HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKETS

By William N. Hudson, Jr. & David D. Burrows **Volume 57** **October 2013**

This quarterly commentary is somewhat challenging to compose. As we write, the political impasse in Washington has no imminent conclusion and threatens to damage the economy. But we believe this crisis will somehow be averted. We hope that some resolution has occurred by the time you read these words.

We are investment strategists and financial market analysts. We are not politicians. We do not know the formula for political compromise in this situation. But we know that prolonged shutdown of the government and default on U.S. Treasury debt will create market chaos and likely recession. We think the Washington politicians – even those with the most entrenched viewpoints – will not allow the country to go down that path. Common sense will somehow prevail.

Absent all the political drama, the investment terrain is actually fairly smooth. The economy is recovering slowly, short-term interest rates will remain historically low, and inflation is subdued. The 2013 year will end positively for equity investors. Many stocks have gotten somewhat pricy and 2014 is unlikely to repeat growth comparable to this year. But equities will still be the place for investors to seek the best possible returns.

At Hudson Advisors, as always, our strategy is to be selective and prudent stock pickers for our clients. We will concentrate in the period ahead on the equity sectors that still represent reasonable valuations and future growth potential. We can navigate the artificial turbulence of the moment and we anticipate positive year-end results with sustained momentum going into 2014.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first nine months of 2013. The equity markets recovered from the uncertainty in late spring over Federal Reserve policy and showed strong positive gains. Meanwhile, the bond market also reacted to the Federal Reserve announcements, losing ground for much of the quarter, but then recovering somewhat in September.

Over the long term, we have allocated between 5-15 percent of client equity portfolios to international and emerging markets. We believe it is important to have portfolio exposure to high growth economies and non-dollar assets. It has been shown that international and emerging markets are often lowly correlated with the U.S. markets and in such cases can positively impact performance. In the short term (3rd quarter), international and emerging markets outperformed U.S. markets. However, over the last 5 years there has been a sharp divergence between these markets. For example the S&P 500 through 6/30/13 has a 5 year annualized return of 6.96% compared with a negative return of -3.59% for the MSCI EAFE. We hope to see a return to a positive correlation between these equity classes.

THE OUTLOOK

Equity Markets: Until the politicians resolve the debt and government shutdown situations, the generally optimistic view of the U.S. markets will remain in doubt. With the outlook for the U.S. economy basically positive, stock prices climbed to record highs in the first five months of the year. The market then paused in June when Chairman Bernanke announced the Fed would slowly "taper" off its maintenance of low interest rates. But the market adjusted to these announcements in the third quarter. The major indexes recorded strong advances in the last months. The Nasdaq composite index – spurred by interest in technology companies – was ahead 11.19% for the quarter and 26.12% for the year. Small companies were also attractive and the Russell 2000 index gained 9.85% for the quarter and 26.42% for the year. The S&P 500 index was ahead 5.24% for the quarter and 19.79% for the year. The relative laggard was the Dow Jones Industrial Average which was ahead just 1.48% in the quarter and 15.46% for the year.

Fixed Income Markets: Bond prices also reacted to the pronouncements of Federal Reserve intention. The yield on the 10-year Treasury, which moves inversely to prices, had quickly spiked from 1.63% to 2.4% at the end of June. The bond market was clearly reacting to the prospect of higher interest rates. This trend continued throughout most of the quarter and the yield rose to almost 3% in early September. Then Chairman Bernanke said the tapering program would be gradual and the Fed intended to keep its foot on the gas pedal well into 2014. Bond prices recovered somewhat and the yield finished the quarter at 2.6%.

The Economy: We all would like economic growth to be more robust. The U.S. economy rose 1.1% in the first quarter and 2.5% in the second quarter. Unemployment remains stubbornly above 7%.

But underlying trends are good. Housing prices have improved. Auto sales are healthy. Improved extraction of shale oil and natural gas is brightening the energy picture. The U.S. is moving to become a net exporter of energy. As mentioned, the Federal Reserve will move more gradually on any increase in interest rates. Inflation is subdued. Some economists see potential for a 3% increase in GDP in 2014.

MAJOR MARKET INDEXES

	3Q Total Return*	YTD Total Return*
Dow Jones Industrials	1.48	15.46
S&P 500 Index	5.24	19.79
Russell 2000 Index	9.85	26.42
NASDAQ Index	11.19	26.12
MSCI EAFE	10.94	13.36
Barcap Intermdt. Govt./Credit	0.57	-1.91

*Total Return Includes Reinvested Dividends.

Compared to Europe, which remains in recession, and many emerging economies, where growth has slowed, the U.S. outlook seems relatively attractive.

The Market: Our prognosis for equities is favorable. But the growth rate of the last three quarters will be difficult to sustain. Here are the reasons:

- The turmoil in Washington creates huge anxiety. The markets will pause until a political compromise is crafted. This situation will hamper returns in the fourth quarter. Even though we do not foresee descent into chaos, the impact will keep the market from moving ahead much further for the rest of 2013.
- Stock prices are now relatively high by the standards of recent history. The S&P 500 is trading 14.3 times the next 12 months' worth of earnings –above the 12.9 for the past five years and 14.0 for the past 10 years. Some major sectors – such as consumer staples – seem notably pricey.
- A big factor in the concern over stock valuations is corporate earnings. Profits in the S&P 500 increased 3.6% in the first quarter and 2.1% in the second quarter. The forecast is for 3.1% in the third quarter. These readings are all soft by the standards of recent years. Part of the burden is that many companies have maximized what they can achieve with cost savings. Future profit growth will have to come from revenue and sales – which are harder to boost when economic recovery is still so gradual.

With that outlook, we do not expect the year ahead to see stocks gain at the pace recorded in 2013. We certainly do not see any retreat in the market. We just think the high double digit gains of 2013 will be difficult to repeat. Stock prices will continue to advance, but at slower rates of growth.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we continue to recommend 60% allocation to equities, and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We look for stocks of conservatively managed blue-chip companies with values that are still reasonable -- and defined and generous dividend policies.

Preferred Sectors: For the equity component, we like the current sectors:

HEALTH CARE: Driven by the demands of an aging population, this sector remains one of our favorites. Pharmaceuticals have particular appeal from an improving pipeline of new drugs.

INDUSTRIALS: Driven by demand from business investment, certain areas such as basic materials and transportation should perform well in the period ahead.

TECHNOLOGY: Despite the strong market performance in this sector, prices of technology stocks are still well valued. Future potential comes from the need and desire of both business and consumers to stay current with their technology.

FINANCIALS: We like regional banks and insurance companies, where risk is contained, and balance sheets are healthy. The P/E ratios are favorable.

Other Investments: Our aversion to bonds with longer maturities is consistent. We prefer maturities under two years and cash for the non-equity component of client portfolios. As explained in past newsletters, we also use investment in municipal tax lien programs to offer clients a reasonable and safe return.

Dow Jones U.S. Sectors
(Percent Change for YTD, Ending September 30, 2013)

Oil & Gas	**16.97**	**Consumer Services**	**27.78**
Basic Materials	**8.52**	**Telecommunications**	**6.83**
Industrials	**25.04**	**Utilities**	**11.81**
Consumer Goods	**20.86**	**Financials**	**22.00**
Health Care	**29.73**	**Technology**	**12.60**

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