BRIDGES
INVESTMENT MANAGEMENT, INC.

**Market Comments**
**October 19, 2014**

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|---|---|
| S&P 500 | 1887 |
| 10 year Treasury | 2.22% |

After a two-year run of essentially uninterrupted price gains since October of 2012, the U.S. stock market experienced a meaningful pullback between mid-September and mid-October, as the S&P 500 declined from an all-time high of 2020 on September 17 to an intra-day low of 1820 on October 15, before rallying to close at 1887 on October 17.

Coincident with the sharp four week stock market decline, stock volatility exploded to the upside, with the VIX (volatility index) spiking from 14 on October 3 to 31 on October 15. To put that volatility in perspective, the average VIX level over the past five years is 19; the average of the past two years is 14.

We believe that the sudden increase in stock price volatility presages a more challenging equity market environment through the end of 2014 and into 2015.

Other key points include:

1. The recent stock market correction materially improves stock valuations. Our 2015 fair value estimate for the S&P 500 is 2100-2200, which implies low double-digit total return potential for stocks from current levels over the next four to six quarters.

2. Corporate earnings remain the most important driver of stock returns going forward. Second quarter earnings were solid, with un-weighted S&P 500 earnings up 11% year-over-year. Early on, third quarter earnings are off to a good start, with un-weighted S&P 500 earnings up 13% through October 17.

3. Bond yields remain unattractive in our view, with nominal and real rates very low relative to historic norms, and with credit spreads very tight.

The capital markets face significant risks (weak global economic conditions, geo-political instability in the Middle East and Russia, Ebola outbreak, continued rancorous political climate in the U.S.), but equity valuations remain reasonable, and U.S. corporate balance sheets are generally in excellent shape; many companies have significant excess liquidity, which provides some measure of downside protection.

While extreme levels of stock price volatility can be unsettling, volatility also creates opportunities to invest capital in strong business franchises at valuation levels that are attractive for investors with long time horizons.

The recent correction has impacted the energy sector, financials, industrials, and small cap stocks particularly hard, and we are also finding opportunities to add to positions in a number of high quality companies in other market sectors at the most attractive valuation levels that we have seen in months.

While we expect the capital markets to remain challenging going forward, we remain constructive on the intermediate to longer outlook for equities.

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