Quarterly Economic Update

August 26, 2014

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

The Federal Open Market Committee (FOMC) most recently met June 17-18th and July 29-30th leaving the federal funds target rate unchanged again and continuing to steadily taper their securities purchases. The target range for the federal funds rate remains at 0 to ¼ percent. As of the July 29-30th meeting, the FOMC is adding to their holdings of longer term Treasury securities at a pace of $15 billion per month and of agency mortgage-backed securities at a pace of $10 billion per month. Communications through the FOMC statements have remained similar with little change to signal a significant shift in policy or outlook. The July 30th statement dropped language around their labor market assessment that the unemployment rate "remains elevated," which seems logical given its continued decline. This was replaced with the Committee's lingering concern that although the unemployment rate is coming down, "a range of labor market indicators suggests that there remains significant underutilization of labor resources." The July 30th statement also expressed the Committee's reduced concern around stubbornly low near-term inflation readings stating "Inflation has moved somewhat closer to the Committee's longer-run objective" and "the likelihood of inflation running persistently below 2 percent has diminished somewhat."

The June 17-18th meeting included an updated Summary of Economic Projections submitted by FOMC meeting participants. Overall, June projections did not differ significantly from March projections with only slight adjustments to most central tendency numbers. GDP projections were reduced for the full 2014 year due to the weak first quarter, but 2015 and 2016 projections did not change and were expected to run above longer run projections. Unemployment rate projections did move down across the board indicating FOMC participants' improving outlook for labor markets.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, June 2014
Percent

Variable	Central tendency[1]				Range[2]			
	2014	2015	2016	Longer run	2014	2015	2016	Longer run
Change in real GDP	2.1 to 2.3	3.0 to 3.2	2.5 to 3.0	2.1 to 2.3	1.9 to 2.4	2.2 to 3.6	2.2 to 3.2	1.8 to 2.5
March projection	2.8 to 3.0	3.0 to 3.2	2.5 to 3.0	2.2 to 2.3	2.1 to 3.0	2.2 to 3.5	2.2 to 3.4	1.8 to 2.4
Unemployment rate	6.0 to 6.1	5.4 to 5.7	5.1 to 5.5	5.2 to 5.5	5.8 to 6.2	5.2 to 5.9	5.0 to 5.6	5.0 to 6.0
March projection	6.1 to 6.3	5.6 to 5.9	5.2 to 5.6	5.2 to 5.6	6.0 to 6.5	5.4 to 5.9	5.1 to 5.8	5.2 to 6.0
PCE inflation	1.5 to 1.7	1.5 to 2.0	1.6 to 2.0	2.0	1.4 to 2.0	1.4 to 2.4	1.5 to 2.0	2.0
March projection	1.5 to 1.6	1.5 to 2.0	1.7 to 2.0	2.0	1.3 to 1.8	1.5 to 2.4	1.6 to 2.0	2.0
Core PCE inflation[3]	1.5 to 1.6	1.6 to 2.0	1.7 to 2.0		1.4 to 1.8	1.5 to 2.4	1.6 to 2.0	
March projection	1.4 to 1.6	1.7 to 2.0	1.8 to 2.0		1.3 to 1.8	1.5 to 2.4	1.6 to 2.0	

NOTE: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The March projections were made in conjunction with the meeting of the Federal Open Market Committee on March 18–19, 2014.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation are not collected.

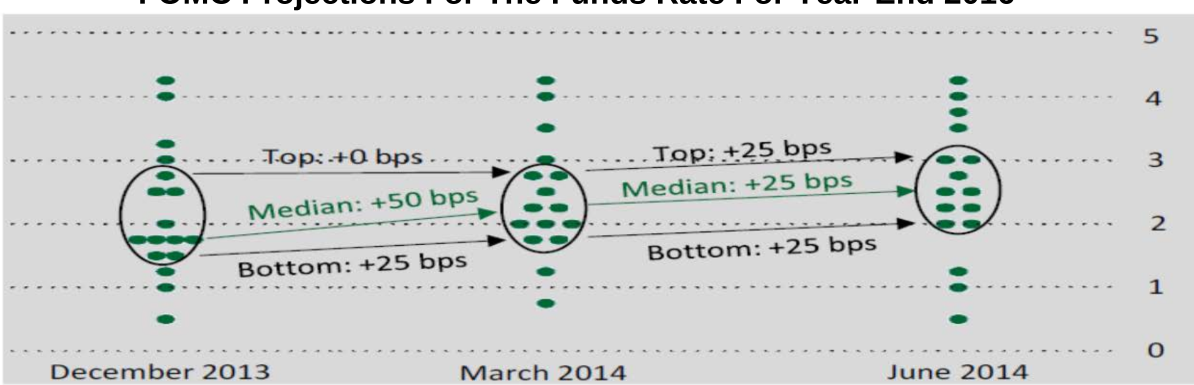
The FOMC has been slowly winding down their large scale asset purchase program since December 2013, tapering the pace of purchases by $5 billion per month of both Treasury and agency mortgage-backed securities at each of their subsequent meetings. Currently purchasing $15 billion per month of Treasury securities and $10 billion per month of agency mortgage-backed securities, the program will likely be discontinued completely in October. The FOMC is expected to decrease purchases again at their mid-September meeting by $5 billion each. They meet again in late-October, where it is expected they will discontinue the remaining $5 billion in agency mortgage-backed securities and discontinue the remaining $10 billion of Treasury securities to end the purchase program. While the FOMC continues to maintain that the pace of purchases is not on a "preset course," they have clearly communicated their desire and expectations to wind down the purchase program. Assuming the continued pace of reductions of $5 billion each per meeting, there has been discussion and deliberation as to whether the FOMC would wait until December to discontinue the extra $5 billion of Treasury purchases. The June 17-18th minutes revealed discussion among committee members around this and explicitly stated that if economic improvements continue as expected, the final reduction of remaining purchases would occur at the October meeting.

While the asset purchase program seems set to end soon, the FOMC is continuing to reinvest maturities and principal payments which will keep the Federal Reserve's balance sheet elevated and will maintain accommodation. The June 17-18th FOMC minutes indicate that a majority of participants prefer continuing reinvestments until or after the first increase in the federal funds rate with most preferring the latter. Discussion is likely to continue around this, but participants seem to favor a gradually reduction of reinvestments over time.

The June minutes also highlighted increasing discussions around the normalization of monetary policy. After an extended period of extraordinarily accommodative policy, we are moving closer and closer to the return of more normal policy as economic and labor market conditions continue to improve. These discussions are not meant to imply an immediate shift to a tighter policy stance, but as part of the planning process to ensure the FOMC has the proper tools and is prepared to implement tighter policy smoothly when the time is appropriate. A great deal of discussion appears to have been dedicated to the use of the interest on excess reserves (IOER) rate and an overnight reverse repurchase agreement facility to influence short term rates. These are likely to be used in combination, though it appears the IOER rate would serve as the primary tool with the overnight reverse repurchase agreement used in a supporting role. The IOER rate pays interest to banks on excess reserves held at the Federal Reserve. By raising the IOER rate paid by the Federal Reserve, banks are only willing to lend excess reserves out at a rate higher than they can get from the Federal Reserve, thus influencing federal funds and market rates higher. The overnight reverse repurchase facility accomplishes the same goal with non-bank counterparties. These discussions continued at the July meeting according to the minutes and there will likely be further discussion and debate around the effectiveness, benefits, and risks of these policy tools as the FOMC moves forward with policy normalization.

While Federal Reserve Chair Janet Yellen and the FOMC maintain policy is data dependent and we are still in the midst of a fragile economic recovery, conditions are clearly improving and we are undergoing a shift towards tighter monetary policy. Economic growth has been improving. Employment gains have been steadily improving and the unemployment rate has continued to come down. Persistently lower inflation readings have picked up some recently and longer term inflation expectations remain stable. While some broader structural employment concerns persist and some areas of growth remain sluggish, it appears the FOMC is becoming more comfortable with the recovery and perceives some of their downside risks have diminished. They are soon to complete the wind down of the asset purchase program and the next step is to begin bringing rates back up towards more normal levels. The majority of FOMC participants have made clear that they believe it will be appropriate to begin raising rates in 2015 and expectations currently gravitate more towards mid-2015. The focus for investors and market participants is not isolated to when they begin to raise rates, but how quickly they will move to increase rates to more normal levels. As FOMC participants have grown more confident and comfortable with economic and labor improvements recently, their projections for the appropriate pace of policy firming has drifted upwards as shown in the chart below.

FOMC Projections For The Funds Rate For Year-End 2016



Sources: Federal Reserve and Cornerstone Macro.

Yellen has been painted with a fairly dovish brush and she has clearly been willing to be very aggressive with accommodative policy on the way down. She is very attentive to downside risks and prefers to err on the side of more accommodation until those risks are better balanced. As these risks to growth and labor markets ease, her willingness to be aggressive on the way up remains unclear and may be underestimated by markets. Yellen recently presented her Semiannual Monetary Policy Report to the Congress and commented "If the labor market continues to improve more quickly than anticipated by the Committee, resulting in faster convergence toward our dual objectives, then increases in the federal funds rate target likely would occur sooner and be more rapid than currently envisioned." While these comments were offset with their willingness to be more accommodative should conditions deteriorate, they were clearly slanted in the other direction. As the asset purchase program is concluded, the FOMC will likely begin adjusting their statement language gradually towards a tightening bias along with additional communications regarding their tools and plans to normalize policy.

Fiscal Policy

By Michael McNair

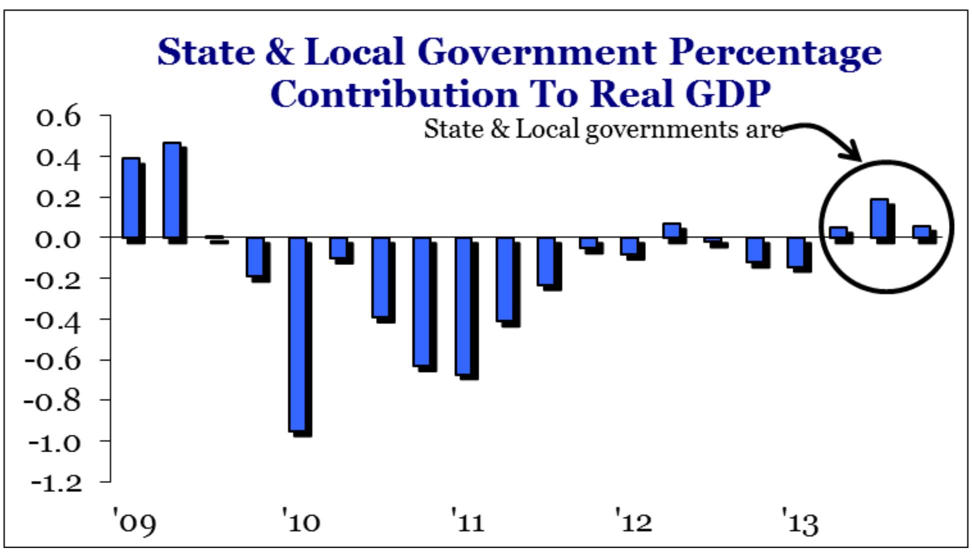
In this quarter's edition of the Fiscal Policy Report we will address the fading fiscal drag and its impact on economic growth, assess the near term potential policy risks and finally we will examine the factors that have led to the $1 trillion reduction in the budget deficit.

Fiscal Drag

There are three factions that contribute to GDP: the government, the private sector and exports. The purpose of assessing fiscal policy is to determine the impact that the government will or has had on economic growth. When we talk about the "Fiscal Drag" we are referring to the times when government actually subtracts from GDP growth due to a combination of spending cuts and tax increases.

Since 2010, not only has the government sector subtracted from US economic growth but it has been the largest fiscal drag in the post war era. This fiscal drag peaked in 2013 when the government sector subtracted over 2% from GDP (in a year when total GDP growth was less than 2%). Fortunately, the fiscal drag has faded over 2014 and should get even better as the year progresses. While fiscal policy will not add to growth in 2014, the reduction of this headwind can allow *overall* GDP to grow at a more rapid pace this year.

Further, state and local governments should actually contribute to GDP in 2014 after being a drag for several years. Strategas is expecting state and local governments to add 0.2% to GDP but they note that it could prove conservative as spending is likely to get ratcheted up with over 30 Governors up for reelection this November and an expected surge in tax revenue this Spring.



Source: Strategas

Potential Policy Risks

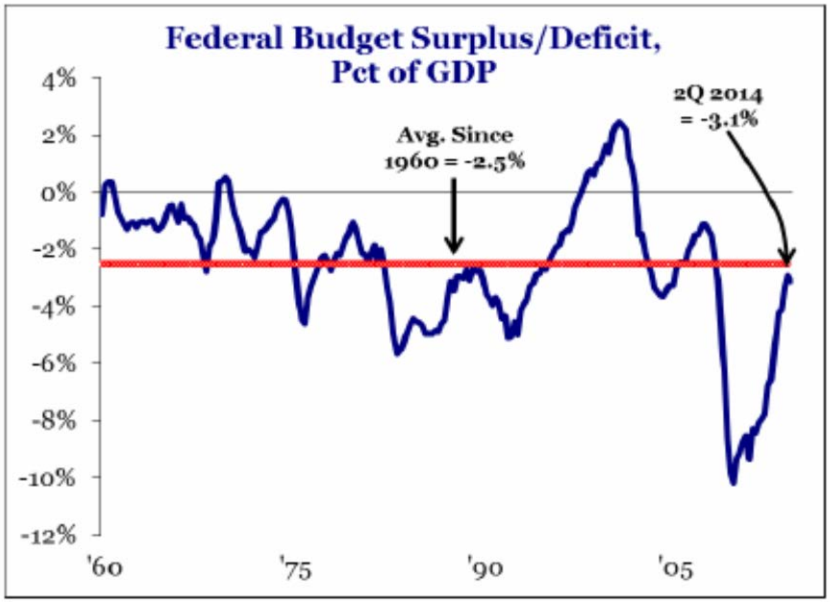
2014 has been a relatively muted year for policy risk especially in comparison to the last few years. The four main sources of policy risk have now faded: 1) Debt ceiling 2) the government shutdown 3) the fiscal drag and 4) the historically wide budget deficit.

We believe that policy uncertainty will continue to remain subdued through 2014 but we recognize that even though all seems quiet on the Washington policy front, there are a few potential catalysts that could cause an unexpected increase in uncertainty.

The federal fiscal year begins on October 1st and Congress must pass a budget before that date. The recently enacted Ryan-Murray budget agreement has already set the level of spending, thus avoiding another government shutdown. However, Congress has yet to agree on how to allocate the spending which opens up the possibility for pickup in political gamesmanship or further gridlock. We believe that there is very little chance that Congress will not be able to eventually come to a final agreement on the budget but it would not be a surprise for it to come down to the last minute. Midterm election years often contain a lot of political noise but rarely do we see any major disruptions. In the event that we do see a pickup in uncertainty around a possible government shut down we believe it would be wise for investors to bet on an eventual resolution. The political landscape has changed dramatically over the past year as Renmac's policy analyst, Kim Wallace, explains, "This time last year the notion of a tactical government shutdown was fully in the media bloodstream. Those advocating such a move were readily identified and seemingly proud of the association. The actual event in terms of economic and political magnitude clearly was not anticipated. Perpetrators suffered mightily in public opinion polls saved only by unrelated real and imagined White House mistakes (recall the ACA technology furor)." With the hard lessons of 2013 fresh in every politicians mind, it seems highly unlikely that either side will be willing to risk a major standoff with the midterm elections right around the corner.

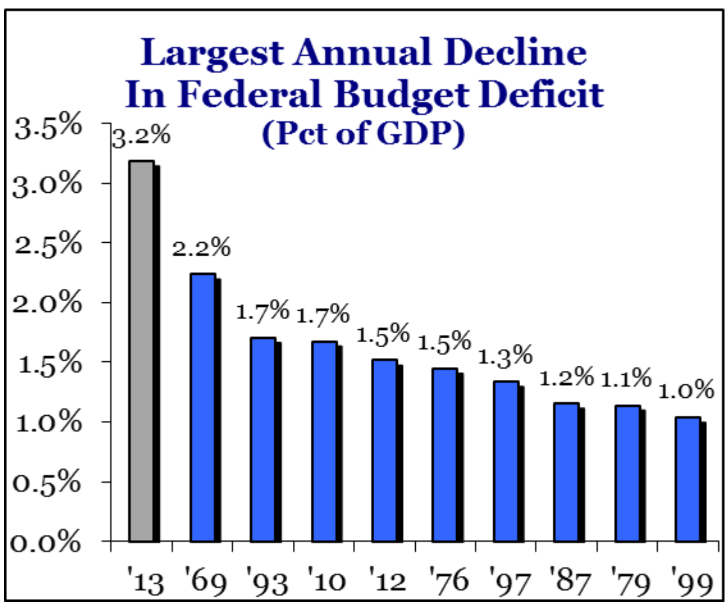
Dissecting the $1 trillion reduction in the budget deficit

In March of 2010 the budget deficit peaked at $1.47 trillion or 10.2% of GDP. Fast forward to 2014 and the budget deficit has fallen by almost $1 trillion dollars to stand at $537 billion and only 3% of GDP.



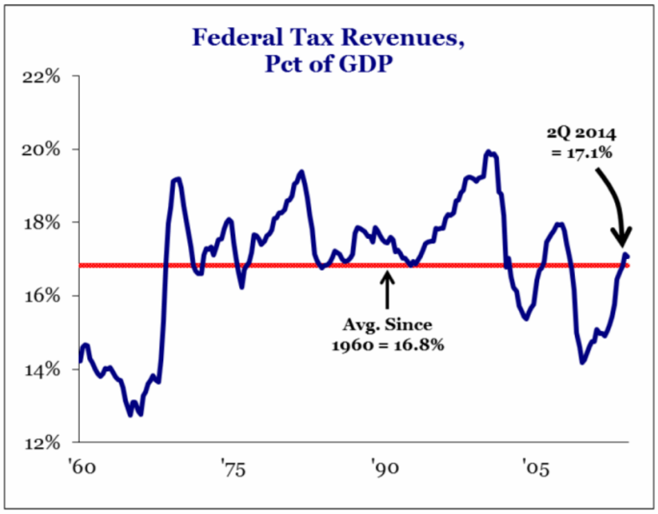
Source: Strategas

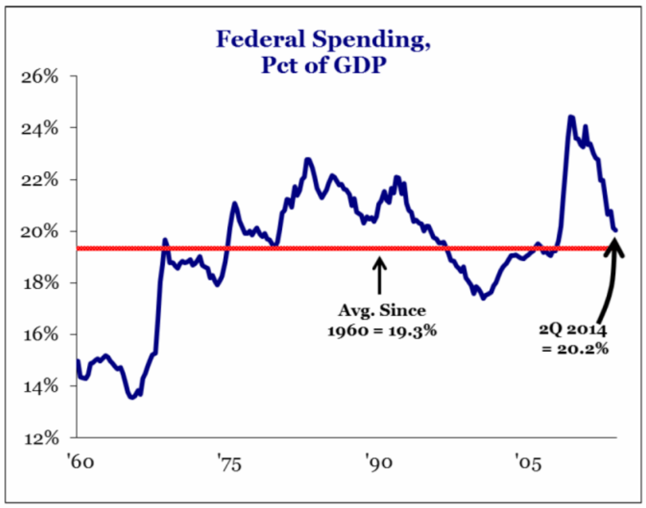
This represents the largest 4 year reduction in the budget deficit in our nation's history by a wide margin. In fact, three of the top 5 years for largest annual declines in the budget deficit occurred in the past four years.



Source: Strategas

This unprecedented 7% of GDP reduction in the budget deficit was the result of tax revenues increasing by 3% of GDP and spending decreasing by 4% of GDP.



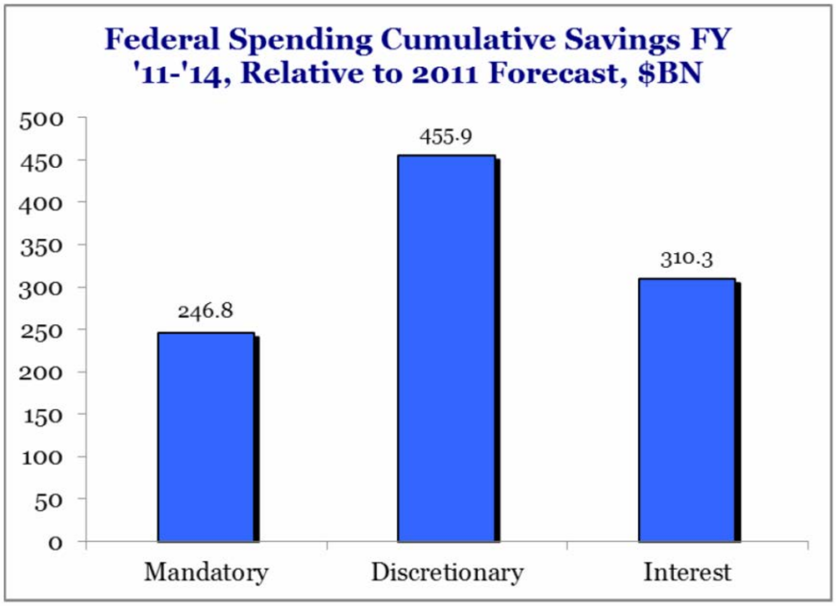


Source: Strategas

The increase in revenue over the past four years is simply a result of the improvement in the economy and the resulting increase in taxes that occur due to the natural stabilizers built into the tax code. Of the 3% of GDP increase in tax revenue, income taxes are up by 1.6% of GDP and corporate taxes are up by 1% of GDP.

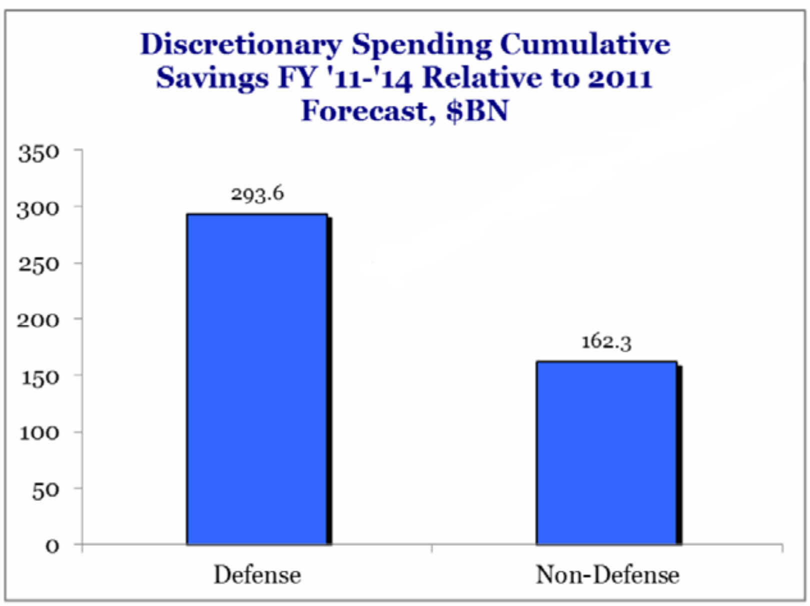
The decrease in spending as a percent of GDP is actually more striking when you consider that for the first time in the post war period spending in absolute terms (as opposed to as a percent of GDP) is actually lower than four years ago. In fact, current spending levels are actually a staggering $1 trillion less than the Congressional Budget Office (CBO) projected back in 2011.

Within the spending cuts the majority of the burden has been placed on the discretionary portion of the budget. Of the $1 trillion in spending savings, relative to the 2011 forecast, 45% comes from discretionary spending despite it comprising just 33% of total spending.



Source: Strategas

Further, defense spending accounts for two-thirds of the reduction in discretionary spending relative to the 2011 CBO projection:



Source: Strategas

The table below shows a complete breakdown of the components that have led to the reduction in the budget deficit since 2010.

Breaking Down The Factors Leading To A Lower Budget Deficit, FY 2010 vs. FY 2014, Percent of GDP

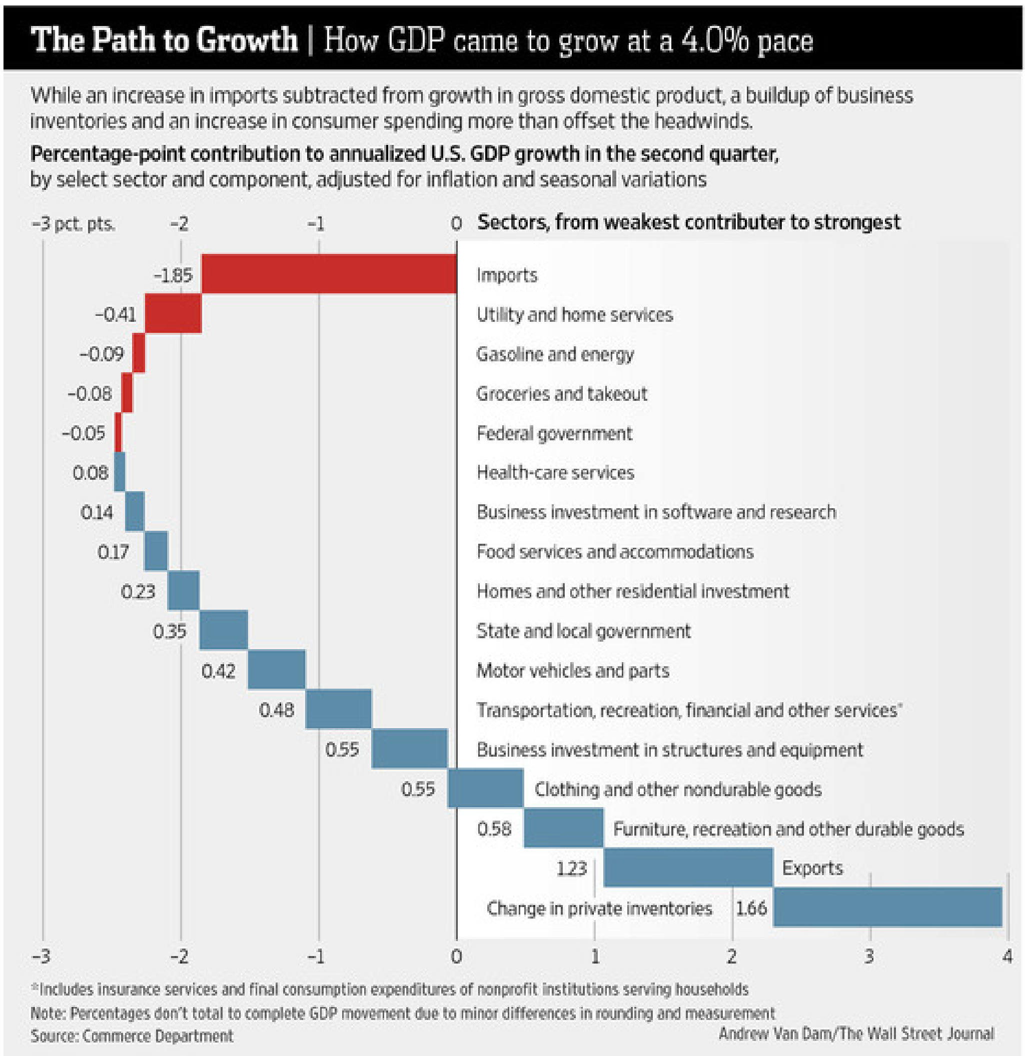
Category	Sub-Category	2010	2014	Change
Deficit		**-8.8%**	**-2.8%**	**6.0%**
	Tax Revenues	14.6%	17.6%	3.0%
	Spending	23.4%	20.4%	3.0%
Tax Revenues		**14.6%**	**17.6%**	**3.0%**
	Income Tax	6.4%	8.0%	1.6%
	Corporate Tax	1.0%	2.0%	1.0%
	Payroll Tax	6.2%	6.0%	-0.2%
	Other	1.0%	1.6%	0.6%
Spending		**23.4%**	**20.4%**	**3.0%**
	Discretionary Spending	8.6%	6.8%	1.8%
	Mandatory Spending	13.5%	12.3%	1.2%
	Net Interest	1.3%	1.3%	0.0%
Discretionary Spending		**8.6%**	**6.8%**	**1.8%**
	Defense	4.6%	3.4%	1.2%
	Non-Defense	4.0%	3.4%	0.6%
Mandatory Spending		**13.5%**	**12.3%**	**1.2%**
	Social Security	4.7%	4.9%	-0.2%
	Medicare	3.5%	3.0%	0.5%
	Medicaid	1.8%	1.9%	-0.1%
	Offsetting Receipts	-1.3%	-1.7%	0.4%
	Other	4.8%	4.2%	0.6%

Source: Strategas

Economic Outlook

By Adam Rogers

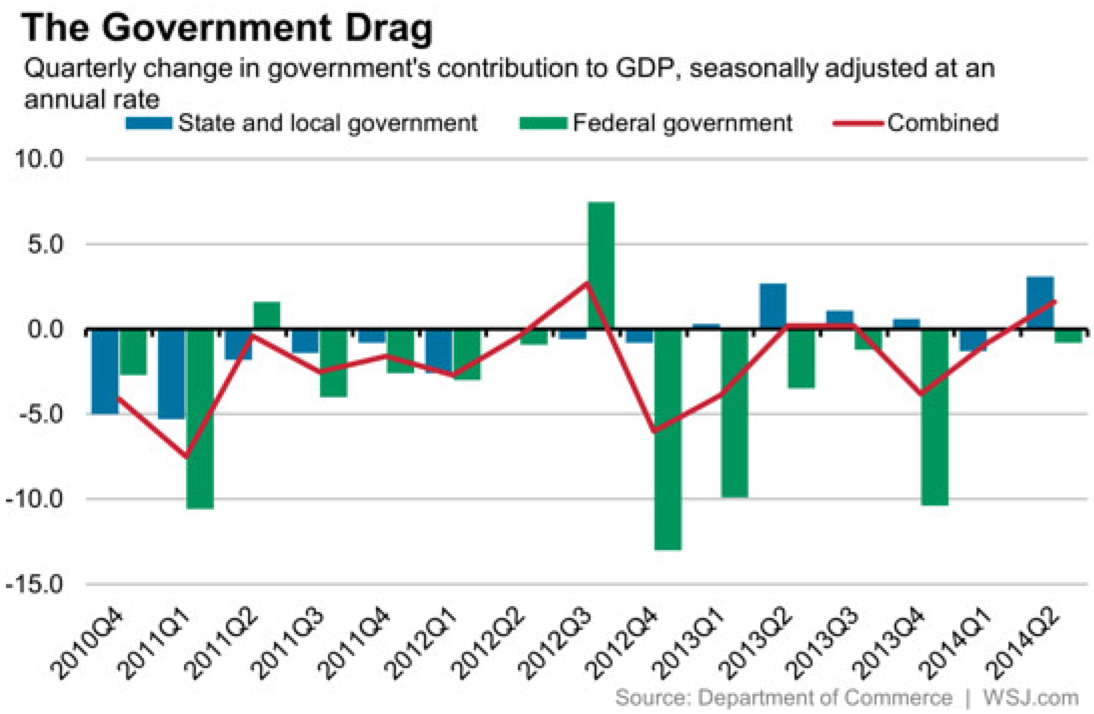
Economic growth during the second quarter was 4%, a sizeable rebound from the 2.1% contraction last winter. The numbers of course are still fluid with possible revisions coming later. This bounce was expected with the recent slowdown proving to be an aberration within the broader context of a mid-cycle slowdown. Taking the recent two quarters as a whole, the data falls in line with the modest pace that has characterized the recovery from the depths of ’08-’09, with growth averaging about 1% for the first half of 2014. The following is a chart breaking down the components of GDP.



Source: WSJ

Take note that state and local government as well as the Federal government are no longer creating a sizeable drag, with state and local actually contributing to growth. This has not been the case for much of the recovery.

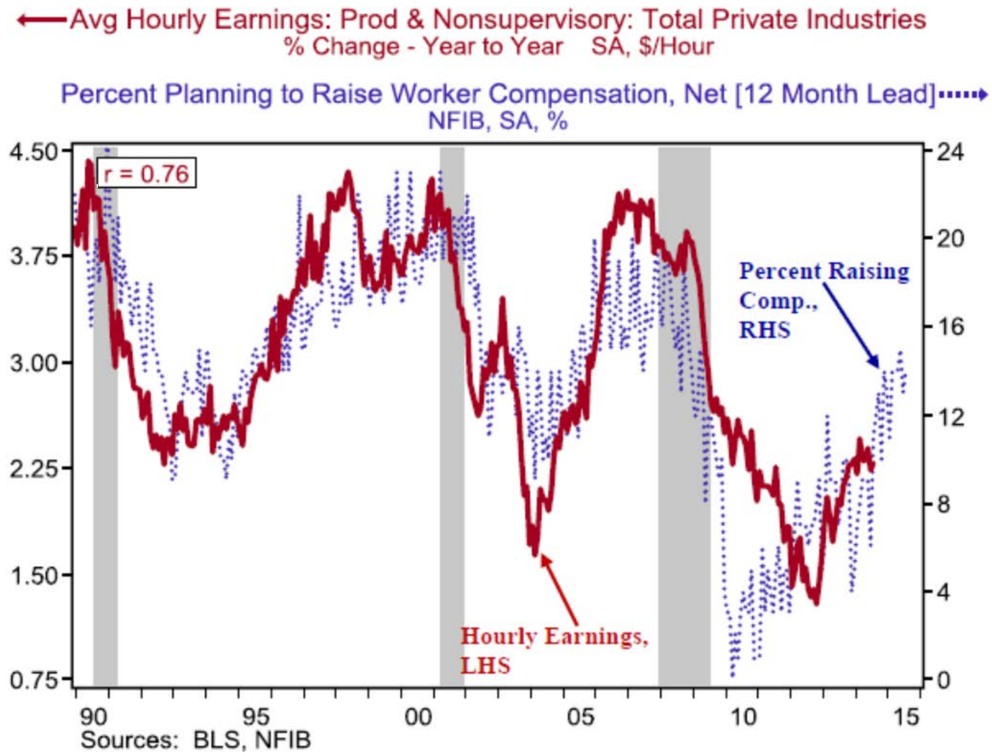
Since the recession, state and local governments have slashed spending and raised taxes while the federal government has also been shrinking, the decline in 2013 being the worst of it as the sequestration went into effect. Accounting for roughly 20% of the US economy, the shrinking government budgets have of course cut into GDP. An encouraging sign, from a GDP perspective, is that government spending has stabilized and the drag which has been so persistent may be ending.



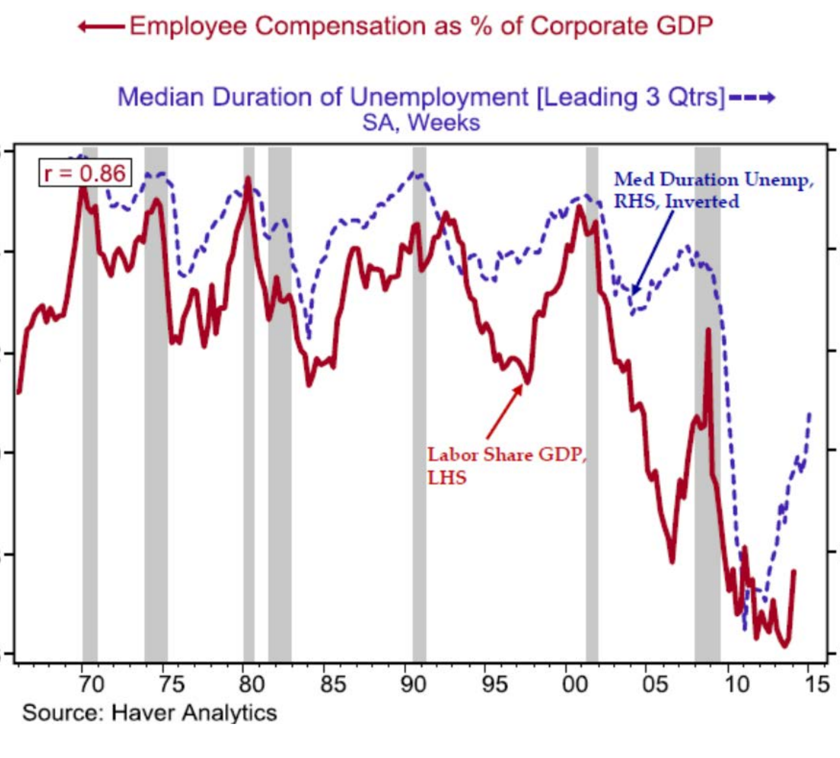
One theme we touched on a few months ago was wage growth. While nonexistent for much of the cycle, we are seeing signs of a turn. From our June report:

"*In a maturing business cycle, once labor share begins to rise, profit margins begin to feel pressure. Early in a cycle, unemployment is high and profits accelerate as companies cut costs (workers). The only way both profits (capital) and labor can benefit concurrently is for productivity to increase, usually the result of new industry. As things stand right now, it is not a leap to suggest we are reaching the lows of labor share and a maturing business cycle will curtail the rise in profit margins going forward. One piece of evidence supporting this is average hourly earnings, which rise in the later stages*"

Again, wage growth typically accelerates during the back half of the business cycle and we are seeing confirming evidence that compensation for workers is gathering upward momentum. The latest National Federation of Independent Business survey leads hourly earnings by about a year and has been consistently increasing.



As we pointed out last meeting; a mid-cycle slowdown, or the mid-point of the cycle, is when labor share of GDP bottoms. One leading indicator of labor share of GDP is the duration of unemployment, or how long people stay out of work before finding another job. The chart below provides further evidence that labor share is bottoming and wage pressures are here to stay for the duration of the cycle. Once this metric makes its turn it usually stays on its path for a while.



So we maintain that the US economy is entering the back half of an expansionary cycle. The labor data speaks volumes and the majority of our economy's characteristics confirm this stance. The non-manufacturing PMI rose to 58.7 in July, factory orders rose 1.1% m/m in June and jobless claims are averaging below 300,000. The 3Q release of the Senior Loan Officer Survey also showed more expansion. Housing is stable and we assume it will pick up after wage growth. Given the data we are operating under the assumption that the US will continue to expand, with the primary risks to growth being geopolitical or a surprise tightening from the Fed.

Interest Rates and Fixed Income Strategy

By Lance Lachney

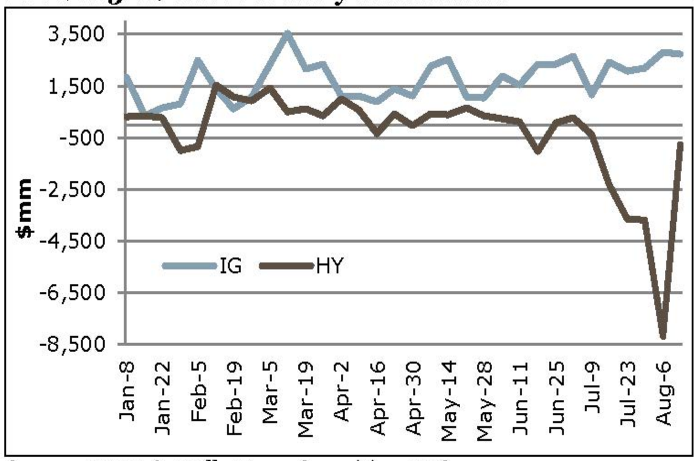
At the time of our last meeting, interest rates had swiftly moved higher from their May lows as the European Central Bank (ECB) lowered its main refinancing rate and took its deposit rate into negative territory. These actions, in concert with additional bank liquidity measures, were made to encourage lending and help kick start the European economy that is currently operating at a suboptimal level. As we have seen time and time again, easy monetary policy decisions made by global central banks produce a positive return for risk assets. With stocks leading the way, the riskier sectors within fixed income provided the best results during the month of June. High-yield securities outperformed government debt by approximately 100bps, while the best performing sector within investment grade was the one with the widest credit spreads- metals and mining. Mortgages produced approximately 40bps of excess return as spreads tightened during the month. The longer end of the treasury curve held in relatively well despite the strength in risk assets. Lower revisions on economic growth, tame inflation readings, and foreign buying out the curve were the likely culprits.

The month of July got off to an abrupt start with the monthly payroll report for June showing substantial strength. The unemployment rate also fell to a six-year low of 6.1%. The intermediate part of the treasury curve rose approximately 10bps in the first three trading days. The move higher was short-lived however, as the weakness in Europe remains a key obstacle. Factory orders and industrial production across the continent continued to disappoint, driving global yields lower across the globe. Inflation within the Eurozone is incredibly weak and slowed during the month to .40%, its lowest level in five years. The 18-country bloc is also struggling with relatively high unemployment in the 11.5% vicinity. The economic recovery is in a fragile state with the ECB predicting marginal growth for the year.

At home, there was a mixed bag of economic data during the month of July. Manufacturing still appears to be in good shape, but there is some concern that the pace of expansion is starting to fade. Perhaps the greatest concern about the economy is the housing sector. We have witnessed some slowing in housing starts and building permits over the last couple of months. This, coupled with the June drop in new home sales, helped keep a lid on interest rates through most of the month.

Credit markets were quite resilient during this time despite the numerous geopolitical risks, which include the bailout of a Portuguese bank, an Argentina default, ongoing Ukraine/Russia tension, Israeli soldiers on the ground in Gaza, and havoc being wreaked by the Islamic State of Iraq and Syria (ISIS). There was very little change in investment grade spreads and only a modest widening in junk spreads, even after the Fed Chair's comment that "valuations look stretched" in some sectors, such as lowerrated corporate debt. However, sentiment changed rather quickly during the last week of July. Possibly driven by the strength in the 4% 2Q GDP print, a shift took hold within the intermediate part of the curve. If only briefly, expectations on the timing of the Fed's first rate hike were pulled forward and investors' appetite for risk retreated. The high yield market experienced an acute downturn as spreads backed up 50bps during the month with half of that coming on the last trading day. Approximately $10bn of capital exited the space and the asset class lost over 1.30% in July. The sudden shift was a reminder of the liquidity risk present within the junk bond market during times of heightened volatility. Lack of supply and continuing inflows allowed the investment grade market to hold its ground with spreads remaining unchanged.

Exhibit 3: IG & HY Weekly Fund Flows

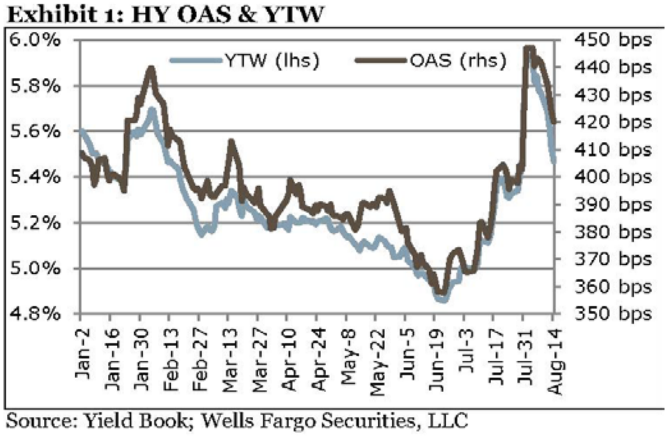


Source: EPFR & Wells Fargo Securities, LLC

Overshadowed in all of this, the Federal Open Market Committee did convene at the end of the month. The tone remained somewhat dovish with Fed Chair Janet Yellen reiterating the view that further evidence of improvement needs to be seen in regards to the labor market. There was the standard reduction of asset purchases from $35bn to $25bn monthly and the program is set to expire in October of this year. Philadelphia Federal Reserve Bank President Charles Plosser did cast a dissenting vote based his view that the economy has enough momentum and wage pressure present to warrant a more aggressive approach.

Over the last few weeks, institutional investors have rushed in to pick up the pieces left in the exodus from the high yield market. It seems that the multi-year record run in junk debt is not coming to an end just yet. The asset class has nearly recovered all losses that it encountered during the month of July. The long end of the treasury market has caught fire once again with the 30yr falling to a 52-week low of 3.13% a few days ago. Just last week we have seen softer numbers in retail sales and jobless claims here and flat to negative growth in the three most influential countries in Europe. Couple this with the strong demand at the treasury auctions and a rise in

Exhibit 1: HY OAS & YTW



Source: Yield Book; Wells Fargo Securities, LLC geopolitical tension, one can see how tepid and fickle the global recovery has become. On a good note, investors did see some strength in housing starts and building permits this week, alleviating some of the recent downward pressure in the long end of the curve.

The Retirement Systems executed very few trades during this time period. In the mortgage space, the fund purchased a 30yr Fannie Mae mortgage in order to reinvest prepayments and add a little money to the sector during the backup in spreads in the month of July. Within corporates, the fund established positions in Prudential and Synchrony Financial as both were issued at healthy concessions to where their sectors peers trade. The RSA also executed a couple of swaps within its treasury holdings, carefully extending out the curve to take advantage of the flattening trend in the marketplace.

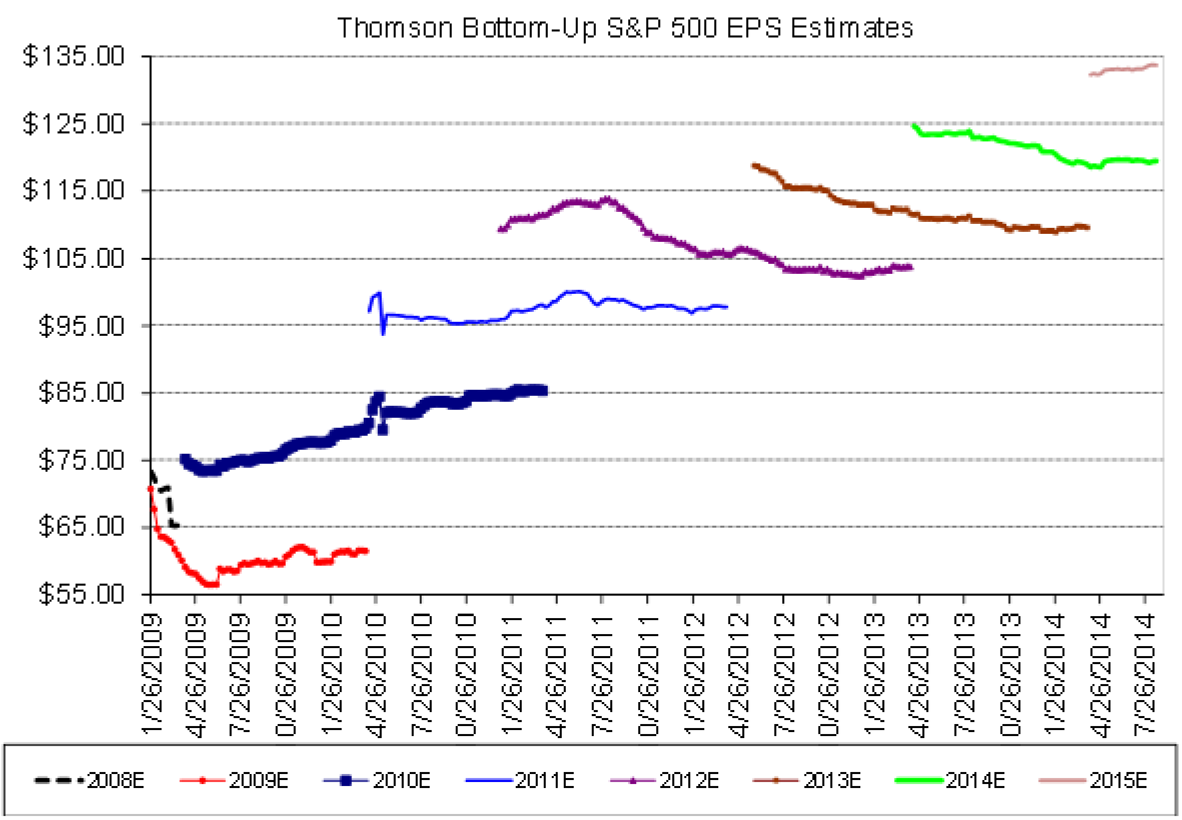
Despite the release of the minutes from the FOMC meeting in July later today, all eyes are focused on the annual gathering of the world's leading central bankers in Jackson Hole. The issue being discussed among global policymakers later this week is the dynamics of the labor market. Fed Chief Janet Yellen will be the keynote speaker and it will be interesting to see if she deviates from the "underutilization of labor resources" remark highlighted in the July FOMC meeting. At this juncture, policy decisions among global bankers are all over the map. While the Federal Reserve is winding down its asset purchase program in the most delicate way possible, the Bank of England is poised to raise rates in the not so distant future. On the other end of the spectrum, the Bank of Japan and the ECB are looking to add stimulus to counter weak inflation and rekindle growth in their respective economies. The divergence between growth rates and policy decisions has been building for some time and is likely to continue in the near term.

Domestic Equity Strategy

By Marc Green

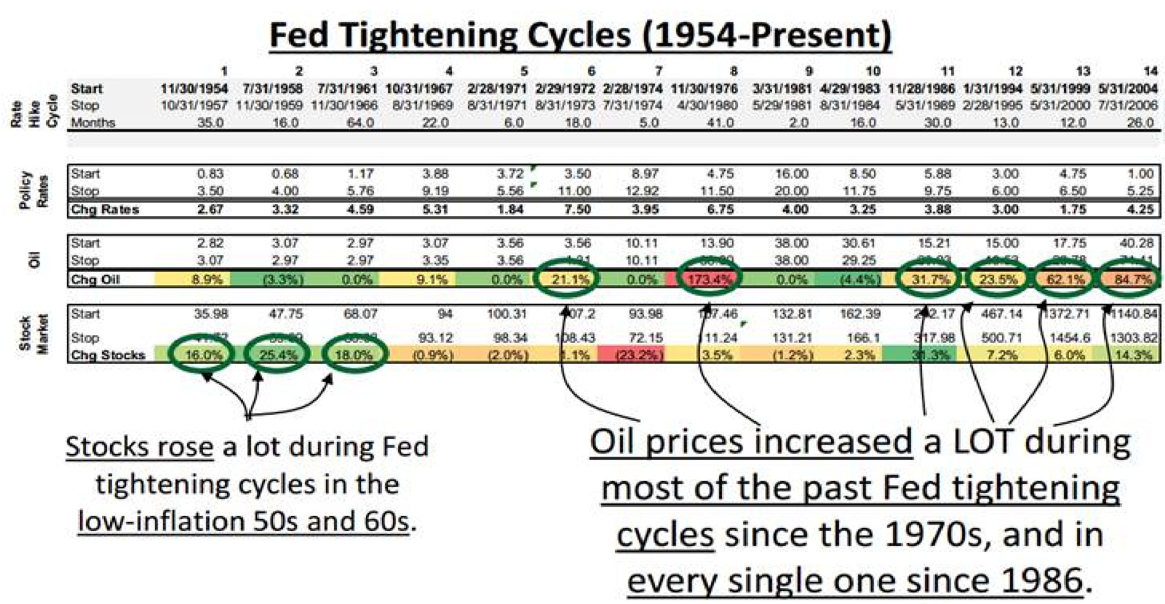
It has been two months since our last meeting and the market is up roughly 1%. The digestion phase that we spoke of seems to be playing out, although it hasn't been a smooth ride in between. The growth scare that has surfaced every year coming out of the last recession manifested itself in the 1st quarter of the calendar year, with the final GDP figure coming in at -2.1%. We did see a bounce back in the 2nd quarter to 4% GDP, and earnings revisions have actually hooked back up after the bar was reset low enough. This has been the game that has been played at some point every year since the "great recession" ended. The following chart provided by Citigroup lays out the evolution of earnings year by year. One can see that the street generally starts out with an optimistic viewpoint that is reigned in over time, and usually hooks back up slightly at year end.

Chart 1



2014 looks to be a replica of what happened in 2012 and 2013. The "lower for longer" interest rate regime has played out in a way that we haven't seen a snapback in the economy that one would have expected to see in a normal business cycle. The street generally gravitates towards roughly 10% earnings growth during an economic midcyle, yet sub 3% GDP growth makes that number very hard to reach. What has been the main driver of returns the past couple of years has been multiple expansion. Like everything else, market multiple expansion or contraction generally trends in one direction for a sustained period. This expansion phase just started three years ago, so it is not unreasonable to assume that multiples could move higher the next couple of years. There have been many market prognosticators who have called for a major leg down, largely premised on the idea that the earnings numbers of the market have been "manufactured," but we think that a large part of the story has been an improvement in the capital allocation process of the companies that make up the market. A large part of this was the fear that was invoked in the psyche of CEOs when the financial markets melted down 5 years ago, and the normal animal instincts that take over at this point in the cycle haven't manifested themselves yet. We have seen a large spike in deals, but we don't feel that they have been frothy deals where companies were using their stock as currency because they feel It is probably overvalued. That was the scenario in the late 90's when we were seeing all stock deals in the technology sector. In retrospect, it probably wasn't too bad of an idea to do acquisitions when your multiple is 35x earnings, but the music obviously stopped playing when the economy slowed and we had a big earnings reset. One of the big questions now is what happens when the Fed stops QE altogether, and eventually starts a true tightening process. In all likelihood, the market will probably hit an airpocket at some point in that process, but it generally is short lived in nature unless it shocks the economy back into a recession. It seems that the current Fed team is very cognizant of that risk and will probably be quite deliberate in the tightening process. The following chart provided by Cornerstone gives a snapshot of what the markets have done in such scenarios.

Chart 2

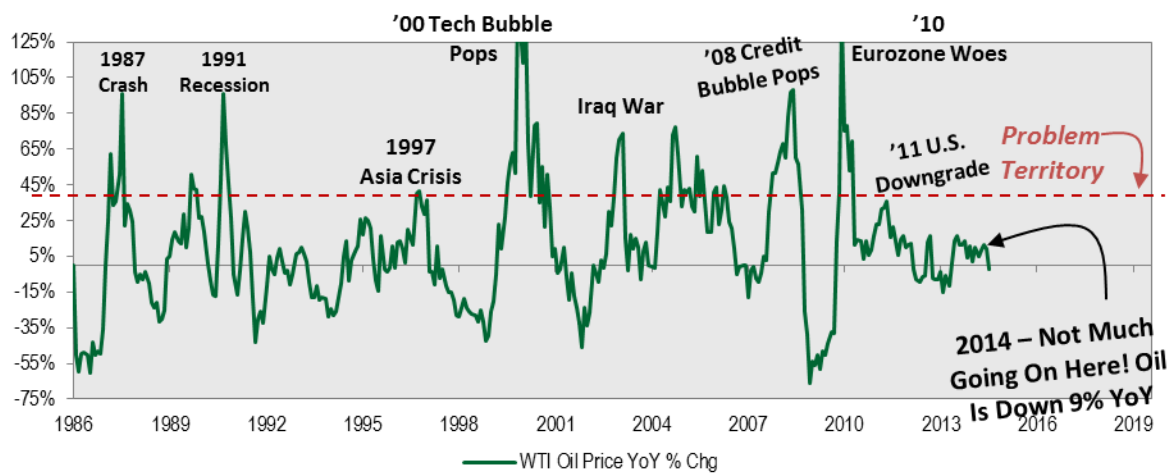


Fed Tightening Cycles (1954-Present)

		1	2	3	4	5	6	7	8	9	10	11	12	13	14
Rate Hike Cycle	**Start**	**11/30/1954**	**7/31/1958**	**7/31/1961**	**10/31/1967**	**2/28/1971**	**2/29/1972**	**2/28/1974**	**11/30/1976**	**3/31/1981**	**4/29/1983**	**11/28/1986**	**1/31/1994**	**5/31/1999**	**5/31/2004**
	Stop	10/31/1957	11/30/1959	11/30/1966	8/31/1969	8/31/1971	8/31/1973	7/31/1974	4/30/1980	5/29/1981	8/31/1984	5/31/1989	2/28/1995	5/31/2000	7/31/2006
	Months	35.0	16.0	64.0	22.0	6.0	18.0	5.0	41.0	2.0	16.0	30.0	13.0	12.0	26.0
Policy Rates	Start	0.83	0.68	1.17	3.88	3.72	3.50	8.97	4.75	16.00	8.50	5.88	3.00	4.75	1.00
	Stop	3.50	4.00	5.76	9.19	5.56	11.00	12.92	11.50	20.00	11.75	9.75	6.00	6.50	5.25
	Chg Rates	**2.67**	**3.32**	**4.59**	**5.31**	**1.84**	**7.50**	**3.95**	**6.75**	**4.00**	**3.25**	**3.88**	**3.00**	**1.75**	**4.25**
Oil	Start	2.82	3.07	2.97	3.07	3.56	3.56	10.11	13.90	38.00	30.61	15.21	15.00	17.75	40.28
	Stop	3.07	2.97	2.97	3.35	3.56	[illegible]	10.11	[illegible]	38.00	29.25	[illegible]	[illegible]	[illegible]	[illegible]
	Chg Oil	8.9%	(3.3%)	0.0%	9.1%	0.0%	21.1%	0.0%	173.4%	0.0%	(4.4%)	31.7%	23.5%	62.1%	84.7%
Stock Market	Start	35.98	47.75	68.07	94	100.31	[illegible]	93.98	[illegible]	132.81	162.39	[illegible]	467.14	1372.71	1140.84
	Stop	[illegible]	[illegible]	[illegible]	93.12	98.34	108.43	72.15	111.24	131.21	166.1	317.98	500.71	1454.6	1303.82
	Chg Stocks	16.0%	25.4%	18.0%	(0.9%)	(2.0%)	1.1%	(23.2%)	3.5%	(1.2%)	2.3%	31.3%	7.2%	6.0%	14.3%

It seems a lot of what happens during a fed tightening cycle is contingent on what oil prices do in concert with the tightening. Obviously it is hard to predict the future price of oil, and we are no better than the next guy at knowing that, but currently oil prices have remained in check, even as global economies have rebounded some. Possibly that is due to some slowing globally (especially Europe and several emerging markets) as well as the renaissance in oil and gas production domestically that an energy spike in concert with Fed tightening will not come to fruition. Other factors that have helped keep oil prices in check have been less miles driven, increased productivity, as well as actual cost effectiveness of alternative energy sources. One of the big drivers of commodity inflation the past decade has been huge demand in China, and they seem to have gotten the bulk of their infrastructure spend out of the way at this point. The following chart by Cornerstone gives the year-over-year price change in oil, and currently oil is behaving nicely.

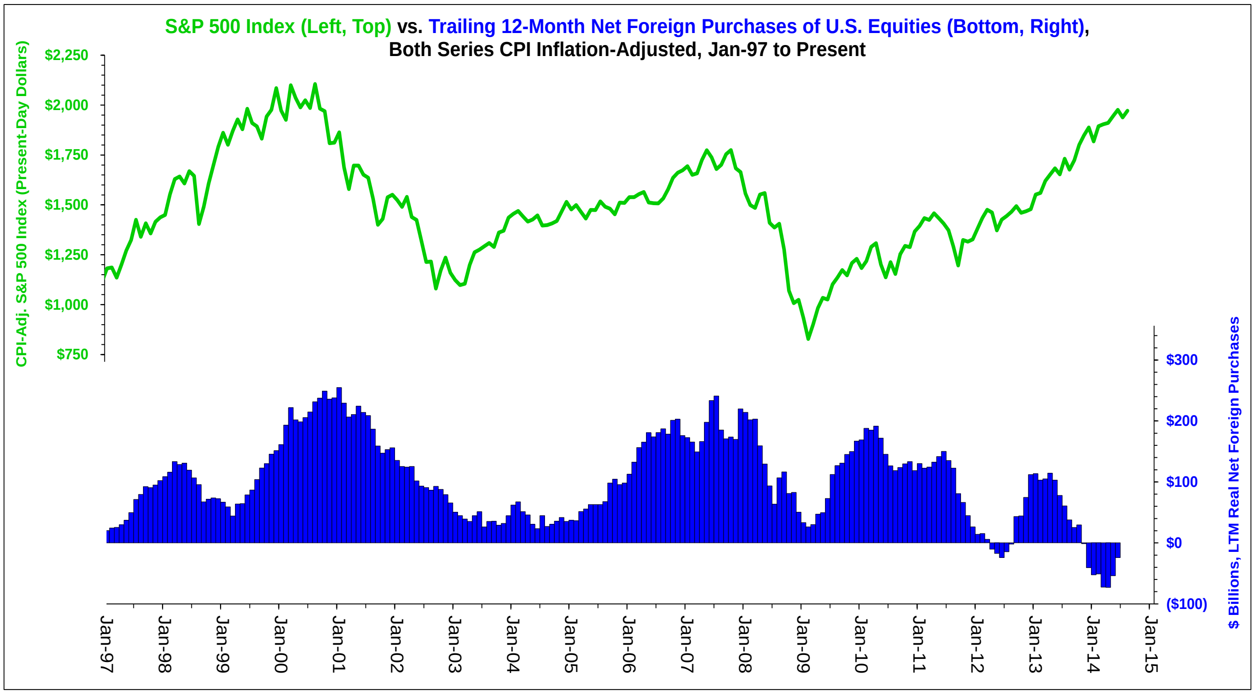
Chart 3



As everyone is aware, this can change in a heartbeat. It is very interesting that we have seen a lot of geopolitical issues the past few months-be it the Ukraine situation, Israel/Gaza conflict, and Venezuela and Argentina unraveling, yet oil prices have remained relatively rangebound.

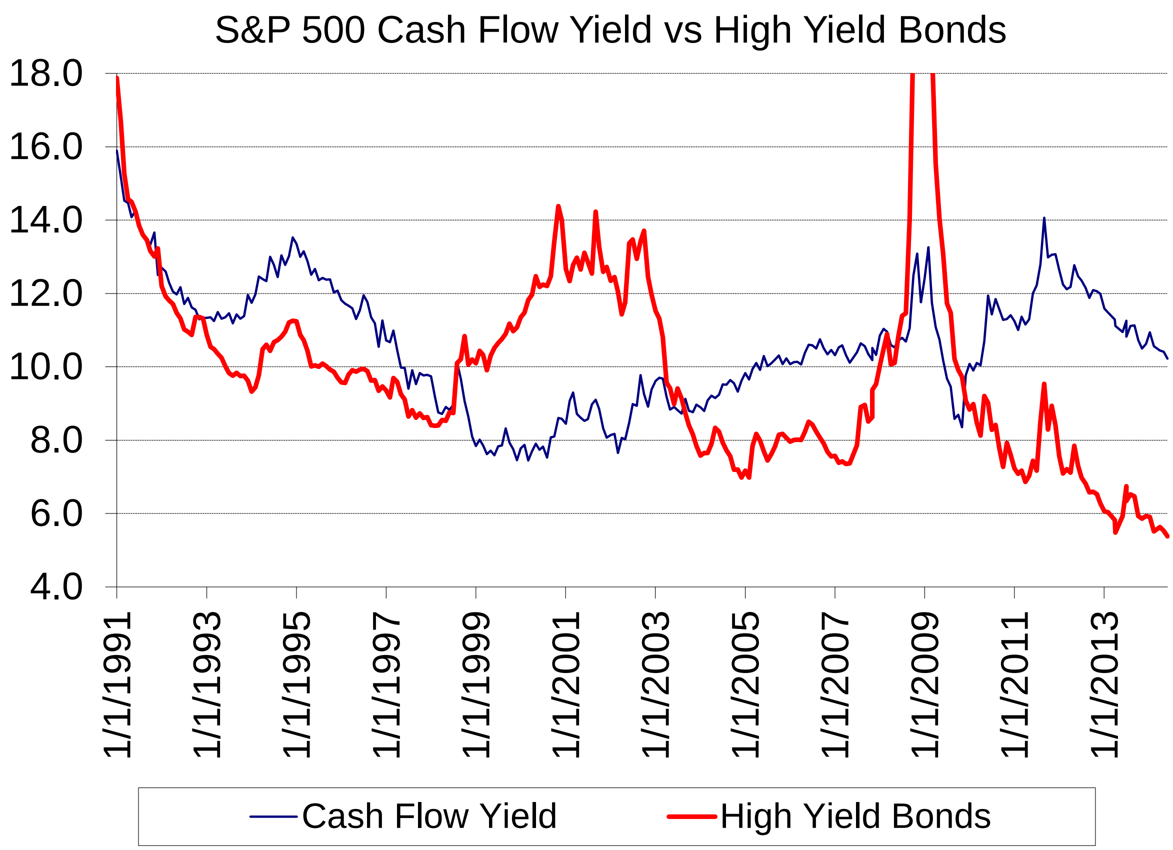
Another topic that is very hard to discern is investor sentiment. We have not really been able to find a good statistic that measures investor sentiment that correlates well with the market longer term. In the short run, it seems that investors have become somewhat negative towards the market, and that is usually a good thing. The most recent American Association of Individual Investors poll showed that roughly 70% of investors were neutral to bearish on the market. This is somewhat borne out by the large hordes of cash sitting in money market accounts earning 25 basis points. Possibly the last nail in this bull market will be when we see investors finally capitulating and sticking their money in the market after it has moved 200% off the bottom, but we see no evidence of that yet. Another fairly good indicator is foreign investor flows into our markets, and the rest of the world seems to not be overly interested in investing in the U.S. The following chart provided by Stifel shows that foreign investors have been net sellers of US stocks year-to-date.

Chart 4



The last crutch of the argument to remain exposed to stocks is the relative valuation argument. The run we have seen definitely makes this argument harder, and stocks aren't as attractive at 16.5x earnings at they were at 11x back in 2011, but versus bonds we still think they have merit. Treasuries possibly rally further but we think the risk reward there is not very good. High yield has had a huge rally off the lows in 2009, though they have recently widened out versus treasuries. Looking at stocks cash flow yield relative to credit instruments still paints a good picture for stocks. The following chart provided by Citi shows that cash flow yields on stocks vs. high yield are the widest they have been in the last 20 years. It could be that both are overvalued and may correct, but we think the odds are better in stocks than high yield.

Chart 5



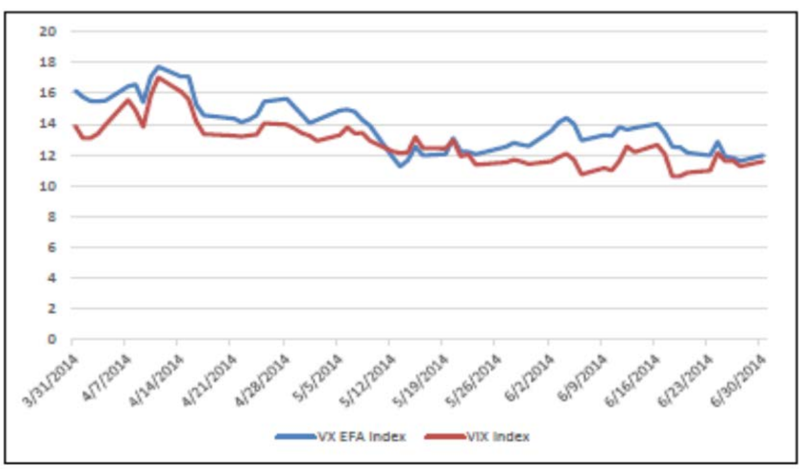
As for what we have been doing recently, we have repositioned the large cap portfolio in the healthcare sector into more value names as the sector has experienced a big run. We continue to have a sizeable overweight in large capitalization stocks as the relative value in large cap is quite wide versus mid and small cap. We have continued to evaluate hedging options but the low volatility environment in the options market make this trade rather expensive. Given the longevity of this bull market, we are nervous like most other investors, but feel that there is enough gas in the tank for another leg up.

International Equity Strategy

By Steve Lambdin

The second quarter of 2014 proved to be another good period for global equities, with most markets posting good returns. This happened even as the Russian/Ukraine situation remained “day to day” and China’s growth rate was still concerning for investors. However, these concerns were put in the backseat as central bank actions in Europe and Japan gave investors comfort the central banks around the globe remained committed to do whatever it takes to support their respective economies. Eurozone, United Kingdom (U.K.), and Japanese equities all posted healthy short term gains as volatility readings fell as the quarter progressed. Even the emerging markets joined the equity party as this equity class was the standout performer in the quarter. The central bank actions in the period gave investors an increased risk appetite, and drew plenty of attention to the emerging markets as valuations still seem very reasonable at the moment. As always, China’s economic readings remain a wildcard, however, most readings are within the bounds of the government’s framed expectations thus far in 2014. Perhaps an even bigger concern is with the Eurozone economy, as several countries now seem to be slipping back into a mild recession. This remains concerning, as this could push overall global growth downward and make investors nervous. However, we still remain optimistic toward global equities and feel even better days lie ahead, especially as central banks around the globe maintain their current postures.

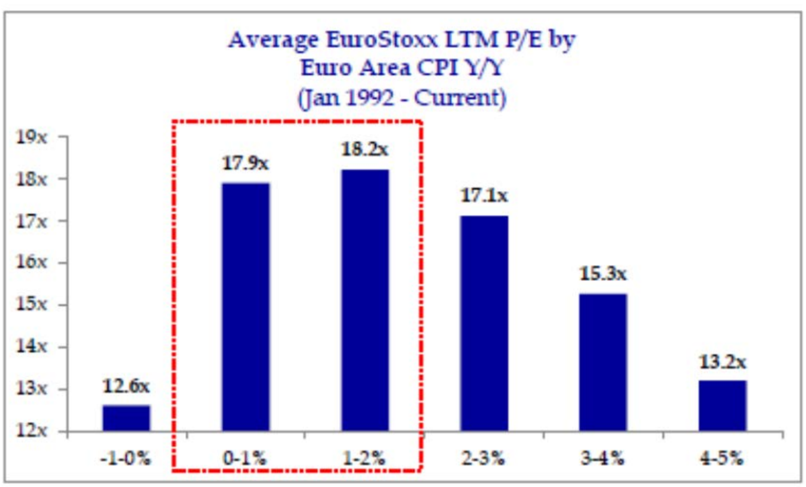
VXEFA vs. VIX
Second Quarter 2014



Source: Natixis Funds – Gateway Investment Advisors, Llc

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +4.09% and +6.60%, respectively during the second quarter of 2014 vs.
+5.23% for the S&P 500 Index. This is the first time in six quarters that emerging markets outperformed both large cap indices and marked a change in risk perception by equity investors. The U.S. Dollar Index was slightly weaker in the quarter, but was no significant factor for returns in the period. Japanese equities were a bit better than European equities as government actions in Japan to stimulate growth were well received. From an economic sector standpoint, Energy, Utilities, and Staples were relatively stronger, while Healthcare and Consumer Discretionary were a bit weaker.

Thus far into the third quarter of 2014, equities have been on somewhat of a roller coaster ride. The Russian/Ukraine situation has actually deteriorated over the last couple of months as a downed passenger jetliner has brought an outcry from the international community and the weakness in the Eurozone economy is catching a lot of attention. Second quarter earnings look okay in most regions around the globe, as comments about demand seem to be positive. Inflation still looks not to be an issue in most parts of the world, even as some countries in Europe could be flirting with potential deflation. This has pushed bond yields down to record levels in Europe. The MSCI EAFE Index and the S&P 500 Index posted returns of -2.7% and +1.0% respectively thru mid-August, while Emerging Markets have returned +3.2%. A rising U.S. Dollar so far into the third quarter has been too much for large cap international equities to overcome at this point. As we look out over the next few months, the Eurozone remains an area to keep watching as well as tensions on the geo-political front. These issues should set the pace for the global equity markets.



Source: Strategas

Asia Update

Things brightened up a bit with the Asian equity markets in the second quarter of 2014, as this region finally posted some positive performance. The broad MSCI Pacific region posted a +5.8% return in the quarter, nearly the best performing region in the MSCI EAFE Index. The Japanese equity market provided the bulk of the positive performance, as the “third leg” of structural reforms announced by the Abe administration was well received by investors. This announcement seemed to take the focus off of the increase in the national value-added tax at the start of the second quarter. Also, Chinese equities staged a rebound as several growth measures hit official government targets in the quarter. The outlook in Australia remains tough over the near term, as dependency on commodities is a tough place to be in a slow growth global economy. Going forward, investors will remain focused on the reforms in Japan and the growth concerns in China over the near term. We feel developments on these fronts will provide the direction for the equity markets in the region.

Market Performance

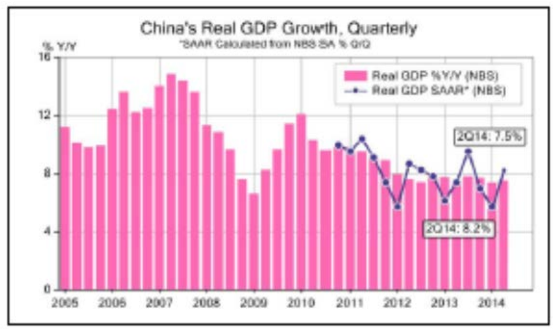
Data as of: 30-Jun-2014

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Taiwan	4.87	10.30	11.51
MSCI Philippines	2.66	9.07	19.92
MSCI Hong Kong	0.70	8.26	4.62
MSCI Japan	5.23	6.66	0.68
MSCI Pacific	3.21	5.77	3.12
MSCI Singapore	-0.21	5.71	4.75
MSCI China	3.17	5.52	-0.67
MSCI Australia	-0.21	2.77	8.86

Source: Factset

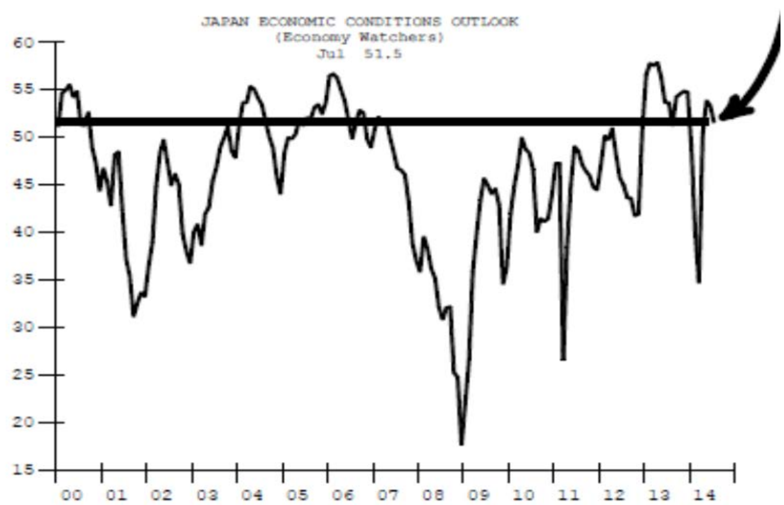
The Chinese economy displayed some acceleration for the first time in nearly a year, as government spending led the way. Gross Domestic Product (GDP) in China rose +7.5% in the second quarter of 2014 from the year earlier period, a slight increase in the pace from the previous quarter. Government measures to cut some taxes, reduce reserve requirements for some financial institutions, and increase some fixed asset investment seems to have stabilized this economy over the near term. Many of these measures came as no real surprise to many investors as government officials telegraphed much of this a couple of months back. Industrial production rose +9.2% in June, which was the strongest reading the second quarter, and a bit ahead of most forecasts. Fixed asset investment was reported up +17.3% for the first half of the year, basically in line with most projects, and just a tad weaker than the previous year. Also, retail sales seem to have stabilized a bit, as July sales were reported up +12.2%, a slight acceleration from the pace of the first quarter. There was good news on the export front, as exports rose +14.5% in July, significantly higher than all estimates. This record surge was fueled by robust exports to the U.S. and parts of Europe. Chinese exports continue to be benefitting from the ongoing recovery in the U.S. Inflation continues to drop as consumer prices only rose +2.3% in July, still well below the government's full-year target of +3.5%. This still leaves plenty of room for more monetary easing and other options to rejuvenate the economy. At this juncture, the Chinese economy appears to have stabilized just a bit and perhaps the government's official targeted growth rate of +7.5% can be achieved at this point. We feel this outlook is probably responsible for the near term strength in the Chinese equity market.

Source: ISI



Source: ISI

Coming as no real surprise, the Japanese economy shrank by -6.8% in the second quarter, as the April sales tax increase took effect. Even though this contraction is the largest since the 2011 earthquake, it was actually less than many had forecasted. In an effort to jumpstart the economy for a quick rebound, the Abe administration announced measures to lower the corporate tax rate as well as efforts to increase domestic equity exposure in the Government Pension Investment Fund. Industrial production rose +3.1% in June from a year earlier, a marked deceleration from the pace of the previous quarter, but stronger than the early part of the second quarter. Exports fell -2.0% in June from a year earlier, as a rebound late in the quarter has yet to be seen. However, a weak yen should be able to help this at some point. Business confidence seems to be relatively steady at present, but a bit weaker than what we have been expecting. Consumer confidence rose to 41.5 in July, which is actually higher than what this measure was at the end of the first quarter. Even though this still remains well below the critical 50 level, it is an improvement at the margin. Retail sales are showing some signs of recent strength, as June sales increased +.4% from the previous month. Perhaps the consumer is starting to move past the sales tax increase. Japan continues to move past its deflation concerns as core prices rose +3.3% in June from a year earlier. We haven't seen much change in the employment outlook recently. The unemployment rate was reported at 3.7% in June, which has been very steady over the last several months. In addition, the jobs-to-applicant ratio looks healthy, moving to 1.10, which is another high. Now that we have passed the recent April tax hike, we need to see how fast the economy can rebound and get back to growth mode. We saw some of this as we progressed through the second quarter, which is a good early read for the next few months. We expect this to be a key focus point for investors.



Source: ISI

Europe Update

The small level of stabilization we saw developing last quarter in the Eurozone region appears to be basically gone. Several countries across the region appear to be entering some type of recession and a few others are on the borderline. At this juncture, a recession would appear to be mild by most measures given the significant amount support the European Central Bank (ECB) is offering the economy. Deposit rates are now below zero at the ECB and it is preparing to embark upon a quantitative easing program for the first time if necessary. This has pushed interest rates to fresh record lows across the region. As an example, Spanish 10 year yields are now on par with U.S. 10 year yields, despite a significantly weaker credit profile and an unemployment rate 3.5x higher than the U.S. We find this quite illogical, but what amazing times we live in. As one would expect, with all of the central bank posturing going on in the region, investors are embracing these actions as it gives a bit of comfort to know that a central bank tailwind is behind you. This led to another quarter of decent equity performance as the MSCI European Index (ex. U.K.) posted a gain of +2.1% in the second quarter of 2014. This has pushed equity valuations higher and to a more neutral level vs. being attractive over the last couple of years. At this point, the biggest risks we see in the Eurozone region are mounting deflationary forces and a potential worsening economic picture leading to a broader recession in certain countries. Equities could remain somewhat volatile over the next few months as investors will remain on edge.

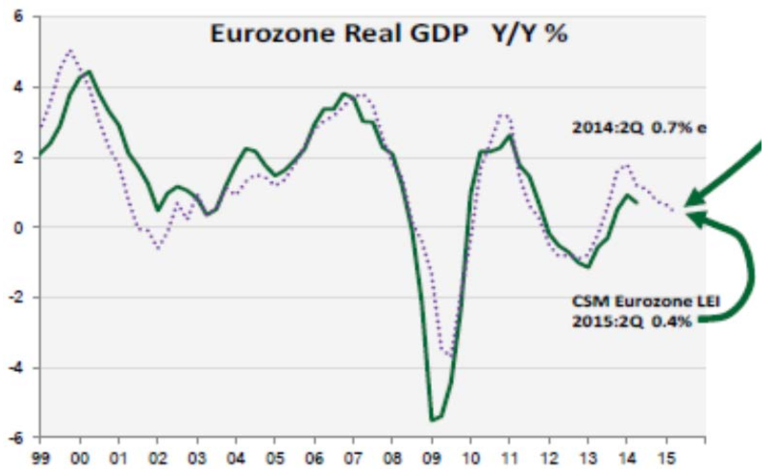
Market Performance

Data as of: 30-Jun-2014

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Spain	1.66	7.17	12.29
MSCI United Kingdom	0.64	6.05	5.17
MSCI Switzerland	-0.55	2.09	6.93
MSCI Europe ex UK	-0.45	2.06	5.63
MSCI France	-1.46	1.70	4.65
MSCI Germany	-0.66	1.65	1.31
MSCI Netherlands	0.96	0.50	1.56
MSCI Italy	-0.60	-0.12	14.45

Source: Factset

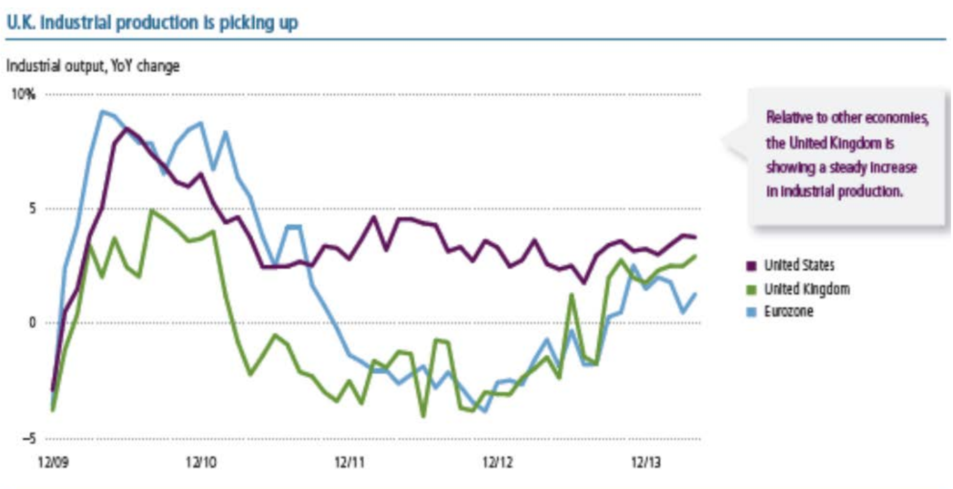
The Euroland economy looks very stagnant at the moment as the region continues to weaken. Second quarter GDP was flat from the previous quarter, but did grow +.7% from the year earlier period. The escalating crisis in the Ukraine is beginning to have a negative effect on the economy here. After being the pillar of strength in the last recession, the German economy posted negative growth for the first time in a long while. In addition, Italy has now officially entered a recession, as it posted its second consecutive quarter of negative growth. At this point, we don't see much in the way of prospects for growth over the near term as geo-political tensions seem to be rising. Industrial production remains weak across the region, as readings in May and June were both in negative territory. However, there are a few bright spots we can look to at present. The index of executive and consumer sentiment continues to remain fairly stable, reaching 102.2 in July, not too far away from the highs reached a few months back. This is probably a positive indicator that actions being undertaken by the ECB will eventually lead to some level of growth in the economy at some point. In addition, retail sales in June increased +.4% from a month earlier, or +2.4% from a year earlier, as this data point remains positive and is good for the economy. Widespread price cutting seems to be bringing the consumer out to spend at the present time. The employment situation remains very weak, but somewhat stable at the moment. The June unemployment rate was reported at 11.5%, a slight improvement from a few months back. We probably won't see much improvement in the employment outlook until we see some level of economic growth returning to the region. Inflation continues to contract, falling to +.4% in July, which is a five year low for the region. Deflation concerns are a major issue at this juncture as the ECB takes measures to avoid this. The ECB in June announced a negative deposit rate and measures to spur bank lending as it remains committed to do what it takes to support the Eurozone economy. We believe this remains a positive step to combat deflationary forces across the region. This should be a positive for investors and bring a little comfort to a weak outlook. At this point, the economic situation remains very weak and will probably remain so over the next few months, especially as the Ukraine story continues to unfold. This will probably make for touchy equity markets with fairly limited upside potential at present.



Source: Cornerstone Macro

The U.K. economy continued its impressive growth in the second quarter, which is in stark contrast to most regions in the developed world. GDP grew by +.8% in the quarter from the previous quarter, or +3.2% from the year earlier period. The government's economic plan appears to be working quite well, as growth is poised to be the best among the major industrialized nations around the globe. GDP has now passed the previous peak established in 2008. Industrial production continues to climb, rising +.3% in June from a month earlier, or +1.2% on an annual basis. Within industrial production, manufacturing remains decent, rising +1.9% from a year earlier. However, Mining and Oil/Gas were a bit weaker than expected. Retail sales remained strong and rose +1.6% from the first quarter, or +4.5% from the year ago quarter. This is the best quarterly figure in ten years. Retailers have not had to resort to steep discounting as they have in the past. In the meantime, inflation remains a non-issue in this economy. July's inflation reading was reported to be up only +1.6% from a year earlier, well below the Bank of England's (BOE) officially acceptable rate. We expect the inflation rate to remain below the BOE's acceptable rate over the next several months. At its recent August meeting, The Monetary Policy Committee

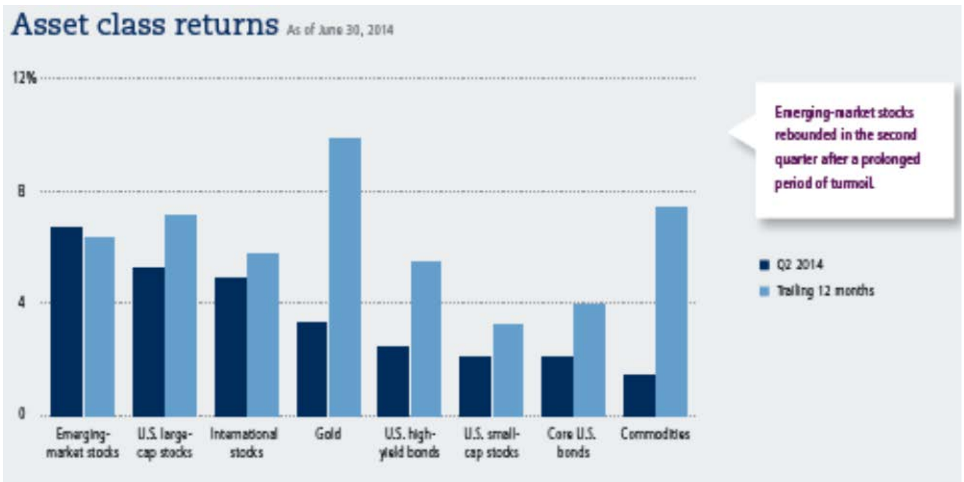
(MPC) kept interest rates at a record low of .50% and its bond purchase target remained at 375 billion pounds as it has been for quite some time. However, we are beginning to see talk of when the first rate hike is expected to take place. Members of the MPC could be near a split on when this happens. We believe we are closer to seeing rising interest rates in this economy than many people believe. However, we still do not see this as a near-term event. The employment situation still remains a mixed bag at the moment. The unemployment rate fell to 6.4% in the three month period through July, which continues to be a positive indicator in the economy. Employment rose by 167,000 in the three month period, to another record of 30.6 million as jobless claims continue to fall. However, wages declined in July for the first time in nearly five years as worker pay increases continue to be lackluster. Overall, the U.K. economy remains very healthy and one of the strongest in the developed world at the present time. One area worth watching are developments surrounding when interest rates will rise. We are beginning to see some dissention on the MPC as to when this should happen. Obviously, any surprises here could provide a new direction for the equity markets. However, we still believe this will not be a near-term event.



Source: John Hancock Investments; Bloomberg

<u>Emerging Markets</u>

Emerging market equities finally had some decent returns in the second quarter, as several countries had positive developments that surprised some investors. The elections in India gave investors something to cheer about, as the prospects of economic reforms are as high as we have seen them in quite some time. Also, Russian equities posted some strength, as tensions with Ukraine seem to simmer down just a bit in the quarter, even though this proved to be short lived. China's growth rate seems to be right in line with government expectations, providing some relief for many that had expected this to be worse. In addition, we saw an interest rate cut in Turkey that caught most investors by surprise. Couple these actions with decent equity valuations in some of these markets, and this proved to be the right formula for good equity returns in emerging markets. It seems investor sentiment toward this asset class has improved significantly over the last few months. Obviously, the geo-political tensions around the globe are worth monitoring here as well as a potentially weakening European outlook. These issues could set the tone over the next couple of months.



Source: John Hancock Investment; Morningstar; Factset

International Equity Activity/Strategy

After robust returns in the second quarter, the international equity markets seem to be a bit tougher to gauge at this point. On one hand, central bankers are still a source of a tailwind on the margin, interest rates are well contained, inflation remains mostly under control, and M&A activity looks very good. However, a recessionary dip is happening with some countries in the Eurozone, geo-political risks are rising in some areas of the globe, and valuations are not as cheap as they have been over the last year. However, relative to other investment alternatives, we still believe global equity markets can move higher, especially if the central bankers remain on course for the next few months. In the end, in the absence of a significant negative development on the geo-political front, it's hard to fight the central banks. This should continue to provide a nice backdrop for the equity markets. Thus far into our current fiscal year thru mid-August, global equity returns remain good, with the S&P 500 Index up +19%, the MSCI EAFE Index up +8%, and emerging market up +11%.

We have not taken any significant portfolio actions in our global equity portfolios in the quarter. The option space is one area where we remain quite active though, as we continue to sell put options on emerging markets ETF in an effort to buy some exposure into a weak emerging markets index if the market turns a bit southward. 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 12.4% for MSCI EAFE equities. *(Charts provided by Strategas, Factset, Natixix Funds, Gateway Investment Advisors, LLC, John Hancock Investments, Morningstar, Bloomberg, Cornerstone Macro, ISI)*