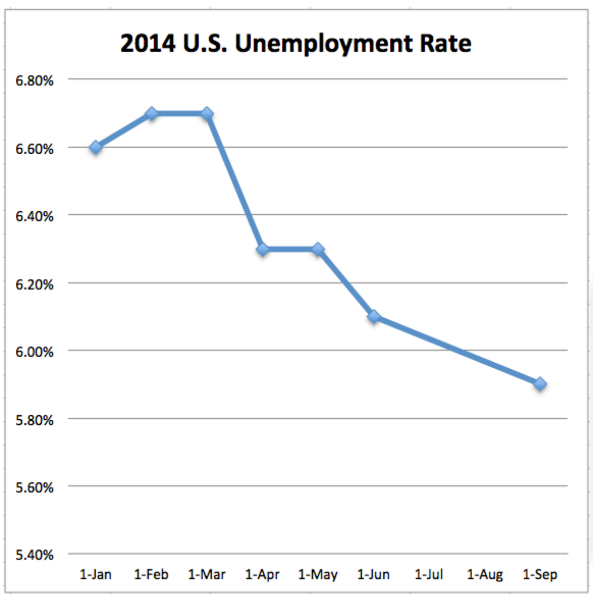
As you are no doubt aware, the market has gotten off to a volatile start in the fourth quarter. But the current headlines have been overshadowing some very important news: The U.S. economy showed considerable strengthening in the third quarter. That economic momentum bodes well for the market over the long term, because the economy, of course, underpins the market.

In late September, the Bureau of Economic Analysis increased its estimate of second-quarter real gross domestic product from 4.2% to 4.6%. That is a major improvement from the first quarter, when real GDP declined 2.1%.

There was good news on consumer confidence as well: It climbed in the third quarter to its highest level since July 2013, according to data from the University of Michigan and Thomson Reuters. Consumer spending accounts for more than two-thirds of U.S. economic activity. And unemployment fell below 6% in September for the first time in six years.



Source: Bureau of Labor Statistics

It is worth noting that these positive trends occurred despite the fact that the Federal Reserve is gradually removing its stimulus. This may signal an economy capable of moving forward under its own steam.

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U.S. stock markets advanced in the quarter, even as some commentators predicted that a market correction was on the way. If a market correction is indeed occurring, we should bear in mind that all bull markets contain periodic corrections. Markets have more than doubled since their low point in the financial crisis, and they've been unusually smooth during that time.

If anything, the markets were overdue for a normal cooling-off period. That should not be mistaken for evidence that we are in danger of a recession. Indeed, the third quarter showed that the economy remains in expansion mode. And over the long term, a healthy economy is good news for the market.

Market/ Index	End of 3Q	End of 2Q	Change	End of 2013	YTD Change
DJIA	*17,042.90*	*16,826.60*	*1.3%*	*16,576.66*	*2.8%*
NASDAQ	*4,493.39*	*4,408.18*	*1.9%*	*4,176.59*	*7.6%*
S&P 500	*1,972.29*	*1,960.23*	*.6%*	*1,848.36*	*6.7%*
Russell 2000	*1,101.68*	*1,192.96*	*-7.7%*	*1,163.64*	*-5.3%*
Global Dow	*2,534.53*	*2,607.22*	*-2.8%*	*2,485.81*	*-2%*
10-yr Treas.	*2.51%*	*2.52%*	*-1 bp*	*3.03%*	*-52 bps*

Stocks Advance

In the third quarter, equities overcame worries stemming from the removal of Fed stimulus, Europe's tenuous recovery, and conflict in Ukraine and the Middle East. The Dow rose 1.3%. The NASDAQ—whose tech-company stocks have performed strongly this year, gained 1.9%. The broad-market S&P 500 marked a slim .6% improvement in the quarter. The indices are up 2.8%, 7.6% and 6.7% for the quarter, respectively. Those are modest numbers to be sure, but following 2013's surprisingly strong market, that modest performance appears reasonable.

Small-company stocks did not fare as well in the quarter, with the Russell 2000 index falling 7.7%. That index is down 5.3% for the year as larger-company stocks are predominating at this point in the market's recovery. Meanwhile, the Global Dow index fell 2.8% in the third quarter. It's down 2% this year, in large part because of China's decelerating growth and Europe's economic weakness.

Fixed Income Remains Challenging

The bond market's strong performance surprised many in the first half of the year, but it could not carry that momentum through the third quarter. The Barclays U.S. Aggregate Bond Index squeezed out a return of just .17%. And after rising 2.04% in the second quarter, the Barclays U.S. Corporate High Yield index fell 1.87%. Ten-year Treasury yields, meanwhile, were all but flat, at 2.52%. The Barclay's Municipal bond index was a bright spot, with a return of 1.49%.

One headwind for bonds was the expectation that the Federal Reserve may raise interest rates earlier than anticipated. In its bid to prop up the economy over the past few years, the Fed has employed quantitative easing, which is set to end this month, and exceptionally low interest rates.

The Fed had been expected to begin raising those rates to normal levels in mid-2015. But the economy's strength stoked concerns that the bank may act sooner rather than later. The Fed has given no reason to believe it will raise rates early, but bonds' third-quarter performance shows that investors are nonetheless concerned. Bear in mind that interest rates and bond prices have an inverse relationship—when rates go up, bond prices go down, and vice versa.

Municipal bonds, meanwhile, have comfortably outperformed the broad bond market for the quarter and the year. They have rallied on low interest rates, reduced supply, improving credit quality and low defaults among issuers. And they have been popular with investors seeking protection against rising taxes. We believe that fixed income remains an important portfolio diversifier, but that investors should proceed with caution due to interest rate risk.

Concerns Overseas

Economic growth abroad slowed unexpectedly in the third quarter. In particular, Europe's economic data sparked concerns that it may be near another recession. Furthermore, very low inflation spurred fears that the region is actually at risk of deflation.

Investor Education: Deflation

Deflation occurs when consumer prices fall rather than rise. While falling prices are good news for consumers, widespread deflation can lead to a dangerous cycle. Falling prices lead to declining wages—if companies are earning less in sales, they must pay workers less, or even reduce their work force. When workers take pay cuts or lose their jobs, they naturally spend less. And that forces consumer prices lower as the cycle plays out. Deflation ultimately can lead to declines in the value of homes and investment portfolios. To fight deflation, central banks such as the Federal Reserve attempt to stimulate the economy by reducing interest rates and increasing the money supply.

The MSCI Europe index fell 6.8% in the third quarter, leading the MSCI world index down 2.05%. Weakness in the European economy is a concern for the United States because it could lead to a decline in exports and to slower business for U.S. companies with international operations.

As we head toward the end of the year, we urge our clients to tune out as much of the headline noise as possible. Market corrections are a normal part of market behavior, and a well-designed portfolio is constructed to keep you on track toward your long-term goals. Please do not hesitate to contact us with any questions or concerns.