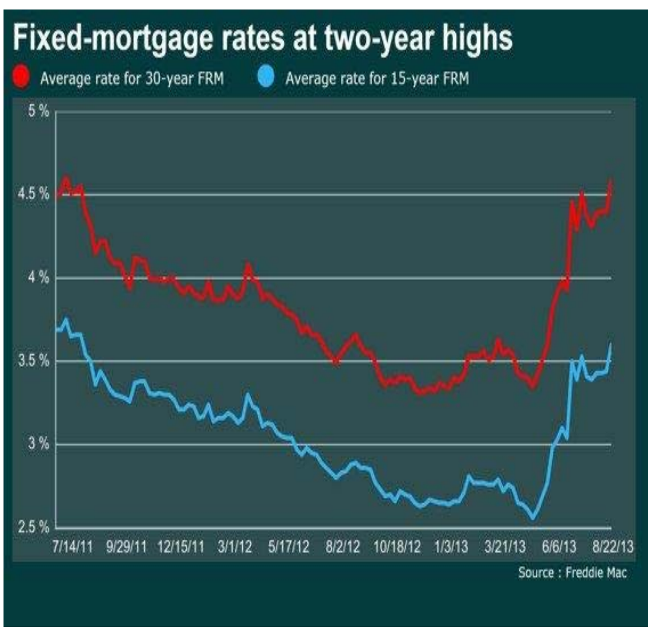
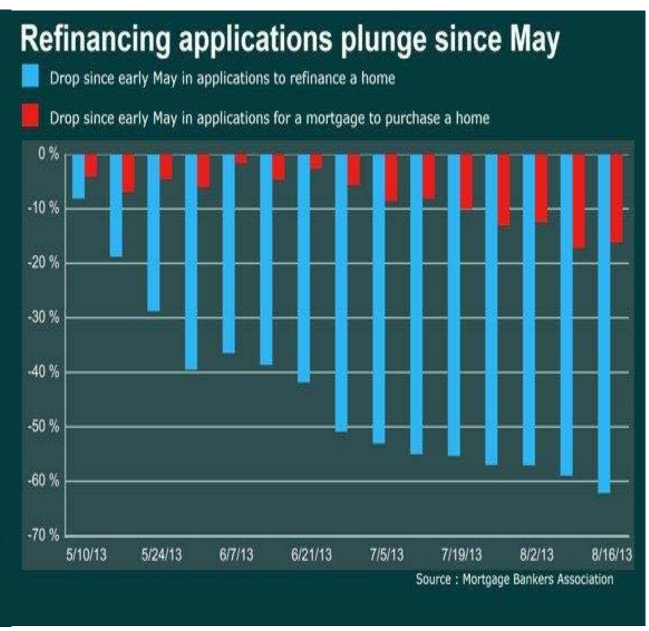
The technique of jawboning has been used by officials from a range of pulpits for many years, often but not always with the desired result as an outcome. Defined as "to try to influence or pressure through strong persuasion, especially to urge to comply voluntarily", it has been an arrow in the quiver of presidents ranging from Hoover (who used it to successfully convince employers to keep wages high as prices fell during the Great Depression) to LBJ (who discovered its limitations when he tried to talk down inflation and avoid higher interest rates while simultaneously spending for a war). George W. Bush criticized outgoing president Bill Clinton for not attempting to lower oil prices by jawboning OPEC to increase supply.

Within the halls of the Federal Reserve, Alan Greenspan was never shy to jawbone. He did so in 1994 after a small rate hike when he told Congress that further increases were inevitable, hoping that the mere threat would restrain inflation. He famously did so in December of 1996 when he flexed his credit tightening muscles and discussed the dangers of "irrational exuberance" in the market, and then again in early 1997 when he testified before Congress and spoke of "excessive optimism (that) sows the seeds of its own reversal in the form of imbalances that tend to grow over time".





Most recently, Ben Bernanke, with a number of assists from his colleagues at the Fed seems to have perpetrated an inadvertent jawbone gone awry. In the months following the June FOMC meeting where tapering was formally introduced, Fed officials provided visibility that they were likely to cut back the pace of the $85 billion per month bond purchases which had blown up the central bank's balance sheet while having a myriad of direct and indirect effects. Presumably their rationale for doing so was to ease the investing public into the idea of a diminishing presence from the market's most prolific buyer, and to keep rate movements muted when the time to act came. What happened instead was that the ongoing discussion of Fed tapering at public appearances caused 10-year interest rates to rise from 1.6% in May to 3.0% in early September. Mortgage rates trended higher in similar fashion, which in turn led to refinancing applications heading in the opposite direction. This was likely one of the factors that kept the Fed from actually tapering, perhaps causing them to miss an opportunity to do so at the point where it was most anticipated and thus least likely to create a significant disruption in global financial markets. After printing close to $1 trillion over a twelve-month period, the Fed decided that the economy under a higher rate regime couldn't withstand even a nominal reduction in bond buying.

So, QE continues unabated and the dust is left to settle amidst its intended and unintended consequences. Among the latter is a wealth effect that has continued to widen the gap between the wealthy and the non-wealthy in this country, as the top one percent have captured 95% of the wealth gains since the recovery from the recession began. In addition, incomes for the middle class have largely remained flat while the wealthy have seen increases. If businesses weren't willing to hire and pay workers at a rate considered typical for this point in a recovery beforehand, it is doubtful that the morass currently enveloping Washington will compel them to do so.

Funding a new budget for our federal government has predictably become a game of political football, with the onset of the Affordable Care Act (or Obamacare) and an included tax on medical devices being the primary points of contention. While one could get vertigo trying to follow the bills and continuing resolutions that were buffeted back and forth between chambers of Congress, and that led to what is as of today officially a shutdown of the US government, the reality is that this isn't the paramount threat to investors. There were 17 such shutdowns between 1976 and 1996 and most often the pullback in the market was short and shallow.[i] Ultimately, the economic impact will depend upon the length of the closure. Macroeconomic Advisers has estimated that a shutdown of all non-essential federal services for a two week period would reduce Q4 GDP growth by 0.3 percentage points on an annualized basis. The number would jump to 0.7 percentage points if the closure were to last an entire month. Ironically, we won't know the magnitude of the impact as quickly as we might otherwise since the shuttered government statistical agencies would delay releasing key data.

That's what may happen if the government closes. What happens if it stops paying its bills? The real fight in D.C. will likely be over the latter issue – the debt ceiling, which the Treasury says it will hit on October 17th. At that point the debt limit will need to be either extended or suspended, and for better or for worse, both options will presumably be on the table. While it is tempting to worry about one manufactured crisis at a time, in this case the two issues are so related politically and chronologically that they need to be considered in tandem. It's hard to fathom, given the consequences, that the threat of a default will fester. But we've seen the damage that even a near-miss can cause. A technical default on Treasuries would be disastrous. Beyond the obvious implications defaulted securities can't be used in repurchase agreements, which are the lifeline of the debt market. After the debt-limit saga of 2011 and the fiscal cliff showdown coming into this year, there appears to be a presumption that some kind of last minute deal will be brokered. Collectively, policymakers are being viewed as the "boy who cried wolf". On the positive side, beyond the tumult that we are currently facing there is good news at hand, as the fiscal drag from tighter

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policy should begin to fade – from 2% on the annual growth rate in the first half of this year to 1% in the second half, to as low as 0.5% in 2014.

While there is little room for error in Washington, many of the other chief worries that the market faced heading into the third quarter have subsided, leaving sentiment markedly improved. The Russia plan helped to at least temporarily defuse the situation in Syria, Larry Summers withdrew his name from consideration as Fed Chairman, Iran responded favorably to a letter sent to President Hassan Rouhani from President Obama, and of course, tapering was eschewed for the moment. This systematic destruction of the market's "wall of worry" would seem to be a good thing, and volatility has dropped materially in the past month as have expectations of future volatility. Another measure of the market's bullish inclination is the falling CBOE Equity Put/Call ratio. These are positive indicators, but they tell a story that has already been written. That is, the 20% gain in the S&P 500 year to date. They similarly leave less room for market moving surprises to the upside.

As of September 30, 2013

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	**Large Cap Equities**	3.1	19.8	19.3	10.0
Russell 2000	**Small Cap Equities**	6.4	27.7	30.1	11.2
Russell 3000 Growth	**US Growth Equities**	4.7	21.8	20.3	12.2
Russell 3000 Value	**US Value Equities**	2.8	20.7	22.7	8.9

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
INTERNATIONAL EQUITY					
MSCI World exUS GR	**Global ex US Equities**	7.1	15.1	22.0	6.6
MSCI EAFE GR	**Developed ex US Equities**	7.4	16.6	24.3	6.9
MSCI Europe GR	**European Equities**	7.2	16.7	25.0	6.7
MSCI Japan GR	**Japanese Equities**	8.4	24.5	31.7	5.3
MSCI EM GR	**Emerging Mrkts Equities**	6.5	-4.1	1.3	7.6

A gain of the magnitude we've experienced this year would suggest that economic growth and earnings are robust and businesses and investors have a clear perception of regulatory, tax, and government policies. Instead, US GDP is growing at a middling rate and both fiscal and monetary policies are arguably being poorly executed, as well as communicated. The big gains in US equity indices this year have been driven by multiple expansion, from 13.1x to 15.4x, not rising earnings. But there is a limit to how much investors are willing to pay for earnings, and the pace of earnings growth has slackened for several quarters. With the third quarter earnings season set to begin on October 8th, the results could disappoint. Profit margins are high and rising interest rates and other cost pressures could begin to show up in company reports. More than ¾ of the companies providing guidance to analysts are encouraging them to adjust their estimates lower. This is consistent with the fact that revenues so far this year have been largely disappointing.

Outside of the US there is a long-term opportunity in emerging markets, where the profile is the mirror image of developing markets on several fronts. For one, the middle class in mature economies is stagnating while the middle class in emerging economies is just starting to thrive. Emerging market equities have suffered mightily with the prospect of Fed tightening, as countries with large current account deficits lose the ability to fund those gaps cheaply when central banks begin, or threaten to begin, tapping the breaks on liquidity. There has been $60 billion of outflows from emerging market equity and bond funds in the past three months, leaving those markets at their cheapest level since 2008/2009. Relative to the S&P 500, emerging market equities are now trading at a 40% discount.[ii] Pockets of emerging market debt present a similar opportunity. Sovereign emerging market yields today are consistent with their averages between 2003 and 2007 while US Treasury rates are only about half as high. Relative value clearly favors emerging market local bonds. We have been increasing exposure to frontier markets in our portfolios, as these markets are in a position to deliver superior earnings growth over the next decade due to structural improvements coming from urbanization, infrastructure spending, increasing fiscal responsibility, and benign inflation.

To a significant extent both US and emerging market fortunes will continue to hinge upon developments in China. China accounts directly for 5% of S&P 500 earnings. By comparison, housing accounts for 2%. That doesn't even include China's influence on commodity prices. The Chinese government will tolerate slower growth in order to rebalance the economy, but authorities will have to target economic stability in all policy decisions. The economy is at the lower band of the target growth range, and a shift towards policies that protect growth is at hand. There has been much consternation about the health of the country's financial sector, where rapid loan growth has given investors pause. But there is little solvency risk since Chinese banks are largely funded by sticky retail deposits that can't easily leave the country. Leverage is an issue but the combined debt of local and central governments comes to roughly 120% of GDP, which is manageable. If needed they could privatize state-owned assets to raise capital.

While tensions within China brew over economic policy, tensions off the coast of China have been elevated in a dispute with Japan over the Senkaku Islands. Japan, led by Prime Minister Abe, has fueled a resurgence of nationalism and a promise to re-arm the nation as a result of the dispute. They have a pretext for moving forward with plans to redraft their constitution to remove the pacifist clauses imposed by the US after WWII. The defense budget in Japan for this fiscal year has already doubled compared to last year. Japan's government may bankrupt itself and kill the economy by crowding out much needed investment as it arms itself. There is often economic benefit to this process, which was the experience of the US after the Great Depression, but this is realized only if there is a young and growing population which is able to pay off debt incurred by militarization with the fruits of future economic growth and available public finances. None of these ingredients are present in Japan. At over 20% of the market cap of developed non-US equities, any long-term implications from policy in Japan need to be carefully considered. Elsewhere, despite an ongoing friction between banks which need to repair their balance sheets in order to maintain higher capital adequacy requirements, and a still fragile credit environment that can't afford to have them do so, Europe may be the region of greater interest. Equities there have done well as the economy has stabilized a bit following years of shocks and after-shocks. Earnings are projected to increase significantly and valuations look attractive relative to the US. Risks on the Continent continue to be fluid in nature, with the latest warning signal flashing squarely on Italy, home to the third largest sovereign bond market in the world. Between now and the end of 2014, almost one quarter of Italy's outstanding debt must be rolled over, with one quarter of that coming due between now and the end of this year. The success of those efforts will go a long way towards dictating the short-term investment outcomes in the region.

As of September 30, 2013

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
ALTERNATIVES					
HFRX Global Hedge Fund Index	**Broad Hedge Funds**	1.0	4.3	5.1	0.4
HFRX: Systematic Diversified CTA Index	**Managed Futures**	-0.6	-4.0	-6.7	-0.7
DJ UBS Commodity	**Commodities**	-2.6	-8.6	-14.3	-5.3
Wilshire US REIT	**REITs**	3.3	2.7	5.3	5.6

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

	As of 3.31.13	Prior Yr End (12.31.12)	One Year Ago (03.31.12)	Five Years Ago (3.31.08)
CURRENCIES				
US Dollar Index Value	80.22	79.77	79.94	79.45
USD vs. Yen	98.27	86.75	77.96	106.11
Euro vs. USD	1.35	1.32	1.29	1.41
GBP vs. USD	1.62	1.63	1.62	1.78
COMMODITIES				
Gold ($ / ounce)	1328.94	1675.35	1772.10	870.95
Crude Oil ($ / barrel)	102.33	91.82	92.19	100.64
Copper ($ / ton)	7290.25	7907.00	8211.50	6388.00
Corn - Generic (Usd/bu)	441.50	698.25	756.25	487.50

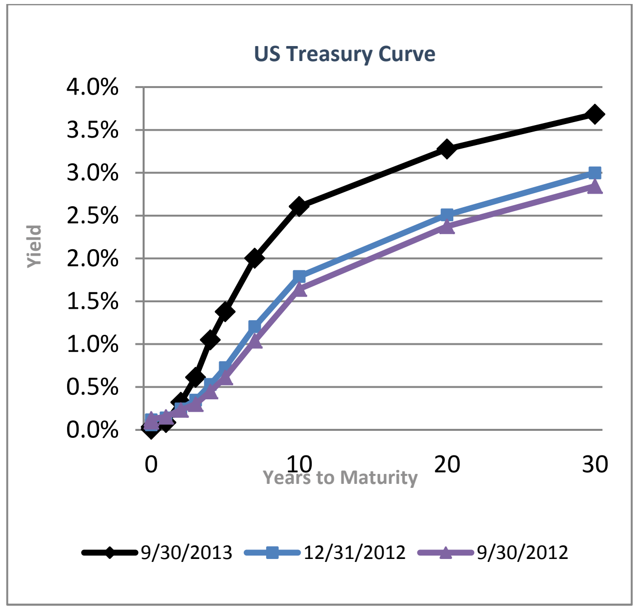
Looking back to the state of the US equity market, the discussion of variables that are likely to have a meaningful impact going forward has to include an analysis on the future direction and magnitude of interest rate movements. The difficulty lies in the fact that even if market participants were able to accurately predict the future of interest rates, which few are, the connection to equity prices is seemingly not as predictable as it once was. Conventional wisdom tells us that rising rates are a decided negative for stocks based on models of pricing that have the discount rate increasing along with the risk-free rate, leading to a commensurate drop in the fair value of the stock price. Of course, like all models this expected outcome comes with the modifying caveat of “all else being equal”, which it rarely is. If rates are being pushed up by a surge in economic growth, corporate profits may rise, dividend payout ratios may increase, and theoretical stock prices can move higher. The empirical evidence of this effect is dependent upon the time series in question. Going back to 1953, in months where the 10-year Treasury yield declined the monthly average return for the S&P 500 was 1.38%. In months where the 10-year Treasury yield increased the monthly average return for the S&P 500 was just 0.63%, so markets fared more than twice as well when rates were falling. Shorten the window back to 1991 and the results are quite different. In that period stocks were up 0.82% in months in which rates declined versus up 0.96% in months in which rates moved higher.[iii] For more than two decades, rising rates have clearly not harmed stock performance. The relevant question seems to be, “will a steadily rising rate regime impact equity prices in a different fashion from the counter-trend rate increases in the recent twenty year bull market for bonds?”

It is not a question that is likely to be a hypothetical one. Everything from demographics, to foreign investor appetite, to the idea of a zero-bound on interest rates suggest that we are facing a scenario of not if, but when, interest rates are going to move meaningfully higher. The demographic issue we are facing as a country and the impact it will have on our budget deficit has been well documented, and largely comes down to reform of entitlement programs. To put some numbers around the generational landscape, today each American who is 65 or older is supported by a workforce of 4.4 people between the ages of 18 and 64. This “dependency ratio” will fall to 2.7 by the year 2038. The non-partisan Congressional Budget Office issued a report several weeks back that had its most optimistic forecast for debt to GDP at 100% by that year, from an already high 73% today. The base case forecast projects federal debt to grow to 190% of the nation’s economic impact by 2038 – worse than Greece, with its 27% unemployment and occasional riots in the streets. Foreign appetite for US Treasuries is already shriveling, and purchases over the last 12 months have declined to $104 billion from $503 billion a year earlier.[iv]

As of September 30, 2013

INDEX	ASSET CLASS	1 Month	YTD	1 Year	5 Years (ann)
FIXED INCOME					
BofAML T-Bills 0-3 Mon	**Cash**	0.0	0.0	0.1	0.1
BarCap US Agg Bond	**Broad US Investment Grade Bonds**	0.9	-1.9	-1.7	5.4
BarCap Municipal	**Municipal Bonds**	2.2	-2.9	-2.2	6.0
BarCap Treasury	**US Treasury Bonds**	0.7	-2.0	-2.1	4.0
Citi WGBI USD	**Global Sovereigns**	2.0	-2.9	-4.6	4.3
BarCap US HY Interm	**US High Yield Bonds**	1.0	3.9	7.2	12.9
JPM EMBI Plus	**Emerging Market Bonds**	2.9	-8.9	-5.9	9.5

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar



While all of these risks have us extremely careful about where we are allocating within fixed income, they also have us mindful of the opportunities that often arise from the dislocations caused by fear which turns a blind eye to fundamentals. As is often the case, nowhere has this been more prevalent of late than the municipal bond market. In recent times it has been hard to get excited about investing in a muni market that gets you a 1.6% yield to worst for a bond with a five-year duration, which is what we saw at the beginning of this year. The opportunities have come from scary headlines that spook retail investors, such as the dire predictions of Meredith Whitney or the historic bankruptcy of the city of Detroit.

The collapse of Detroit was an event that we saw as largely unique, and not as a canary in the coal mine. It was also not a surprise, as it was the result of a sad culmination of six decades of decline, with the industry and population fleeing, which left a decimated tax base. It was a downward spiral that was exacerbated by years of corrupt and inept governance. If the demographics didn't forewarn investors, the seven rating downgrades or downward outlook revisions since 1999 should have. After studying the implications of the bankruptcy and the various tentacles it produced, we were led to a buying opportunity which took advantage of the fear that was rampant in what may be the last bastion of a truly inefficient marketplace. We purchased Detroit school district bonds that were enhanced by the Michigan Qualified School Bond Loan Fund Program – a program that had recently been upgraded to AA status. By virtue of the fact that the bonds had 'Detroit' in the name, retail buyers (and those who report to them) were selling bonds as quickly, and indiscriminately, as they could. It was the proverbial case of "throwing out the baby with the bathwater". Buying AA quality bonds at yields above 5%, when the scales for bonds of that profile are 150-200 basis points more expensive is something that we jump on when we find it. We are content to be buy and hold investors at those levels, so if price discovery takes longer than it should and the bonds drop in price from where we bought them, we are content to receive outsized cash flows feeling confident that we will get par at maturity.

Today the cracks in the market are emanating from Puerto Rico. Headlines about troubles in the Commonwealth have appeared on the front pages of any number of financial publications. While the specific sources of value are different than the situation that played out in Detroit, it is our belief that the "market" has not taken the time to analyze different issuers located in Puerto Rico. This has led to a scenario where certain revenue bonds offer yields that are far superior to what you would expect for the balance sheet and cash flow condition of the borrower. This is another situation we are taking advantage of, and it is one of interest to traditional buyers of both tax-exempt and taxable fixed income. The latter come in as what the municipal market calls "crossover buyers" – more often associated with tax-free issues with steep discounts based on their tax treatment.

Our approach to opportunities across the investment landscape is consistent with the specifics discussed above in municipal bonds. We are long-term investors who realize the importance of entry point in the eventual outcome of our decisions. In the face of headline hysteria, we will continue to be buyers on weakness as long as the fundamentals are solid and the risks are understood. That leaves us squarely in the midst of a time that will likely continue to pair significant volatility with significant opportunity.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

[i] High Frequency Economics- Half-Full and Filling- 9.30.13

[ii] Ashmore Group- Emerging market debt after the summer sell-off: Hold or Add?- 9.24.13

[iii] S&P Dow Jones Indices- Much Ado About Interest Rates- September 2013

[iv] Barron's- What, Me Worry?- 9.30.13