Quarterly Economic Update

March 7, 2014

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

We have officially had a changing of the guard at the Federal Reserve with Ben Bernanke's term as Chairman ending on January 31st and Janet Yellen now officially assuming the role as Federal Reserve Chairman. Chairman Yellen is not expected to significantly alter the current path of monetary policy. She has served on the Federal Open Market Committee (FOMC) and as Vice Chairman of the Federal Reserve since October 2010 and has supported current policy actions. President Obama has also recently nominated Stanley Fischer to serve as Vice Chairman of the Federal Reserve. Fischer is well respected with experience serving at the head of the Bank of Israel, as well as experience with the International Monetary Fund and the World Bank among other credentials. Along with Fischer, Lael Brainard, a former US Treasury official, has been nominated to serve on the Board of Governors and Jerome Powell was nominated for a second term after filling an unexpired term since 2012. All three of these nominees are awaiting their confirmation hearings before the U.S. Senate Banking Committee and are expected to be confirmed by the Senate. Federal Reserve Governor Sarah Bloom Raskin is currently awaiting her nomination to serve as Deputy Secretary of the Treasury to be confirmed by the Senate. Once confirmed, President Obama will need to nominate one more candidate to fill her slot on the Board of Governors to complete the seven member board. While this is a large degree of turnover, we should not expect these changes to significantly affect the current course of monetary policy in the near term.

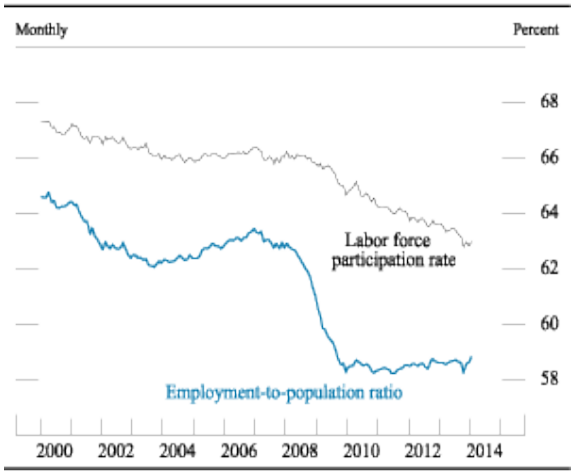
The FOMC has continued to expand the Federal Reserve's balance sheet since the end of 2012 and provided additional policy accommodation through their open-ended asset purchase program, which had persisted at a pace of $45 billion per month of Treasury securities and $40 billion per month of agency MBS. This program differed from prior asset purchase programs in its open-ended nature versus prior calendar date horizons in an attempt to signal the FOMC's resolve to provide policy accommodation as long as was needed until adequate improvement in economic and labor markets was achieved. As we moved through the second half of 2013, FOMC minutes revealed increased discussions around reducing this policy accommodation and how to wind down their asset purchase program. Market participants increasingly scrutinized FOMC minutes and speeches by FOMC members for hints on when and how they would begin to "taper" their securities purchases. At the December 17-18th meeting, the FOMC announced they would reduce the amount of monthly purchases by $10 billion. Beginning in January, Treasury purchases were reduced from $45 billion to $40 billion per month and agency MBS purchases were reduced from $40 billion to $35 billion per month. The FOMC further reduced the amount of monthly purchases at their January 28-29th meeting by another $10 billion, reducing Treasury purchases to $35 billion per month and agency MBS purchases to $30 billion per month. The beginning of this "taper" process in monthly purchases signals that the FOMC is growing more confident that improvements in labor markets, while modest by some measures, are becoming more sustainable without the need for additional support. That being said and even as they reduce the amount of monthly

purchases, they continue to provide significant accommodation through the asset purchase program. With the December FOMC statement announcing the reduction in monthly purchases and repeated again in the January statement, the FOMC made a point to assert that "The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative . . ." The FOMC seems to be comfortable to gradually reduce the amount of monthly purchases over the next several meetings and slowly wind down their asset purchase program. They explicitly stated in both the December and January statements that "If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings." While clearly looking to wind the program down, they also stress that "asset purchases are not on a preset course."

The FOMC has made no change to the federal funds rate and at both the December and January meetings "reaffirmed its expectation that the current 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." Internally, as made apparent through the minutes, the FOMC continues to wrestle with how to communicate forward guidance on the path of the federal funds rate as the unemployment rate declines and their own projections see the unemployment rate between 6.3 to 6.6 percent in 2014 and declining further thereafter. The FOMC added language to the December statement and repeated in the January statement that "The Committee now anticipates, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6 ½ percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal." The January minutes indicate clear agreement that forward guidance will need to be adjusted soon going forward, but a lack of consensus on what type of forward guidance would be most appropriate and which would most effectively communicate the FOMC's views. Opinions seem to have varied around several options that could likely be used in isolation or combination of one another. Some participants supported using similar quantitative guidance to existing thresholds but adjusting those threshold levels. Others thought providing additional detail on qualitative factors being taken into account by FOMC members would be more appropriate guidance. More clearly defining risks to financial stability that are being considered was discussed along with more direct reference to concerns around lower inflation levels. Suggestions were also made to allow the Summary of Economic Projections to play a greater communication role. This is sure to be discussed further when the FOMC meets again and it is highly likely we will see additional forward guidance provided by the FOMC soon.

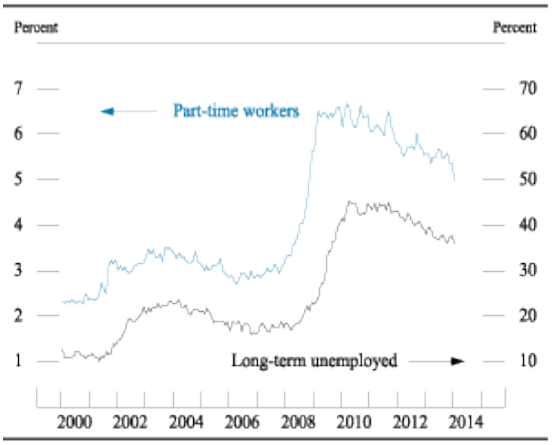
The falling unemployment rate has been encouraging, but there remains significant weakness in employment markets and the FOMC is clearly not satisfied with the pace of improvement. They seem concerned about the lack of improvement in some employment indicators. Chairman Yellen recently presented the Semiannual Monetary Policy Report to the Congress and testified that "The unemployment rate is still well above levels that FOMC participants estimate is consistent with maximum sustainable employment. Those out of a job for more than six months continue to make up an unusually large fraction of the unemployed, and the number of people who are working part time but would prefer a full-time job remains very high. These observations underscore the importance of considering more than the unemployment rate when evaluating the condition of the U.S. labor market." The charts below were included in Chairman Yellen's report. The chart on the left shows the continued decline in the labor force participation rate and the lack of improvement in the employment-to-population ratio. The chart on the right shows the still elevated levels of part-time workers and long-term unemployed and the very modest improvement in these measures.

3. Labor force participation rate and employment-to-population ratio



NOTE: Both series are a percent of the population aged 16 and over.
SOURCE: Department of Labor, Bureau of Labor Statistics.

4. Long-term unemployed and part-time workers



NOTE: The data are monthly. The long-term unemployed series shown is the percent of total unemployed persons who have been unemployed for 27 weeks or more. The part-time worker series is the percent of nonagricultural employees working part time for economic reasons.
SOURCE: Department of Labor, Bureau of Labor Statistics.

The FOMC is watching employment measures like these very closely and is very concerned about the lack of improvement in these measures even as the unemployment rate falls. Long-term unemployment can lead to structural problems in the workforce that can carry long-lasting ramifications and several FOMC members have voiced concern around this potential problem. Without significant improvement, they are unlikely to raise the federal funds rate even as it crosses below their 6 ½ percent threshold. Inflation continues to run below their 2 percent long-run objective, with recent core PCE inflation falling to around 1 percent. FOMC members have expressed concern that continued low levels of inflation could pose risks to economic growth, but that transitory factors have likely been suppressing inflation and inflation would drift back towards their 2 percent objective. Longer-term inflation expectations remain stable and with current inflation measures running below their desired rate, the FOMC has plenty of room to keep rates low and maintain current policy.

The FOMC has maintained that their forward guidance language on the path of the federal funds rate and their asset purchase program are two distinct and separate tools that are independent of the other. The tapering and winding down of their current asset purchases should not be viewed as an indication that they may begin raising the level of the federal funds rate soon. Decreasing and eventually discontinuing asset purchases is not removing accommodation, it is simply not adding to it. While they seem to be nearing a point where they believe additional accommodation is no longer needed or beneficial, they seem to be far from a consensus view that policy accommodation should be removed at this point. There does not appear to have been any serious discussion about selling securities in the near term and based on FOMC participants own projections there is very little support to raise the federal funds target rate in 2014. The FOMC has directed the Federal Reserve to continue testing tools that could be used to manage reserves and short-term interest rates in the future. They have tested a Term Deposit Facility and conducted a sample of agency MBS transactions. More recently they have increased activity around their overnight reverse repurchase agreement facility. They have expanded the number of counterparties and the maximum counterparty allotment cap while extending the program through January 2015. These facilities are being tested so that when the time does come to use them to manage policy, they will be operationally ready with a full understanding of risk and market implications. However at this time, the FOMC seems to be sending a clear signal that while risk has diminished, they remain concerned about weak employment gains and persistent low inflation levels. Employment numbers are just not strong enough and as long as inflation continues to run at or below the FOMC's 2 percent objective, they are unlikely to significantly reduce accommodation any time soon.

Fiscal Policy

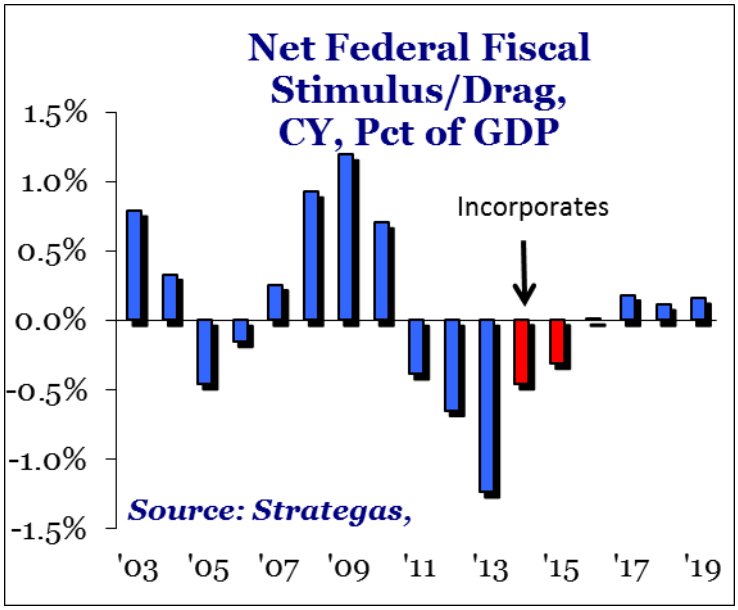
By Michael McNair

After a tumultuous couple of years fiscal policy finally seems to be settling down in 2014. A polarizing social mood in the wake of the nation's worst post war recession and a divided congress led to continuous political bickering and gamesmanship that increased uncertainty and pulled down consumer and business confidence. But recent events out of Washington lead us to believe that policy is finally normalizing. First the debt ceiling limit was raised without a fight, and then Congress passed a two year budget and even agreed to reduce some of the fiscal drag for this year. In fact, this is the first time a divided congress (Republican House and Democrat Senate) has passed a budget since 1986. This was a dramatic turn of events considering that compromise was nonexistent just months prior. So what led to the end of the budget fights that have marred this Congress? It is a confluence of factors including: 1) the combination of deep spending cuts and large increases in tax revenue (expiration of tax cuts and big gains in the stock market) in 2013 has greatly improved the budget deficit. In the past four years the deficit has been cut by $863 billion (from 10% of GDP in '09 to 3.2% currently) 2) debt to GDP has been pushed down and stabilized at 70% 3) the fiscal drag is set to decline from 2% of GDP in 2013 to just 0.2% in 2014 4) polling has made it clear to both parties that the American public is fed up with political brinksmanship 5) the social mood has improved as the economy has recovered and consumer confidence has climbed higher:

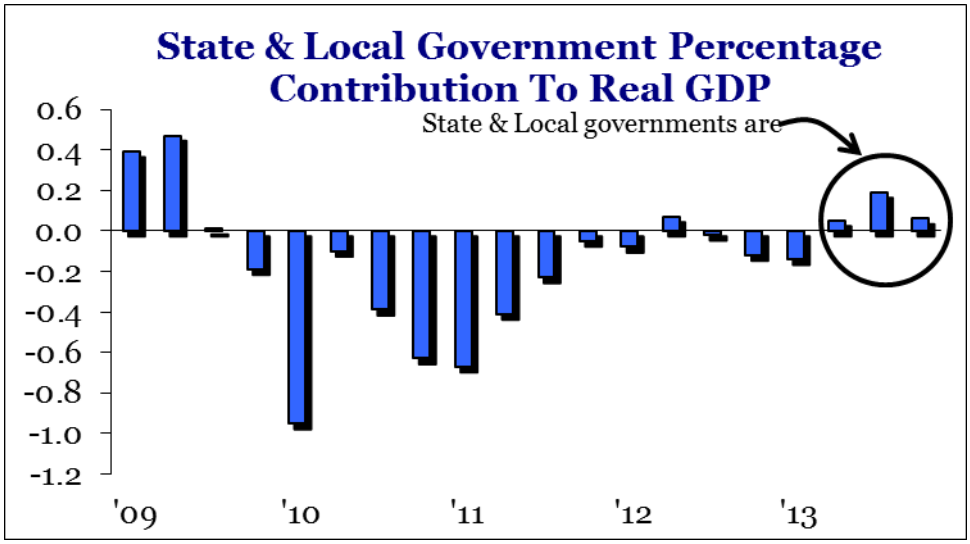
Fiscal Drag

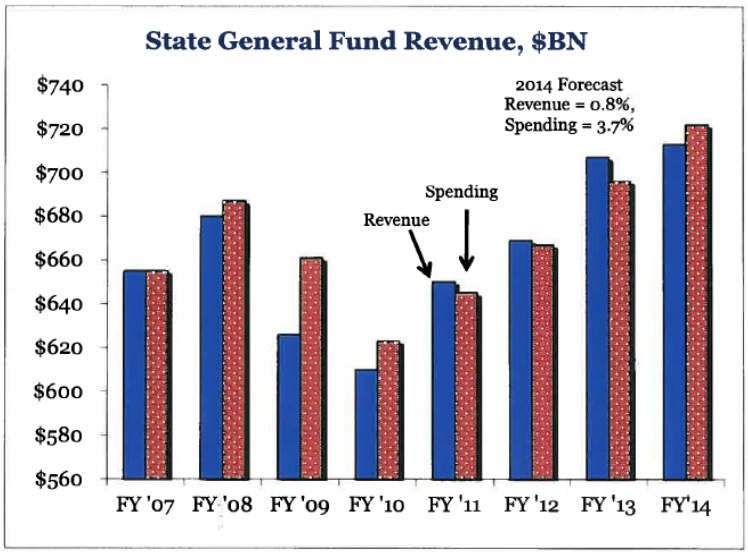
Last year fiscal policy was the topic de jour as it was arguably the single biggest factor affecting US economic growth in 2013. We began to feel like a broken record in the *Fiscal Policy Report* over the past year as we tried to emphasize the significant impact that the fiscal drag was having on the economy. The fiscal drag in 2013 will go down as one of the biggest in our nation's history after it 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. These numbers don't even take into account the impact that the fighting and gridlock in Washington had in creating uncertainty for consumers and businesses.

Fortunately, 2014 looks to be much more favorable from a fiscal policy perspective with the decline of the fiscal drag and no major budget battles. Strategas estimates that the federal government will subtract 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.





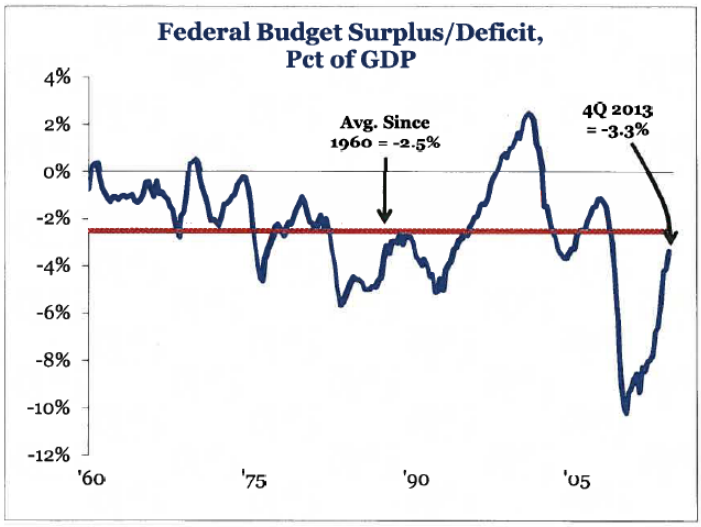
Source: Strategas

Overall, Strategas expects the total fiscal drag to subtract just 0.2% from economic growth in 2014.

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

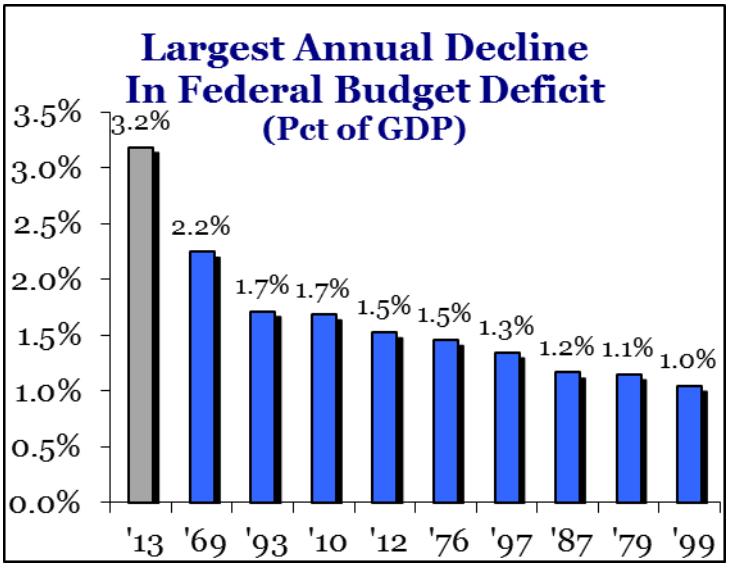
Budget Deficit

The Congressional Budget Office (CBO) forecast the fiscal year 2013 budget deficit at just 3.2% and it is likely to decline to below 3% in FY 2014.



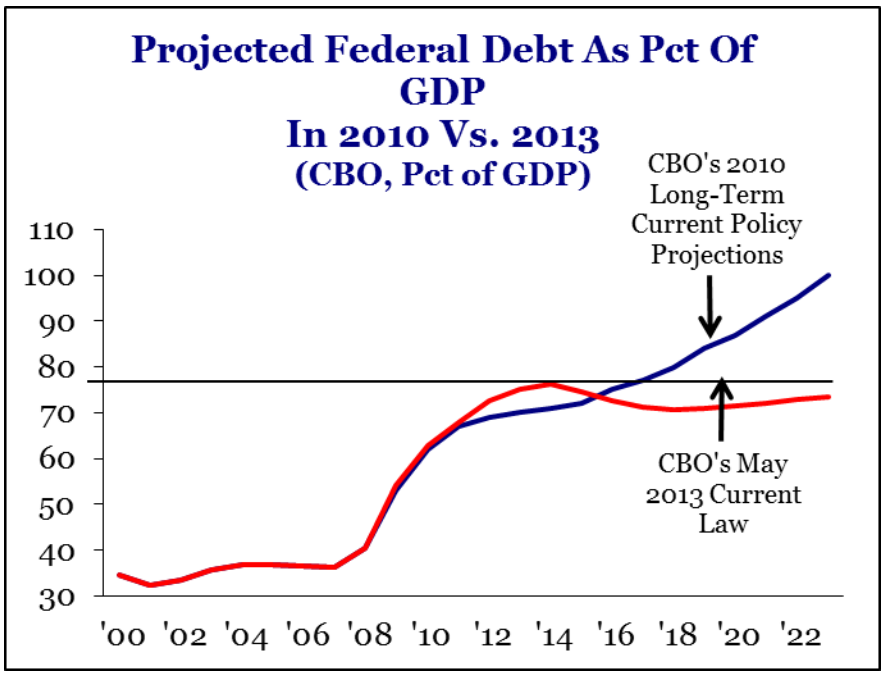
Source: Strategas

In fact, 2013 witnessed the largest annual decline in the federal budget deficit on record:



Source: Strategas

As a result of the dramatic decline in the budget deficit, the CBO will likely have to update their debt to GDP projections which have already improved significantly:



Source: Strategas

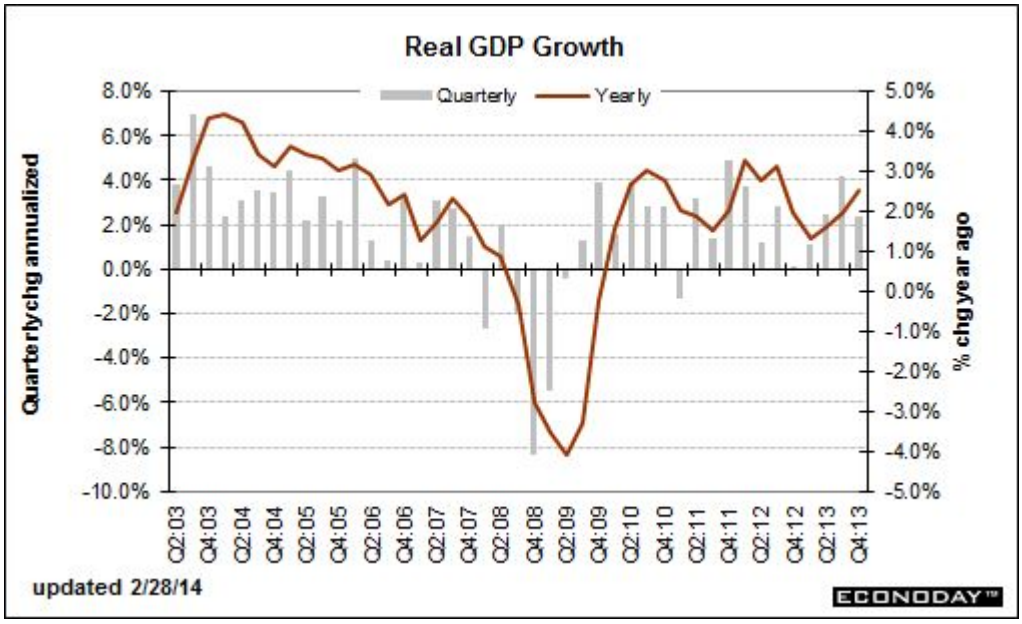
Maybe there is a light at the end of the tunnel after all.

Economic Outlook

By Hunter Bronson

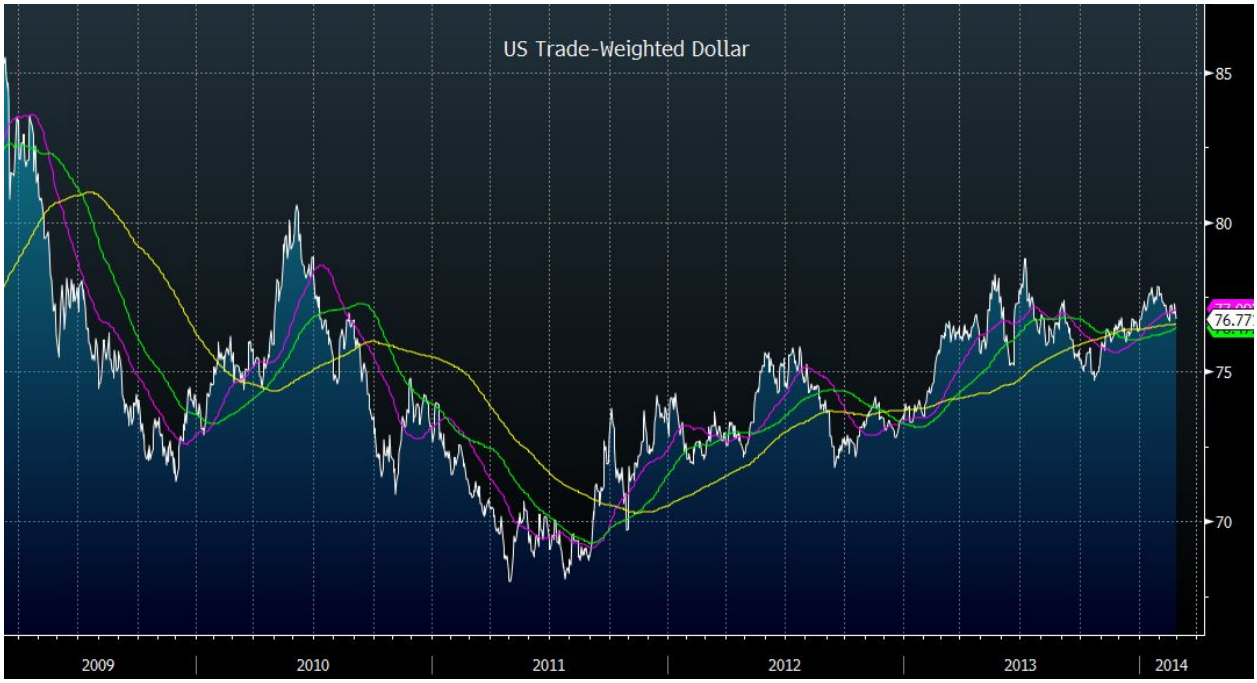
Growth Overview

US real GDP growth for the fourth quarter of 2013 came in at an annualized rate of 2.4%, significantly down from the previous quarter's 4.1% growth, but only marginally short of economists' consensus estimate of 2.5%. While most of the major components of GDP growth received downward revisions in February, it is important to note that contributions to growth from consumer spending, business capital expenditures and net exports are at or near multi-year highs – all relatively positive signs in the midst of a recovery. Weights on GDP growth included slackening in residential construction, flat inventory growth, and the fiscal drag associated with the October government shutdown. The growth scenario continues as modest growth coupled with constrained inflation mitigate fears of recession, monetary tightening, and overheating.



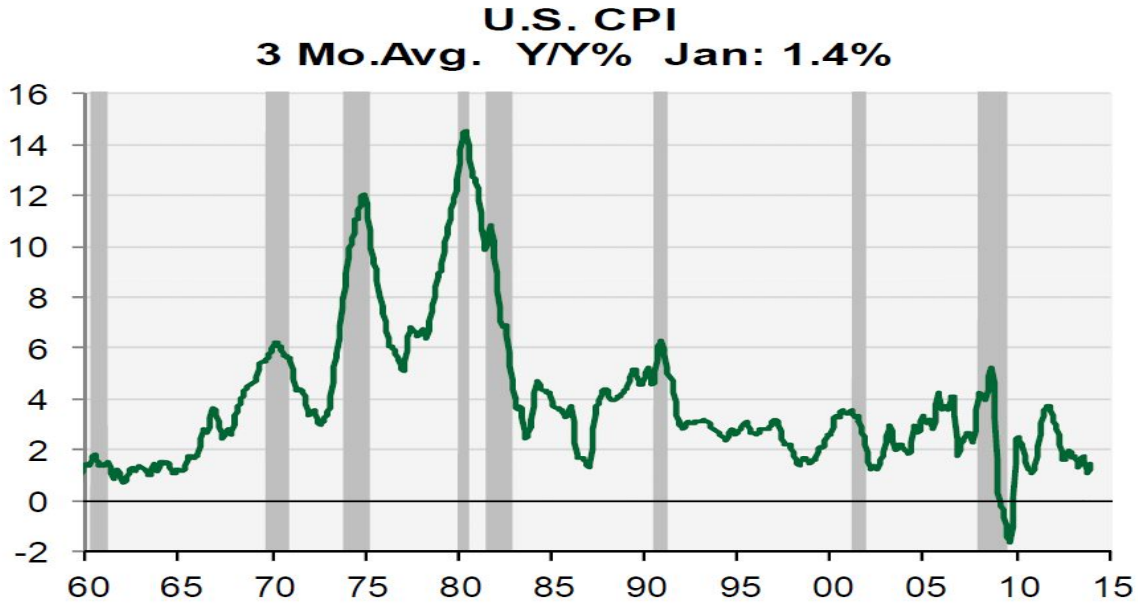
Inflation & Currency

The headline Consumer Price Index registered year-over-year inflation of 1.6% in January, compared with 1.5% in December. Core inflation remained low and flat – also at 1.6%. The U.S. dollar continues to benefit from turmoil in emerging markets – emerging market and commodity-sensitive currencies make up 65% of the US trade-weighted dollar. A stronger dollar lowers the "energy tax" on domestic consumers and makes foreign goods relatively less expensive, both positives in a consumption-driven economy. Higher oil prices are a risk, but it is important to remember that oil prices spurred by geopolitical turmoil tend to be transitory – last year's Egyptian/Libyan crises and the Gulf War are good examples.



Source: Bloomberg

Despite rising energy costs in the short-term from geopolitical shocks, it is difficult to predict a significant increase in inflation over the near term for several reasons: key emerging market demand for commodities is likely to remain low, a strengthening U.S. dollar helps to constrain inflation, and there are few identifiable instances of domestic over-consumption or over-investment. Non-inflationary growth is an effective "tax cut" for domestic consumers and alleviates the need for more aggressive monetary tightening – both advantages for economic growth going forward.



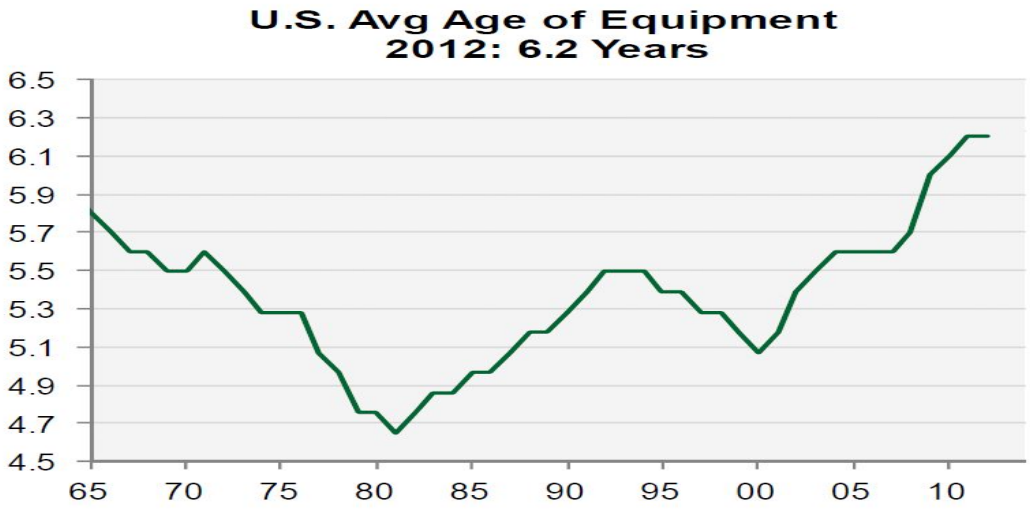
Source: Cornerstone Macro

Spending & Labor

Consumer spending continues to grow at a steady, moderate pace and is showing some signs of modest acceleration – annualized spending growth was 2.6% in the fourth quarter vs. 2.0% in the third quarter and contributed 1.73% to fourth quarter growth. Despite weather concerns thus far through the first quarter of 2014, real consumer spending continued to expand 0.3% month-over-month in January. If this pace continues, we should see a continuation of the steady to modestly improving trend in consumer spending into 2014, especially if consumer confidence can maintain its resilient uptrend.

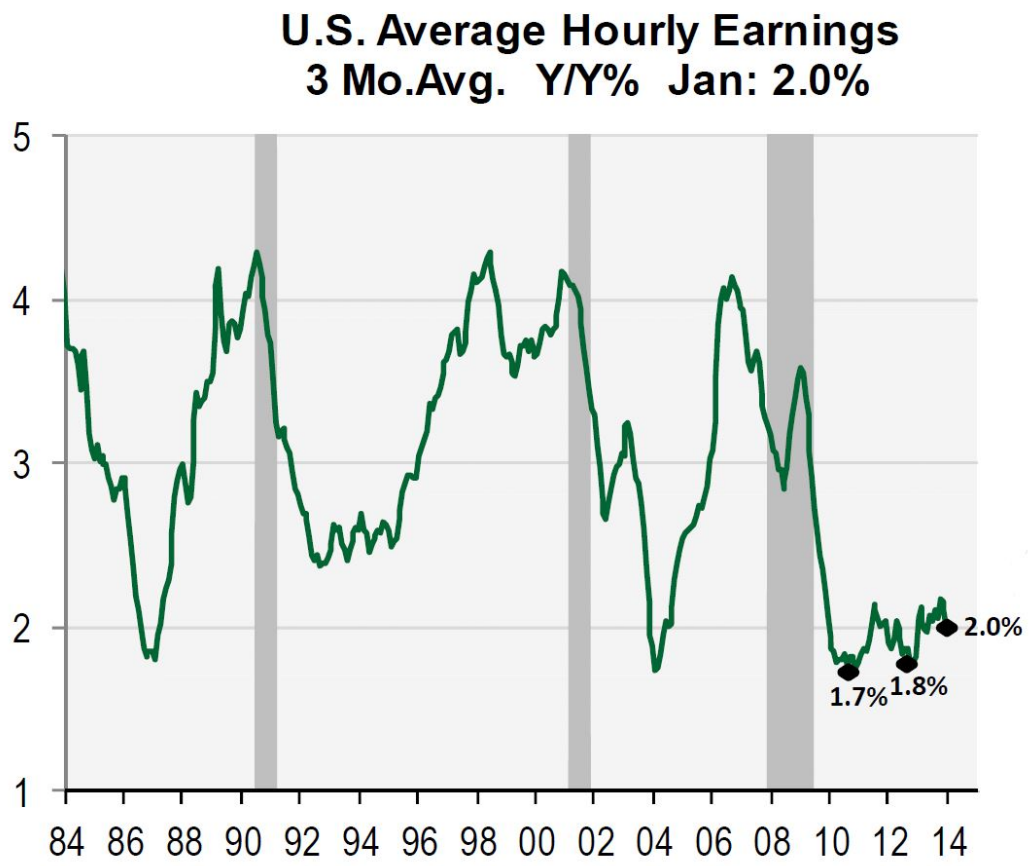
The housing market continues to soften a bit with slower lumber orders, housing starts, and household formation slowing through the end of the fourth quarter and beginning of the first quarter. The deceleration has largely been attributed to weather issues and lagged effects of higher mortgage rates, and there isn't yet any reason to expect anything other than a continued slow-to-moderate pace of housing recovery.

Business spending surprised to the upside, with capital expenditures growing 7.3% quarter-over-quarter and contributing 0.87% to fourth quarter growth, a sign that businesses are becoming more confident in recovery at the margin. Record corporate profits, growing cash balances, the rise of the on-shoring trend, and pressure from shareholders to deploy cash and replace aging capital equipment will continue to pressure management teams to ramp up capital expenditures.



Source: Cornerstone Macro

The unemployment rate continues its steady decline, ticking down to 6.6% in January. However, both non-farm payroll numbers and initial jobless claims have disappointed in recent months with historically cold weather receiving most of the blame. If weather truly is to blame, we should see a corresponding bounce in employment statistics through the spring. Until a long-term driver of growth in disposable income from employment – particularly at the middle & lower end of the pay-scale – can be identified, we continue to expect a slow, modest growth trend. It is still early, but the following chart indicates that income statistics are moving in the right direction:



Source: Cornerstone Macro

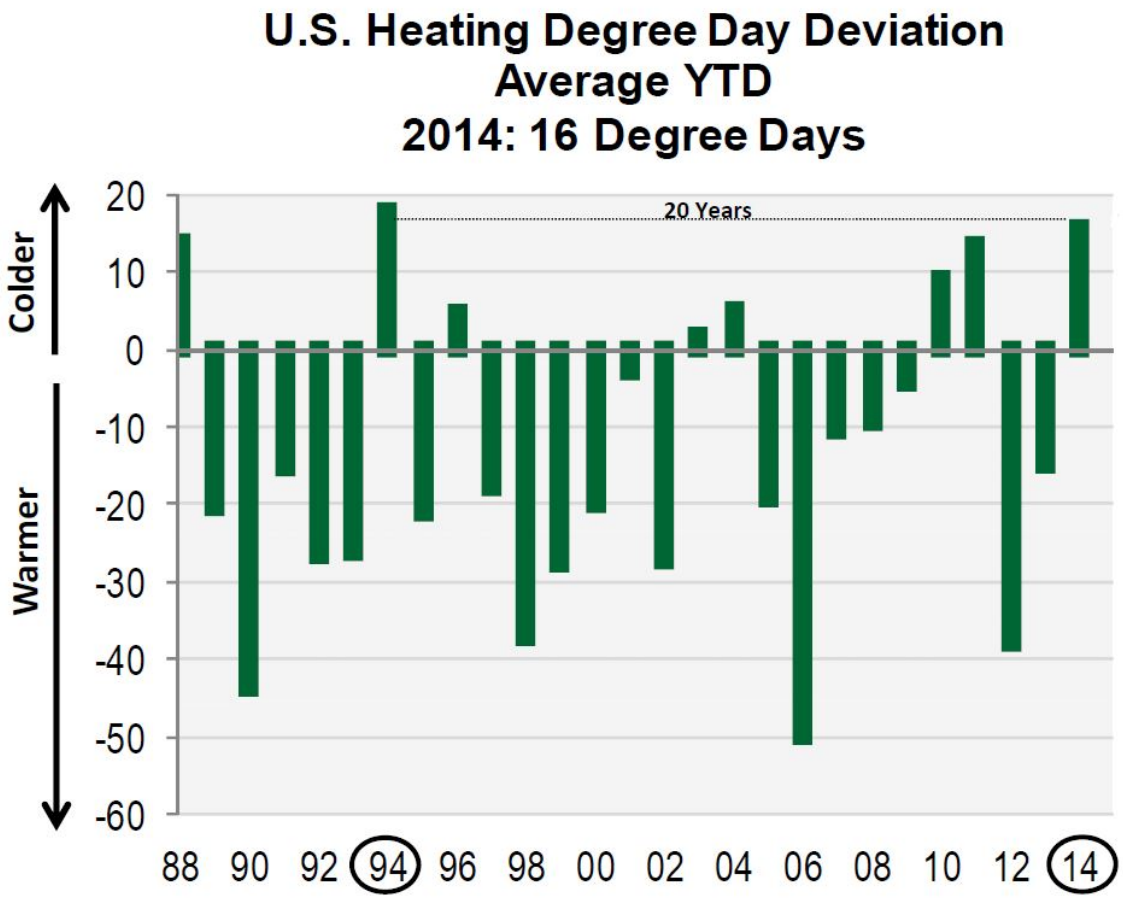
Cuts in government spending continue to weigh down growth. Federal spending and investment fell 12.8% in the fourth quarter of 2013, which includes effects from the October government shutdown, and subtracted just over a full percentage point from real growth. However, with a budget now in place and significantly reduced risk of another shutdown, the federal government will be much less of a drag on economic growth going forward.

Trade

Net exports expanded 9.4% on an annualized quarter-on-quarter basis in the fourth quarter and added a full percentage point to economic growth. A confluence of events are helping to make the U.S. more competitive and driving net exports higher. Cheap domestic prices for petroleum products are making U.S. manufacturing more competitive and driving exports of those petroleum products to record highs. Turmoil in many emerging market economies has driven wage pressures and energy subsidies up in an effort to appease the masses, which drives EM competitiveness and net petroleum exports down. As long as the turmoil continues or spreads, expect U.S. net exports to continue adding to growth.

Note on Weather

Economists are usually loath to blame results or deviation from trend on difficult-to-quantify variables like the weather. However, several leading economic indicators have weakened in conjunction with an especially bitter start to 2014. The following chart of degree day deviations reflects demand for energy to heat houses or businesses:



Source: Cornerstone Macro

On March 5, the Federal Reserve's Beige Book release indicated that eight of the Fed's 12 districts reported economic increases that were "modest to moderate." Fed districts reported that much of the recent economic weakness can be attributed to weather as "severe winter weather limited activity," "weakened retail sales," "disrupted supply chains and delayed shipments," "had a negative effect on sales and production," and that weather caused "at least part of the recent slowdown [in hiring]." If all of this is true – no matter how long the winter, spring is sure to follow, so expect the corresponding bounce.

Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting, we were approaching the end of the fourth quarter of the calendar year. Interest rate levels were moving higher on encouraging economic data and long anticipated Fed tapering. The Fed announced the initial taper without adding to the market's interest rate uncertainty, which in turn was bullish for risk assets and spreads. Equities therefore provided the best total return for December, followed by high-yield corporates and then high-grade corporates. For the fourth quarter as a whole, the story was the same for total return – Equities fared the best with the S&P 500 returning nearly 10%, while high-yield corporates returned 3.42% and high-grade corporates returned 1.16%. The chart below shows the fourth quarter returns listed by broad asset class:

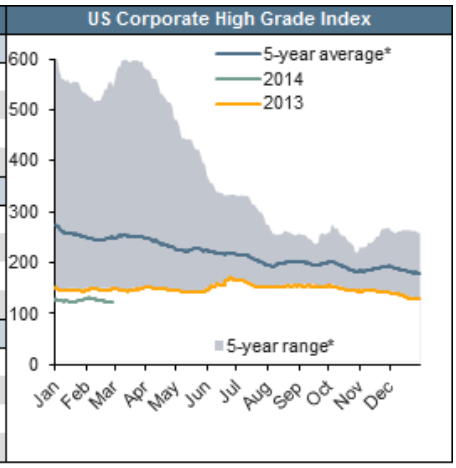
January was a different story. There were two main developments that dominated the markets during the month. The first was a weak December employment report that was announced early in the month. Treasury yields declined notably following the announcement, with the 10-year yield falling 11 basis points on that day alone. Additional economic data was also weaker than expected, partially due to poor weather. Treasury yields decreased another 20 basis points by the end of the month following broad market weakness and emerging markets concerns. Therefore interest rates fell nearly 40 basis points during the month of January. This rally in Treasury yields led to positive returns for all major fixed income asset classes. High grade credit spreads were only a bit wider on the month despite the volatility in emerging markets and resulting risk aversion, leading this sector to deliver the highest total return for January of 1.78%. Treasuries came in a close second, returning 1.60% while mortgage-backed securities and agency debt returned 1.59% and1.09%, respectively. High-yield debt offered the lowest fixed income returns for the month at .74%.

January was a strong month for new issue supply, with nearly $105 billion issued. The pace was strongest early in the month, and then market volatility and seasonal factors slowed the pace a little for the remainder of the month.

The Federal Reserve meeting in late January was the last one for Chairman Ben Bernanke, and Janet Yellen was sworn in as the new Chairman a few days later. There was at least some expectation that the Fed might put tapering on hold at this January meeting and continue with purchases of $75 billion a month given the weaker data and volatility in the emerging markets. This did not happen as the Fed announced another $10 billion reduction in asset purchases – Treasury purchases coming down to $35 billion a month and mortgage purchases coming down to $30 billion a month.

February saw more weak economic data releases, however much of this was attributed to poor weather conditions across the nation. While the U.S. equity markets continued their trek higher, the rate market was somewhat choppy. Five year Treasury yields declined to a low of 1.43% early in the month, rose to 1.57% by mid-month, and then declined back to around 1.49% by month end. Ten year Treasury yields had a similar move, with a low of 2.57% early in the month, rising to 2.76% mid-month and then declining back to around 2.64% at month end. Therefore yield levels across the curve essentially ended the month at the same level they started the month. The credit sector had a strong month, with spreads contracting across the board. Media-Cable was the best performing sector as the Comcast/Time Warner Cable deal was announced and spreads for Time Warner Cable debt rallied significantly. While the more defensive industries such as Consumer and Healthcare saw the least tightening of credit spreads, they still produced positive excess returns for the month. As has been the case for some time, with a rally in risk assets, the high yield sector performed the best, returning around 2.0% for the month of February. Investment grade credit returned 1.10%. Other spread sectors such as agencies and mortgage-backed securities turned in positive total returns as well, however not near the levels of the corporate sector. The chart below shows current spread levels within the investment grade credit sector, and the continued move tighter in recent months:

	Level	Change			
OAS (bp)	**28-Feb-14**	**Dec**	**Jan**	**Feb**	**2014**
High Grade	122	-13	2	-8	-6
Financials	117	-15	5	-10	-5
Industrials	124	-13	2	-8	-6
Utilities	121	-11	-2	-6	-8
Excess Return (%)		**Dec**	**Jan**	**Feb**	**2014**
High Grade		1.00	-0.18	0.71	0.54
Financials		0.82	-0.31	0.72	0.42
Industrials		1.08	-0.15	0.72	0.59
Utilities		1.05	0.12	0.57	0.70
Total Return (%)		**Dec**	**Jan**	**Feb**	**2014**
High Grade		-0.18	1.78	1.10	2.90
Financials		-0.14	1.11	1.02	2.14
Industrials		-0.18	2.00	1.14	3.16
Utilities		-0.34	2.84	1.08	3.95



Source: BofA/ML Indices (C0A0, CF00, CI00, CU00), CreditSights
*2009-2013

Supply volume continued at a fairly healthy rate in February as well, with roughly $83 billion in issuance. This was mainly driven by favorable market conditions as credit spreads tightened and Treasury levels remained lower. Some of this supply was likely pulled forward from March into February while conditions were so favorable, therefore it would not be surprising to see March supply levels be a little lower than average.

At the end of the month we also heard from Janet Yellen in her testimony to Congress during the semi-annual monetary policy hearing. There were basically no surprises in her testimony as she acknowledged the recent weakness in data and also that the recovery in the labor market was "far from complete." She also reaffirmed the Fed's current expectation to continue the moderate cutbacks in monthly bond purchases at each of the FOMC meetings going forward. However she reinforced the fact that tapering is not on a definite, predetermined path and if the economy continued to take steps in the wrong direction, the Fed would respond appropriately.

March has begun on a more volatile note, mainly due to the crisis in Ukraine, but in response to mixed economic data as well. Very early in the month we saw weakness in global equity markets and a resulting flight to quality bid in the U.S. Treasury market as geopolitical tensions rose quickly. As news improved over the next few days, equity markets stabilized and moved somewhat higher while the safe haven bid for Treasuries declined and yield levels rose off their lows. It is difficult to predict what exactly will happen with the situation in Ukraine in the short term, and how markets will react. We do not think that this conflict, or the recent economic data, will change the Fed's plan for tapering asset purchases. We expect that they will continue with another $10 billion cut at the next meeting in mid-March. Once the dust settles from these recent macro developments, we think it is likely fundamentals will regain some importance as the focus on tactical, short term moves declines.

Given the notable decline in yields that we have experienced throughout January and February in the fixed income markets, our actvity within the portfolio over the past couple of months has been somewhat subdued. Within the corporate sector we purchased FedEx debt, both in the primary and secondary markets as spreads looked attractive outright as well as relative to other issues the company has outstanding. We also executed a swap out of our 2037 maturity Anheuser Busch bonds and into the Verizon 2033 bonds. This swap allowed us to marginally shorten our duration while adding nearly 50 basis points of yield for a small credit rating differential. We believe that swaps like this where we can add incremental yield with minimal credit or interest rate risk make a lot of sense and will continue to look for similar opportunities. We also initiated a position in Medtronic, purchasing notes in the primary and secondary market. Again, spreads looked attractive given the credit metrics of the company and also when compared to companies within the same sector.

In the agency debt sector we have seen spreads remain stable and fairly tight. Earlier in the quarter we purchased an off-the-run 7-year agency bullet that was offered several basis points cheaper than comparable maturity on-the-run issues. It allowed us to add some yield while leaving duration basically unchanged, which is a scenario that we find attractive. We also added a Freddie Mac issue that has a one-time call, one-time step up coupon feature. At the call date, the issue is either called away, or the coupon steps up to higher level than when originally issued. This type of structure is somewhat defensive and helps to hedge against higher rate levels that may occur before maturity. With higher rates being a likely scenario later this year, we thought it made sense to add an issue with this type of stucture.

Spreads have also remained fairly stable and tight within the mortgage sector. The narrow spread level coupled with low volatility has limited the number of opportunities within this sector. We did add a few 30-year/3% pools in January and early February to reinvest prepayments and to add some duration to the portfolio as rates were declining. We were a little underweight this part of the curve and wanted to make sure the portfolio

would benefit from the decline in rates. We have kept our weighting stable within this sector and currently the duration is still a bit below that of the Index.

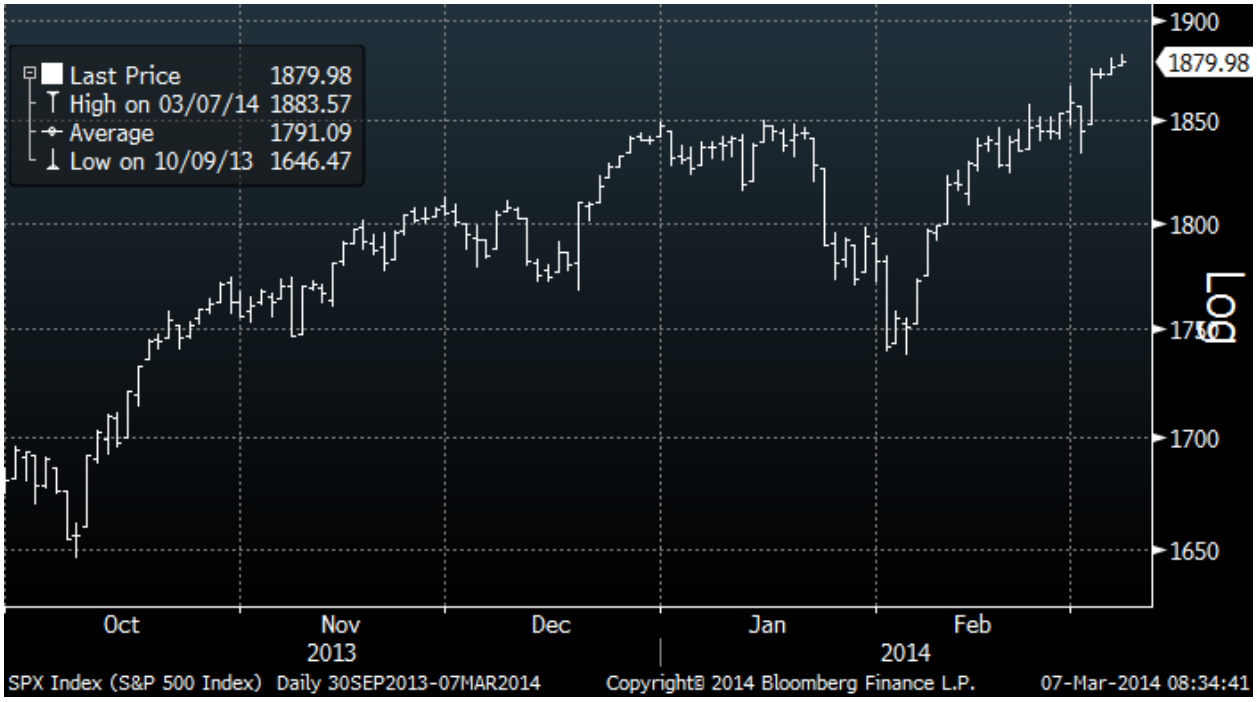
Lastly, we executed a swap with a portion of our Treasury holdings in the intermediate part of the curve. As yields began to decline in early January, we sold a block of our 2020 maturity notes and purchased the 2023 maturity notes for a pick up of 80 basis points of yield and a duration extension of less than half a year. We think swaps like this where we can add a material amount of yield with minimal interest rate risk make sense and we will continue to look for opportunities to use this strategy going forward.

Domestic Equity Strategy

By Kevin Gamble

While little has materially changed since our last equity strategy update, the general trend of the US equity market remains broadly higher with the S&P 500 continuing to inch out new all-time highs. Following a very strong first quarter to our fiscal year 2014, the domestic equity market has largely been consolidating its gains calendar year-to-date with the SPX just slightly positive on the year. A modest level of volatility has crept back into the equity market as slowdown risk in the emerging markets remains on the forefront of investors' minds (given the Federal Reserve is currently on pace to gradually reduce its level of monthly bond purchases in $10 billion increments) in addition to the recent uncertainty surrounding the conflict in the Ukraine.

Exhibit 1: S&P 500 Fiscal Year-To-Date



Source: Bloomberg

Given the relative stability in the equity markets following an extremely volatile last six years, we thought we would take this opportunity to explore where our thoughts are within the technology sector of the equity market. The technology sector is a particularly important sector of the marketplace as it represents over 19% of the S&P 500 and over 16% of the S&P 400.

We currently have an overweight exposure within our funds to the technology sector of the market given reasonably attractive valuations relative to the market as a whole, many sound investable themes with large and growing total addressable markets, strong balance sheets and cash flow, better profitability and return on invested capital characteristics than the market as a whole, dividends greater than the overall market in many cases (certainly a change from the technology go-go days of the 1990s), and strong potential for M&A activity as we move through the remainder of 2014.

What are the themes driving the technology space as we enter 2014 and how do we plan to capitalize on these bullish themes?

Mobility and connectivity of all devices to the Internet (a.k.a "The Internet of Things"), movement of software application delivery to the cloud from on premise servers, big data and the opportunity for business intelligence software to make sense of it all, wearable technology, social media, data security, and the high likelihood of a strong M&A environment for the technology space are some of the major themes we are attempting to capitalize on within our individual technology holdings.

Mobility and connectivity of all devices to the Internet: Gone are the days of wires being necessary for device connectivity. In are the days when consumers are armed with smartphones with location based technology with the capability to perform all the functions of a desktop computer and more…..In are the days in which Google purchases Nest for $3.2 billion as the connected home becomes a reality. Nest currently offers remotely controlled thermostat systems as well as smoke alarm systems. Surely Google has much greater plans as garage doors, televisions, refrigerators, lights, etc…..become connected and controlled via an app on one's smartphone.

Exhibit 2: Nest Connected Themostat

Source: Google Images

In addition to the connected home, there is the potential for smart cars which could work to avoid collisions as well as potentially drive themselves. Google already has some of these cars on the streets in San Francisco. We could even have digital billboards adjust their advertising based on the cars which are passing by and their known preferences at some point in the near future. Sensors could be used in agriculture to monitor field conditions and to monitor amount of watering and fertilizer needed for optimal crop results. These are just a few of many examples. Within this theme, we currently are invested in Google (GOOG), Broadcom (BRCM), and Silicon Labs (SLAB). BRCM and SLAB are semiconductor companies which allow for the connectivity of devices.

Exhibit 3: Google Driverless Car on Road in San Francisco

Source: Google Images

Movement of Software Application Delivery to the Cloud from On Premise Servers: Diminishing are the days of on premise software licenses sold with maintenance agreements. In are the days of software applications being delivered via subscription over the Internet. The benefits of this delivery model include substantial cost savings as companies don't have to build out internal data centers, customers can work from anywhere as they now only need an Internet connection, training can be done online, customers will always be using the most updated version of the software……Within this theme, we are invested in cloud pure plays such as Salesforce.com (CRM) as well as software companies which we think can transition their businesses effectively over time including Oracle (ORCL) and Microsoft (MSFT). Microsoft interestingly just appointed the head of their cloud division, Satya Nadella, to succeed Steve Ballmer as the next CEO of the company. We think Satya was a logical choice for several reasons, not the least of which is this secular change we are seeing to the cloud away from the client/server model.

Big Data and the Opportunity for Business Intelligence Software to Make Sense of It: The amount of data being created and stored is increasing exponentially and is staggering quite frankly. Businesses that are able to make sense of the vast amount of data will survive and prosper and businesses not able will be at a serious disadvantage. Thus strong demand for the best platforms to synthesize the data will likely continue. While many of the independent companies have been acquired by larger players, we see QLIK Technologies (QLIK) and Microstrategy (MSTR) as being particularly well positioned as two of the few remaining independent publicly-traded companies within the business intelligence software space.

Wearable Technology: Wearable technology was the talk of the town at this year's Consumer Electronics Show in Las Vegas at the beginning of the year. I was fortunate to attend a "wearables themed" dinner at this year's show and came away thinking there is definitely a future for this category. Smart watches from Samsung and Qualcomm have already been introduced, Google glasses are in the marketplace, there is the potential for an iWatch later in the year, bras which monitor healthcare vitals, skin tight wearables which are barely noticeable, chips which can sit in NFL players helmets and monitor the impact of blows to the head are just some examples of wearable applications. These

devices can be connected to the Internet and monitored and analyzed over time. Healthcare definitely stands out as an industry which could potentially be transformed by wearable devices over time. Might your future monthly health insurance premium be affected by how much you exercise? Certainly possible. Clearly privacy issues were cited as the biggest hurdle in wearable technology's future in healthcare. Investments along this theme include Qualcomm (QCOM), Google (GOOG), and Apple (AAPL).

Exhibit 4: Google Founder Sergey Brin Wearing Google Glasses

Source: Google Images

Social Media: Facebook has over 1.3 billion active users! Think about how amazing this is for a second. We just crossed the 7 billion mark for global population. Almost 20% of the world is a Facebook user. According to Internet World Stats, roughly 2.5 billion people are connected to the Internet worldwide……in other words, over half the people who have access to the Internet have a Facebook account. 35% of the world's population lives on less than $2/day! Thus Facebook's reach to global citizens worldwide which have purchasing power is tremendous. Despite the stock's hiccup out of the gate following its IPO, Facebook has turned its mobile business around which now accounts for over 50% of its profits and the financial model is now working with strong profit margins…..the future of course is unknown, but the current reach is undeniable. We currently have a long position in Facebook (FB) as not many largecap stocks have this type reach, growth characteristics, and profitability. With the company's addition to the S&P 500, it is a very relevant company and stock at this point.

Data Security as a Top of Mind Priority for CIOs: Don't have to look past the nightly news to realize data security is a huge issue. Target would surely tell you that following its massive data breach. Companies simply can't afford for their information to be compromised. I recently had a chance to tour a data center in Las Vegas and let me tell you that the security of this place would make getting into the boarding terminal at Hartsfield International Airport look like a piece of cake. We were followed around by guards which were armed by machine guns after we relinquished all forms of identity to the security at the front. Data security is clearly of paramount importance for CIOs and we are invested in Fortinet (FTNT), Juniper (JNPR), Imperva (IMPV), F5 Networks (FFIV), and EMC Corp (EMC) to best capitalize on this expected robust spending.

Exhibit 5: Data Center

Source: Google Images

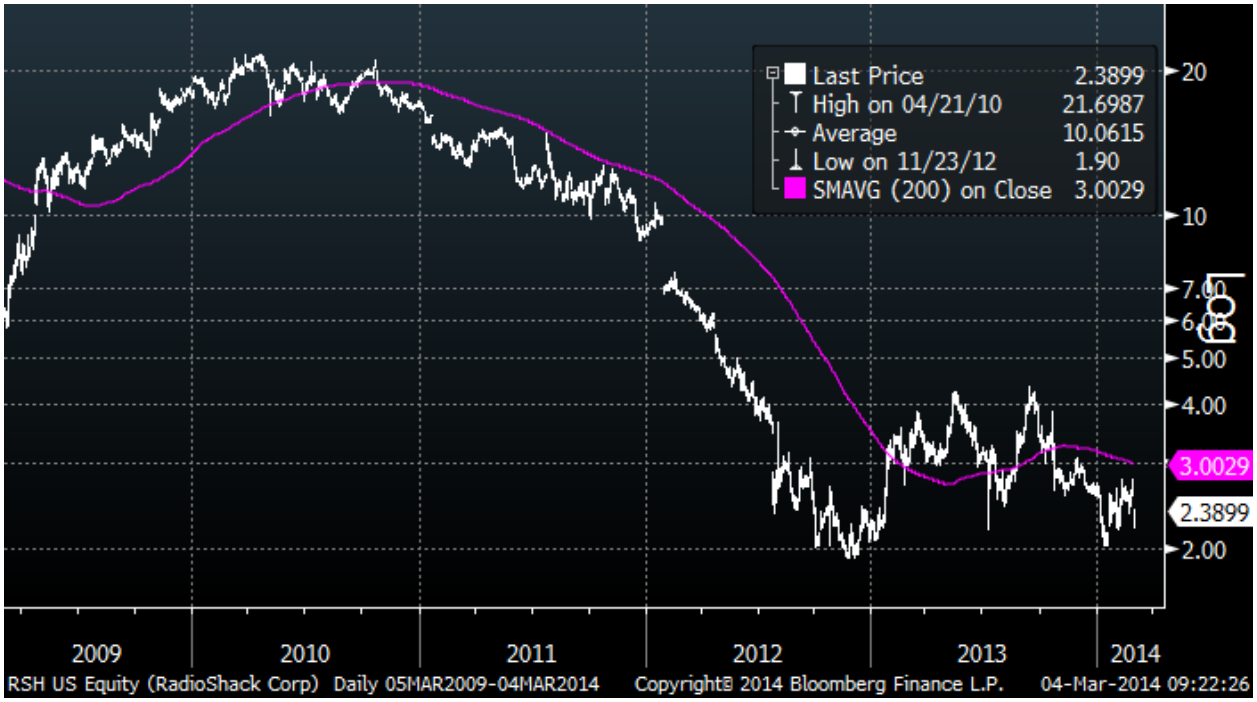
Strong M&A backdrop: The M&A backdrop has been strong for quite some time but has lacked a key catalyst, confidence. With the market making new highs, confidence has begun to return to the marketplace as evidenced by Facebook's acquisition of WhatsApp for $18 billion. The backdrop is supported by high cash levels on balance sheets, strong cash flow, strong currencies in the form of stock which FB used for example, low interest rates, high synergy potential for smaller players to leverage the global salesforces of the larger players, lack of true organic growth among many of the larger players, etc…In addition, the marketplace is currently rewarding both buyers and sellers post the announcement of many deals. In other words, the market is saying it wants to see more consolidation. We think the next few years are likely to see many small to medium tech companies either merge together to get bigger or be acquired by the larger global technology companies. M&A candidates in our portfolio include: Skyworks Solutions (SWKS), QLIK Technologies (QLIK), F5 Networks (FFIV), Tibco Software (TIBX), Fusion IO (FIO), Silicon Labs (SLAB), Informatica (INFA), Fortinet (FTNT), Imperva (IMPV), Riverbed (RVBD), Polycom (PLCM), and Microstrategy (MSTR). While the potential for M&A activity alone is rarely a great thesis, if the stocks have this potential in addition to being good stand-alone investments, then we view this as icing on the cake which only enhances the investment case.

What are the particular risk factors we monitor closely with regards to our technology equity holdings?

In addition to general market risks, the technology sector is particularly exposed to the threat of creative destruction as new technologies are constantly being developed in an effort to displace the current leading edge products. Given this dynamic, we are always on the lookout for anything new which could alter the real or perceived future of current best practice technologies. The advent of the tablet and smartphone, virtualization, software defined networking, and cloud based software application delivery are just a few of many examples. The recent Super Bowl commercial in which historic figures from the 1980's such as Hulk Hogan and Alf invade Radio Shack to reclaim all their old Boom Boxes, radios, wires, etc….is a good example of the risk of creative destruction within technology which we want to try and avoid. I doubt the Encyclopedia Britannica

salesperson that used to effectively sell us updated versions for our bookshelves at home is doing too well in a post Google world!

Exhibit 6: Chart of Radio Shack – Creative Destruction Victim



Source: Bloomberg

In addition to creative destruction, there is a general level of deflation associated with technology as evidenced by outright price declines as seen in the price of personal computers or more covert deflation as OEMs get faster and faster speeds and greater and greater memory over time for the same semiconductor price. The following is a chart of storage deflation over time which is staggering.

Exhibit 7: Price of 1Gb of Storage Over Time

1981 $300000
1987 $50000
1990 $10000
1994 $1000
1997 $100
2000 $10
2004 $1
2012 $0.10

Source: ISI Group

Volatility is also an issue with technology equities as many of the quarters are back-end loaded which can often lead to individual technology equities moving violently from quarter to quarter around earnings announcements. This volatility creates both opportunity as well as risk in the particular individual equities within the sector.

Given the unique risks associated with the group, Porter's five forces (an MBA staple) is often a helpful framework for industry analysis of the technology sector.

Exhibit 8: Porter's Five Forces Analysis Framework

Source: Google Images

With each of our individual technology holdings, we go through the exercise of assessing how each of the five forces affects the particular business. The more insulated a technology business is from each of the five forces, the better. We continually assess each technology holding within this framework both on an absolute basis as well as on the margin to best assess what the future profitability of the business will look like relative to its current state.

The impact of Edward Snowden is also an ongoing risk in the technology space as companies, people, and foreign governments among others worry about privacy concerns associated with data.

In addition to the "Snowden effect," the slowdown in emerging markets is also a risk worth monitoring as more and more of S&P 500 operating profits are coming from outside the United States. Large technology companies are no exception and a significant slowdown in growth could negatively affect those companies with the greatest exposure.

International Equity Strategy

By Steve Lambdin

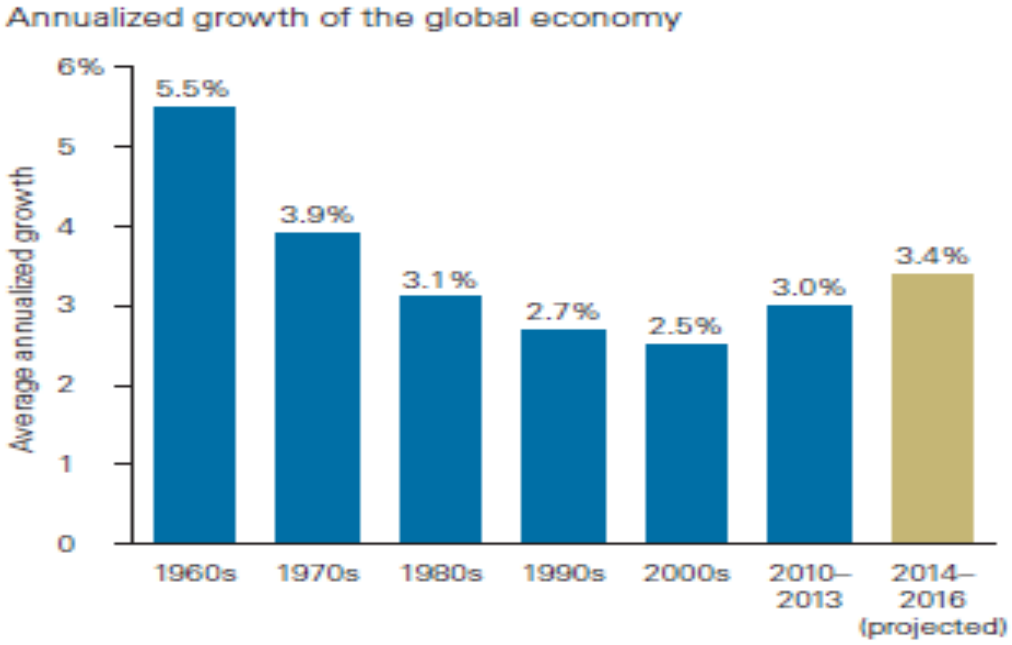
The positive momentum in the global equity markets continued in the first quarter of our new fiscal year. Most regions' equity markets saw positive returns in the quarter as the global economic recovery gained traction and investors' felt a sense of ease with it. The long awaited taper by the U.S. Federal Reserve (Fed) is finally happening and investors did not seem overly concerned by this action. The European Central Bank (ECB) continued to orchestrate lower interest rate spreads which is helping most of the countries in the Eurozone. A quick survey of economic data points around the globe seemed to indicate a strengthening growth outlook, indicative of better equity markets. European equity markets were strong in the quarter as the positive momentum continued in the region. Japanese equities had another positive quarter, as Abenomics continued to draw investors to the region. Emerging market equities managed to post a slight positive return in the quarter, but economic fundamentals remain very mixed by region and this pushed many investors toward the exits. Also, from a political standpoint, many of the emerging markets remain a mess as elections move toward the forefront. The news flow out of China remained skewed toward the negative side, as many are questioning the longer term growth for the region. As usual, there is always some issue of significance on the geo-political front. A potential Russian invasion of Ukraine remained a tense subject with investors. While no one knows what the ultimate outcome might be, we could see some level of equity market turmoil if this situation continues to deteriorate. At this point, the global economy feels a bit better than a few months back and most investors have sensed this and have pushed equity markets to yet fresh new highs recently. Whether these gains can hold and move even higher will be much dependent on data points yet to come.

Source: William Blair

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +5.7% and +1.8% respectively, during the fourth quarter of 2013 vs.
+10.5% for the S&P 500 Index. The U.S. equity market seems to be deemed the leader of the global recovery by investors as money flow into U.S. equities was robust in the quarter. The U.S. Dollar Index was nearly flat in the quarter and provided no real benefit or detriment for global equities in the quarter. As with the previous quarter, the European region performed better than the Asian region, as actions by the ECB brought comfort to investors in the region. From an economic sector standpoint, Technology, Industrials, and

Consumer Discretionary led the way, while Utilities and Staples were weaker on a relative basis. This was consistent with investors willing to take on more risk.

So far into the first quarter of 2014, equities have been very volatile, but continue to be the place to be for investors. A sharp selloff in January gave way to a very strong recovery in February, pushing many equity markets to all-time highs. Overall, corporate earnings season looked decent and many companies still see plenty of avenues for growth going forward. Inflation remains well contained in the developed markets and interest rates are very conducive for a good M&A environment going forward. This has the potential to make for a good equity market environment in the first part of 2014. The MSCI EAFE Index and the S&P 500 Index posted returns of +1.4% and +1.0%, respectively, through February, while Emerging Markets have returned -3.4%, as investors are nervous over the near term outlook in many of these markets. As we look out to mid-2014, barring a bad outcome on the geo-political front, the fragile recovery seems to be giving way to a more broad-based firmer recovery at the moment. This should provide a nice backdrop for a decent equity market outlook in the more developed markets around the globe.



Notes: World GDP is shown at market exchange rates, in constant U.S. dollars. Data are from World Bank for 1960 through 1969 and International Monetary Fund's World Economic Outlook (WEO), October 2013, for subsequent years. Projected growth is from the IMF.

Sources: Vanguard calculations, based on IMF and World Bank data.

Asia Update

After a very strong third quarter of 2013, the equity markets cooled off a bit in the Asian region in the fourth quarter. The broad MSCI Pacific region posted a +1.6% return in the quarter. Currency movements during the quarter continued to be a headwind for unhedged U.S. investors. In Japan, Abenomics continues to be a wildcard going forward and Australia's commodity oriented economy were poor performers in the quarter. The Chinese equity market did recover modestly during the quarter, but for all of 2013 equities were a dismal performer here due to a multitude of issues going on across the country.

Market Performance

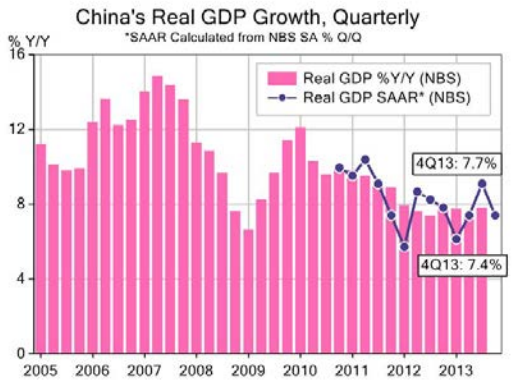
Data as of: 31-Dec-2013

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Taiwan	1.43	4.32	9.06
MSCI China	-3.43	3.81	3.64
MSCI Hong Kong	0.14	3.35	11.09
MSCI Japan	0.80	2.29	27.16
MSCI Pacific	0.04	1.56	18.27
MSCI Singapore	-1.28	0.72	1.70
MSCI Australia	-1.78	-0.87	4.16
MSCI Philippines	-6.54	-5.01	-2.70

Source: Factset

The Chinese economy, the second largest in the world, returned to slower growth in the fourth quarter of 2013. Gross Domestic Product (GDP) in China rose +7.7% in the quarter from the year earlier period, a slight deceleration from the previous quarter's growth rate. Slightly tougher credit standards were a headwind for investment spending in the quarter as China's leaders were trying to reduce the risks of a banking crisis associated with debt. Many economists were not surprised with this reading as the slowdown became more visible as the quarter progressed. Industrial production rose +9.7% in December, which was a bit slower than a few months back, as weaker automobile sales took hold. Fixed asset investment also weakened, and was reported up +19.6% in December, the weakest reading in all of 2013. Export growth also weakened a bit, posting just a +4.3% increase in December from a year earlier. In a bit good, retail sales rose +13.6 in December from a year earlier, as the consumer continues to be the catalyst to a more domestic driven economy. Inflation continues to be well under control as consumer prices rose +2.5% in January, well below targeted levels. This gives China's leaders plenty of room to support growth in 2014 which will probably be the slowest in nearly a quarter century. At this point, it's clear to most that China's growth rate will continue to fall going forward. In fact, the official targeted growth rate for this economy in 2014 is +7.5%. Many believe this will

be difficult as the country deals with a large local government debt problem and a weak shadow-banking industry. However, as the rest of the world continues to recover, this is a plus for their economy and could make these growth goals attainable. Investors will be watching with a high degree of skepticism which could make for a volatile situation in 2014.

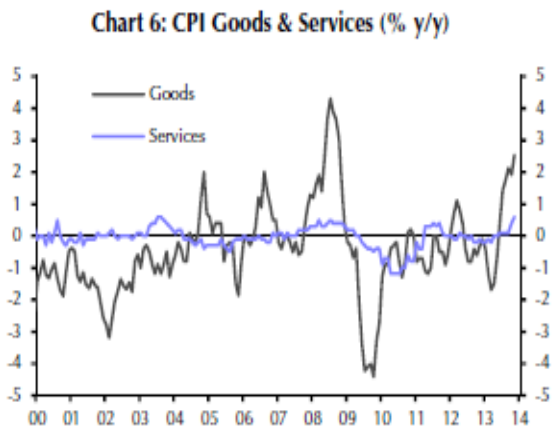


Source: ISI

Source: ISI

The Japanese economy continues to be a roller coaster ride late in 2013. Prime Minister Abe's anti-deflationary policies continue as the Bank of Japan (BOJ) continues to expand the monetary base. Just as we mentioned before, this ought to work over the short term, but the long term effects of this remain cloudy. Fourth quarter GDP was reported to be up +1% on an annualized basis, surprising most as expectations were much higher than this. This could spur additional easing by the BOJ. Core machinery orders fell -15.7% in December from the previous month, but rose +6.7% from the year earlier period. This data point is the weakest monthly number reported in 2013 and shows how touchy this economy is at the present time. Business confidence indicators remain at high levels in early 2014, as many companies forecast good demand for their products. However, the consumer seems to be painting a different picture at the moment. January consumer confidence was reported at 40.5, the lowest level in over a year. Consumers have yet to fully embrace Abenomics. Retail sales continue to look strong in early 2014 and were reported up +4.1% in January from the year earlier. However, we believe the strength in this statistic stems from the increase in the consumption tax beginning in April. We expect consumer spending to fall after this increase. Reflation continues to push consumer prices higher and were reported up +1.4% in January. The employment outlook seems to be a mixed bag at the moment. The unemployment rate was reported at 3.7% in January, the lowest among the major regions around the globe by a wide margin. In addition, the jobs-to-applicant ratio looks very strong, and moved to 1.04, the highest rate in distant memory. However, base wage growth is only marginally positive in early 2014, but we could see better increases over the next few months. At this point, the economy here should pick up a little more steam in front of the consumption tax increase in April. The potential for more monetary easing by the BOJ should push the Yen lower, and therefore could be good news for Japanese equities over the near term.

Source: ISI



Source: Capital Economics

Europe Update

Even though still weak by most measures, the economic climate in the Eurozone has improved a bit from the previous quarter. We should see slightly better economic growth from reduced fiscal tightening due to reduced spending cuts and smaller tax increases. While not a "game changer" by any measure, it's improvement at the margin and this has motivated investors across the region to re-evaluate exposure to the region. Actions by the ECB over the last few months seemed to have pleased the credit markets, as spreads continue to tighten and this has pushed many to more risky assets, such as equities. Sentiment across the Eurozone is definitely changing in the right direction. During the fourth quarter of 2013, the MSCI European Index (ex U.K.) posted a gain of +8.2%, making this one of the best performing regions around the globe. Large-cap valuations, cash flow metrics, and earnings growth all still remain attractive relative to other parts of the world. Though still lackluster, we do see economic improvement across the region and this should be good for equity markets in early 2014.

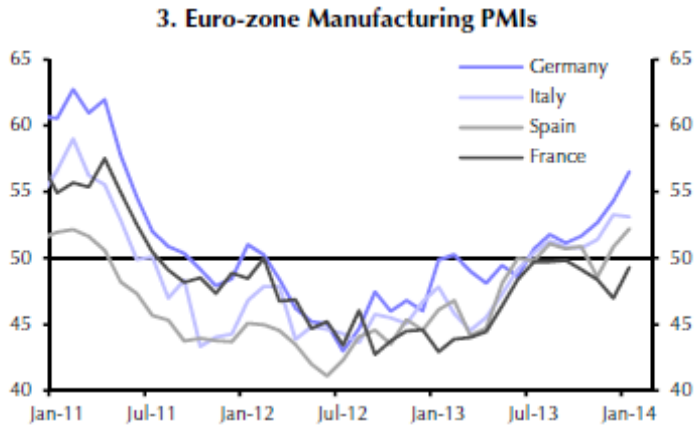
Market Performance

Data as of: 31-Dec-2013

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Germany	2.79	13.28	31.37
MSCI Spain	2.29	11.39	31.32
MSCI Italy	0.71	10.67	20.43
MSCI Netherlands	2.24	8.62	31.30
MSCI Europe ex UK	2.00	8.12	27.65
MSCI United Kingdom	2.74	7.41	20.67
MSCI France	1.64	6.01	26.33
MSCI Switzerland	1.05	4.27	26.61

Source: Factset

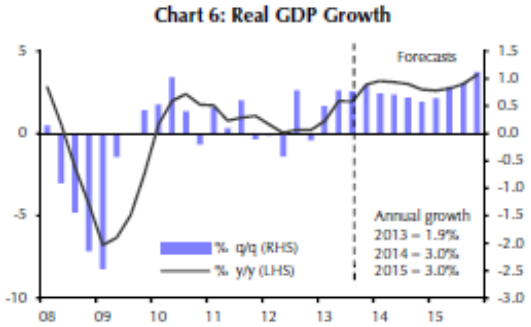
Growth in the Euroland economy picked up just a little in the fourth quarter of 2013, but still very weak by most measures. Fourth quarter GDP rose +.3% from the previous quarter, or +.5% from a year earlier, which was mostly in line with what many economists expected. Export growth of +1.2% led the way, while household consumption remained weak and was barely positive in the quarter. The economies of Germany, France, and the Netherlands showed the best growth, while Italy and Finland's growth was rather poor. Even though the Euroland economy remains weak and below trend, we have nevertheless seen three straight quarters of growth. We find this at least positive on the margin. Industrial production continued to jump around from growth to slight contraction on a month-to-month basis in the fourth quarter. However, on a year over year basis, we did manage to see growth in this metric. The PMI composite has gained just a bit of strength in the first couple of months in 2014, a slight improvement from the fourth quarter and is another sign of the increasing strength going on in the region. The index of executive and consumer sentiment continues to gain momentum over the last several months and reached 101.2 in February, the highest level since July 2011. We view this data point as very critical to the ongoing recovery in the region and this seems to indicate a stabilizing economy. Retail sales in January increased +1.6% from a month earlier, one of the best monthly gains in this data point over the last year. However, retail sales flop around from month-to-month as the consumer still remains spotty at the present time. Believe it or not, the Euroland employment situation may have gotten better on the margin over the last few months. The January unemployment rate was reported at 12.0%, holding steady since last October for the region. This is down from the record highs we saw in late summer. However, there still remains a lot of divergence from country to country and the situation remains extremely weak. Inflation still remains under control and continues to decline, falling to +.8% in January, a new low for the region. The ECB's key refi rate remained at .25% following its most recent meeting. Deflationary concerns are beginning to crop up in a few discussions lately as this remains an area worth watching over the next few months. Taking into account what we have seen coming out of the Euroland economy over the last the few months, we are feeling marginally better about the economic outlook for the region, though not to a great degree. We do see growth picking up just a bit from the anemic pace of the last three quarters. However, risks still remain regarding domestic demand, progress on structural reforms, and the market for exports. Any surprise on these fronts could make for volatile equity markets over the next few months.



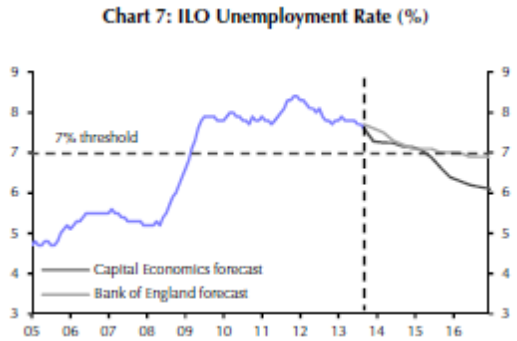
Source: Capital Economics

The U.K. economy continues to surprise many as growth looks robust relative to the Eurozone. GDP rose +.7% in the quarter from the previous quarter, or +2.7% from the year earlier period. This is the fourth straight quarter of growth in this economy and is clear evidence the recovery is gaining momentum in this region. Net trade, consumer and government spending, and business investment all helped the economy during the quarter. Industrial production continues to limp higher, rising +.4% in December from a month earlier, or +1.8% on an annual basis. Mining & quarrying, oil & gas, and manufacturing all posted positive month over month results in December, even though these sectors remain a bit weak overall. Retail sales cooled a bit in January from an impressive December, and fell -1.5% for the month. However, retail sales were still up +4.3% from the year earlier period in January. We do not read too much into the January figures as results in December were unusually strong and surprised many to the upside. If retail sales are any indication, maybe the consumer feels a bit more comfortable at the present time. Wages continues to grow, but at a weak pace. December wages grew +1.5% from a year earlier, the best growth in seven months and moving in the right direction. Inflation has finally fallen below the Bank of England's (BOE) official target. January's inflation reading was reported to be up +1.9% from a year earlier, the lowest rate of inflation in quite some time. We now expect this rate to remain fairly steady going forward as plenty of slack remains in the economy and central bank tightening looks to be well off into the future at this time. At its recent February 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 nearly everyone expected. The MPC believes rates are appropriate at the present time as inflation just made it to targeted levels and headline unemployment remains just a bit higher than the committee's threshold rate. We very well may have reached the bottom of the short term interest cycle in this region. Many now see the next move to be higher interest rates, but this is still some time away and not a near term concern. The employment situation continues to move in the right direction. The unemployment rate fell to 7.2% in the fourth quarter, as employment rose by 193,000 in the quarter, to a record 30.1 million. In addition, jobless claims fell for the 15th month in a row in December, a good signal of the health of the job market in the region. The U.K economy is performing well at this point and is in much better shape than the Euroland economy. We expect this momentum to continue into the spring

which paints a good picture for the region and this could push equity markets higher over this timeframe.



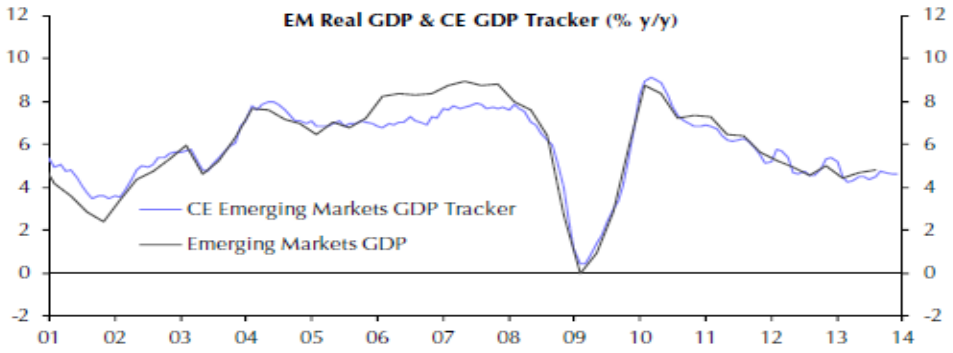
Source: Capital Economics



Source: Capital Economics

Emerging Markets

Emerging market equities continue to be the laggards of the equity world in the fourth quarter of 2013. The +1.8% return was rather "skimpy" when compared to what we saw in the rest of the developed world. Investors are very concerned with inflation in many of these markets and generally slowing economic growth as well. We are seeing increased political turmoil in several countries and capital seems to be leaving many of these markets in response to potentially higher interest rates in the U.S. Also, fresh concerns surrounding future growth rates in the Chinese economy as well as banking concerns here have prompted investors to have a cautious view of this region. In addition, as far as the structural reforms being undertaken in China, many are somewhat pessimistic whether most of these will be instituted. No doubt that emerging market fundamentals remain very mixed at the present time as many of these countries are struggling for any momentum. Trends and economic indicators are very divergent by region and we do not expect this to change over the near term. However, at the end of the day, one must keep in mind that emerging market economies still make up about half of global GDP and are still responsible for a bulk of the growth of the world economy. Needless to say, valuations still remain very attractive by most measures. But recent trends do not look favorable at the moment as near term concerns seem to be overwhelming long term opportunities.



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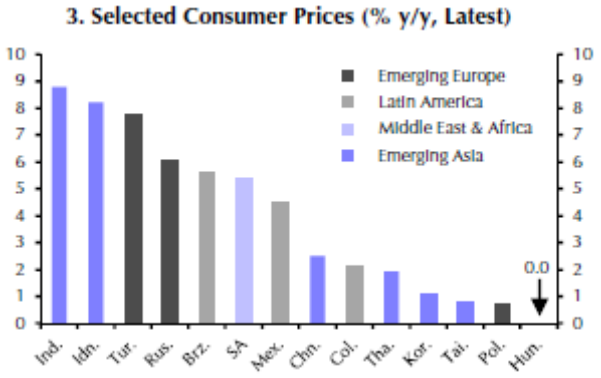

Source: Capital Economics

International Equity Activity/Strategy

We continue to remain relatively constructive on the global equity market over the next few months. Global growth could be a bit stronger than we anticipated a few months ago in the developed economies and this should be beneficial for corporate earnings growth on a global scale. Even as the U.S. Fed's tapering program continues, we still see global monetary policies as very accommodative over the near term and short term interest rates should remain quite low for some time into the near future. When one considers where we are in terms of growth, inflation, interest rates, balance sheet stability, free cash flow margins, and overall corporate profitability, global equity valuations still seem very reasonable with upside potential. Thus far into our current fiscal year through the end of February, global equity returns have been good, with the S&P 500 Index up +11.5% and the MSCI EAFE Index up +7.2%. However, emerging market equities continue to struggle as inflation shows divergent trends by region, as emerging Europe and Asia remain low, but Latin America is trending higher. Many business indicators have lost a bit of momentum lately and seem to indicate a recovery could still be a ways off for right now. In addition, consumer confidence within the emerging markets looks weak at the moment. As a result, we have seen investors cut some exposure to these weak regions as money flows out of the emerging markets into the more developed markets. In the developed markets, the recovery appears to have gained a bit of momentum over the last few months, as the European region seems to be stronger on the margin and the Asian region looks steady. Also, the U.S. economy looks fairly solid at the moment, even as severe winter weather has been tough lately. However, this should prove to be just a temporary issue with little medium term implications.

Since our last meeting, we have not taken any meaningful 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 down. Premiums for doing this still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.30% of total assets and approximately 12.3% for MSCI EAFE equities. *(Charts provided by William Blair, ISI, Capital Economics, Vanguard, IMF, World Bank, Factset)*

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING December 31, 2013

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
TRS CORE FUND	2,115,870,639	2.56	10.12	31.90	10.12	31.90	14.31	16.28	6.79	Oct-94
TRS S&P 500 FUND	5,831,321,641	2.54	10.52	31.86	10.52	31.86	16.15	17.92	7.47	Oct-94
TRS MID CAP INDEX	1,209,233,390	3.08	8.31	33.50	8.31	33.50	15.62	22.01	10.41	Oct-94
TRS S&P SMALL CAP INDEX	794,805,422	1.49	9.96	42.14	9.96	42.14	19.15	22.08	11.11	Mar-01
TRS SMALLCAP ACTIVE FUND	15,115,536									Jun-06
TRS MIDCAP ACTIVE FUND (SSF)	786,212,283	2.41	5.60	28.38	5.60	28.38	15.15	21.25	9.95	Oct-94
TRS TOTAL DOMESTIC EQUITY	10,752,558,912	2.49	9.81	32.54	9.81	32.54	15.73	18.11	7.84	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		2.54	10.05	33.35	10.05	33.35	16.30	18.81	8.08	
S&P 500		2.53	10.51	32.39	10.51	32.39	16.18	17.94	7.41	
S&P MID CAP 400		3.09	8.33	33.50	8.33	33.50	15.64	21.89	10.36	
S&P SMALLCAP 600		1.45	9.83	41.31	9.83	41.31	18.42	21.37	10.65	
INTERNATIONAL EQUITY										
TRS EMERGING MARKETS FUND	306,199,454	-0.44	3.68	-3.23	3.68	-3.23				Oct-11
TRS INTERNATIONAL EQUITIES	2,795,470,578	1.47	5.68	23.19	5.68	23.19	8.66	12.87	7.38	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	3,101,670,033	1.28	5.48	20.06	5.48	20.06	7.60	12.33	7.40	Nov-94
TRS CUSTOM INTERNATIONAL EQUITY IND		1.20	5.32	19.80	5.32	19.80				
MSCI EAFE (NET)		1.50	5.71	22.78	5.71	22.78	8.17	12.44	6.91	
MSCI EMERGING MARKETS		-1.45	1.83	-2.60	1.83	-2.60	-2.06	14.79	11.17	

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

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PERIODS ENDING December 31, 2013

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TRS TOTAL GLOBAL EQUITY	13,854,228,945	2.22	8.81	29.57	8.81	29.57	13.76	16.71	7.72	Oct-75
TRS CUSTOM GLOBAL EQUITY INDEX		2.24	8.96	30.12	8.96	30.12	14.10	17.11	7.71	
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,408,869,581	-0.63	0.23	-0.93	0.23	-0.93	4.34	6.27	5.67	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		-0.45	0.24	-1.82	0.24	-1.82	3.85	5.75	4.82	
TRS TOTAL FIXED (ex. Private Placements)	2,408,869,581	-0.63	0.23	-0.93	0.23	-0.93	4.34	6.27	5.67	Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		-0.45	0.24	-1.82	0.24	-1.82	3.85	5.75	4.82	
Barclays Aggregate Bond		-0.57	-0.14	-2.02	-0.14	-2.02	3.26	4.44	4.55	
TRS PRIVATE PLACEMENTS	2,105,170,491	0.34	1.47	16.79	1.47	16.79	18.24	5.90	6.71	Aug-99
TRS CASH ACCOUNT	323,401,909	0.01	0.02	0.11	0.02	0.11	0.16	0.24	1.92	Sep-03
TRS TOTAL FIXED INCOME	4,837,441,980	-0.14	0.84	7.10	0.84	7.10	10.16	5.80	5.99	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED STOCK	427,888,980	0.18	0.53	14.67	0.53	14.67	22.22	-17.25	-11.37	Sep-03
TRS REAL ESTATE	1,959,314,097	0.01	0.01	0.15	0.01	0.15	1.34	0.19	2.70	Oct-03
TRS SHORT TERM INVESTMENTS	529,139,338	0.02	0.08	0.34	0.08	0.34	0.39	0.54	2.28	Oct-03
TRS OPTION COLLATERAL	0									Sep-03
TRS TOTAL ALTERNATIVES	2,916,342,416	0.05	0.12	2.69	0.12	2.69	3.32	-3.02	-0.68	Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,753,784,395	-0.07	0.59	5.49	0.59	5.49	7.71	2.90	3.89	Oct-93

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING December 31, 2013

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
TRS TOTAL PLAN	21,608,013,340	1.38	5.74	19.74	5.74	19.74	11.31	10.45	6.10	Oct-87
TRS TOTAL PLAN POLICY		1.36	5.85	18.49	5.85	18.49	10.00	12.27	6.19	