THE BUTTONWOOD

On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

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THIRD QUARTER 2013

Henry J. Wildhack II
Matthew J. Abbott

110 West Fayette Street
One Lincoln Center
Suite 900
Syracuse, New York 13202

(315) 701-6452
WWW.ARMORYCM.COM

Very Good so far…Very Uncertain Ahead

The third quarter of 2013 ended with both domestic and foreign indices posting gains. The US exchanges have all recorded double digit gains year to date. What is interesting from our perspective is that the third quarter of 2013 proved to be the best quarter year to date for the three international indices we follow. This is a development that we will continue to monitor with an eye towards committing a portion of each portfolio to the foreign markets.

US Stock Index	12/31/12	9/30/13	Point gain	YTD % gain	3rd qtr % gain	3 yr. gain per WSJ
S&P 500	1426.19	1681.55	255.36	17.91%	4.69%	15.78%
S&P 400 mid cap	1020.43	1243.85	223.42	21.89%	7.15%	18.36%
S&P 600 small cap	476.57	607.76	131.19	27.53%	10.40%	23.17%
NASDAQ	3019.51	3771.48	751.97	24.90%	10.82%	19.74%
DJ Gbl ex US TSM *	2113.74	2295.31	181.57	8.59%	9.65%	3.44%
STOXX Euro 600	279.68	310.46	30.78	11.01%	8.93%	6.51%
DJ Asia Pacific TSM *	1314.28	1420.43	106.15	8.08%	6.64%	3.18%

* TSM = Total Stock Market

The fourth quarter begins with a great deal of uncertainty as Congress yet again plays Russian roulette with the national debt ceiling and government shutdowns. Warren Buffet has said that the current "debt politics is like a nuclear bomb" and referred to the situation as idiocy. Treasury Secretary Jack Lew said that crossing the debt ceiling is "dangerous and unthinkable". Our guess and our hope is that Congress will avert a disaster with a last minute increase in the nation's debt ceiling thus averting a default.

Unfortunately this game of fiscal chicken is nothing new. The nation was put through another debt ceiling fight in 2011. That fight ended with a last-minute increase in the nation's borrowing limit. Congress averted default but provoked a credit downgrade. The US financial markets were mixed in 2011 as the Dow Jones gained 5.53%, the S&P 500 was flat, and the NASDAQ was down 1.80%. Standard & Poor's announced the credit downgrade on August 5, 2011. In the time just before and after the announcement the Dow Jones and S&P 500 dropped slightly more than 10%. We have said many times that market corrections are a part of the investment process and that a correction wouldn't come as a surprise to us. What's interesting is that recently the fiscal cliff, sequestration, and Syria have not had much of a negative effect on the US stock markets. Will the current situation be enough to initiate a correction? Only time will tell.

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While no one can predict with absolute certainty what the end game will be with respect to a debt ceiling resolution or potential downgrade, we do need to look to the 4th quarter and into 2014 from a fundamental perspective to gauge where the markets might be headed. Critical areas include employment, inflation, GDP projections, and interest rates.

The employment situation has become an increasingly important variable for the markets because both the Bank of England and the Federal Reserve have stated that interest rate increases are not likely until the unemployment rate falls to 6.5% in the US and 7% in the UK. While the global economy does show gradual signs of growth, labor productivity has kept significant new hiring at low levels. Looking deeper into the employment picture shows that the number of people who are under-employed is significant. The under-employed are defined as those who are overqualified for their current job or those who are working part time. According to a ***Capital Economics Global Economics Update*** article dated 9/15/13 if these people move to full-time jobs for which they are qualified, there would not be much of a material impact on the overall employment rate. Hence, we look for the employment numbers to improve gradually over a long period of time.

Inflation expectation surveys favor low/manageable inflation numbers. While there are many inflation forecast surveys published on a timely basis two of the more widely watched surveys point to benign inflation. The ***Survey of Professional Forecasters***, the oldest quarterly survey of macroeconomic forecasts in the United States, pegged the Consumer Price Index increase at 2.1%. The survey suggested that with low CPI inflation and a domestic unemployment rate of 7.1% it is unlikely that the economy will push inflation up meaningfully. The Personal Consumption Expenditures (PCE) inflation index came in at 1.6%, well below the Federal Reserve's target figure of 2%.

Gross domestic product grew in the second quarter at an annualized rate of 2.5 percent in April through June of this year. The government initially estimated GDP at 1.7 percent.

A growth rate of 2.5% is still far lower than what the country needs to recover the ground lost during the recent recession anytime soon. The long-term average growth rate for the economy is more than 3 percent, and the economy needs above-trend growth to make up for sharp losses from the downturn. None the less, the better than expected GDP figure was welcome news.

Interest rate policy may be the most critical of the four areas mentioned earlier. As we have stated many times rates are going up for obvious reasons. In so doing it is important to remember that rates are returning to normal long term levels from all-time lows.

Given the current employment picture, a benign inflation forecast, and low GDP growth projections it seems that interest rates are likely to rise slowly. The more critical uncertainty ahead remains in Washington and not with the economy. This recovery comes on the heels of a near epic economic meltdown, in a low inflation, slow growth, and low interest rate environment. While far from perfect, we view the current market environment as favorable for patient, long-term investors.

As we have said many times before, there are significant challenges that lie ahead. We believe that as these challenges are resolved we will find ourselves on a common ground that will pave the way for very good returns for those willing to hold good quality investments over the long term.