Quarterly Economic Update

December 3, 2013

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

Monetary policy and the Federal Open Market Committee (FOMC) are in a stage of transition as Janet Yellen waits to be confirmed as the new Federal Reserve Chairman and the FOMC moves towards beginning the removal of policy accommodation by tapering the amount of their large scale securities purchases. While we are in a stage of transition, there has been no actual change to current policy. The target range for the federal funds rate has remained constant at 0 to ¼ percent. The Federal Reserve also continues to purchase $45 billion in Treasury securities and $40 billion in agency mortgage-backed securities per month. It appears the next move by the FOMC is to begin tapering their securities purchases, but questions and speculation about when they begin, how much, the pace and composition of tapering all remain. Now that Janet Yellen has been nominated and as she moves through the confirmation process, investors have begun to contemplate what the Federal Reserve looks like with Yellen at the helm and what it means for future policy action.

Going into the September meeting, markets were confident that the FOMC would begin tapering their large scale asset purchases by year end and expectations that they would begin tapering at the September meeting were high. There were questions around how much the FOMC would taper purchases and whether it would include both Treasuries and agency MBS, but leading into the meeting expectations had been increasing that some form of tapering was likely. So when the FOMC announced following their September 17-18th meeting that they would continue with the pace of their securities purchases, many market participants were surprised. The FOMC statement cited concerns around the sharp rise in mortgage rates over the summer and fiscal policy as potentially restraining economic growth. While noting improvement in economic and labor market conditions, with concerns that these tighter financial conditions could slow the pace of improvement the Committee "decided to await more evidence that progress will be sustained before adjusting the pace of its purchases." They also hammered the point again that "asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's economic outlook as well as its assessment of the likely efficacy and costs of such purchases."

Chairman Bernanke further explained in his post meeting press conference that "the Committee concluded that the economic data do not yet provide sufficient confirmation of its baseline outlook to warrant such a reduction" in asset purchases. Bernanke stressed that policy action would be data dependent and that prior quantitative thresholds provided on employment and inflation were indeed thresholds and not explicit triggers for tighter policy. He stated that a "decline in the unemployment rate to 6 ½ percent would not lead automatically to an increase in the federal funds rate target" and that "the first increases in short-term rates might not occur until the unemployment rate is considerably below 6 ½ percent." These statements combined with the statement that the "Committee would be unlikely to increase rates if inflation were projected to remain below our 2 percent objective for some time" show us that the FOMC remains in no hurry to raise rates any time soon. According to their own economic projections, even as unemployment is projected to fall below the 6 ½ percent threshold by 2015, inflation projections remain well below 2 percent through 2016.

The minutes from the September FOMC meeting, released October 9th, shed further light on the discussions surrounding whether it was appropriate to continue the pace of securities purchases or begin to taper purchases. It is clear from the minutes that many members wanted to begin tapering purchases, but had some concerns about the sharp move in interest rates and its effect on housing along with the weaker pace of improvement in employment. Couple this with the uncertain fiscal outlook and some participants clearly had less confidence in their outlooks. A "number" of participants expressed concern about the uncertain fiscal policy in light of the potential government shutdown and debt ceiling debate. A "number" of participants also indicated that gains in payrolls over the summer had been disappointing. There were varying views on whether the conditions for reducing the pace of securities purchases laid out in June had been met. There were also differing opinions on what kind of signal tapering or not tapering would send in light of prior communications and the subsequently mixed economic data. Participants who felt prior conditions had been met voiced concern that credibility could be questioned if the Committee did not taper purchases rendering their communications as a policy tool less effective. Others thought that beginning to taper purchases in light of a weaker pace in employment gains might bring to question whether policy actions were truly data dependent. In light of expectations for a taper beginning in September, concerns were also expressed that not tapering purchases could signal that the FOMC had become significantly more pessimistic about the economy. The minutes did state that the majority of those in favor of reducing the pace of purchases only supported a small reduction, indicating that the majority of participants were more cautious in light of the mixed data. While the minutes explicitly state that the decision was a "relatively close call", in the end all FOMC members but one voted to maintain the current pace of purchases.

At the October 30th FOMC meeting, there was again no change in policy and the FOMC statement released was virtually identical to the September statement outside of some small adjustment around the economic commentary. The October minutes, released on November 20th, indicate further discussion around how and under what conditions to implement tapering and how to best communicate the FOMC's intentions on future policy actions. The FOMC is clearly not happy with the way the financial markets are interpreting their communications. It is important that asset purchases and forward guidance on the federal funds rate are viewed as two separate policy tools both independent of the other. Market participants are linking these together. The FOMC is trying to communicate that a change to the asset purchase program, specifically decreasing the amount of monthly purchases and eventually discontinuing purchases, does not represent a change to their economic outlook and does not represent a change to their expectations on the level of the federal funds rate. They are trying to communicate that their forward guidance means exactly what it says, that the rate will remain low at least until the unemployment rate declines below 6 ½ percent and that their economic projections expect that the rate will remain at that level until 2015 and that this is independent of their large scale purchase program. Financial markets seem to be interpreting a reduction in their securities purchases as guidance on the timing of tightening the federal funds rate and this appears to be frustrating the FOMC.

It seems many FOMC members would like to decrease and wind down their large scale purchase program, but are struggling with how to do this without causing tighter financial conditions that could stall economic improvement. The reaction in interest rates this summer when they began discussing winding down the program has concerned them and they seem to be having difficulty figuring out how to exit the program. The October minutes did note that participants thought the economic data would warrant trimming the pace of purchases in coming months. It was also discussed whether it would be useful to tie an adjustment in the pace of purchases to some sort of quantitative employment measure, tie the total program size to a dollar figure, or announce a timetable to exit the program. While some thought these actions could help communicate a smooth removal of accommodation, they seem to have all been dismissed on various issues that could reduce the flexibility and data dependent nature of the program. The composition of reducing Treasuries, agency MBS, or a combination was discussed again as well with no apparent resolution on how they may proceed when they do begin to taper purchases. There seems to be consensus among members that additional forward guidance for the expected path of the federal funds rate would be helpful and various quantitative and qualitative measures appear to have been discussed. It was decided that additional guidance was not needed at this point, but that it would be helpful to provide in the future and might be beneficial to provide additional guidance on the federal funds rate along with implementing a reduction in their securities purchases.

In September, the short list for the next Federal Reserve Chairman had been narrowed down with either Larry Summers or Janet Yellen as the most likely nominee. It had become apparent that President Obama seemed to have a preference for Summers, but concerns were being voiced that indicated it would be difficult to get him through the confirmation process. On September 15th, Summers withdrew his name from consideration. Other candidates were still being considered, but Summers withdrawal made Yellen the clear frontrunner for the nomination. On October 9th, President Obama announced Janet Yellen as his nominee for the next Federal Reserve Chairman. Yellen is currently making her way through the confirmation process and testified before the Senate Committee on Banking, Housing, and Urban Affairs on November 14th. Her confirmation hearing, as expected, was mostly uneventful with Yellen indicating little deviation from current Fed policy under Bernanke's leadership. Yellen faces some opposition, but is expected to be confirmed. On November 21st, the Senate Banking Committee approved Yellen's nomination by a 14 to 8 vote which now allows her nomination to move forward to a full Senate confirmation vote by year end or early January.

With Yellen likely to be confirmed as the next Federal Reserve Chairman, market participants look forward to what the Federal Reserve will look like under Yellen's leadership. Currently serving as Vice Chairman of the Federal Reserve, Yellen has had a strong voice within the Federal Reserve and been instrumental in pushing forward with policy action in recent years. She has played a big role in increasing transparency and communications from the Fed and should be expected to continue to do so. Those who have worked with her say she holds strong to her views but is open to differing opinions and tolerant of disagreements, not willing to compromise her views in order to build consensus but nonetheless effective building consensus. She is viewed as very dovish, even more so than Bernanke, but this should be viewed in the context of the unique environment we have had over the past several years. She clearly favors maintaining accommodative policy until it is clear that improvement in growth and employment is sustainable and is very reluctant to remove accommodation prematurely, especially in light of low inflation. Her measure of the sustainability of economic improvement is likely a higher bar than others on the Committee, but she is likely unwilling to compromise on this as she views the risks associated with a recession as high. However, once growth and employment gains do become more sustainable, she is likely to move quickly to normalize accommodation and would be aggressive if inflationary pressures rose above acceptable levels. She is not ignorant of the costs associated with accommodative policy tools and people likely underestimate her willingness to act as the economic environment changes.

The next FOMC meeting is December 17-18th and after that January 28-29th. Chairman Bernanke's term as chairman officially ends on January 31st. Once Yellen is confirmed, assuming she is confirmed, she is likely to take the reins either officially or unofficially depending on whether Bernanke stays on through the end of his term. Either way, at this point, she will now be assuming the leadership role on policy decisions going forward as Bernanke transitions out. Whether the FOMC begins to taper the pace of their securities purchases at the next meeting or not remains unknown, but if employment gains continue it is highly likely that they will taper purchases at some point over the next several meetings. We can also anticipate that the FOMC will provide additional forward guidance on expectations for the path of the federal funds rate in the near future as their communication tools seem to be giving off mixed signals lately. This additional guidance will attempt to provide more reassurance that they intend to hold the federal funds rate at extremely low levels and provide transparency on the conditions they will be looking for when it is deemed appropriate to tighten policy. The FOMC will continue to stress that policy actions on tapering and the federal funds rate should be viewed separately and that they remain data dependent as we move forward.

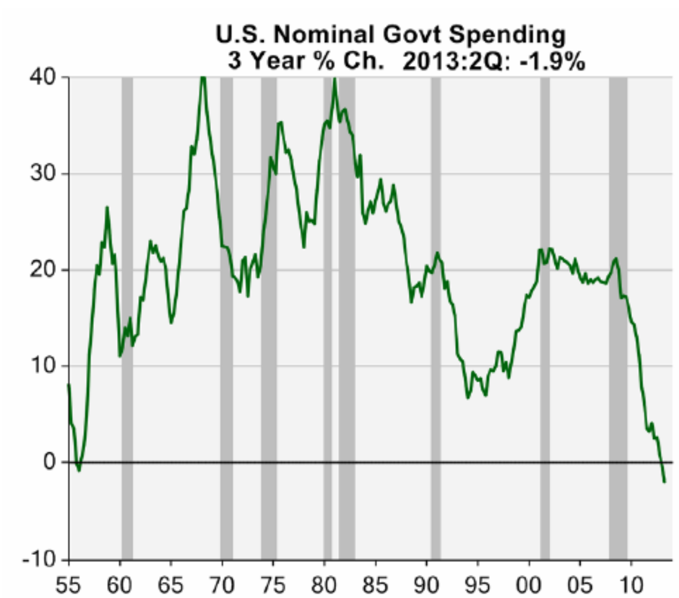
Fiscal Policy

By Michael McNair

From the spending cuts and tax increases to the overall hit to consumer confidence from tense political battles, the Federal government has not been kind to the US economy over the past few years and especially in this most recent quarter.

Since 2010, a consistent theme in the *fiscal policy report* has been the fiscal drag the economy has faced as a result of spending cuts and tax increases at the federal level, which has kept the US economy from achieving a much stronger recovery from the financial crisis. We cannot emphasize enough the role that tightening fiscal policy has played in suppressing the US economy during this "recovery."

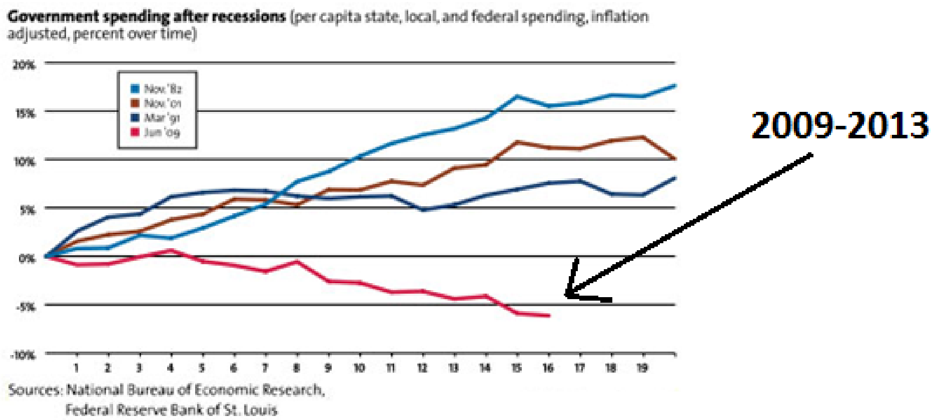
After a recession, it is typically the job of the federal government to increase spending to keep the economy in a steady recovery. **However, over the past three years, federal spending has actually fallen by a post war record 2%.**



Source: Cornerstone

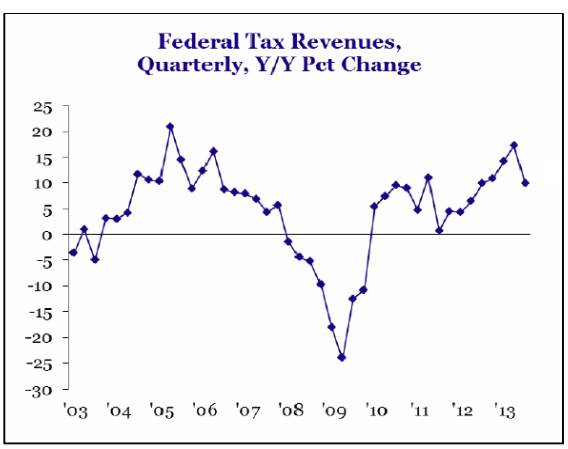
The size of the recent spending cut is unparalleled even during times when the economy was strong, let alone in the wake of the worst post war recession in our nation's history.

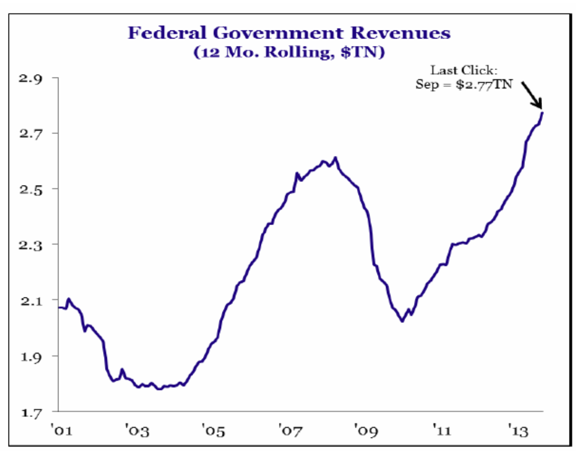
To put the cuts into perspective, the chart below compares government spending after the past four recessions. Four years after the three previous recessions (1981 under President Reagan, 1990 under President H.W. Bush and 2001 under President W. Bush), federal spending was 7-10% higher than it was prior to the start of the recession. Yet, despite the most recent recession being far worse than the three previous episodes, federal spending is currently 7 percent LOWER than it was at the start.



We must reemphasize the fact that over the past three years, not only did federal spending drop by the most in our nation's recorded history but it did so during three of the most fragile years our country has ever experienced. In other words, we did exactly the opposite of what we should have done.

The drop in federal spending, on its own, was an extraordinary hurdle for the fragile US economy to overcome; yet, fiscal policy also hit the economy with sharp tax increases. As you can see in the chart below, federal tax revenue has risen by 13% in the last year.

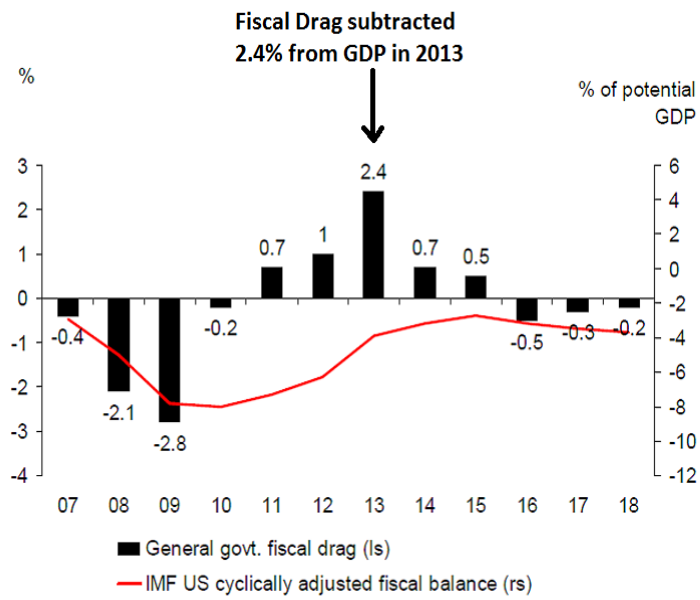




Source: Strategas

Despite the consistent reporting and coverage of the fiscal drag by economists, we continue to get asked if the fiscal drag really is a big deal. The answer is unequivocally yes, it is a huge deal.

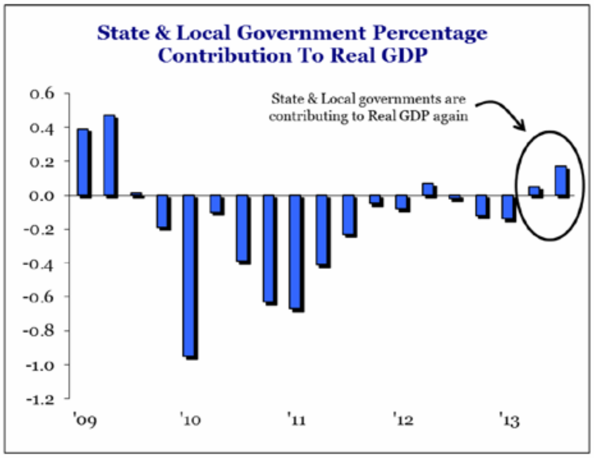
According to the IMF, the fiscal drag this year is **2.4%**, which means that federal government spending cuts and tax increases subtracted 2.4% from US GDP growth in 2013. **The US economy is expected to grow at a tepid 1.7% in 2013 but absent the drag from fiscal policy the economy would have grown at a strong 4.1% pace.**



Source: IMF Fiscal Monitor, October 2013, Haver Analytics, DB Global Markets Research

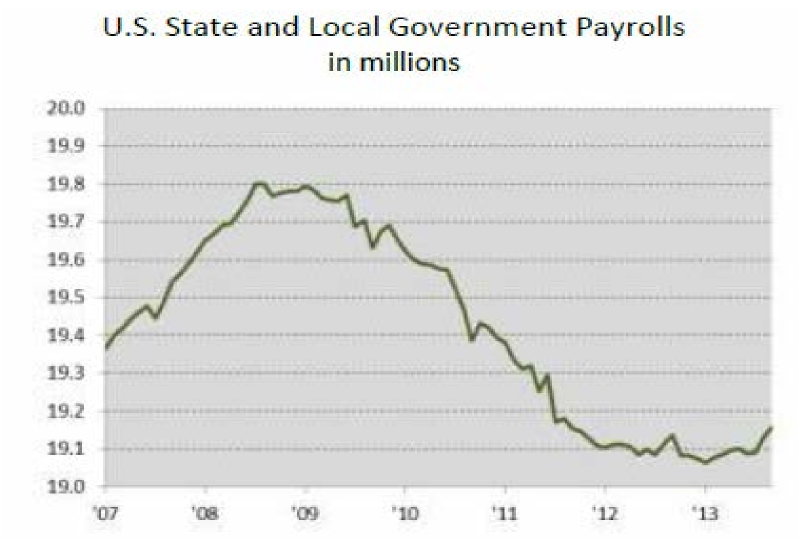
It's often difficult to fully grasp an abstract statistic like GDP; therefore, it may be easier to comprehend the impact of the fiscal drag by looking at more tangible number like employment. According to Deutsche Bank economists, the private sector added 186,000 jobs per month (based on non-farm payrolls) in 2013, but that number would have been over 400,000 without the fiscal drag. In other words, **the fiscal drag cost the US economy around 2,600,000 jobs in 2013 alone.** While fiscal policy has been a drain on the US economy since 2010, the fiscal drag hit a peak in 2013. The good news is that the fiscal drag begins to decline in the 4th quarter of this year and drops significantly in 2014, with estimates for next year's fiscal drag ranging from 0.7% to negligible. Absent the fiscal drag, the US economy would have seen strong growth in 2013; therefore, it is likely that economic growth reaccelerates in 2014, as the fiscal drag is removed.

Our previous comments on the fiscal drag have pertained only to the impact from the federal government's contribution to GDP; however, state and local government spending can also have a large impact on the economy. Fortunately, our outlook for state and local government fiscal policy is also improving. State and local governments were able to balance their budgets last fiscal year and, in aggregate, states did not face deficits in the current 2014 fiscal year (which began July 1, 2013 for most states). Unlike the federal fiscal drag which is only getting "less bad" next year, we expect state and local government spending to actually be a stimulus to the economy in 2014.



Source: Strategas

We also believe that state and local government employment has finally bottomed after 5 years of cuts. There are seven times more state and local government jobs as there are federal; therefore, we believe that even gradual job growth at the state and local level will be enough to offset the continued declines in federal employment.



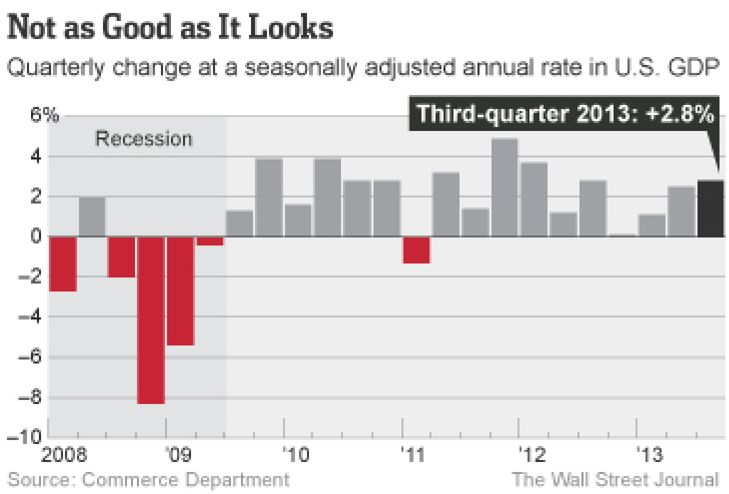
Source: Bloomberg, cornerstone

For the past three years tight fiscal policy has increasingly encumbered the US economy; however, it is likely that the economy will now begin to reaccelerate since the fiscal drag has finally reached a crescendo.

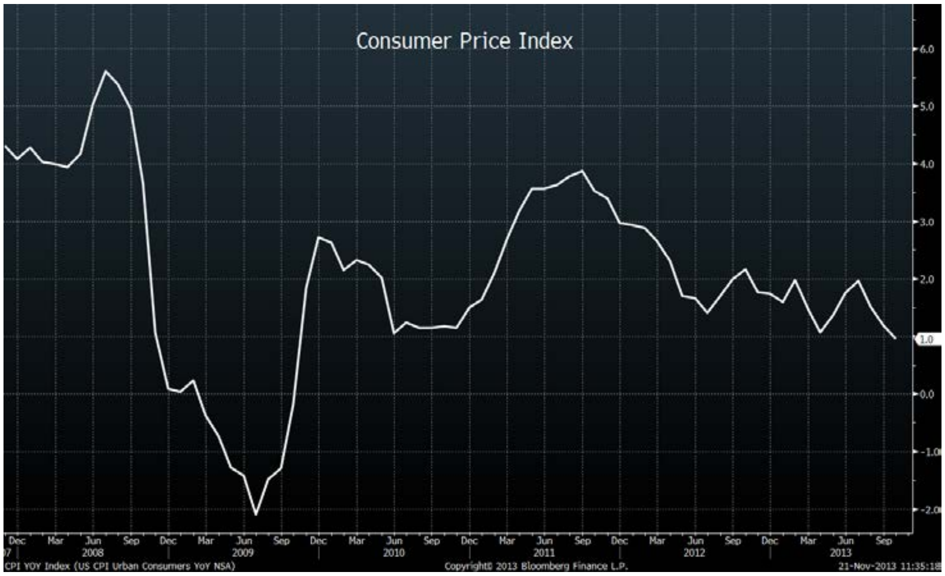
Economic Outlook

By Keith Buchanan

The US economy grew 2.8 percent last quarter, faster than the 2 percent rate that economists forecasted, due to a larger than expected inventory build. As this is the second consecutive report with a larger than expected inventory build, many worry that inventory destocking could weigh on the next two quarterly reports. The third quarter report furthers the belief that, in aggregate, the economy is growing at a decent clip without warranting fanfare or the ire of monetary policymakers. The economy seems to have found a balance between stoking fears of slipping into another recession and near-term overheating. Consumer spending and business investment came in less than consensus expectations. Residential construction increased at a 14.6 percent annualized rate, while government spending rose at a 0.2 percent rate, the fastest growth since 2009.

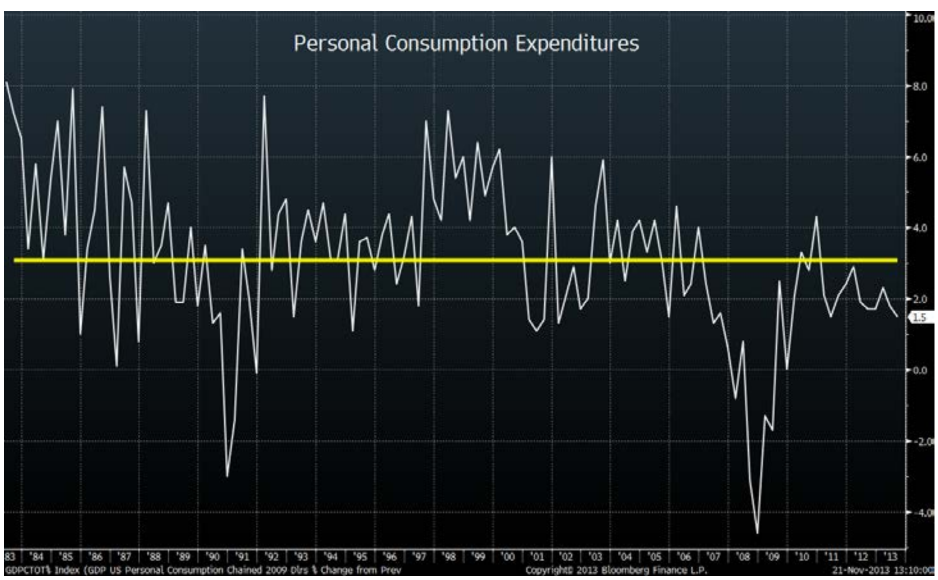


The Consumer Price Index rose at an annualized rate of 1% in October, the slowest rate of the inflation measure in the past four years. The impact of low inflation on the economy going forward is two-fold. Inflation at low levels helps to keep the Fed at bay. Also, lower cost of living falls straight to the consumer's bottom line, leaving them with more discretionary funds.



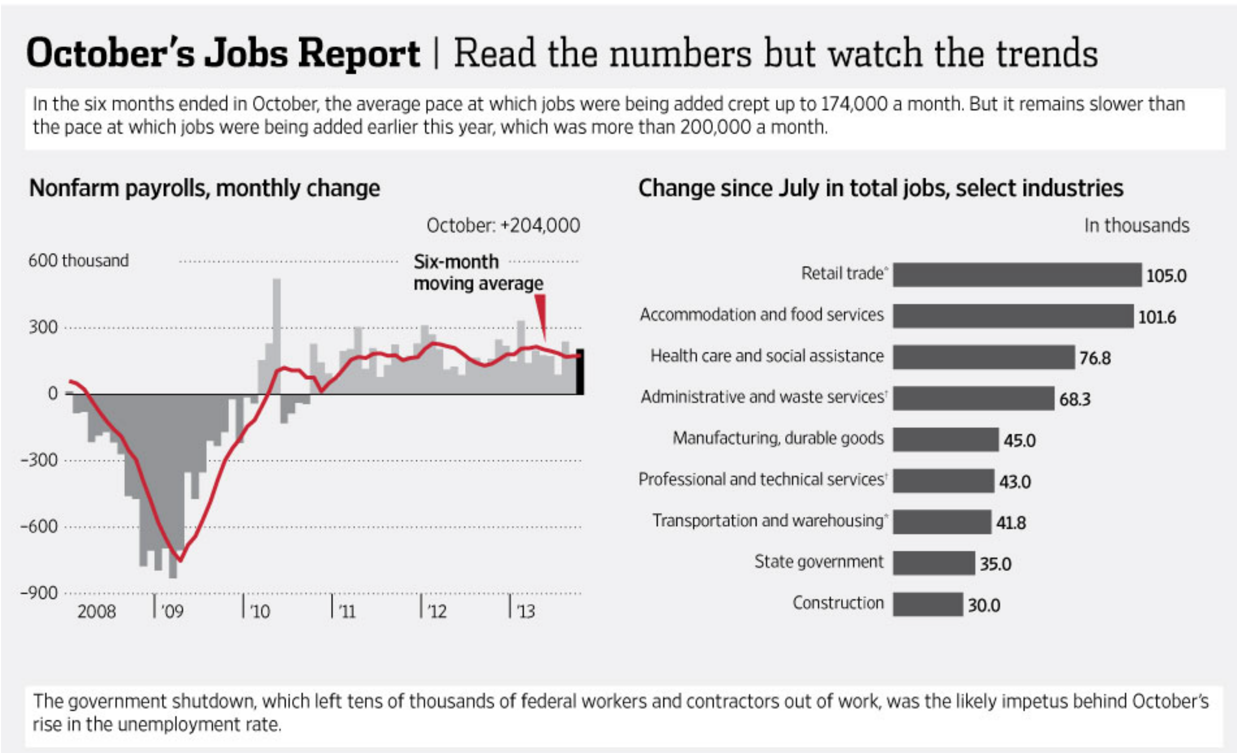
Source: Bloomberg

Consumer spending is currently growing at a 1.5 percent annualized rate, well below the 3 percent long-term average. Automobile sales have been the bright spot in consumer spending. Even through the 16-day government shutdown, Americans are buying automobiles at a 15.2 million annualized clip, compared to 14.4 million last year.



Source: Bloomberg

October's nonfarm payrolls report surprised to the upside as the labor market weathered the partial federal shutdown. The economy added 204,000 workers in October after adding 163,000 in September, reflecting a much healthier labor market than most experts expected. The Labor Department noted that "there were no discernible impacts" of the shutdown on the monthly survey. Private sector employment gained 212,000 jobs, marking the largest gain since February. All eyes are on the November nonfarm payrolls report. Many economists believe that if November proves that the 200,000 new jobs per month is a trend, then monetary policymakers will have to take notice.

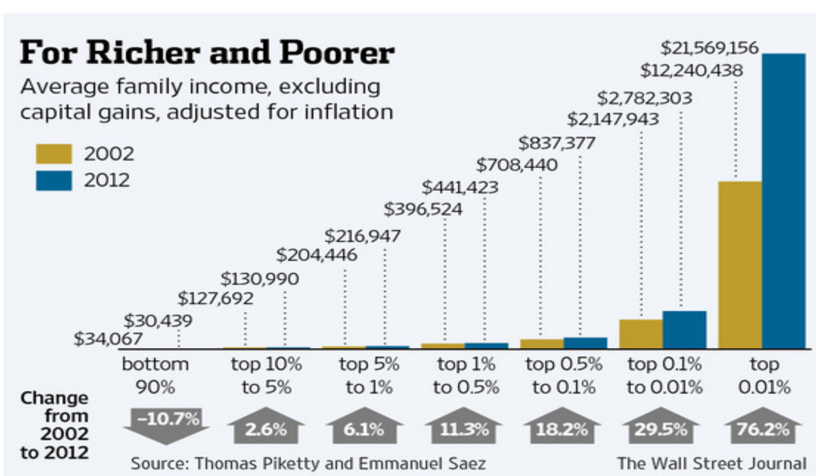


Source: The Wall Street Journal

The housing market seems to have cooled from a frenzied pace this spring. Existing home sales declined 3.2 percent in October, marking the slowest pace since June. Rates for a 30-year fixed rate mortgage are up to 4.5%, a full 110 basis point move in 12 months. Housing affordability has suffered as a result, dampening the recovery in the housing market.

Source: Bloomberg

Economic inequality has been the topic du jour of many economists' circles of late. Economic equality is the idea that as the economy improves, both high and low wage earners should share the increase in a proportionate way. In other words, the tide should lift all boats. If this does not come to pass and more assets and income accumulate in the hands of fewer and fewer Americans, this growing inequality leads to economic instability. Economic inequality is not a new concern that just cropped up over the past few years. From the end of World War II through the 1970s, the middle class exploded and took home a stable if not growing slice of gross domestic income. However, that has since changed as the top earners have taken home an ever larger portion of national income. Only in 1927, the height of the "Roaring '20s" that set the stage for the Great Depression, has income dispersion been as top-heavy as it has been over the past few years. Since the financial crisis of 2007-2009, the problem has become even worse. The top 1% of income earners has absorbed 95% of the nation's income gains of the current recovery.



Interest Rates and Fixed Income Strategy

By Lance Lachney

At the time of our last meeting, interest rates were on the rise as the Federal Reserve appeared eager to begin the process of unwinding its quantitative easing program, known as QE3. The $85bn monthly purchase of treasury and mortgage-backed securities was initiated during the second half of 2012. The idea of tapering, or reducing the amount of bond purchases, delivered by Chairman Ben Bernanke caught investors off guard and led to abrupt increases in interest rates during the summer months. In response, the Retirement Systems executed duration-extending trades within our treasury and mortgage portfolios as a hedge against weaker than expected growth and a return to lower absolute yields. The thought process being that a relief rally in rates was likely in the near term considering the magnitude of the recent increase. By early September, the 10yr treasury yield breached 3% after flirting with the 1.60% level just four months prior.

The Federal Reserve, taking notice of the damage inflicted on fixed income markets, chose not to alter the current pace of its asset purchases. Investors had been expecting at least a $10-15bn reduction at the September meeting. The inaction came in the midst of an uninspiring payroll report and uncertainty surrounding the debt ceiling and potential government shutdown. The bond market received the news favorably, resulting in positive returns across all asset classes. Mortgage-backed securities were the biggest beneficiary as the largest player (the Fed) remained firmly entrenched in the mortgage market. Corporate bond spreads were essentially unchanged during the month of September, achieving most of their gains on the back of a treasury market rally. Companies used this downdraft in yields as yet another opportunity to borrow before the Fed removes accommodation. The most notable development within the corporate sector was the $49bn issuance from Verizon. The proceeds of the eight-tranche debt offering are being used to purchase the remaining stake of Verizon Wireless from Vodafone. Despite having more than $100bn in orders, these securities were priced at a significant concession due to the size of the deal and the current rate environment. The deal was roughly three times larger than the biggest issuance on record, Apple’s $17bn behemoth that came to market earlier this spring. The RSA participated in the 5yr floating-rate note, as well as the 7yr and 20yr fixed debt. These issues were priced at 175bps, 215bps, and 250bps respectively over comparable treasuries.

With Washington passing a continuing resolution and a debt ceiling showdown shelved for another day, risk assets rallied during the month of October. The appetite for risk spread across all asset classes as tapering was no longer viewed as an imminent threat. As expected, high yield debt was the best performing sector within fixed income, posting a monthly return of approximately 2.50%. High grade corporates locked in their second strongest month of the year with a return of 1.50%. Metals and mining were the best performing sectors within high grade, highlighting that investors opting to move down the credit spectrum were rewarded handsomely. The Retirement Systems experienced very little trading activity on the fixed income side during the month. On the new issue front, the fund purchased Bank of America's 5yr note that was priced at 128bps over treasuries. In our view, the 5/10s credit curve was trading too flat in comparison to its banking peers Citigroup and JP Morgan. This discrepancy presented approximately 15-20bps of spread tightening potential. Secondarily, the fund purchased a small block of intermediate utility paper in order to pick up additional yield in a relatively stable sector within fixed income.

Comparative Total Returns										
Oct 31, 2013	Short-Term Cumulative Returns						Annualized Returns			
	YTD	WTD	1Mo	3Mo	6Mo	1yr	2yr	3yr	5yr	10yr
US										
Treasury	-1.92%	-0.10%	0.55%	0.77%	-2.69%	-1.84%	0.94%	2.37%	4.12%	4.45%
High Grade Corp.	-0.99%	-0.05%	1.50%	1.65%	-2.70%	-1.09%	4.54%	4.88%	11.05%	5.54%
High Yield Corp.	6.34%	0.25%	2.46%	2.83%	1.46%	8.83%	10.97%	8.88%	18.02%	8.74%
Leveraged Loans	4.38%	0.10%	0.74%	0.93%	1.50%	5.47%	7.04%	5.74%	11.64%	5.41%
Convertibles	21.21%	-0.18%	1.99%	5.17%	10.98%	24.98%	16.54%	11.27%	17.16%	7.48%
Municipals	-2.33%	0.26%	0.94%	1.61%	-3.92%	-2.13%	3.63%	3.69%	6.73%	4.80%
Preferreds	-2.16%	-0.07%	1.62%	-1.17%	-5.98%	-2.48%	4.78%	5.01%	9.94%	2.05%
Mortgage Markets										
Mortgage Master	-0.23%	-0.11%	0.71%	1.83%	-0.67%	-0.30%	1.59%	2.57%	5.12%	4.89%
Global Equity Markets										
S&P 500	25.30%	-0.16%	4.60%	4.75%	11.14%	27.17%	21.00%	16.54%	15.15%	7.45%

Source: CreditSights, BoA/ML, S&P/LSTA, Bloomberg, British Bankers Association.

After dropping approximately half of a percent from its recent high through the end of October, the 10yr treasury yield has reasserted its upward trend over the last few weeks. In fact, the 30yr yield is touching a new high once again after its post non-taper rally. During this time, economic data has come in better than expected. The economy grew 2.8% in the third quarter, despite the drag from a 16-day government shutdown. Employers also added more than 200,000 to their payrolls in the government's latest report. Credit risk has remained fairly stable during the latest uptick in interest rates. In the new issue market, the fund has purchased a few high quality names in the intermediate part of the curve. From a pure allocation standpoint, the Retirement Systems is adding a minimal amount of new money to fixed income.

Looking ahead, Vice Chairman Janet Yellen is set to replace Ben Bernanke as Chairman of the Federal Reserve when his term expires in January. The minutes from the Federal Open Market Committee's October meeting revealed that policymakers expect the upcoming data to "warrant trimming the pace of purchases in the coming months." This statement has made a December reduction of purchases a legitimate possibility. After staying the course in September and October, investors pushed the timetable for the Fed's initial tapering into early 2014. This development has led to steepening in the yield curve, as the front end remains firmly anchored with policy rates near zero for some time to come. Fed Vice Chairman Janet Yellen made it perfectly clear in her nomination hearings that she will continue to provide monetary accommodation until a robust recovery is intact. The fund is well positioned for what we believe to be a less volatile move higher in interest rates than the one experienced this past summer.

Domestic Equity Strategy

By Allan Carr

Since we last met, the market has continued to chug along with the S&P 500 up over 10%. At our last update on August 27th we highlighted the precarious spot the market was in with the Fed expected to taper quantitative easing(QE) despite tepid economic data. A few weeks later risk assets received two positive announcements regarding monetary policy. The first came with Larry Summers withdrawing his name as a candidate to succeed Bernanke as Fed Chairman on September 16 as Summers was viewed as being the most hawkish of possible replacements. Then on September 18, the Fed surprised by not tapering QE at all and stating they would wait for more evidence of economic recovery before beginning to pull back on their $85B monthly bond purchases. The S&P 500 closed at an all time high on that day on the news, but it was short lived.

From September 18 to October 8 the market sold off 4% over the well documented wrangling in Washington regarding the government shutdown and debt ceiling negotiations. From there, we reversed course sharply as it became clear that the shutdown would end and the debt ceiling would once again be raised and put off to worry about at a later date. With these two distractions in the rearview mirror and the likelihood of Fed tapering being pushed out until at least March 2014, the market has increased roughly 8.5% since October 8. This puts the market up north of 25% year to date with the S&P 500 hovering around 1800, a remarkable run from the March 2009 intraday low of 666.

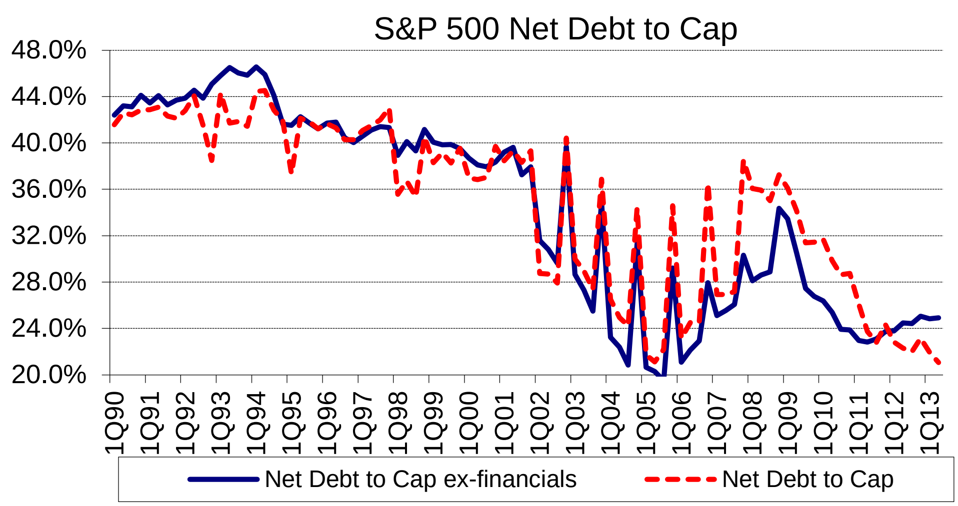
Given the market is at all time highs, history would tell us we should be seeing signs of complacency and arrogance in Corporate America in regards to spending. In the past this is when we've seen over exuberance in capex, hiring, lavish spending on things such as private jets and headquarters, egregious multiples being paid on deals, etc. But this time around we aren't seeing irrational spending, and if anything, we are seeing the opposite. We have written several times previously about this dynamic where what is good for corporations is not necessarily good for the overall economy. Companies are reluctant to spend on capex and hiring which leads to suboptimal GDP and employment growth.

It is likely a confluence of factors contributing to this dynamic: uncertainty on issues in Washington DC (fiscal/monetary policy, end of QE, clarity on new rules/regulations such as bank capital requirements, the shutdown, debt ceiling, tax laws, healthcare costs, Obamacare, midterm elections, etc.), continued focus on margins/productivity, companies being rewarded for returning excess cash to shareholders instead of spending it, and simply the credit crisis still being fresh on management's minds. Whatever each particular company's reason might be, the cumulative result is spending is not out of control this time and if anything is on the cautious side. This is good for companies in that the risk of a substantial decline in earnings is much less likely in the near future. But as stated, this continues to lead to muted economic growth.

So if economic growth has continued to be slower than expected, what has been behind the market continuing to soar? We think the simple answer is there is no obvious "800 pound gorilla in the room" to worry investors in the near term, which has led to steady multiple expansion. Since the credit crisis there has continuously been something macro related lingering that posed downside tail risk, whether it be here in the U.S. or abroad. Taper talks and the debt ceiling debates have been pushed out, Europe is doing better, gas prices are down and at 2013 lows, the consumer is in better shape, and earnings are fine. The general consensus has become that there is not a macro issue looming in the near term to derail this ongoing global expansion in developed markets. Adam Parker at Morgan Stanley summed it up with "it doesn't seem to be the base case that matters but the lack of a plausible bear case that's driving the market...the base case is mediocre, but the bear case isn't that likely." Let's take a look at the underpinnings of this thought process.

We mentioned managements focusing on the P&L in regards to margins and spending and they also continue to be conservative on the balance sheet as well. We have mentioned repeatedly about the health of corporate balance sheets and they continue to get stronger and remain in great shape. Chart 1 from Citigroup shows how clean balance sheets have become.

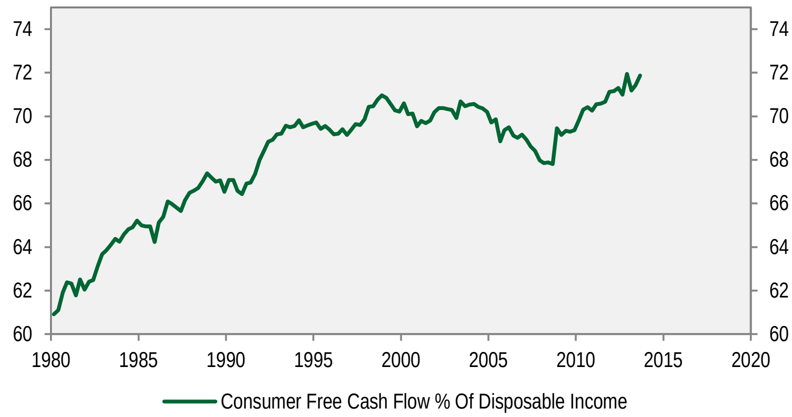
<u>Chart 1</u>



Managements seem to increasingly get the message that the use of excess cash to return to shareholders is being rewarded. David Kostin at Goldman Sachs wrote that the shares of companies with the largest buyback programs have outperformed the market by 970 bps so far this year. On the flip side, companies with higher capital spending have been underperforming. Once again, good for individual companies and shareholders, but not necessarily good for the overall economy as managements may be more inclined to increase capital returns rather than spend on new equipment or workers.

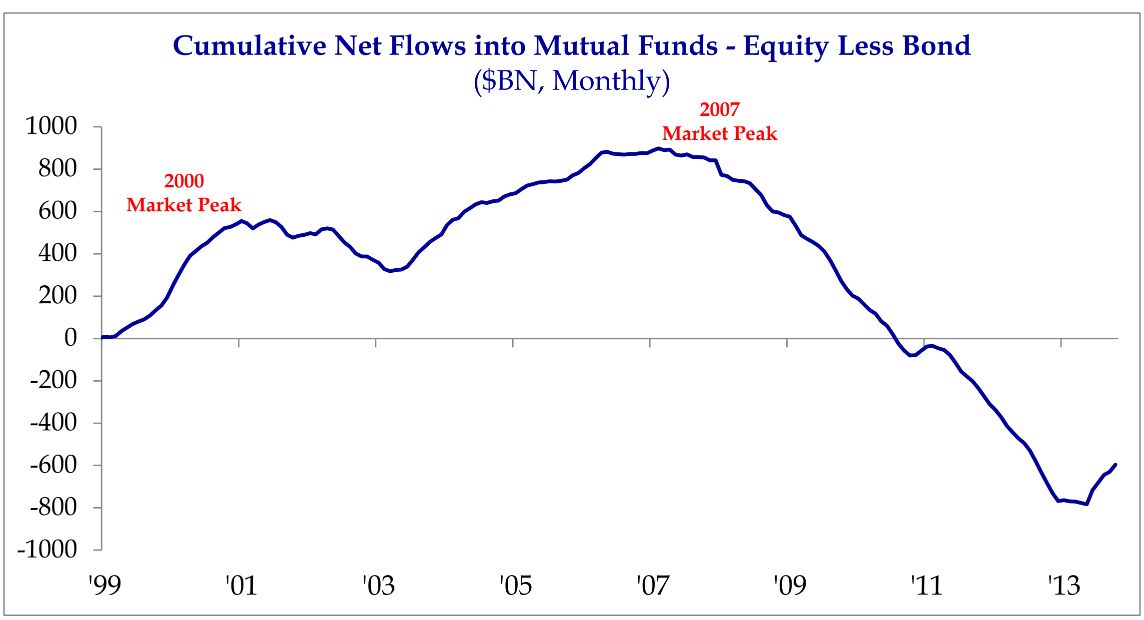
In addition to the strength of corporate America, the state of the consumer continues to strengthen and the near term outlook is encouraging. Strong stock market gains, the rebound in housing, gasoline prices falling, steady employment growth, and confidence should continue to bolster consumption which is over 70% of GDP. Chart 2 from Cornerstone Macro shows record levels of "consumer free cash flow" which they define as disposable personal income less debt service, rent, auto lease, property tax, insurance, and food and energy spending.

Chart 2



The enormous amount of flows into bond mutual funds over recent years has been well documented as has the possible "Great Rotation" of these funds back into equities as a catalyst for continued strength in equities. Chart 3 from Strategas shows that while we have started to see some rotation out of bonds and into stocks in recent months, it is still in the very early innings and so far the predominant beneficiary of bond fund redemptions has been money market funds as opposed to equities. The timing and magnitude of a "Great Rotation" is debatable, but the fact remains there is a ton of dry powder and we have yet to see the retail investor come back in size.

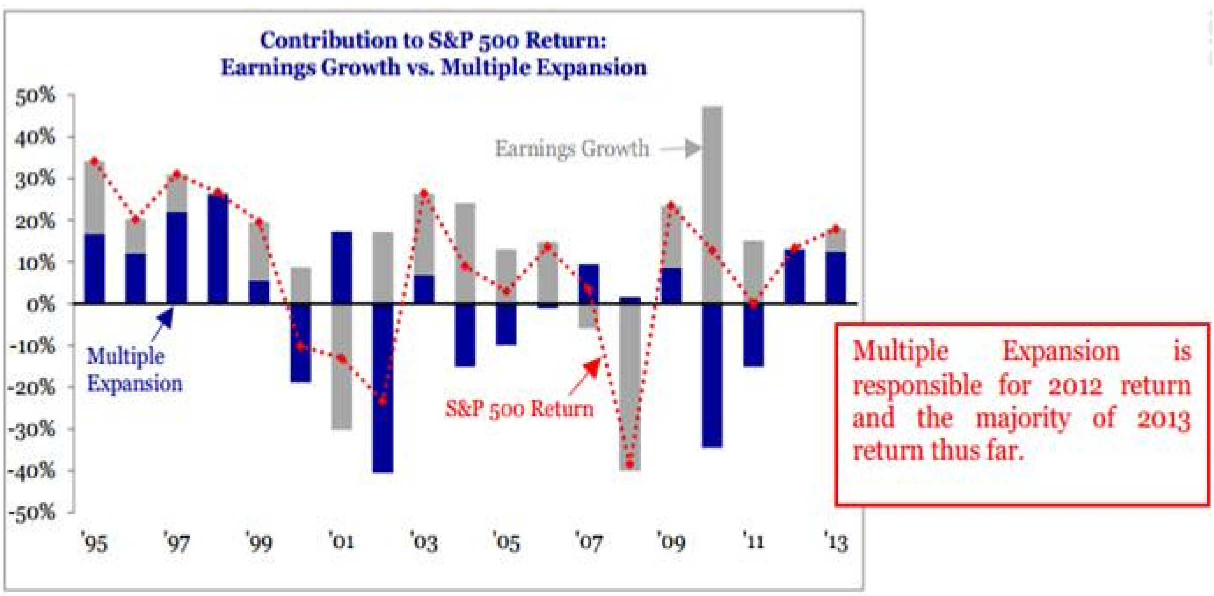
Chart 3



So what worries us? The fact that the consensus seems to have moved towards complacency causes a little pause, for example CNBC had a segment on November 15 on “Boring is Better.” We saw housing slow down on the spike in rates midyear from the initial Bernanke taper talks and continue into the fall on the political standoff in Washington. Hopefully this was just a bump in the road but it is too early to tell and any setback in housing would have a negative ripple effect. We also worry about how and when the Fed tapers and how they communicate it. Tapering is not tightening and hopefully the Fed can make this apparent and not spook markets. While we avoided the debt ceiling in October, that debate is back on the table in March. While Europe is improving, there could easily be some hiccups along the way and that does not seem to be the consensus. Emerging markets demand is concerning as tapering subsides and rates rise. We saw signs of this in the summer on the spike in rates and again this earnings season with companies such as Cisco Systems and IBM pointing to emerging market demand weakness. Emerging markets are north of 20% of S&P 500 revenue and a higher percentage of expected growth.

In this current state of suboptimal growth and lower tail risk, the focus has moved heavily towards valuation. Specifically, the predominant debate investors struggle over is the market multiple. We have seen the market multiple rise as tail risk and near term earnings risk have fallen. As seen in the chart 4 from Strategas, almost all of the market return in 2012 came from multiple expansion while nearly 75% of it has thus far in 2013.

Chart 4



Debating the market multiple is tough because anyone can cherry pick a set of data from a specific time that shows the market is expensive, fairly valued, or even cheap to support their underlying view. People try to compare valuation today to previous times to try and justify what the multiple should be 12 months from now.

Some use trailing EPS, some forward, some exclude financials, some exclude tech from the bubble years, etc. They point to the long term average P/E but history shows that it can drift higher for longer or vice versa before mean reverting. In sum, we are in the camp that trying to guess what the multiple will do in the next year is an exercise in futility. Valuations are not screaming to buy or to sell in our opinion.

What we do know is that the market will get a 5% jump start from dividends and buybacks in 2014, which coupled with even muted GDP growth should lead to mid to high single digits EPS growth. Our best guess is we see more normal returns but if we are up another 25% next year then it will again be due to multiple expansion. It is not hard to fathom some further multiple expansion with some combination of stronger growth, a smooth transition out of tapering, no blowups in DC, and no big macro fears coming to the forefront. And some multiple compression is not impossible either if some of the worries we listed come to fruition.

Given the run in stocks and the growing consensus becoming that there is not much concern, we would not be surprised if we saw a pullback at some point. But barring something unforeseen we do not see anything currently that would cause a massive selloff in equities. Jason Trennert at Strategas recently put out a "Bull Market Top Checklist" seen in Chart 5 which shows the usual suspects that have indicated prior market tops are not flashing currently, except for rising real rates.

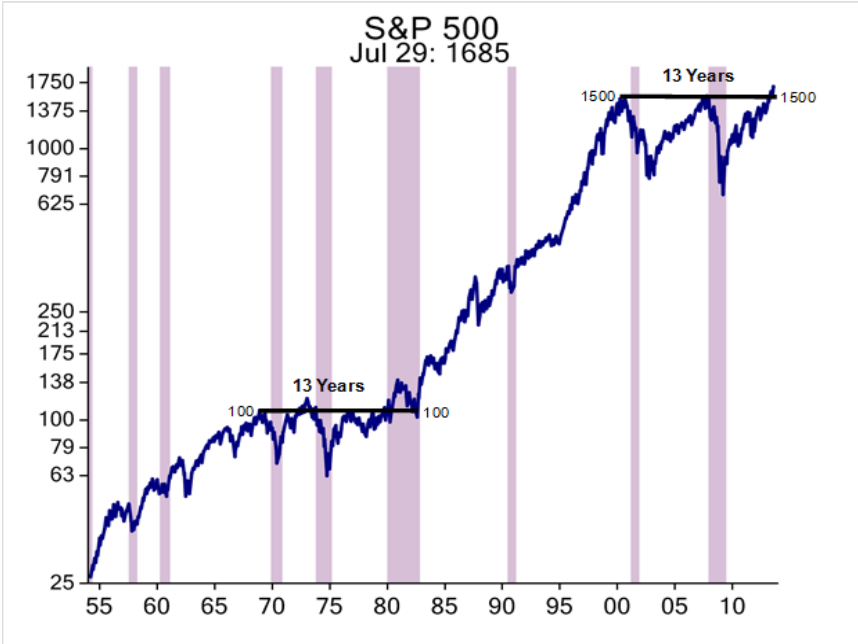
Chart 5

Bull Market Top Checklist

		2000	2007	Current
1.	Blow-off top	✓	✓	x
2.	Heavy inflows into equity market mutual funds	✓	✓	x
3.	Big pick-up in M&A activity	✓	✓	x
4.	IPO activity	✓	✓	x
5.	Rising real interest rates	✓	✓	✓
6.	Weakening upward earnings revisions	✓	✓	x
7.	Erosion in number of stocks making new highs	✓	✓	x
8.	Shift towards defensive leadership	✓	✓	x
9.	Credit spreads moving in wrong direction	✓	✓	x

In closing, we want to show one of the more interesting charts (chart 6) we have seen recently from Ed Hyman at ISI.

Chart 6



In a recent meeting, Hyman showed us this log chart of annual S&P 500 returns from 1955-present. We've talked in recent years of the "lost decade" of stock returns and this chart shows that we have just recently broken out of a 13 year period with virtually no progress in the market. He pointed out that the last time this happened it too was 13 years in length (1969-1982) and that we also had similar slack in the economy, specifically in the employment gap. While we are certainly not calling for a 1982-2000 type bull market in either length or magnitude, we nonetheless found it interesting as this too would point to the path of least resistance being up. Our hope is we can continue this slow and steady grind higher in corporate profits and the economy, and that the stock market follows.

International Equity Strategy

By Steve Lambdin

The global equity markets finished our fiscal year (ended September 30, 2013) in amazing fashion. Every major index posted positive returns in the quarter as investors' poured money into the global equity markets chasing returns. So what was responsible for these outsized returns? Clearly, the U.S. Federal Reserve's (Fed) decision to continue to delay its "tapering" of bond buying was a driving force for the global equity markets. This surprised most investors, including us, as most had expected the Fed to initiate a curtailment of these purchases. In addition, the European Central Bank (ECB) continued its stimulative actions over this time frame in an effort to bring the Eurozone economy out of a recession. Generally speaking, economic data points are still a mixed bag around many parts of the world, as growth is not as strong as equity markets might seem to indicate. European equity markets led most regions as investor attention gravitated toward the countries with the weakest past returns in an effort to make outsized gains in a short period of time. Japanese equities posted a good quarter, as many speculated on a tax cut to spur the economy. In addition, earnings remain resilient as estimates keep moving northward in the region. Emerging market equities were strong in the quarter, especially in September on the heels of the news from the Fed as this helped the countries that have been hurt by the prospects of future tapering the most. The Chinese equity markets posted a rebound as well, as near term growth concerns seem to brighten as economic data points were a bit firmer than many had expected. On the geo-political front, the Syrian crisis seemed to diffuse a bit, as the leadership agreed to give up control of its chemical weapons to Russian authority, averting a near certain U.S. missile strike. At this point, the Eurozone economy seems to be in a very weak recovery and remains fragile. Japan seems to be responding to Abenomics, but whether this can remain a medium to longer term force remains a giant question mark for the region. Also, when the Fed embarks on a tapering program still remains a mystery. These are some of the issues global investors are digesting at present and could shape returns over the next few months.

Source: William Blair

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +11.6% and +5.8%, respectively, during the third quarter of 2013 vs.
+5.2% for the S&P 500 Index. Investors rushed to equities outside of the U.S. in order to pursue lower valuations in a global equity market "melt up." The U.S. Dollar Index did fall in the quarter, especially on the heels of the Fed tapering announcement, as this provided a nice tailwind for global equities in the quarter. The European region performed better than the Asian region, as lower valuations were present across Europe as investors rushed to regions that suffered the most over the last few years. From an economic sector standpoint, Materials, Industrials, and Consumer Discretionary led the way, while Utilities and Staples were weaker on a relative basis.

So far into the fourth quarter of 2013, equities continue to be very strong and are posting new highs almost on a daily basis. Unprecedented central bank support remains very supportive of equity markets. In addition, corporate earnings around the globe seem to be stronger than most of us have been anticipating, providing further support for global equities. With this in mind, investors remain content to own higher risk assets at the present time. The MSCI EAFE Index, Emerging Markets Index, and the S&P 500 Index posted returns of +3.5%, +3.9%, and +6.6%, respectively, thru mid- November. As we look out to early 2014, most economies seem to be continuing with the theme of a slow sustainable recovery at best. Thus far investors have embraced this and equities seem the place to be at the present time.

Global Economic Forecast

	Real GDP			Inflation			Stock Market Earnings[1]		
	2012[2]	2013	2014	2012[2]	2013	2014	2012	2013	2014
US	2.2%	2.0%	3.0%	2.1%	1.5%	2.0%	6%	8%	11%
Euro Area	-0.5	0.0	1.2	2.5	1.5	1.3	-5	12	14
UK	0.3	1.0	2.0	3.2	2.7	2.7	-4	5	9
Japan[2]	1.9	1.9	1.5	0.0	0.0	2.1	15	54	20
China	7.8	6.9	7.3	2.6	2.7	3.5			
World	2.6	2.6	3.3	3.2	2.9	3.3			

[1]FactSet, based on IBES estimates
[2]Consensus Economics

Sources: Wellington Management, Consensus Economics, FactSet

Asia Update

Equity market returns in the Asian region were very strong in the third quarter of 2013. The Chinese and Australian equity markets reversed course and rose significantly in the quarter as the push out of the Fed taper benefited the Australian equity markets with its resource rich economy as well as better economic reports aided the Chinese equity markets. The broader MSCI Pacific Basin finished up nearly +8% in USD in the quarter. Currency movements generally helped on the margin for unhedged U.S. investors across the region.

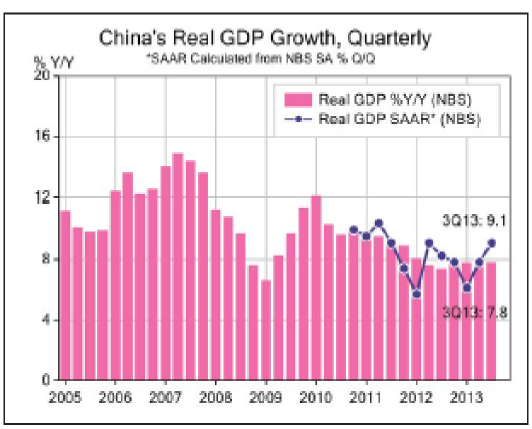
Market Performance

Data as of: 30-Sep-2013

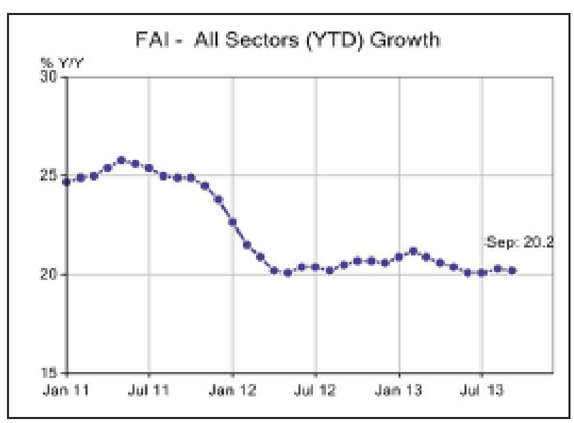
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI China	5.26	12.18	-0.16
MSCI Australia	7.23	11.94	5.08
MSCI Hong Kong	5.90	8.89	7.50
MSCI Pacific	7.83	7.99	16.45
MSCI Japan	8.35	6.66	24.31
MSCI Singapore	6.74	4.65	0.97
MSCI Taiwan	2.73	3.11	4.54
MSCI Philippines	4.66	-5.30	2.43

Source: Factset

After three straight quarters of slowing growth, Gross Domestic Product (GDP) in China accelerated in the third quarter of 2013 and rose +7.8% from the year earlier period. Recent stimulus actions seemed to have spurred a higher level of growth in the region. Most now feel the government's +7.5% growth rate forecast for all of 2013 is almost certainly going to be met and would be a big boost for Premier Li Keqiang. This should be beneficial for the overall world economy, as China represents the second largest economy in the world growing at a good clip. Industrial production rose +10.3% in October, on the heels of some significant spending on railway projects. Fixed asset investment remains strong, and was reported up +20.2% in September, and up over +20% for all of 2013. Exports have accelerated a bit lately, rising +5.6% year over year in October, as automobile sales continued to climb higher and surpassing many expectations. Stronger global demand from other recovering regions seems to be a factor here. In addition, retail sales rose +13.3% in September from a year earlier, as the slow transition to a consumer driven economy continues. Consumer prices rose +3.2% in October, basically in line with most projections. This rate still remains below the official +3.5% full year target deemed acceptable by the country's leadership. With this in mind, we should continue to see the government stimulate the economy over the near term until inflation becomes an issue. As we review all of the economic data points in the region, we feel more confident in China's ability to hit its growth targets for 2013 than we did a few months ago. This should add a bit of stability to overall global growth as we exit 2013. However, we do still see 2014 growth at a pace less than 2013, but not to a large degree. This still remains a critical issue for the region and one for investors to deal with.

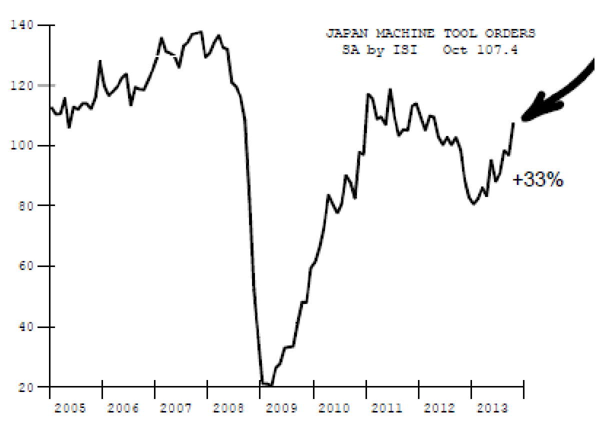


Source: ISI

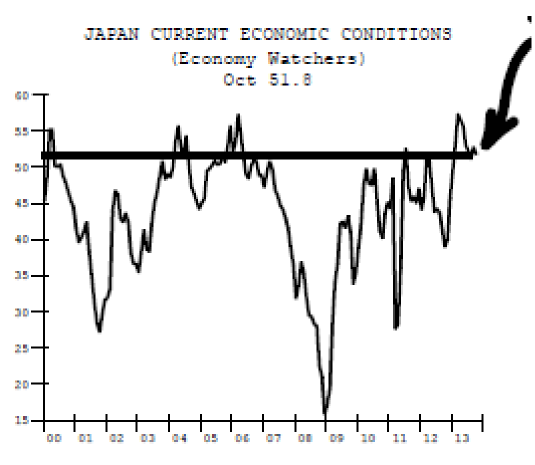


Source: ISI

The Japanese economy continues to grind higher as Abenomics seems to be kicking into high gear. Prime Minster Abe continues to use aggressive monetary policy to fight deflation and restore this economy back to sustained long term growth. While we may have concerns whether this will work long term, over the short term things seem to be moving in the right direction. Second quarter GDP was revised upward to +3.8% on an annualized basis from +2.6% reported earlier. In addition, third quarter GDP rose +1.9% from the year earlier period and the economy has now passed the 2008 peak in economic output at $5.3 trillion (USD). While the growth rate did come down from the previous quarter, these figures still remain much better than a few short years ago and are proof the economy is on the mend, at least over the short term. Core machinery orders rose +11.4% in September from the year earlier, which is a good indication of future capital spending. These orders are above what we saw in the previous quarter. Business confidence remains at the best levels in years, as corporate profits have been very strong. Recently, Toyota Motor raised its earnings forecast in response to better global demand. Overall, consumer confidence looks a bit choppy from month to month, but the broader trend still looks positive. Recently, September consumer confidence was reported at 45.4, nearly the high point for the year. We feel this is a key for any level of sustained longer term economic rebound. Retail sales continue to build upon the momentum of the previous quarter and were reported up +2.6% in September from the year earlier. This is the strongest reading with this data point in quite some time. Consumer prices continued to trend higher in the quarter and were reported up +1.1% in September, another indication the reflation strategy is working. The employment picture continues to post improvement, as the September unemployment rate was reported at 4.0%, the lowest among the major regions around the globe. Also, the jobs-to-applicant ratio continues to improve, and moved to .95 in September, the highest rate in over five years. The recovery in this economy continues to grind along at a slow pace, even though it has slowed down just a bit from the early summer. At this point, we don't see this as anything to worry significantly about. Abenomics still seems to be working, at least over the near term. We are still somewhat doubtful whether this strategy will work over the long term. However, investors seem to have a positive view lately, as the equity markets in Japan are up approximately +36% in USD over the last year.



Source: ISI



Source: ISI

Europe Update

Investors seem to be ushering in a change of tides in their posture toward the Eurozone. We have gone from a shrinking economy to one growing at a "snails" pace. However, this is a decent change at the margin, and one that has not gone unnoticed. ECB President Mario Draghi continues to push an accommodative monetary policy stance, which is welcomed relief for equity investors. Sovereign credit spreads continue to reflect a less risky environment at present and equity markets across the region reflect outsized gains over the last few months. During the third quarter of 2013, the MSCI European Index (ex U.K.) managed to post a gain of +14.4%. In fact, this is the best performing major region around the globe in the third quarter. Investors flocked to the region's relatively cheaper valuations as soon as evidence of growth emerged. Whether this is a sustainable rally or a quick bounce off the bottom remains to be seen. Earnings seem healthy and cash flow remains robust across the region. With the ECB set to remain accommodative over the near term, this should be positive for the equity markets and could push many equity markets to record highs. We remain watchful to see if further economic strength can develop for a more sustainable recovery.

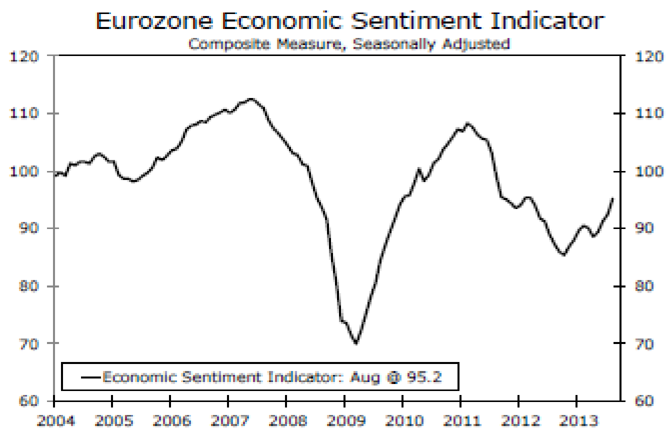
Market Performance

Data as of: 30-Sep-2013

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Spain	14.32	25.65	17.89
MSCI Italy	7.52	19.63	8.82
MSCI France	8.24	15.43	19.16
MSCI Netherlands	5.75	14.79	20.88
MSCI Europe ex UK	8.01	14.42	18.06
MSCI Germany	8.67	12.71	15.97
MSCI United Kingdom	5.57	12.04	12.35
MSCI Switzerland	6.82	9.47	21.42

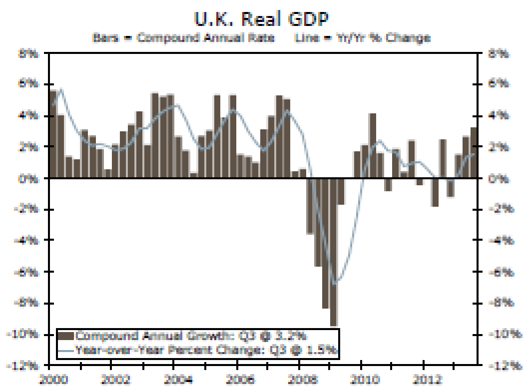
Source: Factset

The Euroland economy posted its second straight quarter of growth, albeit at the slowest pace possible. Third quarter GDP rose +.1% from the previous quarter, a level below what many economists were expecting. Unfortunately, the German and French economies slowed, and Italy remained stuck in a recession. The rate of recovery in the region shows just how fragile it is. However, growth is positive and investors seem to like the two straight quarters of growth. Industrial production across the region continues to limp around, with no clear upward path, even though September did show the first month of growth on a year over basis since earlier this year. Both the PMI Services and Manufacturing composites still remained above the critical 50 level over the last few months. The index of executive and consumer sentiment continued to strengthen over the third quarter, reaching 97.8 in October, a level not seen in a year and a half. This data point would suggest some measure of strength heading into the fourth quarter. Just as we saw in China, car sales were robust in Euroland as government incentives are motivating buyers. Also, large retailers have reported recent strength as well. In fact, retail sales in September increased +.3% from the year ago period, the first increase since May. However, many feel we need to see more upside in this key statistic to become more bullish on a recovery. Unfortunately, the Euroland employment picture continues to be bleak. The September unemployment rate was reported at 12.2%, as this is yet another record high level for the region. The only good news with this is the rate has held steady since July. There are still over 19 million people out of work in this region, with the majority of these among the younger crowd. On a good note, inflation remains under control and fell to 1.1% in September, the lowest rate in quite some time. With inflation readings well under acceptable levels, the ECB surprised most of us at its November meeting and unexpectedly cut its key refi rate to .25% from .50%. Recent inflation readings have spurred this action as well. Many feel the ECB is beginning to have deflationary fears. The ECB could even move to more non-traditional measures if the region moves more toward a deflationary environment. As we assess the current situation, we do feel things are a bit better on the margin and we could see better growth in 2014 than 2013. We just do not know to what degree at this time. Also, investors will be watching inflation data very closely for any more deflationary signals that might develop over the next few months.

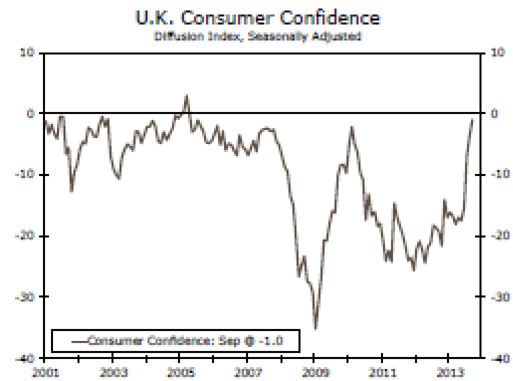


Source: Wells Fargo and IHS Global Insight

The U.K. economy continued to accelerate in the third quarter of 2013. GDP rose +.8% in the quarter from the previous quarter, or +1.5% from the year earlier period. The recovery is really taking hold as the region appears to have good momentum heading into 2014. For the second quarter in a row, services, construction, and manufacturing all contributed to growth. Industrial production continued its slow rebound, rising +.9% in September from August, or +2.2% on an annual basis. Manufacturing, mining, and oil & gas were particular areas of strength. Retail sales continued in an upward trend, rising approximately +2.0% in the third quarter from the year earlier period. While this is not as strong as many would like to see, it is nonetheless a movement in the right direction with perhaps more to come as we enter 2014. The consumer seems to be spending in a guarded mode. Perhaps keeping a lid on spending is the slow rate of recent wage growth in the region. Wages only rose approximately +.8% on a year over year basis in the third quarter, a slowdown from the previous quarter. We need to see a pickup in this for consumer spending to accelerate from here. Inflation is finally starting to fall across the region. Inflation slowed to +2.2% in October from a year ago, which put the rate very close to the Bank of England's (BOE) 2% target. Falling energy prices are serving to bring down the inflation rate in the region. Even though inflation remains right near targeted levels, we see no need for further policy easing at the moment. At its November 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 we expected. BOE Governor, Mark Carney, feels interest rates remain conducive to foster growth at the present time in the economy and there is no need to take the actions the ECB recently undertook. The employment picture continues to improve ever so slightly on the margin. The unemployment rate fell to 7.6% in the third quarter, as employment rose by 177,000 in the quarter, to a record 30 million. Falling unemployment is good and is needed for the leadership of this region as they head into the next election cycle. Overall, the U.K economy appears to be performing better by each passing quarter and appears to have a decent level of momentum heading into 2014. However, growth is still weak by most measures as this region still needs a Euroland economic recovery in order to see further strength in this region.



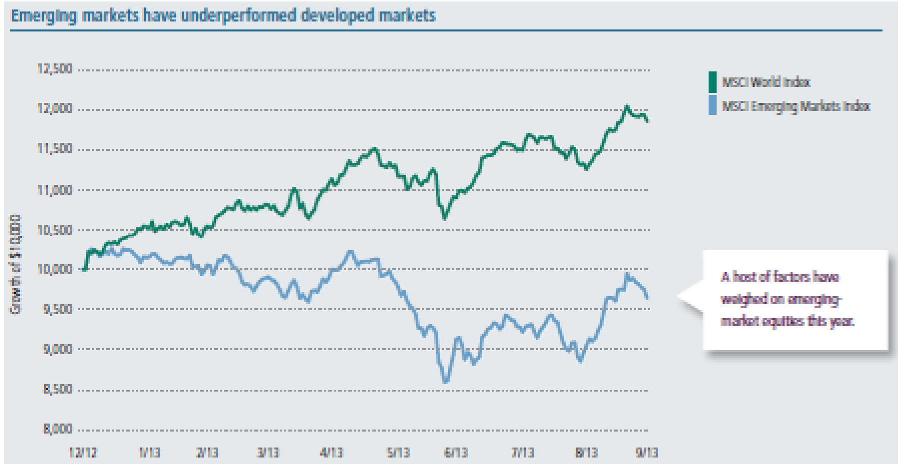
Source: Wells Fargo and IHS Global Insight



Source: Wells Fargo and IHS Global Insight

Emerging Markets

Even though emerging market equities had a nice return in the third quarter of 2013, over our entire fiscal year the return was only +1%. Investors are still very concerned over the eventual U.S. Fed tapering. While the timing got surprisingly pushed back in September, we do feel it will happen sometime in early 2014. We do expect this to put renewed pressure on these equities as many of the emerging market countries have weak current accounts. As U.S. interest rates rise and the U.S. Dollar strengthens, we should see depreciation of their respective currencies and fresh inflation concerns in many countries. However, we do see global growth picking up in 2014 vs. 2013 and this should be a benefit to many of these economies. While we acknowledge the short term impact from a U.S. Fed tapering can be meaningful, from a longer term strategic viewpoint, this should provide an opportunity in these equities. Valuations remain attractive trading about 10.5x forward earnings, well below most other equity asset classes. In addition, long term growth rates remain much better in many of these markets. We still believe once the tapering begins to happen, opportunities will present themselves with respect to these equities.



Source: John Hancock Investments and Factset

Emerging-market equities appear undervalued

	12-month forward P/E ratios
Emerging markets	9.7x
Asia ex.-Japan	11.5x
Europe	13.3x
Japan	13.6x
U.S.	14.9x

Emerging-market valuations look cheap relative to their developed-market peers.

Source: John Hancock Investments, Bloomberg, and Manulife Asset Mgmt

International Equity Activity/Strategy

This past fiscal year has witnessed some very impressive global equity returns. For the year, the MSCI EAFE Index was up +23.8%, the best one year return since our 2006-2007 fiscal year. However, we have seen the exact opposite happen within the emerging markets. For the year, the MSCI Emerging Markets Index was up only +1%. Our saving grace has been our relatively small allocation to the emerging markets vs. the large cap counterparts. In the developed markets, we have a gradual recovery taking place in most regions, while within the emerging markets, you have slowing economic landscape in many regions. The constant threat of a U.S. fed taper seems to be keeping a lid on any outsized emerging market returns. However, if you take a medium to longer term approach, the Fed taper is a signal of more sustainable U.S. growth, which should eventually foster demand for exports from these countries. But over the near term, the picture should remain volatile with regard to emerging market equities. However, large cap global equities seem to be benefitting from money flows into this asset class. Corporate earnings have been nothing short of fantastic, as margins are at all-time highs. The Eurozone economy has emerged from a recession, even though growth seems anemic at present. Japan seems okay at least over the near term and China should hit its growth targets for 2013. Large cap valuations still seems to have some upside left in front of them before becoming extended, but the gap is quickly disappearing. Emerging markets look set for a bumpy ride over the near term, even though valuations look very attractive in this asset class.

Since our last meeting, we did sell approximately $46 million of our emerging markets equity ETF in late September as the price of this ETF moved above our strike price on our written calls. We still remain very active in the option space, as we continue to sell put options on this index in an effort to buy some exposure into a weak emerging markets index if the market turns down. 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 12.7% for MSCI EAFE equities. *(Charts provided by William Blair, ISI, Factset, Wells Fargo, Manulife Asset Management, John Hancock Investments, Bloomberg, IHS Global Insight, Wellington Management)*