Quarterly Economic Update

June 3, 2015

MACROECONOMIC COMMENTARY

Monetary Policy

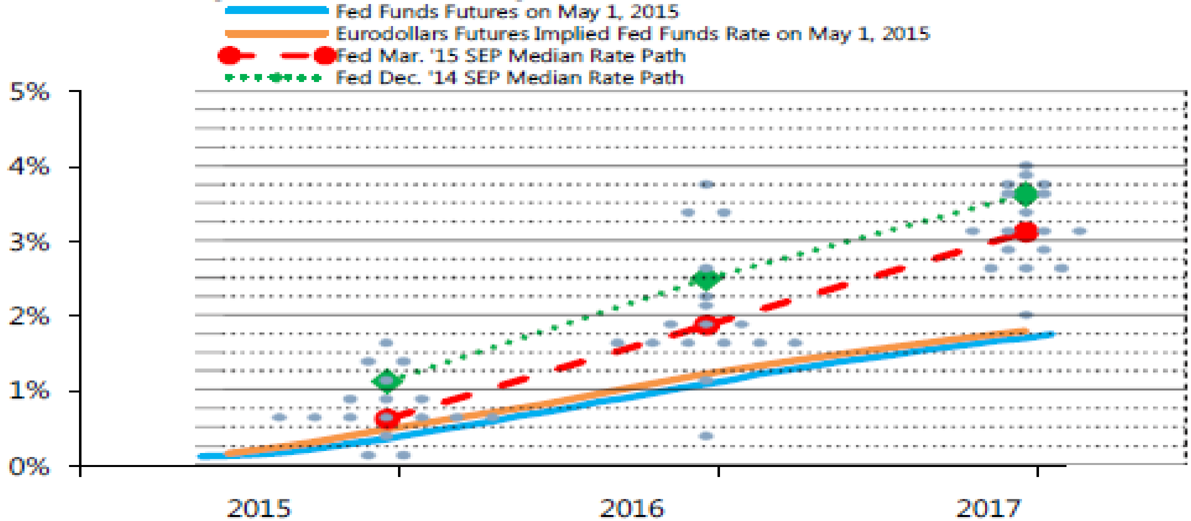
By Bobby Long

The Federal Open Market Committee (FOMC) continues to hold the target range for the federal funds rate at 0 to ¼ percent and we are awaiting "lift-off" from this zero bound range. The initial rate increase, the first increase since the target range was brought to its current low level almost 7 years ago, is likely to happen sometime before the end of the calendar year. The exact timing remains uncertain and seems to move with the ebb and flow of new economic data. Federal Reserve Chair Janet Yellen has repeatedly stated that policy decisions are data dependent and the FOMC seems to be moving forward now under a true data dependent decision making process. While the FOMC has defined specific objectives, there is some subjectivity to the data which will keep market participants guessing around the timing of the first increase. To some degree, we have entered a period where good news is bad news and bad news is good news in regards to tighter policy decisions. Regardless, policy is likely to remain very accommodative for some time even after the initial rate increase. The FOMC also continues to direct the reinvestment of maturities and prepayments from their securities portfolio, keeping the balance sheet elevated and holding accommodation steady.

The FOMC most recently held meetings on March 17th-18th and April 28th-29th. As expected, they did drop the "patient" language from their forward guidance at the March meeting. They had previously made the statement that "the Committee judges that it can be *patient* in beginning to normalize the stance of monetary policy." The "patient" language was used to imply that conditions are moving in that direction, but are not yet at a point that warrants consideration for a rate increase. Removing the "patient" language puts the potential for a rate increase in play at any meeting, removing any time component from the decision making process and making it strictly data dependent. The new forward guidance simply states that "The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." To help with the transition to this new guidance and to convey that the change in guidance did not imply an imminent increase in rates, the statement explicitly stated that an increase was unlikely at the April FOMC meeting. In her post meeting press conference, she also stressed that "just because we removed the word 'patient' from the statement doesn't mean we are going to be impatient."

While the change in guidance lends itself to move up the time table for the first rate increase off the bottom, the statement also contained some dovish language around economic growth and low levels of inflation. More importantly, the March meeting also contained an updated Summary of Economic Projections from participants, which indicated a more dovish approach to raising rates. Participants lowered their projections of the likely pace of tightening fairly significantly from their prior projections as shown in the chart on the following page. While their median projections did shift down, there remains a fairly wide gap between their projections and the market's expectations for the pace of tightening as implied from the fed funds futures curve.

Fed SEP rate path v market expectations

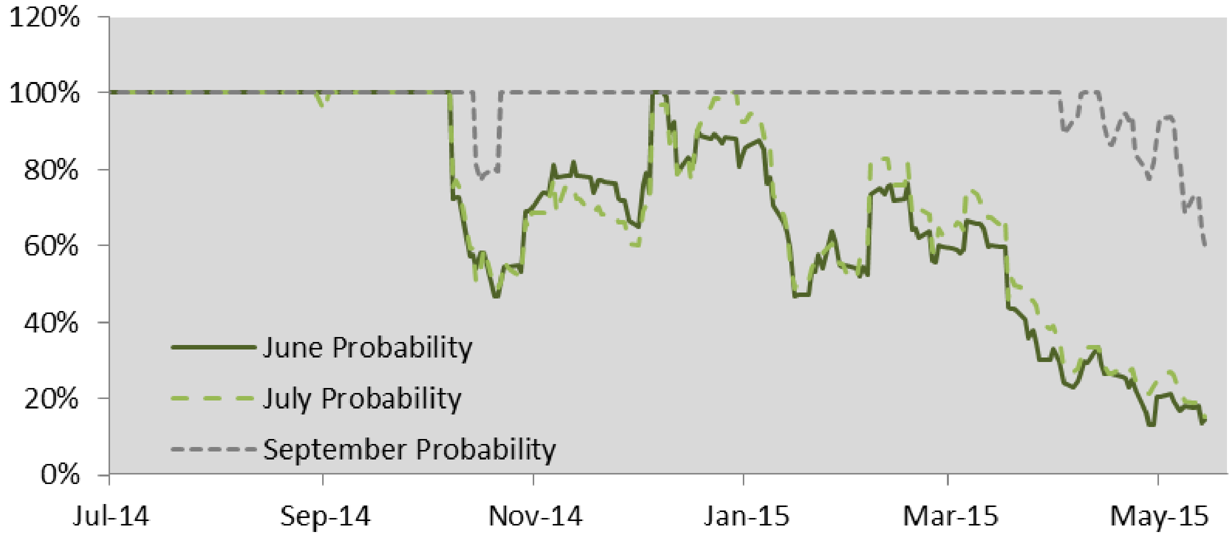


**The Eurodollars implied fed funds rate shown here is based on the LIBOR Eurodollars futures curve adjusted by taking out the LIBOR-OIS future spread but with no additional adjustment for term premia.*

Source: Federal Reserve, Bloomberg
Evercore ISI

The April FOMC meeting resulted in no policy changes or guidance changes, but the statement did acknowledge some weaker economic data that were less than encouraging. The statement noted that economic growth had slowed during the first quarter, job gains had moderated, growth in household spending declined and business fixed investment softened. It also stated that exports had weakened further in light of the strong dollar. While FOMC members have said the weaker first quarter data was likely due to transitory factors, acknowledging further deterioration in the April statement pushed down the probability for an initial rate increase at the June FOMC meeting.

The minutes from the April FOMC meeting provided additional insight into discussions around the softer economic data. Participants attributed much of the slower economic activity to the harsher winter weather, weaker exports in light of the strong dollar, labor disputes at West Coast ports, and decreased investment in the energy industry. Most participants saw these issues as transitory and expected activity to pick back up as the year progressed. Participants noted that the pace of improvement in labor market conditions had slowed, but did not seem to view this loss of momentum as a trend and held expectations that the pace would pick back up. Indications of wage growth were viewed as encouraging but remain mixed. Inflation was expected to remain low over the near term and run below the FOMC's two percent objective. Lower energy prices and lower import prices were cited as holding inflation lower with expectations for these pressures to ease some in the future. Participants seemed to be a little more perplexed about weaker consumer spending given several favorable factors supporting spending and questioned whether this was temporary or reflected a greater underlying weakness. The softer economic data and questions around whether it was due to a confluence of transitory factors or a deeper weakness signaling a real loss of positive momentum has left the FOMC anxious to see more data before moving forward with an initial rate increase. While the June meeting had been viewed as having a high probability for a rate increase earlier this year, this probability has declined with the weaker economic data. The chart below shows the declining probabilities of a rate increase at the June, July, and September meetings prior to the release of the April FOMC minutes. The April minutes explicitly state that "Many participants . . . thought it unlikely that the data available in June would provide sufficient confirmation that the conditions for raising the target range for the federal funds rate had been satisfied," leaving the probability of a June increase to decline even further.



Source: Cornerstone Macro

Following the weaker data, the September meeting moved ahead as the likely timing for the initial rate increase, however additional weak data has left its probability trending down further and some market participants viewing the December meeting as more likely.

As Yellen and the FOMC have stated many times, the timing of the first rate increase is data dependent and the data will determine appropriate policy. With near term inflation readings running low and longer term inflation measures stable, the FOMC remains cautious to begin tightening policy too early and stifle the momentum of the recovery. In a recent speech to the Providence Chamber of Commerce, Yellen stated that "the labor market is approaching its full strength. I say 'approaching' because in my judgment we are not there yet." Yellen sites remaining concerns about the unemployed who are not seeking work due to a lack of good job opportunities and a disappointing pace of wage growth. In the same speech, Yellen does state that if recent weakness does prove to be transitory and labor market conditions do continue to improve, "I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate target." She further states that "the pace of normalization is likely to be gradual" and that "the FOMC's objectives of maximum employment and price stability would best be achieved by proceeding cautiously, which I expect would mean that it will be several years before the federal funds rate would be back to its normal, longer-run level." These statements seem to argue for a later in the year "lift-off" and a less aggressive tightening policy.

Fiscal Policy

By Michael McNair

Earlier this month Congress approved the 2016 Budget which set overall base discretionary spending at $1.016 trillion and a deficit target of $400 billion for fiscal year 2016. This is the first congressional budget to be agreed upon in the formal budget process since 2010; therefore, it is necessary to review how this budgetary process works and what steps are to be taken next.

The 2016 Budget agreement was passed by the Republican majority but it is a nonbinding resolution and is not subject to a presidential veto. The budget agreement is only the first step in the congressional spending process and serves as an enforceable guideline to overall spending and priorities for the binding appropriations legislative process that is to follow. With the passing of the 2016 Budget, Congress will now simultaneously embark on two separate but related tracks to finalize federal spending: budget reconciliation and appropriations legislation.

Reconciliation

The recently passed 2016 Budget includes instructions for how the relevant congressional committees are to turn the general budgetary provisions into specific policy actions under the reconciliation process. The Budget Committees are now in the process of drafting "budget reconciliation" legislation in accordance to these instructions. Once finalized (likely by the end of July), the committees will send this legislation to the House and Senate to be considered under special "reconciliation" procedures which override the typical Senate rules that apply to all other bills. The most consequential of these special "reconciliation" procedures include the ability to constrain debate to only 20 hours (subverting the use of a filibuster) and the requirement for only a simple majority for approval (as opposed to the normal 60 vote supermajority). Therefore, these special procedures make it far easier to pass reconciliation legislation.

Appropriations

The second alternative for passing a spending bill is through the appropriations process; whereby, the appropriations committees in the House and Senate draft spending legislation that is then sent to the full House and Senate for consideration. The main difference between the appropriations process and the reconciliation processes is that an ordinary appropriations bill requires 60 votes to pass as opposed to the 50 required under reconciliation.

The reconciliation process was created by the Congressional Budget Act of 1974 and set up special rules pertaining to specific tax, spending and debt limit legislation. The laws intended purpose was to create an efficient way for Congress to act on matters that improved the government's fiscal position. However, the vague wording in the original bill paved the way for future congresses to use the process to enact major legislation that advanced a parties political agenda. However, the implementation of this provision outside of its intended use is highly frowned upon and therefore only used in order for one party to pass a highly important piece of legislation. The most recent use of this provision in this way was in 2010, in order to help the Democrats pass the Affordable Care Act (ACA). As a result, Republicans have stated that they will now use reconciliation as a tool to repeal and replace the Affordable Care Act; however, only health care provisions that change spending can be included in reconciliation legislation.

The consensus view is that any move by the Republicans to repeal the Affordable Care Act, even using the reconciliation option, will fail because Obama will veto any bill that threatens his signature legislation. Since the Republicans do not have the 2/3 majority needed to overturn a presidential veto the logic is that the Republicans have no chance of repealing ACA while President Obama is in office.

However, this view fails to consider the impact that the Supreme Court's late June ruling on the *King v Burwell* case could have on Obama's willingness to negotiate changes to ACA with the Republicans.

King v Burwell

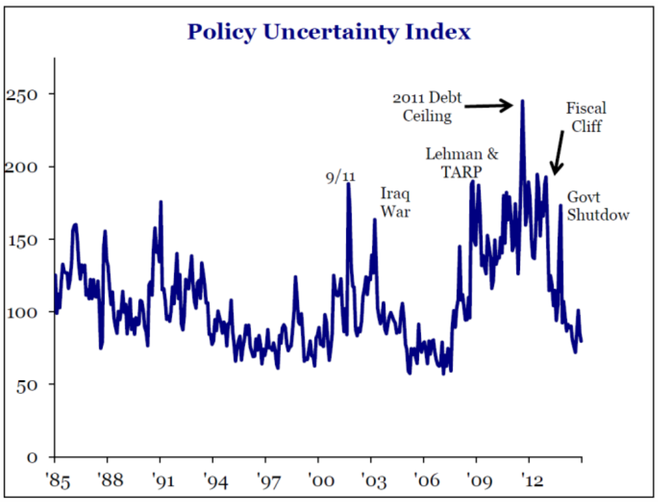
The future of the Affordable Care Act is riding on the outcome of the *King v Burwell* case which is currently being heard by the United States Supreme Court. According to ISI policy analyst Terry Haines, "The issue in *King* is whether IRS regulations on ACA properly reflect Congress' intent or go beyond it. IRS rules permit tax credit to be granted to all ACA insured, but plaintiffs in the case argue that Congress in ACA wrote that tax credits could only be granted to ACA insureds that got their care through state exchanges. The question in the case is whether IRS's regulations exceed the authority Congress granted it." In essence, the Supreme Court is deciding if the language of the law means that subsidies are only available for states that set up state exchanges.

If the case is decided against the Government, the 7 million ACA insureds residing in states without state exchanges will lose their tax credits. This outcome would effectively destabilize the economics underlying the ACA program, as the IRS tax credits partially subsidize the cost and are essential in incentivizing Americans to sign up. Thus, without the tax credits the cost to insure through ACA will rise substantially and result in ACA not having the enrollment necessary to hold premiums down to a level consistent with current projections.

Economic Impact

As we have stated in previous reports, there are two key ways in which fiscal policy impacts economic growth: 1) the fiscal impulse (i.e. the direct impact to GDP from government spending which can be either a stimulus or a drag) and 2) policy uncertainty. While the fiscal impulse will be mostly unchanged, policy uncertainty will have two wildly different outcomes based on the decision in the *King* case.

If the Supreme Court rules in favor of the Government and upholds ACA, then no changes will occur. Congress will still likely move ahead and pass reconciliation legislation to repeal ACA but Obama will veto the bill and the Republicans will not have the votes to override. In this case policy uncertainty will stay at its current relatively low level.



Source: Strategas

However, if the Supreme Court rules against ACA then it will be highly disruptive in the near term and unleash a wave of political and economic uncertainty. Economic uncertainty will range from the millions of Americans that may be forced to repay their tax credits to the businesses in the health care industry that accounts for 17% of US GDP.

Further political uncertainty will likely surge higher as it will almost certainly force a rewrite of the Affordable Care Act. Any such undertaking will require the President to negotiate with the Republican Congress and a resolution will require concessions from both sides. However, with Obama desperate to save his signature legislation and the Republicans just as determined to repeal it, an eventual compromise will be highly unlikely to be a smooth process. There is a significant fundamental divide between the two sides on this issue. As a result, we envision a rise in political brinkmanship that will rival 2012, as we believe each side will be willing to use every ploy in their playbook in order to gain leverage in this monumental debate.

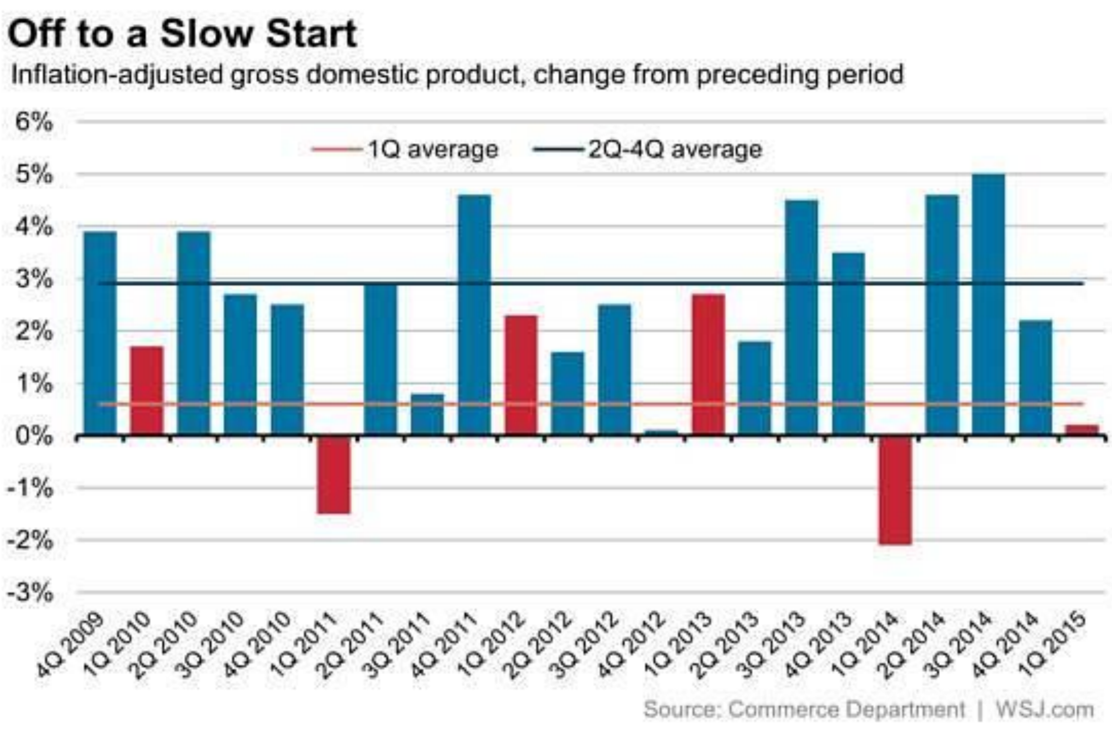
ISI's Terry Haines currently handicaps the odds that the Supreme Court rules against the Government and ACA at just over 50%. In the *Fiscal Policy Report* we translate this to mean that there is a near 50% chance for a sharp spike in policy uncertainty in 2015. The fiscal impulse will only be a slight stimulus in 2015; therefore, the direction of policy uncertainty will likely play the biggest role in determining fiscal policy's impact on the economy over the next year. As a result, we believe that the outcome of King v Burwell is the single most important fiscal policy event in 2015.

Economic Outlook

By Adam Rogers

The consensus as of this writing is that the second estimate of 1Q GDP growth will be revised down from 0.2% to somewhere between -0.7% to -1%. Winter weather, the West Coast port slowdown and weak trade from a strong dollar are being blamed for the decline. Despite this most economists expect the economy will bounce back in 2015 much the same way it did after a weak first quarter of 2014. In fact, since 2010, first quarter GDP has averaged a rate of 0.6% while all other quarters average 2.9%. The trend holds up as you go back. This is due to a phenomenon and current economic hot topic known as "residual seasonality." In a nutshell, "residual seasonality" causes statistical quirks that understate 1st and 4th quarter GDP and overstate 2nd and 3rd quarter GDP. The Commerce department says it is planning a series of steps to smooth this out going forward. Steps include: *Adjust measures of federal government defense services spending, which appear to have lower growth rates in the first and fourth quarter of the year. Start adjusting some inventory investment numbers that don't now account for seasonal factors. Start adjusting some figures from the Census Bureau's quarterly services survey that until now haven't had sufficient time spans for seasonal analysis.* Point being a negative GDP print is disquieting but the decline coming in the first quarter calms our worries. On the following pages we will take a look at some factors that point to a rebound in growth and a few concerns.

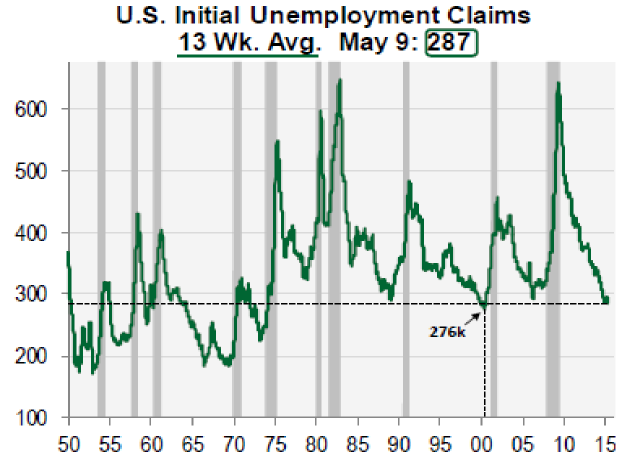
Chart 1:



Employment

Unless you're in the oil and gas industry, employment trends are solid. The four-week moving average for first time unemployment claims stands at 266,250 as of May 16th – the lowest since April 2000.

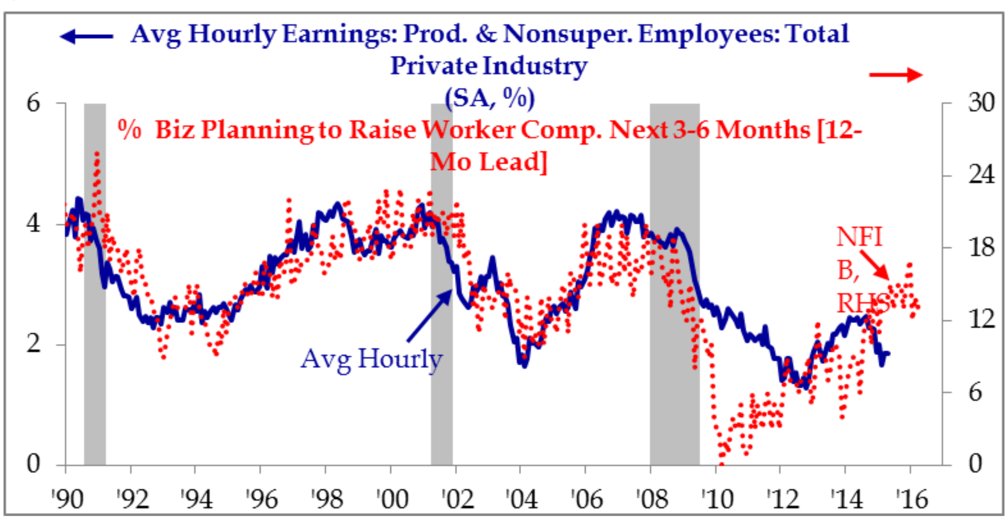
Chart 2:



Source: Cornerstone Macro

The U.S. unemployment rate is down to 5.4%, but wage inflation is still tepid. We still believe wage inflation will lift very soon as historically we've seen average hourly earnings accelerate once the unemployment rate crosses below 5.5%. Keep in mind that during the first quarter, severe winter weather slowed activity in much of the country, the port shutdown on the West Coast created bottlenecks in the supply chain, and the painful element of lower oil prices – decreased investment – took effect while the obviously positive elements for the consumer work with more of a lag. So putting aside all these transitory factors and looking at the labor market specifically we see good trends with room for improvement. The NFIB Small Business Optimism Index is trending positively, a measure which has historically led average hourly earnings by about a year.

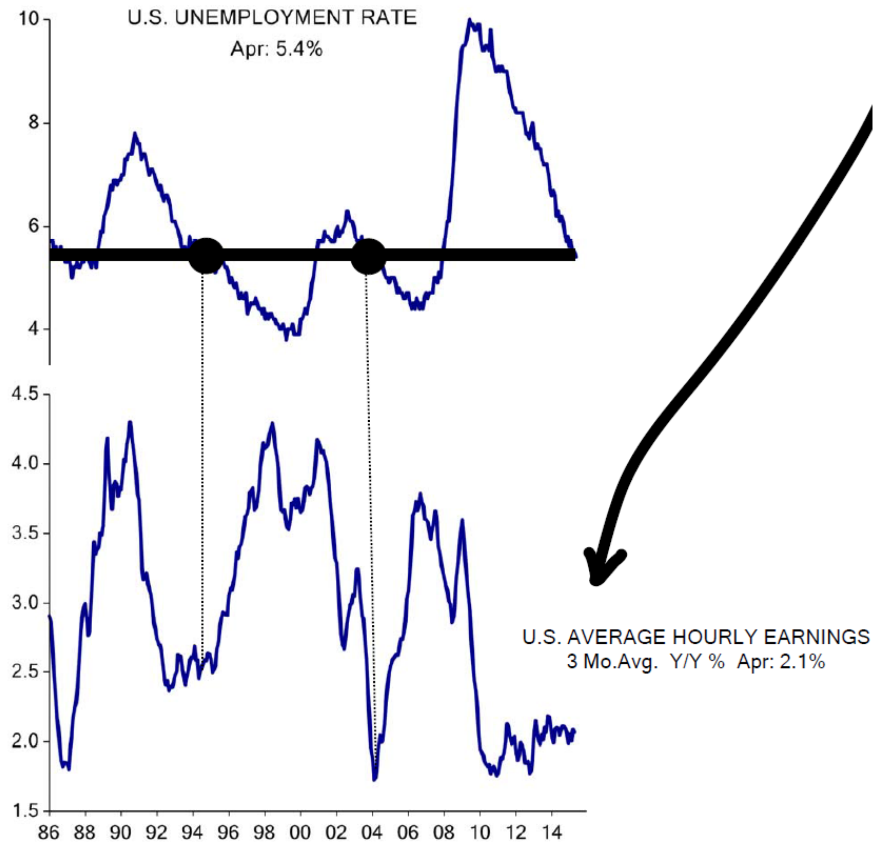
Chart 3:



Source: Strategas

And here we are again at the magic number for unemployment. In 1995 and 2004, average hourly earnings accelerated when the unemployment rate crossed below 5.5%.

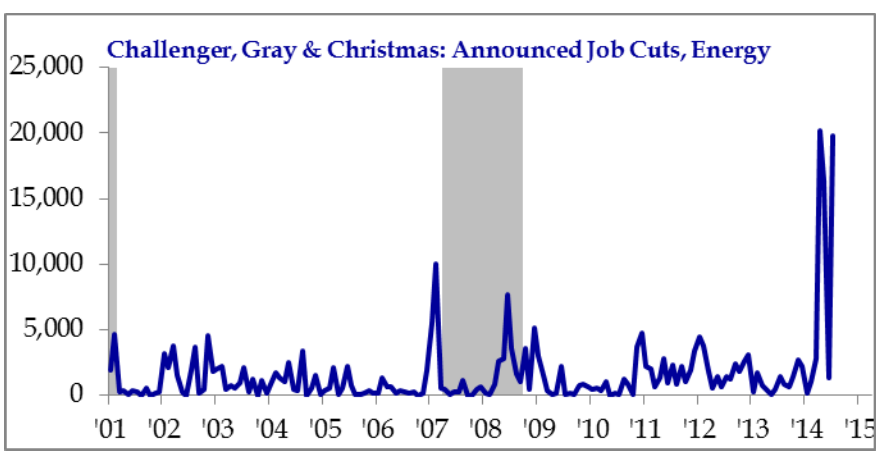
Chart 4:



Source: Evercore ISI

As mentioned, the energy sector has been an exception to the improving employment picture. For the year, the energy sector has planned 57,556 cuts, more than double the second ranked industry.

Chart 5:

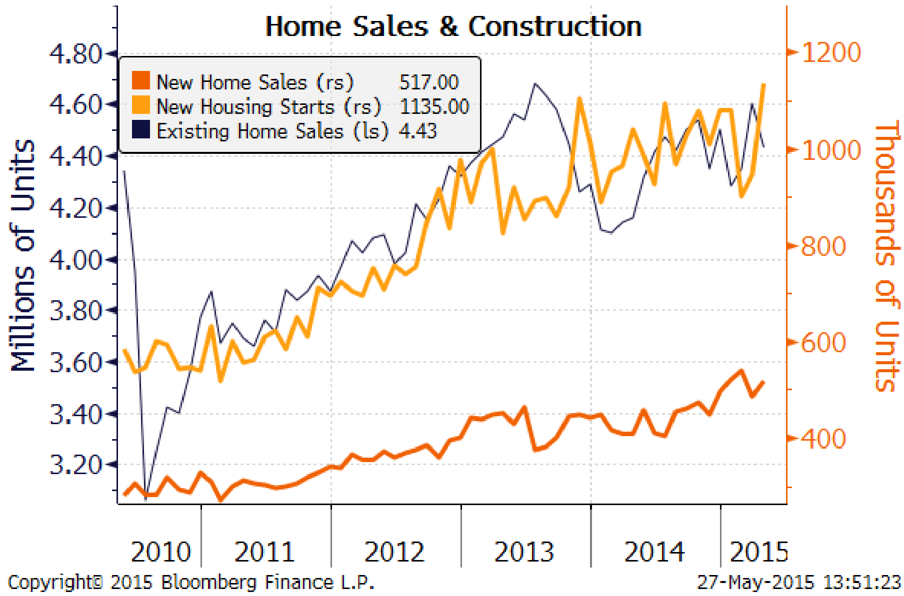


Source: Strategas

Housing:

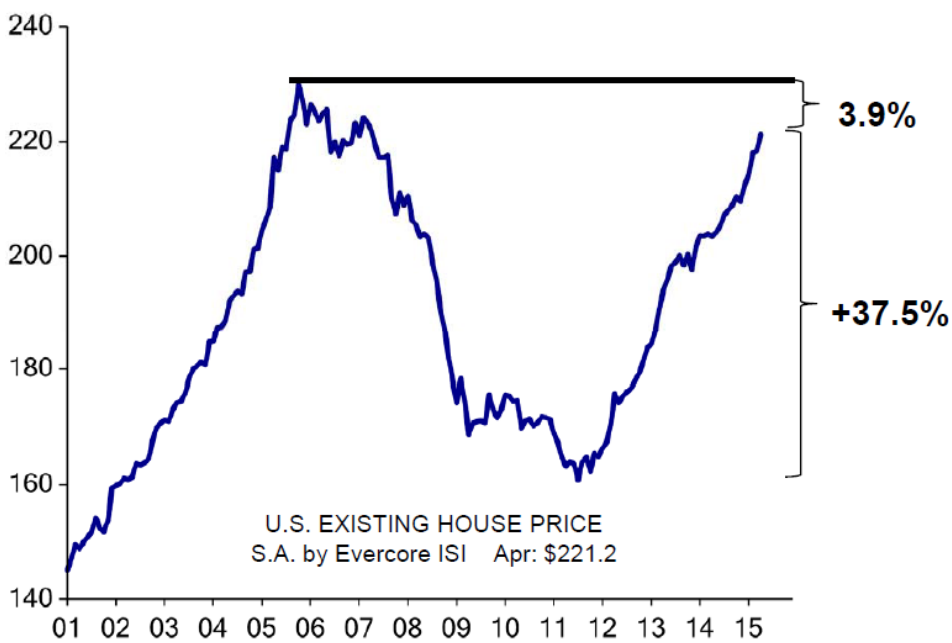
Along with employment, which is a lagging indicator, there are many leading indicators supporting a rebound in growth. In April, housing starts rose 20.2% m/m, much more than expected. Our hope is once wages get off the ground we will begin to see quicker improvement in the housing market. It appears we are beginning to see the first shift in speed in this important part of the economy.

Chart 6:



And while most of us still feel under water, house prices have rebounded significantly.

Chart 7:

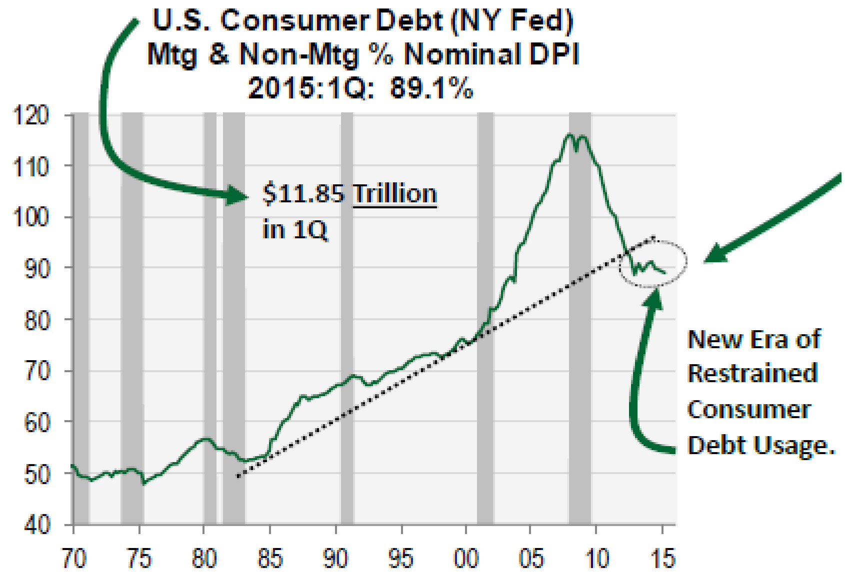


Source: Evercore ISI

Additionally, mortgage rates remain low which provides support for housing; corporate bond yields remain low which supports capital spending; energy prices are low supporting the consumer; headline inflation is low; government spending on healthcare is a tailwind; profits are still rising supporting employment; and the Eurozone is recovering which is supporting trade. This is a solid list of supporting factors for the economy.

A final point to remember is that this entire recovery has been a balance of consumer deleveraging (deflationary) and expansion of the fed balance sheet (inflationary). The recession 7 years ago wasn't just a pause and reset, it was a turning point in the credit cycle. Consumers are borrowing cautiously, saving more, and are much more educated about the cost of debt and while the economy can chug along in this balanced state for a while, real acceleration will probably require the powerful tailwind of consumer credit expansion.

Chart 8:



Source: Cornerstone Macro

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Lance Lachney

On the heels of a strong February payroll number, investors became obsessed with the timing of the Federal Reserve's eventual liftoff during the month of March. After half a decade of zero interest rate policy (ZIRP) and numerous quantitative easing measures, it seemed as though the day or reckoning was nearly upon us. As such, equities and high yield debt were the worst performing asset classes for the month. While investment grade spreads widened at the margin, high grade debt was able to eke out a positive return due to the decline in long term interest rates. Corporate issuance was extremely robust, posting one of the highest monthly supply totals on record. The prospect of higher rates, coupled with the seemingly never-ending appetite for yield, allowed corporate management teams another opportunity to lock in low cost financing before this too good to be true story comes to a close. In Europe however, it seemed the story was just beginning.

The European Central Bank (ECB) began its public sector purchase program during the month of March. The amount of sovereign debt and other secured assets the ECB is absorbing equates to approximately $50 billion on a monthly basis. This program is expected to expire in September 2016, but could be extended until monetary authorities achieve their intended inflation target. This amount of demand meeting limited supply logically suggests rising prices and falling yields for government-like securities. As such, the European sovereign debt market has been an unstoppable force with German 10yr yields touching .07% in mid-April. In fact, yields on German debt all the way out to the 7yr part of the curve were negative during this time. Long-time credible investors began to claim that the European debt rally had become overdone and the German 10yr Bund was the short of a lifetime. The compression of European sovereign yields also kept interest rates at home in check as the treasury market offers global investors higher relative yields and a stable currency.

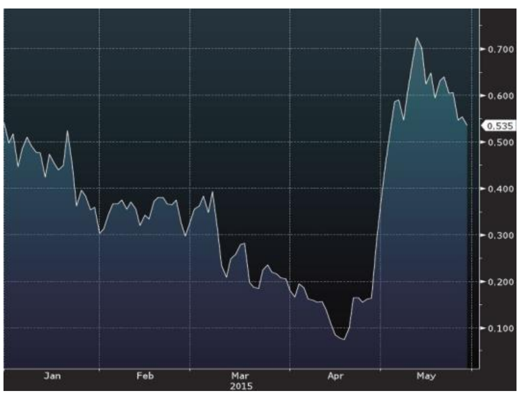
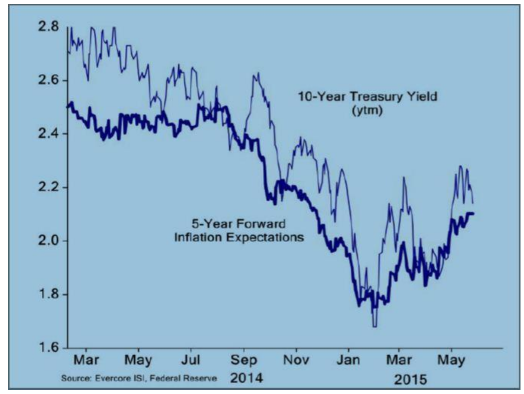


Figure 1: Bloomberg-German 10yr

Referencing the behavior of government securities during QE1 and QE2, yields can rise even as the purchases made by monetary institutions outpace supply. In fact, the main objectives of these programs are to stimulate growth and boost inflation expectations. A slight improvement in the Eurozone economy and an inflation rate without a negative sign attached to it is all it took. In a matter of weeks, German 10yr yields had risen approximately 65 basis points. The treasury market was not immune to the swift unwinding of positions within safe-haven assets. The yield on the long bond continued its march upwards eclipsing 3.00%, an 80bp increase since the beginning of February. High-yield securities were able to reverse course from the previous month and outperform all other sectors within fixed income, largely due to its lower duration profile.

Global sovereign yields continued to move upward during the first couple of weeks in May. Despite the apparent weakness in economic data at home, the gradual steepening trend within treasury and credit markets remained intact. Inflation expectations have moved considerably higher over the last three months as core inflation rose at a 2.6% annualized rate during this time. The market has experienced a brief pullback over the last several trading days. Last week, the European Central Bank relayed its plans to frontload its public sector purchases in the coming weeks to combat potential liquidity issues during the summer months. The uncertain outcome of the negotiations between the Syriza-led government in Greece and its creditors has weighed on the market as well. A solution is needed soon as the country faces a liquidity crunch next month as repayments to the International Monetary Fund of approximately $1.85 billion come due. In response, the yield curve has flattened substantially with the long bond roughly 20bps lower over the last few days.



The fixed income side of the fund has been fairly active over the last several weeks. Within the agency sector, the fund has monetized some large gains in bullets and reinvested that money into higher-yielding callable paper. At the start of this recent run up in rates, the fund advantageously shed some duration within its mortgage portfolio by swapping out of longer-dated pools and into 15yr loans. The underlying theme within the corporate portfolio has been to purchase high quality issues within the intermediate, and in some cases, long end of the curve to take advantage of current market conditions. Given the state of the credit cycle, the fund's investments in names like AT&T, Amgen, Comcast, and JP Morgan will likely remain stable regardless of the future direction in rates. The fund has benefitted relatively speaking from the increase in long term interest rates. That being the case, the addition of a block of 30yr treasuries to the fund's underweight position seemed prudent after a 75bp increase in the last three months.

Going forward, it seems like September remains the most likely lift-off date for the Federal Open Market Committee. I think it is safe to say that a June beginning is off the table. However, some economists have pushed out their estimates into late 2015 and in some cases early next year due to 1Q weakness and uneasiness about current quarter results. However, Chairman Yellen recently stated that the "apparent slowdown was largely the result of a variety of transitory factors." There remains a large discrepancy in the fed funds rate projections over the next 18 months. The market's conclusion is that the federal funds rate will be roughly 1.00% at the end of 2016, while the Fed estimates it to be 1.875%. To be fair, the Fed has notoriously been aggressive in its future growth assumptions over the last few years, only to have them fall below expectations. However, if they are even remotely accurate in this case, there will be a significant adjustment to be made and the pain in the bond market may have just begun.

Domestic Equity Strategy

By Marc Green

With the intent of writing a fresh outlook for the domestic equity strategy, the more digging you do, the more it seems things are the same. The economy has had a growth scare every year following the financial crisis, and in three of the last four we have seen a swoon in GDP in the first calendar quarter. This year was no different, and more so than in others, has caused quite a resetting of earnings expectations. Part of this was obviously due to the steep decline in energy prices, as earnings in that sector were slashed dramatically. Intuitively one would think that would translate to dollars in consumers pockets, and that did occur to a degree. However, consumers used some of this to pay down debt. The other noteable gainer seems to be the tobacco companies. One good thing about a choppy economy is that it keeps expectations in check. After slashing estimates throughout the first quarter, earnings revisions and company guidance both hooked up as earnings were being reported for the 1st quarter. The following two charts provided by Citigroup depict the upswing that has recently occurred.

<u>Chart 1</u>

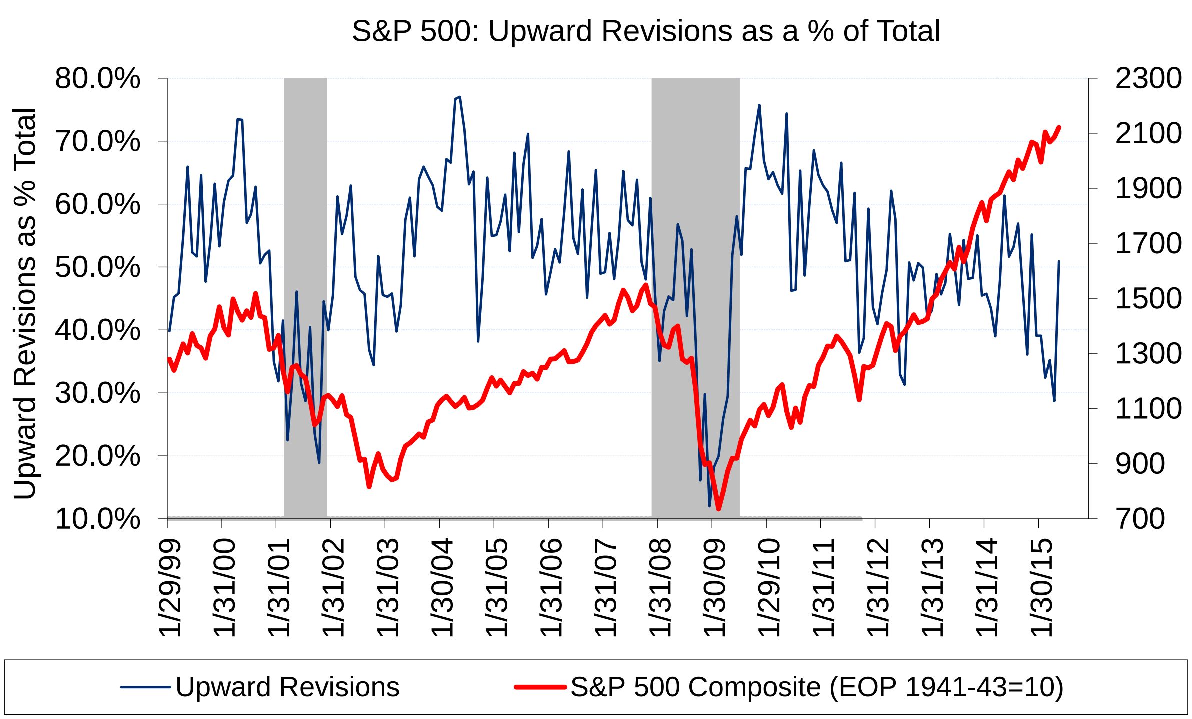
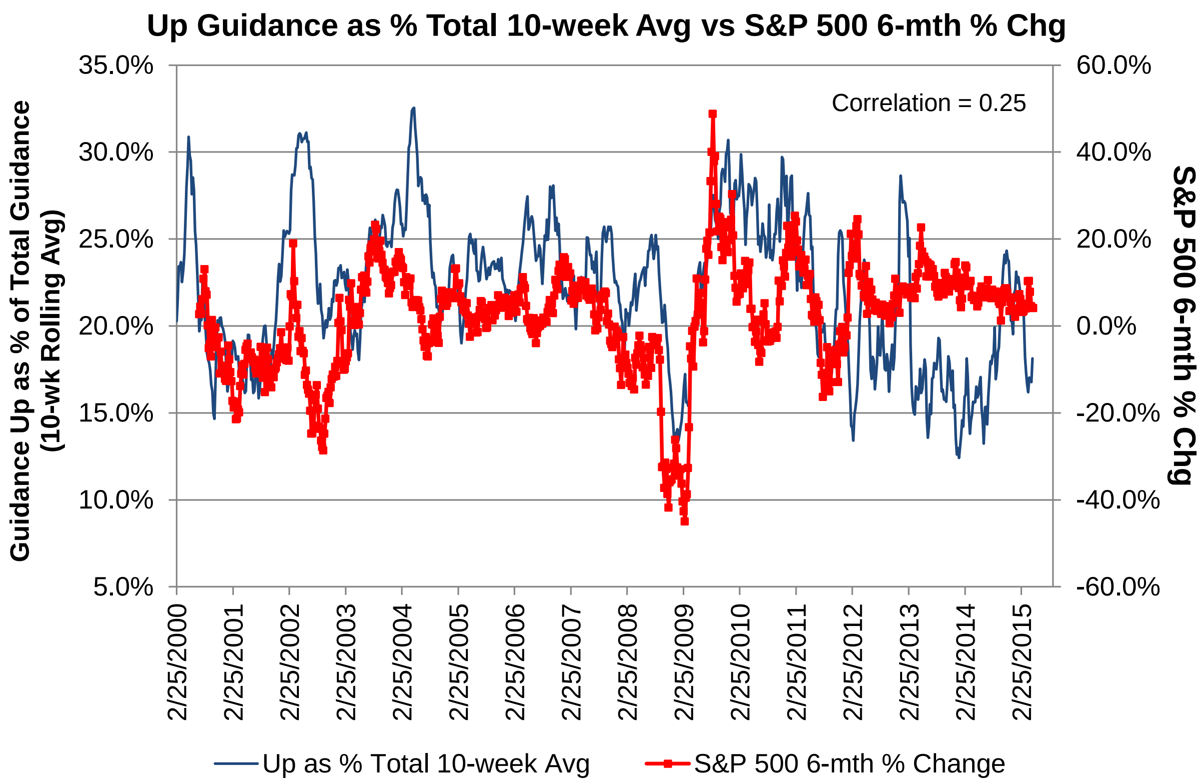


Chart 2

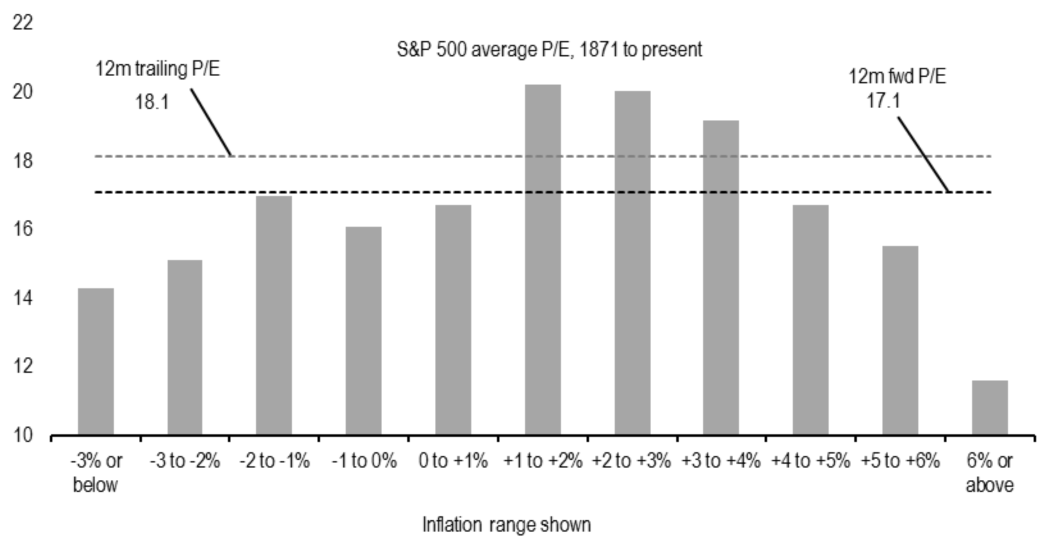


The real significance of this is that there has been a strong correlation between earnings revisions and the direction of the market. With the idea that we have had an earnings reset and both revisions and guidance have turned up, we would expect that the markets will follow. As we mentioned previously, it is not just a U.S. phenomenon but a global one, as estimate revisions are moving up in both developed markets in Europe and Asia, as well as some emerging markets, thought to a lesser degree. With the dollar rally that we have seen over the past 3 quarters, a pause seems likely. This should help U.S. multinationals both competitively and with foreign currency translation. The analyst consensus predicts that we should see further dollar strengthening as foreign central banks continue on the path of QE, but the pace and size of the move experienced thus far argues for at least some sideways action in the dollar.

Having seemingly survived another growth scare, it seems that the near term trajectory for earnings is up. This is not to make the case of simple mean reversion, but it seems the table is set for a rebound in the economy. We are still in a global central bank stimulus environment, although the U.S. is about to slowly reverse course. Interest rates are still low relative to history, and commodity prices are down. We are on the front end of a pickup in wage growth. We think that this early in the cycle some wage inflation should be viewed as healthy. Some wage inflation obviously boosts consumer health, as well as alleviates some of the socio-economic issues that have been dogging the recovery (Wall Street vs. Main Street). We are, it seems, a long ways away from a wage price spiral.

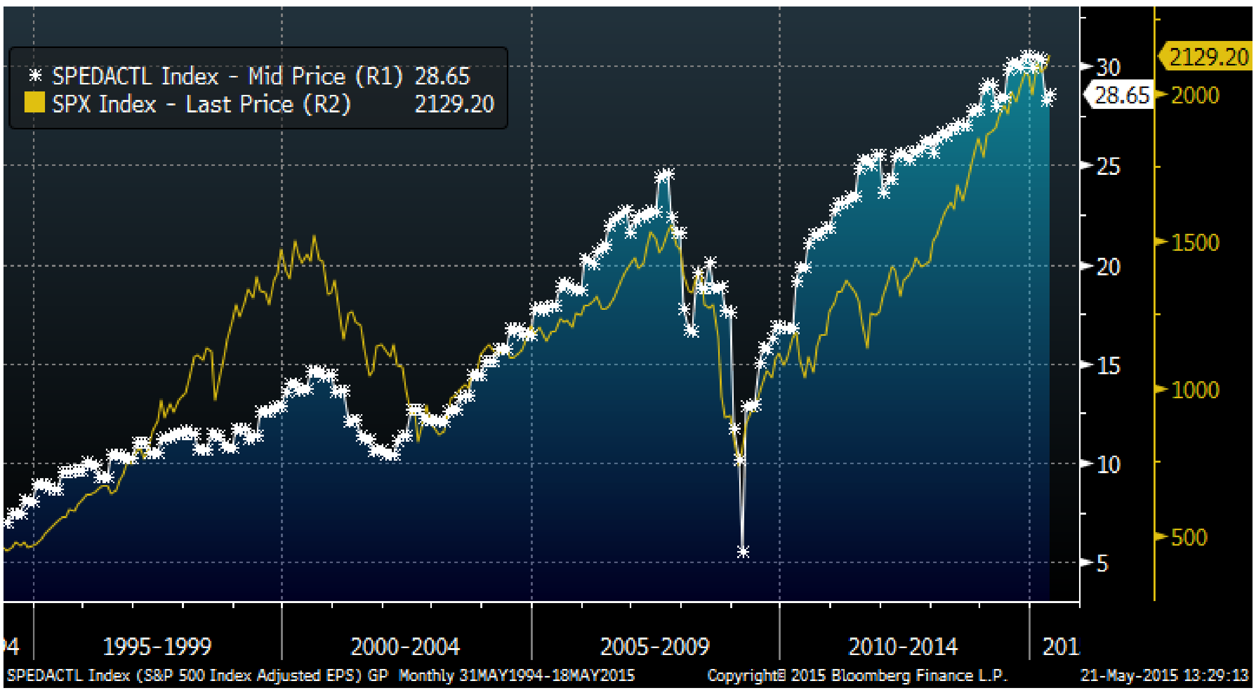
Another issue that continues to be problematic is valuation. We agree that you can not make the argument that the market is cheap. However, the same set of drivers that have propelled the market the past few years are still in place. Corporations are generating ample cash flow to drive increases in dividends and buybacks, margins are still at elevated levels with little sign of a pullback, and corporate management is still operating somewhat cautiously given the fits and starts nature of the economy over the past 6 years. It is hard to find any CEO, and as far as that goes, many investors who are overly bullish. Although valuations have moved up to a historically expensive level, the underlying drivers of valuation argue that it is justified. One also has to remember that just because a stock or market is either cheap or expensive doesn't necessarily mean that it can't get more cheap or expensive. Global interest rates are still very low, and inflation remains in check. The following chart provided by RBC shows the average market price-to-earnings ratio relative to inflation rates over the past 144 years. Given that the global economy has been in a deflation battle since the great recession, and we are still fighting to get back to levels deemed to be "good" or target rates of inflation, we see the markets as remaining in the sweet spot for sustained higher valuations.

Chart 3



We continue to go back to the idea that the market is ultimately driven by expectations for earnings and interest rates. As we have laid out, we don't see an earnings recession in the near future. Although it is hard to predict exogenous shocks such as a geopolitical conflict, currency wars, or some other black swan type event, we think the market is worried enough about headline risk as represented by the high equity risk premium still baked in the market. Many talking heads espouse about the imminent rate rise coming this year as the likely nail in the coffin for the U.S. bull market, but we think that concern has been largely discounted. Unless the Fed really accelerates rates at the short end of the curve, it seems there is room for the long end of the curve to move up without drastically changing the landscape for equities. It also seems that much of that is priced in, and a rate rise would be very helpful to the earnings of the financial sector. Fund flows also show that investors as a whole are still cautious, as money continues to flow out of stock funds and ETF's and into bonds. We also continue to see share shrinkage of 2.5-3% annually, which amounts to over $2 trillion (net of new issuance) of buybacks over the past 10 years. The punchline is that there really isn't a contrarian call to make at this point as we see it. As long as we don't experience an earnings recession in the near future, we think the slow grind that we have experienced the past several quarters continues on. The following Bloomberg chart overlays quarterly earnings vs. the S&P 500, and you can see the strong correlation. If earnings continue to grind higher, we expect the market to follow suit.

Chart 4

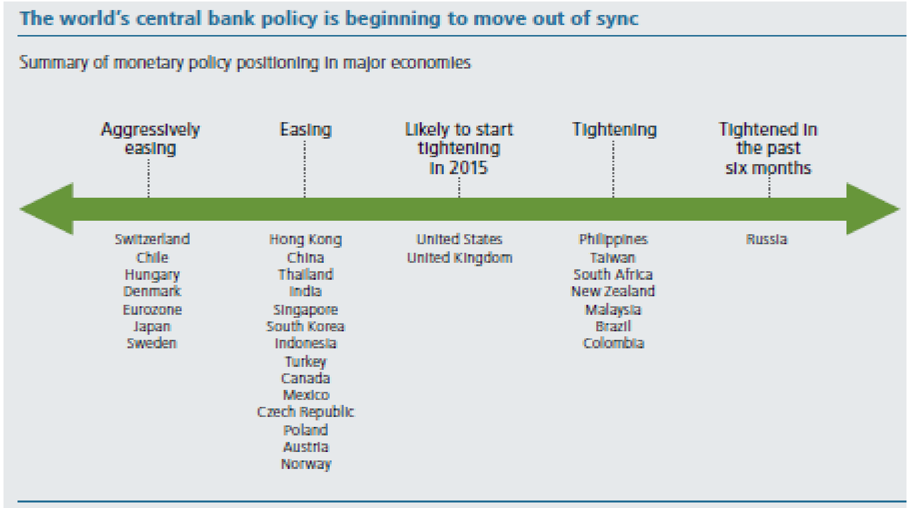


As for activity at the RSA, we have continued to remain at the upper end of our range in equities. We had talked about moving money overseas last year, and did add a small amount to emerging markets. The sharp rally in international stocks in the first calendar quarter somewhat caught us by surprise, and we think that those markets have some valuation digestion to do before meaningfully advancing further. We have continued to overweight large and mid capitalization stocks vs. small, and that has worked. We have also put on a small amount of protection by selling some S&P 500 and buying some equity linked notes that have a small amount of downside protection, while allowing for leveraged returns in the event the market only moves at a single digit level by year end. With time premium getting compressed, and volatility still low, pricing is not very favorable in the options market for putting on protection.

International Equity Strategy

By Steve Lambdin

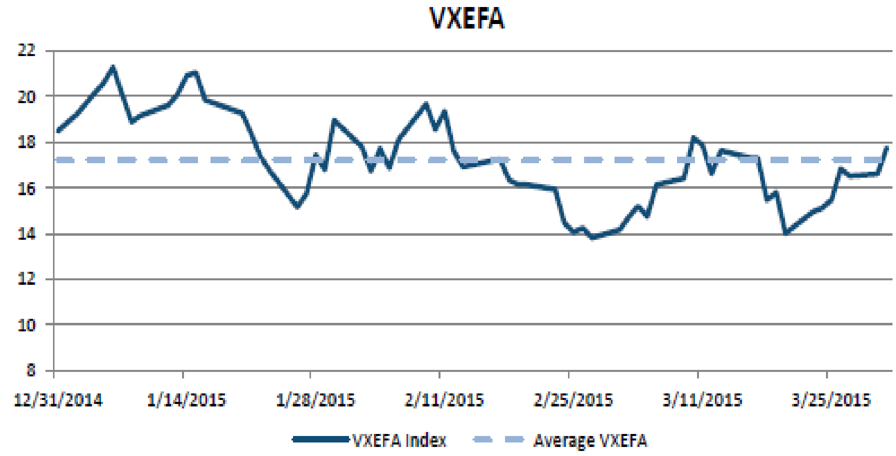
International equities reversed course from the previous quarter and started 2015 out very strong as the Eurozone markets led the way. The European Central Bank (ECB) stole the show as its quantitative easing program pushed interest rates to historic lows and provided needed confidence to equity investors. The German, French, and Italian equity markets anchored European equities as growth prospects began to pick up. Underlying business trends continued to grow more solid by each passing month as low interest rates and cheap oil seemed to underpin some type of recovery in the region. The euro continued to fall versus the U.S. dollar which is proving to be beneficial for exporters across the region. In addition, unemployment seemed a bit better on the margin and deflation concerns seemed to ease slightly late in the quarter. These points of good news overshadowed the news coming out of Greece, as fears of a Greek exit from the euro grew by each day. How this situation is ultimately resolved still remains a mystery. During the first quarter, Japanese equities were quite strong as the economy posted growth in the quarter after two straight periods of contraction. The weak yen has no doubt provided a nice boost to the region as corporate earnings look solid. This has also led to a wave of shareholder activism and better corporate governance, which should be beneficial for equity holders over time. These actions seem to have the blessing of the Japanese leadership after being frowned upon for so many years. As far as conditions in China, growth continues to match the pace set by government officials, which comes with little surprise. Concerns over the property markets remain widespread, as the government tries to soften the impact to the economy from these concerns. Conditions on the geo-political front seemed to have eased just slightly over the quarter as the Russian/Ukraine crisis continues to be in negotiation and progress is being made against the terror group known as ISIS. Also, the U.S. and Cuba are moving rapidly toward some level of formal diplomatic relations after over 50 years of isolation from the U.S. This seems to be a positive development with some level of small benefits down the road. As we move into mid-2015, we are looking at a healthier global economy overall, which should be beneficial for many equity markets around the globe.



Source: Ned Davis Research Group, Manulife Asset Management, John Hancock Investments

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +4.88% and +2.24%, respectively, during the first quarter of 2015 vs. +.95% for the S&P 500 Index. Growth prospects picked up for regions outside of the U.S. during the quarter which helped fuel the rally in many of the international equity markets. As has been the case over the last few quarters, the U.S. Dollar Index was stronger as the U.S. dollar rose +11.6% against the euro, +5.0% against the British pound, but was virtually flat against the Japanese yen. Even though currency movements continued to be a detractor of returns for unhedged U.S. investors, we find it impressive that returns were still positive even taking this into consideration. For the third straight quarter, the Pacific region was a bit stronger than the European region as the Japanese market was very strong during the quarter. From an economic sector standpoint, health care and consumer discretionary stocks were relatively stronger, while energy and utilities were the weakest. Crude oil continued its descent, falling -11% in the quarter as this continued to play havoc for the energy sector.

So far into the second quarter of 2015, global equity markets continue to move higher and seem to be the preferred place for global investors. Most equity markets remain at or near record high levels. Central Bank stimulus continues to be the main driver of returns as these actions are leading to strengthening economic data points. At present, there seems to be little uncertainty surrounding central bank policies, as the European Central Bank (ECB), Bank of Japan (BOJ), and the People's Bank of China (PBOC) are all in aggressive easing mode and investors seem happy. Commodity prices and inflation remain rather low, which should be good news for consumer confidence and spending. The outlook for the global equity markets seems reasonable good at the moment, even as volatility could pick up from profit taking and rebalancing by investors.



Source: Gateway Investment Advisors, Natixis Funds

Asia Update

Once again, the MSCI Pacific region was the best performing region in the MSCI EAFE Index during the first quarter of 2015, up +7.6% in USD. The Japanese equity market was once again the star performer in the period as this market was up +10.2% in USD. However, unlike the previous quarter, these gains were not taken away by currency movements as the U.S. dollar was very stable verse the yen in the quarter. Continued heavy buying of equities by the government pension fund seems to be providing a nice floor for equities in this market. In addition, we have witnessed a lot of progress from shareholder friendly activities such as dividend increases and share buybacks, which are being welcomed by investors and government officials alike. Chinese equities were strong once again in the first quarter, as continued monetary stimulus seems to be giving life to the equity markets here. Growth expectations also seem to be managed right in line with most investors' thoughts, thus providing little in the way of downside expectations. Australian equities did manage to post a gain in the quarter which was probably due to more of a technical bounce rather than any clear catalyst that developed, as this market still seems out of favor at the moment. At this point, Asian equities look fairly solid as most investors like the developments in Japan and the recent stimulus actions by the BOJ. This should be a supportive backdrop for a good equity climate going forward.

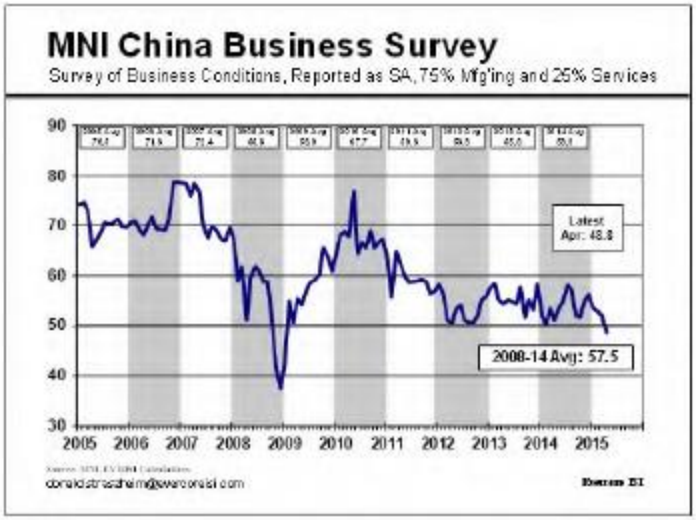
Market Performance

Data as of: 31-Mar-2015

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Japan	1.53	10.21	10.21
MSCI Philippines	1.30	9.90	9.90
MSCI China	2.41	8.12	8.12
MSCI Pacific	0.51	7.61	7.61
MSCI Hong Kong	0.92	6.00	6.00
MSCI Taiwan	-0.75	3.95	3.95
MSCI Australia	-2.49	3.09	3.09
MSCI Singapore	0.20	-1.91	-1.91

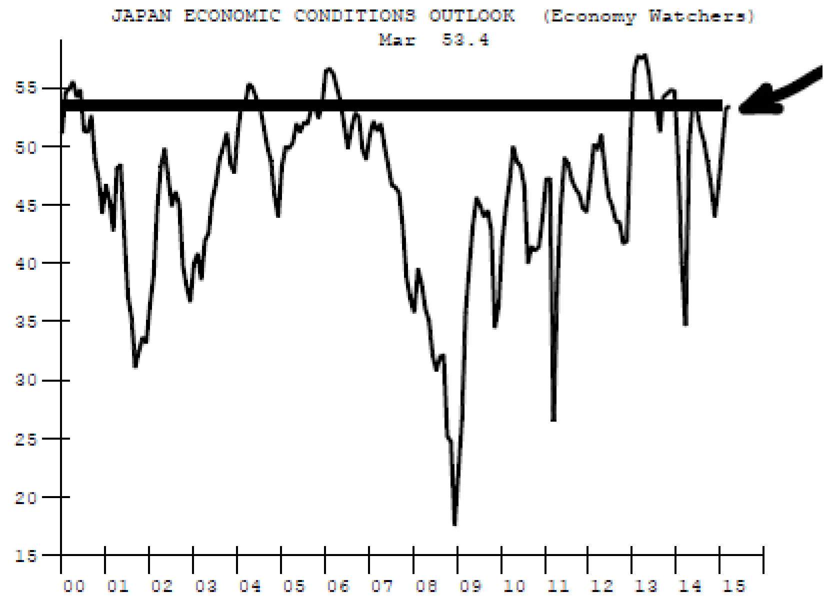
Source: Factset

The Chinese economy continued down its path of producing a slower growth rate in the first quarter of 2015. Gross Domestic Product (GDP) in China rose +7.0% from the year earlier period, which matched the government's official target for 2015. Even though this was right in line with government projections, it is still the slowest rate of growth since 2009. The leadership here continues to slow down growth in an effort to attack debt problems which are rampant across the country. Premier Li Keqiang's government continues to inject stimulus into the economy as home buying rules have been relaxed, interest rates continue to be cut, and reserve requirements by banks have been lowered. Officials here continue their efforts to transition toward an economy which is more domestic driven as services account for 52% of the economy, outpacing manufacturing by nearly 9%. We still expect this trend to continue over the long term. Industrial production rose +6.4% in first quarter of 2015, however, the pace of expansion was notably weaker in March. This puts industrial production growth at the weakest rate in recent memory and could weaken further over the coming months. Fixed asset investment growth continues to shrink and was reported up +13.5% during the first quarter. This is a direct result of slower spending in real estate and manufacturing facilities. Exports continue to slide as well and grew by only +5.0% year over year in the first quarter. This reflects some lost competitiveness from a stronger currency and a bit of unexpected weakness from the U.S. economy during the period. Retail sales continue to move southward, as first quarter sales were reported up +10.6%, reflecting issues over wage growth as well as overall falling wealth levels. Inflation continues to fall in this economy as consumer prices only rose +1.4% in March, reflecting what we see across most major economic regions of the world. Commodity and energy prices are the main issues here as this gives the opportunity for policy makers to argue for more sweeping stimulus measures. As we look out over the next few months, we see downside risk to this economy as many March data points were the weakest of the first quarter. With this in mind, official growth targets for 2015 could be at risk. However, officials here have a lot of room for policy actions which could reinvigorate growth here. With this in mind, we believe in the soft landing scenario in China.



Source: Evercore/ISI

The Japanese economy continues to move away from the short-lived recession of mid 2014 as GDP in the Japanese economy grew by +2.4% in the first quarter of 2015 from the year earlier period. However, this was on the heels of a reduction in the rate of growth from the previous quarter. While corporations continue to benefit from a weak yen, consumer demand has struggled as the costs of imports continue to rise. Policy makers are playing a delicate game as they try to keep the momentum going in this economy. Inventories made a slightly larger than expected contribution to GDP growth in the first quarter, so we could see some giveback in the second quarter. Exports continue to impress and were generally healthy in the quarter. The weakened yen has really helped on this front. We continue to expect the BOJ's quantitative easing to continue over the near term, but the benefits of this will probably be more muted going forward than at the beginning of the program. Industrial production continues to struggle and was reported down year over year for each month in the first quarter. We should see some marginal improvement in this indicator in the second quarter, but not to a great degree. Small business confidence improved from the low levels in early 2015 and was reported at 49.8 in March and 47.4 in April. Improvement here is key to a sustainable economic outlook. Consumer confidence has been trending up in the first quarter and was reported at 41.5 in April, which is well above the levels of late 2014. Perhaps this is a sign that consumers feel overall conditions are beginning to improve. Government officials need to see this move higher to solidify the ongoing recovery. Core prices rose only +.7% in April from the year earlier, which is a little concerning as this has stoked fresh concerns about the potential for deflation to redevelop in this economy. However, we see most of this stemming from the drastic fall in crude oil prices. This will certainly be watched very closely going forward to see if this is the case. The labor market continues to be very steady as we have seen very little movement in key statistical measures with this data point. The March unemployment rate was reported at 3.4% and the jobs-to-applicant ratio remained at 1.15. These are both very solid at this juncture in the recovery. Wages are beginning to increase as companies such as Toyota, Nissan, and Hitachi have all increased base pay at rates not seen in a long time. As long as Abenomics continue, we would expect the economy here to continue to grow and this should be good for the equity markets as a weak yen, rising wages, and decent valuations give investors some level of confidence. However, many feel the easy gains have been made and the road from here becomes a bit harder. We will see.



Source: Evercore ISI

Europe Update

The ECB's 1.1 trillion euro quantitative easing program seems to have been just what investors ordered in the first quarter of 2015. This drove up equity markets across the region, especially in Germany and Italy. As mentioned earlier, the euro responded by falling over 11% versus the U.S. dollar during the first quarter. We have not seen this level of the euro in over ten years. Many feel the timing of this was perfect, as energy prices are falling and already low interest rates are underpinning the Eurozone economic recovery. Business trends seem to be improving as does the employment situation, which is welcome news for this region. This has led to economic growth projections being raised, not lowered, which is a new phenomenon for the region. However, there are still areas of concern within the Eurozone. First, the Greek situation remains a mess as "bailouts" seem to be coming on a fairly regular basis. One has to wonder how many new programs will be required in the coming months and years to move this country back on a path to prosperity. But our base case is that Greece remains in the Eurozone and new programs aimed at helping Greece continue to be put in place over the near to medium term. Also, deflation concerns still circulate around this economy. However, we see this as becoming a little bit less of an issue as growth prospects begin to pick up. But this is still an issue to continue to monitor.

The MSCI European Index (ex. U.K.) posted a gain of +5.5% in USD for the first quarter. This gain would have even been larger had it not been for the movement of the euro in the period. Investors remain attracted to the region as the quantitative program seems to be providing a measure of safety at this point. The key will be if the consumer can respond at some point, just as most companies have from a weak euro. As a result of recent equity market movements, valuations are not nearly as attractive as they once were, so many feel the easy gains may have been had. But taking valuation alone can give the wrong signal with equity markets many times.

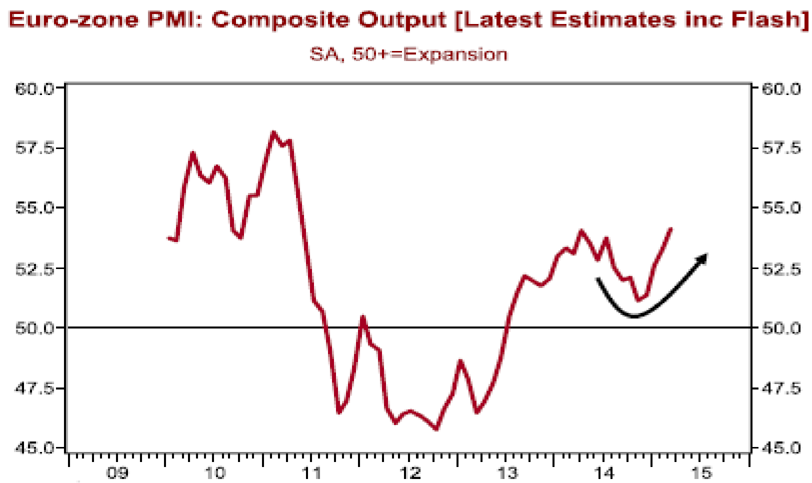
Market Performance

Data as of: 31-Mar-2015

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Germany	0.31	8.28	8.28
MSCI Italy	-1.43	6.84	6.84
MSCI Europe ex UK	-1.20	5.50	5.50
MSCI Netherlands	-1.76	4.91	4.91
MSCI Switzerland	-0.52	4.74	4.74
MSCI France	-2.43	4.70	4.70
MSCI Spain	-0.83	-0.57	-0.57
MSCI United Kingdom	-5.85	-0.96	-0.96

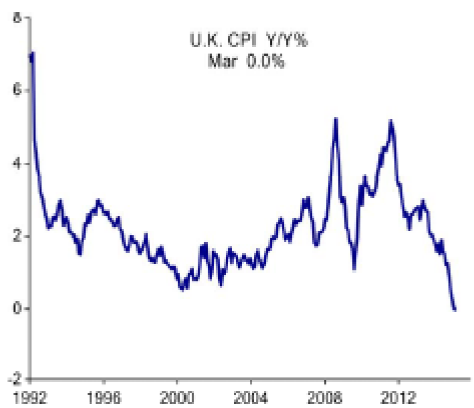
Source: Factset

The Eurozone economy continues its slow growth trajectory as lower crude oil, a weaker euro, and an aggressive central bank were enough catalysts to keep things going in the right direction. First quarter GDP rose +.4% from the previous quarter, or +1.0% from the year earlier period. The French and Spanish economies provided the bulk of the upside surprise, while the German economy was a bit weaker on margin than many had expected. We see this as a good sign as the economy in Germany does not always have to be the single driver of growth in the Eurozone. The French economy expanded at the fastest pace in two years and the Spanish economy posted its best growth in nearly seven years. In addition, the Italian economy posted its first growth in nearly a year. We see this as good evidence of the progress being made across the region from past stimulus actions. With this first quarter print in GDP, most analysts have increased their respective GDP growth estimates for 2015. Perhaps we are finally on the path to sustained growth after the best start since 2011. We believe the export side of the economy remained in good shape in the quarter and domestic consumption may have finally arrived once we get these statistics in early June. Industrial production continued its weak path in the first quarter and was up +1.9% in March from the year earlier period. This was a little weaker than many had expected as German industrial production was surprisingly weak in the first quarter. The index of executive and consumer sentiment continues to rise, reaching 103.7 in April, and the highest level in over a year. This is just another sign of the recovery going on across the Eurozone. Retail sales continue to struggle and fell -.8% in March from the previous month, but did rise +1.6% from the year ago period. Obviously, the consumer continues to have its doubts over the recovery that so far has been business driven. Consumer prices did record an increase in April from the previous month for the first time in four months, rising +.2%. Again, the significant fall in energy prices is still keeping a lid on any inflation across the region at present. The employment trends made some small improvement recently. The March unemployment rate was reported at 11.3%, just a bit better than a few months earlier. Obviously, this is key if we are to see any material improvement in this region's economy. In addition, interest rates remain at record lows after the ECB's April meeting as we expect this to be the case for well into the future.



Source: Markit and Strategas

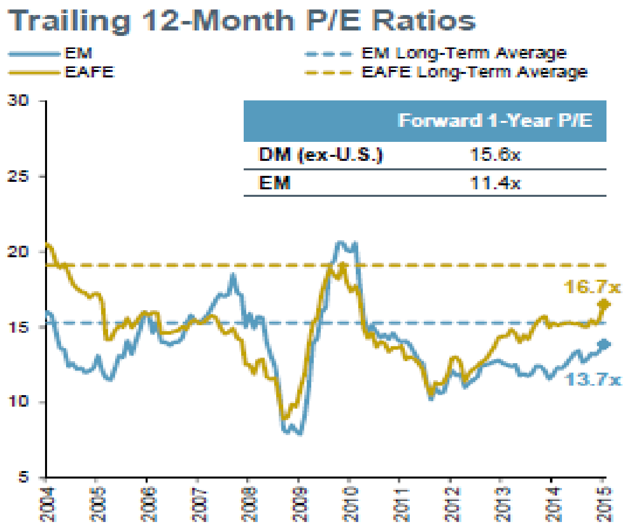
The gradual slowdown of the U.K economy continued in the first quarter of 2015, catching many by surprise. GDP grew by +.3% in the quarter from the previous quarter, or +2.4% from the year earlier period. This was the weakest rate of expansion in over two years. The business services sector, which is the largest part of the economy, did manage to grow +.4% from the previous quarter, even though this is certainly a loss of momentum with this sector. The other parts of the economy seemed to have stalled out in the quarter. Industrial production did manage to rebound in March to the highest levels in six months from very weak readings in January and February as manufacturing output rose. At this point, it is too early to know whether the recent rebound in industrial production is sustainable or not. Retail sales still look decent, rising +1.2% in April from the previous month, or +4.7% from the year earlier. Clothing and footwear sales were very strong as consumers took advantage of warm weather conditions to get out and spend. This was the biggest monthly gain in three years. Inflation continues to be non-existent in this economy as has been the case in most other parts of the globe lately. April CPI was up +.2% from a month earlier, or -.1% on a year over year basis. Again, the main issue here was falling energy prices, as core CPI continues to register year over year gains, though at a small pace. We are not too concerned about CPI as long as the weakness comes from falling energy prices and does not spread beyond this. At its early May meeting, the Monetary Policy Committee (MPC) opted to keep interest rates at a record low of .50% and its bond purchase target remained at 375 billion pounds. Though we feel we are moving closer to higher interest rates in this economy, the MPC still believes there is no immediate need to raise short term interest rates. Our best guess for higher interest rates still remains somewhere in late summer or early fall. The employment situation continued its trend of better readings as the unemployment rate fell to 5.5% in the three month period through March, which is the lowest rate in seven years. Employment rose by 202,000 in the three month period ending in March, to yet another record of 31.1 million. Wage growth is starting to move higher, rising to the +2.2% level on a year over year basis. We continue to believe as the unemployment rate continues to move lower, we will see wage growth pickup from here. This will probably usher in higher interest rates as well. The U.K. economy seems to be a bit weaker lately relative to most expectations, but certainly not to a problematic level by any means. We could see the equity markets become more volatile over the summer as we move closer to higher interest rates in this economy. A degree of caution should be the case as this unfolds.



Source: Evercore/ISI

Emerging Markets

Emerging market equities have finally given investors something to smile about. For the first time in three quarters, these equities produced a gain that outpaced large cap U.S. stocks. There was a wide variation in returns between countries as divergence is about as large as we have seen. Countries that have a “self-help” type focus and theme seem to be much more in favor with investors. On the other side of the card, countries that are dependent to a commodity cycle continue to be shunned by the investment community. The MSCI EM Index (net) rose +2.24% in U.S. dollar terms in the first quarter of 2015. Chinese equities continued their recent trend, rising +7.9% as interest rate cuts and other stimulative actions were well received by investors. Russian equities rebounded from an easing of tensions with Ukraine as well as some stability in oil prices. However, Brazil continues to struggle as fresh concerns over its economy remain as corruption and scandals seem to be dominating the news flow in this region. We continue to have a positive bias toward countries that are growing more of a consumer focus rather than a commodity focus. However, while the movement of the U.S. dollar is producing some pain for U.S. investors, we do feel over time this movement will support export growth from the emerging markets to the U.S. and Europe.



Source: Fidelity Investments

<u>International Equity Activity/Strategy</u>

Overall, we remain relatively constructive on the global equity markets as we enter the middle part of 2015. However, this does not mean we are not concerned about a few issues. Investing in a climate where global equity valuations are at their highest levels in a few years, constant geopolitical risks, and the risk from potential central bank policy errors can make for some restless nights. However, when we add up the so called “scorecard,” we still like the potential that global equities have over the near to medium term. It’s hard to fight the central banks around the globe. The growth outlook in the Eurozone economy has actually improved in our opinion since our last update, as this can have broad ramifications for overall global growth. Some of the leading economic indicators in the Eurozone economy are pointing to strengthening growth, leading to increased growth forecasts for the region. On the other side of the globe, Abenomics continues to work in Japan, as growth targets here are being raised and deflation is being replaced with a low level of inflation. China should continue to hit its reduced expectations, which should bring a bit of comfort to investors. After the route of the U.S. dollar over the last year, the U.S. dollar looks somewhat steady at the present time, perhaps an indication that investors see some stability over the short term. Corporate M&A and activism seem to be very much alive. This coupled with rising earnings expectations in many parts of the world should make for a robust equity market climate for both U.S. and global equities.

We still continue to sell put options on emerging markets ETF in an effort to buy some exposure into the emerging markets index if the market turns a bit. Premiums for doing this still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.50% of total assets and approximately 11.8% for MSCI EAFE equities. *(Charts provided by Fidelity Investments, Markit, Strategas, Factset, Gateway Investment Advisors, Natixix Funds, Ned Davis Research Group, Manulife Asset Management, John Hancock Investments, Evercore ISI)*