<u>Outlook for October, 2013: "A Data Void…"</u>

US equity markets are in a ***state of flux*** with the shutdown in the Federal Government affecting crucial data releases for the month ended September. Indeed, the Bureau of Labor Statistics has not yet "collected" employment data for September. The BLS has suggested that it is therefore unlikely to issue a labor market report until at least three days after the Federal Government reopens.

While the timing of a ***partial shutdown*** of the Federal Government is unfortunate, the actual shutdown (as long as it lasts for just a few weeks) might only have a modest impact on overall Gross Domestic Product. The order of magnitude is likely to be somewhere between two-tenths and four-tenths reduction in GDP for the few weeks of the partial shutdown. Much to the chagrin of politicians everywhere, the populace might well get used to the idea of not having a functioning Federal Government!

Survey data released earlier this month do reiterate that the US economy is ***growing***, but in fits and starts: The Institute of Supply Management's PMI index of manufacturing activity rose a modest 0.5 points to 56.2 in September. Diffusion indices relating to production (+0.2 points), employment (+2.1 points) and prices (+2.5 points) rose during September, but those relating to new orders (-2.7 points), imports (-3.0 points) and exports (-3.0 points) posted losses for the same period.

The ISM's non-manufacturing index – a survey of business conditions in the service sector – posted a surprising decline of -4.2 points for the month of September to 54.4 points. Business activity declined a precipitous -7.1 points for the month as did those relating to employment (-4.3 points) and supplier deliveries (-4.5 points). The Index relating to prices rose 3.8 points and new export orders increased a surprising 7.0 points for the month of September – the two main components that showed some strength in the data.

In policy related news, Lawrence Summers a former Treasury Secretary withdrew his name from consideration for the next chair of the Federal Reserve leaving the current vice-chair Janet Yellen as the leading contender to get the nod from the Administration. Mr. Summers implied the risk of an ***"acrimonious confirmation hearing"*** – especially from members of the President's own party in the Senate – as the reason for his withdrawal.

We have gone on record earlier to suggest that Janet Yellen's term as the Fed Chair is likely to be difficult at best and an unmitigated disaster at worst. While she is known to be a very careful economist who marshals her ideas after much study and deliberation, the fact remains that she often is known to talk about the ***"human cost of recessions"*** and is obviously ***a "dove"*** among central bankers.

The very fact that the FOMC chose to leave its quantitative easing at the $85 Billion level per month, despite preparing the markets for a ***"tapering"*** earlier this spring, also suggests that the risk of policy mistakes now appear to be higher. Some wags have suggested that the September FOMC meeting might have indeed been the first one presided over by a new de facto Chairman Yellen!

Regardless of when the FOMC choses to start the process of "tapering", it appears that the members of the FOMC have painted themselves into a corner by suggesting that their decisions are ***"data dependent"***. Tying policy outcomes to contemporaneous economic data is quite foolhardy and could well make for weird and unsatisfactory outcomes. The unemployment rate, that ***"touchstone"*** of when tapering is likely to occur, is affected by a number of imponderables: Demography, immigration, wage increases, business conditions and investment spending to name just a few.

Furthermore, Chairman Bernanke's hallmark at the Federal Reserve has been ***"transparency"*** and the use of ***"unconventional monetary policy tools".*** While we will save our readers from editorial comments regarding the latter, it is important to recognize that the Federal Reserve has essentially put themselves in quite an untenable position by virtue of increasing transparency and providing unusual color to their thinking and the real short term focus of such decision making.

After all, it was Chairman Bernanke who alluded to "tapering" at his press conference earlier this spring (May, 2013), then spent the next few months suggesting that the timing was likely to be in the fall (read September) only to disappoint at the actual FOMC meeting in September. Markets do take pronouncements by the Chairman of the Federal Reserve as an ***article of faith***. Be that as it may, the Federal Reserve does have to undertake some restoration to its credibility in the near to medium term.

Farther afield, Chancellor Angela Merkel handily won re-election in Germany with her Christian Democrat Party (CDP) doing well at the hustings. However, her coalition partner, the Free Democrat Party (FDP) was turfed out of the ***Bundestag*** (winning less than 5.0% of the vote). This necessitated ongoing negotiations between the CDP and the opposition Social Democratic Party (SPD) and/or the Green party. It will be interesting to see what form the coalition ultimately takes.

The beleaguered Indian Rupee appears to have stabilized after moves by the newly minted Governor of the Reserve Bank of India, Raghuram Rajan (a former chief economist at the IMF and University of Chicago Professor), to restore some credibility by easing liquidity conditions. He has, however, used the opportunity to stress his vigilance on inflation over the medium term, suggesting that policy makers are likely to tackle the "twin deficits" that shackle the Indian economy.

It is obvious from a cursory examination of the fiscal policy mess (Government shutdown and debt ceiling debate) that the good old US of A finds itself in, is primarily due to a lack of leadership. While saying "I am not going to negotiate" might be posturing, to actually carry through in this vein is bordering on ludicrous. Regardless of who gets blamed for the shutdown, it is quite clear that Washington DC is downright dysfunctional.

The US Treasury has intimated that it will run out of maneuvering room even after using ***"emergency measures"*** around Oct 17th which then threatens the ugly specter of ***"default"***. Financial markets have ***become inured*** to expect the inevitable eleventh hour deal, thus staving off dire outcomes until the next such episode of "playing Russian Roulette with your nation's credit rating" plays on a television channel. We do expect to see market volatility the closer we get to the eleventh hour without the prospect of a "deal".

Municipal yields seem to have stabilized after a virulent reaction to "event risk" driven increases from earlier this summer. Indeed, with the City of Detroit filing for bankruptcy and problems with Puerto Rico (and other similar issuers), market participants appear to be throwing the ***proverbial "baby out with the bath water".***

Of the more than 50,000 issuers (yes, over 50,000) of municipal credits, not all of them are a City of Detroit or a Birmingham, Alabama. From a valuation standpoint, municipal yields typically trade at an 80% to 90% of equivalent Treasury yields under "normal" conditions. Currently, municipal yields are above 110% of comparable Treasury yield equivalents: This does speak volumes about the attractiveness of this sub-class. Nonetheless, it pays to be selective from a credit standpoint.

In summary, equity markets appear to be in a state of flux, awaiting the resumption of economic data and resolution of fiscal uncertainty in Washington DC. While your portfolios remain fully invested, we are worried about the prospect of near term volatility in the US. As always, our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain ***favorable investment outcomes*** over the long haul remains steadfast.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

Important Disclosures

MBR Financial is registered with the SEC as a Registered Investment Advisor.

Investing involves risk including the potential loss of principal. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values.

Past performance is not a guarantee of future results.

This memorandum is based upon information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete.