground, this aggressive monetary policy has had the perverse effect of widening the income and wealth distribution gap.

Further, with Fed policy aimed at reducing interest rates to negative *real* (i.e., adjusted for inflation) return levels, holders of fixed income instruments (e.g., bonds, savings accounts, annuities, etc.) find themselves seeking income via riskier investments such as high-yield bonds, hedge funds, and other so-called alternative vehicles. In a sense, the longer-term impact of our central bank take-over of the financial markets has been to reward debtors while disadvantaging savers. "Sell-siders" (i.e., financial services providers, Wall Street product designers and/or brokers) have begun to game this anomalous confluence of unintended consequences by flogging computer-modeled alternative investment vehicles and "structured" products promising greater yields, *and* downside price volatility protection.

Politicians are demogoguing the widening income and wealth distribution gap without providing any context, or background, as to why this scenario is unfolding (assuming in the first place they care, or could understand the causes). Said another way, in saving the too-big-to-fail financial institutions (e.g., Bear Stearns, AIG, etc.) in 2008-2009, by transferring massive amounts of toxic private debt to taxpayers, the Federal Government and our monetary authorities have laid the foundation for a tectonic shift in the US, and just as importantly, worldwide financial markets. How the Fed and European Central Bank (ECB), and central bankers around the world, implement their exit strategies, and return the financial markets to a state of "new normalcy" will determine whether these unelected officials should take a victory lap around the track.

Moving from Economic Recovery to Expansion (What To Do About the Fixed Income Part of a Balanced Account?)

Although our European counterparts continue behind the curve, in the US, the longer-term outlook for our economy continues to improve. This fundamental economic backdrop supports a positive domestic corporate earnings growth expectation. Ultimately, the trend in corporate earnings is what moves stock valuations, in the long run the main driver of investment returns. But today, the Fed-administered structure of interest rates remains near 60-year low levels. *Real* yields approximate zero on shorter-term fixed income vehicles. And the Fed seems intent on keeping rates at present levels at least into next year.

By default, relative to domestic equities, conventional liquid fixed income securities are unattractive. Wage inflation continues moderate, purchasing power erosion expectations appear modest. Central bankers await rising wage-cost inflation indicators before feeling compelled to allow interest rates to move up and back to more normal ranges. However, surveys of corporate CFOs now anticipate wage-cost pressures are mounting. Unemployment rates just announced (5.8% for September) could decline faster than expected. Since the Fed seems focused on this measure as a metric determining when to begin to raise rates, the timing of this could be closer than consensus predictions. So hunting for yield by extending duration, moving down the credit quality ladder to junk bonds, or placing fixed income investment assets in the hands of unconstrained active bond fund managers, continues to strike us as potentially hazardous to one's personal wealth. Remaining in high quality, shorter duration fixed income positions (3 year average duration) and accepting lower coupon income while awaiting the Fed's inevitable tightening, seems a more prudent course. A sample of current bond market yields:

Bond Type	Current Yield		
	2 Year	5 Year	10 Year
US Treasury Bonds	0.6%	1.8%	2.5%
US Investment Grade Corporate Bonds	0.9%	2.1%	3.1%
US Municipal Bonds (AAA, AA)	0.4%	1.2%	2.2%

Patience and Discipline in a Time of Shifting Asset Class Relative Values

During the past 12 months, major asset class relative valuation realignments have taken place. Due to the oil and natural gas extraction bonanza in the US, and our resulting foreign petroleum import contraction, at $80 per barrel, the price of oil is now near a four year low. The Saudi's seem agreeable to this, but should further declines ensue, both OPEC and certainly Russia, can be expected to react. Russia's economy (nearly 50% of its fiscal revenue is derived from petroleum export revenues) operates at break-even today with oil prices at $90. Other commodity prices have declined as well, symbolic of moderating demand and rising global supplies, all of which mitigates global inflationary pressures.

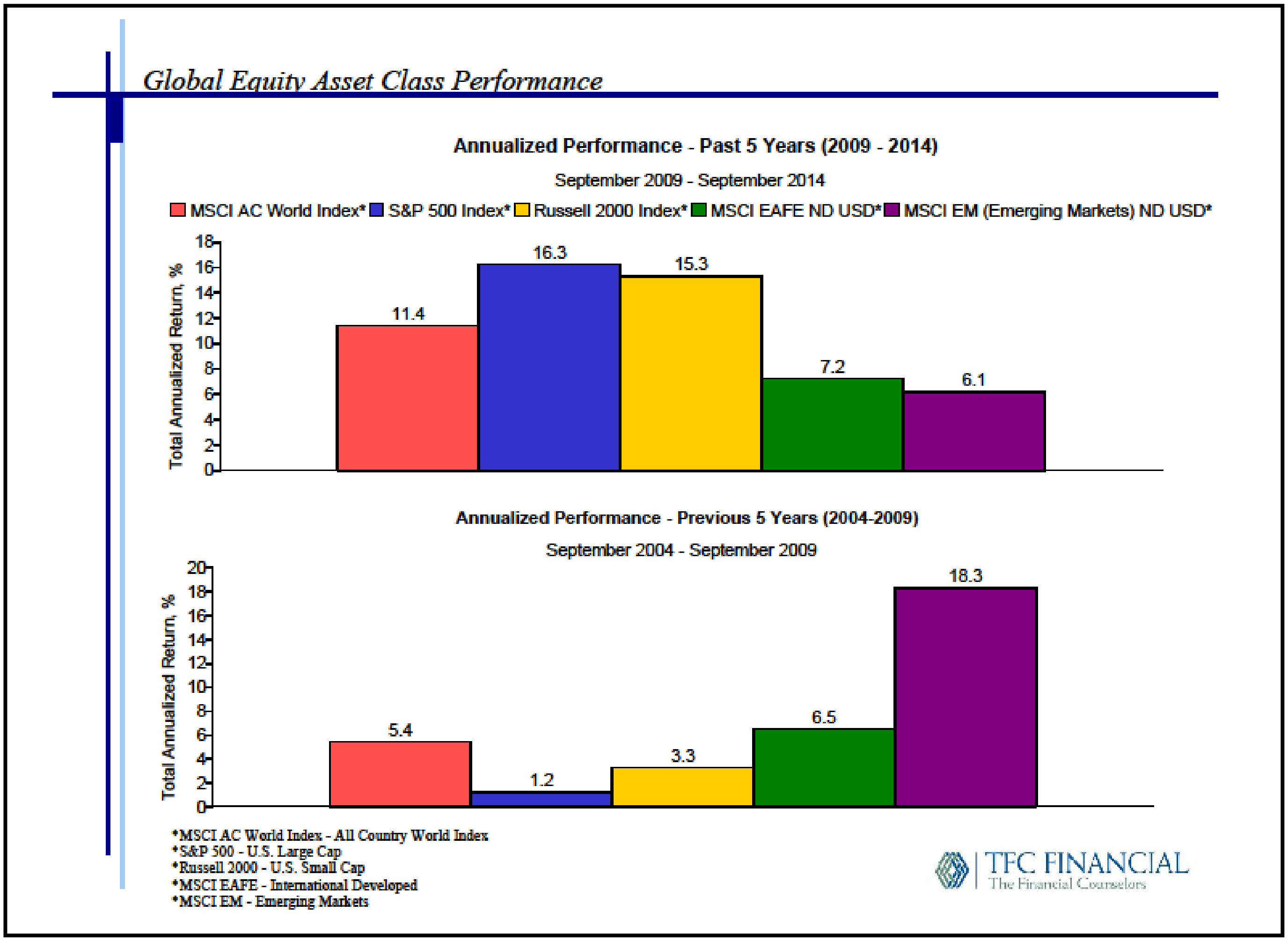
So far this year, in global investment markets, US large company stocks have continued to outperform compared with non-dollar denominated international developed country stocks (see attached exhibit "International vs. US"). Relative to US large company stocks, emerging market equities have also underperformed (see exhibit "MSCI Emerging Markets vs. S&P 500" attached).

Further, in the US, small company stocks have struggled this year relative to larger companies (see exhibit "Large Cap vs. Small Cap" attached), after outperforming since the market bottom. The cumulative total return of the Russell 2000 Index, which represents US small cap stocks is +247% since March 9, 2009 vs. +227% for the S&P 500 Index. Strategically, we have been reducing our US small cap allocation over the past 18 months as relative valuations have been rising beyond historical norms.

This is in addition to periodic portfolio rebalancing when we have been selling from US small cap funds in client portfolios to add to fixed income or for cash needs.

Significant differences in asset class and global regional performance are not unusual, but appear more glaring in weak or down markets. Over longer time frames, relative valuations and performance revert to long-term averages. Periodic rebalancing and paring from the top performing, and often most expensive asset classes, adding to the worst performing and cheapest asset classes continues to be an effective portfolio strategy. However, patience and discipline are required to override our emotional tendencies, including chasing recent performance, short term focus, hindsight bias, and overconfidence in predicting the future.

The graphs on the chart below illustrate major equity asset class performance for the past five years (September 2009 to September 2014) and the preceding five years (September 2004 to September 2009).



The chart below reflects current price-to-earnings ratios for these asset classes based on projected 12-month earnings. Please also refer to the “Global Regional Valuations” chart on page six.

Current Equity Market Valuations

Index	P/E Ratio (12 Months Forward)
World (MSCI ACWI)	13.6X
World Ex-US (MSCI ACWI ex-US)	12.5X
US Large Cap (S&P 500 Index)	14.6X
US Small Cap (Russell 2000 Index)	19.9X
International Developed Markets (MSCI EAFE)	13.1X
Emerging Markets (MSCI EM)	10.7X

Source: Bloomberg Data

As always, we welcome your comments and questions.

Sincerely,

Jim

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Chairman, CEO & CCO

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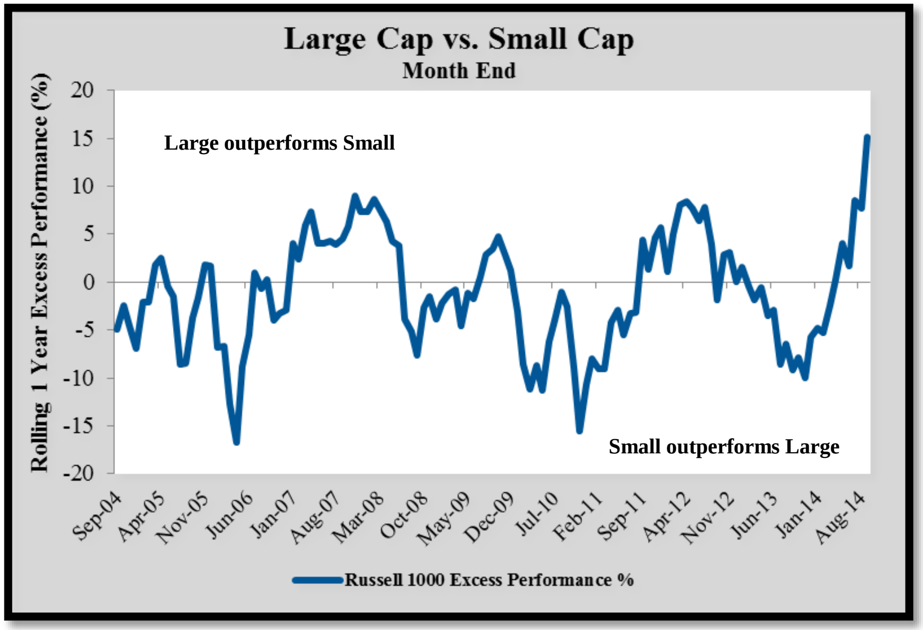
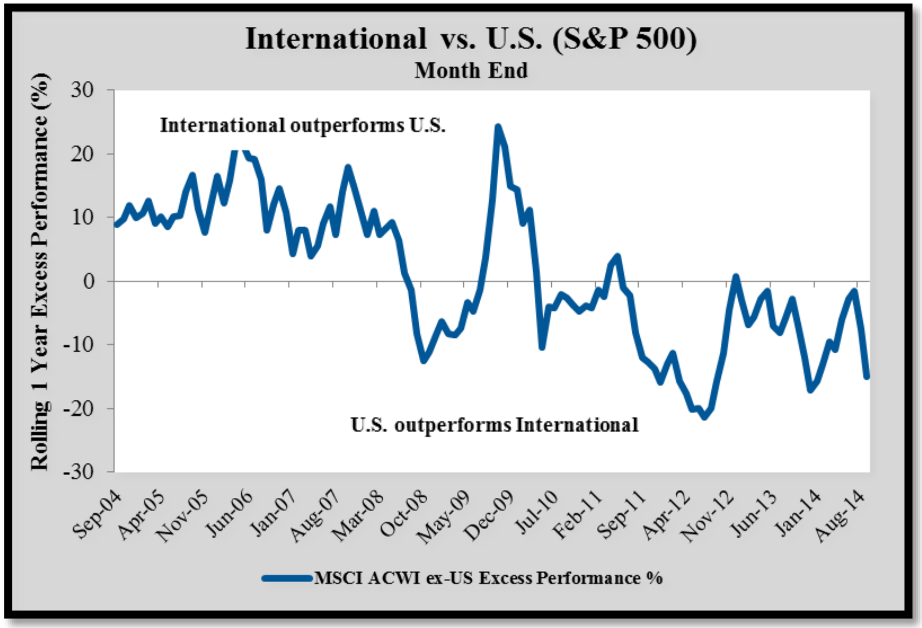


Source: TFC Chart, Bloomberg Data



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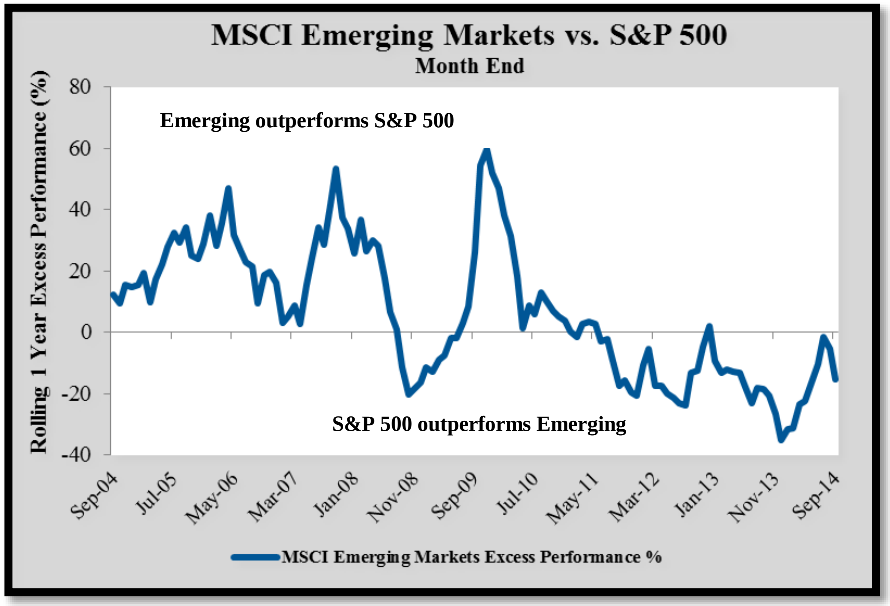

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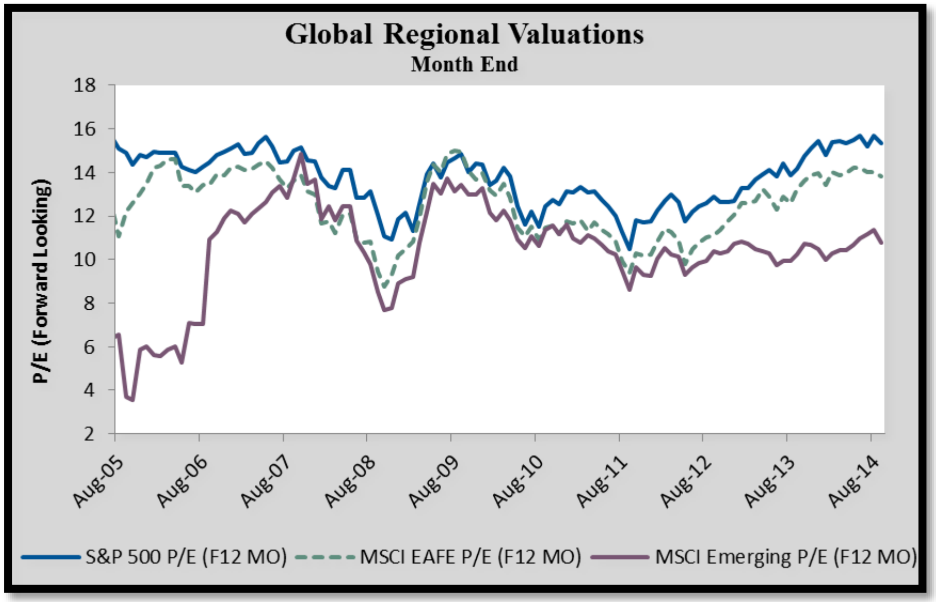

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