

20 *Third Quarter*
13 **Commentary
& Market Outlook**



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Market Review

The equity markets continued to move ahead in the third quarter 2013 led by Europe. The MSCI All Country Europe Index advanced by 13.48%, while the S&P 500 Index rose by 5.25% and the Dow Jones Industrial Average added another 2.12% in the quarter. Mid capitalization and small capitalization stocks also performed well as the S&P Small Cap 600 and S&P Mid Cap 400 were up 10.73% and 7.54%, respectively.

The rebound in European equity markets is indicative of the possible ending of the recession in Europe as plenty of data supports an economic turnaround. There is also renewed confidence by

“The beginning is the most important part of the work.”

~ Plato

investors that the European Sovereign debt crisis is over thanks to an accommodative European Central Bank and tough austerity measures taken by many of the troubled countries.

The equity returns in the United States reflect continued earnings growth and improvement in economic data. In addition, investors were

Index Performance					
CATEGORY	REPRESENTATIVE INDEX	3rd Q 2013	Y-T-D 2013	3 Year* Annualized	5 Year* Annualized
Dow Jones	Dow Jones Industrial Average	2.12%	17.64%	14.94%	9.93%
U.S. Large Companies	S&P 500	5.24%	19.79%	16.27%	10.02%
U.S. Mid Cap Companies	S&P MidCap 400	7.54%	23.23%	17.45%	13.08%
U.S. Small Companies	S&P SmallCap 600	10.73%	28.66%	20.68%	12.40%
International	MSCI EAFE Index	11.61%	16.59%	8.97%	6.85%
European	MSCI All Country Europe Index	13.48%	15.72%	8.96%	6.46%
Pacific	MSCI All Country Pacific Index	7.62%	10.66%	6.92%	8.41%
Emerging Markets	Dow Jones Emerging Markets	6.16%	-3.18%	-0.37%	6.76%
U.S. Bonds	Barclays Capital U.S. Aggregate Bond	0.57%	-1.89%	2.86%	5.41%
Municipal Bonds	Barclays Capital U.S. Municipal Bond	-0.19%	-2.87%	3.24%	5.98%
Real Estate	Wilshire REIT Index	-3.04%	2.71%	12.48%	5.55%
Commodities	Dow UBS Commodity Index	2.13%	-8.56%	-3.16%	-5.29%
Gold	S&P GSCI Gold	8.26%	-21.20%	-0.22%	7.76%

* The 3-Year Annualized and 5-year Annualized data are through 9/30/2013



able to “shrug” off concerns of rising interest rates. The Federal Reserve had hinted at the “beginning of the end” of its third version of quantitative easing (QE3) prior to the end of the

“October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.”

~ Mark Twain

second quarter of 2013. Interest rates began rising in the second quarter 2013 and rose even higher in the third quarter. The 10-year U.S. Treasury Bond yield started the quarter at 2.52% and rose to 2.98% before backing off and finishing the quarter at 2.64%.

Investors will continue to focus on the Federal Reserve, economic data, corporate earnings

and events from overseas in the fourth quarter. Likewise, as we ended the quarter with an imminent government shut down, many investors will undoubtedly question whether or not we finish the year strong.

Outlook

Federal Reserve

After setting up investors for the beginning of the end of its quantitative easing program known as “QE3,” the Federal Reserve surprised nearly everyone and chose not to “taper” after the September Federal Open Market Committee (FOMC) meeting. The “taper” refers to the Federal Reserve’s reduction of its monthly Treasury and mortgage bond purchases it has been undertaking through its current quantitative easing program. The equity markets posted a huge rally after the Federal Reserve opted against tapering at its September meeting only to sell off in the days following the meeting.

A question raised by investors who sold equities after the Fed’s decision to not taper, is if the Fed did not taper, what does the Fed see in the economy that we should be worried about? Does the Fed see slower economic



*“A bank is a place
where they lend you
an umbrella in fair
weather and ask for it
back when it begins to
rain.”*

~ Robert Frost

conditions on the horizon or was it anticipating the potential government shut down and is simply choosing to defer tapering until after the stalemate in Washington is settled? It can certainly be argued that the Fed has been a little confusing with regard to tapering in recent months.

After the June meeting concluded, investors were looking for “dovish” comments from the Fed (dovish referring to a Fed that is more accommodative versus “hawkish” referring to a Fed that is less accommodative). Bernanke stated in June that the Fed could begin tapering prior to the end of this year, a less dovish stance.

After the August meeting, investors awaited the release of the minutes from the last FOMC meeting looking for clarity as to the beginning of the tapering process. However, investors were disappointed as the Fed minutes provided very little clarity. Because of the lack of clarity, the Dow Jones dropped 105 points.

Considering the past few FOMC meetings, is it any wonder why investors may be just a little confused as to the direction of Fed policy? Nonetheless, no one doubts whether tapering will begin at some point in the near future. Rather, it’s just a question of when.

Interest rates and the bond market

Interest rates were volatile in the third quarter 2013 as the Fed prepped investors for the eventual tapering of QE3. The yield on the 10-year US Treasury Bond began the quarter at 2.52%, peaked at 2.98% on September 5th, and subsequently closed the quarter at 2.62%. Our expectation is that the yield on the 10-year US Treasury Bond will finish the year around 2.75%. Unless we begin to see faster growth in Gross Domestic Product (GDP) beyond the current 2.50% growth rate, it not likely that the 10-year US Treasury Bond yield will be able



to sustain a rise much past 3.00%. If we do see real GDP growth accelerate next year as shown by the Bloomberg consensus forecast of 3.00% annualized quarter over quarter by third quarter 2014, then the 10-year US Treasury Bond would likely increase above 3.00% in 2014.

As such, we continue to maintain a bias toward short term fixed income investments with a 75% weight to short term to 25% weight to intermediate term bonds. Likewise, we utilize floating rate loan and flexible duration strategies where appropriate to manage interest rate risk.

Turnaround in Europe

The Euro zone economies have been improving and the European recession that started as a result of the European debt crisis is likely over. In response to the turnaround in Europe, we believe that now is the time to increase our allocations to European equities.

To support our assertion, we point to recent positive economic data. For example, the Gross Domestic Product (GDP) in both the 17 Country Euro Area and the 27 country European Union (EU) each increased by 0.3% in the second quarter, on a quarter-over-quarter basis. This

marked the first positive reading for GDP since 2011. Besides the increase in GDP, economic sentiment rose by 1.6 points in the Euro Area and 2.4 points in the EU in the month of September 2013. The rise brought the indicator above the long term average for the EU which has not been seen since July 2011. In addition, the consumer confidence indicator reflected improvement in both the Euro area and EU. In the EU, the indicator exceeded its long term average which had not been seen since June 2011 (data reported by Eurostat, the statistical office of the European Union).

“We don’t have to be smarter than the rest. We have to be more disciplined than the rest.”

~ Warren Buffett

The Composite, Services and Manufacturing Purchasing Managers’ Indices (PMI) reflect an expanding economic activity in Europe. Any reading above 50 is considered expansionary and below 50 is recessionary. The Euro zone



PMI Composite Output Index was reported at 52.1 in September from 51.5 in August, a 27-month high. The Euro zone Services PMI Activity Index came in at 52.1 for September versus 50.7 in August, also a 27-month high. The Euro zone Manufacturing PMI was reported at 51.1 in September versus 51.4 in August. The manufacturing index was actually a two month low but still reflects expansion. Lastly, the Euro zone Manufacturing PMI Output Index September reading came in at 52.1 versus 53.4 in August. This was a 3-month low but again indicates expansion (data reported by Markit Economics, September 23, 2013).

Other positive points to consider include Angela Merkel's re-election in Germany. According to Barron's (July 21, 2013) she is widely credited for holding the EU together and "crafting the response to the European debt crisis." Barron's also cites European Central Bank (ECB) Chairman Mario Draghi's "defend the Euro at any cost" attitude has helped prevent any further issues from the sovereign debt crisis. It is important that investors feel confident that the sovereign debt crisis is over. In addition to Draghi's attitudes, tough austerity programs have

taken hold amongst many of the most troubled European nations which should further lend confidence to investors.

European equity prices have also rebounded strongly in recent months. From January 1, 2013 to June 30, 2013, the MSCI All Country Europe Index advanced 1.97% versus the S&P 500 Index of 13.82%. However, from July 1, 2013 through September 30, 2013, the MSCI All Country Europe Index returned 13.48% versus the S&P 500 index's return of 5.24%. It is evident that investors are beginning to recognize a rebound in the European economy and directing investments toward Europe.

In response to the European Sovereign Debt Crisis and subsequent European recession, we reduced our international allocation to 10% of our equity allocation. At this time, we are recommending an increase in our international allocation to 20% of our equity allocation. Although we are not utilizing a European specific manager, all of our international managers have sufficient exposure to Europe.



Are the emerging Markets at an inflection point?

Recent performance in the Emerging Markets continues to be a drag on investor portfolios as emerging markets countries have been impacted by a series of shock waves generated from external events. Year to date, the emerging markets are down -7.0%, but have rebounded strongly in the third quarter, posting a positive return of 5.8%. If we look over a longer time frame, 10 years ending May 31, 2013, the MSCI Emerging Market Index has returned an annualized 15.1% as compared to the S&P 500 Index of 7.6%.

Since the emerging market countries' economies are fueled by commodity-driven natural resources, low cost of labor and low cost of capital, the supply side of the equation is ample. The future growth component to this sector lies on the demand side. In the long run, we expect growth to emerge from two sources, internal and external. Internally, emerging market countries such as China, India, Brazil and Russia are on a significant growth path for infrastructure

construction, thus spurring higher employment and greater spending. At the same time, a growing consumer middle class is benefitting from slightly higher wages and higher skill related work, thus raising the overall salary level as compared to farming or production line work. As a result, industrial earnings for Emerging Markets are projected to grow over 11.5% as compared to the US of 9.5%.

“The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell.”

~ John Templeton

From an external perspective, current demand from struggling developed nations are causing a short term slowdown in exports. Despite that, however, future growth expectations remain high. For example, Taiwan recently reported exports to China dropped 7% from a year



earlier as a result of reduced level of consumer spending. With the recent slowdown in Europe, the demand for goods and services from the emerging markets has impacted exports as well. For example, Brazil and Turkey, which typically have a large percentage of their exports going to Europe, both saw a drop in exports for August, down 2% and 4.58% respectively, as reported by Bloomberg. However, as stated earlier we believe Europe is improving.

Overall, current valuations for the emerging markets reflect a 37% discount to the U.S. based on standard price-to-earnings, price-to-book and price-to-cash flow ratios. On the other hand, long term fundamental analysis suggests that with an estimated GDP growth rate in the 6% range as compared to the U.S of 1% to 3%, that shorter term economic anomalies will give way to longer term positive trends. Clearly emerging markets are more volatile than the U.S. since their economies are less diversified and rely more on commodity-based products. But, over the long run, it is widely felt that the global growth engine will be driven by the emergence of those countries whose populations morph into significant consumers and whose economies

evolve from a more agrarian to an industrial economy. The combination of the demand for natural resources, as well as a continued leveraging of higher technology and lower labor costs in these developing nations will again be primary drivers of growth. We believe shorter term economic and market dislocations in the emerging market economies only provide investment opportunities for those with a longer term time horizon.

Mutual Fund Flows

According to the Investment Company Institute (ICI) the year to date mutual fund flows have experienced positive total flows. However, there have been distinct trends across the major categories of funds. There have been approximately \$145.2 billion in total inflows with \$108.9 billion flowing into equity funds, \$63.1 billion into hybrid funds and \$26.8 billion flowing out of bond funds.

At a macro level, investors appear to believe that investments in equity funds are better suited for the current environment. Between June and September total equity inflows have increased from \$76.9 billion to \$108.9 billion. Some of



this may be a reaction to a sustained low interest rate environment and the ensuing focus on dividends to achieve income goals.

A more noticeable trend is that mutual fund investors continue to focus on the world equity category, supporting the consensus that the global recovery is underway especially in Europe (as discussed earlier). Through June, fund flows into the domestic and world category stood at approximately \$7.7 billion versus \$68.9 billion. That equates to approximately \$8.90 flowing into world funds for every dollar of U.S. investment. During the period ending September 2013, that gap has widened. Fund flows into domestic and world funds stand at approximately \$9.1 billion versus \$99.7 billion. That equates to \$10.80 flowing into world funds for every dollar of U.S. investment.

Despite some confusing words from the Federal Reserve regarding the imminent tapering of bond purchases, fund investors seem convinced that tapering will occur soon and that fixed income funds will be adversely affected. The ICI data shows total bond outflows of over \$60 billion with over \$44 billion of that amount flowing out of taxable bond funds as of June

despite bond fund flows being positive year-to-date through May 2013. As of September, that trend has intensified with total outflows of \$120.2 billion from June through September 2013. Total flows for the year are now negative at \$26.8 billion leaving bond funds.

Third Quarter Economic Review

The U.S. economy continues to grow at a slow but steady rate reflecting a very strained economic, political and international environment. The gridlock that has developed between the Obama administration and Congress, the ongoing challenges faced by the Federal Reserve in navigating the economy

“Investing is the intersection of economics and psychology.”

~ Seth Klarman

through unprecedented times, and other issues facing America on an international front, are all causing corporate America as well as consumers to be very cautious regarding their growth and spending plans for the future.



GDP came in above expectations at 2.5% as compared its original reading of 1.7% for the second quarter 2013. The unexpected revision was buoyed by gains in consumer spending, exports, private inventory investment, and residential fixed investment. Residential fixed investment, which is one of the brighter spots for the economy, grew at a 12.9% annualized rate in the second quarter and 12.5% annualized rate in the first quarter. On the other hand, the GDP growth rate of 2.5% still falls short of what we need to see in order to recover from previous losses during the “great recession”. A more acceptable growth rate would be in the 3%-4% range.

Other economic data points during the third quarter also reinforced the view that the economy is still not yet as healthy as it could be. The Consumer Price Index (CPI) registered a modest 0.2% monthly rise as compared to the higher than expected 0.5% monthly rate recorded in July. The greatest upward pressure for the August report came from tobacco and apparel while the greatest downward pressure was generated by airline fares and used cars & trucks.

“There are only two kinds of forecasters – those who don’t know and those who don’t know they don’t know.”

~ John Kenneth Galbraith

Unemployment edged down to 7.3% in August from the prior report of 7.4%. Unfortunately, an important component to the decline is simply a drop in the labor force participation rate. The labor force declined by 312,000 in August following a decline of 37,000 in July. This rate is growing faster than the rate of those finding jobs. Finally, both the Industrial Production Index (IPI) and ISM Manufacturing Index reported higher levels. The IPI Index was up 0.4% versus the previous report of 0% and the ISM index was up to 55.7% versus the previous report of 55.4%. With both current and expected grow expectations up from previous levels; these reports do raise the bar for GDP growth expectations for the rest of the year.



What continues to confuse many economists is that, despite unemployment remaining relatively high and economic growth still reflecting modest returns, consumer sentiment remains strong and is rising. What do consumers see that economists don't? Consumer sentiment came in at 82.1 versus the previous reading of 80 and continues to suggest that consumers see the economy picking up. Overall, we believe that the economy is improving.

Washington's Effect on the Markets

Pointing fingers and blaming the other party on the other side of the aisle has become more the norm rather than the exception in our nation's Capital. The possibility of a government shutdown rattled the markets at the end of September. A shutdown would impact "non essential employees" of the government, furloughing them for a time, while others who remain employed might see their paychecks and other benefits delayed.

The impact of a shutdown on the economy may be substantial. According to many economists, a possible shutdown could reduce fourth quarter economic growth by as much as 1.4 percentage

points, depending on the duration of a shutdown. The threat of a government shutdown may be weighing on consumer confidence which has been a bright spot in the economy, as the level of consumer confidence fell to a five month low in September, according to data from the University of Michigan.

While the S&P has climbed over 19% for the year through the end of September, with the help from Fed stimulus and good corporate earnings, a continued lack of clear direction from either party in Washington concerning the federal budget and the debt ceiling is not beneficial to a market which does not like uncertainty. The markets may look at the potential of another government stimulated crisis with a little more worry as it has implications for the credit rating of the United States. Looking back at the summer of 2011, the last time the debt ceiling increase was debated, the political wrangling resulted in Standard & Poor's downgrading the debt of the United States. The implications of another downgrade of our debt would likely be devastating for the financial markets.



Corporate earnings and equity market valuations

One of the key drivers to higher equity prices is earnings growth along with a continued expectation of earnings growth. Although the pace of growth in earnings has slowed in recent quarters, earnings are still growing nonetheless. Such growth has helped propel equities higher this year. Earnings released in the third quarter (reflecting the earnings from the second quarter of the year) showed that an impressive 65% beat, 8% met and 27% missed their earnings estimates for the quarter from the S&P 500 companies.

As of the end of September, the prior 12 month earnings reported by Bloomberg was 104.16 per share for the S&P 500 Index. Based on a September end closing price for the S&P 500 Index of 1,681.55 gives us a trailing price earnings ratio of 16.1 times earnings. The price multiple has expanded since the end of the second quarter 2013 when it was 15.7 times and the end of 2012 when it was 14.4 times trailing earnings. We are in a trend of price multiple expansion where the market is applying an increasingly higher market value to the value of earnings.

For the full year 2013 the Bloomberg consensus estimate is 110.99. If we apply a price multiple of 16.1 times earnings estimate of 110.99, we would see a market value of around 1,786.90 which is about 6.2% higher from the end of the third quarter. If the increasing price multiple trend continues and the full year calendar earnings come in at the 110.99 value, the market value could be even higher. It will be important to see how earnings actually are reported for the third quarter and beyond compared to the estimates.

Investment Implications; Strategic and tactical outlook

The preceding comments help us formulate our tactical short term portfolio weights and help influence or strategic, long term portfolio weights. As such, we provide the following guidelines for approaching the management of our clients' assets.

*“Price is what you pay.
Value is what you get.”*

~ Warren Buffett





Equal weight large cap value stocks and large cap growth stocks. Large cap value stocks outperformed large cap growth stocks for the first half of 2013. However, that trend reversed in the third quarter, as large cap growth stocks outperformed large cap value stocks. We had been overweight large cap value versus large cap growth and now suggest an equal weighting between large growth and large value. On an historical valuation basis, large growth is the most undervalued investment style of all of the domestic styles. If the over performance continues, we may eventually overweight large cap growth to large cap value.

Overweight mid cap growth stocks versus mid cap value stocks. Mid cap growth stocks have been out-performing mid cap value stocks this year. Mid cap growth stocks are less expensive than they have been on average over the past 20 years. Also, the momentum is in favor of mid cap growth over mid cap value stocks over recent months suggesting an over-weight is appropriate.

Overweight small cap growth stocks versus small cap value stocks. For the same rationale as mid cap stocks, we suggest an overweight of small cap growth relative to small cap value as the small growth is less expensive and the momentum is favoring small growth this year.

Increase the developed international equity weighting. We suggest increasing our clients' weighting to developed international stocks primarily due to the improvement in the European economy following the European sovereign debt crisis. Japan has also benefited from its own stimulus program this year as well. Although we do not recommend a dedicated European manager, our active international managers are heavily weighted toward Europe.

“The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions.”

~Seth Klarman



Increase the emerging markets equity

weighting. We have been underweighting emerging markets within our portfolios. We believe the outlook for emerging markets is improving and we want to target a current 4% weighting of our total equity allocation toward emerging markets.

Maintain a 75% short term fixed income to 25% intermediate term weight.

Given our projection that interest rates may move higher, especially if we see faster growth in GDP, we are suggesting a bias toward short term duration fixed income investments. We suggest weighting short duration fixed income at 75% and intermediate term duration at 25%. Also, we suggest a floating rate note allocation as well as a flexible duration strategy.



Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	12.8 / 13.9	14.3 / 16.1	16.3 / 20.9
Mid	14.2 / 14.0	15.9 / 16.3	17.7 / 21.8
Small	14.6 / 14.3	16.8 / 17.1	19.2 / 21.3

Current P/E as % of 20-year avg. P/E

E.g.: Large Cap Blend stocks are 11.5% cheaper than their historical average.

	Value	Blend	Growth
Large	92.1%	88.5%	77.8%
Mid	101.6%	97.6%	81.3%
Small	102.7%	98.1%	90.0%

Source: Standard & Poor's, Russell Investment Group, FactSet, J.P. Morgan Asset Management.



Conclusion

Equity markets continued to perform well in the third quarter and we expect that positive performance to continue through the end of the year. Bond market investing has been challenging and will continue to be challenging going forward as we expect interest rates to continue to rise.

It is widely thought that the Bernanke Federal Reserve is transparent by preparing the markets for its anticipated moves. However, with regard to tapering, recent monthly statements prepared investors for tapering which did not occur. The signal it is sending right now may be a little confusing and add to some uncertainty in the markets. The Fed's statements in recent months (Beginning on May 22nd) have led to interest rate volatility. We expect volatility to continue with an upward bias in rates.

It appears that both developed international and emerging markets have turned positive and appear to provide an opportunity for investment. Investors are moving assets into international mutual funds versus domestic mutual funds.

We enter the fourth quarter with a looming government shut down. Although history shows

us that prior government shut downs are not necessarily a negative for equity markets there may be evidence that they do detract from economic growth. With an already slowly growing economy, any impediment to growth is not what we need right now. Syria has faded from the headlines although nothing has really changed over there. Likewise other foreign policy concerns may arise going forward which will occupy time from the politicians. Crisis seems to bring everyone together in Washington, eventually.

We expect corporate "bottom-line" earnings to provide a positive catalyst for the markets but also realize that we may see slowing "top-line" revenue growth for the third quarter 2013.

On balance we maintain a positive view on the economy and financial markets. At the center of our convictions is our objective to help our clients meet their goals.

“For all long-term investors, there is only one objective – maximum total real return after taxes.”

~ John Templeton



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