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During the quarter, equity markets continued to rally, and the S&P 500 Index reached an all-time high in September of 1,725. This is the third quarter in a row in which the S&P 500 has set a record. Nonetheless, interest-rate-sensitive asset classes experienced significant price volatility as investors digested contradictory comments from the Federal Reserve Board. After suggesting in late May that monetary stimulus programs might soon be reduced, the Federal Reserve Board instead decided at its September meeting to continue these programs, given persistent weakness in several economic indicators. This surprise announcement stabilized bond prices and higher-dividend stocks, many of which had suffered price declines earlier in the quarter. Sometime in the future, the Fed will likely taper bond purchases, perhaps as early as the first quarter of 2014. For now, the Federal Reserve is once again on hold, and the environment remains reasonably favorable for many investments.

The S&P 500 Index gained 5.3% on a total return basis for the quarter and is up 19.8% for 2013. From an economic sector perspective, the Materials, Industrials, and Consumer Discretionary sectors led the way this quarter, while returns were weak in the higher-dividend-yielding Telecommunication Services and Utilities sectors.

From a global perspective, some foreign equity markets outpaced the U.S. this quarter, but most continue to trail for the year. The German DAX is now up 15.5% for the year, and the French CAC is up 20.2%. The Japanese Nikkei is up 23.7% for the year but has experienced significant price volatility. The MSCI Emerging Markets Index is down 6.9% for the year. More specifically, on a year-to-date basis, China's Shanghai Composite Index is down 0.6% and Brazil's Bovespa is down 21.0%.

The Federal Reserve Blinks

Over the past few years, the U.S. economy has made substantial progress. Consumer confidence has trended higher, home sales and prices are up, and auto sales are at a five-year high. At the same time, overall economic growth has been inconsistent and well below levels experienced during other post-recession periods. In addition, unemployment remains elevated, and inflation is still running at a low level. The Fed, therefore, has worked to keep interest rates low, which has helped the economy heal.

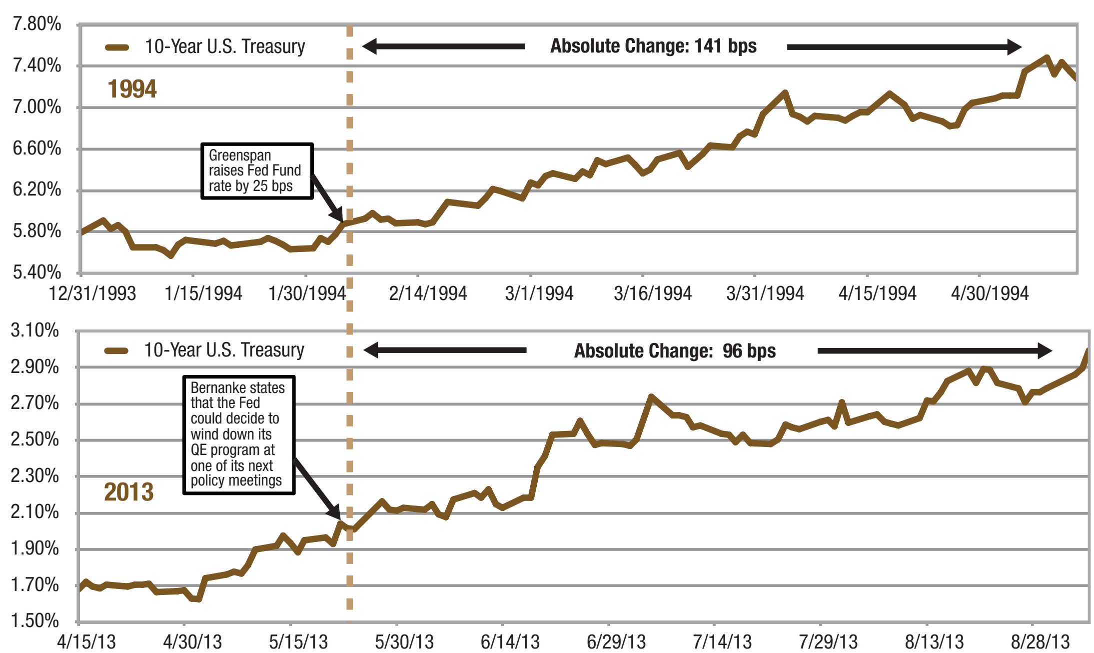
Perhaps believing that bond rates were too low, the Federal Reserve in late May signaled a gradual tapering of its $85 billion monthly purchases of Treasury and mortgage debt, also known as quantitative easing (QE3). The timing of these comments surprised many market participants. There were record outflows from bond mutual funds and exchange-traded funds totaling $73 billion in June—a level that shattered the prior record of $42 billion in October 2008.

Over the two months following the Fed's May comments, interest rate yields on the 10-year U.S. Treasury bond increased from 2% to 3%. Since the price of a bond moves in the opposite direction from its income yield, many investors suffered large price declines over a very short period of time. In 1994, Federal Reserve Chairman Alan Greenspan surprised the fixed-income markets by doubling benchmark interest rates over a 12-month period. Although 1994 is often referred to by bond investors as the year the bond market crashed, the absolute change in yields experienced this year is approaching that seen in 1994.

Despite the May comments, at its September 18 meeting, the Fed surprised the financial markets yet again by announcing that quantitative easing programs would remain in place. At the same time, the Fed reduced its forecasts for economic growth. The domestic economy as measured by Gross Domestic Product (GDP) is now expected to grow between 2.0% and 2.3% in 2013 and between 2.9% and 3.1% in 2014.

A big part of the U.S. economic recovery to date is the recovery in housing. As the Fed's tapering comments continued during the early summer months,

Figure 1: 10-Year U.S. Treasury Bond Yields, 1994 vs. 2013



Source: Bloomberg – Data as of 9/30/2013 mortgage rates moved quickly higher. The average rate on a 30-year fixed-rate mortgage loan rose to 4.6% in September, compared with the record low of 3.3% in November of 2012. Although rates are still very low by historical standards, housing-related securities experienced significant price corrections in anticipation of a housing slowdown. The Fed's decision not to taper bond purchases suggests that the Fed was surprised by the summer's sharp rise in mortgage and other long-term interest rates.

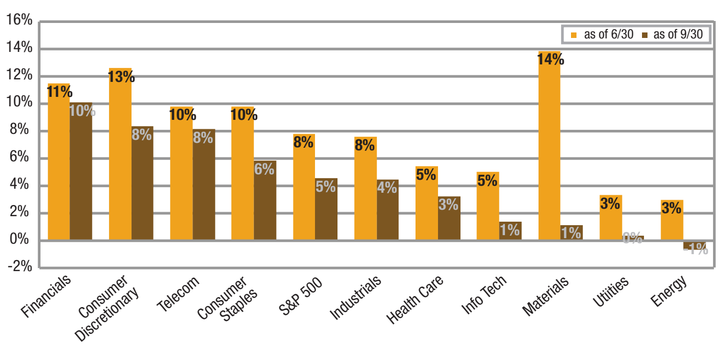
Still Looking for Revenue Growth

With interest rates now at a higher level, the incremental benefit of a low-interest-rate environment will be slightly more subdued going forward. As we have stated in previous commentaries, we believe that for stocks to gain significant ground from here, companies will need to show top-line revenue growth and not just count on margin expansion through cost cutting and further changes in the capital structure. With top-line growth still running at below-normal levels, many companies have experienced a decrease in their earnings growth rate.

Earlier this year, analysts had projected that 2013 S&P 500 earnings would grow by 15%. That estimate has now been reduced to slightly less than 10% annual growth. The almost 20% rise in stock prices this year implies that a large portion of the stock market's return has come from an increase in security valuations. At the beginning of 2013, the 12-month forward price-to-earnings ratio for the S&P 500 was 14 times. This metric has now risen to about 16 times, which is generally in line with the long-term historical average.

Figure 2 looks at the S&P 500 on an economic sector basis. All sectors experienced a reduction in year-over-year earnings growth expectations as the third quarter progressed. For now, the overall stock market has taken these reductions in stride, but at some point, further reductions may result in market weakness for certain sectors. We believe that top-line revenue growth, driven by increased economic activity, should eventually translate into even higher earnings growth.

Figure 2: U.S. Economic Sectors Q3 2013 Year-Over Year Earnings Growth Estimates



Source: Factset – Data as of 9/30/2013. Percentages listed represent year-over-year earnings growth estimates for S&P 500 and each of the underlying sectors

Inverness continues to focus on companies with a strong core business that can absorb and pass on input and wage inflation. These companies are frequently secular growth leaders that can expand their market share and drive top-line revenue growth, and can exist in any sector.

Manufacturing Renaissance

In previous commentaries, we discussed the potential for a renaissance of the American manufacturing industry. Major discoveries of domestic energy resources have generated significant natural gas and crude oil reserves. At the same time, wage inflation in export-oriented emerging market nations (e.g., China) has dramatically increased, resulting in a narrower spread of wages compared to the United States. We believe that these factors and several others, such as 3D printing and enhanced robotics, could drive some manufacturing back to U.S. shores.

We have also identified an increased need for higher spending on existing nonresidential buildings and equipment. The average age of manufacturing plants in the U.S. is over nine years, and equipment in these plants is nearly six years old, with both measures at record levels going back to 1965. Other surveys highlight that many companies have delayed replacement of heat and air conditioning systems, building controls, and lighting for even longer periods. As confidence in the economy continues to improve, companies may begin to increase their capital expenditures on larger projects.

Some recent economic indicators suggest that overall domestic manufacturing is beginning to expand. In both July and August, the Institute for Supply Management (ISM) Manufacturing Index exceeded 55, solidly above the 50 level that signals expansion. The Federal Reserve Bank's leading composite index of equipment spending is also signaling strength, suggesting that the pace of capital expenditures is likely to increase. We have identified a number of companies that could benefit from this trend, and we continue to research additional ideas.

Course of Action

For now, corporate revenue growth remains challenged. We believe that the economy will continue to improve and that this improvement will eventually translate into higher earnings growth for many companies, but top-line revenue growth will be key. Within equity portfolios, we have been increasing exposure to the economically sensitive Industrials, Energy, and Materials sectors. We continue to have significant exposure to Consumer Discretionary companies that are benefitting from improving domestic consumer confidence levels.

The currently low levels of both growth and inflation should continue to keep the Fed accommodative for some time and should support security valuations at today's levels or even higher. At the same time, we acknowledge that anticipation of a change in Fed policy sometime in the future may cause financial markets to become more volatile or perhaps stagnate for a period of time. The market's reaction to this change in policy will be a key factor in determining future equity and bond returns.

In order to avoid heightened volatility in financial markets, we believe that market participants will need to become more comfortable with the concept of less Fed support, which we may have begun to see at the end of this quarter. Accelerating growth in our economy would appear to be the next catalyst for the financial markets, helping to offset current concerns and provide long-term investment support.

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