Quarterly Economic Update

December 10, 2014

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

Federal Reserve Chair Janet Yellen and the Federal Open Market Committee (FOMC) continue to hold accommodative monetary policy steady while preparing to potentially tighten policy in 2015 as employment and inflation improve. The target range for the federal funds rate remains at 0 to ¼ percent, where it has now been held for the past six years since December 2008. The FOMC has been reducing additional securities purchases at a measured pace throughout the year and, as expected, did formally conclude this most recent asset purchase program at their October 28-29th meeting. The Federal Reserve's balance sheet remains elevated as maturities and prepayments from their securities portfolio continue to be reinvested, but at this point, they are no longer adding or removing accommodation. Policy action remains data dependent, but the FOMC continues to lay the groundwork to begin removing accommodation if improvement remains on course.

The September 16-17th meeting included updated economic forecasts and projections for the appropriate pace of policy firming from FOMC participants. Economic projections did not change significantly from their June predictions and can be found in the table below. Participants continue to see improvement in the unemployment rate and inflation drifting back towards their 2 percent longer run objective.

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, September 2014

Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

Percent

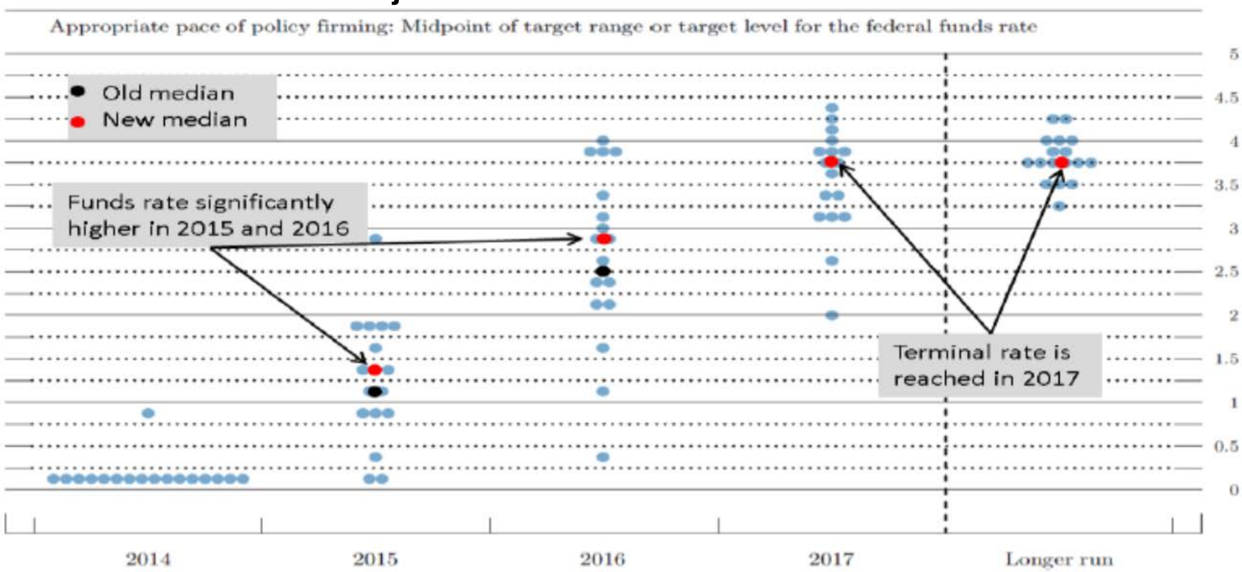
Variable	Central tendency[1]					Range[2]				
	2014	2015	2016	2017	Longer run	2014	2015	2016	2017	Longer run
Change in real GDP	2.0 to 2.2	2.6 to 3.0	2.6 to 2.9	2.3 to 2.5	2.0 to 2.3	1.8 to 2.3	2.1 to 3.2	2.1 to 3.0	2.0 to 2.6	1.8 to 2.6
June projection	2.1 to 2.3	3.0 to 3.2	2.5 to 3.0	n.a.	2.1 to 2.3	1.9 to 2.4	2.2 to 3.6	2.2 to 3.2	n.a.	1.8 to 2.5
Unemployment rate	5.9 to 6.0	5.4 to 5.6	5.1 to 5.4	4.9 to 5.3	5.2 to 5.5	5.7 to 6.1	5.2 to 5.7	4.9 to 5.6	4.7 to 5.8	5.0 to 6.0
June projection	6.0 to 6.1	5.4 to 5.7	5.1 to 5.5	n.a.	5.2 to 5.5	5.8 to 6.2	5.2 to 5.9	5.0 to 5.6	n.a.	5.0 to 6.0
PCE inflation	1.5 to 1.7	1.6 to 1.9	1.7 to 2.0	1.9 to 2.0	2.0	1.5 to 1.8	1.5 to 2.4	1.6 to 2.1	1.7 to 2.2	2.0
June projection	1.5 to 1.7	1.5 to 2.0	1.6 to 2.0	n.a.	2.0	1.4 to 2.0	1.4 to 2.4	1.5 to 2.0	n.a.	2.0
Core PCE inflation[3]	1.5 to 1.6	1.6 to 1.9	1.8 to 2.0	1.9 to 2.0		1.5 to 1.8	1.6 to 2.4	1.7 to 2.2	1.8 to 2.2	
June projection	1.5 to 1.6	1.6 to 2.0	1.7 to 2.0	n.a.		1.4 to 1.8	1.5 to 2.4	1.6 to 2.0	n.a.	

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 June projections were made in conjunction with the meeting of the Federal Open Market Committee on June 17–18, 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.

At the current pace of improvement, the FOMC is likely to begin tightening policy in 2015 and fourteen of seventeen FOMC participants expressed their view that it would be appropriate to increase the target range for the federal funds rate during the 2015 calendar year. The "dot plot", which represents the appropriate pace of policy firming, provides additional information on participants' varying views on how quickly the FOMC should move to raise rates once they begin. Each dot represents the FOMC participant's view of the appropriate target level for the federal funds rate at the end of the specified year. The dots, i.e. projections, have gradually drifted higher over the past several meetings suggesting that FOMC participants have grown more hawkish on the pace of tightening. The chart below represents the most recent projections from the September meeting and highlights both the previous median projection from the June meeting represented by the black dot and the new median projection represented by the red dot. The higher median from the September meeting again suggests that participants as a group have grown more hawkish on the appropriate pace of tightening.

FOMC Projections For the Federal Funds Rate



Sources: Federal Reserve and Cornerstone Macro.

In her September press conference, Yellen downplayed the upward drift of the dots, but pointed out that it does likely reflect the modest downward reduction in the path for unemployment and increased expectations for inflation to approach their 2 percent objective and that this illustrates the data dependent nature of policy decisions.

In conjunction with their September meeting, the FOMC released a statement of their Policy Normalization Principles and Plans. They have provided information in the past on possible plans and policy tools to be used to remove accommodation once conditions have improved to a level consistent with their mandate of maximum employment and price stability. Recent FOMC meeting minutes have also revealed much discussion around potential policy tools and implementation as they move closer towards the appropriate time to tighten policy. This release serves as a more formal communication and update on their intentions as they seek to normalize policy. The release confirms that they will use a target range for the federal funds rate and will use an interest on excess reserves (IOER) rate as their primary tool to move the federal funds rate into that target range. They will also use an overnight reverse repurchase agreement facility to control the federal funds rate. The overnight reverse repurchase agreement will be used as necessary during policy normalization and will likely be phased out over time. The release also confirms that they will seek to reduce the Federal Reserve's securities holdings by ceasing or tapering the reinvestment of principal payments and maturities at some point after they begin to raise the target range for the federal funds rate. They do not intend to sell agency mortgage-backed securities as part of the normalization process and over the longer run intend that the Federal Reserve will only hold a minimal amount of primarily Treasury securities. In her post meeting press conference, Yellen emphasized that this release should not be viewed as a change in policy or be interpreted as a signal that these normalization steps were imminent, but was simply an update from the FOMC in their attempt to be transparent and communicate the intentions for future policy actions when it does become appropriate to return to more normal policy.

The FOMC statement from their October meeting revealed a committee who appears to be growing more constructive and confident on improvements in the labor market. Economic commentary from the statement repeated that "Labor market conditions improved somewhat further," but chose to accentuate this statement by adding "with solid job gains and a lower unemployment rate" in place of "however, the unemployment rate is little changed." More importantly, they changed their statement that "a range of labor market indicators suggests that *there remains significant underutilization of labor resources*" to "*underutilization of labor resources is gradually diminishing*." While the committee seemed to communicate a more positive view towards employment, it indicated some growing concern around lower inflation readings. The statement noted that "market-based measures of inflation compensation have declined somewhat" and "inflation in the near term will likely be held down by lower energy prices and other factors." While acknowledging the near term concerns, the statement did maintain that "longer-term inflation expectations have remained stable" and that "the likelihood of inflation running persistently below 2 percent has diminished somewhat." The minutes from the October meeting indicate a good amount of discussing around inflation and that some participants had concerns that inflation may run below their 2 percent objective for some time. Others noted that this would become more concerning if growth slowed and that evidence of lower longer-term inflation expectations should be monitored closely.

The October FOMC statement did repeat that "it likely will be appropriate to maintain the 0 to ¼ percent target range for the federal funds rate for a *considerable time* following the end of its asset purchase program." There had been some debate as to whether the "considerable time" language would be removed and forward guidance language adjusted or added now that the asset purchase program has officially ended and the FOMC moves closer towards removing accommodation. The minutes show continued discussion regarding the appropriate forward guidance communications on the path of the federal funds rate. The decision was made to keep the "considerable time" language in the October statement, but it was supplemented with new language that "if incoming information indicates faster progress toward the Committee's employment and inflation objective than the Committee now expects, then increases in the target range for the federal funds rate are likely to occur sooner than currently anticipated. Conversely, if progress proves slower than expected, then increases in the target range are likely to occur later than currently anticipated." This added statement seemed to serve as a way to stress the data-dependent nature of future policy decisions and discourage the focus on the “considerable time” language that is more time oriented.

With the FOMC having laid out a fairly clear roadmap on how they will normalize policy, the questions left to contemplate are when will they begin removing accommodation and at what pace will they tighten. The next FOMC meeting will be held on December 16-17th and will include an updated Summary of Economic Projections. Consensus expectations are gravitating towards a mid-2015 initial rate hike and no policy action is expected at the December meeting. Investors and market participants will continue to watch for a change to the forward guidance language and whether the committee abandons the “considerable time” language. Any shifts in the participants’ economic projections and drift of dots on the “dot plot” will be studied as to how it affects the timing of the initial rate hike and for signals on the potential pace of tightening.

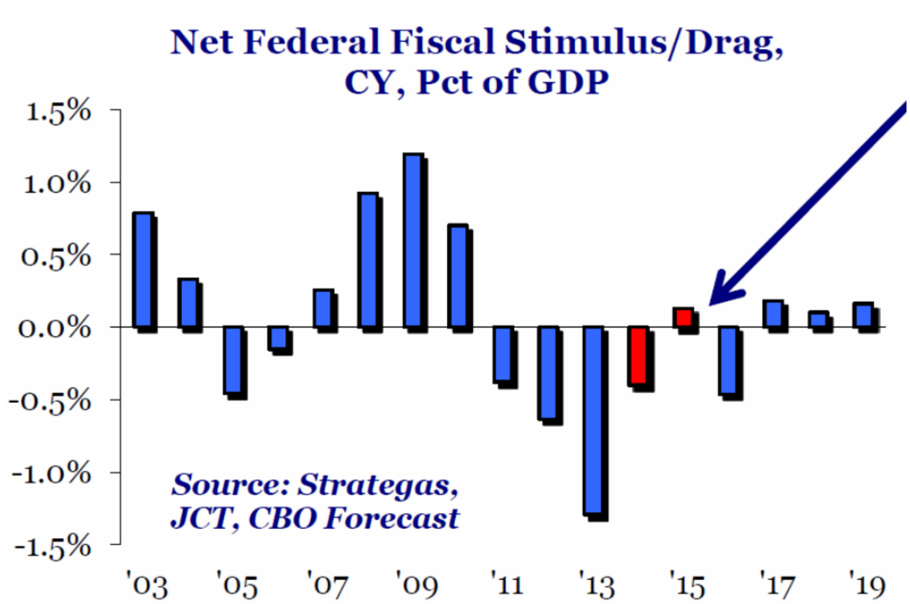
Fiscal Policy

By Michael McNair

Summary:

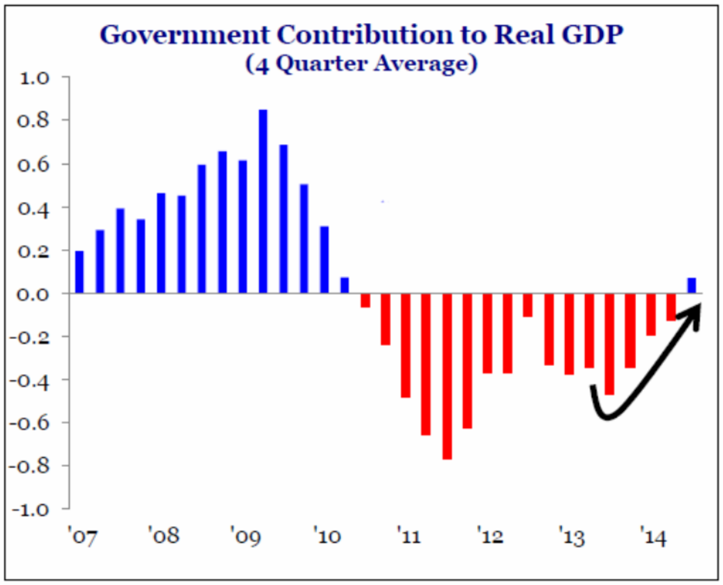
Over the last four years, the US economy has faced an unprecedented headwind from fiscal policy as a result of the largest fiscal drag and the highest level of political uncertainty in the post war era. However, 2015 looks to be a turning point in fiscal policy as political uncertainty has subsided and government spending will be a stimulus to the economy for the first time in four years.

The most direct way to measure the impact of fiscal policy on the economy is to calculate the year over year change in government spending and taxes. Through a combination of tax increases and spending cuts, the federal government has been highly restrictive, creating a historically unprecedented fiscal drag on the US economy over the last four years. While the peak in the fiscal drag occurred in 2013, the federal government was still a drag on the economy in 2014. Fortunately, federal fiscal policy is set to actually be a positive contributor to growth in 2015.



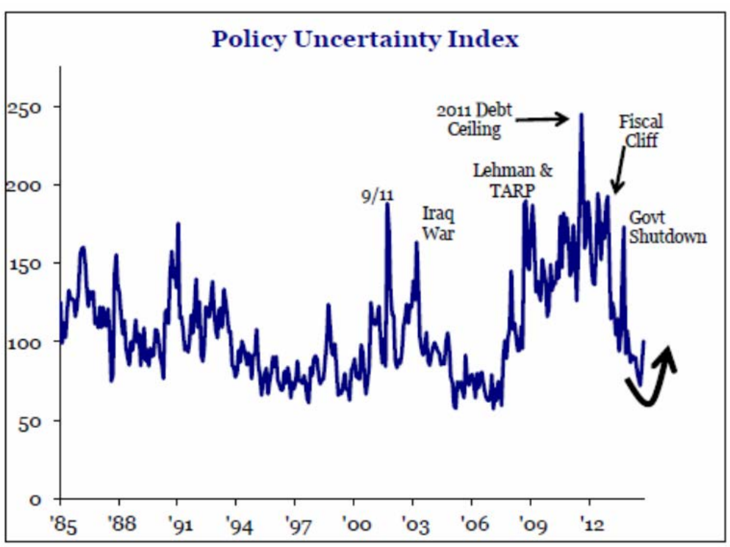
Source: Strategas

If we include state and local governments with the federal government's contributions to GDP, we see that total government fiscal policy will add to real GDP for the first time in four years.



Source: Strategas

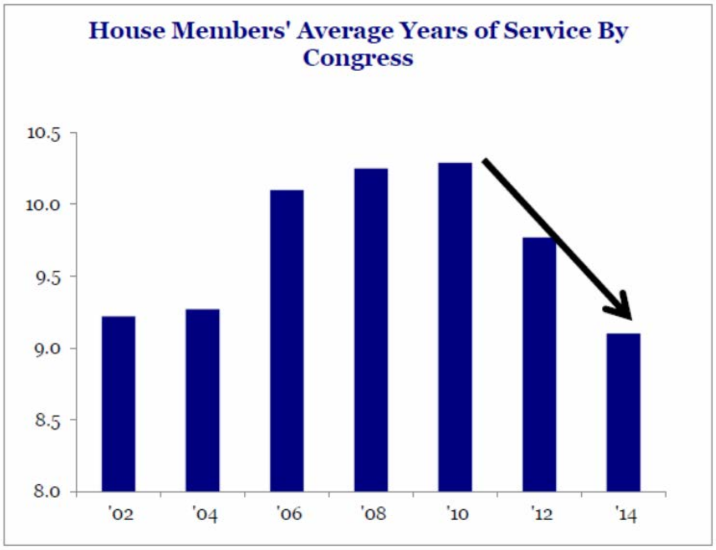
Looking only at the changes in government taxation and spending levels underestimates the impact that fiscal policy has on the economy. Political fighting and policy uncertainty also have a major impact on economic growth through its effect on consumer confidence and businesses willingness to invest. While it is nearly impossible to quantify the impact political uncertainty has on the economy, the analysts at Strategas Research Partners have developed a proprietary index to help measure the relative level of political uncertainty.



Source: Strategas

Over the last several years the level of political uncertainty was the highest since the 40's and 50's. But, as you can see from the chart above, there has recently been a significant decline in political uncertainty.

Unsurprisingly, the American electorate has become disenchanted with their politicians due to this elevated uncertainty and, as a result, many incumbents have been voted out of office.



Source: Strategas

The sweeping Republican win in the most recent election is further evidence of voter's frustration. We believe the results have more to do with voter's overall disregard for the majority in power rather than a wholesale shift in voter's political views. Therefore, we believe Republicans should be careful not to over step their bounds, as the party in power has been removed in four of the last five elections. We believe this trend will continue as long as political uncertainty remains high and economic growth remains low.

We do not believe that political uncertainty and hostility will rise to the levels we have seen over the last several years, but there are several upcoming catalysts that could increase uncertainty above the current relatively low level.

Sometime in early 2015 Congress must vote to once again raise the debt ceiling. While there is always a chance for another major standoff on this issue, we view such a showdown as highly unlikely due to the fact that Republicans do not have enough seats in the House to demand major concession's over this issue. It is more likely that Republicans instead choose to fight over the budget which is supposed to be passed in April. Since Republicans will control both Houses of Congress, they can choose to change the laws concerning entitlements, such as Obamacare and Medicare, with a reconciliation bill. Further, such a bill cannot be filibustered by the Democrats in the Senate because it only needs a simple majority and not the usual 60 votes. However, we do not believe that the Republicans will use reconciliation to repeal Obamacare or push through tax reform because President Obama would veto any such bill and many Republican Senators running for re-election in more moderate states in 2016 would not want to cast a politically contentious vote for a bill they know has no chance of being signed into law.

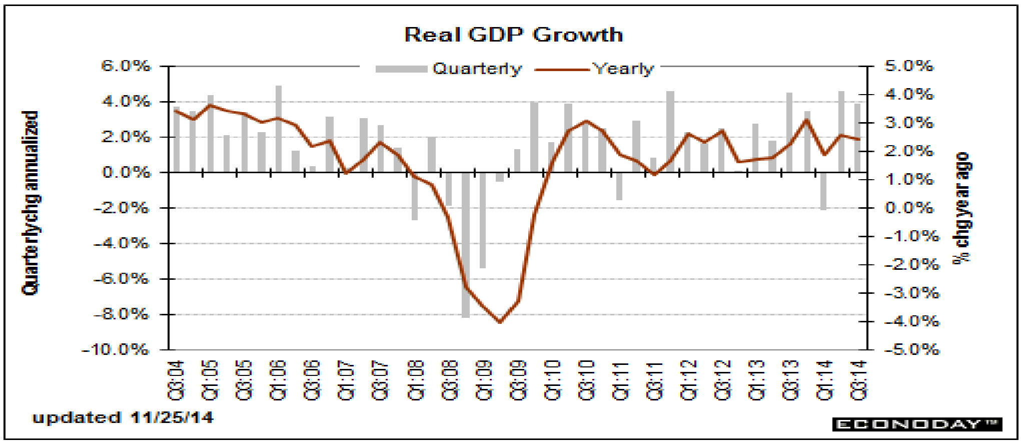
The biggest wildcard may be the Tea Party members strategy to refuse to vote for any budget bill that does not overturn Obamacare. Since its emergence, the Tea Party has played a major role in increasing political uncertainty in Washington; however, over the last year House Speaker John Boehner has been successful in consolidating power within the party and marginalizing the influence of the Tea Party. If the Republican leadership can continue to unify the party, then the chances for a spike in political uncertainty are significantly reduced.

When we combine the likelihood that political uncertainty stays below the extremely elevated levels seen over the past four years with the fact that net government spending will be a stimulus to the economy for the first time in four years, it gives us a high degree of confidence that the multiyear fiscal policy headwind will finally turn into a tailwind for the US economy in 2015.

Economic Outlook

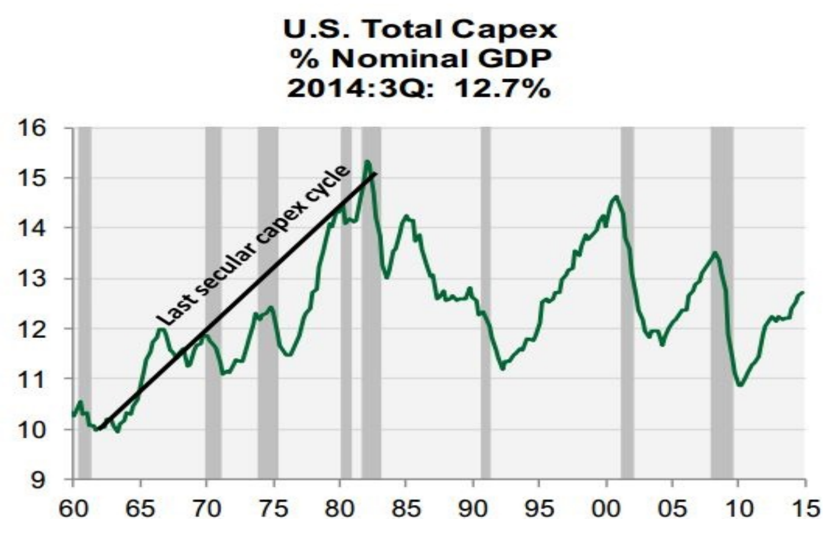
By Hunter Bronson

Revised economic growth during the third quarter was 3.9% which solidly beat the consensus forecast of 3.3%. Real GDP growth has now exceeded 3.5% in four of the last five quarters and has exceeded 4% in two of those quarters. Additionally, the combined growth rate in the second and third quarters is 4.25%, which is the strongest semi-annual pace since 2003. The following chart shows quarterly and yearly estimates through 2014 and demonstrates that real growth through the recovery continues apace at 2-3%.



CAPEX

U.S. corporate capital expenditures continue to drive the bulk of economic growth, increasing 7.1% over the previous quarter. Record-high total capital expenditures are being driven by corporate profits that are reaching new highs operating on an aging capital base. We expect the CAPEX cycle to continue as long as corporate profits remain strong and domestic businesses are incentivized to bring manufacturing home amidst a weakening emerging market cycle. As you can see below, we are not yet approaching peak levels of CAPEX as a percentage of total GDP – there is plenty of room to go.

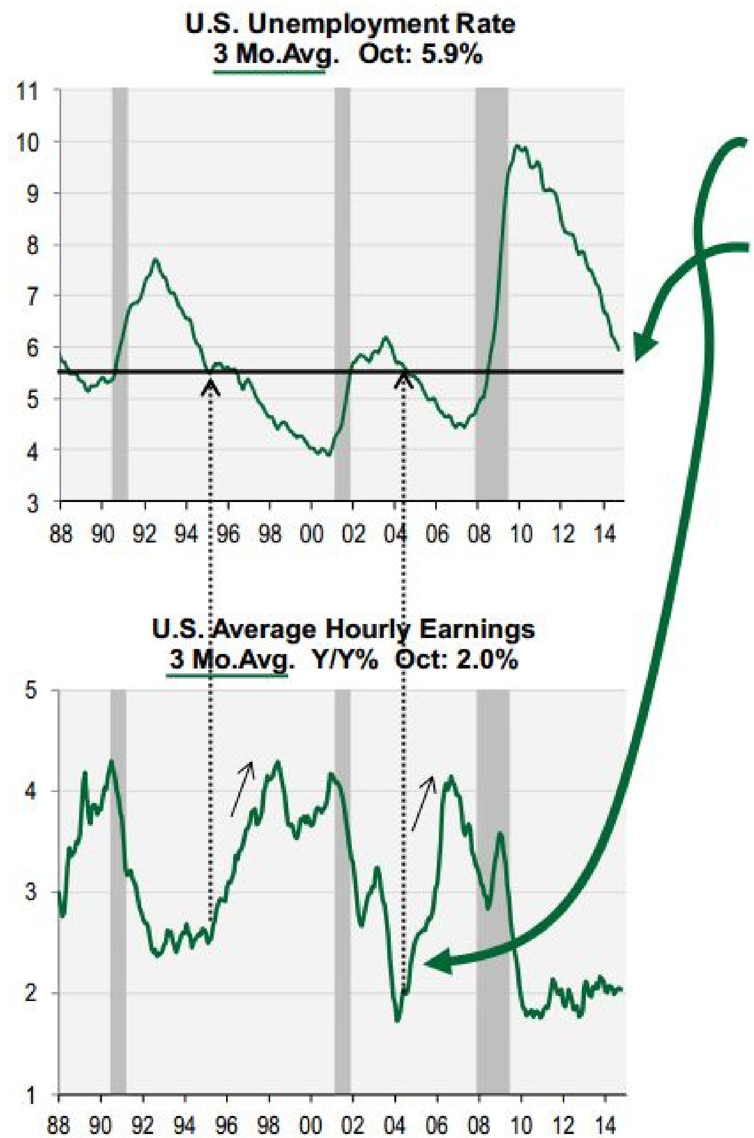


Source: Cornerstone Macro

Consumption & Employment

Third quarter consumer spending registered growth of 2.2% as it continues its steady, modest trend higher. Additionally, the unemployment rate continues its consistent decline, reaching 5.8% in October.

Wage growth acts as a wealth transfer mechanism from idle profits on corporate balance sheets to wage earners/consumers. As we have discussed in recent reports, wage growth is an essential process in the natural progression from early-cycle capital investment to later-cycle consumer spending so that total economic activity can continue to grow. We see evidence from both employment and hourly wage figures that we are nearing the point at which business CAPEX passes the baton to wage growth & consumer spending.



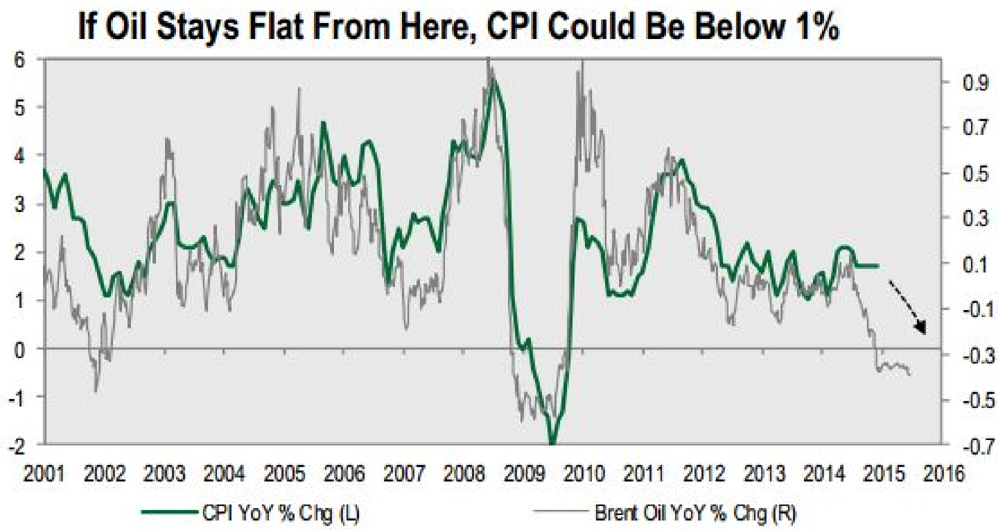
In the most recent recoveries, wages didn't begin to reaccelerate significantly until the unemployment rate (3 Mo. average) pushed through 5.5%. Currently, the 3-month average unemployment rate stands at 5.9%.

If the unemployment rate can pass through this threshold level, we would expect previously sluggish wage growth to reaccelerate and to carry consumer spending and, potentially, housing activity significantly higher with it.

Source: Cornerstone Macro

Inflation

The recent dramatic decline in oil prices has created an interesting dynamic for domestic consumers and could be setting the US economy up for a prolonged disinflationary boom. As you can see in the chart below, oil prices are an extremely important driver of domestic headline inflation numbers.



Source: Cornerstone Macro

The chart makes it clear that oil probably doesn't need to fall much farther from here to get to US headline deflation in 2015. While many market participants are spooked by the possibility of headline deflation, we think it is important to distinguish between the components of the headline number. Wage inflation (good inflation) coupled with commodity deflation (good deflation) is certainly positive for the domestic consumer (the largest component of GDP). The consumer experiences tailwinds on two fronts – lower energy/transportation costs & higher income – and has more discretionary income to make purchases in the economy.

Effects of Global Decoupling

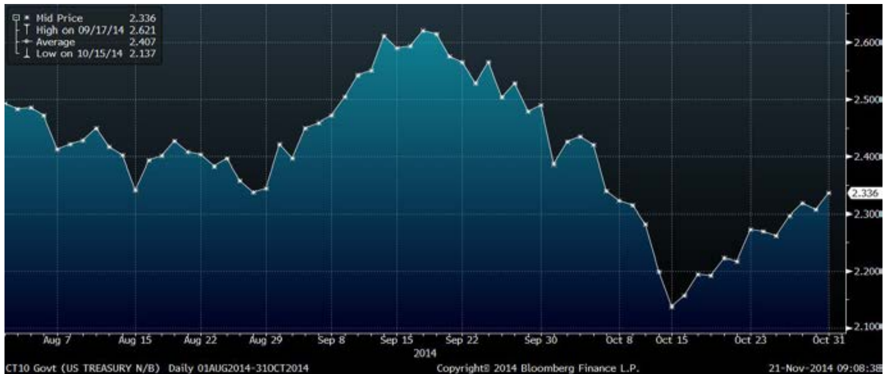
While this is a domestically-focused piece, it is hard to ignore the effects global dynamics have on the US economy. Many emerging market economies are weakening in a cascading effect whereby Chinese overinvestment has kicked off a self-perpetuating cycle of weak global demand. Additionally, oil producing countries are unwilling to cut supply for the need to prop up deteriorating fiscal situations. Taken together, these effects have created a situation in which commodities are likely to remain weak for quite some time, global demand will continue to soften, and global central banks will need to cut rates to bolster failing economies. What should all of this mean for the US economy? The US Dollar (USD) should continue to strengthen against weakening global currencies, domestic inflation should remain low, and the Fed will be given room by global central banks to keep rates lower for longer. On the back of wage inflation and commodity deflation and barring any major geopolitical surprises, the stage is set for the re-emergence of the US consumer.

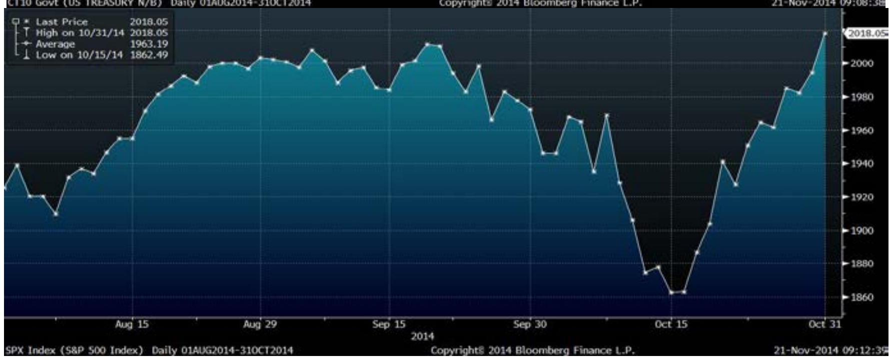
Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting, we were approaching the end of the fiscal year. While interest rates had been fairly stable and range bound throughout the summer months, yield levels had begun increasing early in September in advance of the next FOMC meeting. At this meeting the Fed reaffirmed its previous forward guidance and retained the phrase that is was "appropriate to maintain the current target range for the fed funds rate for a *considerable time* after the asset purchase program ends." Despite this continued reassurance from Chairwoman Yellen, the bond market interpreted a more hawkish view and yields resumed their upward trend. The 5-year treasury yield reached 1.80%, while the 10-year rose to 2.65% and the 30-year rose to 3.35%.

Yields did not stay at these levels for long as October brought back global growth fears and selloffs in domestic and international equity markets, European markets in particular. Eurozone manufacturing output as well as industrial production saw large declines during the month and Eurozone inflation printed at its lowest rate in five years. These data points added to deflation fears and concerns that this global weakness would spill over into the U.S., slowing growth here as well. As equity markets sold off early in the month, U.S. Treasuries rallied hard. The yield on the 10-year Treasury note fell from 2.50% at the end of September to 2.15% by mid-month as the flight to quality trade came into play once again. Yield levels on other areas of the curve declined as well; the 5- year note declined from 1.65% to 1.35% while the long bond yield declined from 3.20% to 2.90% during this time period. Encouraging U.S. economic data and corporate earnings reports soon soothed investors' fears about the U.S. economy's resiliency however, and equity markets began to climb again. Treasury yields retraced most of their decline before month end as equity markets hit new highs. The charts on the following page depict these simultaneous moves for the 10-year Treasury yield (top) and the S&P 500 (bottom):





Despite giving back some of their gains in the latter half of the month, U.S. Treasuries were the best performing investment grade sector for October, returning 1.09%. Mortgages returned .96% while high grade corporates returned .93% and agencies returned .63%. High grade credit spreads widened early in the month as Treasuries rallied, but continued to languish even after the risk aversion subsided. Similar moves were seen in the mortgage and agency sectors as well. High yield credit spreads were a different story, however. While spreads widened early in the month similar to the high grade sector, they reversed course significantly once the equity markets began to move higher. By month end spreads had recovered all of their widening, and tightened an additional 10 basis points. This resulted in a 1.14% total return for October, making high yield credit the best performing sector of the bond market overall. Also, as expected, the Federal Reserve's monetary policy committee halted new bond purchases, which have helped support the economy for the last six years by making credit easier to get. This has been well communicated for some time therefore it did not cause any immediate disruptions in the market.

Market strength continued into November. Equity indices continued to move higher on stronger corporate earnings reports as well as solid economic data. Oil prices continued to move lower and U.S. Treasury yields saw little movement one way or the other, trading in a fairly narrow range. Early in the month investors saw action from the Bank of Japan, China and the European Central Bank as they all stepped up their quantitative easing efforts in order to spur growth in their respective areas. These moves were well received by U.S. investors as there was continuing concern about weak global growth dragging down U.S. growth in the near term. This also contributed to a narrow trading range of Treasuries during the month as low growth and inflation expectations that are being experienced globally are not allowing interest rates, particularly on the longer end of the curve, to rise. Yields ended the month at lower levels across the curve due in part to the additional oil price decline that occurred after OPEC's announcement to maintain current oil production levels late in the month. Five year Treasury yields ended the month at 1.48% while 10-year and 30-year yields hit 2.16% and 2.89% respectively.

Other sectors of the bond market turned in a positive performance as well, but trailed Treasury returns. Agency and mortgage backed securities returned slightly less than investment grade credit. Despite the positive total return for November, spreads were actually wider for the month across all sectors, with energy related names widening the most. The high yield sector produced a negative return for the month, also due to its exposure to the energy sector and the effects of lower oil prices on the performance of these companies.

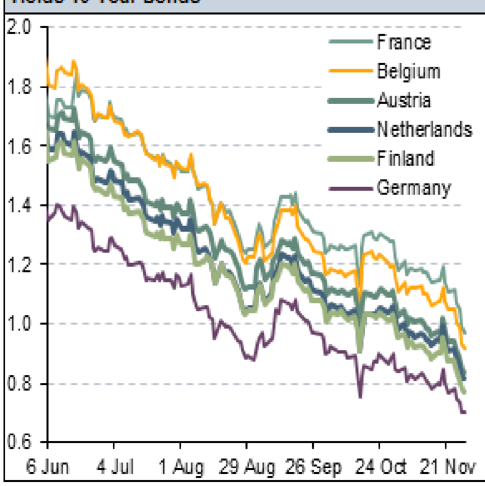
Supply in the high grade sector has been robust over the past couple of months with roughly $87 billion issued in October and $120 billion issued in November. December will see lower levels of issuance as activity historically slows early in December through the end of the year.

Going forward the outlook is a bit uncertain. The Fed has been communicating its intent to start the rate hiking cycle in 2015, possibly in June. Many investors think this plan is too optimistic and that it could be closer to September or perhaps even later. While economic data including GDP growth has been improving, there are still some pockets of weakness within the economy. This coupled with very low inflation expectations means that the Fed does not have to be aggressive with beginning the rate hiking cycle. In recent commentary, most Fed members have emphasized this, noting that they want to let data guide them, not particular dates, and they do not want to surprise the markets.

Additionally, Euro area rates as well as U.K. and Japanese rates are all at levels lower than those of the U.S. None of these countries have GDP growth levels as strong as the U.S., hampering their ability to pull out of their economic slump by growth. Europe has had two recessions since 2007 and appears on the verge of another. The European Central Bank is seeking to pump money into the market but how much of an effect this will have is open for debate. With low growth and deflation concerns rising, rate levels in these countries have moved lower. The chart below depicts recent levels for 10-year government bonds in several of the Euro-area countries:

The Sub 1% Club

Yields 10-Year Bonds



Change in yields since June 6, 2014*

Country	June 6, 2014	Nov 28, 2014
France	1.702	**0.969**
Change	-73.3 bp	
Belgium	1.808	**0.920**
Change	-88.8 bp	
Austria	1.659	**0.836**
Change	-82.3 bp	
Netherlands	1.586	**0.816**
Change	-77 bp	
Finland	1.552	**0.771**
Change	-78.1 bp	
Germany	1.351	**0.700**
Change	-65.1 bp	

Source: Bloomberg, CreditSights

With yield levels below 1% versus roughly 2.25% for the U.S., foreign demand for U.S Treasuries should remain stable; this should also aid in keeping rate levels, at least on intermediate and longer end of the curve from rising too much in the near term even if the Fed does start its rate hike cycle next year.

Despite the downward trend in yields that we have experienced since the summer months, we have been somewhat active within the fixed income portfolio. Most of the recent activity has been within the corporate sector. With October and November both seeing high new issuance levels, there were several new deals that we participated in. We purchased Verizon 7 and 10-year maturity debt, Wells Fargo 30-year subordinated debt, Noble Energy 10 and 30-year debt, Aflac 10-year debt, and Walgreens 7-year debt.
In early December we purchased Amazon 20-yr debt, and positions in 2 high quality utilities, Ameren Illinois and Entergy Arkansas. In each case these new issues were offered at attractive spreads versus the company's outstanding issues and therefore offered decent relative value. Additionally, some of the issues, such as Wells Fargo and Aflac, were being offered at spread levels that were more attactive than their similarly rated peers, which also made them attractive on a relative value basis. We will continue to look for similar opportunities within the corporate sector, adding value/yield when possible.

In the agency debt sector we have seen spreads remain stable and fairly tight. Earlier in the quarter we purchased an off-the- run 10-year agency bullet that was offered several basis points cheaper than comparable maturity on-the- run issues. We also added an 8.5 year callable issue whose call option is well out of the money. This issue was offered at a notable discount and offered at an attractive spread versus comparble bullet issues. Both of these purchases allowed us to add some yield as well as a little duration, which we think has been a prudent move given rate levels over the past few months. We are currently a bit underweight within this sector and would add selectively if an attractrive opportunity arose.

Spreads have remained fairly stable and tight within the mortgage sector as well. The narrow spread level coupled with low rates has limited the number of opportunities within this sector. We did execute one swap within this sector, early in the quarter. We sold a 2.5% 15-year pool and purchased a 3.0% 30-year pool. This enabled us to lengthen duration a bit here as well, and make sure the portfolio would benefit from the move lower in rates. We have kept our weighting stable within this sector and look to add selectively as attractive opportunities arise.

Lastly, we added to our Treasury holdings early in the quarter as well. We purchased a block of 10-year notes to lengthen duration somewhat in this sector and to reduce our underweight versus the Index as rates were declining. The 10-year note had not rallied quite as notably as the 30-year bond and we felt that it offered more upside going forward.

Domestic Equity Strategy

By Allan Carr

Since our last update in late August, the market is up roughly 3% though not in a very linear fashion. September was more or less flat as we closed the books on our Fiscal 2014 year with the S&P at 1972, roughly 2% off the all-time closing high set just two weeks prior. From there the next two weeks got shaky with fears over Ebola and a global growth slowdown, culminating with a weak U.S. retail sales number the morning of October 15. The market sold off over 3% by midday to 1820 before recovering strongly to close down less than 1%. The 1820 intraday low was 9.9% from the intraday all time high set on September 19, so technically we have gone over 1,150 days without a market correction of 10%.

October 15 would mark the low as from there the market rallied on better global economic news, corporate earnings here in the U.S., and hopes of stimulus abroad. And in a surprise move on the last day of the month, the Bank of Japan announced a more aggressive version of their QE which sent global markets higher and saw the S&P close at an all-time high of 2018.

November was a solid month as the market gradually moved higher setting 12 new all-time highs. Early in the month we saw more global stimulus via the ECB and China to bolster their sluggish growth. U.S economic data improved giving investors more confidence that the global slowdown was not filtering over to our economy. Crude oil continued to slide, likely pushing back the start of Fed rate hikes as well giving a boost to consumers' wallets. The S&P closed at yet another all-time high the day before Thanksgiving of 2073 and we are just above that level as of this writing.

Since the 1820 low on October 15, the market has rallied back over 13.5% and stands roughly 12% higher for the year (14%+ with dividends). 2014 has been similar to prior years with the "lower for longer" theme continuing to play out with the US economy gradually improving, but not expected at that pace. We are now over five years into the bull market and the stock market is at all-time highs, up over 200% in price appreciation and over 240% inclusive of dividends from the March 2009 lows.

While we acknowledge that stocks aren't as cheap as they were, and the market has had an impressive run, those alone are not sound reasons to think the bull market has run its course. We have spoken in past updates that bull markets do not come to an end simply when market multiples hit a magic number, indices hit a certain threshold, or the rally has gone on for a certain amount of time. Bull markets end when recession ensues. And that usually comes in the form of conflict/terrorism/war, policy errors (tightening at the wrong time or too much), or when greed/overconfidence lead to excesses that cause a credit event.

Geopolitical risks remain present and are hard to handicap. Given recent developments with inflationary cost pressures coming down, the odds of Fed action continue to get pushed out further and further suggesting more "lower for longer." And we do not see the signs of excess at the consumer or corporate level. Therefore we presently see recessionary risk as being very low and the cycle continuing to move forward. Below is a checklist from RBC of some of the predominant indicators of prior recessions and as you can see none are currently flashing "WARNING."

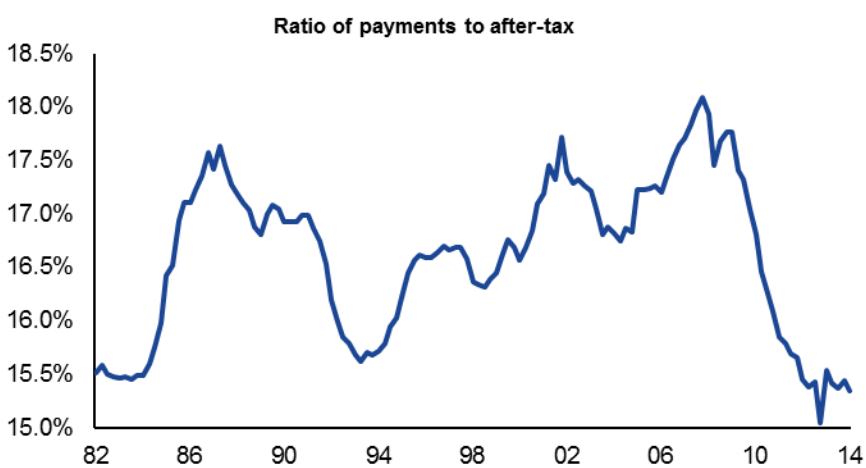
Recessionary Indicator Scorecard

Start of Recession	Yield Curve	ISM Mfg.	Inflationary Trends	Capacity Utilization	Housing Starts	Avg. Wkly Hours
Dec-69	✗	✗	✗	✗	✗	✗
Nov-73	✗	✗	✗	✗	✗	✗
Jan-80	✗	✗	✗	✗	✗	✗
Jul-81	✗	✗	✓	✓	✗	✓
Jul-90	✗	✗	✗	✗	✗	✗
Mar-01	✗	✗	✗	✗	--	✗
Dec-07	✗	✗	✗	✗	✗	--
Present	✓	✓	✓	✓	--	✓

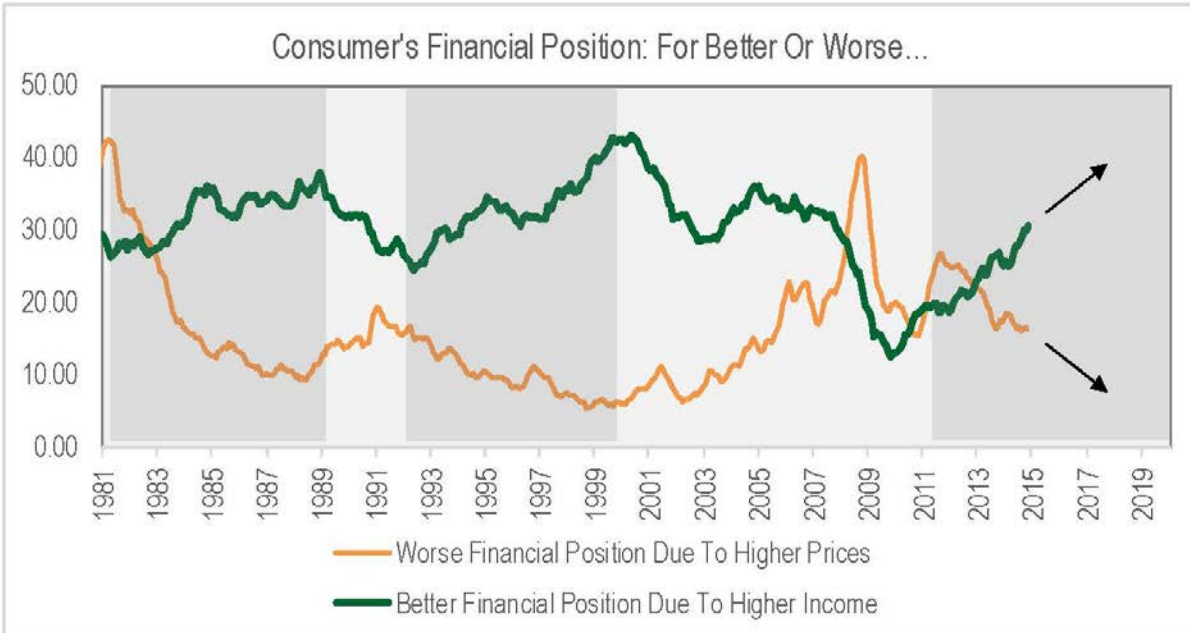
Key: ✗ Recessionary Territory
✓ Expansionary Territory
-- Neutral

Source: S&P, NBER, Federal Reserve, BLS, ISM, Census Bureau, Haver, and RBC Capital Markets

Since the credit crisis, the consumer has de-levered considerably as evidenced in the chart below of the Fed's "financial obligations ratio," which they release quarterly. It measures mortgage/rent payments, credit card payments, auto payments, homeowner's insurance and property tax payments as a percent of disposable personal income. By this measure, consumer leverage is at a healthy level not seen since the early 80's.



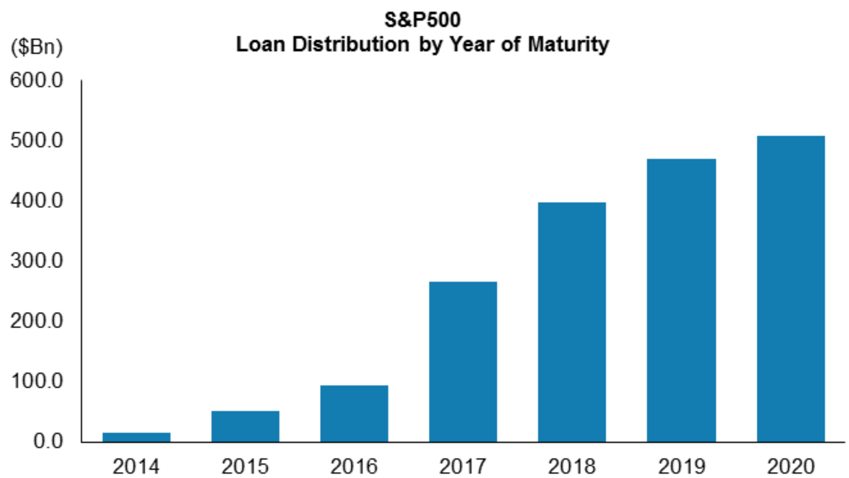
In addition to deleveraging, consumers are getting a break from lower rates, lower energy prices, and the stronger dollar. What about the effect of interest expense on the consumer when rates finally rise? Per Morgan Stanley, roughly 75% of US consumer debt is mortgage debt. And of that, roughly 90% of outstanding mortgages are currently in fixed rate products at the lowest effective yield in history (3.9%). The chart below from Cornerstone shows that the consumer is in a much better position now both from an income and expense position.



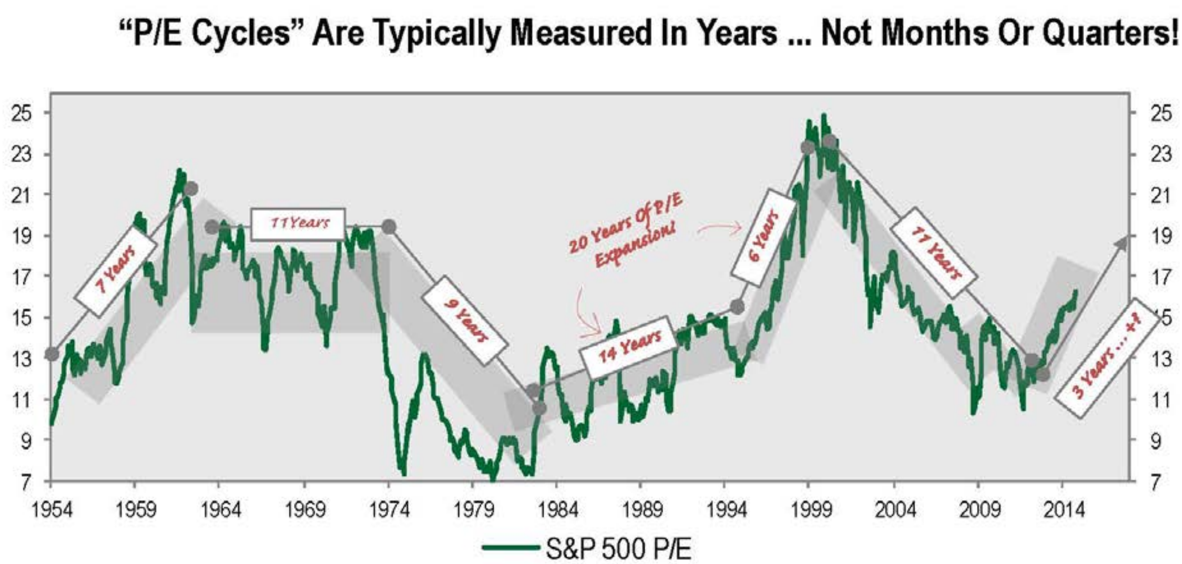
In sum, the consumer has less debt overall, more financial flexibility with free cash flow, declining delinquencies, and the majority of their debt obligation locked in at historically low fixed rates. This is not suggestive of a consumer debt problem looming. A solid financial position with tailwinds of more purchasing power from the stronger dollar, lower gas and energy prices, strong equity markets, and an improving job market should lead to increased consumer confidence which paints a strong picture for the U.S. economy.

On the corporate side, we have highlighted for years that CEO's are not showing the usual signs of hubris that has accompanied prior bull markets and record highs in equity prices. Capex has improved but remains muted. Inventories are in check. M&A has heated up which is encouraging, but not to a level that is worrisome. In just November we saw 65 plus deals in aggregate of nearly $360 billion. For the year we've seen roughly 600 deals totaling north of $3.5 trillion. CEO's continue to prefer the immediate payback of share repurchases, with gross buybacks over $2 trillion in S&P companies over the last 5 years.

Management teams have continued to stockpile cash and take advantage of low rates to strengthen balance sheets. The hoarding of cash post crisis has resulted in the interest coverage ratio doubling in the last five years from 4x to 8x, so companies have double the cushion to pay their debt. In addition, debt maturities have been pushed out substantially, with very little debt maturing over the next two years. As the chart below from Morgan Stanley shows, the bulk of it is due 2018 and beyond. Companies are in as good a position to meet their debt obligations as they have been in quite some time.



With the backdrop for the consumer and corporate America looking healthy, the debate usually turns to EPS growth, the market P/E and multiple expansion. Contrarians claim the market is expensive versus history and that multiples will mean revert and come down. But as the chart below from Cornerstone shows, multiples don't usually hover tightly around the average on a short term basis but more often trend directionally for some time.



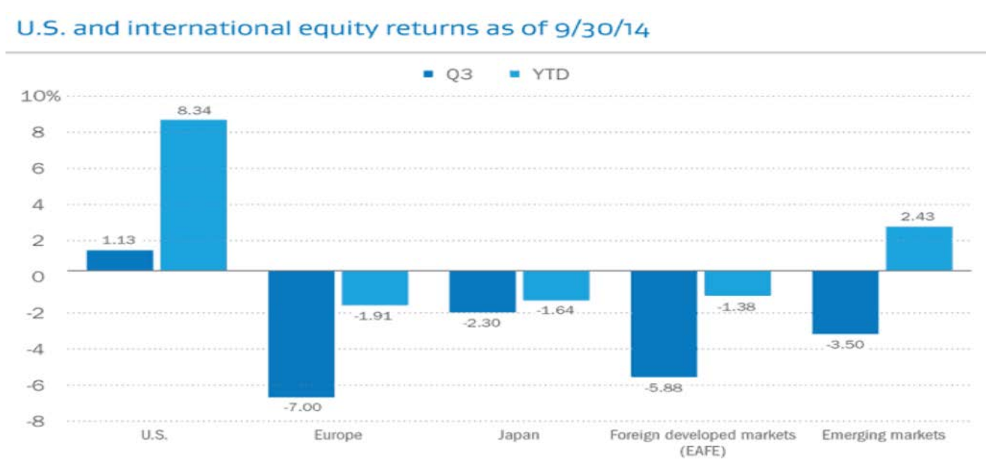
At roughly 16x 2015 EPS, the market is marginally above the long term average but by no means extreme. And the current backdrop suggests that it could move higher. Strength in the dollar, lower inflation via commodity prices, and “lower for longer” interest rates all point to multiples more likely to move higher than lower. While there is always the fear of the unknown, the outlook for the U.S. equity markets remain constructive despite the sizable gains in prior years. As we have discussed before, it is not that there is an extremely compelling bull case to hang your hat on but rather the odds of the bear case are low.

The S&P 500 has made nearly 50 new highs in 2014 alone yet it doesn’t seem to garner much attention. This has been a strange bull market as it hasn’t seemed to be embraced like prior ones, bragged about, and in many cases has been discredited. A lot of it is likely still the scars from the credit crisis. Five years later Wall Street is still painted in a negative light with movies like Wolf of Wall Street, as well as being portrayed as not being “fair” or “rigged” with books such as Flash Boys. Given the recent history of the U.S. and foreign economies moving in tandem, it is not hard to see why some are skittish of the recent global decoupling and question it spilling over. News shows focus on the stronger dollar hurting exports, yet forget to point out that exports are roughly 15% of GDP while consumption (the consumer) is over 70%. We still are yet to see retail money move into equities even with treasury yields at 2.3%. Since 2008 individual investors have poured $1 trillion into bond funds versus $500 billion of outflows in domestic equities. Whatever the reasons may be, there is still a lot of skepticism about the market which we see as a good thing. As famed mutual fund pioneer and investor Sir John Templeton once said “Bull-markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.”

International Equity Strategy

By Steve Lambdin

The third quarter of 2014 was a very difficult period for U.S. investors in the international equity markets. The significant strengthening of the U.S. Dollar during the quarter pushed most equity markets into the red over this period. Monetary policies in the U.S. are quite different relative to the Bank of Japan (BOJ) and the European Central Bank (ECB) and this has led to a very volatile currency market over the last few months. The U.S. seems to be continuing down a path of curtailing monetary stimulus while other central banks are cranking up monetary stimulus in a big way. In addition, the economic recovery in Europe continues to be very shaky at best, as economic readings seem very weak and this is leading to a lack of investor confidence. This has led to interest rates at historic lows as German 10-year government bond yields finished the quarter at .95%, while two-year yields are in negative ground in several countries in the Eurozone. This is quite a reversal when two-year yields were in double digit territory just a few short years ago. In China, the risk of following below official growth targets seems to be growing lately as many economic readings have been viewed as very weak. Japan continued down the path of Abenomics during the quarter as monetary policies remain very supportive to growth as the economy tries to recover from the economic shock of the recent tax increase. The geo-political front remains a mess from the continuing saga of the Russian/Ukraine tensions, persistent problems with the ISIS terror group, pro-democracy protests in Hong Kong, and the spread of Ebola just to name a few. Each of these issues can lead to economic distress in their respective country or region and can have ramifications beyond their borders. At this point, we are increasingly concerned with the economic outlook of the Eurozone economy going forward. Many indications seem to be pointing toward some level of a recession. We just do not know to what degree at this point. This should make for some nervous equity markets as we head into late 2014.



Source: Factset, TIAA-Cref Financial Services

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -5.88% and -3.5% respectively during the third quarter of 2014 vs. +1.13% for the S&P 500 Index. For our fiscal year, the MSCI EAFE Index and MSCI Emerging Markets Index both returned approx. +4.3% vs. +19.7% for the S&P 500 Index. U.S. equities continued to be the preferred place for global equity investors as most see this economy appearing to be on solid footing relative to other regions around the globe. The U.S. Dollar Index was significantly stronger in the quarter as the U.S. Dollar rose +7.75% against the Euro, +5.0% against the British Pound, and +8.2% against the Japanese Yen. This was a big hit to global returns for unhedged U.S. investors. The Pacific region was a bit stronger than the European region as the Japanese market was quite strong during the quarter on a local currency basis. From an economic sector standpoint, Healthcare and Technology were relatively stronger, while Energy and Materials were the weakest. This came as little surprise as the global commodity complex continues to slide as crude oil fell nearly -13.5% during the quarter.

Thus far into the fourth quarter of 2014, global equity markets continue to be "hit or miss" by market. International equities, both developed and emerging, have been nearly flat, while U.S. equities are up just over +5%. Weak economic data reports across Europe and China have been concerning to investors as many expect government growth targets in China to be reduced and the European economy could be heading for a recession. In addition, a weak commodity outlook continues to plague many emerging market economies. However, growth looks solid in the U.S. economy as recent corporate earnings look good. Also, crude oil prices continue to fall which is acting like a stimulus for the U.S. consumer. Deflation concerns are very much alive across Europe. Many fear a "Japanese" style deflation scenario forming as interest rates continue to fall in the region. The U.S. Dollar continues to rise thus far in the fourth quarter, pressuring unhedged returns. Many will be watching central bank actions over the next few months to look for additional signs of easing to bring any relief to equity markets.

Source: Capital Economics

Asia Update

While posting a negative return in the third quarter, the MSCI Pacific region actually wound up being the best performing region in the MSCI EAFE Index, down -3.64%. The lone bright spot in the region was the emerging market economies, as further monetary stimulus in China was well received by these countries. The Japanese equity market was quite a show in the quarter as a strong local return in the quarter of +5.79% was completely negated by the rapid appreciation of the U.S. Dollar against the Yen, sending the U.S. return of this market to -2.3%. The massive stimulus program by the Bank of Japan (BOJ) to weaken the Yen seems to be working. This looks to be reversing the long cycle of deflation that has plagued this country. A weaker currency makes Japanese products more competitive on the global marketplace. Chinese equities continue to move ahead on the heels of fresh new stimulus measures aimed at solidifying their +7.5% stated growth target in 2014. Australian equities are still struggling as the global commodity complex continues to weaken. As we move into late 2014 and early 2015, investors will be watching developments in Japan to see if the recent growth snag was just a hiccup from the increase in the value added tax or something deeper going on here. Also, many will be monitoring what China's stated growth goals for 2015 will be.

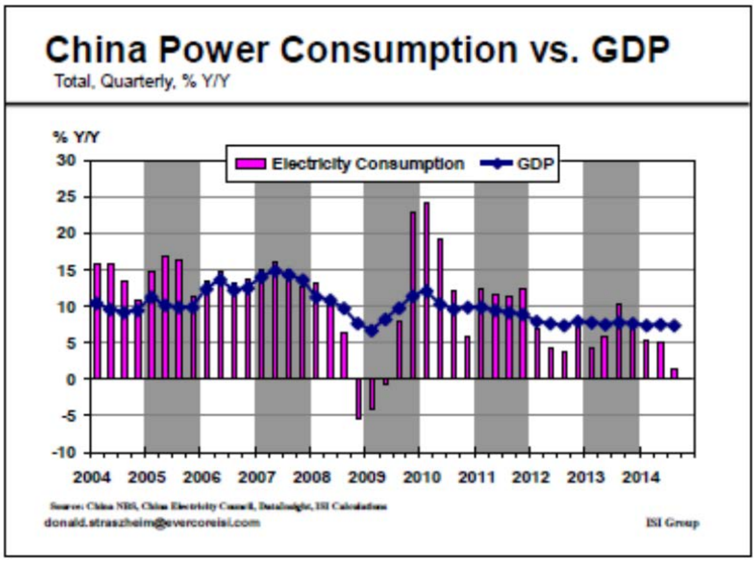
Market Performance

Data as of: 30-Sep-2014

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Philippines	0.51	4.03	24.75
MSCI China	-6.38	1.42	0.74
MSCI Hong Kong+	-6.92	0.17	1.90
MSCI Singapore	-4.08	-1.19	3.50
MSCI Japan	-0.71	-2.30	-1.64
MSCI Taiwan	-7.00	-3.56	7.54
MSCI Pacific	-4.12	-3.64	-0.63
MSCI Australia	-11.41	-7.93	0.22

Source: Factset

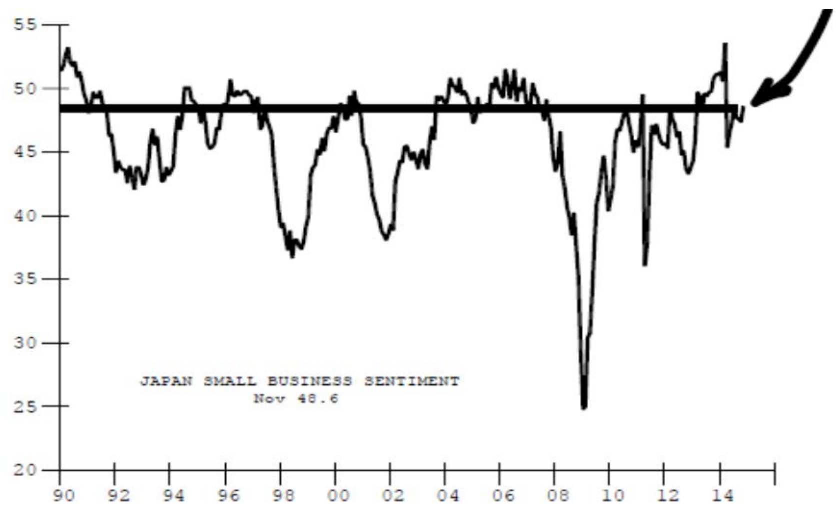
The Chinese economy continued to chug along at a healthy, but slowing pace in the third quarter of 2014. Gross Domestic Product (GDP) in China rose +7.3% from the year earlier period, a slight decrease in the pace from the previous quarter. This was right in line with most economists' expectations. The People's Bank of China (PBOC) continued with its stimulus measures by injecting approx. 700 billion Yuan into the banks in addition to a reduction in repo rates. Also, the central bank took measures aimed at the housing sector, opting to reduce mortgage rates and down payment requirements. We continue to expect these measures to continue over the near term as PBOC aims to keep the economic engine growing. Even though PMI has been weak lately, industrial production rose +8.0% in September from the year earlier, which was an improvement from August. Fixed asset investment continues to slowdown and was reported up +16.1% for the first nine months of the year, down from the +16.5% pace seen in the January-August time frame. Exports continue to be a bright spot, as they rose +15.3% in September from a year earlier, well up from the August reading. Strong demand from the U.S. economy seems to be helping here. Retail sales look to be holding up decently, as September sales were reported up +11.6%, just a very slight deceleration from a month earlier. Inflation continues to drop as consumer prices only rose +1.6% in October, still well below acceptable government targets. This still keeps the door open for more aggressive easing actions in order to boost economic growth. As we look out over the next few months, all eyes will be on the government's targeted growth rate for 2015. We expect growth of about 7%, which would be slowest rate of growth since 1990. Many already expect this and this should not be much of a surprise for investors.



Source: ISI, China NBS, China Electricity Council, DataInsight

In a real surprise, the Japanese economy contracted by another -1.6% in the third quarter, and entered into a technical recession. This was the second straight quarter of negative growth in this economy. Like most investors, we were expected a quick "snapback" in this economy from the effects of the April sales tax increase. However, the effect of this tax increase has clearly lingered on much more than we estimated. This should push out the scheduled October 2015 tax increase well into future. The government is also considering additional stimulative measures to aid the economy. Industrial production did manage to rise +2.9% in September from a month earlier, in a sign that perhaps this recession will be very short lived. Exports also rose +9.6% in October from a year earlier, the strongest reading in eight months. The weakening yen seems to be really helping on this front. Small business confidence looks to be very stable in October and November and could rise as we move into early 2015. However, consumer confidence remains well behind that of business and was reported at 38.9 in October. The recent improvement we saw in this key indicator is now gone, with little hope of significant improvement over the near term. This is further evidenced as retail sales fell -1.4% in October from the previous month, as no one wants to spend.

The BOJ's recent actions are having the desired effects on deflation, as core prices rose +2.9% in October from a year earlier. While this is a bit slower than early summer, it is still miles ahead of the deflationary grip that Japan had been stuck in for years. The employment situation in Japan has remained relatively steady over the last few months. The unemployment rate was reported at 3.5% in October, which is a fresh low for this region. In addition, the jobs-to-applicant ratio looks rather steady, remaining at 1.10 in October. These employment figures should lead to some level of decent wage growth. At this point, we see Japan's recession as being short lived and expect the BOJ to continue to pump in monetary stimulus in a big way over the near term. This should mean an exit for the recession, but growth will probably remain sub-par relative to other parts of the world.



Source: Evercore ISI

Europe Update

Confidence continues to fall across the Eurozone as the economic recovery continued to stall out in the third quarter of 2014 as inflation continued to fall and growth concerns in other economies took its toll. European exports were weaker than many had expected as economic sanctions against Russia and a slowing Chinese economy are being felt across the region. This has been especially tough on Germany as exports are a big part of this country's economy. The ECB has responded with fresh accommodative monetary policies by cutting interest rates in addition to expanding its balance sheet with targeted actions. It seems this may not be enough and only some type of wide scale quantitative easing will be needed to keep this economy out of a prolonged recession. With these announcements, interest rates fell to fresh new historic lows and the region is flirting with deflation. Also, fresh fears of a debt crisis did emerge in the quarter as a bank in Portugal did miss a loan payment. All of this led to a significant decline in the Euro vs. the U.S. Dollar to the tune of about -8%, which severely hurt equity market returns for U.S. investors. The MSCI European Index (ex. U.K.) posted a loss of -7.45% in the third quarter. At this point, we would expect a significant quantitative easing program at some point in the near future in the region, which will probably pull the Eurozone out of recession territory, but growth will be anemic at best. Also, a falling Euro will help exports across the region, but this will take time to filter through the economy. So in the meantime, we expect equity markets to remain somewhat weak relative to other regions as we head into late 2014 and early 2015 until investors get more comfortable with the economic picture in the Eurozone.

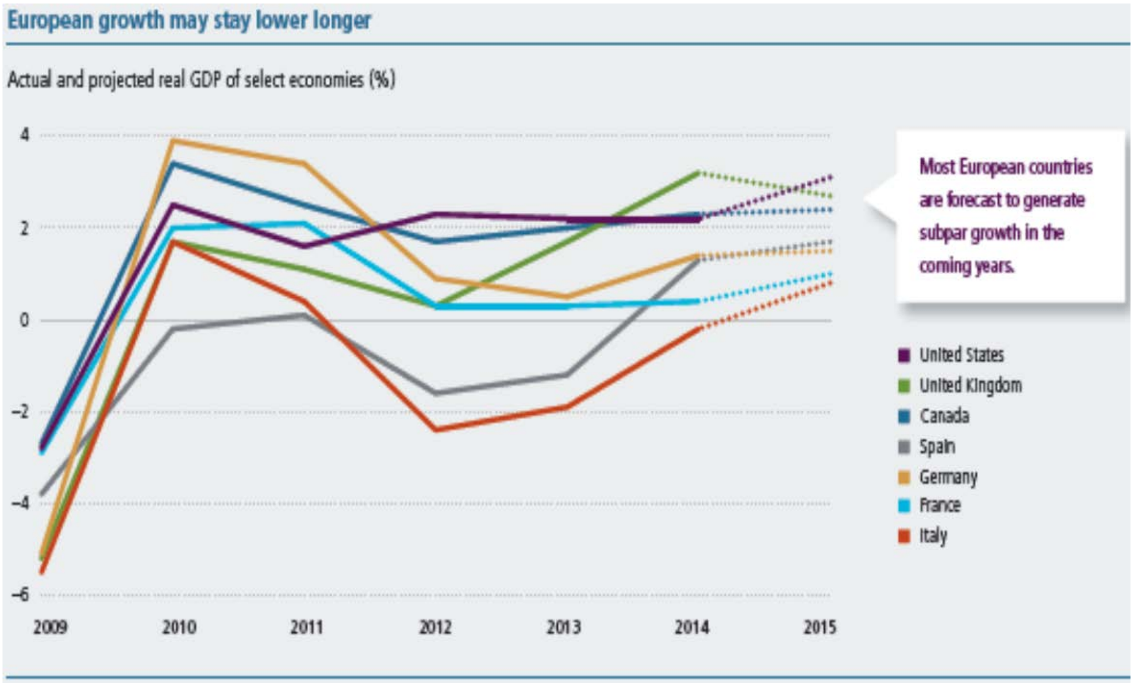
Market Performance

Data as of: 30-Sep-2014

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Switzerland	-2.61	-4.43	2.19
MSCI Netherlands	-1.38	-4.69	-3.20
MSCI United Kingdom	-5.21	-6.06	-1.20
MSCI Europe ex UK	-3.05	-7.45	-2.24
MSCI Spain	-3.12	-7.48	3.89
MSCI France	-3.57	-8.38	-4.11
MSCI Italy	-1.31	-8.71	4.48
MSCI Germany	-4.20	-11.17	-10.01

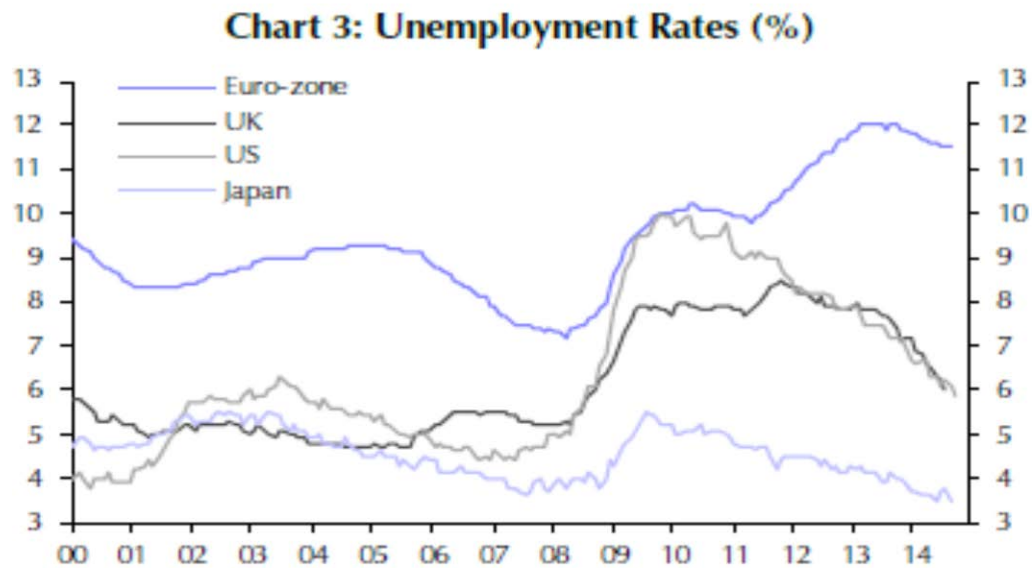
Source: Factset

The Euroland economy continues to sputter at best as the region seems stuck in economic purgatory. Third quarter GDP did manage to rise +.2% from the previous quarter, or +.8% from the year earlier period. The German economy posted very slight growth in the quarter while the Italian economy remains stuck in a recession. Export growth fell across the region to only +.8% in the quarter from a gain of +1.4% in the previous quarter. As a result of this news, the ECB continues to cut future economic growth forecasts and we may only see +1% growth in 2015 at best. Industrial production did manage to be up +.6% in September from a very weak August, as capital goods showed a bit of strength. The index of executive and consumer sentiment finished at the high point of the third quarter in September, reaching 100.8. However, this is still well below the levels just a few months back. Retail sales in October increased +.4% from the previous month, or +1.4% from a year earlier, as strength in non-food products was a little bit of a positive surprise. However, this is weak relative to other regions around the globe in a sign the consumer remains worried about the outlook of this economy. The employment situation is still very weak in the region, but somewhat stable. The October unemployment rate remained at 11.5%, right at where it has been for three straight months. We don't expect to see any strength in this key indicator over the near term and are just hoping it does not get any worse. Inflation continues to move down, falling to +.3% in November, which is yet another fresh low in the Eurozone. It now looks like ECB President Mario Draghi will propose new stimulus programs aimed at combating a deflation scenario developing in the region. Coming as no surprise, the ECB kept interest rates at record lows at its early December meeting. We will wait and see what the next steps for the ECB will be in early 2015 to try to bring this economy back to life.



Source: John Hancock Investments; IMF, *World Economic Outlook, Legacies, Clouds, Uncertainties*, October 2014

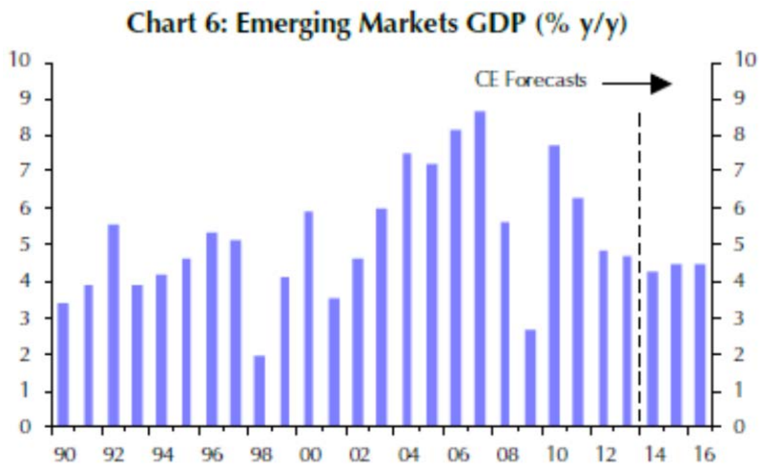
As has been the case this year, the U.K. economy continued to be quite resilient relative to other large economies around the globe in the third quarter. GDP grew by +.7% in the quarter from the previous quarter, or +3.0% from the year earlier period. Growth in this economy looks very solid as the government seems to have a well-managed plan as it appears to be domestically driven, as net trade acted as a slight drag on the economy. Industrial production continues to climb, rising +.6% in September from a month earlier, or +1.5% on an annual basis. Within industrial production, manufacturing still remains very solid, rising +2.9% from a year earlier. As expected, the Mining and Oil/Gas sectors were very weak as the large drop in crude oil and commodity prices in the quarter played havoc with this group. Retail sales were very strong in the quarter, rising +.8% from the previous quarter, or +4.3% from the year earlier. Reports of widespread price cutting brought consumers out in a big way as lower prices for food and gasoline has put more money in consumers' pockets. Inflation continues to fall just as we have witnessed in most other parts of the world. October inflation was reported to be up only +1.3% from a year earlier, keeping up the pace of declines we have grown accustomed to in this region. This still remains well within limits perceived acceptable by the Bank of England (BOE). At its early December 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. The MPC still remains split on the call for higher interest rates. At this point, our best guess on this still remains sometime in early second quarter of 2015, but this is subject to economic conditions in the region. The employment situation continued to show signs of improvement as the unemployment rate fell to 6.0% in the three month period thru September. Employment rose by 112,000 in the three month period to another record of 30.76 million. At some point, we would expect wage growth to pick up as the labor market tightens. The U.K. economy continues to be a source of strength in the global economy, especially when compared to the Eurozone. However, the longer the Eurozone economy flounders, we would expect the growth rate in the U.K. to begin to weaken on the margin. We believe this will be the most likely scenario for this region in 2015. To what degree, we just do not know at this time. We feel this should not come as a major surprise to investors.



Source: Capital Economics

<u>Emerging Markets</u>

Emerging market equities struggled in the third quarter as U.S. monetary policy continued to play havoc with investors in these equities. Investors continue to grabble with what potentially higher interest rates in the U.S. will mean here. Also, falling oil and commodity prices from a stronger U.S. Dollar have hit Brazilian and Russian equities hard, sending these equity markets down. It's been especially tough with Russian equities as economic sanctions from the west are being felt as well. In addition, as China's growth rate continues to fall over time, this will put pressure on emerging market equities to perform well. Perhaps the best returns in emerging markets will be from countries that depend less on resources and have more sustainable internal structural reforms in place. With the recent weakness in these markets, we are seeing a healthy valuation discount to many of the developed markets. However, valuation alone proves many times not to be a good indicator of near term future returns. We believe a high degree of caution is still warranted here with these equities until investors get more comfortable with the future of monetary policy in the U.S. and some level of stability in the currency and commodity markets.



Source: Capital Economics

International Equity Activity/Strategy

While remaining somewhat constructive on global equity markets over the medium to longer term, we do acknowledge the near term outlook for many of the international equity markets relative to U.S. equities stills looks tough at the moment. Even though we expect more central bank actions out of China and Europe, we expect the growth outlook to continue to worsen over the next few months. The Eurozone looks to be on the edge of a recession at this point, we just do not know to what extent. The recent downward trajectory of interest rates across Europe seems to indicate this is becoming a reality. However, there are many things to be positive about. We expect corporate margins and cash flows to remain healthy. M&A activity should remain at robust levels, keeping a bit of valuation premium in these markets. Also, we could see some measure of relief on the geo-political front if diplomatic efforts in some of the hotspots around the globe can continue to improve on the Ebola front. While equity valuations are up over the last year, we believe we are not anywhere near extreme levels, especially considering current inflation and interest rate levels.

We did add approximately $12 million to our emerging markets index portfolio as one of our written puts did expire below the respective strike price recently. We still 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 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 12.0% for MSCI EAFE equities. *(Charts provided by Capital Economics, IMF, Data Insight, China NBS, China Electricity Council, Factset, TIAA-Cref Financial Services, John Hancock Investments, Evercore ISI)*