THE WASHINGTON SHUFFLE

The third quarter has a bad reputation for the stock market and for good reason. Nonetheless despite a poor earnings season, rising interest rates, and a dysfunctional government, stocks powered ahead convinced the Fed's continued support will trump all evils. The S&P 500 gained 5.25% while small and mid-capitalization stocks did even better. Even international stocks joined the party with the MSCI World ex. U.S. up a hearty 10.68%. On the downside long dated bonds had their second straight quarterly loss.

Our bullish message eighteen months ago gave way to a less enthusiastic but still optimistic outlook last quarter. **However, we are slowly starting to lose our enthusiasm for risk assets.** As mentioned above the second quarter earnings season was terrible. We sold several stocks we considered fully-valued and choose not to reinvest the proceeds. Valuations on stocks are not at extremes but neither are they cheap.

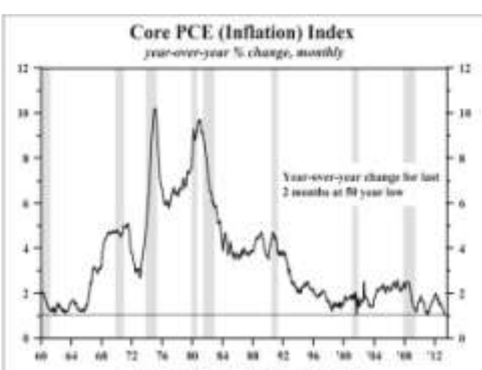
On the other hand, stocks overshoot all the time and can easily go higher. The bulls site low inflation (chart below), accommodating central banks, improving purchasing manager's indexes (even in Europe), and recovering housing and auto sectors. The Fed's favorite inflation indicator, the core personal consumption expenditures deflator, stands at a record low. Sustained higher inflation is not on the horizon giving central banks considerable leeway in monetary policy. Not much is expected to change in the near term with Janet Yellen at the helm.

However, it is unclear whether or not these improvements can continue since real household incomes (chart below) in the U.S. are still about 8% below their peak in 2007. A worrisome headwind is the impact from the payroll tax increase at the beginning of the year. Various academic studies show there is a two or three quarter lag in curtailed spending after a tax increase, meaning weakness in the economic data could start showing up right now. Most bulls believe corporate earnings will continue to chug along at a healthy clip. We're skeptical.

It appears that investors will have to endure a steady diet of Washington rancor. The best our politicians can do is to agree to have another crisis a few weeks down the road. It is unlikely that stocks will surge ahead under these conditions. But neither are they likely to collapse. Despite our political dysfunction, America remains a safe place to invest and do business by comparison with other places. It would be a shame to lose this critical competitive advantage.

Our strategy is to remain diversified and flexible. This is not the time to take big bets. Our focus will be on corporate profits and Washington D.C. **While stocks appear to be the most attractive asset class over the long term, they are no longer outright cheap and investors must fight the urge to be complacent.**

Jim Tillar, CFA *Steve Wenstrup*



OUTSIDE COMMENTARY

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Problem #2—Aging demographics is slowing developed world economic growth?

WWII synchronized global economic demographics. After the war ended, most went home and did the same thing—made new labor inputs! The resulting post-war baby boom ensured solid labor resource growth for the next generation. The rate of resource growth (i.e., land, labor, and capital) has always been the chief factor establishing the speed limit of economic growth. And, the available labor supply is arguably most important. This has been true throughout history and across economies. Those with rapidly growing labor supplies simply possess a greater capacity to sustain a faster economic growth rate.

If you compare a chart of the working age population to the annual rate of real GDP growth since 1960, they would illustrate the important role played by demographics within the U.S. economy. Prior to 1985, fueled by baby boomers and women entering the workforce, the working age population in the U.S. grew at a rapid annualized pace of more than 2%! The positive impact of these trends began to wane in 1985 and growth in the working age population has since sustained at only half the rate it did prior to 1985. Indeed, in the contemporary recovery, the working age population has risen at only a 0.8% annualized pace!

The downshift in labor growth since 1985 has significantly lowered the inherent speed of achievable economic growth. In the 25 years leading up to 1985, annual real GDP growth exceeded 4% more than one-half the time, whereas since, it has surpassed a 4% annual growth rate only about 25% of the time. Moreover, before 1985, annual growth often reached levels between 5% and 8%. Since 1985, however, it has reached as high as a 5% rate in only two out of 110 rolling four-quarter periods!