

QUARTERLY ECONOMIC REVIEW OUTLOOK

INVESTMENT NEWSLETTER / THIRD QUARTER 2014

Executive Summary

The U.S. economic report card is much improved from weather related weakness earlier in the year. Following a first quarter contraction, GDP growth rebounded at a 4.6% clip in the second quarter and is expected to grow 3%, annualized, in the second half of the year.

Notwithstanding poor participation rates and weak wage growth, the labor market has come alive as well. Weekly jobless claims fell to a 14 year low during the third quarter, the unemployment rate dropped to 5.9% in September, and payrolls have expanded by an average of 227,000 workers per month in 2014 – the fastest nine month pace of net job gains since early 2006. On the corporate side, second quarter earnings growth was healthy and business outlooks have improved. The Institute for Supply Management's Composite Purchasing Managers Index nearly eclipsed a ten year high in August and small businesses report feeling more confident about the economy. As for government, fiscal squabbles have diminished and upcoming elections are not

expected to change governing dynamics appreciably (i.e. gridlock will remain). The Federal Reserve remains accommodative, albeit less so, and inflation expectations, both contained and stable, afford the central bank reasonable policy latitude going forward.

While the prognosis for the U.S. has improved, the same cannot be said for many other areas of the globe. Aside from the U.K., Europe is weak, its recovery is faltering, and disinflation has become an urgent issue. Japan contracted dramatically in the second quarter and subsequent progress has been weak. Prime Minister Shinzo Abe's economic road map is increasingly challenged to get the Japanese economy on the right path. The ability of China to meet its 2014 growth target of 7.5% is uncertain. The nation's banks have reported a surge in soured loans and a widespread downturn in real estate (tied to 25% of the economy) has deepened despite stimulus efforts.

Geopolitical tensions are a challenge as well. Flare-ups in the Ukraine

and Israel have simmered down, but associated political posturing continues. Likewise, Ukraine is now faced with the economic impact of devastated infrastructure, and trilateral sanctions between the U.S., Europe, and Russia are already a challenge for Putin's economy as well as that of Europe. Meanwhile, Mid East turmoil rages on in Iraq and Syria as the U.S. progressively re-engages in the region in an effort to contain and destroy the extremist Islamic militant group known as ISIS.

Looking forward, the relatively favorable economic backdrop in the U.S. is arguably priced into investment markets. Accordingly, third quarter investment returns ranged from poor to lackluster and the future may bring more of the same. That said, as expressed above and in the following pages, challenges and opportunities for the U.S. economy and its investors seem more likely to come from distant shores than from developments at home.



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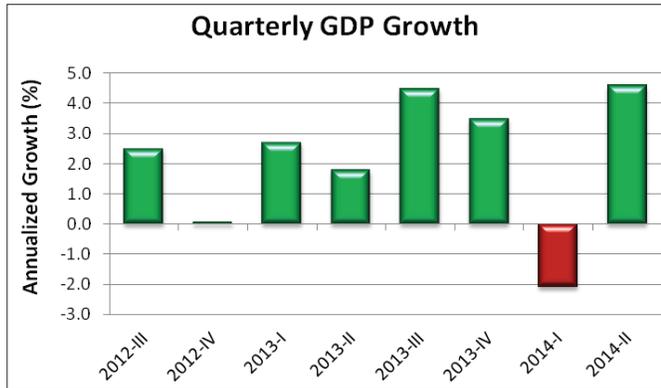
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Economic Review and Outlook

Economic Growth

Following a disappointing contraction in the first quarter, U.S. economic output grew at a seasonally adjusted annualized rate of 4.6% in the second quarter.



U.S. Department of Commerce

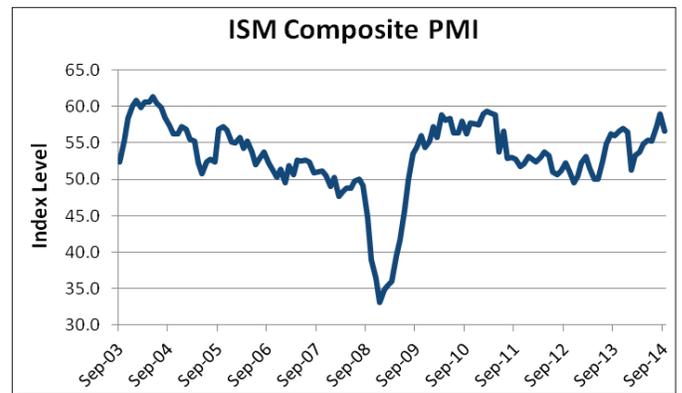
Business investment was particularly strong in Q2. Growing at an annualized rate of 9.7%, this category accounted for one quarter of total GDP growth. Consumer spending was also favorable, chiefly in durable goods (items expected to last more than three years). Inventory gains were substantial, and government spending was a positive for only the sixth time out of the 20 post-recession quarters.

Looking forward, expected second half growth of 3% would bring full-year 2014 results to a somewhat lackluster gain of 2%. Although that pace of growth is comparable to previous years of the current recovery, the economy presently seems to have a more substantial foundation. Among other metrics discussed throughout the remainder of this newsletter, this strength can be illustrated by the Institute for Supply Management's Composite Purchasing Managers Index, which nearly took out a 10 year high in August.

U.S. economic growth is proving to be more robust, and sustainable, than other major economies.

Europe

The European recovery is faltering, and disinflation is a pressing concern. German industrial production has slowed, business confidence has fallen for five



Institute for Supply Management

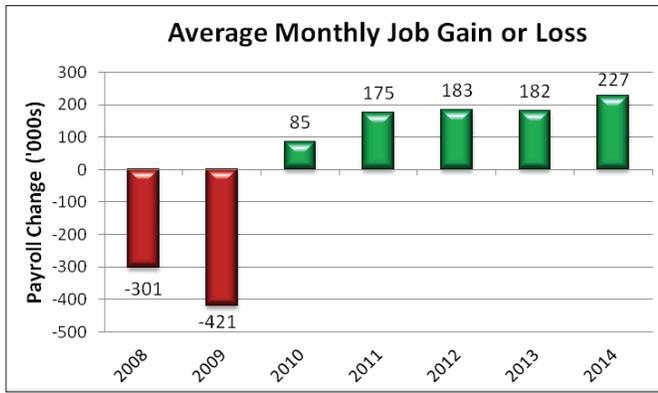
consecutive months, and the nation's overall economic growth has stagnated. France stalled in the second quarter, lowered its growth forecasts for 2014 and 2015, and pushed back the timeline to meet required deficit targets by two years. Italy is in its third recession since 2008.

Japan

In Japan, a sales tax increase drove the economy to contract at an annualized rate of 7.1% in the second quarter. The nation's industrial production also fell at the fastest pace in years, inventories are reportedly bloated, and consumer inflation is up less than expected. A surging trade deficit is an economic headwind, and S&P continues to have a negative outlook on the nation's debt. In short, Prime Minister Shinzo Abe's economic prescription (dubbed "Abenomics") appears to be coming up short. On that note, the International Monetary Fund (IMF) has encouraged Japan's leaders to quickly embark on structural reforms to deal with an increasingly tentative outlook.

China

The ability of China to meet its 7.5% 2014 growth goal remains uncertain. Reduced capital efficiency, a buildup in debt, and widespread/accelerating weakness in real estate markets are issues. Unfortunately, the government's targeted stimulus efforts have thus far proven fruitless, and the nation's Beige Book survey indicates the third quarter was a challenge. That said, recent purchasing managers surveys were positive and consumer confidence rebounded during the quarter.



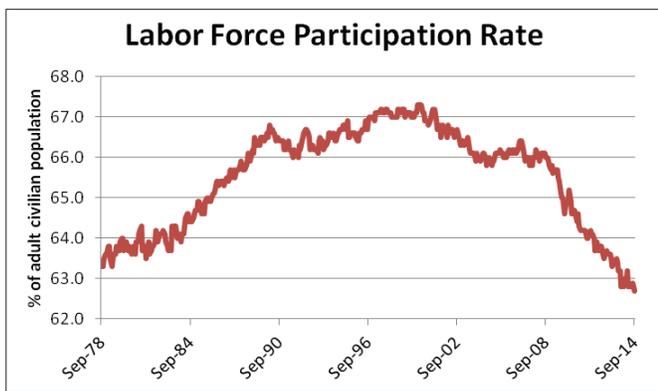
U.S. Department of Labor

Employment

Following weather related weakness last winter, the labor market bounced back in both the second and third quarters. Initial jobless claims fell to a 14 year low during Q3 and year-to-date payroll gains through September represent the fastest nine month pace of job creation since early 2006.

Moreover, the unemployment rate, down to 5.9% in September, is nearing the Federal Reserve's estimate of full employment (between 5.2 and 5.5%).

Clearly, the labor market has shown substantial improvement from the dark days illustrated by the red bars in the previous graph. That said, key metrics remain out of sync with historical norms. For example, the labor force participation rate, stunningly down to a 36 year low, continues to decline.



U.S. Department of Labor

Job quality is also lacking. New jobs created during the recovery pay an average of 23% less than those lost



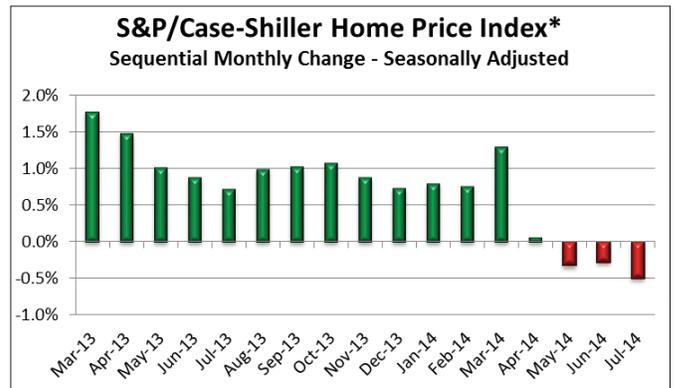
U.S. Department of Labor

during the downturn. As shown below, wage gains have also been subpar when compared to previous periods.

In short, despite fewer job losses and accelerated payroll growth, the U.S. economy is nearing a four decade low in the percentage of adults participating in the labor force. Those that do have jobs are receiving uncharacteristically low pay raises, and those finding new jobs, on average, are being paid a fraction of pre-crisis incomes. This set of circumstances is neither characteristic of a healthy labor market nor does it lead to attractive consumer spending and economic growth.

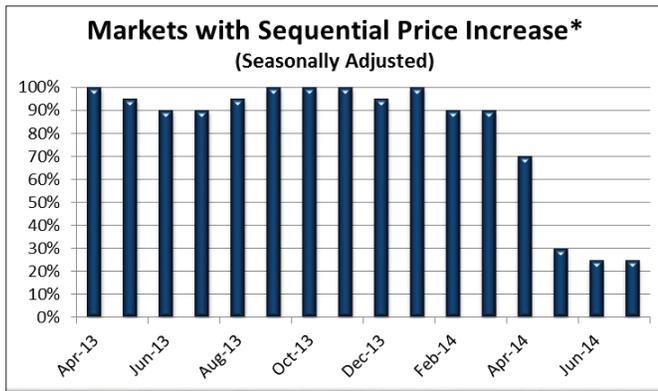
Real Estate

The housing market stalled this year and prices have been trending lower.



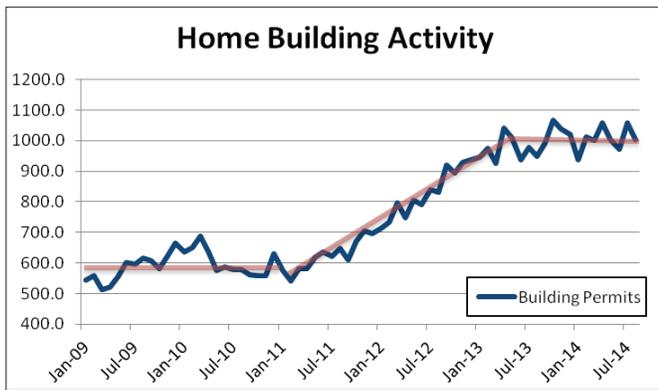
S&P/Case-Shiller

Whereas prior to this year nearly all markets were experiencing consistent sequential monthly price gains, only one in four markets are doing so today.



S&P/Case-Shiller

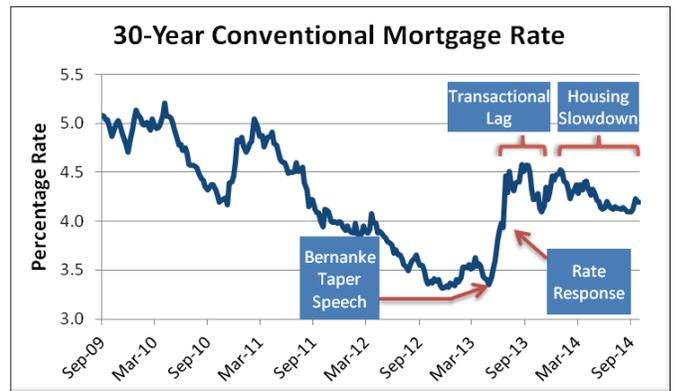
Building permits and housing starts, after rising rapidly throughout 2011 and 2012, have now plateaued at a rate of about one million units per year.



U.S. Department of Commerce

Considering the abruptness of the change in housing market dynamics, an acute event was likely the cause of the slowdown. That event was most surely Bernanke's famous speech(es) in May and June of last year. His guidance that quantitative easing would slow, or taper, was followed by the so-called "Taper Tantrum." The corresponding jump in mortgage rates and timeline of events is shown in the next graph.

Admittedly, the housing market is more interest rate sensitive than many other industries. As a result, inferences drawn from housing to the broader economy are less than perfect. That acknowledged, a substantial housing market slowdown due to higher (but still historically very low) rates suggests two things. First, the Federal Reserve has engineered an economic system dependent on artificially low rates. Keep in mind, this includes financial assets as well. Second,



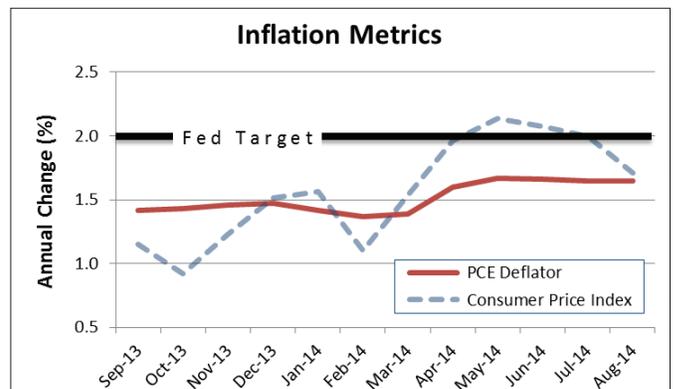
U.S. Federal Reserve

the inability of the economy to deal with higher rates makes lower rates a self-fulfilling prophecy. In other words, elevated interest rates are likely to die an untimely death at the hands of an ensuing recession.

* The Case-Shiller Home Price Index incorporates a three month moving average methodology. As a result, a data point from April 2014, for example, represents economic events from February through April.

Monetary Policy

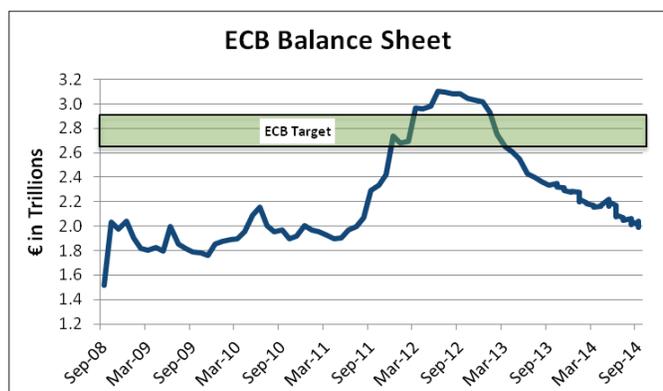
Following the completion of \$15 billion in bond purchases this month (October), the U.S. Federal Reserve is expected to end quantitative easing. The focus going forward, for investors and the Fed, will be the timing and pace of interest rate increases. Market expectations suggest the first rate hike will take place around the middle of 2015. While some believe an earlier move is necessary to control inflation and financial excesses, the majority of economists believe the Fed will actually wait too long. The IMF, for its part, believes the central bank may have the [macroeconomic] latitude to do so. In furtherance of this



U.S. Department of Labor

“lower for longer” thesis, the labor market has improved, but wage pressures remain tame (see Economic Cost Index earlier in this report). Likewise, as measured by the Fed’s preferred inflation gauge, the Personal Consumption Expenditures price index, or PCE Deflator, inflation remains below target.

Internationally, the European Central Bank (ECB) continued to unabashedly push for a weaker euro and a higher rate of inflation. As expected, a first tranche of four year, low interest rate loans was offered to banks in September. The uptake was disappointing. Policymakers hope for a greater utilization of the facility at a second offering in December. In the meantime, the European central bank also cut interest rates deeper into negative territory and assured markets that rates will stay low for an extended period of time. The ECB will also begin to purchase both covered bonds and asset-backed securities in the fourth quarter. Through these types of asset purchases over the next two years, Mario Draghi and his colleagues target to restore the ECB’s balance sheet to a size comparable to that of early 2012.



Bloomberg

Capital Markets Review and Outlook

Overview

Investment market returns for the third quarter were lackluster to poor.

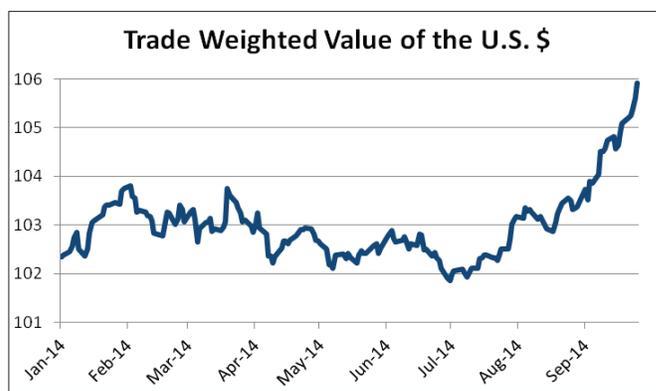
Aside from large capitalization domestic stocks and investment grade domestic bonds, all major investment categories were down. Small capitalization stocks were particularly challenged and entered correction territory

Capital Market Returns	3rd Qtr 2014	Year-to-Date
Cash and Fixed Income		
U.S. Treasury Bills	0.0 %	0.0 %
Barclays Aggregate Bond	0.2 %	4.1 %
Barclays Municipal Bond	1.5 %	7.6 %
Barclays Gbl Agg. ex. U.S.	-5.4 %	-0.1 %
Domestic Equities		
Wilshire 5000	0.0 %	7.0 %
S & P 500	1.1 %	8.3 %
Russell 2000	-7.4 %	-4.4 %
International Equities		
MSCI ACWI ex. U.S.	-5.5 %	0.0%
MSCI EAFE (Developed)	-5.9 %	-1.4 %
MSCI EM (Emerging)	-3.5 %	2.4%
Hedge Funds and Alts.		
Bloomberg Commodity	-11.8 %	-5.6 %
DJ US Real Estate	-2.7 %	13.3 %
HFRI FOF Composite	0.5 %	2.7 %

Morningstar & Hedge Fund Research, Inc.

(defined as a decline in excess of 10%) during the period.

An impactful theme throughout the quarter was a material upward move by the U.S. dollar.



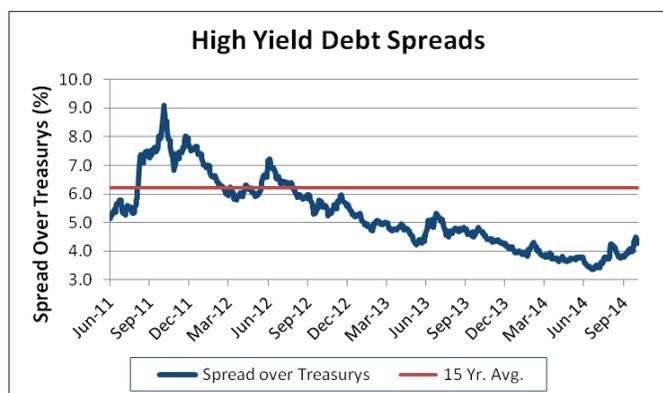
U.S. Federal Reserve

Dollar strength weighs on international investments as weaker foreign currency exposures are translated into fewer dollars. International stocks and bonds lost 4 to 5% in Q3 simply due to the impact of currency

movements. Commodities, previously a market darling in 2014 and commonly priced in dollars, were substantially hurt by dollar strength as well.

Despite the challenging return environment described, valuations remain stretched and complacency is running high. The Bank for International Settlements (BIS) recently warned [again] that central bank policies are encouraging capital market euphoria and a false sense of security. The organization, often referred to as the central banker's central bank, believes complacency about risk has reached worrying levels. Their suggestion, presently unheeded, is for global central banks to raise rates to reduce the risk of financial instability.

To their point, despite weak global growth, stocks are near record highs. Likewise, notwithstanding the uptick shown below, junk credit spreads remain well below average.

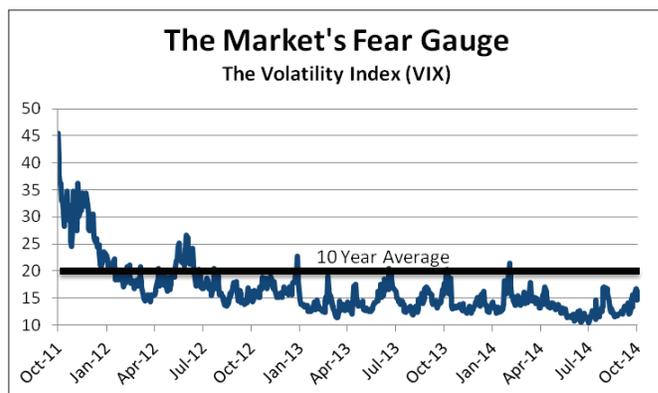


BofA Merrill Lynch

For investors pushing on credit risk to drive “portfolio yield,” the seemingly small upward move in spreads shown in the previous graph translated into a 1.9% third quarter loss in junk bonds. Finally, historic lows in volatility, shown below, are perhaps the most pure embodiment of the complacency described by the BIS.

Equity Markets

Market leadership has narrowed. Investors unwilling to leave the equity market have sought refuge in a shrinking subset of larger capitalization companies. In the process, large caps outperformed small caps by 8% for the quarter. This move brought the year-to-date performance differential between large and small to over 12%. Growth stocks modestly outperformed value



Chicago Board Options Exchange

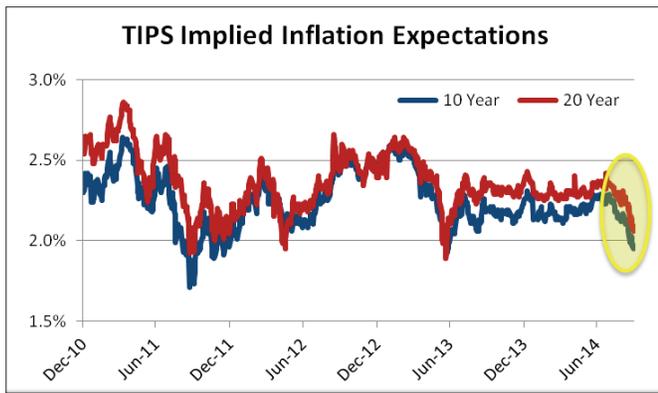
during the quarter, but the reverse is true thus far for the year.

Fixed Income Markets

Following the quarter's out performance of investment grade debt over junk, high quality fixed income has now outperformed weak credits in 2014. More of the same may be in store.

- Fed Chair Janet Yellen commented that low yields have incentivized investors to reach for yield, leaving valuations in low-rated debt “stretched.”
- The Comptroller of the Currency (OCC), an independent bureau within the U.S. Treasury, has warned of eroding underwriting standards in the high yield market.
- U.S. banks, in agreement with the OCC, have warned of excessive risk taking and complacency as a result of one-way markets.
- The percentage of junk rated loans with minimal investor protections (protective covenants) has risen to 61%. That compares to only 25% in 2007, the last credit peak.
- U.S. bond issuance is on pace for a third record year in a row – it has been a seller's market.

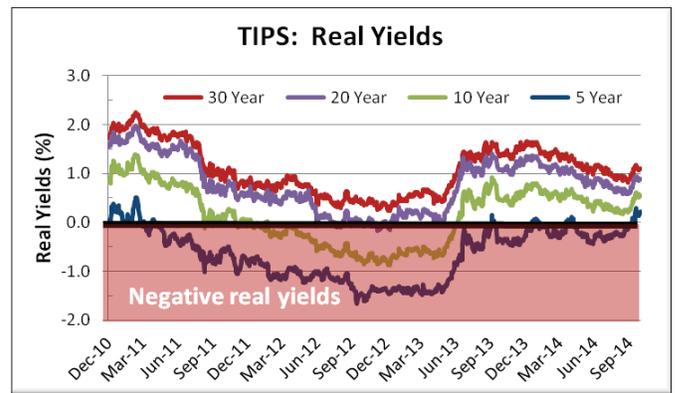
If the risk/reward of high yield is not favorable, where should fixed income be allocated? The over-arching answer is a broad allocation to investment grade debt. An interesting subcategory, presently worthy of mention, is Treasury Inflation Protected Securities (TIPS). TIPS are currently pricing in diminished inflation expectations. Such periods have proven to be fleeting in the past.



U.S. Treasury

Moreover, as illustrated on the following page, the TIPS market is providing some of the highest real yields we have seen in years.

The combination of high credit quality, diminished inflation expectations, and improved real yields make TIPS a timely fixed income subcategory. One caveat, TIPS tend to have somewhat higher sensitivity to interest rate movements than typical intermediate investment grade bonds. Enthusiasm for the category must therefore be tempered by the potentially negative impact of rising rates.



U.S. Treasury

Hedge Funds and Alternatives

Hedge funds delivered slightly positive results for the quarter, bringing year-to-date gains to low single digits. Macro and Event Driven strategies have slightly edged out other mandates in 2014, but the dispersion across investment styles has been rather tight.

A rough third quarter for commodities made the asset class the worst performer for the year. Real estate also lost ground in Q3, but stellar performance in the first half of 2014 left the category as the year's top performer.

Disclaimers

This market commentary was written by Robert W. Lamberti, CFA, a Principal of and Vice President of Investments for Summit Financial Resources, Inc./Summit Equities, Inc., 4 Campus Drive, Parsippany, NJ 07054. Tel. 973-285-3600, Fax: 973-285-3666. Sources of Performance: Morningstar®. Indices are unmanaged and cannot be invested into directly. The investment and market data contained in this newsletter is not an offer to sell or purchase any security or commodity. Standard & Poor's 500 Index (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. The Wilshire 5000 Index is a market capitalization-weighted index of the market value of all stocks actively traded in the United States. The index is intended to measure the performance of all U.S. traded public companies having readily available price data. The MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. Emerging markets are considered risky as they carry additional political, economic, and currency risks. Real Estate Investment Trusts, REITs, are securities that invest in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, however, have liquidity constraints. The Barclays Capital U.S. Aggregate Bond Index is a market capitalization-weighted index comprising Treasury securities, Government agency bond, Mortgage-backed bonds, corporate bonds, and some foreign bonds traded in the U.S. Fund Category Performance is not inclusive of possible fund sales or redemption fees. Investment grade bond analysis included bonds with ratings of AAA, AA, A, and BBB. Municipal and Corporate Bonds are backed by the claims paying abilities of the issuer. TIPS are inflation-indexed securities issued by the U.S. Treasury in an effort to widen the selection of government securities available to investors. Past performance does not guarantee future results. Information throughout this Newsletter, whether stock quotes, charts, articles, or any other statement or statements regarding market of other financial information, is obtained from sources which we, and our suppliers believe to be reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. Neither we nor our information providers shall be liable for any errors or inaccuracies, regardless of cause, or the lack of timeliness of, or for any delay or interruption in the transmission thereof to the reader. Opinions expressed are subject to change without notice and are not intended as investment advice or a guarantee of future performance. Consult your financial professional before making any investment decision.

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