MARKET OVERVIEW
THIRD QUARTER, 2013

INDEX	3RD QUARTER %	1 YEAR %	3 YEAR %	5 YEAR %
Dow Jones Industrial	2.12	15.59	14.94	9.93
NASDAQ Composite	10.82	21.03	16.77	12.51
Standard & Poor's 500	5.24	19.34	16.27	10.02
Russell 1000	6.02	20.91	16.64	10.53
Russell Midcap	7.70	27.91	17.53	12.97
Russell 2000	7.59	27.04	16.57	9.13
Barclay US Aggregate Bond	0.57	-1.68	2.86	5.41
MSCI World ex. US	11.31	21.45	7.89	6.12
MSCI Emerging Markets	5.77	0.98	-0.33	7.22
COUNTY OF SAN BERNARDINO 457(b) PLAN PERFORMANCE	**7.51**	**22.26**	**14.11**	**10.60**
COUNTY OF SAN BERNARDINO 401(k) PLAN PERFORMANCE	**7.36**	**22.32**	**14.21**	**10.76**
COUNTY OF SAN BERNARDINO RMT PLAN PERFORMANCE	**6.33**	**16.97**	**12.45**	**9.86**

EQUITY MARKETS

For the second consecutive quarter, the final month of the quarter deflated an otherwise acceptable quarterly equity performance. The below average performance only occurred in the last eight (8) days of September. After closing at 1,726 on September 18, (the day the Fed indicated that they would not slow the bond purchasing program), the S&P 500 index fell on seven (7) of the last eight (8) trading days of the quarter.

September has a long history of leaving stock portfolios in red numbers. Despite the weak closing, the S&P 500 started September red hot as it finished up in eleven of the first twelve days of the month. This winning streak has occurred in only three (3) other months over the past 40 years. The S&P 500 closed the quarter at 1,682, up 5.24% for the quarter. The end of quarter decline can be attributed to concern over inaction by Congress and the prospect of a government shutdown if a budget could not be agreed to by both houses of Congress and the President by September 30.

According to Morningstar the average domestic equity fund produced a 6.05% return for the third quarter. Healthcare stocks continue to fare well and the Technology sector roared back after an underwhelming performance over the past year.

International stocks outperformed domestic stocks, rising 11.31% in the third quarter. September was a strong contributor to the third quarter performance with a one (1) month return of 7.07%. Europe demonstrated particular strength for the quarter. After declining 8.08% in the second quarter the Emerging Markets funds rose 5.77%. China's Shanghai index returned 10.4% for the third quarter and is up 15% through October from a low in late June. Although due to China's weak performance in the first six months of 2013, the Shanghai Index is still down 6% year to date.

Just one (1) year ago, Europe was sliding into a double dip recession and many global investors questioned whether the European Union could survive. The region's problems still exist. Social and political tensions are prevalent and the jobless rate is at 12%.

Emerging Markets have underwhelmed investors for almost two (2) years, so even though the rebound lagged behind domestic, European and Japanese stocks, the positive performance has provided some enthusiasm among investors. This segment of the equity market warrants some caution. While earnings are expected to grow, the central banks have raised rates in an effort to keep inflation in check and prop up their currencies.

The average bond fund was up 1% for the quarter despite the increase in yields. The two leading components driving up bond performance were high yield and Emerging Markets bonds. The yield on the ten (10) year Treasury note rose to a recent high of 3% in early September and closed the quarter at 2.62%. Treasury Inflation Protection bond funds took a significant hit as interest rates rose and inflation declined. Year to date the TIP index is down -6.74%.

On July 5th the Russell 2000 index of small companies closed above 1,000 for the first time at 1,020. As a historical perspective, the DJIA first closed over 1,000 on November 14, 1972. The focus on the small cap stocks is important because many analysts consider small cap stocks a leading indicator for the overall equity markets. A small cap rally also indicates that investors are willing to take risks.

STYLE COMPARISONS* **Performance includes dividends*

INDEX STYLE	3RD QUARTER %	1 YEAR %	3 YEAR %	5 YEAR %
RUSSELL 1000 GROWTH	8.11	19.27	16.94	12.07
RUSSELL 1000 VALUE	3.94	22.30	16.25	8.86
RUSSELL MIDCAP GROWTH	9.34	27.54	17.65	13.92
RUSSELL MIDCAP VALUE	5.89	27.77	17.27	11.86
RUSSELL 2000 GROWTH	10.21	30.06	18.29	11.15
RUSSELL 2000 VALUE	12.80	33.07	19.96	13.17

Except again for small cap value, growth oriented stocks outperformed value stocks in the third quarter. Analysts typically favor growth over value as it indicates greater investor confidence in the equity markets. Value presents a more defensive position. The Morningstar U.S. Growth Index rose 10% in the third quarter. The Morningstar U.S. Blend/Core Index rose 5% in the third quarter. The Morningstar U.S. Value Index rose only 3.2%.

In the third quarter there were five (5) categories where active equity managers outperformed their respective indexes. The three (3) asset categories where active management had the biggest tailwinds against the indexes were large cap, midcap and small cap growth. 96% of active large cap value managers beat their index in the third quarter of 2013. Only 22% of the small cap growth managers beat their respective index in the third quarter.

SECTORS

Nine (9) sectors of the key eleven (11) sectors had positive performance for the third quarter.

Defensive Super Sector – The Defensive sector provided a third quarter return of 4.40%. While Investments with steady, robust cash payouts are difficult to find, many investors favored growth stocks over dividend paying stocks. Interest rate sensitive **Utilities** stocks as a sector was down -0.33%. Utilities were viewed negatively by investors on the expectation that the Fed may slow down bond purchases and allow interest rates to increase. Only the **Healthcare** sector had a strong quarter with a return of 8.24%. This sector is led by the acquisition of Onyx Pharmaceutical by Amgen. Onyx had a return of 43% in the third quarter.

Cyclical Super Sector – This super sector provided the second best performance in the third quarter with a 5.80% return. The sector with the best overall performance was last quarter's worst performing sector, **Basic Materials.** That sector was the weakest performer of all sectors with a quarterly return of -3.95 in the second quarter and turned in the best performance of all sectors in the third quarter with a return of 10.08%. The **Real Estate sector** continued its negative performance with a -3.10% return in the third quarter. That was the worst performing sector for the quarter. Rising interest rates and/or the threat of rising interest rates is bad news for REITs. Rising rates make it costlier for REITs to borrow money for new developments or acquisitions. The **Financial Services** sector now has the highest one (1) year performance, 34.73% and benefited from credit card companies Capital One and Master Card. The **Consumer Cyclical** sector benefited from more than an 80% gain from Tesla Motors.

Sensitive Super Sector went from the weakest super sector in the second quarter to the strongest performing super sector in the third quarter. The **Technology** sector provided some big winners such as Facebook, Qualcomm, LinkedIn, Yelp and Apple. The now famous Carl Icahn tweet and latest release of the iPhone generated attention and a 20% third quarter raise in Apple's stock price. Some big name bellwether stocks in the Industrial sector enjoyed strong quarterly performance. FedEx, Boeing and Raytheon each posted double digit returns. The only laggard in the super sector was the **Communication Services** sector where stocks have sensitivity to rising interest rates.

ECONOMIC ISSUES

The big economic news is that since Congress did not agree on a budget by September 30, 2013 the 800,000 "non-essential" Federal government employees were furloughed as of October 1, 2013. First, what is the cause of the shutdown? Under the Constitution, Congress must pass laws to spend money. If Congress cannot agree on a spending bill or if the President vetoes the spending bill, as happened during the Clinton Administration, the government does not have the legal authority to spend money. According to the Congressional Research Service a shutdown has occurred 17 times since 1977.

When both houses of Congress and the President finally agree on a spending bill the next major action to be taken is to raise the debt limit. That too presents a political battle. In August, 2011 Congress delayed approval of raising the U.S. debt ceiling and Standard & Poor's lowered the credit rating on U.S. debt. When the U.S. credit rating is reduced, the cost of borrowing increases.

On October 16 Congress and the President agreed on a short term proposal to end the government shutdown and raise the debt ceiling. The compromise leaves a small window for Congress to agree on a budget as January 15 is the expiration of the current compromise. The authority to borrow money expires February 7, 2014. The genesis of this quick short-term solution was the placement of the U.S. on a Negative Credit Watch by a major credit rating agency, Fitch.

What is the difference between a shutdown and a debt crisis? As stated above, in a shutdown the government lacks legal authority to spend money on non-essential services. In a debt crisis, the government is mandated to spend money to pay bills they already owe, but they do not have the legal authority to borrow the money to meet its obligations. In 55 of the last 60 years the government has spent more money than it has received.

Some pundits claim a government shutdown is much ado about nothing. One "pundit" claimed it is no more impactful than a needle prick. Not so, while the actual cost will not be known for a couple of months, the estimate of the cost of the shutdown on the economy is thirty basis points, (0.30%) or $12 billion. This is from a forecasting firm, Macroeconomic Advisors. Standard & Poor's estimated that the shutdown will cut about 0.6% off the inflation adjusted GDP. Either estimate indicates a very high cost to our anemic economic growth.

Consumer Confidence in the U.S. declined in October by the highest percentage since August, 2011 when the Debt Ceiling debate was last a central issue. The Conference Board's index of consumer confidence is now 71.2, down from a healthy 80.2 in September. The decline was due to the 16 day shutdown of the non-essential elements of the federal government and lower than expected job gains. Consumer confidence is a key measure as the consumer is responsible for 70% of the economy.

The Thomson Reuters/University of Michigan Index of Consumer Sentiment hit a six (6) year high of 85.1 in July and then hit a higher level of 85.5 in August. However, under the cloud of a government shutdown, consumer sentiment dropped to 77.5 in September and 73.2 in October.

More supporting evidence that the federal government shutdown significantly impacted the consumer's confidence comes from Gallup's Daily Consumer Confidence Index. A negative reading indicates lower confidence. At the end of May, after interest rates started to rise, the Index stood at -1. This was actually a strong reading dating back to the financial collapse. At mid-September, after threats by the Tea Party to shutdown the government and possible default on our debt, the index fell to -16. On October 1, when the government actually shutdown the reading was -35 and grew to -43 as the shutdown persisted.

Internationally, the euro zone is showing signs of recovery. The most striking news is that the Spanish economy crawled out of their recession with positive growth in the third quarter of 0.4%. Between the housing bubble and 26% unemployment, Spain was one of the biggest concerns in the euro debt crisis. It appears that the recession in Portugal has also ended. There is renewed confidence that the "Misery Belt", (Spain, Portugal, Greece, Italy and Ireland), will be growing their economies. These countries are finally benefiting from measures taken to improve their economies. A big contributor is the reduced labor costs which may lure new investors and jobs. Currently unemployment in the entire euro zone is 12%.

Confidence is growing in Europe's fragile economy. The Composite Purchasing Managers index compiled by Markit Economics, a data and analysis firm, is at 51.5 for October. While down from September, 52.2, it is above 50 which signals expansion.

The International Energy Agency and the U.S. Energy Information Administration reported that the U.S. has surpassed Russia in the production of oil and gas. The U.S. produced the equivalent of about 22 million barrels a day of oil, natural gas and related fuels in July. Russia will remain the second largest crude oil producer in the world. Only Saudi Arabia will continue to be number one in the production of crude oil.

Federal tax revenues through June are up 14% over January to June 2012. In 2009 the income tax revenues declined by 20% over 2008 and corporate tax revenues fell by 55%. Also in 2009, for the first time since 1946, social security revenues declined. The budget deficit, the one (1) year shortfall that adds to the cumulative national debt, is expected to drop for the fourth year in a row. The deficit was projected to be $642 billion for twelve months ending September 30. That is the first shortfall below $1 trillion since 2008. As a fraction of the economy, the annual deficit has fallen 3% since 2009. It is the sharpest reduction by that measure since 1946.

FEDERAL RESERVE BOARD

Ben Bernanke's term as chairman of the Federal Reserve Board ends February 1, 2014. We may not know for years what grade Bernanke should be given. What we do know is that he will remain controversial. He maintained short-term interest rates near zero for nearly five (5) years. He also conducted successive rounds of Quantitative Easing that swelled the Fed's balance sheet to more than $3.7 trillion.

He was also chairman during the financial crisis and worst recession since the Great Depression. The DJIA declined 33.8% in 2008 which ranks as the worst year for equities since the loss of 52.7% in 1931.

Janet Yellen will be the new Fed Chairperson. She was the key architect behind the bond purchases which were designed to spur economic growth by reducing long-term interest rates, driving up stock prices and encouraging borrowing and spending. While the current Fed finds 2% inflation acceptable, Yellen will accept 2.5% if that helps drive down unemployment. Yellen is very concerned with the negative impact of high unemployment and long-term unemployment on the fabric of American society and is willing to accept somewhat higher inflation to drive down unemployment. In fact, Yellen and some economists believe that more inflation would trigger greater economic growth. Rising prices help companies to increase profits and rising wages help borrowers to repay fixed debts, like mortgages and increase spending. That being said, inflation may be too low currently, but increases in the inflation rate increases the cost of borrowing and debt.

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On October 9, 2002, the American stock market hit bottom after the 2001 recession. Exactly five (5) years later, on October 9, 2007, the bull market reached its peak. Within months, stocks around the world were falling into the worst bear market since the Great Depression. That bear market ended on March 9, 2009. Improvement has been slow for most countries during this six (6) year period from the beginning of the bear market to October 9, 2013. An examination of country performance from the collapse starting October 9, 2007 through recovery to October 9, 2013 highlights the quick and beneficial reaction of the U.S. central bank.

Over that six (6) year period the U. S. stock market is up 7%, while only one other major country is in positive territory for that same period, Switzerland. The MSCI World index, ex. U.S. is negative 22% over that same period. As a reference point, in the bull market that ran from October 9, 2002 to October 9, 2007, the U.S. stock market was up 104% compared to the MSCI World index, ex. U.S. that was up 201%.

A large amount of the U.S. stock market rally since 2009 is due to the accommodating polices established by the Fed, highlighted by the Quantitative Easing program that is purchasing $85 billion of U.S. bonds monthly. In the Fed's September meeting global markets believed the Fed would start trimming its purchases. The Fed announced that the economy was not strong enough for the Fed to start tapering its purchases.

The Fed has set an example for foreign Central Banks to follow the Fed's style of providing forward guidance and open communications. This approach is much different from the cloak and dagger approach central banks used to follow.

UNEMPLOYMENT

The September unemployment rate dropped to 7.2%, the lowest rate since 2008 and down from 7.65% in June. However, job creation in September was only 148,000. Because of the weak job growth the DJIA went up 75 points, a 0.5% gain. The rise in the DJIA was due to investors feeling more confident that the Fed will not start tapering its bond buying program through year end.

Part-time employment remains at an elevated 19% compared to 17% before the recession. Since the 19% has changed little since the recession began, the Wall Street Journal claims that the anticipation of the Affordable Healthcare Act has had little impact on the percentage of part-time workers. The increase in part-time workers actually occurred prior to the passage of the Act. Additionally, according to the Labor Department, during the past 12 months full time employment has increased by 1.6 million jobs, while part-time employment has fallen by 300,000 jobs.

The Misery Index is an economic indicator designed to help determine how the average citizen is doing economically. It is calculated by simply adding the inflation rate to the unemployment rate. The current Misery Index is 8.7%. The Misery Index as of June was 8.96%. The Misery Index was 12.87% at its peak in November, 2011.

LEGISLATIVE

The U.S. Supreme Court struck down a key portion of the Defense of Marriage Act, DOMA. In late August the Internal Revenue Service said it would recognize all same sex marriages in the U.S. for federal tax purposes. Included in the announcement is the inclusion of defined contribution plans. In September the Department of Labor issued similar guidance. Previously, same sex married couples did not have the same spousal IRA benefits as other married couples. Now, same sex spouses are subject to all the special rules that apply to any spouse. The guidance also covers the children of same sex couples. However, the IRS also stated that if the same sex couple are not officially married as recognized by their state of residence, regardless of the length of their partnership, they are not covered by this ruling.

HOUSING

After a yearlong rally, the housing market is showing signs of cooling off as higher prices and higher interest rates have impacted housing sales, particularly with investors. Particularly hard hit is the one part of housing that leads to substantial job creation, new home sales. In July and August, new orders declined by 12.7% over the same period, 2012. Home sales typically slowdown in August as families look to stay put due to school starting.

According to the National Association of Realtors, the index of pending home sales, which measures contract signings for previously owned homes, fell 5.6% in September from August. That decline actually put the September, 2013 numbers below the September, 2012 level. The September data is tempered by the historical trend that September, like August, is generally a slow month.

The cause of the decline is due to rising costs. The cost increases were due to the rise in interest rates from 3.35% in early May to 4.3% in September and appreciation of home prices. According to the S&P Case-Shiller home price index for August, home prices were up 12.5% over August, 2012. The unofficial September data indicates that the median home price rose 11.7% from one (1) year earlier.

The rising cost of homes is heating up demand for apartments. Rents now average $1,073 monthly, up 1% from the second quarter. This is according to a report by Reis Inc., a real estate research firm. However, the supply of apartments is on the rise and this may keep rents down. It is expected that 170,000 new units could hit the market this year, followed by 190,000 next year and another 300,000 in the following two years, 2015-16.

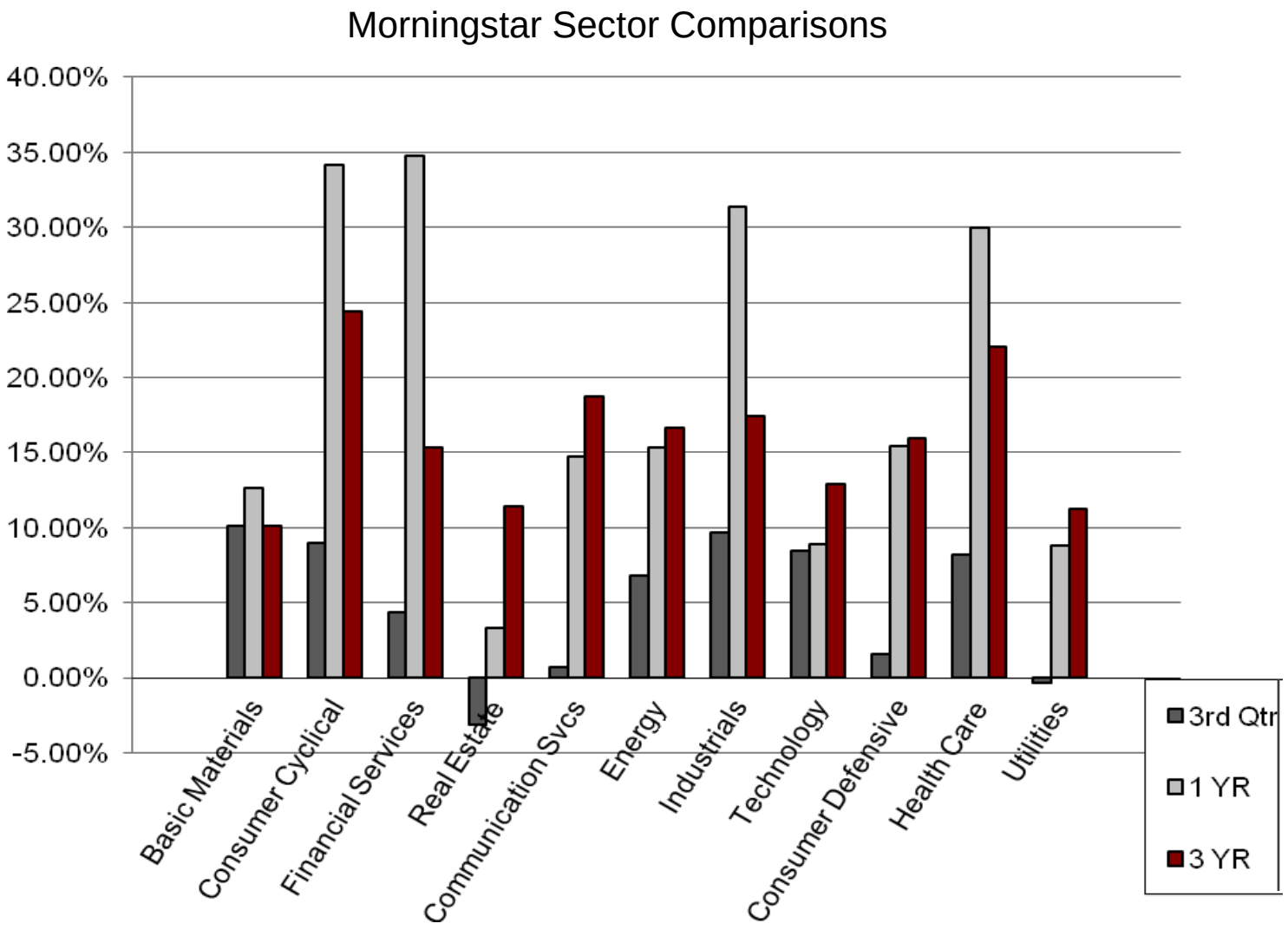
The proportion of homeowners with past due home loans has fallen sharply. Nationally, the delinquency rate fell from 5.49% in the second quarter, 2012 to 4.09% in the second quarter 2013, (only second quarter data was available at the time of writing). Delinquency is defined by those loans that are past due for 60 days or more. This data comes from a new study conducted by the credit bureau, TransUnion.

CONCLUSION

Sir John Templeton, a renowned 20th century investor wrote, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Right now the investor sentiment is stuck, one foot in skepticism and one foot in optimism. A large part of the current skepticism is caused by the lack of compromise and cohesiveness of our three (3) branches of the federal government. Optimism is driven by corporate earnings and growth in Europe.

Domestic stock markets are reacting more to political news than to earnings and stock fundamentals. The markets have experienced this type of reaction to political news in the past, but this time it is lasting longer. While this should be a short-term reaction, we expect that in the long-term earnings will drive investor sentiment and the stock value / price.

The volatility of the markets will continue. Benjamin Graham stated, "In the short run, markets behave like voting machines, but in the long-term they act like weighing machines." Voting machines measure sentiment, which can change without warning and trump fundamentals. But. over time, fundamentals rule.


Morningstar Sector Comparisons
40.00%
35.00%
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
Basic Materials
Consumer Cyclical
Financial Services
Real Estate
Communication Svcs
Energy
Industrials
Technology
Consumer Defensive
Health Care
Utilities
3rd Qtr
1 YR
3 YR