Quarterly Economic Update

June 19, 2014

MACROECONOMIC COMMENTARY

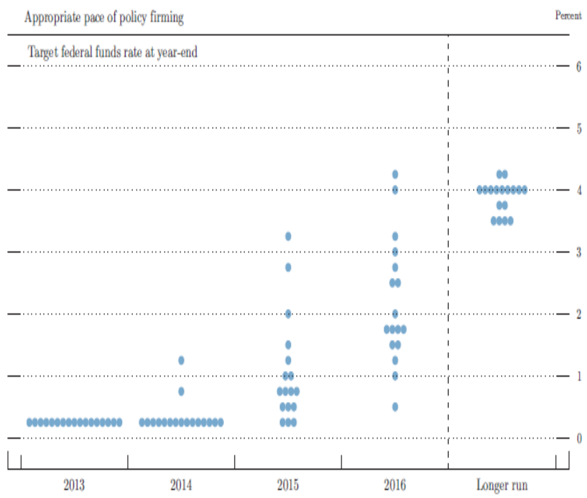
Monetary Policy
By Bobby Long

The Federal Open Market Committee (FOMC) continues to hold the federal funds rate steady and taper the pace of their securities purchases under the leadership of Federal Reserve Chair Janet Yellen. The FOMC held meetings on March 18-19th and April 29-30th where they continued to hold the federal funds target rate at 0 to ¼ percent. They have also continued to reduce the monthly amount of Treasury and agency mortgage-backed securities purchases by $10 billion at each of the meetings. Following the April meeting and beginning in May, the FOMC is purchasing additional Treasury securities at a pace of $25 billion per month and additional agency mortgage-backed securities at a pace of $20 billion per month. The FOMC is steadily winding these asset purchases down and both FOMC members and market participants seem comfortable with the pace of reductions. The initial open-ended program was purchasing $45 billion in Treasury securities and $40 billion in agency mortgage-backed securities per month. Since the December meeting, the FOMC has reduced the pace of these monthly purchases by $5 billion each at each of the subsequent meetings. If they continue to taper their asset purchases at the current pace, the program will be wound down before the end of the year.

We did see a change in forward guidance given on the path of the federal funds rate following the March 18-19th FOMC meeting. This change was expected as the unemployment rate approached the FOMC's 6 ½ percent threshold, making the prior guidance problematic given the FOMC's statements that they anticipate it will be appropriate to hold the current low rate "well past the time that the unemployment rate declines below 6 ½ percent." The March FOMC statement dropped their more quantitative guidance language that "the exceptionally low target range for the federal funds rate of 0 to ¼ percent will be appropriate at least as long as the unemployment rate remains above 6 ½ percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored." This was replaced with the more qualitative language stating that, "In determining how long to maintain the current 0 to ¼ percent target range for the federal funds rate, the Committee will assess progress - - both realized and expected - - towards its objectives of maximum employment and 2 percent inflation." This change to the forward guidance was made solely to remove the 6 ½ percent unemployment threshold and clarify the FOMC's intentions. It did not represent any change in policy or outlook, which the FOMC and Yellen made a point to explicitly communicate in the statement and the post meeting press conference. The statement repeated that "it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends." The FOMC also added a paragraph to the statement that when they do begin tightening policy, they would take a balanced approach and included the dovish statement that "The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

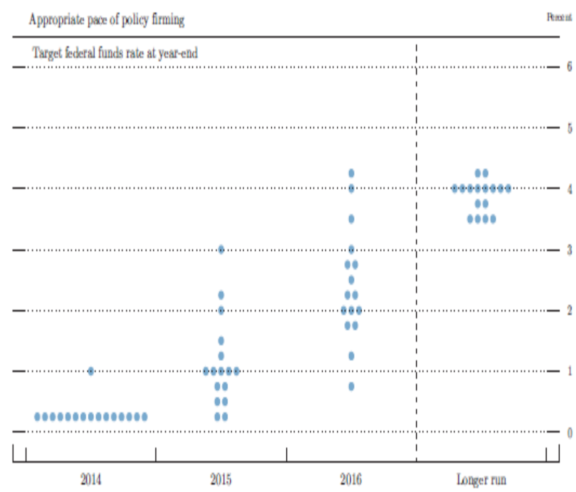
While the statement may have provided a slightly more dovish picture, the Summary of Economic Projections painted a picture of FOMC participants becoming slightly more hawkish. The two charts below are intended to provide a projection of the appropriate pace of policy firming with each dot indicating a FOMC participant's view on the appropriate level of the federal funds target rate at the end of the specified year. The March 2014 projections on the right below show a few of the dots as of year-end 2015 and 2016 have drifted up slightly relative the December projections on the left.

December 2013 Projections



Source: Federal Reserve Board

March 2014 Projections



Source: Federal Reserve Board

Investors took notice of this upward shift in the dots, however Yellen was quick to dismiss this in her post meeting press conference saying "I think that one should not look to the dot plot . . . as the primary way in which the Committee wants to or is speaking about policy to the public at large. The FOMC statement is the device that the Committee as a policymaking group uses to express its opinions, and we have expressed a number of opinions about the likely path of rates." She went on to say these dots would move up and down a little bit over time, but downplayed the significance.

With the March meeting being the first scheduled FOMC meeting under Yellen, investors were eager to tune in to the post meeting press conference in order to get a better read on Yellen's outlook for monetary policy. Yellen is pretty straightforward with her views and communications similar to her predecessor, however her Q&A responses were scrutinized and she provided some fodder for investors when asked how long following the end of the asset purchase program should we expect before they begin to raise rates. The FOMC has stated that it will likely be appropriate to maintain the current level of the federal funds target rate "for a considerable time after the asset purchase program ends." Yellen defined the language "considerable" as "probably means something on the order of around six months or that type of thing." There had been some confusion around a prior question regarding the likely timeline of the asset purchases, which seemed to leave Yellen a little flustered and left us wondering whether she was intending to communicate a shorter period between the end of the asset purchase program and the first rate increase. Consensus seems to expect, at the current pace of reductions, the asset purchase program would be wound down by the end of the year and as early as the late October FOMC meeting. If considerable is defined as six months, this would place the first rate hike as early as the April 2015 meeting which is a little ahead of expectations. It is likely Yellen meant to define "considerable" as *at least* six months and subsequent communications and FOMC minutes seem to support this. However, her comments left investors questioning whether Yellen might be more hawkish than perceived by the market.

The FOMC minutes indicated two topics of more lengthy discussion that are likely to be a recurring focus at subsequent meetings as we move forward through the recovery. The first is the appropriate measure of slack in the labor market. Yellen also addressed this at a recent speech to the Economic Club of New York, describing the difficulty as "Thus far in the recovery and to this day, there is little question that the economy has remained far from maximum employment, so measurement difficulties were not our focus. But as the attainment of our maximum employment goal draws nearer, it will be necessary for the FOMC to form a more nuanced judgment about when the recovery of the labor market will be materially complete. As the FOMC's statement on longer-term goals and policy strategy emphasizes, these judgments are inherently uncertain and must be based on a wide range of indicators." The minutes indicate a good amount of debate around the amount of slack in the labor market and the ability of the unemployment rate to provide an accurate assessment. While the unemployment rate itself has continued to fall, many FOMC members seem to have lingering concerns around the broader employment picture. Uncertainty around the high levels of part-time employment for economic reasons, high levels of long-term unemployed, low labor force participation, and slow broad-based wage growth are measures FOMC participants have debated and express concerns. The second topic that seemed to be discussed at more length in the April minutes was the next steps towards policy normalization. The FOMC has evaluated and tested several policy tools to remove accommodation when it does become appropriate. The minutes indicate a more detailed discussion and review of the best way to implement these tools going forward and instructed staff to perform further testing and analysis on their application. If the pace of improvement continues, this will become a much larger discussion at future meetings.

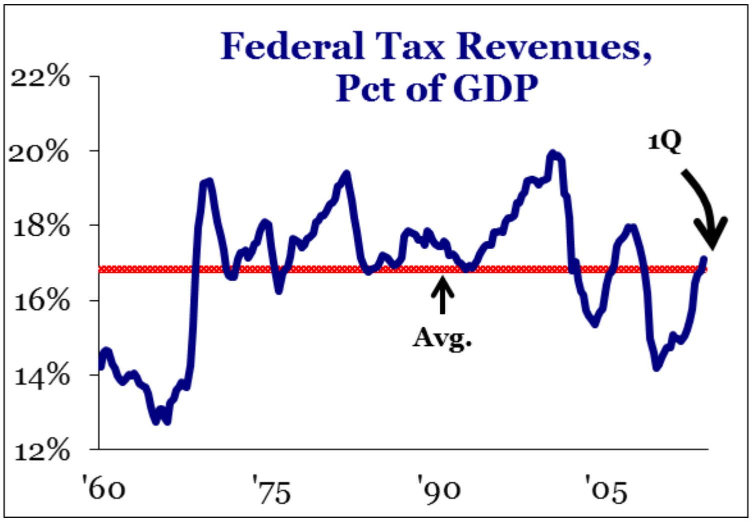
As we stand today the FOMC seems encouraged with improvement in the unemployment rate, but remains somewhat disappointed with the rate of improvement in other employment measures. They continue to feel the extraordinary accommodative monetary policy is necessary to support the recovery in labor markets, especially in light of benign inflation and low inflation expectations. The FOMC continues to taper their securities purchases and seems set to continue to taper at the measured pace with the asset purchase program being wound down by year end. While they continue to stress the reductions are data dependent and not on a preset course, if economic and labor market improvements continue to show improvement their consensus view seems to be that the additional purchases will no longer be necessary or beneficial. Even as they discontinue adding accommodation through the asset purchase program, they will continue to maintain an elevated balance sheet holding the current level of accommodation steady. They continue to stress that winding down the asset purchase program is not removing policy; it is simply no longer increasing it. While they maintain they can sell securities to remove accommodation if needed, there seems to be no inclination to sell assets in the near term. The FOMC continues to reinvest maturities and prepayments from their portfolio in order to maintain the level of accommodation and would likely discontinue the reinvestment of these before they began to outright sell securities. We are clearly moving closer towards a hike in the federal funds target rate, however an increase in the near term is unlikely. If labor conditions continue to improve at the current pace, the first rate hike is likely to occur sometime around mid-2015. The FOMC has sought to be very transparent with their communications and intentions on future policy actions. While we scrutinize ever word of the FOMC statement and over-analyze comments from FOMC members, their message has been very straightforward. They have provided their outlook and laid out their expectations of policy actions should conditions continue along the current expected path. Policy action is data dependent and the timing may be somewhat uncertain in light of the data, but the direction over the near term should be fairly clear.

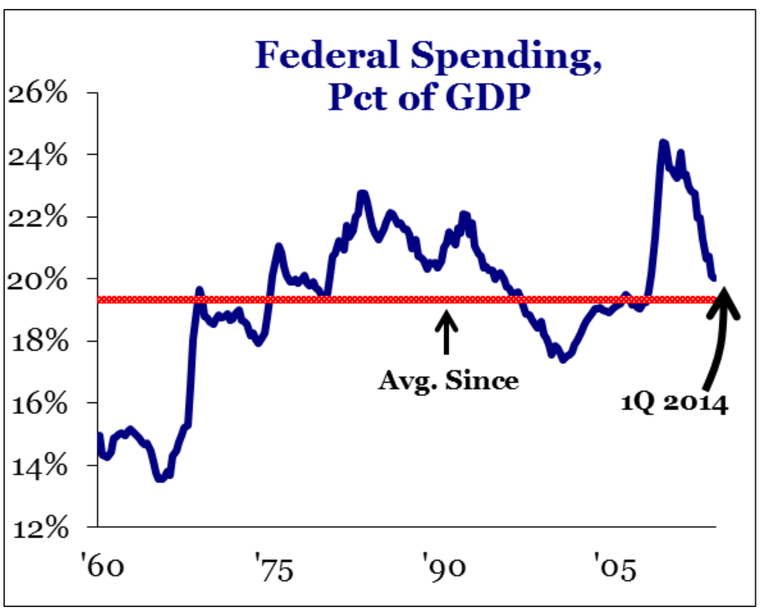
Fiscal Policy

By Michael McNair

In the Fiscal Policy Report we were kept very busy in 2013, as fiscal policy arguably played its biggest role in the US economy in the post-World War II era. Fortunately for the economy, the news around fiscal policy in 2014 can be described as boring.

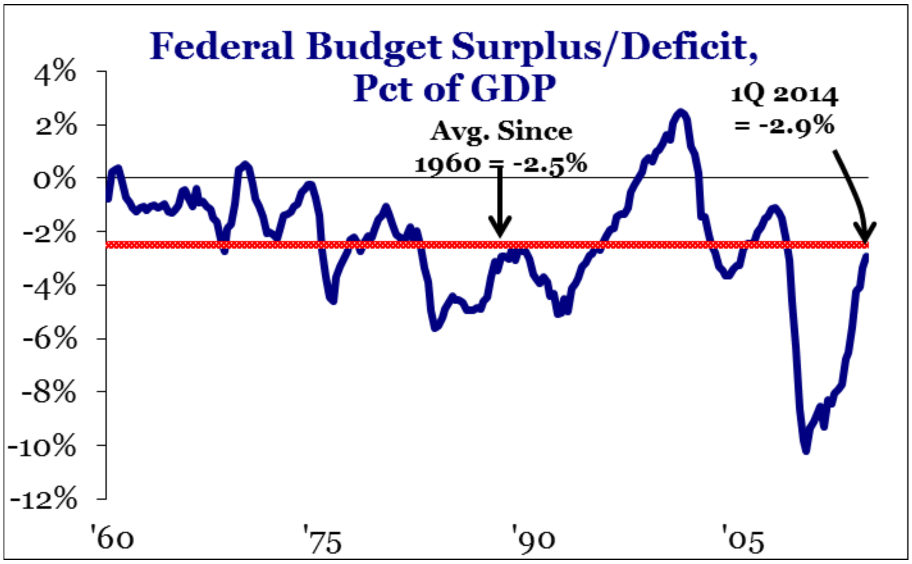
Fiscal Policy took center stage in 2013 as politicians and the public voiced their concern over the federal budget deficit and the growing national debt level. As a result steps were taken to dramatically increase tax revenue and decrease federal spending levels. As you can see in the charts below, federal tax revenue and spending as percent of GDP are now at their historical averages.





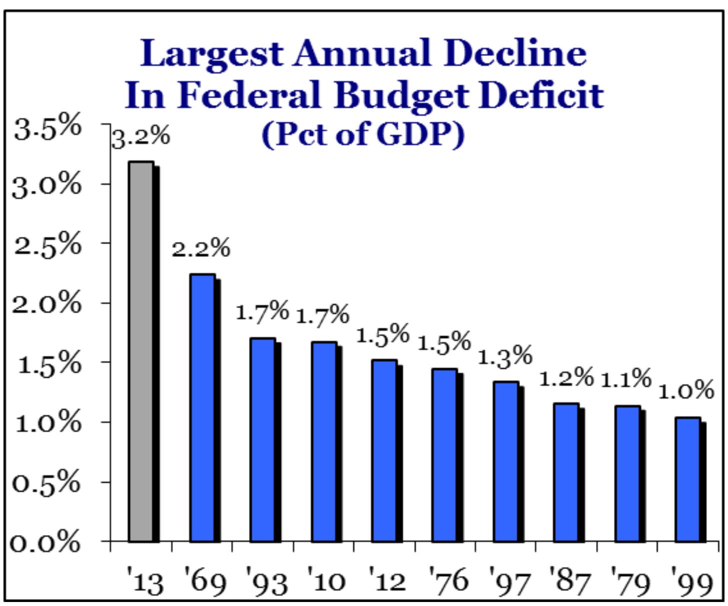
Source: Strategas

As a result, Washington was successful in drastically reducing the federal budget deficit.



Source: Strategas

If the singular goal was deficit reduction then they were historically successful, as 2013 saw the fastest decline in the budget deficit on record.

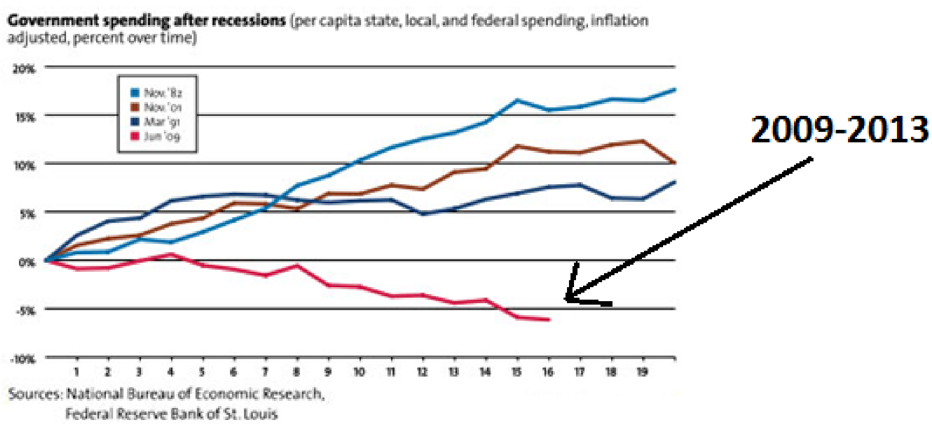


Source: Strategas

However, we do not believe that lawmakers should be commended for "achieving" this level of deficit reduction because reducing the budget deficit by unnecessarily forcing fiscal austerity at a time when the economy is trying to recover from a recession is a horribly ill-conceived goal. At such a time the focus should be on helping the economy recover not trying to close the budget deficit. While we succeeded in lowering the deficit we did so with horrible consequences to the economy.

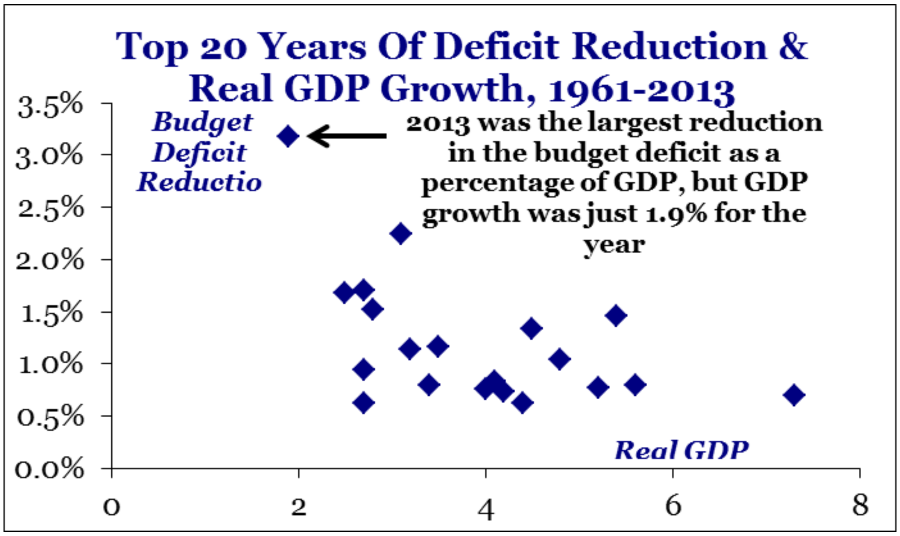
Historically, after a recession the federal government increased spending to keep the economy in a steady recovery. However, in 2013 politicians took it upon themselves to force the budget down irregardless of the state of the economy.

The chart below compares government spending after the past four recessions. 16 quarters after the three previous recessions 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.



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. Therefore, it should be of no surprise that this recovery has been much slower than the previous three.

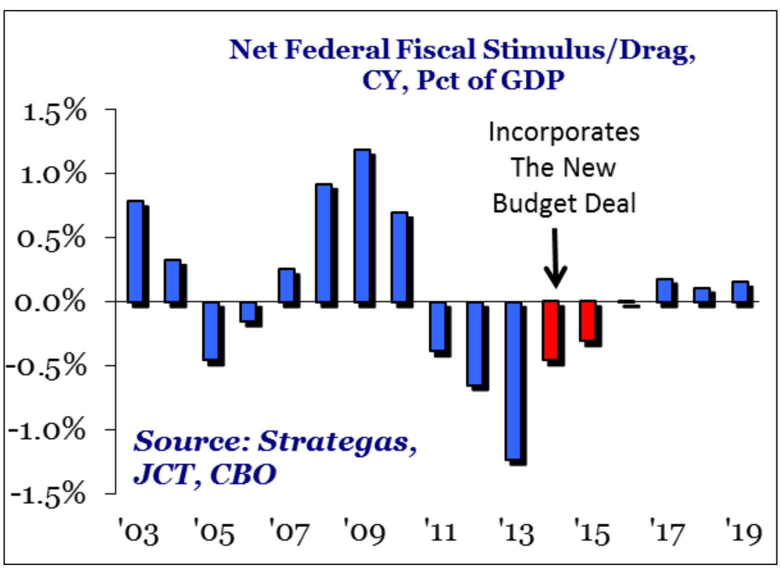
This is a drastic change in policy as historically the budget deficit was only allowed to decrease once the economy had recovered and was growing quickly. The chart below shows that the 19 largest years for deficit reduction averaged 4% real GDP and 1.1% of GDP reduction in the budget deficit. However, 2013 was a clear outlier as growth was just half the average yet we forced three times the deficit reduction.



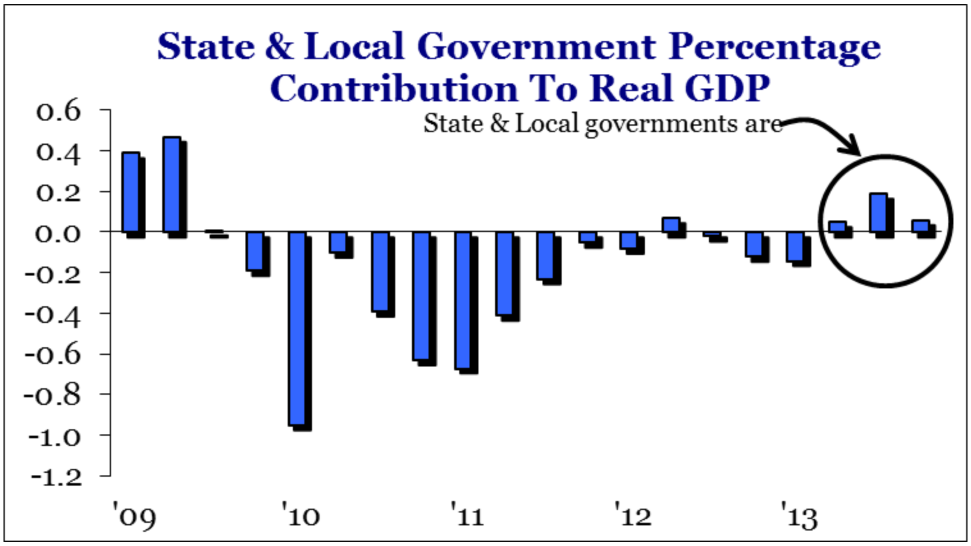
Source: Strategas

Our point is that in an attempt to close the budget deficit, the spending cuts and tax increases produced the biggest fiscal drag in our nation's history which subtracted at least 2% from GDP (in a year that the economy grew less than 2%) and, according to Deutsche Bank, cost the US almost 2.5 million jobs. If not for the fiscal drag, we believe that in 2013 the US economy would have finally reached "escape velocity" from the Great Recession and as the economy recovered the natural stabilizers in the budget would have allowed the budget deficit decline.

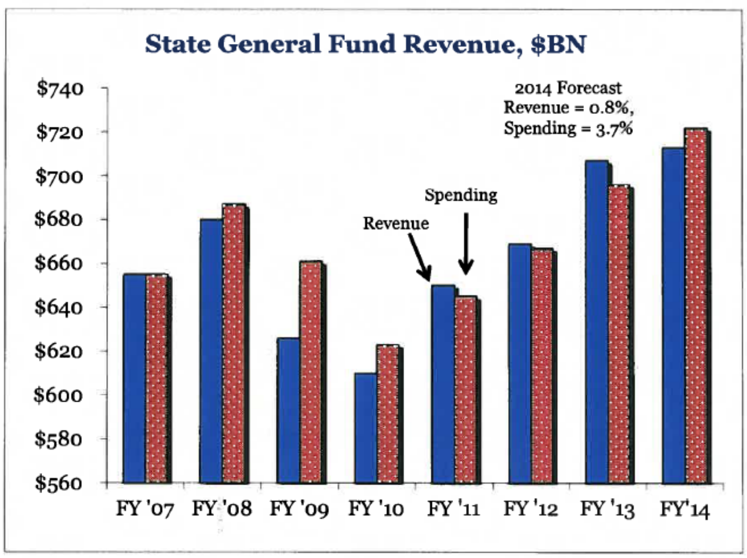
Fortunately, the federal fiscal drag is now mostly behind us and economists at Strategas are forecasting federal fiscal policy to subtract only 0.4% from GDP in 2014.



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



Source: Strategas



Source: Strategas

Overall, Strategas expects the total (federal, state and local) fiscal drag to subtract just 0.2% from economic growth in 2014.

Further, the fiscal drag numbers do not take into account the impact that the fighting and gridlock in Washington had in creating uncertainty for consumers and businesses. Consumer and business confidence took a major hit in 2013 during the debt ceiling debate and the government shutdown. Fortunately 2014 will not bring a repeat of these political battles, as government spending levels have already been set through September 2015 and the debt ceiling will not have to be raised until at least March 2015.

While the fiscal policy headwinds of 2013 are not likely to turn into tailwinds in 2014, just the removal of the enormous fiscal drag and uncertainty from last year should allow growth from the private sector to allow the economy to accelerate this year.

Economic Outlook

By Adam Rogers

Mid-Cycle Slowdown

Economic data in the US is signaling the familiar traces of a mid-cycle slowdown. The phrase isn't catching on like it has in the past, with many economists preferring to say we are enjoying a "refreshing pause" or a "delayed recovery", but the idea is the same. Examples of this environment include 1986, 1996, 2006, and even as late as the first quarter of 2011 when we witnessed negative first quarter GDP. The question then was the same one we face now: Is the economy hitting the brakes or just taking its foot off the gas for the moment? The result in 2011 was a quick rebound one quarter later and there is a striking similarity between now and first quarter of 2011 with many economists expecting a comparable re-acceleration. Ed Hyman of ISI went so far as to point out that based on an early read from April's real consumer spending; the second quarter of 2014 could match 2Q of 2011 exactly.

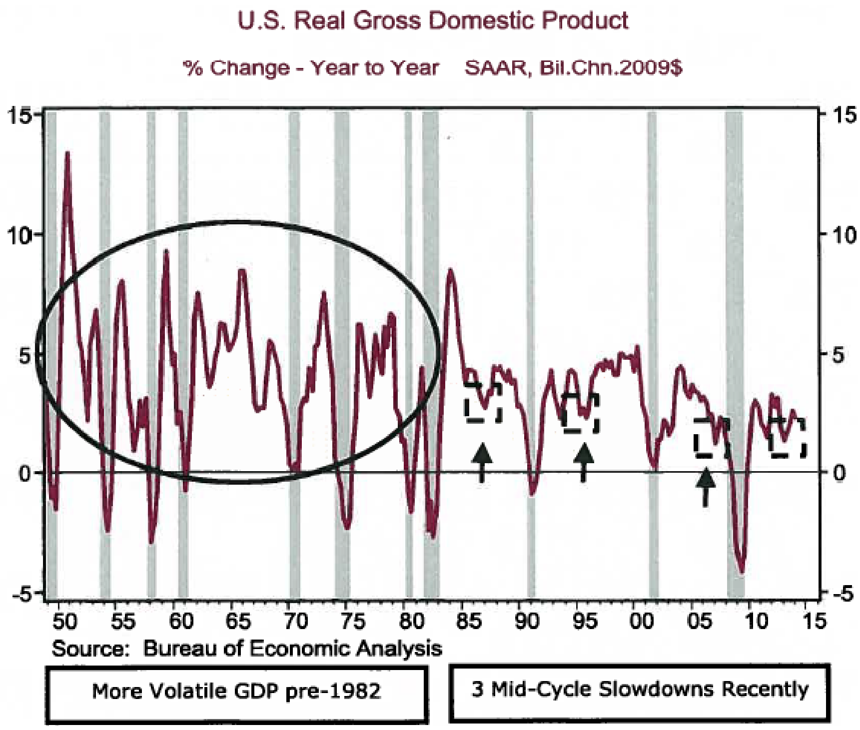
U.S. REAL GDP

2011	**1Q**	-1.3%	
	2Q	+3.2%	
	3Q	+1.4%	**+3.2%**
	4Q	+4.9%	

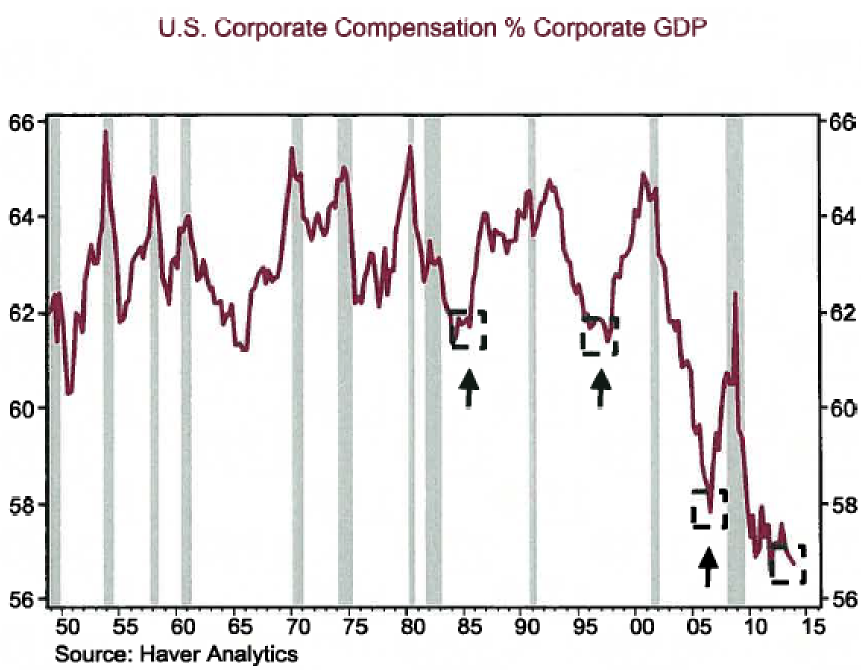
Based on real consumer spending for April, real GDP in 2Q of 2014 may increase only about +3.2%, same as in 2Q of 2011.

Source: ISI

There are other factors pointing to a 2Q rebound as well. First, the -1% print from the first quarter was highly affected by the weather. Hopefully it will be a long time before we hear Polar Vortex again. Second, a large portion of drag on GDP came from a sharp slowdown in business stockpiling (which can also be blamed on the weather). Now that things have warmed up, we expect the weak inventory figure from the first quarter will lead to stronger restocking in the second. In short, the 1% contraction from the first quarter does not appear to be the type of contraction that will gather momentum. Rather we can view it as an aberration within the broader context of a mid-cycle slowdown.



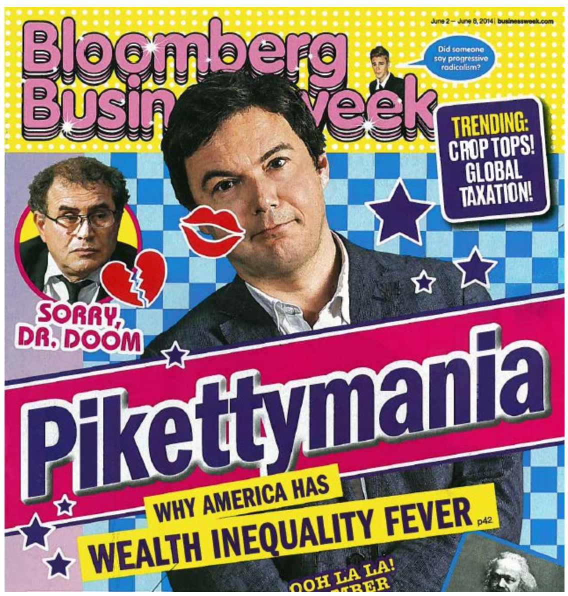
What does a mid-cycle slowdown look like? In 1986 and 1996, four years of expansion followed. In 2006, four years into recovery from the tech bust, we slowed down, bounced for a year, and then collapsed. Each mid-cycle slowdown is unique and how long the economy expands and in what manner will be different. And while there are many differences between 1986, 1996, 2006, and today, one characteristic is constant in that **labor share of GDP stops falling at this point**.



The chart above depicts an economy that for the bulk of its recovery has only benefitted owners of capital. It's the reason Occupy groups pop up and "we are the 99%" videos go viral. Thomas Picketty has written 700 pages in his much-hyped book Capital in the Twenty-First Century, expounding on this subject. Wealth disparity is at record highs and the amount of media attention and academic papers addressing the subject has reached a fevered pitch. According to sentiment, this is the perfect environment for an inflection point in labor share. The following recent headlines are good examples of what companies have been doing. We expect the pace of these actions to slow.

**Covanta Cutting Jobs, Intends to Increase Dividend Starting in 3Q – 6/09/14*
**HSBC Promises to Boost Dividends Despite 40,000 Job Cuts – 5/23/14*
**AIG Beats Street, Raises Dividend, Cuts Jobs – 2/14/14*

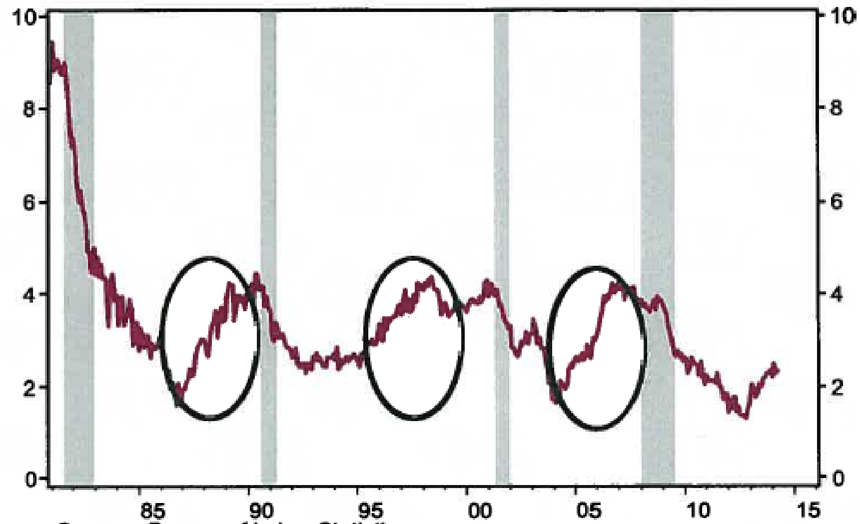
Further evidence of sentiment can be seen in the latest Bloomberg BusinessWeek Cover



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

Avg Hourly Earnings: Prod & Nonsupervisory: Total Private Industries

% Change - Year to Year SA, $/Hour

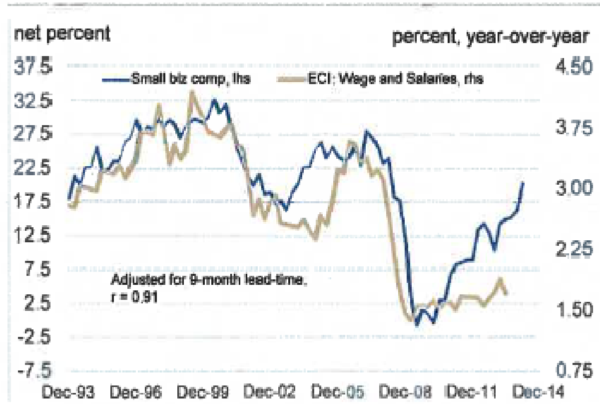


This is an important metric as it tells us how much slack remains in the labor market. As slack wanes, the pressure will reignite pay increases. The unemployment rate has fallen from 10% in October 2009 to 6.3% today, but wage growth doesn't pick up until all the slack is out of the system. Fortunately for workers, we are beginning to see encouraging signs for compensation growth. According to the National Federation of Independent Business (NFIB) Small Business Optimism Index, the number of small businesses raising worker compensation over the past 3 to 6 months has moved sharply higher back to pre-crisis levels. The compensation practices of small employers tend to lead broader wage and salary growth and its trajectory suggests upward pressure on broader measures could emerge later this year. The first chart below shows the move this measure has made while the second is the same chart overlaid with the Employment Cost Index, a broader measure of wages and salaries and adjusted for a 9-month lead time.

Exhibit 6: Net Percent of Small Businesses Raising Worker Compensation Over the Past 3 to 6 Months

Source: NFIB, Morgan Stanley Research

Small Business Compensation vs ECI Wages and Salaries (adjusted for lead-time)



Source: BLS: Employment Cost Index, Morgan Stanley Research

Wealth inequality is certainly the issue of the day with labor having very little power during this recovery. Eventually there is an inflection point towards the back half as labor markets tighten. We are close to this point and hopefully stronger wage and salary growth will in turn boost household spending and the economy will continue to expand for some time with more people enjoying the growth.

Any fears of a looming recession derailing this progress can be put on hold. There are no early signs of this being an imminent concern. The yield curve is not inverted and yields are not spiking, commodity prices are stable, high yield spreads are at seven year lows, the ISM is at 56.4 and consumer sentiment is still close to the high it hit last July. The economy remains stable and we expect to return to growth in 2Q.

Interest Rates and Fixed Income Strategy

By Nick Prillaman

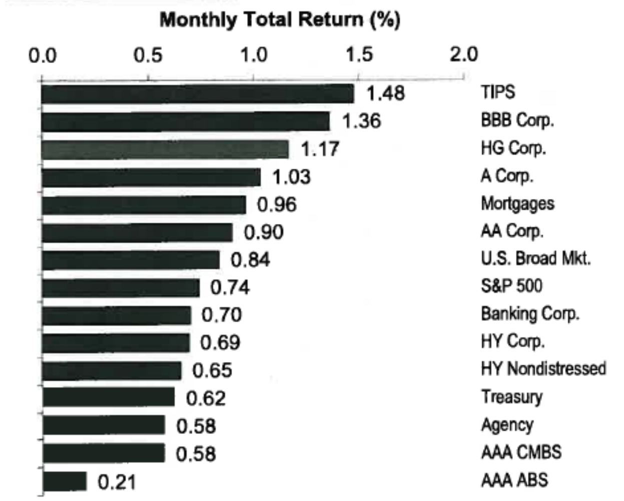
At our previous meeting, geopolitical concerns surrounding the events in Ukraine combined with mixed economic data were producing oscillating interest rates. The 10-year Treasury was essentially unchanged in early March from late January even as the Federal Reserve under Janet Yellen continued to taper both their Treasury and mortgage purchases. As the month of March progressed, the belly of the Treasury curve came under significant pressure as expectations changed with respect to the end of the Fed's ultra low interest rate policy. Comments by Federal Reserve Chair Yellen produced the selloff as she said "the central bank's stimulus program could end this fall and benchmark interest rates could rise six months later" according to Bloomberg News. This caused the yield on the 5-year Treasury to rise by 20 bps on March 19 to 1.74%. Even though the middle part of the Treasury curve was experiencing weakness, the 30-year Treasury was virtually unchanged at the end of the month which enabled the entire curve to flatten.

In the midst of Fed tapering and the potential for an interest rate rise on the horizon, spreads across various fixed income products tightened during the month. The mortgage index saw spreads fall from 186 to 172bps against the 5-year Treasury. Mortgage investors were clearly not deterred even though the Fed said in their March statement that they would reduce their monthly mortgage purchases to $25 billion from $30 billion. In agencies, the Credit Suisse 5-7 Year Agency Index compressed from 24 to 15.7bps. On the corporate bond front, high grade companies saw their spreads tighten by 3 bps in aggregate. According to CreditSights, "industrials were able to outperform on an excess return basis at 0.35% versus the 0.27% for financials and .21% for utilities" after considering rebalancing impacts. The high yield market also improved with spreads coming in by 4bps.

The month of April was a tale of two markets. In the beginning, investors were concerned over the sluggishness of the economy while in the latter half, participants saw growth starting to percolate. The 220,000 rise in employment per the ADP Research Institute combined with an improving Thomson Reuters/University of Michigan Consumer Confidence Index which increased from 80 to 82.6 in April helped to instill greater optimism among investors. Within the Treasury market, the selloff in the belly of the curve abated as the Federal Reserve's minutes "eased concern about the timing of future interest-rate increases" according to Bloomberg News. The 30-year Treasury posted a solid rally of 10bps while the 5-year yield only fell by 4 bps.

Sectors that are contingent on credit spreads put in a mixed performance for the month. As one can see in the chart below, agencies underperformed Treasuries because the duration of the agency index is shorter than that of Treasury index. As interest rates fell, the sector did relatively poor during the month of April. From a spread perspective, the Credit Suisse 5-7 Year Agency Index actually tightened by a couple bps. Mortgage spreads tightened by 7 bps versus the 5-year Treasury and outperformed a number of fixed-income asset classes. Corporate bonds continued their advance with high grade spreads compressing by 5bps. On a total return basis, utilities were the best performer with a 1.53% return due to their longer duration. Industrial returns were 1.29% while financials were the clear laggard with only a 0.83% return according to CreditSights. BofA Merrill Lynch said high grade new issue supply dropped to $95bn in April from $121.3bn in March due to "the earnings related slowdown." Down the credit spectrum, CreditSights said that high yield investments saw spread tightening with a 6bp movement. On a total return basis, the sector lagged high grade because of a shorter duration profile.

Figure 3: Broad Asset Class Total Return Performance, April 2014



Source: BofA Merrill Lynch Global Research.

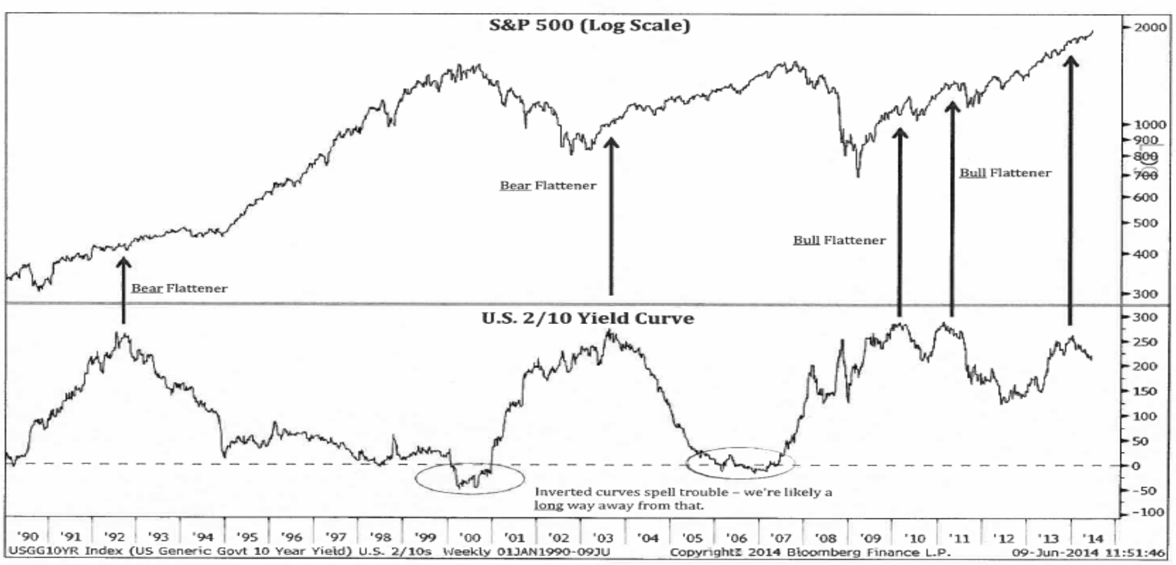
Source: BofA Merrill Lynch

May was a very interesting month for the bond market as interest rates posted a decent rally even though economic growth was adequate and the Federal Reserve was continuing to taper. The 5-year Treasury fell almost 14bps in yield while the 30-year Treasury fell 13bps. BofA Merrill Lynch called the move a "complete short capitulation in rates" as traders looked to unwind their positions. They said the short covering was aided by the ECB Chairman's comments regarding their plan to further ease monetary policy in June. While this drop in rates was occurring, economic data was coming in favorable. The National Association of Realtors said existing-home sales rose 1.3% to 4.65 million. The Institute for Supply Management's non-manufacturing index rose to 55.2 in April from 53.1 in March; both of which showed a level of expansion. With regards to the Federal Reserve, they said at their April 30th meeting that the taper of asset purchases would proceed at a pace of $20 billion per month for MBS and $25 billion for Treasury securities. This was a $5 billion reduction of each beginning in May.

Fixed-income spread products performed on different levels versus Treasuries. High grade corporates and mortgages beat their risk-free brethren while high yield and agencies underperformed. High grade bonds tightened by 2bps for a total return of 1.53%. Utilities' total return of 1.88% outpaced industrials' 1.63% return and financials' 1.24%. While mortgage spreads tightened versus the 5-year Treasury, High yield spreads actually widened by 4bps(prior to month-end rebalancing) during the month according to CreditSights. Agency spreads were fairly flat, but the sector suffered once again from a lack of duration.

The start of June has been very different from May. A selloff in the Treasury market has been in force and has retraced most of the prior month's gains. The big news in the market has been the decision by the European Central Bank to lower its main refinancing rate to a record .15 percent. It also dropped the deposit rate below zero and "will introduce targeted offerings of liquidity to banks to encourage them to lend" as reported by Bloomberg News. The hope is that these actions stimulate growth in the Eurozone and thus help provide a tailwind for the global economy.

In the terms of RSA's bond portfolio, a number of actions were taken over the last few months to better position the fund. In Treasuries, RSA raised the weighting of the Treasury portfolio as a bullish technical picture presented itself. We reduced our exposure in the belly of the curve by selling a 7-year Treasury and ultimately purchasing a 10-year Treasury which should improve our performance in a flattening environment. At this stage in the economic cycle, playing for the bear flattener seems to be the prudent course of action. The idea is illustrated in the chart below where the U.S. 2/10 yield curve is still very high and it will probably flatten as the Federal Reserve starts raising rates due to strong economic growth. Typically once the curve is in an inverted state, a recession ensues like in 2000 and 2006/07. We are clearly far from an inverted curve, however, it seems that the U.S. 10/30-year swap has gotten a little extended after the 30-year posted a vigorous rally, so we would be willing take the 10-year over 30-year at this juncture.



Source: Strategas Research Partners

The agency portfolio experienced multiple adjustments throughout the quarter to better optimize performance. RSA replaced a called agency bond with a 6NC1 which had a decent pickup versus 5-year bullets and presented a good roll down opportunity. We also sold an agency note to reduce our exposure to the belly of the curve. Finally, we completed a swap where we sold a late 2020 bond and bought an early 2020 bond which allowed us to pick yield, shorten duration, and add a more favorable call structure. The outlook for agency bonds is lackluster in comparison to corporates and mortgages. The Credit Suisse 5-7 Year Agency Index is currently showing a spread of 23bps which is very low so future returns will be more reliant on interest rate rather than spread movement.

Mortgage activity was made up of swapping pools and reinvesting prepayments. RSA sold a 30-year Fannie Mae 3.0% coupon and purchased a 30-year Freddie Mac 4.0% to reduce the interest rate sensitivity of the portfolio. To reinvest prepayments, we bought a 30-year Fannie Mae 4.0% coupon with an original loan-to-value ratio of 93% which should prepay slower than its cohort. From an investment perspective, the mortgage sector seems to be the most attractive among the government-related fixed income sectors. With a spread of 1.585% over the 5-year Treasury which is seen in the chart below, mortgage pools are attractive when compared to the 23bp spread offered by agency debt for the same credit risk. While mortgages do have prepayment risk, it seems that interest rates would need to rally a lot to induce a new refinancing wave. If interest rates continue to oscillate sideways in the near future, the larger spread will definitely improve investment returns.

Source: Bloomberg

In the corporate bond portfolio, RSA deployed capital in a number of securities over the last few months. For example, we participated in both Verizon's new 10-year issue which priced at 140bps over the 10-year Treasury and Apple's new issue 10-year which was offered at spread level of 77bp. The focus on 10-year bonds was done to help provide a cushion against a drop in interest rates. RSA also completed a Treasury for corporate bond swap. Here, a short-term Treasury yielding 16bps was sold and in its place, we purchased an October 2015 JPMorgan bond with an 86bp yield. Our outlook is somewhat still favorable on high quality corporate debt. Balance sheets continue to be healthy and credit risks don't seem to be a major problem at this point. While the debt doesn't have the upside it did a couple years ago, the spread is still attractive when compared to other fixed-income products.

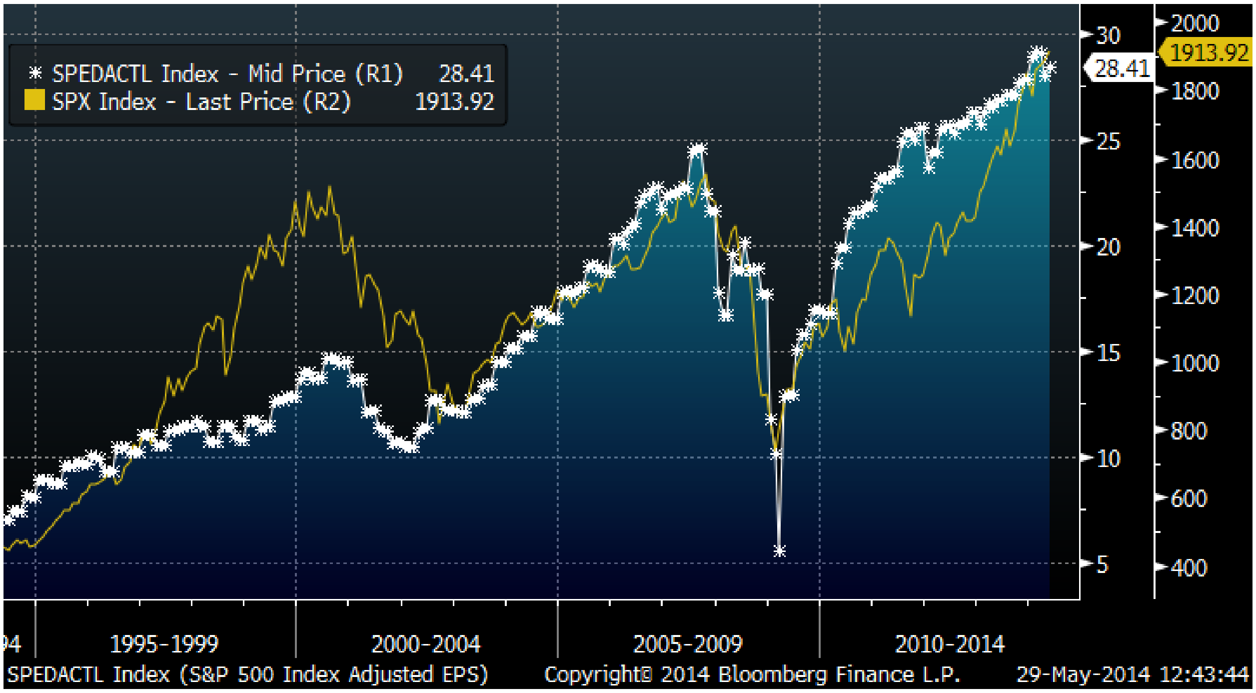
Domestic Equity Strategy

By Marc Green

Arguably the hottest topic at the moment in the financial markets is the rally in both the stock and bond markets, and who has it right? The past several years we have experienced a growth scare coming out of the spring heading into summer, and the bond market seems to be sending that message again. Certainly first quarter GDP numbers were weak, with the latest revision sending it into negative territory. We are all aware that the 1st quarter was greatly impacted by the severe weather across large swaths of the U.S. Now that the weather "excuse" is behind us, all eyes are on earnings and economic reports to see if we are seeing a material rebound. The early read is that is that the economy is rebounding, as demonstrated by the most recent ISM purchasing managers reports following the 1st quarter. So why have rates rallied so much the past few months? It seems there are several plausible explanations. There are lots of natural buyers of treasuries, on a risk adjusted basis, as government bonds have rallied around the globe. Would you rather own a US treasury or a Spanish government bond at effectively the same yield? There is definitely a mass of investors starved for yield, both domestically and abroad. There is also increased demand by banks to hold more treasuries as part of the new capital requirement rules coming out of the great recession, so there is another incremental buyer. Generally speaking, the fiscal condition of the U.S. has improved as the federal deficit has narrowed greatly. This is mostly a result of sequestration and higher tax receipts. Therefore the government is issuing fewer new treasuries while still buying back $25 billion per month in the QE taper.

We are making the pitch that there are several factors which have caused the bond market to rally alongside the stock market. The bigger question is what happens on a going forward basis? It is easy to make the argument that considering the rally we have seen across most every asset class the past several quarters that we are due for some type of consolidation phase. The following chart overlays the earnings of the S&P 500 and the index price.

Chart1



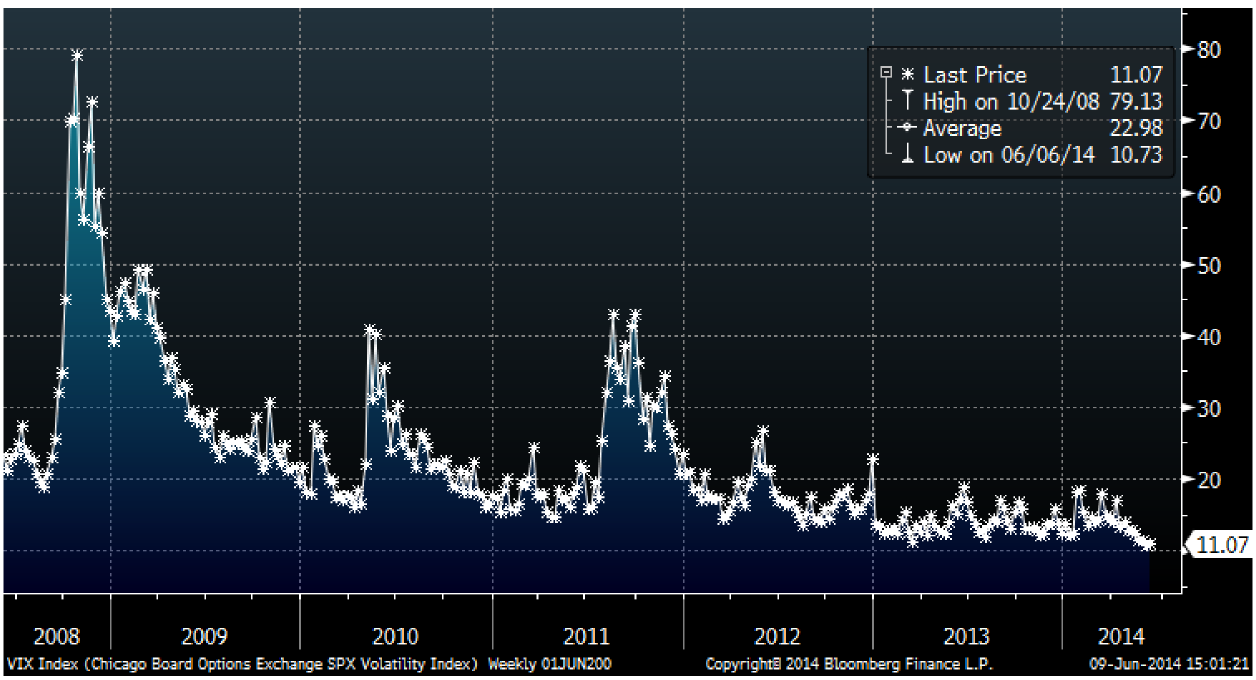
Over the long term, the market correlates very well with earnings growth. Looking back you can see that the market was far ahead of itself at the end of the dot-com bubble. It was lagging the rebound in earnings coming out of the great recession, but in recent months the market and earnings have once again converged. Going forward, changes in the market multiple will have a greater impact on returns as the market has converged with earnings, or is not as undervalued. If we don't see any change in multiples, we should expect returns commensurate with earnings growth going forward. Most top down strategists are calling for 6-7% earnings growth this year and next, and the icing on top is continued share count shrinkage of 2-3%. It is fair to assume that total returns with dividends and buybacks should average in the high single digits the next couple of years. P/E multiples are usually expanding or contracting over a good number of years not quarters, and we are fairly early in the P/E expansion phase, which arguably started in 2011. If we can get improvement in P/E ratios, low double digit returns are quite achievable.

As touched on briefly in the opening paragraph, the other 800 lb. gorilla for the stock market is interest rates. The "lower for longer" period in both the economy and rates looks set to hang around at least for the foreseeable future. We have experienced a very guarded and cautious view by corporate chieftains for an unusually long time, so they have been better stewards of capital this go round than one would expect this far into a recovery. Generally we would have already seen a much larger increase in capital expenditures, but the "fits and starts" nature of this recovery has mellowed out the animal instincts that typically prevail this late into a recovery. The three items that usually cause a recession, in no particular order, are generally perceived to be a war, some type of bubble, and Fed tightening. As for the prospect of a war breaking out, the market has had this concern for several years running, be it Russia, Syria, The Arab Spring, North Korea, etc. A war could arise, but this is always the case. We don't really see any bubbles in the economy, though house prices in select markets have rebounded to new all- time highs. Overall, we are more concerned with a slowdown in the housing market versus the prospect of it overheating. Lastly, we are much closer to the Fed tightening by default, but it is still a guessing game as to what pace they tighten at when they get to that point, and the likelihood of them turning dovish more quickly if the economy begins to slip. The great Greenspan-Bernanke put lives on.

Another pertinent topic has been the consistently low volatility environment we have seen the past few months as demonstrated by the VIX Volatility Index. After peaking out around 80 in the fall of 2008, the VIX has traded all the way down to 11 as of this writing.

<u>Chart 3</u>

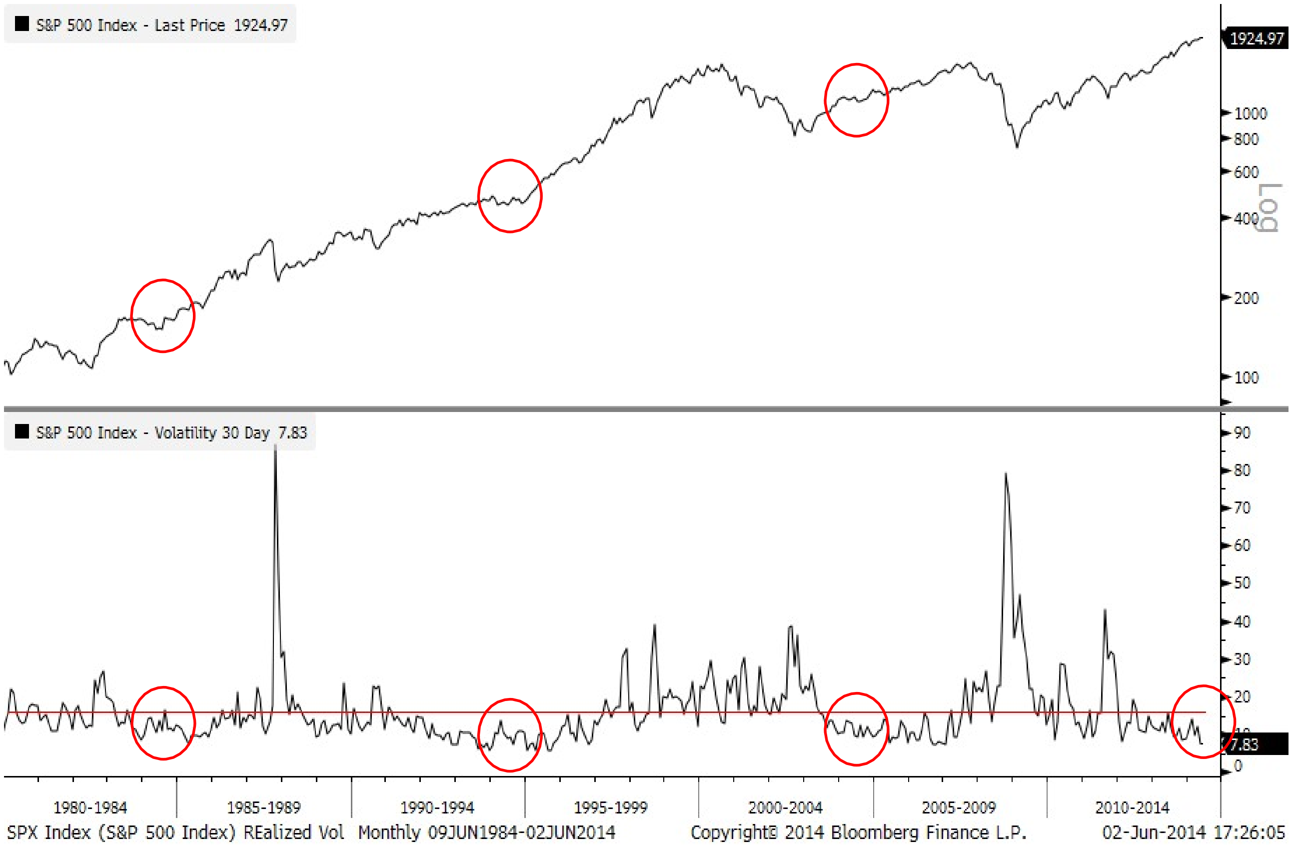
<u>The Vix</u>



Extending out to for a longer time frame on the chart below, you can see that there have been several periods where the VIX has traded at current levels, and most of these periods where in the middle of an economic cycle. The following chart shows that a lot of the decline has been due to the decrease in the realized volatility in the market, meaning that historical volatility has been decreasing as daily market movements have been less than forecast. A lot of this decrease is due to the reasons we have discussed above.

Chart 3

Realized Vol Tends to Run Low



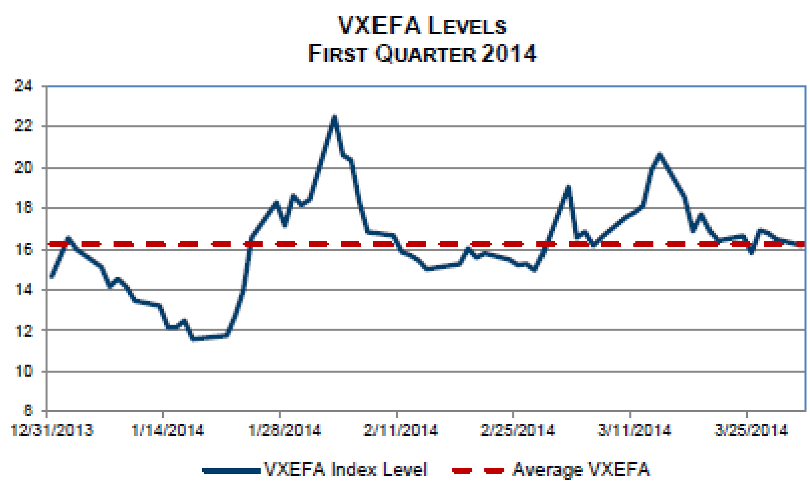
The low volatility environment we have been experiencing the past several quarters is not atypical. It is quite often symptomatic of a market in a consolidation phase. The chart (provided by RENMAC) above shows the realized volatility of the market on the bottom versus the S&P 500 price chart on the top. Volatility in the derivatives market has been running at constantly low levels the past several months, and this has usually been associated with complacency amongst investors, which usually leads to some type of market correction. Without a doubt, this line of reasoning has been well vetted and advertised by every market bear around. We fully understand that the market could have a correction, and that very well may be the healthiest thing that could happen. We feel that a correction will be just that, in that we don't see the end of the cycle, as the ingredients for a recession are not in place yet.

As far as RSA equity activity, we have been relatively quiet the past quarter. It seems that the market is starting to better separate the winners and losers, as correlations have gone down in recent months. As for sectors, we have seen a couple of violent rotations as the high valuation and high growth stocks got hammered in the 2nd quarter. We have been mostly devoid of those names in our active portfolios so we picked up some relative performance in the quarter. The consumer discretionary stocks, which have been vast outperformers since the bottom, have recently become a laggard group as well. Industrials and transports have become the market leaders, which is another indication that the economy is picking up steam after a slow first quarter. As our equity allocation has continued to creep up, we have pared back our exposure to small caps as we view this group as the most expensive. As for hedging, we have been reluctant to put protection on as the low volatility in the derivatives markets make the terms look pretty weak relative to what we have seen the past couple of years.

International Equity Strategy

By Steve Lambdin

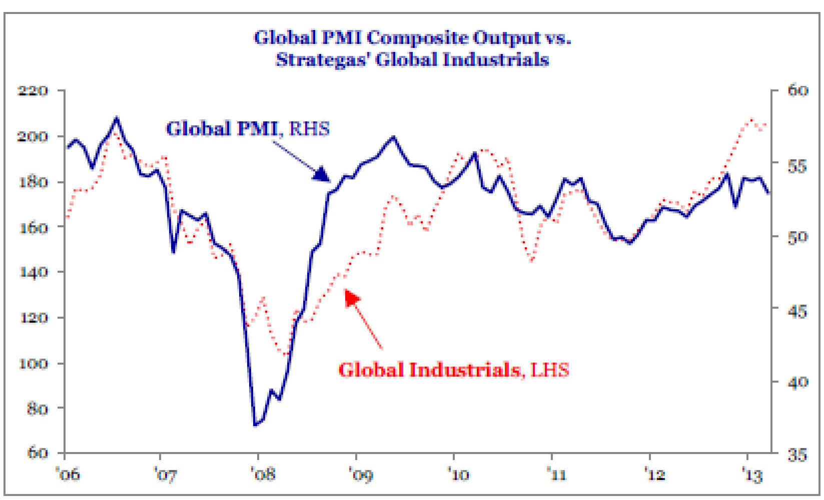
The international equity markets seemed to endure a bit of volatility in the first quarter of 2014 as tensions in the Ukraine and economic concerns, especially in China, were on many investors' minds in the period. After posting robust gains in 2013, global equity markets struggled to stay even for the quarter. European equities were up slightly in the period, while Japanese equities gave up ground from a strong 2013 as fresh tax increases are set to take hold in the region. The Bank of Japan (BOJ) and The European Central Bank (ECB) continued to provide stimulus to their respective regions as the U.S. Federal Reserve (FED) sustained its curtailing of stimulus activity in the period. In fact, recent actions by the ECB have pushed short term interest rates to record lows across the Eurozone region. While winter weather was tough in many parts of the world, the global economy still looks to be in growth mode as we go through the spring. Equity investors have responded with improved sentiment and have pushed valuations higher in nearly all parts of the world. Emerging market equities posted just a very a slight loss in the first quarter, even as the MSCI Russian Index was down -14% in the period. We felt this resilience in emerging market equities has to do a lot with investors' attraction to relatively cheaper valuations in many of these markets. Data points out of China in the period still seemed to be viewed with a negative tilt by investors, as many are still looking for a slowdown in the region. At this point, we believe the modest economic recovery around the globe is still in place, and could be getting better on the margin. With this outlook, equity investors are becoming more comfortable with risk and have pushed many markets to fresh highs recently. We are optimistic these gains can hold through the summer even as we have the usual sources of risk with the global markets at the present time.



Source: Natixis Funds – Gateway Investment Advisors, Llc

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +.66% and -.43% respectively during the first quarter of 2014 vs.
+1.81% for the S&P 500 Index. The U.S. equity market continued to be the equity market of choice for investors as many expect growth in the U.S. economy to really pick up momentum in the late spring and early summer relative to other parts of the world. Again, for the second quarter in a row, the U.S. Dollar Index was nearly flat and provided no real benefit or detriment for global equities in the quarter. The European region performed better than the Asian region, as Japanese equities were weak in anticipation of tax increases set to increase post first quarter. From an economic sector standpoint, Healthcare, Utilities, and Technology led the way, while Telecom and Consumer Discretionary were weaker on a relative basis.

So far into the second quarter of 2014, equities have once again been very good for investors. An improving situation in the Russian/Ukraine standoff and improving economic readings in many parts of the world have pushed investors toward equities and many markets are posting fresh new highs. Corporate earnings season got a pass as weather seemed to be the main culprit and many companies are seeing plenty of pent up demand as we move through the second quarter. As has been the case for quite some time, inflation looks well contained in the developed markets and interest rates still remain near historic lows. The M&A environment is very strong right now as one would expect, with news deals being announced almost on a daily basis. We expect to see equity markets remain good over the near term. The MSCI EAFE Index and the S&P 500 Index posted returns of +4.3% and +4.6% respectively through mid-June, while Emerging Markets have returned +6.1%, as investors are embracing a better geo-political climate recently with the Russian/Ukraine situation. As we look out through the summer of 2014, the global economy seems to be getting better on the margin which should be good for the global equity markets.



Source: Strategas

Asia Update

The equity markets in the Asian region continued its recent trend of negative performance in the first quarter of 2014, as this region was the worst performing one within the MSCI EAFE Index. The broad MSCI Pacific region posted a -2.51% return in the quarter. The main culprit was the Japanese equity market, as the set increase in the national value-added tax proved to be too much of a headwind to overcome for investors. In addition, concerns over China's sustained growth going forward impacted returns in the Hong Kong market. Things rebounded a bit in Australia, as we are seeing the beginnings of a better economic climate in this region. As we move forward, the keys for the region are how much of an effect the additional tax increases in Japan will have on the economy and how much confidence is in China's growth outlook for 2014. Positive news on these fronts could push markets higher over the near term.

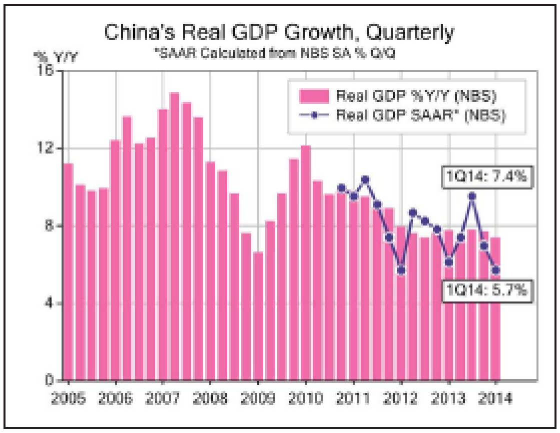
Market Performance

Data as of: 31-Mar-2014

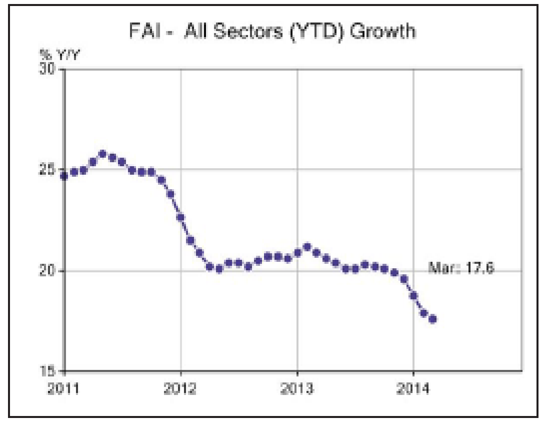
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Philippines	-0.05	9.95	9.95
MSCI Australia	3.97	5.92	5.92
MSCI Taiwan	2.79	1.10	1.10
MSCI Singapore	2.57	-0.90	-0.90
MSCI Pacific	0.07	-2.51	-2.51
MSCI Hong Kong	-2.22	-3.36	-3.36
MSCI Japan	-1.29	-5.61	-5.61
MSCI China	-1.69	-5.87	-5.87

Source: Factset

The Chinese economy continues to grind slightly lower by each passing quarter. Gross Domestic Product (GDP) in China rose +7.4% in the first quarter of 2014 from the year earlier period, the weakest pace in the last six quarters. Credit still seems to be tight and demand is lackluster as risks from the shadow banking system and heavy local government debt continue to be concerns. We would expect some level of targeted easing aimed at the real estate market, as Premier Li Keqiang addresses one of the main areas of risk in this economy. Industrial production rose +9.0% in March, which was a bit better than the January-February reading, but still below what we saw in late 2013. Fixed asset investment continues to weaken, and was reported up +17.7% in the first quarter, a deceleration from the previous quarter. In addition, retail sales have also been weakening lately, as April sales were reported up +11.9, the smallest rate of expansion in quite some time. However, there was good news on the export front recently, as exports in May grew +7% from a year earlier. Chinese exports seem to be benefitting from the recovery in the U.S. and Europe. Inflation continues to not be much of an issue as consumer prices rose +2.5% in May, still well below the government's full-year target of +3.5%. This leaves plenty of room for more monetary easing in an economy that is struggling to re-ignite the growth rate. As we look out further into 2014, we believe the government's official targeted growth rate of +7.5% will be difficult to achieve. As this unfolds, we could see equity investors become very nervous and this could be a decent size headwind for the equity market to overcome. We are just not sure if the recovery outside of China is strong enough to push the economy to its targeted growth level.

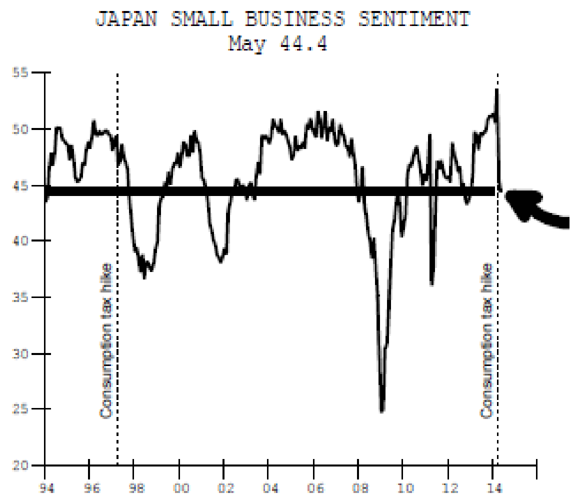


Source: ISI

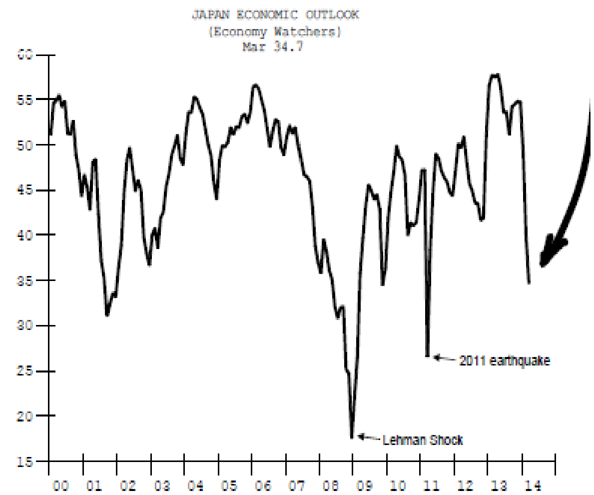


Source: ISI

As many expected, the Japanese economy was very strong in the first quarter, prior to a sales tax increase taking effect on April 1st. The Abe administration continues to push new reforms, as special economic zones were announced in March in an effort to keep the economy bolstered. Many are now looking for the next leg of growth in Japan which will depend on structural reforms to the economy, which could be difficult to achieve. First quarter GDP grew +6.7%, a pace much higher than many had expected. Industrial production rose +7.4% in March from a year earlier, as business machinery and steel production seemed to be very good. Exports rose +5.1% in April from a year earlier, as a weak yen should be good for this. Business confidence looks decent, as the coincident index continues to signal a robust demand climate. The consumer remains a tough nut to crack in this economy. Consumer confidence was reported at 39.3 in April, just above some of the lowest levels seen in this economic cycle. Clearly, government officials have not won over the consumer's outlook toward spending. Retail sales, while strong in March, fell -13.7% in April from the previous month, as the sales tax increase dampened the need to further spend. Again, this was not much of a surprise. With the increase in the sales tax, inflation ran to the highest levels since 1991 in April, as core prices rose +3.2% from a year earlier. The employment outlook seems to be about the same as it has been lately. The unemployment rate was reported at 3.6% in April, and remains the lowest among the major regions around the globe by a wide margin. Also, the jobs-to-applicant ratio looks very strong, moving to 1.08, yet another high. But keep in mind, Japan's economy remains one of the largest users of part-time employees, so the true employment picture still remains rather cloudy. The biggest question at this point remains how the economy picks back up some momentum post the recent tax increase. We expect a negative GDP print in the second quarter, but growth should resume in the third quarter. We expect to see the continued support of the BOJ over the near term, which is good news for the economy. We will have to wait and see how the economy responds to these actions.



Source: ISI



Source: ISI

Europe Update

Since our last update, we continue to see further stabilization of the Eurozone region. There seems to be less bad news coming out of the smaller countries in the region that once dominated the news flow. Austerity measures enacted are having the desired effect on budget deficits. As a result, interest rates continue to fall across the region marking a stark contrast of what we saw just a couple of short years ago. In fact, some of the short term interest rates in the peripheral nations are on par or even less than some of the more developed nations. This has led to increased investor confidence and improving sentiment, while pushing equity valuations to the highest levels in a few years. However, much work remains to be done. Economic growth remains rather sluggish for the most part and deflation concerns are cropping up in many parts of the Eurozone. Unfortunately, this is what happens when focusing on austerity. The ECB has taken some recent actions in an effort to step in and foster a better growth climate going forward. Many feel this should help alleviate fresh deflationary concerns. As all of this unfolded, the MSCI European Index (ex U.K.) posted a gain of +3.5% in the first quarter of 2014, making this the best performing region in the index. Equities still look attractive on many metrics, provided the ECB continues providing stimulus to the region and economic growth picks up a bit from current levels. All in all, things seem to be continuing to improve in the region and this should be good for equity investors over the near term.

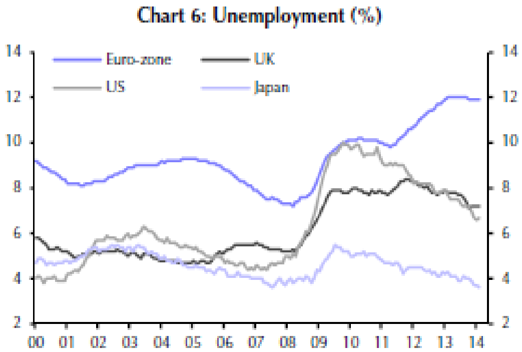
Market Performance

Data as of: 31-Mar-2014

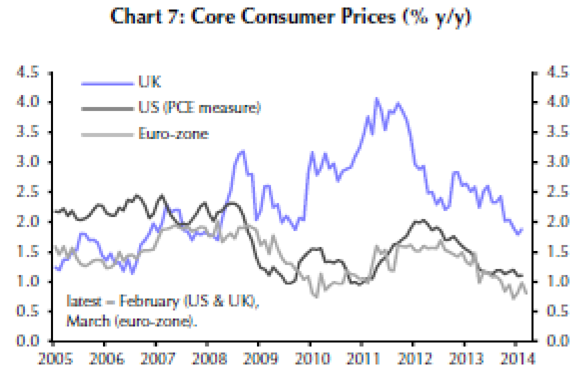
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Italy	6.41	14.59	14.59
MSCI Spain	2.35	4.78	4.78
MSCI Switzerland	-0.04	4.74	4.74
MSCI Europe ex UK	-0.01	3.49	3.49
MSCI France	-0.18	2.91	2.91
MSCI Netherlands	1.14	1.06	1.06
MSCI Germany	-1.74	-0.33	-0.33
MSCI United Kingdom	-3.17	-0.83	-0.83

Source: Factset

Growth in the Euroland economy continued at a snail's pace in the first quarter of 2014, as GDP rose +.2% from the previous quarter, or +.9% from the year earlier period. Household consumption just managed to be positive, government spending was strong, capital spending slowed, and net exports turned negative again. The economies of Germany and Denmark led the way, as Italy and the Netherlands posted negative growth for the period. This is the fourth straight quarter of growth for the Euroland economy, but we are on the edge of possible negative growth. Up to this point, the ongoing recovery remains anemic in the region. Industrial production in the region remains challenging, as March fell -.3% from February's level. Up to this point, nothing positive seems to be sustainable across the region with industrial confidence remaining firmly in negative territory. However, the index of executive and consumer sentiment continues to build on recent momentum and reached 102.7 in May, a new three-year high. Many feel the ongoing change in sentiment will lead to increasing demand over the second half of 2014. On another positive point, retail sales in April increased +.4% from a month earlier, or +2.4% from a year earlier, building upon recent gains in this data point. Perhaps the consumer is coming out of its shell in the region. The employment situation continues to stabilize across the region, as the April unemployment rate was reported at 11.7%, a slight improvement from the levels of late 2013. While we are seeing improvement at the margin, unemployment remains a major issue and serious improvement still seems distant into the future at this point. Inflation continues to decline, falling to +.5% in May, and yet another new low for the region. At this point, deflation concerns are taking center stage as many are warning of a negative price spiral. The ECB, in an effort to combat potential deflation, cut its key refi rate by 10 basis points to .15% at its most recent meeting. Also, the ECB announced a negative deposit facility rate as well as a targeted longer-term refinancing option. All of this is an effort to boost inflation and jump start economic growth in the region. Most investors applaud the ECB's recent actions, which could be good for the equity markets. From an economic standpoint, we are still very concerned over the outlook for the region. While growth is positive at the moment, it would not take much to see growth turn negative. We will have to just wait and see what effect the latest ECB actions will have on the economy. However, we still want to maintain an optimistic stance toward the equity markets as this unfolds.

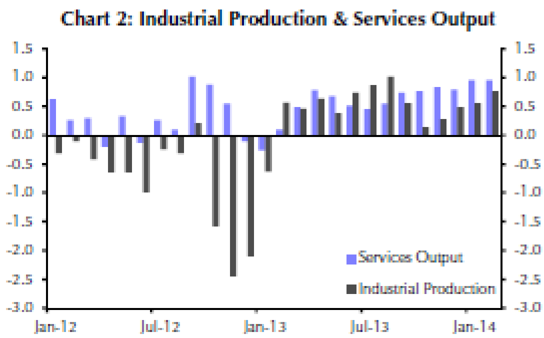


Source: Capital Economics

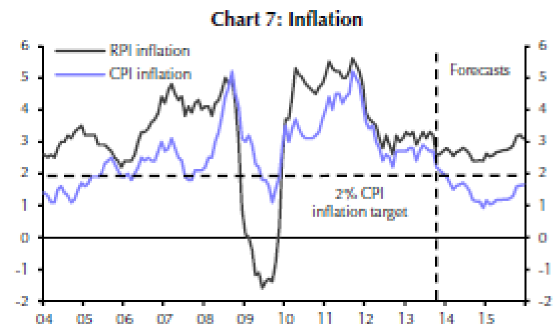


Source: Capital Economics

As most of the developed world struggles with little economic growth, the U.K. economy continues to generate decent growth, especially when compared to the Eurozone. GDP accelerated to +.8% in the quarter from the previous quarter, or +3.1% from the year earlier period. This is the fifth straight quarter of growth in this economy as the region is humming along in solid fashion. Household and capital spending provided most of the growth, as net trade and government spending were near neutral. In fact, GDP is only slightly below peak levels reached in 2008. Industrial production continues to climb, rising +.4% in April from a month earlier, or +3.0% on an annual basis. Within industrial production, manufacturing was very strong, rising +4.4% from a year earlier. This marks the fifth straight month of rising factory output. Consistent with what we saw with other data points, retail sales rose +1.3% in April from a month earlier, or +6.9% from a year earlier. The yearly increase in April is the most in ten years. The consumer seems to be experiencing a feeling of elevated confidence as we head into the summer months. Average weekly earnings continue to move higher, and were reported up +1.7% in March from a year earlier. This was certainly a surprise. Inflation continues to be quite manageable and remains below the Bank of England's (BOE) official target. April's inflation reading was reported to be up +1.8% from a year earlier, staying very steady through the early part of 2014. The outlook for inflation continues to be favorable over the next few months and could actually fall slightly from current levels. However, we expect no threat of deflation like what we see in the Eurozone economy. At its recent June 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 believes rates are appropriate at the present time as there is plenty of slack in the economy to warrant keeping rates at current levels. Higher interest rates still remain a ways off, but not as far off as with the U.S. economy. On the employment front, the unemployment rate fell to 6.6% in the three month period through April, in yet another sign of the strength of the recovery going on in the region. Employment rose by 345,000 in the three month period, to another record of 30.5 million. This is the largest increase in employment over a three month period in forty years. In addition, jobless claims fell for the 19^{th} month in a row in April, providing even more evidence of a healing job market. As we digest the economic data over the last few months, the recovery in the U.K economy is clearly picking up a lot of momentum as we head into the summer months. While we may cool off just a bit from the pace we have witnessed lately, we see this economy as one of the strongest in the developed world at the moment and appears to be on very solid footing. With this in mind, it would not surprise us to see the equity market continue to perform well over the near term.



Source: Capital Economics

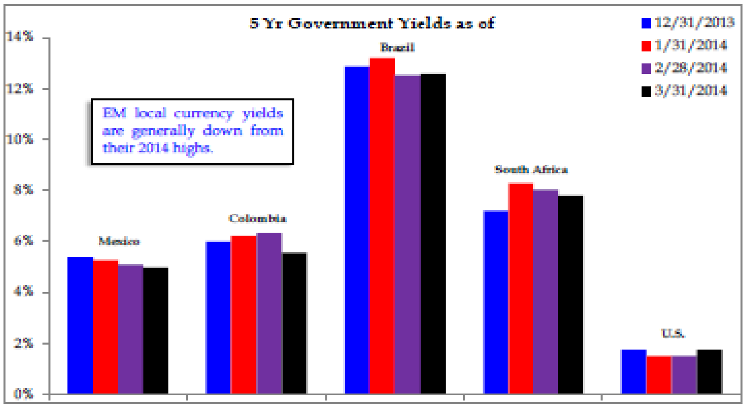


Source: Capital Economics

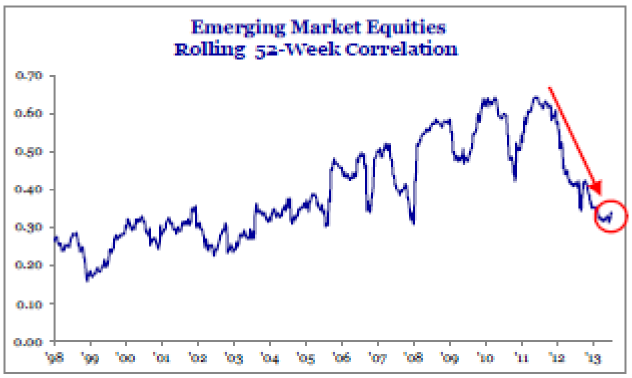
Emerging Markets

During the first quarter, emerging market equities did little to get investors excited. Geo-political instability in certain regions, China's imminent slowing, and a general "risk-off" attitude by investors toward countries with high current account deficits and funding needs came together to zap any enthusiasm toward this asset class. As a result, much better returns were had by maintaining exposure to U.S. and EAFE markets during the first half of our current fiscal year. However, post the first quarter, emerging market equity returns have been one of the best performing equity classes. With the recent de-escalation of the Russia/Ukraine crisis and the various central bank actions, investors have embraced a much more risk-on attitude toward equities with a higher beta, with emerging market equities playing a central role. Recent money flows into this asset class have been quite strong. Valuations still look attractive relative to other equity markets around the globe and future earnings growth looks good as well. Regions with exposure to U.S. and European demand, falling inflation, and lower interest rates look to be ideal at the present time. With these issues in mind, while caution is always warranted, we would not be surprised to see emerging market equity returns remain very good over the near term.

EMERGING MARKETS NORMALIZING



Source: Strategas



Source: Strategas

International Equity Activity/Strategy

The international equity markets continue to look appealing to us over the next few months. Most of the weakness in the first quarter was probably more related to investors taking some profits after a strong 2013. With this behind us, we see the potential for positive performance going forward. Global economic activity looks set to continue a modest recovery over the balance of 2014, especially in the large developed countries. We look for the BOJ to continue with its monetary expansion policies and the yen weakness should be good for the economy. Recent actions by the ECB should provide additional support for the region as the Euroland economy attempts to accelerate growth going forward. Corporate earnings growth looks modest at this point, with prospects of slightly better growth ahead. Profit margins are very high and free cash flow is quite good, which should continue to be conducive for global M&A activity, capital spending, and share repurchase activity. These actions should provide a nice backdrop for the equity markets. In terms of valuation, while equity market valuations are not as cheap as we saw in the recent past, they are not in excessively high valuation territory either. Thus far into our current fiscal year thru mid-June, global equity returns have been stellar, with the S&P 500 Index up +17% and the MSCI EAFE Index up +11%. Even emerging market equities have joined the party lately, and are up +8% on our fiscal year. As we all know, equity markets always face some risk of a correction from a variety of different reasons. However, at this point, we don't see a lot of risk with an extended bear market. Equity markets and the global economy look to be on relatively solid footing at the moment.

Since our last meeting, things have been very quiet with regard to portfolio actions in our global equity portfolios. We still remain very aggressive 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 a bit southward. Premiums for doing this still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.40% of total assets and approximately 12.6% for MSCI EAFE equities. *(Charts provided by ISI, Capital Economics, Strategas, Factset, Natixix Funds, Gateway Investment Advisors, LLC)*