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Dear Valued Investor:

We do not believe the volatility seen in recent weeks is immediate cause for alarm when viewed in the context of historical trends. There is precedent for moves of this magnitude — both up and down — that have taken place during an overall expansion in the economy and favorable period for stocks. Market pullbacks are actually quite common, but the lack of them in recent years has caused investors to be less accustomed to them. Considering this context and the current market environment, we think it is unlikely that recent volatility is an early signal of a recession or bear market.

Looking at historical evidence of the S&P 500 Index, volatility has been customary for a bull market:

- In the mid-2000s cycle we saw a similar series of 5 – 7% pullbacks, never a 10%.
- It has been three years since we have experienced a 10% pullback; on average we expect one 10% drop per year.
- In a typical mid-cycle year, stocks experience four 5% pullbacks, and this year (and last) we have only seen one.
- A three-digit absolute value drop is a smaller relative percentage drop than in prior bull markets, given the higher overall level of the widely followed market indexes.

The S&P 500 rose or fell by at least 1.5% each day for three days on October 7 – 9, 2014, marking the first time since November 2011 that the S&P 500 experienced such wild swings over three consecutive trading days. That last bout of volatility accompanied the U.S. debt ceiling debacle and the threat of the Eurozone breakup. In the period following the late 2011 volatility, the S&P 500 went on to return 7.3% over the next three months and 14.6% in the next year. Prior to that episode, May 2010 — around the so called "flash crash" — was the last time the market experienced three days or more of 1.5% swings. Markets endured similar volatility in late 1998 as the Asian financial crisis swirled. Following those episodes, markets recovered quickly and the economy continued to expand.

We believe the current market volatility is being driven by a number of factors: a host of geopolitical issues, including the spread of Ebola; the rise of Islamic State militants in Iraq and Syria; ongoing concerns about the underlying health of the Chinese economy; and most importantly, persistent economic weakness in Europe. Although the geopolitical situation has deteriorated in recent weeks, in our view, the concerns about global growth (which we have consistently cited as a major threat to equity markets) are sparking this latest bout of volatility. Despite these risks, a number of positive factors in the global economy and U.S. economy may offset.

- The U.S. economy continues to expand at a pace well above its long-term average, the labor market has created over 2 million jobs in the past year, and the unemployment rate is 5.9%, according to the U.S. Commerce Department and the Bureau of Labor Statistics.

- While the Federal Reserve (Fed) will end its bond-purchase program (known as quantitative easing) later this month, Fed policymakers have indicated there is no hurry to raise rates, and when they do, rate hikes are likely to be modest.
- The European Central Bank is preparing to add a much needed dose of monetary stimulus to the European economy, following the results of European-wide bank stress tests later this month. In addition, Chinese authorities stand ready to invigorate their economy.
- Valuations on the S&P 500 remain near historical averages, and while no longer cheap, remain reasonable given the interest rate and earnings environment.
- Other economic and market indicators that we have found to be good predictors of increased fragility of the economic cycle and potential market downturn may be signaling the continuation of the bull market.
- Concerns around global growth have driven oil and gasoline prices sharply lower, which may support consumer spending.
- The decline in bond yields in 2014 has lowered borrowing costs for corporations, which in turn lower expenses and help support profitability.

Although pullbacks are unwelcome, they are often a short interruption in the context of a longer-term bull market, such as the current one that began in March 2009 and has returned 218% cumulatively as of Thursday, October 9 (23% average annual return). Our view remains that the U.S. economy is expanding and the upcoming corporate earnings season is likely to reveal that growth is robust. While the geopolitical issues may spark profit taking, they will not end the recovery.

As always, if you have questions, I encourage you to contact your financial advisor.

Sincerely,

John Canally
Chief Economic Strategist

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The economic forecasts set forth may not develop as predicted.

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results do not reflect any particular investment. Past performance is no guarantee of future results.

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