Lane Asset Management

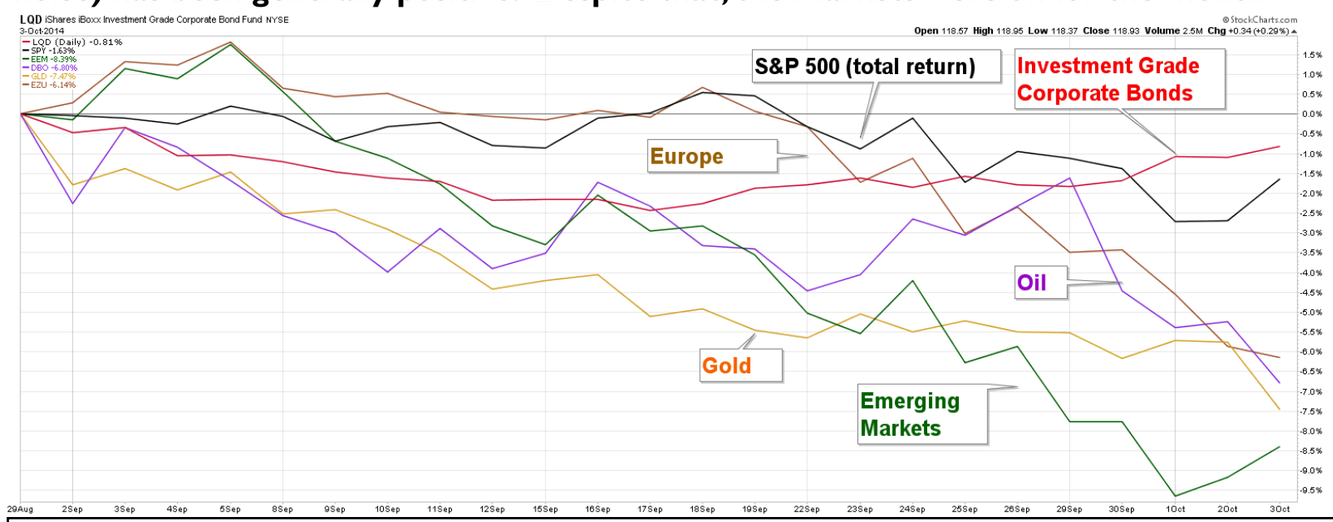
October 7, 2014

Stock Market Commentary

Market Recap for September 2014

As I was preparing this month's Stock Market Commentary and thinking back to summaries made in prior months, I was reminded of the title of Nate Silver's book, The Signal and the Noise since, once again, we have economic and geopolitical events which are credited by analysts for stock market performance almost every day.

In September, the noise began with better-than-expected readings in the ISM manufacturing and nonmanufacturing indexes, followed by disappointing nonfarm payrolls for August, followed by a report of the highest level of job openings since June 2007, then weakness in European manufacturing, then the Empire State factory sector survey of business conditions rose to the highest level in 5 years, followed by a drop in housing starts and building permits, then a report by the Conference Board's Leading Economic Indicators reached the highest levels in 7 years, next a drop in the Chicago Fed National Activity Index, followed by an upward revision in the second quarter GDP to 4.6 with strong business fixed investment, followed by...well, you get my point. That was the noise. In general, at least for the U.S., including the parts I've left out, the news and (the noise) has been generally positive. Despite that, the markets were off for the month — bonds and equities.



On the other hand, the signal — which is the underlying driver of the market — could be summed up by a slowly improving U.S. economy with the help of an accommodative Fed offset by intractable weakness in Europe, slowing in China, lowered global growth estimates from the IMF and unease among financial analysts. The next major signal to come will be 3rd quarter corporate earnings reports, most of which are due out over the next 4-6 weeks.

Investment Outlook

For both technical and fundamental reasons, I remain positive about the U.S. equity outlook, though not so much for international equities. That doesn't mean we can't have a correction of sorts in the U.S. — anything is possible. My view, though, is that any such correction will be relatively mild and will serve to take steam out of the market and keep it on track for steady, long term growth, albeit at levels probably in the mid-to-high single digits on an annualized basis.

As I suggested last month, the pre-September 9% gain for the S&P 500 was due for some let down and we got that in September. Despite a very encouraging payroll report for September, I suspect what we see for the balance of the year in the S&P will be modest growth, at best, and be almost entirely controlled by 3rd quarter earnings reports and the Fed (absent, of course, an unforeseen significant geopolitical event).

The charts on the following pages use mostly exchange-traded funds (ETFs) rather than market indexes since indexes cannot be invested in directly nor do they reflect the total return that comes from reinvested dividends. The ETFs are chosen to be as close as possible to the performance of the indexes while representing a realistic investment opportunity. Prospectuses for these ETFs can be found with an internet search on their symbol. Past performance is no guarantee of future results.

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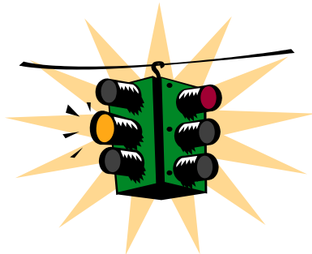
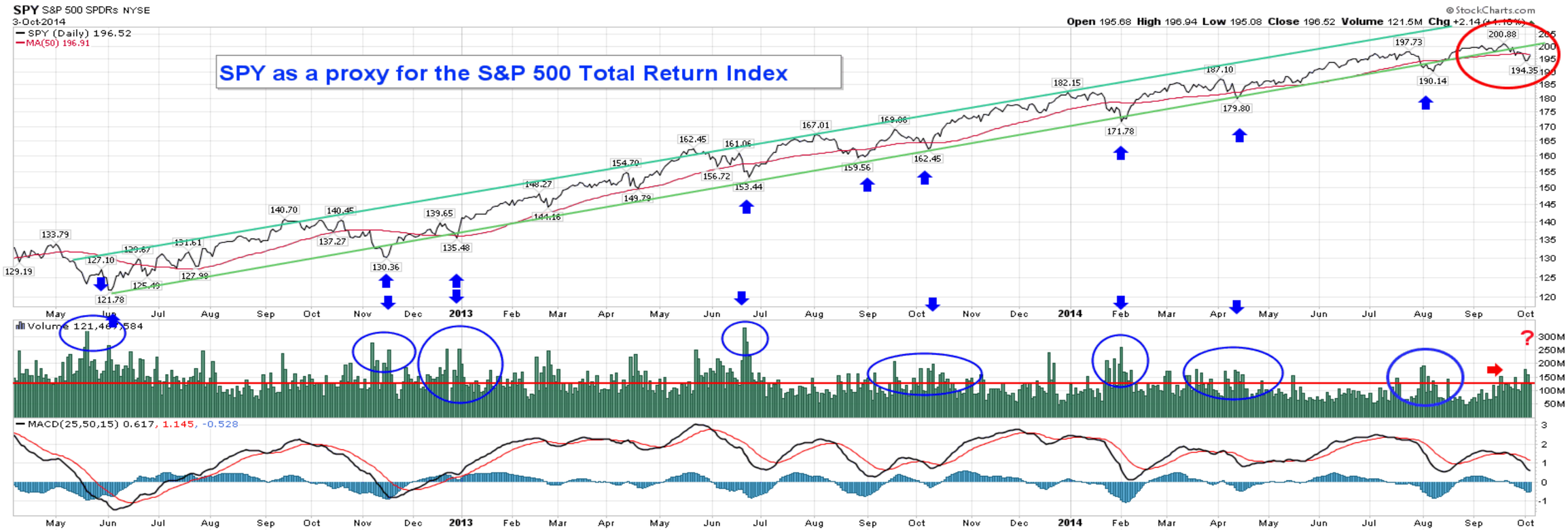
S&P 500 Total Return



Last month we found that the pattern of price recovery signaled by spiking volume coincident with a drop in price to the (rising) trend line once again proved itself. While I still need to point out that past performance is no guarantee of future results, at the end of September we have another opportunity to see if the pattern will repeat. This time, I admit, I'm a little skeptical in that the price fell well below the trend line and the moving average is "threatening" to turn over. In addition, the trend on the momentum (MACD) is also negative. On the other hand, we know that last Friday's jobs report generated a nice one-day turnaround. So the question will be whether there will be follow-through in the coming days. If so and we do recover to well within the prior trend, I'd say that was a very positive signal for the market for at least the balance of the year, absent a significant exogenous event.

On a longer term basis, while the constructive signals are getting weaker at the moment, I don't yet see any reason on a technical basis to be concerned about a major downdraft. On a fundamental basis, absent unexpected action by the Fed and absent a major geopolitical event, the larger concerns relate to the state of the European and Chinese economies and their impact on the U.S. economy.



SPY is an exchange-traded fund designed to match the experience of the S&P 500 index adjusted for dividend reinvestment. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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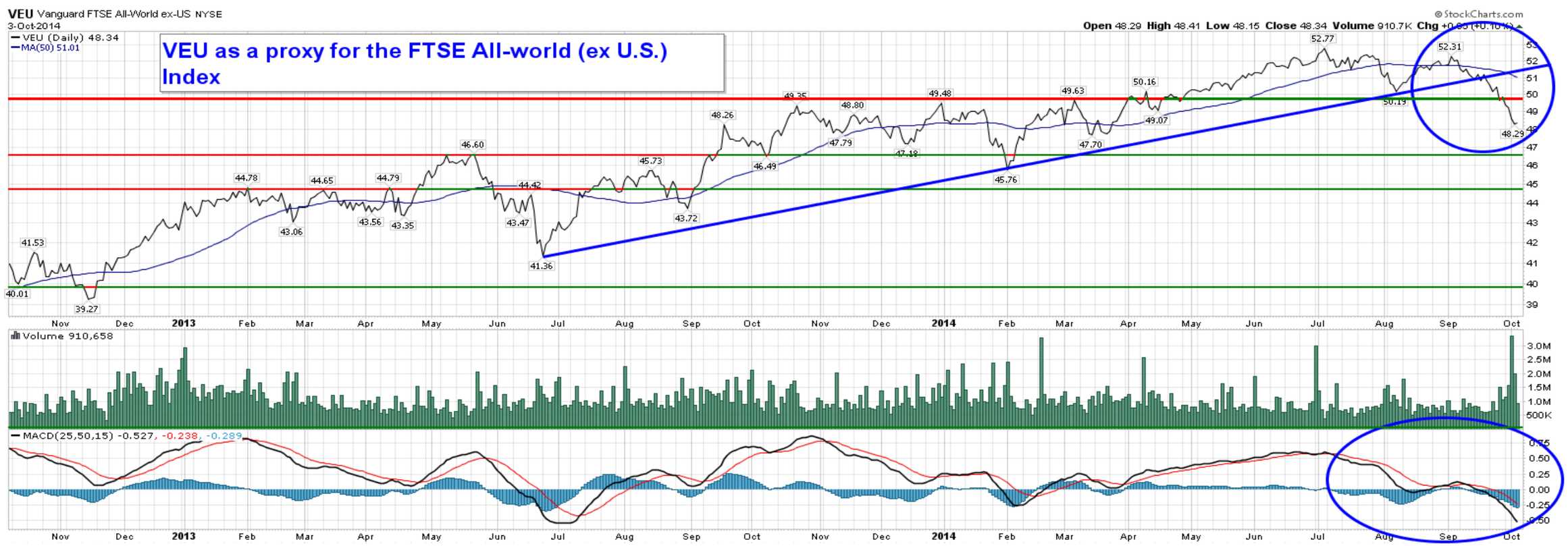
All-world (ex U.S.) Equities

International equities, represented here by Vanguard's ETF, VEU, had a disastrous month in September owing to a combination of circumstances which add up to lowered global growth prospects — the recession in Europe, geopolitical events in Ukraine and Hong Kong, slowing in China, and gridlock in Washington — leading to a collapse in oil, precious metals and other commodities, and the resulting impact on commodity-producing regions, like Brazil, Canada, Australia, and others.

Concerns about global growth have been raised by the IMF where forecasts have been lowered. The IMF states that growth requires infrastructure investment and that currently low interest rates make this an ideal time to make that investment . They are not alone in this belief. Unfortunately, in my view, it appears resources and/or political will are lacking and the prospects for any kind of significant investment program do not seem to be in the cards. At some point, market weakness in global securities will turn into a buying opportunity but I don't think we are quite there today. At this stage, while a technical recovery of sorts would not be unexpected, I would avoid adding to an international position at this stage and would consider peeling back any tactical allocation from long term strategic levels.



VEU is an exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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Asset Allocation and Relative Performance

Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show the relative performance of the S&P 500 (SPY) to an investment grade corporate bond index (LQD) on the left, and to the Vanguard All-world (ex U.S.) index fund (VEU) on the right.

On the left, although equities "beat" bonds in September, the trend that has been in place for many months appears to be on the verge of a reversal. Oversimplifying, while I believe U.S. equities have a long term upper hand relative to bonds and the recent economic data are supportive, global economic challenges are bound to take a toll on U.S. businesses. In the short term, a little extra conservatism may be warranted here in recognition of weakening momentum (MACD) and as we await 3rd quarter earnings reports.

On the right, global economic and geopolitical difficulties already mentioned can be seen impacting the broad international equities index fund and this pattern played out in virtually every region of the world during last month. To me, that would be a time to consider lowering international exposure while paying attention to opportunities for "bottom fishing" in selected countries (Germany, Brazil and Belgium looking like examples of future opportunities as they are well below their long term performance relative to the U.S.).

SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**

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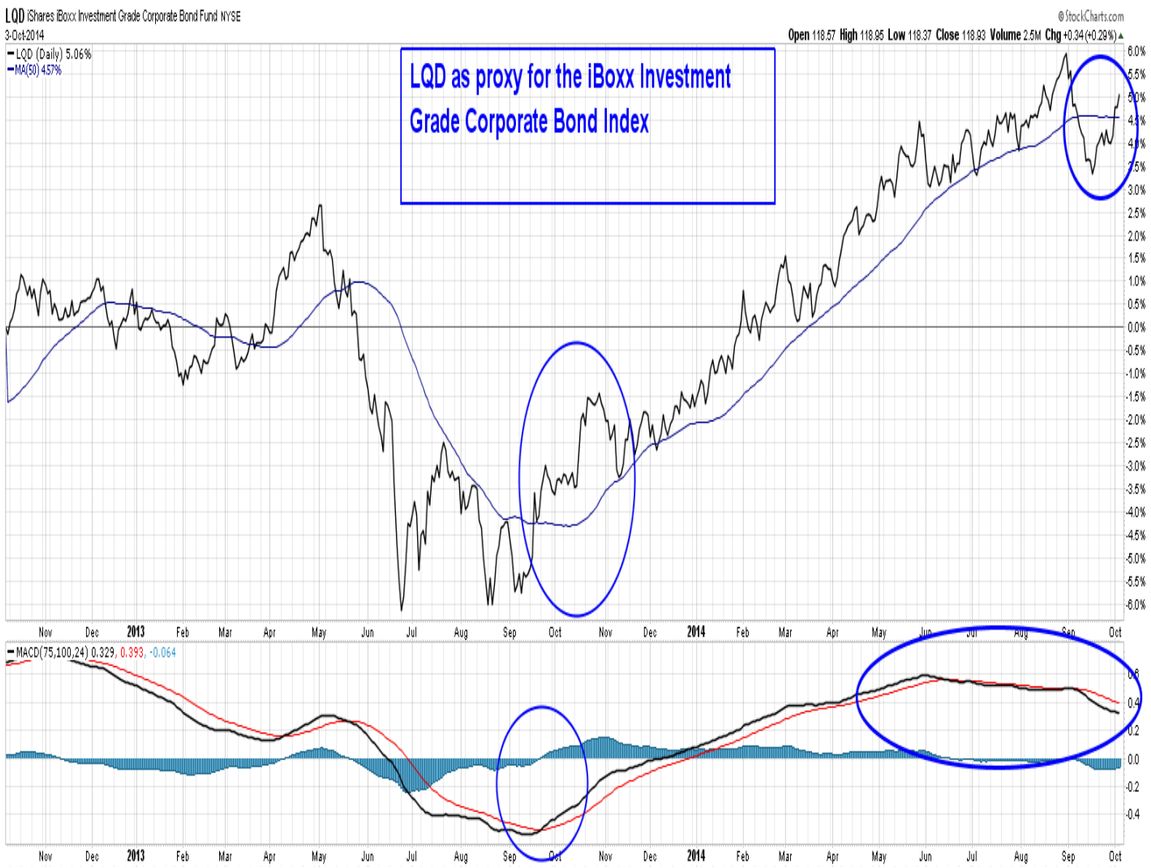
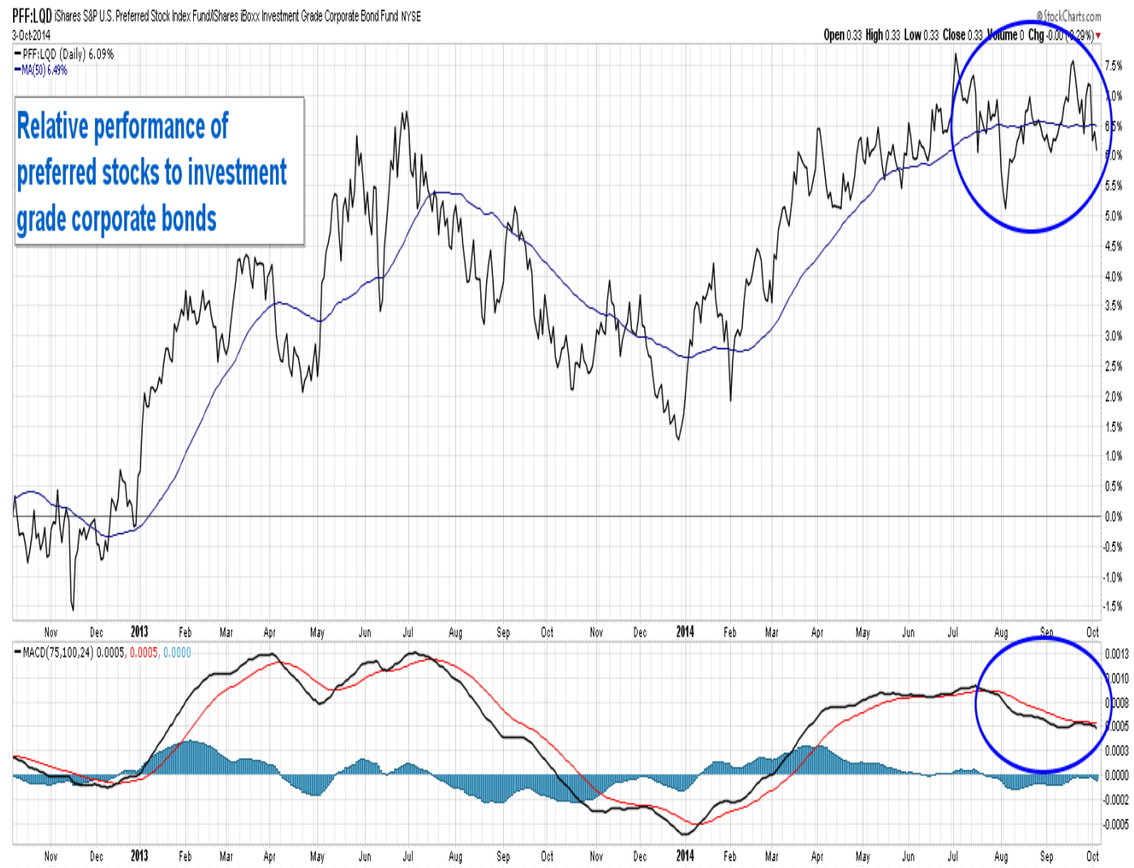
Income Investing

Investment grade corporate bonds lost their momentum in June, worsening briefly in September before bouncing back. Bonds and other income-oriented investments will continue to provide portfolio balance as investors are nervous about the sustainability of equity performance.

On a year-to-date basis, there have been quite a few alternative income investments that have outperformed investment grade corporate bonds, including REITs, preferred stocks, convertible bonds, and long term Treasury bonds.

Shown on the right below is the relative performance of the preferred stock index fund, PFF, compared to investment grade corporate bonds on a total return basis. Even though PFF has recently lost momentum, I believe the higher yield relative to LQD (currently about 6.9% vs. 3.5%) will continue to attract investors and, in any event, provide balance and diversification to the income portion of an asset allocation.





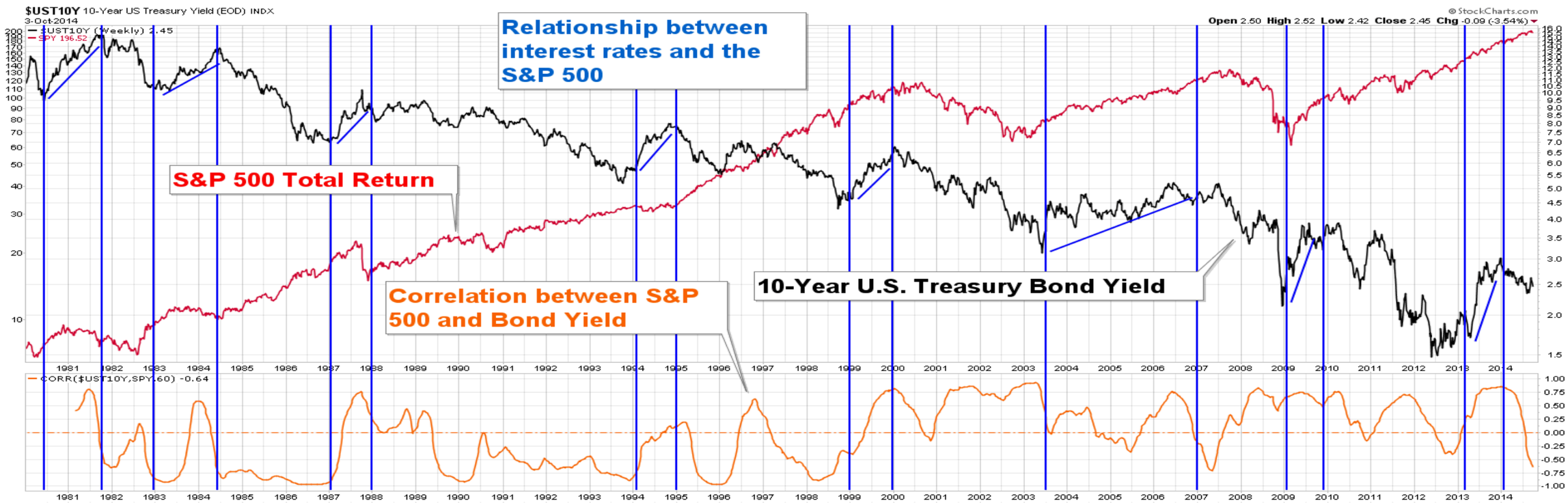
PFF seeks to track the investment results of the S&P U.S. Preferred Stock Index (TM) which measures the performance of a select group of preferred stocks . LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. **Past performance is no guarantee of future results.**

Interest Rates and Equities

Shown below is a comparison of the 10-year Treasury yield to the S&P 500 since 1980. A lot has been said about what is expected to happen to equity prices when interest rates rise as they are destined to do. While it's quite understandable to be concerned that rising rates will slow down corporate investment and consumer purchases, it's not at all clear that, in the current low interest rate environment, that rising rates will suppress stock prices (other than an initial emotional reaction) for anything more than a short term reaction.

What this chart shows is that prior to about 1999 when interest rates were generally above 5%, periods of rising rates were often associated with weakness in stock prices. However, following 1999 with interest rates below 5%, rising rates were often associated with rising stock prices and falling rates were associated with falling stock prices. Indeed, the orange line at the bottom of the graph that shows the 60-week correlation between the S&P 500 and the 10-year Treasury yield shows generally negative correlation before 1999 and generally positive correlation after, 2014 notwithstanding.

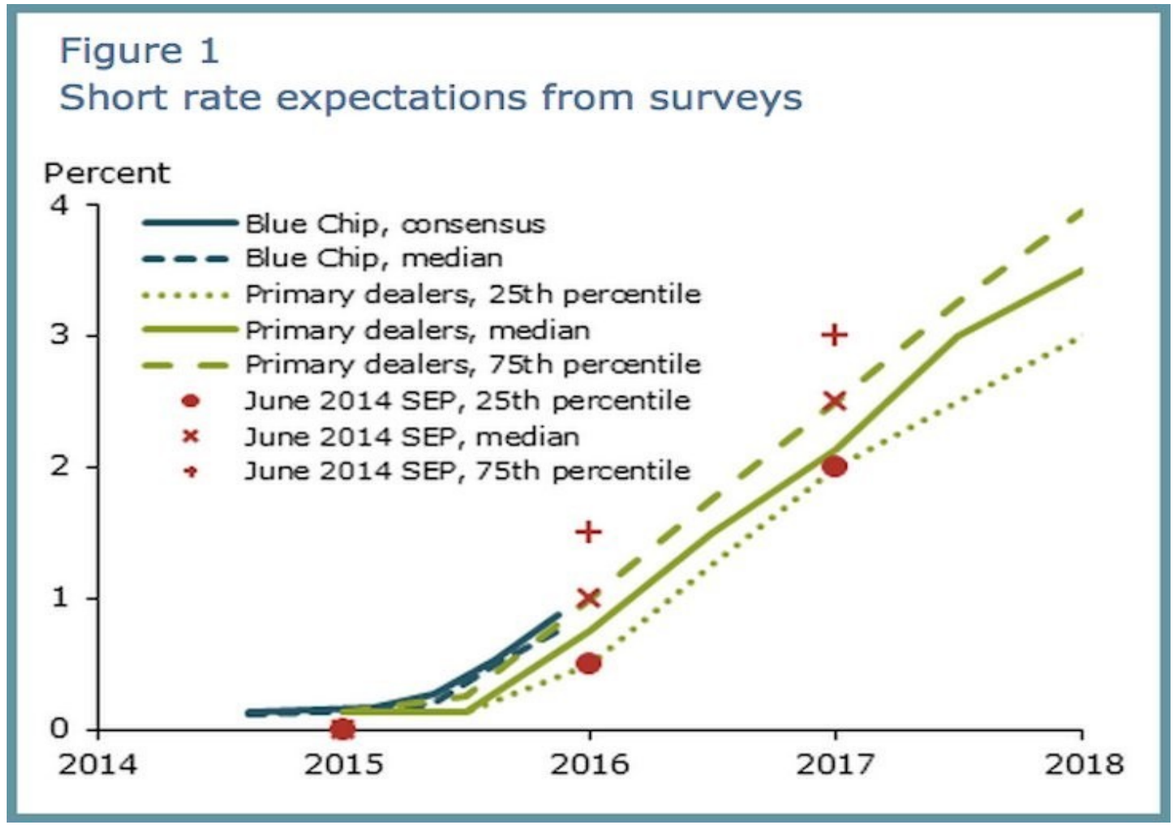
The securities markets, both equity and income investments, are in an unprecedented spot on account of the exogenous influence global central bank policy of ultra low interest policy rates and bond purchase programs. With all the speculation about the potential negative long term impact of these policies, especially as they get unwound, it's just possible that the impact will be a whole lot less disruptive than many might think.

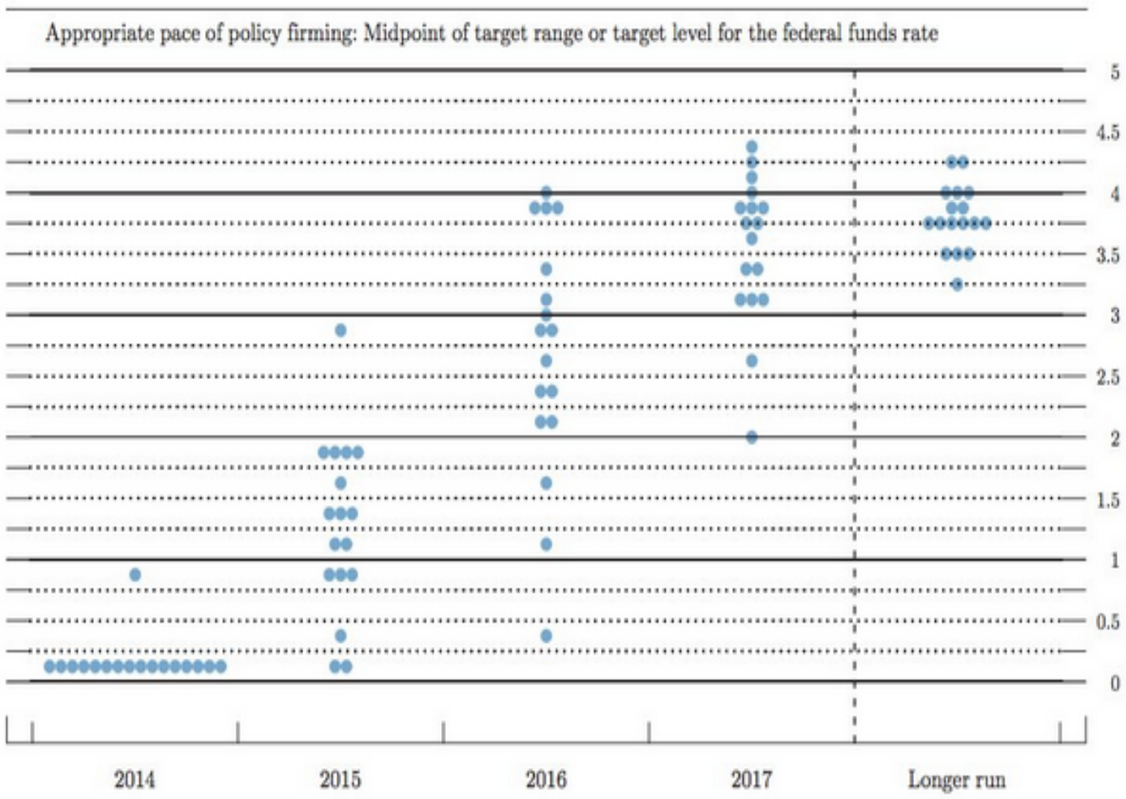


Interest Rate Outlook

For a different perspective this month, I'm highlighting investor expectations for the move in short term interest rates and comparing that to the Fed outlook for the Fed funds rate. On the left below is a chart provided by Forbes magazine showing investor expectations for short term interest rates drawn from futures contracts — essentially, a view of when and by how much the Fed would be increasing the Fed funds rate. This chart and a recent article in Barron's indicates that investors expect the Fed funds rate to begin an ascent in mid– to late-2015 with a currently expected level of about 0.775% at the end of 2015.

In contrast, the chart on the right below is the Fed Dot Plot where the Fed governors indicated their expectation for the future of the Fed funds rate. What's interesting here is that while the Fed governors don't put a date on the rate increase, they do indicate their views of what the Fed funds rate will be at the end of 2015, 2016 and later (the dots represent the views of different Fed governors). In contrast to current investor expectations for a rate of about 0.775% at the end of 2015, the Fed governors, on average, are expecting a rate about twice as high — about 1.5% at that time — a more hawkish view. It's hard to tell if there who is right here, but I suspect that the investor community may be closer to the mark on account of a more uncertain economic outlook.





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Investors should consider the investment objectives, risks, and charges and expenses of mutual funds and exchange-traded funds carefully for a full background on the possibility that a more suitable securities transaction may exist. The prospectus contains this and other information. A prospectus for all funds is available from Lane Asset Management or your financial advisor and should be read carefully before investing.

Note that indexes cannot be invested in directly and their performance may or may not correspond to securities intended to represent these sectors.

Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

The charts and comments are only the author's view of market activity and aren't recommendations to buy or sell any security. Market sectors and related exchanged-traded and closed-end funds are selected based on his opinion as to their usefulness in providing the viewer a comprehensive summary of market conditions for the featured period. Chart annotations aren't predictive of any future market action rather they only demonstrate the author's opinion as to a range of possibilities going forward. All material presented herein is believed to be reliable but its accuracy cannot be guaranteed. The information contained herein (including historical prices or values) has been obtained from sources that Lane Asset Management (LAM) considers to be reliable; however, LAM makes no representation as to, or accepts any responsibility or liability for, the accuracy or completeness of the information contained herein or any decision made or action taken by you or any third party in reliance upon the data. Some results are derived using historical estimations from available data. Investment recommendations may change without notice and readers are urged to check with tax advisors before making any investment decisions. Opinions expressed in these reports may change without prior notice. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this report may be unsuitable for investors depending on their specific investment objectives and financial position. The price or value of the investments to which this report relates, either directly or indirectly, may fall or rise against the interest of investors. All prices and yields contained in this report are subject to change without notice. This information is intended for illustrative purposes only. **PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.**

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