HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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The stock market has been relatively calm and slowly growing for most of 2014. Then, wham! – the early weeks of October have been marked by some wild gyrations. This recent volatility has some analysts quoting the old saying: "The yo-yo goes up and down and up and down, and then it breaks – and when it breaks, it just keeps falling."

We do not share that viewpoint in this situation. In our last newsletter, we did caution the six-year bull market could be due for a correction – defined as a 10% decline from the highest price level. The current turbulence may be the signs of that correction taking place. But we do not think we are headed for a bear market – defined as a 20% decline in prices.

The volatility of recent weeks seems driven by concerns over slowdown in the world economy. The economic signs from Europe and China are more troubling than encouraging. With stock prices fairly high, this news rattles the markets. But we expect the pattern of wild gyration to settle down. The fundamentals of the U.S. economy – while not stellar – are basically sound. Corporate earnings should remain essentially positive.

So, yes, stock prices may retreat for a short period. But the period will end and the steady, modest growth in prices should resume. The only possible cause of a bear market is some exogenous event – such as a geo-political crisis -- and good market professionals cannot operate for fear of something totally unpredictable. At Hudson Advisors, our common sense tells us to stay with stocks because their long-run potential is simply better than the alternatives of bonds or cash. Our challenge is to find stocks that can weather the volatile periods and emerge as long-run winners.

MARKET TRENDS

The accompanying chart summarizes stock and bond market results for the first three quarters of 2014. The stock market rose gradually to new heights in the quarter – prior to arrival of October tumult. Meanwhile, the U.S. Treasury market continued to show moderate gains.

Equity Markets: The equity markets showed calm, steady growth in the third quarter – with both the Dow Jones Industrial Average and S&P 500 Index reaching record levels in September. The Dow gained 1.45% in the third quarter and was ahead 9.28% for the year. The S&P 500 rose 1.13% in the quarter and was ahead 8.34% for the year. The Nasdaq Composite was up 5.53% for the quarter and 13.83% for the year. The contrarian index was the Russell 2000, which lost 7.36% in the quarter and was down 4.41% for the year. Small stocks seem already to have experienced a technical correction. Then came the terrible second week of October – with the Dow slipping into negative territory for the year. The S&P 500 lost about a third of its previous yearly gain and the Nasdaq Composite two thirds of its September 30 year-to-date gain.

Fixed Income Market: Meanwhile, bonds edged higher as investors sought U.S. Treasuries for their perceived value. The yield on the U.S. Treasury 10-year note, which moves inversely to price, fell slightly to 2.49% from 2.51% at the end of the second quarter. Corporate bonds struggled somewhat and lost .1% -- while high-yield corporate bonds were more challenged and declined 1.9%.

MAJOR MARKET INDEXES

	3Q Total Return	YTD Total Return
Dow Jones Industrials	1.83	4.46
S&P 500 Index	1.13	8.34
Russell 2000 Index	-7.36	-4.41
NASDAQ Index	5.53	13.83
EAFE Index	-6.39	-3.63
Barclays Aggregate Bond Index	0.34	3.06

*Total Return Includes Reinvested Dividends.

THE OUTLOOK

The Economy: The basic story is that the U.S. economy holds its own despite setbacks in the rest of the world. It is not a stellar performance – but it seems consistent and sustainable. The consensus forecast is for GDP growth to be in the 2 to 2.5% range for both 2014 and 2015. That is consistent with 2102 and 2013 – even though it is lower than the average 3.1% growth in the last 60 years.

There are definite good signs in the economy. Consumers are spending down recent savings gains as inflation moderates. Housing activity continues to improve – although slower than hoped – but still a net boost to the economy. The development of U.S. energy production provides another floor of support for growth. The federal budget deficit is actually shrinking. Most significant, the Federal Reserve indicates that changes to monetary policy will be gradual and measured.

So why has the market turned a bit whacky in October? The reasons seem to lie internationally. The attempt at economic recovery in Europe has sputtered out. After just a year of anemic growth, Europe did not show any gain in the second quarter. Even the German manufacturing sector is struggling. Meanwhile, the outlook for China and its global demand for commodities seems uncertain. Weak foreign economics have potential to hurt U.S. exports – which also are effected by the relative rise in the U.S. dollar. The most helpful sign is that central banks seem to be coordinating policies to assist an international economic recovery. .

The Market: The future trend in the stock market will be driven heavily by investor attitudes about equity prices. Have they become too high? Many analysts look at the work of Yale professor Robert Schiller. Rather than one year's worth of earnings, his method averages the past 10 years of earnings to measure price-to-earnings ratio. His method indicates that stocks are now at a historically rich valuation. Significantly, however, Schiller in recent interviews is not recommending to get out of stocks. Rather, he cautions to keep an eye on corporate earnings as key indication of how the market will behave. He has indicated that he has a 50% allocation to equities.

So, indeed, we will watch earnings reports closely in the weeks ahead. We expect a mixed picture. The fundamentals in the U.S. economy will allow many companies to show reasonable profit gains. Other companies may be hurt by the weaknesses abroad. Overall, we expect the market to fluctuate for a while. But the growth trend will re-assert itself – even though that growth may be restrained until the international outlook brightens.

OUR STRATEGIES

Asset Allocation: For clients investing new money, we recommend 55% allocation to equities and the remaining portion to cash, bonds with maturities under two years, and alternative investments. We suggest fully invested clients to trim equities to 55-65% depending upon time horizon and objectives.

Preferred Equities: We remain focused on large cap companies with strong balance sheets, sustainable cash flows, and credible business models. Companies that pay attractive dividends are central to our strategy. Some of the sectors we are like are similar to those indicated last quarter:

- FINANCIALS: The stocks of insurance companies and some regional banks have attractive value.
- TECHNOLOGY: Some technology companies have room for further growth – especially those with innovative consumer products.
- ENERGY: We like the potential of companies with activity in the domestic production of natural gas and shale oil: especially in the 3 to 5 year time horizon.
- INTERNATIONAL: Emerging market stocks have been underperformer in recent years – and have not been our friend. But we anticipate them to rebound in the period ahead.

Fixed Income: At some point, interest rates will rise and inflation will resume. The risk to holders of longer maturities is substantial. Our viewpoint on this issue is well-known to our clients and it is another area where we stick to our story. Instead, for the non-equity portion of client portfolios, we utilize cash, short bond instruments, and alternative investments like municipal tax lien programs

Dow Jones U.S. Sectors
(Percent Change for YTD, Ending September 30, 2014)

Oil & Gas	**3.78**	**Consumer Services**	**3.19**
Basic Materials	**7.06**	**Telecommunications**	**6.97**
Industrials	**1.11**	**Utilities**	**12.82**
Consumer Goods	**4.95**	**Financials**	**5.86**
Health Care	**16.56**	**Technology**	**15.27**

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