OJAI VALLEY SANITARY DISTRICT

A Public Agency

1072 Tico Road, Ojai, California 93023
(805) 646-5548 • FAX (805) 640-0842
www.ojaisan.org

MEETING OF THE FINANCE COMMITTEE

Date & Time:
October 7, 2014
Tuesday, 3:00 p.m.

Location:
OVSD Board Room

Members:

Peter M. Kaiser
William C. Murphy
John R. (Randy) Burg, Chairman

AGENDA

1. **Public Comment - (Items not on the agenda - 3 minute limit)**

FOR DISCUSSION & RECOMMENDATION

2. **Quarterly Review of District's Investments**

FOR DISCUSSION & REVIEW

3. **General Discussion**

   a. Audience
   b. Committee Members
   c. General Manager

A staff report providing more detailed information is available for most agenda items, and may be reviewed in the District office during regular business hours. Copies of individual reports may be requested from Brenda Krout (646-5548).

ATTEST TO POSTING:

Brenda Krout

Brenda Krout – Clerk of the Board

October 3, 2014 @ 11:30 a.m.
Date & Time Posted At District Office

Memorandum

Ojai Valley Sanitary District

October 3, 2014

To: Finance Committee – Bill Murphy, Peter Kaiser & Randy Burg

From: Jeff Palmer – General Manager JP

Subject: Quarterly Review of District's Investments

The District contracts with Sage Advisory Services, Inc. (through Morgan Stanley) to manage the District's investments.

Attached for your information is a Performance Report (issued by the District's financial advisor, Howard Smith) on the District's portfolio at Morgan Stanley. The report indicates that for the quarter ending September 30, 2014 the District's net return is a negative 0.22 percent; the net return for this calendar year is 0.53 percent.

The regular monthly reports from Morgan Stanley and Sage detailing the investment activity in the District's portfolio had not been received at the time of this writing. Select sheets from these reports summarizing the District's net returns will be available at your meeting.

Mr. Smith will be in attendance at your meeting, to review the investment information and to respond to your questions and/or concerns.

If you have any questions or need additional information please call me at 646-5548.

Morgan Stanley

Performance Report for:

OJAI VALLEY SANITARY DISTRICT

10/1/2014

HOWARD SMITH

Financial Advisor

300 ESPLANADE DR, 10TH FLOOR

OXNARD, CA 93036

Phone: (805) 278-3600

This Performance Report may show the consolidated performance of some, but not necessarily all, of your Morgan Stanley accounts. In addition, it may show the full performance history of your accounts or just the performance of your accounts since inception in their current Morgan Stanley programs. In some cases, it may show the combined performance of brokerage accounts and advisory accounts (for more information about the differences between brokerage and advisory accounts, please refer to the Glossary of Terms contained at the end of this report). **It is important that you understand the combination of accounts and account histories that are included in this Performance Report. Upon your request, performance information can be obtained for other accounts you may have at Morgan Stanley, but which are not shown here.**

Accounts included in this Performance Report may have had different investment objectives, been subject to different rules and restrictions, and incurred different types of fees, mark-ups, commissions, and other charges. Accordingly, the performance results for this portfolio may blend the performance of assets and strategies that may not have been available in all of your accounts at all times during the reporting period. Please consult your Morgan Stanley Financial Advisor for more information about the fees and expenses applicable to the accounts included in this Performance Report.

The following account(s) have been included in this performance report:
244 025091

For additional information about all accounts listed, please refer to the Consolidated Accounts List section.

This report is not an official statement. The information contained in this report is not complete without the required disclaimer and glossary, which you should read carefully. The information in this report should not be considered as the sole basis for any investment decision.

Morgan Stanley

Consolidated Executive Summary
Time Weighted Return (TWR)
September 30, 2014

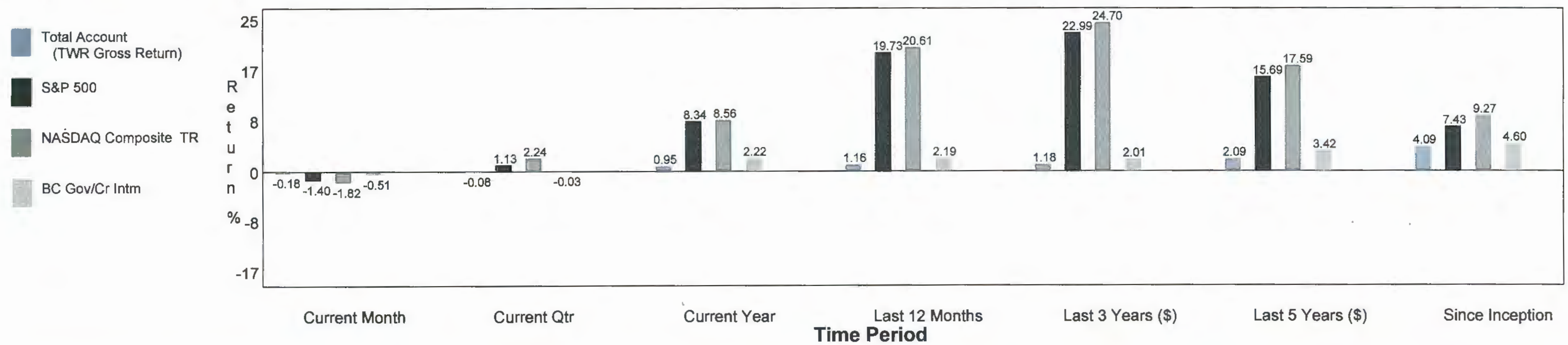
Ojai Valley Sanitary District

HOWARD SMITH
(805) 278-3600

Change In Portfolio

	Current Month ($) 8/31/14 - 9/30/14	Current Qtr ($) 6/30/14 - 9/30/14	Current Year ($) 12/31/13 - 9/30/14	Last 12 Months ($) 9/30/13 - 9/30/14	Last 3 Years ($) 9/30/11 - 9/30/14	Last 5 Years ($) 9/30/09 - 9/30/14	Since Inception ($) 4/12/06 - 9/30/14
Total Beginning Value (includes accrued income)	14,998,943.03	16,056,509.10	12,905,324.51	12,000,462.49	10,126,827.91	12,753,383.72	5,750,000.00
Net Contributions/Withdrawals	0.00	(1,050,000.00)	2,000,000.00	2,900,000.00	4,650,000.00	1,250,000.00	6,720,803.78
Net Invested Capital	14,998,943.03	15,006,509.10	14,905,324.51	14,900,462.49	14,776,827.91	14,003,383.72	12,470,803.78
Net Portfolio Appreciation	(27,176.99)	(34,743.06)	66,441.53	71,303.55	194,938.13	968,382.32	2,500,962.26
Total Ending Value (includes accrued income)	14,971,766.04	14,971,766.04	14,971,766.04	14,971,766.04	14,971,766.04	14,971,766.04	14,971,766.04
Cumulative Total Account (TWR Net Return)	-0.18	-0.22	0.53	0.59			34.00
Annualized Total Account (TWR Net Return)					0.59	1.49	3.51

Performance History



Comparative Performance Returns

	Current Month (%) 8/31/14 - 9/30/14	Current Qtr (%) 6/30/14 - 9/30/14	Current Year (%) 12/31/13 - 9/30/14	Last 12 Months (%) 9/30/13 - 9/30/14	Last 3 Years (%) 9/30/11 - 9/30/14	Last 5 Years (%) 9/30/09 - 9/30/14	Since Inception (%) 4/12/06 - 9/30/14
Total Account (TWR Gross Return)	-0.18	-0.08	0.95	1.16	1.18	2.09	4.09
S&P 500	-1.40	1.13	8.34	19.73	22.99	15.69	7.43
NASDAQ Composite TR	-1.82	2.24	8.56	20.61	24.70	17.59	9.27
BC Gov/Cr Intm	-0.51	-0.03	2.22	2.19	2.01	3.42	4.60

Performance for all periods greater than one year is annualized

Morgan Stanley

Consolidated Executive Summary
Time Weighted Return (TWR)
September 30, 2014

Ojai Valley Sanitary District

HOWARD SMITH
(805) 278-3600

Top 10 Holdings

Security		Symbol	Current Value ($)	% of Port	Sector
UNITED STATES TREASURY NOTE			1,798,164.00	12.05	Government Issues
UNITED STATES TREASURY NOTE			826,064.25	5.54	Government Issues
UNITED STATES TREASURY NOTE			754,481.25	5.06	Government Issues
UNITED STATES TREASURY NOTE			732,934.65	4.91	Government Issues
FED HOME LN MTG CORP			681,924.40	4.57	Government Issues
BANK DEPOSIT PROGRAM		BDPS	516,443.69	3.46	UNCLASSIFIED
UNITED STATES TREASURY	NOTE-INFLATION INDEXED		420,369.08	2.82	Government Issues
FED NATL MTG ASSN			369,015.00	2.47	Government Issues
UNITED STATES TREASURY	NOTE-INFLATION INDEXED		297,612.09	1.99	Government Issues
JP MORGAN CHASE & CO			239,484.00	1.60	Corporate Bonds

Gain & Loss Summary as of 9/30/14

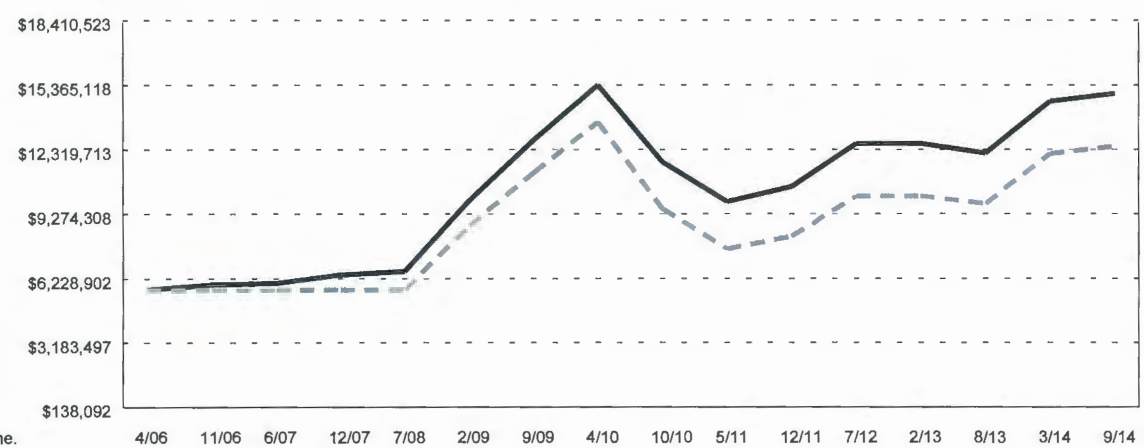
Unrealized	Total Cost ($)	Market Value ($)	G(L) Amount ($)
Short-term Gains & Losses	10,049,065.58	10,018,036.25	(31,029.33)
Long-term Gains & Losses	4,402,334.45	4,383,717.92	(18,616.53)
Total	**14,451,400.03**	**14,401,754.17**	**(49,645.86)**
Realized	**Total Cost ($)**	**Market Value ($)**	**G(L) Amount ($)**
Short-term Gains & Losses	7,928,939.73	7,930,480.88	1,541.15
Long-term Gains & Losses	1,525,306.61	1,536,497.52	11,190.91
Total	**9,454,246.34**	**9,466,978.40**	**12,732.06**

Unrealized Gain and Loss excludes tax lots with a market value of $0 and the Market Value column excludes Money Market and Cash positions.

Allocation as of September 30, 2014

Asset Class		Current Value
Fixed Income	**96 %**	14,401,754.14
Cash & Equiv	**4 %**	522,471.82
Total Market Value		**14,924,225.96**

Net Invested Capital



Invested Capital
Total Ending Market Value - Portfolio Value

Net Invested Capital represents the inception value of the account, net of additional capital contributions and withdrawals, graphed against the account market value over time.

Ojai Valley Sanitary District

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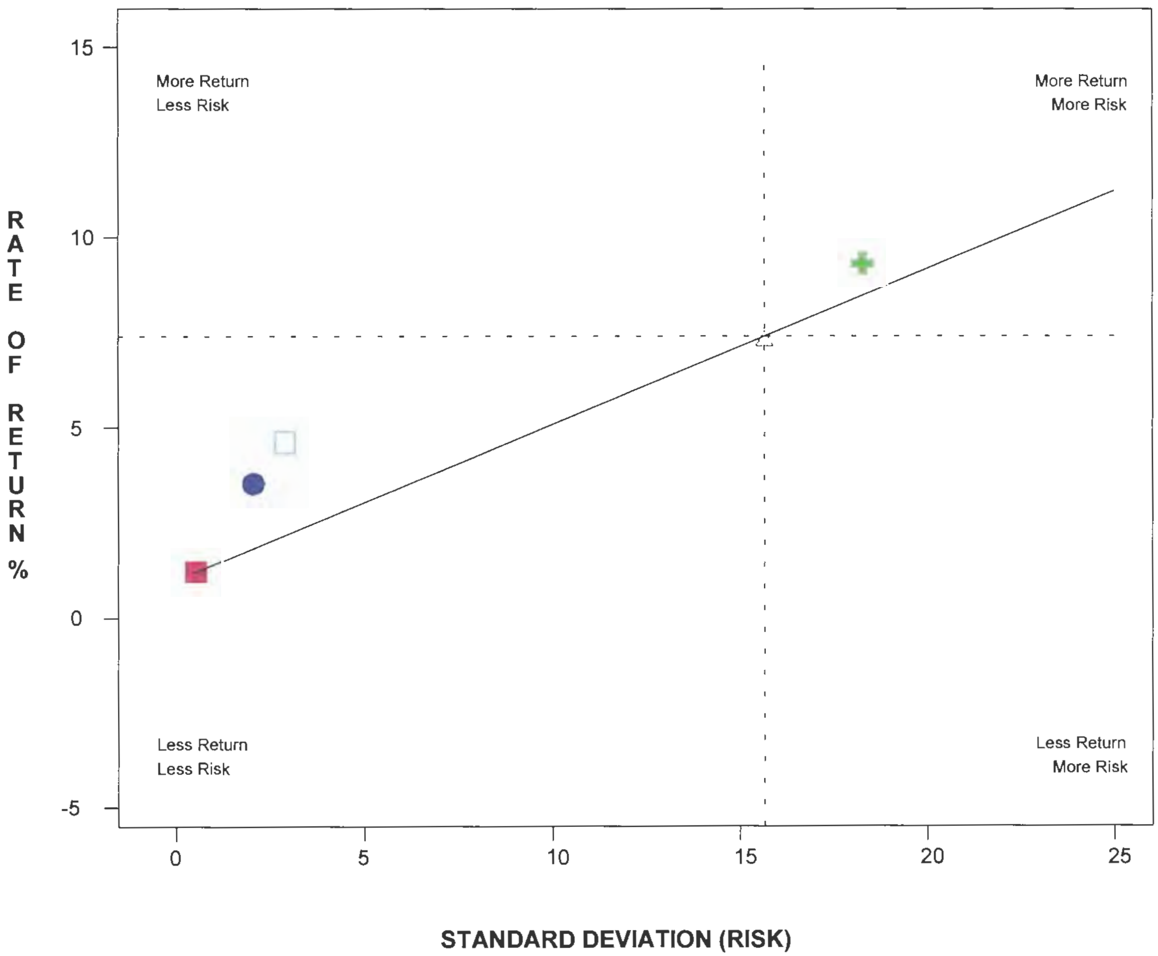
Comparative Risk/Return (Net of Fees)

April 12, 2006 through September 30, 2014



	Rate of Return (%)	Standard Deviation %
Your Portfolio (Net)	3.5	2.06
TBILL	1.2	0.54
SP500	7.4	15.66
NASDAQ	9.3	18.27
LBGC-INT	4.6	2.90

Please Note: The measurement period for all Standard Deviations starts from the beginning of the month following the account's inception. Also, if your account was enrolled in performance reporting prior to May 1, 2003, your gross portfolio returns and the returns for all comparative indices have a start date of the month following the account's inception date.

All returns are annualized.

For TRAK Fund Solution accounts, since inception gross performance and index returns are always measured from the beginning of the month following the account's inception. Additionally, the following indices are available only on a monthly basis and are, therefore, measured from the beginning of the month following the account's inception: CPI, IFC Investable Emerging Markets, National Association REIT, Wilshire REIT, all Merrill Lynch Municipal Indices, the Merrill Lynch Investment Grade Convertible and the Merrill Lynch High Yield Master.

Morgan Stanley

Annual Performance Summary
Time Weighted Performance
Calendar Year Report - Net Return
September 30, 2014

Ojai Valley Sanitary District

HOWARD SMITH
300 ESPLANADE DR, 10TH FLOOR
OXNARD, CA 93036
(805) 278-3600

	Period Start Date	Period End Date	Total Beginning Value($)	Net Contributions & Withdrawals($)	Net Portfolio Appreciation($)	Total Ending Value($)	Account Period Return(%)	Account Cumulative Return(%)
History:								
2006	04/12/2006	12/31/2006	5,750,000.00	(50,000.00)	227,795.07	5,927,795.07	4.00	4.00
2007	01/01/2007	12/31/2007	5,927,795.07	0.00	475,391.40	6,403,186.47	8.02	12.34
2008	01/01/2008	12/31/2008	6,403,186.47	20,803.78	492,234.90	6,916,225.15	7.68	20.96
2009	01/01/2009	12/31/2009	6,916,225.15	5,500,000.00	373,666.73	12,789,891.88	3.17	24.79
2010	01/01/2010	12/31/2010	12,789,891.88	(1,700,000.00)	535,363.19	11,625,255.07	3.45	29.09
2011	01/01/2011	12/31/2011	11,625,255.07	(1,300,000.00)	238,124.89	10,563,379.96	2.35	32.13
2012	01/01/2012	12/31/2012	10,563,379.96	250,000.00	133,388.58	10,946,768.54	1.16	33.66
2013	01/01/2013	12/31/2013	10,946,768.54	2,000,000.00	(41,444.03)	12,905,324.51	-0.27	33.30
2014 YTD	01/01/2014	09/30/2014	12,905,324.51	2,000,000.00	66,441.53	14,971,766.04	0.53	34.00

Cumulative Return Since Inception	**34.00**
Annualized Return Since Inception	**3.51**

Inception values for accounts starting after inception are included in Net contributions. Termination Values, as of the end date, are included in Net Withdrawals.

Accounts Included in this Report

Name	Account Number	Program/ Account Type	Investment Style	Manager	Advisory or Brokerage	Start Date	End Date
OJAI VALLEY SANITARY DISTRICT	244 025091	CONSULTING GROUP / AAA	FIXED INCOME	SAGE ADVISORY SERVICES LTD CO.	ADVISORY	09/03/2008	
OJAI VALLEY SANITARY DISTRICT	244 025091 *	PAD /		TAXABLE FIXED INCOME	ADVISORY	04/12/2006	09/03/2008

Please note that the accounts included above may not represent your entire relationship with Morgan Stanley
* Indicates accounts that have had a change in manager.

This performance report has been prepared for your information only and is not a substitute for your official Morgan Stanley Smith Barney LLC account statements. Do not use the information in this report as the sole basis for investment decisions, nor take action relying on this information without confirming its accuracy and completeness. Please carefully review the attached glossary. Past performance is not a guarantee of future results.

Information is approximate: The information in this report is approximate and subject to updating, correction and other changes. We are not obligated to notify you if information changes. If there are discrepancies between your official account statement and this report, rely on your official account statement. Prices shown in your official account statement may differ from the prices shown in this report due to, among other things, different reporting methods, delays, market conditions and interruptions. Also, the figures in this report do not include all relevant costs (e.g., fees, commissions and taxes).

We obtain pricing and other information from various standard quotation services and other sources which we believe to be reliable, but we do not warrant or guarantee the accuracy or completeness of this information. The price that you would actually receive in the market for any investment may be higher or lower than the price shown in this report. The prices of securities and other investments not actively traded may be estimated or may not be available. For example:

- Bonds trading less frequently: We rely on outside pricing services or a computerized trading model, which cannot always give us actual market values.
- Annuities: Data in this report may have been provided by third party insurance carriers. (Not all insurance carriers provide data on annuities for performance calculations. The list of providers that provide data is available on request. Performance calculations are based on annuity values as of December 31, 2006 or later, depending on carrier participation.) This report might not reflect a transaction that posted at the insurance company before this reporting period. Depending on the carrier, annuities transactions may be net of certain fees or expenses.
- Alternative investments: The assets in these investments (and in corresponding benchmark indices) are difficult to value, values may be several weeks or more old, and the index values reflect pricing from multiple sources. Index values may be more up-to-date than the data for the alternative investments shown in this report. This report shows the latest generally available alternative investment and index data as of the date of this report.
- Non-traded Real Estate Investment Trusts (REITs) and certain other investments: These are illiquid and have no public markets.
- For floating rate securities, the estimated accured interest and estimated annual income are based on the current floating coupon rate and may not reflect historic rates within the accural period.

We are not responsible for any clerical, computational or other errors or omissions. You are responsible for promptly reviewing your report and seeking clarification about entries that you do not understand. If you do not understand an entry in this report, suspect an error, or want more details on current prices or other information, contact your Financial Advisor.

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Benchmarks, charts and graphs: Benchmark indices are provided for general reference purposes only. Indices are unmanaged and do not reflect payment of any expenses, fees or sales charges an investor would pay to purchase the securities it represents. Such costs would lower performance. You cannot invest directly in an index. An index's past performance is not a guarantee of future results. Index values for certain types of investments (e.g. alternative investments) are approximate and subject to updating, correction and other changes. Charts and graphs are for illustrative purposes only and are not intended to represent the performance of any Morgan Stanley offering. If your account was incepted prior to 7/2006 and contains the NASDAQ index, please note that price returns are being used from inception to 7/2006 and total returns are used from 7/2006 to present.

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Other: This report does not contain information on DVP or margin rollup accounts carried by Morgan Stanley Smith Barney LLC. Also, all accounts with a mid-month daily fair market value at the total or asset class level below $500 will have performance defaulted to 0% until month end. Please reference this account again when the account or asset class is above $500 or at month end.

Morgan Stanley Smith Barney LLC. Member SIPC. Positions that are not custodied at Morgan Stanley Smith Barney LLC may not be covered by SIPC.

Accrued Income

The dividends and interest earned but not yet received at both the beginning and end of each reporting period.

Advisory Account

An investment advisory relationship is designed for clients who prefer that their Financial Advisor act as an investment consultant, with their assets invested in a mutual fund asset allocation program or in a Advisory account that is directed by a professional money manager either at Morgan Stanley or at an external money management firm. There are important differences in your relationship with your Financial Advisor and Morgan Stanley in brokerage accounts and in advisory accounts. Additional information about these differences is available at http://www.morganstanley.com/ourcommitment

Annualized Standard Deviation

A measure of volatility, it quantifies how much a series of numbers, such as portfolio returns, deviates around its average. Since it measures the portfolio's investment volatility, the account's gross rate of return is used.

Brokerage Account

In a brokerage relationship, your Financial Advisor will work with you to facilitate the execution of securities transactions on your behalf. Your Financial Advisor also provides investor education and professional, personalized information about financial products and services in connection with these brokerage services. You can choose how you want to pay for these services and you will receive the same services regardless of which pricing option you choose. There are important differences in your relationship with your Financial Advisor and Morgan Stanley in brokerage accounts and in advisory accounts. Additional information about these differences is available at http://www.morganstanley.com/ourcommitment

Comparative Indices

A complete description of the comparative indices included in this Performance Report is available upon request.

Dollar-Weighted Return

Rate of return calculation methodology that reflects both the timing and magnitude of external contributions and withdrawals and measures the portfolio's performance. The return for each month is calculated as the average return on all dollars invested.

Gross Return

The return of the portfolio before the deduction of fees/commissions and other expenses.

Net Contributions/Withdrawals

The total value of capital contributed to or withdrawn from the account during the reporting period. The dollar amount represented by contribution or withdrawal transactions is excluded from the calculation of Portfolio Appreciation.

Net Invested Capital

The sum of the Total Beginning Value and the net of additional capital Contributions and Withdrawals for each reporting period.

Net Portfolio Appreciation

The total dollar gain/loss of the portfolio for each reporting period. The Net Portfolio Appreciation includes the impact of income received and is calculated as the difference between Net Invested Capital and Total Ending Value.

Net Return

The return of the portfolio for the period reduced by the amount of fees/commissions paid. The net of fees return is calculated gross of certain custody fees.

Time-Weighted Return

Rate of return calculation methodology that eliminates the impact of external contributions and withdrawals to the portfolio value and measures the manager's performance. Portfolio returns are calculated at least monthly and individual monthly returns are geometrically linked to calculate total cumulative return.

Total Beginning Value

The total market value of the portfolio, valued on a trade date basis, at the beginning of each reporting period. The Total Beginning Value includes Accrued Income.

Total Ending Value

The total market value of the portfolio, valued on a trade date basis, at the end of each reporting period. The Total Ending Value includes Accrued Income.

Weighted Average

The average in which each yield to be averaged is assigned a weight. These weightings determine the relative importance or frequency of each yield on the average.

Ojai Valley Sanitary District
Third Quarter, 2014 Notes
October 1, 2014

At the last meeting of the Federal Reserve Bank, Fed Chair Janet Yellen cautioned last week that the Fed's commitment to keep interest rates near zero for a "considerable time" could change if U.S. economic performance continues to exceed expectations. "It is important for markets to understand that there is uncertainty and that the statement is not some sort of firm promise about a particular amount of time," Yellen said.

This is good news for the Sanitary District. It means that the Prime Rate, which most directly impacts the investments of the District, is expected to rise in the next few quarters and we are at or very close to the bottom in terms of total return for the account.

Bond purchases, which have pushed down long-term yields, were another easing tool used by the Fed. Now, with unemployment down to 6.1 percent from a 26-year high of 10 percent in 2009, the Fed is planning to end bond purchases after its October meeting. Yellin sees the jobless rate receding into the mid-5% range in 2015 and low-5% range in 2016. The Fed's estimate for full employment, one of its policy goals, is 5.2 percent to 5.5 percent.

Prices of existing bonds remain fairly stable. Money market returns and short term bond rates remain at or near record low levels. As before, this continues to weigh heavily on income streams generated from almost all fixed income investments. For example, daily LAIF rates remain near all-time lows of 0.24%. Please note all appropriate disclaimers that follow this summary.

The shape of the Yield Curve remains normal for almost all maturities. For example, the national average for a five year Treasury is at 1.80, up from last quarter's 1.65%. As of today (10/1/2014), the two year rate on T-bills continues to inch up marginally to 0.58% from 0.46% from last quarter. It was 1.07% 3 years ago. The national average for "A" rated corporate bonds for 2 years edged up from 0.78% to 0.96%.

Yields on the benchmark U. S. Treasury Ten Year bond continue to slide back down from 2.98% nine months ago to 2.53%. The 30 year treasury continues to drop from 3.93% six months ago to 3.21% and still lags behind the summer of 2012's 4.01%.

Stock investors have watched their portfolios slide up and down.. As of today we are hovering just below 17,000 which is about 5,000 points above where the markets were before the 2008 crash and near its all-time high.

Daily LAIF rates remain at 0.24%. Our annual rate of return, while low at 0.59% is still 2x higher than the comparable rate for LAIF.

Since inception on 4/12/2006 through 9/30/2014, we have returned a Cumulative Total Net Return of 34%, which averages out to 3.51% Net Return per Year.

Our capital appreciation after seven and a half years in actual dollars is now at $2,500,962.

By comparison, during the same time period the Average Annual Return of the S&P 500 was only fractionally higher at 4.09% with far greater risk. The Standard Deviation (RISK) for the S&P for that same time period is 15.66. Our bond portfolio, while no longer outperforming the S&P, had a significantly lower Standard Deviation of only 2.06 or less than 1/7th the RISK.

"All prices and yields are as of 10/1/2014 and subject to change and availability. Past performance is not a guarantee of future results. The information and data contained in this report are from sources considered reliable, but their accuracy and completeness is not guaranteed. This report has been prepared for illustrative purposes only and is not intended to be used as a substitute for monthly transaction statements you receive on a regular basis from Morgan Stanley Wealth Management. Please compare the data on this document carefully with your monthly statements to verify its accuracy. The Company strongly encourages you to consult with your own accountants or other advisors with respect to any tax questions."

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Weekly Economic Commentary- Week of September 26, 2014

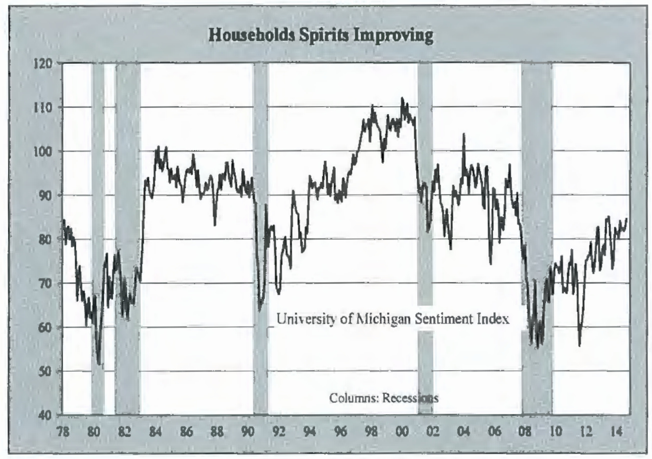
Investors can be excused for fastening their seatbelts this week, as the prolonged period of muted volatility was shattered by some wild swings in market prices, including Thursday's steepest one-day dive in equity prices since late July. It remains to be seen if that disconcerting plunge, followed by a solid rebound on Friday, ushers in a period of heightened volatility and shatters the complacency that is typically associated with an extended bull market. Interestingly, the relatively boring economic backdrop would seem to belie the turmoil in financial markets. Certainly, there was nothing in the way of recent data that would cause a shift in perceptions regarding the near-term outlook or, by extension, in the course of monetary policy.

That's not to say there's nothing to worry about. Geopolitical tensions, highlighted by air strikes aimed at terrorists by the U.S. and its allies, continue to grab headlines. There is still a good deal of uncertainty over the timing and speed of the rate increases that the Fed is expected to undertake next year. And even as plans for a tightening are being formulated in the U.S., policy makers overseas are struggling with how best to stimulate growth of their sagging economies. Indeed, the strength of the U.S. economy relative to most other developed and developing nations is boosting the dollar in the currency markets which could eventually bite into exports and impede growth.

Notwithstanding these potentially disruptive influences, it's hard to not have a positive vibe regarding the near-term outlook. After staging an impressive 4.6% growth rate in the second quarter, the economy is on track to deliver another solid performance in the third. If real GDP increases by more than a 3% annual rate, which many expect, it would be only the second time that growth exceeded that threshold for two consecutive quarters since early 2005. Not too shabby for a recovery that seems to be forever defined by its lackluster performance. We'll have a firmer grip on the current quarter's performance when data on personal consumption for August - which accounts for 70% of total activity - is released next week.

That said, there is little question that households are feeling better about things. The final Reuters/University of Michigan sentiment index, released Friday, rose 2.1 points to 84.6 in September, led by a 4.1 point increase in the expectation component. The overall index is now back to prerecession levels, and there's every reason to believe that household spirits will continue to improve. Job prospects are getting steadily better, financial conditions are becoming more favorable and inflationary expectations remain well anchored. One other spur: falling gasoline prices. Indeed, for the first time in nearly four years, prices of regular gas dipped below $3 a gallon in many parts of the country this week. Whether the more upbeat mood of households translates into a sustained increase in spending behavior remains to be seen, but lower gasoline prices have usually led at least to a temporary spurt in discretionary outlays. That's just another reason to be optimistic about third-quarter growth prospects.

What's more, the economy is garnering support from some important sectors. The Commerce Department released its third and final revision of second-quarter GDP on Friday which boosted the growth rate to the aforementioned 4.6% from the previous estimate of 4.2%. While the second quarter is well into the



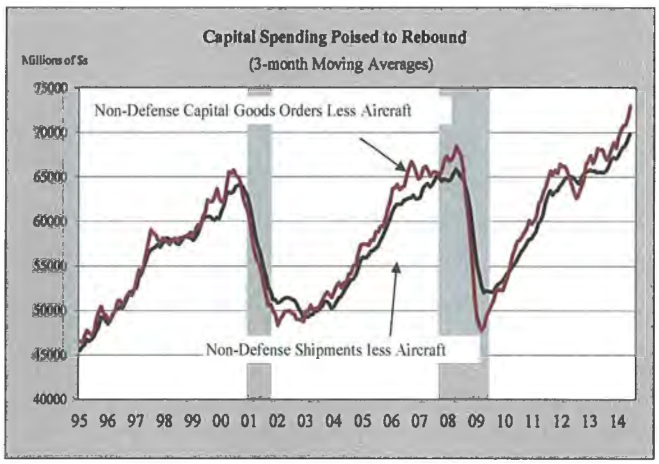
history books, the upward revision was still encouraging because it primarily reflected more investment spending by businesses than thought. The latest figures boosted the growth rate in nonresidential fixed investment to 9.7% from 8.4%. When the first estimate of GDP was released two months ago, showing a 4% growth rate in real GDP, business investment was thought to have increased by only a 5.5% annual rate. So the final tally puts spending growth at nearly double the pace initially estimated and the strongest in nearly three years.

Keep in mind that the sluggish pace of capital spending has been a troublesome feature of the recovery, particularly in view of the record profits racked up by corporations. Instead of plowing their profits back into the spending stream by expanding capacity or upgrading the capital stock, companies used their copious cash flows to repurchase stock, boost dividends and accumulate a formidable hoard of liquid assets. That behavior clearly helped buoy the stock market, boost returns for shareholders and restore corporate balance sheets to health. However, it did little to increase productivity or provide any oomph to the economy's growth engine.

Business leaders, of course, had compelling reasons to act the way they did. The unprecedented plunge in industrial production during the Great Recession left a gaping hole in plant capacity that vaporized any incentive to add new structures or equipment to existing facilities. The slow recovery in demand and repeated headwinds that prevented the upturn from sustaining momentum were further disincentives to step up outlays. Indeed, by keeping a low worker headcount, the modest gains in output over the first several years of the recovery were accomplished through increased worker productivity, a process that was integral to the boom in profits companies enjoyed during the period.

But more than five years into the upturn, that dynamic may be on the verge of changing. Steady growth in output, spurred by increased exports and more recently by muscular sales of autos, has closed the output gap. Over the past six months, capacity utilization has averaged 79% among all industrial companies which is a slim 1.1 percentage point under the long-term average (from 1972- 2013). That's still a shortfall, of course, but one that pales in comparison to the record 13.2 percentage point gap that existed at the start of the recovery in mid-2009. And while operating rates need to rise well above 80% before bottlenecks - and, hence, inflationary pressures - begin to proliferate, corporate leaders may not wait that long to ramp up investment budgets. After churning out product from aging plant and equipment for the past five years, the need to upgrade and modernize the tools of production becomes more urgent. Failure to do so runs the risk that productivity will suffer and sales will be lost to more efficient competitors - both in the U.S. and overseas.

Simply put, the hefty increase in investment spending in the second quarter may be the first sign that this process has begun. To be sure, conditions are not ripe for a capital-spending boom. But more recent indicators suggest that the current quarter will at least be a decent one for such spending and sturdier gains can be expected in the fourth quarter as well. According to this week's government report on durable goods, shipments of nondefense capital equipment, excluding volatile aircraft sales, in July and August are on pace for a double-digit increase over the second quarter. What's more, new orders for these so-called "core" capital goods - which are a barometer of future capital spending in the GDP accounts - are showing even more strength. Such orders increased at an annual rate of 18.7% in July and August compared to the second quarter average.



Of course, orders can be cancelled so it may be premature to interpolate the gains into actual spending. That's particularly the case with orders coming from overseas where worsening conditions could readily lead to cancellations. What's more, some foreign companies may balk at the steeper cost brought on by the strengthening dollar and take their business elsewhere. But there is at least one potential domestic source of offsetting strength: the housing sector. Builders have become much more optimistic about the housing market over the past several months, and are responding by stepping up groundbreaking activity. Assuming this trend continues, it will lead to increased demand for construction supplies, including cement, lumber and steel as well as tractors and earth-moving machinery.

No doubt, builder sentiment was further bolstered by the latest report on home sales released this week. According to the Commerce Department, new home sales blew away just about every forecast, surging 18% in August to a 504,000 annual rate. That's a monthly sales pace not seen in more than six years. Admittedly, the monthly figures can be highly volatile, and many industry analysts viewed the August spike with a jaundiced eye. But the totals for the previous three months were revised up as well which should at least alleviate fears that the spring swoon in sales indicated the housing recovery was faltering.