KNOX & DOWNING ADVISORS

A Member of Advisory Services Network, LLC

WELCOME

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We welcome a very select and much appreciated group of clients to our initial quarterly comment on the markets, the economy and other issues of interest to investors. While we will be discussing many of these issues with you individually as we work together, we will offer these quarterly communications as a way to outline our thoughts on market and economic topics, current events and the impacts these events may have on our investment strategy.

Our initial message comes with the stock market close to all-time highs after a remarkable five year recovery from the depths of the recession of 2008-2009. Since most of our clients have been with us as portfolio managers since those frightening days it is a great relief to have experienced the kind of recovery in the market we thought possible and probable five years ago. With the S&P 500 closing the quarter September 30, 2013 at 1681.55, the index is up 16.72 % year to date and a remarkable 149% since the lows of March of 2009. The magnitude of this advance in stocks is a reflection not only of how severe the recession was but more importantly, how overwhelming the fear and pessimism were during the crisis.

The recovery in stocks has been far more dramatic than the rather tepid recovery in the economy. Many experts believe the recovery in stocks has more to do with the Federal Reserve Bank's efforts to provide liquidity than sound economic underpinnings. We believe this is partially correct and we would like to see the Fed begin to reduce their accommodative policies and allow the economy to stand alone on what admittedly might be somewhat unsteady legs. In our view, given the severity of the recession, both in the US and overseas, a painfully slow recovery might have been expected. We believe the economic recovery will continue and gather some pace as we move into 2014.

Concerning the stock market, the consensus earnings estimates for the S&P 500 according to Bloomberg are $110.67 for 2013 and $121.41 for 2014. With the S&P 500 at 1681.45 there is a Price/Earnings Ratio of 15.1x for this year's estimated earnings and 13.85x for 2014. While we are cautious about consensus estimates, the valuation levels as measured by P/E are not unusually high and lead us to conclude that the market is not significantly overvalued nor is it any great bargain.

The current level of interest rates is an important factor in assessing the relative value of the stock market and rates are still extremely low. According to a matrix of currently available bonds for purchase provided by Schwab, the yield on the 5 year Treasury Notes is 1.48% and 5 year AA corporate bonds are yielding 1.83%. While these rates are above the absolute recent lows, the relative attraction of a 5 year AA corporate bond yielding 1.83% versus a top quality common stock with a record of regular dividend increases yielding close to 3% seems to be an easy call. That is not to say that some top quality stocks with attractive yields are not currently overvalued, but given a 5 year time frame and a head start of a yield more than a 1 percent higher we believe the stock is a much better value. As bond yields inevitably increase as the economy continues to improve the relative attraction will gradually change.

The financial media is focused on the dual issues of monetary (the actions of the Fed) and fiscal (the inaction of Congress) policy. Events such as the Fed reducing liquidity by tapering its purchases of securities and the debate over the debt ceiling may cause stock market volatility. In spite of these near term disruptions we remain positive on the economy and the stock market for the long term. We are most appreciative of the faith you have placed in us and we look forward to working with you.

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