Quarterly Economic Update

March 12, 2015

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

Federal Reserve Chair Janet Yellen and the Federal Open Market Committee (FOMC) continue to cautiously guide market participants towards the coming removal of monetary accommodation and tightening of the federal funds rate. The level of accommodation provided over the past several years to support economic growth and employment through the economic recovery has been significant and unprecedented. With the FOMC no longer adding accommodation through asset purchases, they have held policy steady as they gain confidence that growth and employment gains are on solid footing to sustain themselves once accommodation is removed. Sluggish wage growth and lower inflation has led the FOMC to approach the next phase of removing accommodation with caution. As they look for further evidence that improvement in labor conditions is sustainable and inflationary readings are stable, they continue to prepare market participants for the eventual transition to tighter monetary policy.

At their December meeting, FOMC members took another step to shift towards the eventual normalization of policy by adjusting their forward guidance language. The December FOMC statement dropped the language that it would be appropriate to hold the federal funds target rate at the current low level for a "*considerable time* following the end of its asset purchase program." This was replaced with a statement that "the Committee judges that it can be *patient* in beginning to normalize the stance of monetary policy." It was noted in both the FOMC statement and the following press conference that this did not signal a change in policy, but simply reflected more appropriate guidance language now that asset purchases had ceased. It had been expected that the "considerable time" language would be dropped, and left market participants focused on how "patient" should be interpreted. In her post-meeting press conference, Yellen defined "patient" specifically as "the Committee considers it unlikely to begin the normalization process for at least the next couple of meetings."

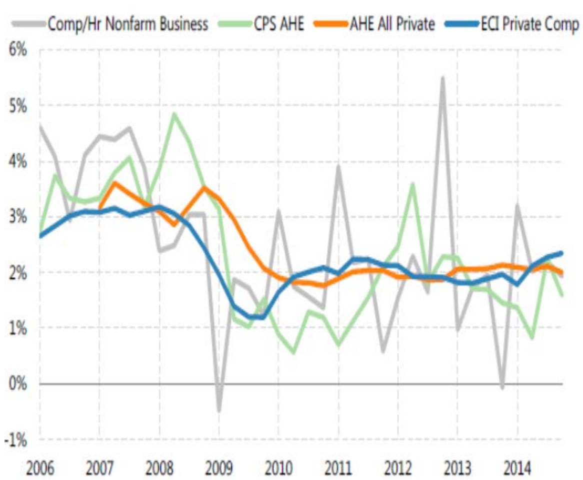
The FOMC met again in January, where they repeated their statement that "the Committee judges that it can be *patient* in beginning to normalize the stance of monetary policy." The January minutes indicated a significant amount of time was dedicated towards discussing future forward guidance, the timing and economic conditions appropriate for the initial rate increase, and the likely path of rate hikes following the initial increase. The likely next step will be dropping "patient" from the forward guidance as it conveys a *not for the next couple of meetings* signal that is somewhat calendar oriented. The FOMC has repeatedly emphasized that future policy decisions are data dependent, and shifting the forward guidance away from the "patient" connotation would provide the necessary flexibility needed to make conditional policy decisions as they evolve. In her February 24th Semiannual Monetary Policy Report to the Congress, Yellen further defined the "patient" guidance as the view that economic conditions were unlikely to warrant an increase in the federal funds rate over the next couple of FOMC meetings. As conditions improve, it will become appropriate to consider an increase on a meeting-by-meeting basis. As we approach these conditions, the guidance will likely need to be adjusted to reflect that. In her prepared remarks to

Congress, she stated that "a modification of the forward guidance should not be read as indicating that the Committee will necessarily increase the target range in a couple of meetings. Instead the modification should be understood as reflecting the Committee's judgment that conditions have improved to the point where it will soon be the case that a change in the target range could be warranted at any meeting." Yellen went on to state "Provided that labor market conditions continue to improve and further improvement is expected, the Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when, on the basis of incoming data, the Committee is reasonably confident that inflation will move back over the medium term toward our 2 percent objective." This guidance best reflects the conditional nature of policy decisions going forward I n regards to the FOMC's mandates and is likely to work its way into future FOMC statements.

While there has been significant improvement in employment, the FOMC remains concerned with the slow improvement of some labor market indicators – specifically sluggish wage growth, lower labor force participation rates, and the elevated share of workers employed part time that would like to work full time. Wage growth typically lags employment, but Yellen and other committee members clearly would like to see stronger wage growth at this point in the recovery. Although there have been some positive indications of strength, it has been mixed with some negative data and generally stagnant. They would like to see consistent acceleration across several metrics, which they have just not seen yet as the chart on the left below shows. The labor force participation rate, shown on the right below, seems to have stabilized somewhat but has shown no real improvement. The decline over the past several years can partly be attributed to demographic trends, but the lack of any improvement as growth has recovered may also indicate the perception of poor job opportunities. These labor market concerns have the FOMC moving forward cautiously.

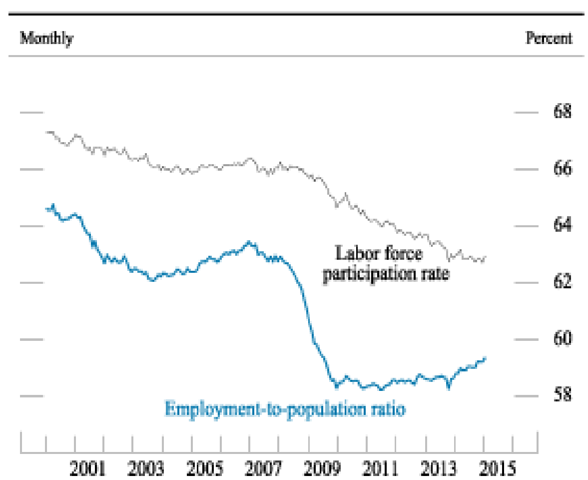
Growth of selected wage measures since 2006

Y-Y percent growth



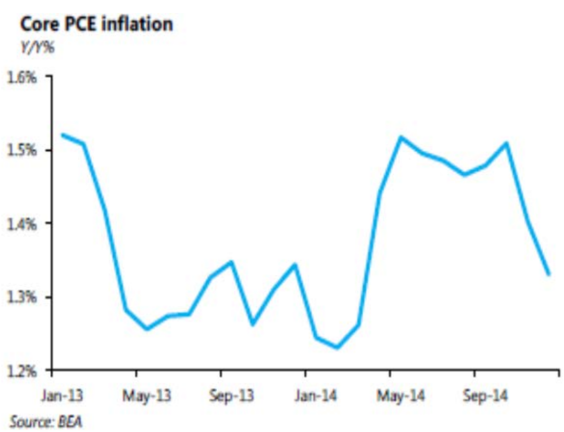
Source: BLS, Evercore ISI.

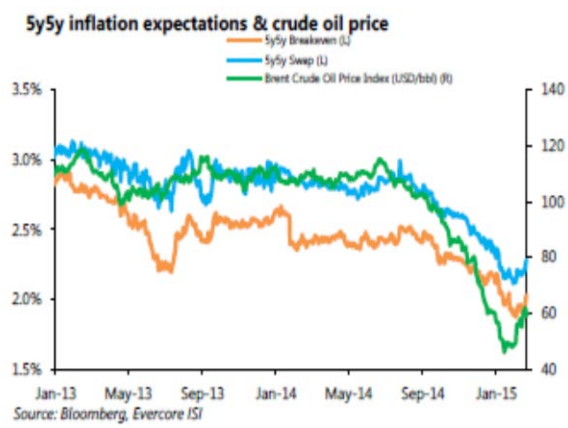
2. Labor force participation rate and employment-to-population ratio



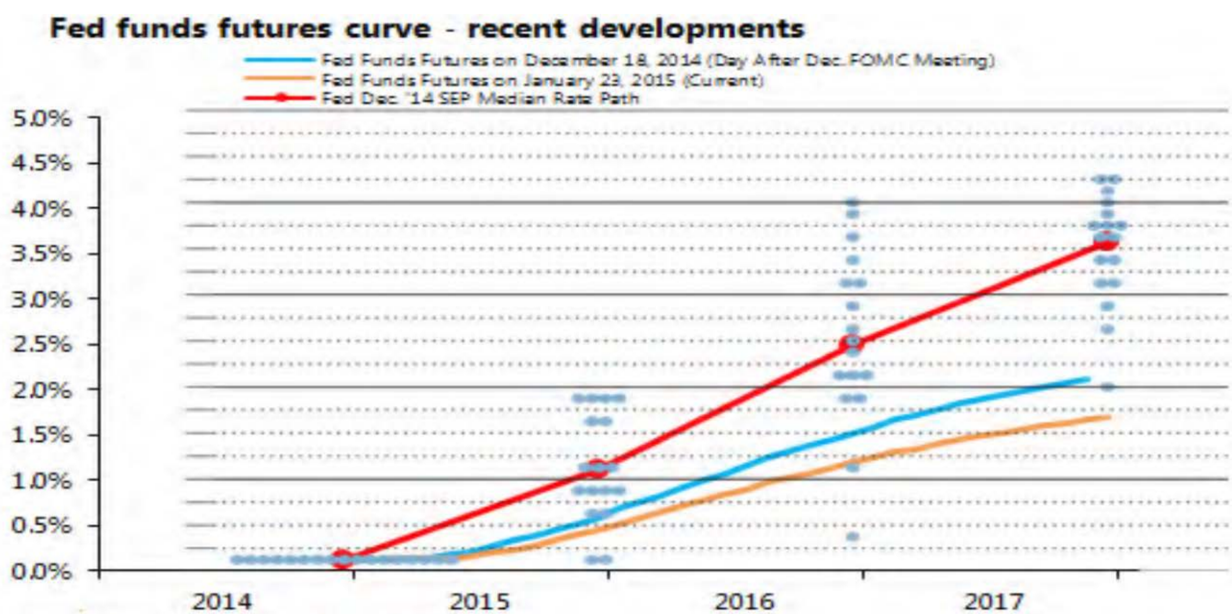
NOTE: Both series are a percent of the population aged 16 and over.
SOURCE: Department of Labor, Bureau of Labor Statistics.

The FOMC is optimistic that labor market conditions will continue to improve and these weaknesses are areas where they are looking for confirmation that the improvements we have seen so far are indeed sustainable. More concerning has been the recent declines in inflation. Current inflation has declined sharply over the past several months and is running below their forecasts and longer run objective of 2%. At both their December and January meetings, the FOMC statements indicated increased concerns around lower inflation trends and the subsequent minutes showed significant discussion around what was driving current lower inflation and whether it reflected a change in longer run inflation trends. The significant decline in oil prices and weaker import prices from the stronger US dollar have contributed to lower inflation in the near term and most FOMC participants believe this is likely transitory. However, they are concerned because market-based measures of inflation expectations five to ten years ahead have declined recently as well. Survey-based measures of longer-term inflation expectations have remained stable, and discussions point to the potential that the lower market-based measures of intermediate inflation compensation likely reflect lower risk premiums for inflation. The recent stabilization in oil prices seems to reflect that it has played a large role in the decline in inflation readings and inflation compensation which is exhibited by the chart below. Yellen and the FOMC maintain that the lower near term inflation is transitory and that inflation expectations remain well anchored and inflation will gradually rise back towards their two percent objective. However, they have stated that they will be monitoring inflation closely and the inflation outlook is likely now the primary driver when it comes to making policy decisions.





Currently, the market has assigned an implied probability of around 50% that the FOMC will initially raise the federal funds target rate at their June meeting. Expectations for the initial rate increase have wavered between the June and September meetings. The recent lower inflation readings may have pushed expectations back some, but June is definitely still on the table. Both June and September are FOMC meetings with updated economic projections followed with a post-meeting press conference. Yellen has stated that the FOMC is not confined to making policy decisions only at meetings followed by scheduled press conferences, but it is perceived that these meetings would be more ideal for an initial rate increase. The next meeting will be held March 17-18th and will include updated economic projections. Whether they adjust their forward guidance language and any shift to their projections and drift in the dots will provide better indications on when we might see the initial hike. The timing of the initial hike is likely not as important as the path and pace of increases following the initial hike. Yellen and the FOMC seem to have done a good job in telegraphing that an increase is coming, but there remains a large discrepancy between the FOMC and market expectations on the path of rates going forward. The chart below shows the fairly wide difference between the FOMC's most recent median projections for the federal funds rate (red line) and the market's expectations based on the fed funds futures as of the end of January (yellowish line). The fed funds futures curve has shifted around some recently, but still represents a fairly wide disagreement on the expected path of the federal funds rate. According to the minutes, FOMC participants discussed the wide divergence in market-based expectations for the path of rates and speculated that the market could be assigning higher probabilities to less favorable economic outcomes, whereas FOMC participants are expressing their view of the most likely path.



Source: Federal Reserve, Bloomberg

The FOMC is transitioning to the next phase of removing accommodation and pushing short term rates higher to tighten policy. The stronger forward guidance in this direction is a shift by itself. They have been adamant that policy decisions going forward will be data dependent, and are clearly focused on inflation and further labor market improvements, specifically an uptick in sustainable wage growth, barring an unexpected deterioration in general economic activity. Even as the FOMC begins to raise the federal funds rate and remove accommodation, there is still a significant amount of accommodation being provided. Yellen and others on the FOMC have expressed that they are aware of the fragility of the recovery and are moving forward consciously not to remove needed support prematurely. Yellen reinforced this more recently in her speech before Congress that even as they shift to tighter policy "it may be necessary for the federal funds rate to run temporarily below its normal longer-run level because the residual effects of the financial crisis may continue to weigh on economic activity."

Fiscal Policy

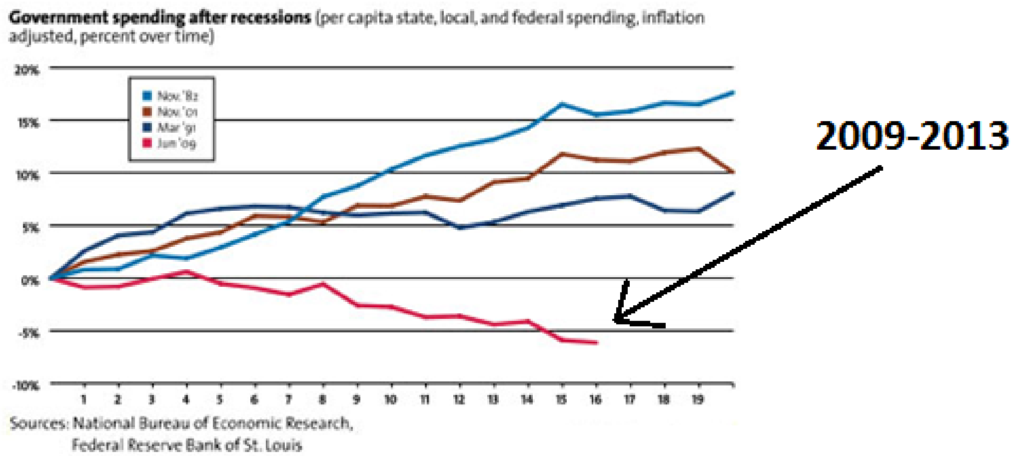
By Michael McNair

The purpose of the *Fiscal Policy Report* is not only to explain how fiscal policy has impacted economic growth in the past but more importantly, to forecast how fiscal policy will effect growth in the future. We believe there are two key ways in which fiscal policy impacts economic growth: 1) the fiscal stimulus/drag and 2) policy uncertainty. The fiscal stimulus or drag measures the direct impact that changes in government taxing and spending decisions have on gross domestic product (GDP) growth. In the GDP equation (**GDP** = **<u>C</u>**onsumption + **<u>G</u>**overnment spending + **<u>I</u>**nvestment + **<u>N</u>**et exports) *G* measures the level of net government spending and its impact on total GDP; however, the fiscal stimulus/drag is equivalent to the change in *G*, which measures how the change in net government spending contributes to GDP growth (as opposed to the level of GDP). While the fiscal stimulus/drag is typically the only way most economists measure fiscal policy's impact on GDP growth, we believe that it is also essential to incorporate a measure of policy uncertainty in order to generate a more robust forecast of the impact fiscal policy has on GDP growth.

Fiscal Stimulus/Drag

In a recession private sector spending falls and leads to a drop in GDP. Since spending = income, if total spending in the economy were to fall it would create a vicious cycle between lower spending leading to lower income which leads to even lower spending. Therefore, if private sector spending drops, only government spending and net exports can reverse this vicious cycle. Thus, it has typically been the policy of the government to step up spending to provide a stimulus to the economy in order to jump start a recovery and replace a portion of the lost private sector spending until it becomes clear that private sector spending growth will push GDP back to its "natural" level. In fact, prior to this last recession, this has been exactly the way fiscal policy has responded. However, long time readers of the *Fiscal Policy Report* will recall that from 2011 – 2014 the US economy has faced a significant headwind from one of the largest fiscal drags in our nation's history. Yet, the '11-'14 fiscal drag becomes even more unprecedented when you consider the fact that it occurred in the wake of our nation's biggest recession since the Great Depression.

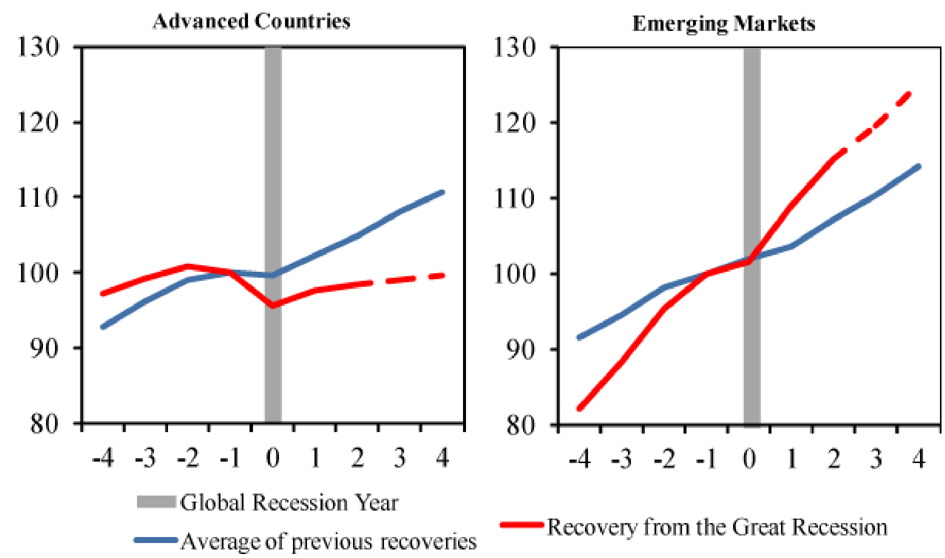
The chart below compares government spending after the past four recessions. 16 quarters after the three previous recessions federal spending was 7-10% higher than it was prior to the start of the recession. Yet, despite the most recent recession being far worse than the three previous episodes, by 2013 federal spending was 7 percent LOWER than it was at the start.



Moreover, the US economy also could not rely on the strength of net exports as most governments in OECD countries around the world were following the US path of fiscal austerity (i.e. fiscal drag). In fact, a recent study by the International Monetary Fund (IMF) examined why the recovery in advanced economies was far weaker than previous ones. IMF economist Kose et al. (2013) writes, “One specific aspect of the current global recovery makes it different from previous ones. Over the course of past recoveries fiscal policies maintained an accommodative stance. In this global recovery, fiscal policy in advanced economies is pushing in the opposite direction.”

The study goes on to show that there was a sharp divergence in the economic recovery between advanced economies and emerging market countries. They show that in advanced economies the recovery in real GDP per capita has been far below the average seen in previous recoveries while the opposite is true for emerging market countries.

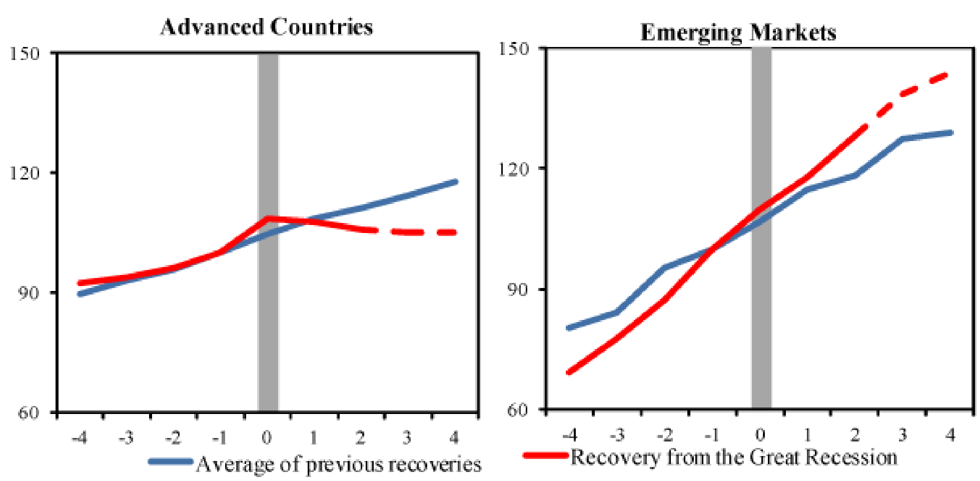
Real GDP per capita: Advanced countries and emerging markets



Source: IMF, Kose et. Al (2013)

While there are many contributing factors to this divergence, the IMF concludes that it is largely explained by the differences in fiscal policy. IMF economist Kose et al. (2013) writes, “The current and projected paths of government expenditures in the advanced economies are quite different than during past recoveries (Figure 3). During the past recoveries, fiscal policy was decisively expansionary, with increases in real primary government expenditures. This time is different. It is true that in some advanced economies, especially in the US, the fiscal stimulus introduced at the outset of the Great Recession was far larger than during earlier recessions. However, the stimulus was unwound early in the ensuing recovery. In contrast, in the emerging market economies the ongoing recovery has been accompanied by a more expansionary fiscal policy stance than during past episodes.”

Real primary expenditure

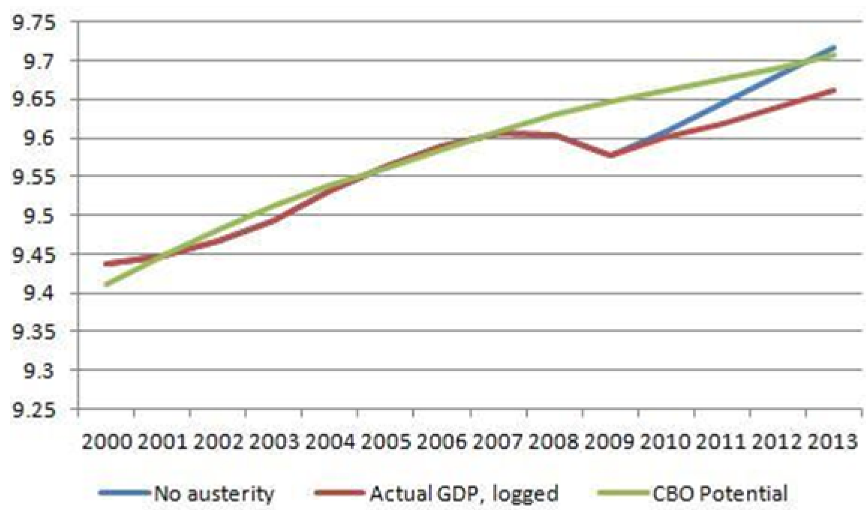


Source: IMF, Kose et al. (2013)

This slow recovery from the Great Recession has led many to question if advance economies, such as the US, have entered into a secular stagnation where economic growth is permanently (or at least for a long time period) constrained by various forces outside of our control.

Simon Wren-Lewis, Professor of economics at Oxford University, tackles this exact question in a recent study. His findings show that the weak economic growth following the Great Recession is a result of contractionary fiscal policy and not secular stagnation. Lewis finds that had real spending on government consumption and investment (G) grown by 2% per year from 2010 – 2013, (which he believes is close to the natural rate. Growth in G was a little above trend in '08 and '09 at 3% compared to an average of 2.3% over the previous decade) US growth would have averaged 3.2% over those four years rather than the actual 2.2% growth. As a result, US GDP would have returned to the pre-recession GDP trend, and above the CBO's newly forecasted potential GDP trend, by 2013.

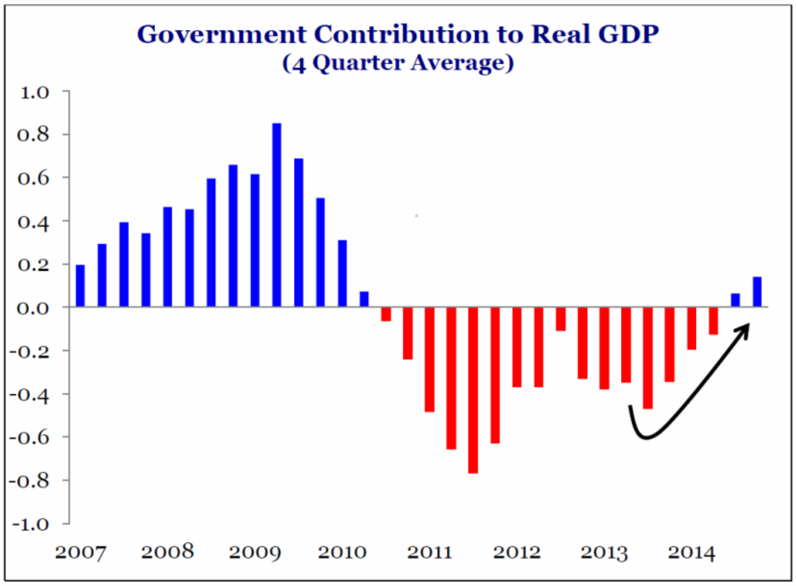
US GDP, logged, compared to a no-austerity counterfactual and potential



Source: Wren-Lewis (2015)

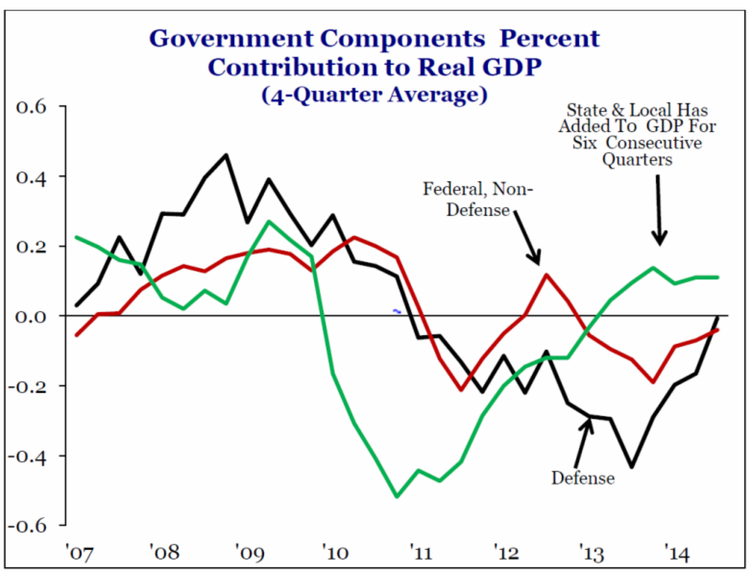
The implications of the Wren-Lewis and IMF studies are that if the post crisis below trend economic growth in advanced countries, like the US, was largely a result of contractionary fiscal policy and not some systemic problem related to secular stagnation, then we can assume that as fiscal policy becomes more accommodative economic growth should accelerate. Further, trend growth in the US should also move higher and even converge with the pre-crises trend. We should also note that if these findings are true then the CBO's new estimate for potential GDP is underestimating the economy's true potential GDP trend.

Fortunately, we can now report that fiscal policy in the US is finally moving from a major fiscal drag to a slight fiscal stimulus.



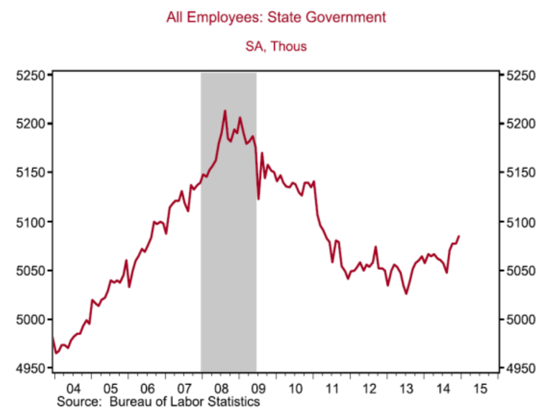
Source: Strategas

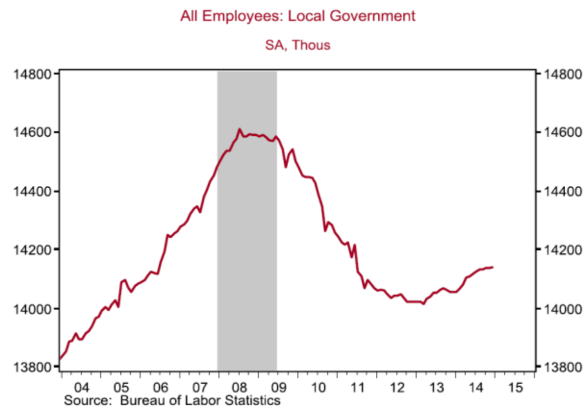
Examining the individual components we can see that state and local government spending is currently the only component adding to GDP (and it has been a positive contribution to GDP for the last 6 quarters). However, the trend clearly shows that both defense and federal non-defense spending are close to joining state and local government spending in positively contributing to GDP growth.



Source: Strategas

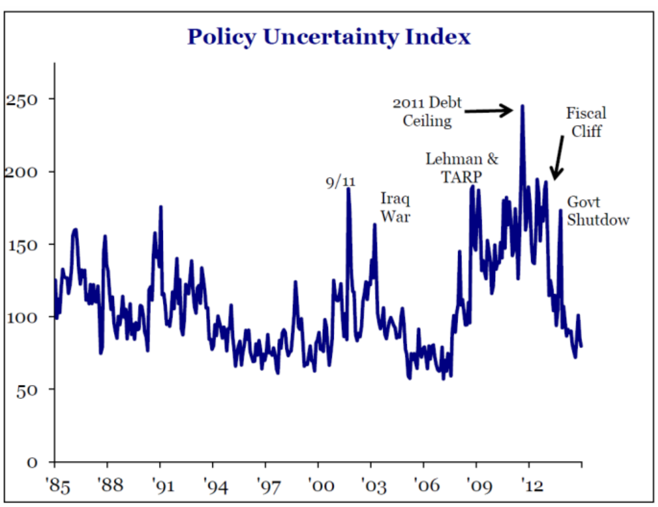
The government has also been a major drag on employment due to unprecedented job cuts at both the federal and state and local levels. However, this trend is gradually starting to reverse and as government begins to actually add to job growth rather than drag it down, unemployment rates will fall and wages will rise.





Policy Uncertainty

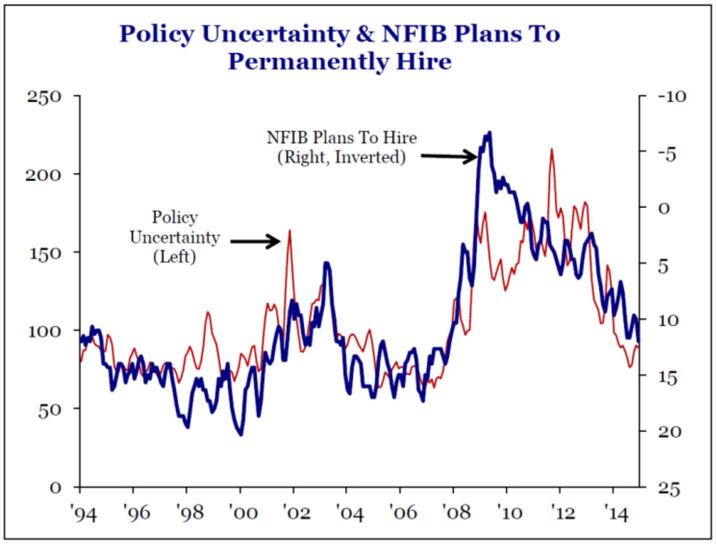
As we stated earlier, policy uncertainty out of Washington also has a major impact on economic growth; however, the impact is not measured directly in GDP as it is with government spending (**G**). Instead, policy uncertainty impacts private sector **C**onsumption and **I**nvestment. The problem is that there is no statistic that can measure a qualitative factor such as policy uncertainty; therefore, the best we can do is estimate its impact by measuring certain indicators. Fortunately, Strategas Research Partners have developed just such a proprietary index that we believe does an excellent job of measuring policy uncertainty.



Source: Strategas

A couple things are clear from the above chart: 1) the level of policy uncertainty witnessed over the past several years was consistently higher than at any point in at least the past 30 years (as far as the data goes back) and 2) policy uncertainty has recently declined significantly.

More importantly, we believe that policy uncertainty will continue to remain low in 2015 and will serve as a major stimulus to the economy. To illustrate just how large an impact policy uncertainty can have on the private sector, we overlay the Policy Uncertainty Index with the National Federation of Independent Business (NFIB) Plans to Permanently Hire Index in the chart below.



Source: Strategas

Conclusion

The combination of significantly lower political uncertainty and government spending turning from a drag to a stimulus will create a powerful tailwind for the US economy in 2015. Barring a widespread recession outside of the US dragging down exports, the US economy should accelerate in 2015 as fiscal policy becomes more accommodative and US consumption benefits from falling inflation.

Economic Outlook

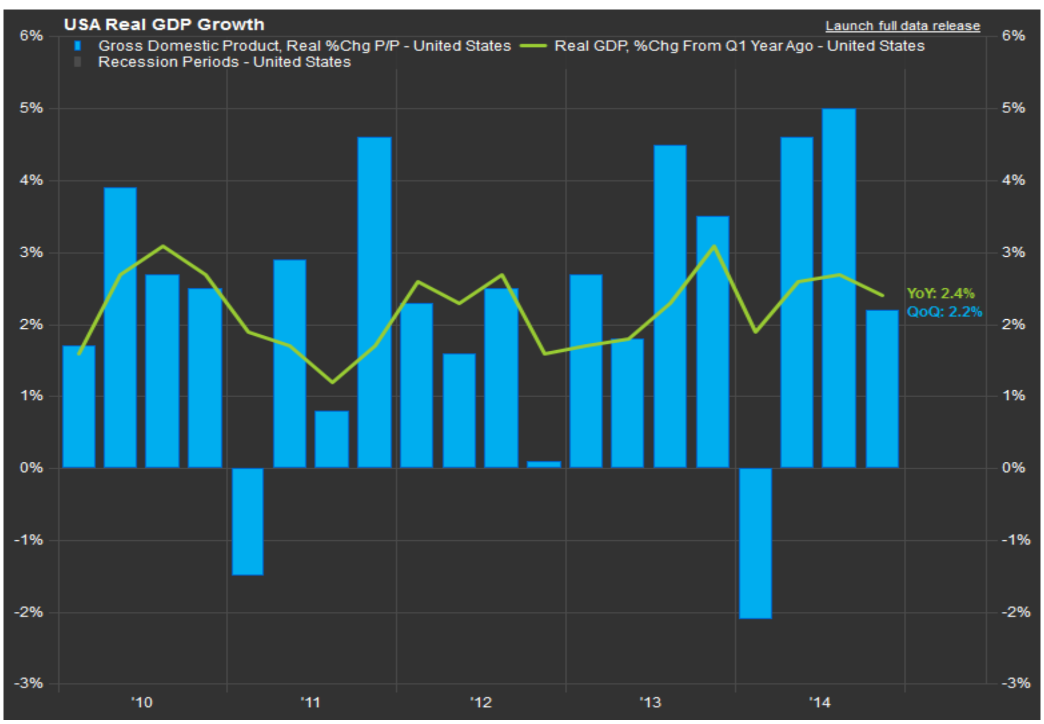
By Adam Rogers

Fourth quarter GDP has been revised to 2.2%. The overall deceleration in real GDP growth mostly reflects an upturn in imports, a downturn in federal government spending, and decelerating nonresidential fixed investment and exports. The net export line is the biggest drag with the trade-weighted dollar at a level not seen since 2003, making US goods more expensive overseas and overseas goods cheaper here. The softer than expected print has created some uncertainty among forecasters regarding the underlying momentum in the economy.

But the bigger story for the fourth quarter and 2015 is the US consumer. Real consumer spending in Q4 increased 4.3% quarter-over-quarter (q/q), the fastest since 2006, contributing 2.8% to overall GDP growth. Until this point consumer spending has not been the major driver of growth, averaging just 2.2% since 2010.

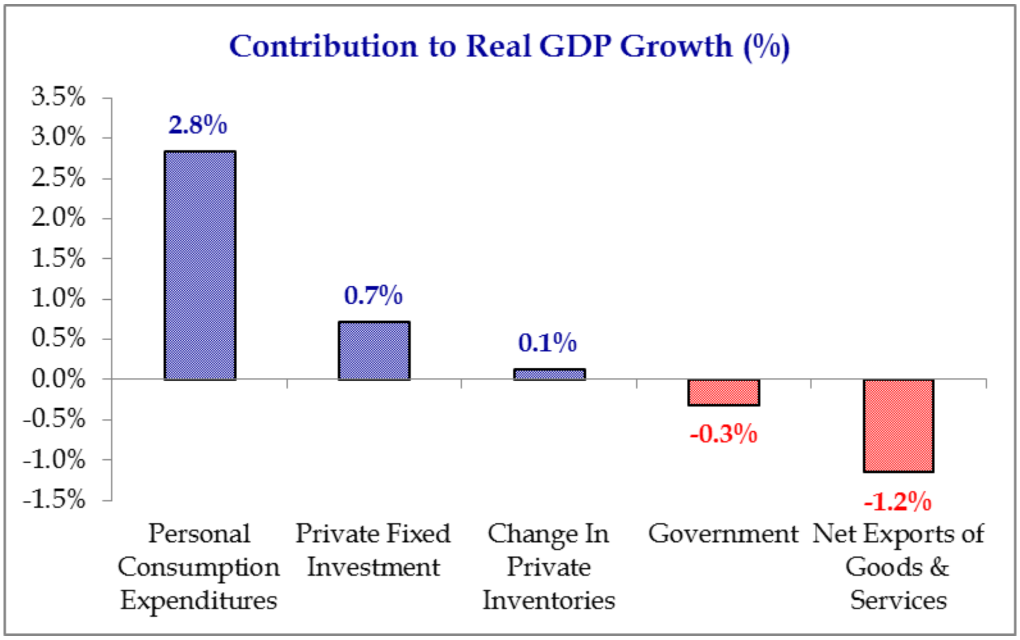
So we wonder if we are seeing a real sustainable shift in consumer behavior that will drive the economy in the way capital expenditures have since 2010. Or is this recent data merely a temporary anomaly? There are many tailwinds that suggest the possibility that this shift has more room to play out: lower oil prices, a stronger dollar, low interest rates, healthier consumer balance sheets, and most importantly the beginning stages of wage gains, which have been woefully absent. Because the consumer is such a large piece of the American economy (70%), the healthy backdrop is encouraging for the near term. On the following pages we will focus mostly on consumption, and what factors may be compelling it to switch gears.

Chart 1: US GDP Growth



Source: Factset

Chart 2: GDP Components



Source: Strategas

Employment

First, consumer health begins with jobs and the US labor market took a big step forward in January, capping the best three-month jobs gain in 17 years while delivering the largest wage increase since 2008. Average hourly earnings jumped 0.5% from December, the most since November 2008 and were up 2.2% over the previous year. Payroll gains averaged 336,000 over the fourth quarter with retailers, construction firms and health care doing the bulk of the hiring. Despite these gains the unemployment rate managed to rise from 5.6% to 5.7% as more than a million Americans re-entered the labor force looking for work.

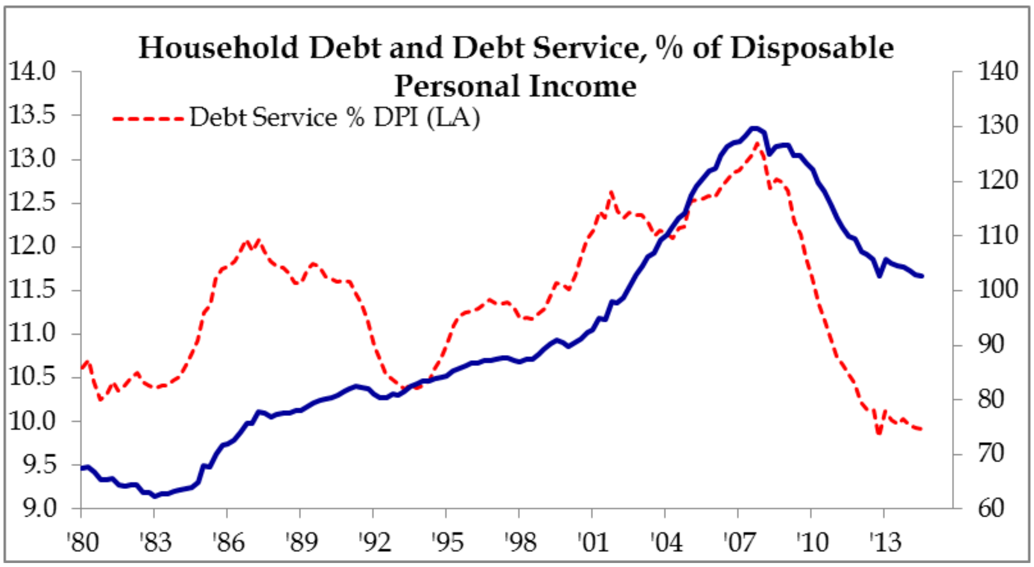
Chart 3: US Unemployment Rate

Source: Strategas

Consumer Credit

Second on the list is consumer debt. The NY Fed's *Household Debt and Credit Report* claims consumer debt increased at a $195 billion q/q annual rate in Q4, well below the average debt growth rate of $1,062 billion we saw in 2003-2007. Consumers in the current cycle are borrowing cautiously, saving more, and are sensitive to the cost of credit. Broad based deleveraging by consumers is a major headwind for the economy and left alone leads to a painful deflationary cycle. The Fed of course has fought these deflationary forces with QE, providing a countering inflationary force. At this point, the headwind from consumer deleveraging is waning and we are left with a consumer class with much healthier personal balance sheets.

Chart 4: Consumer Debt



Source: Strategas

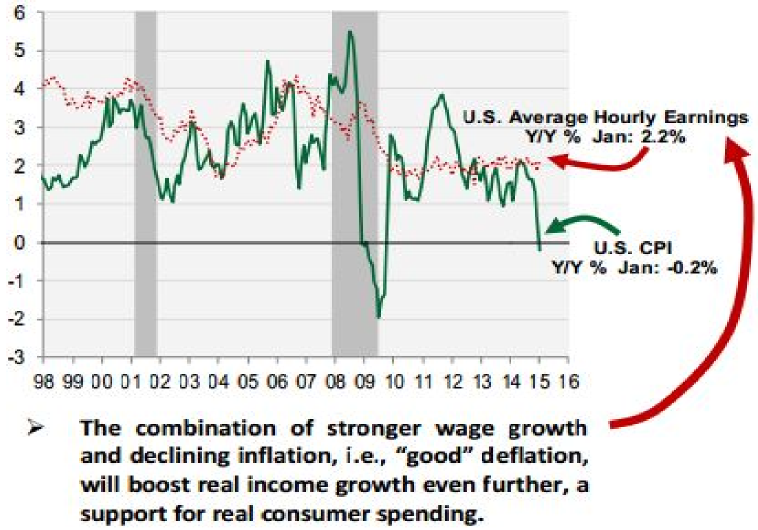
Good Deflation

A third tailwind for consumers is the concept of "good deflation". This is a phrase rarely used because deflation is typically the result of the end of a credit cycle when everyone deleverages and wages and prices decline in a vicious circle - not a good thing. Right now something different is going on. The CPI is declining, but wage inflation is at the very least flat and poised to accelerate. So the declining CPI is not the result of slowing wage growth.

Specifically, headline CPI in January declined 0.7% m/m, and turned negative y/y – falling 0.2%. Factors that may constrain CPI going forward include: a rising dollar, weaker EM growth, US energy production and restrained consumer debt.

On the wages side, average hourly earnings are rebounding, the US Employment Cost Index suggests higher wages, and the NFIB US Small Business Optimism Index, which leads hourly earnings by about a year and has been consistently increasing. So our best guess for the near term is flat-to-higher wages and lower consumer prices – a good deflation that boosts real income growth for consumers.

Chart 5: Hourly Earning vs CPI

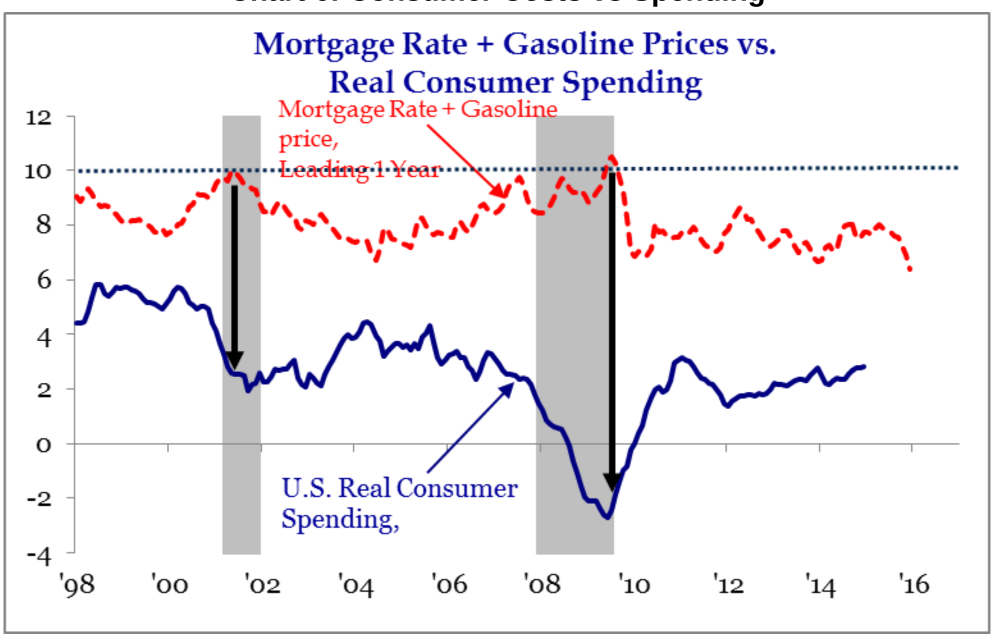


Source: Cornerstone Macro

Gas Prices and Mortgage Rates

Finally we zero in on two of the biggest factors that determine consumer behavior: interest rates and oil prices. In the following chart you can see how the sum of mortgage rates and gas prices provides us with a mirror image of spending.

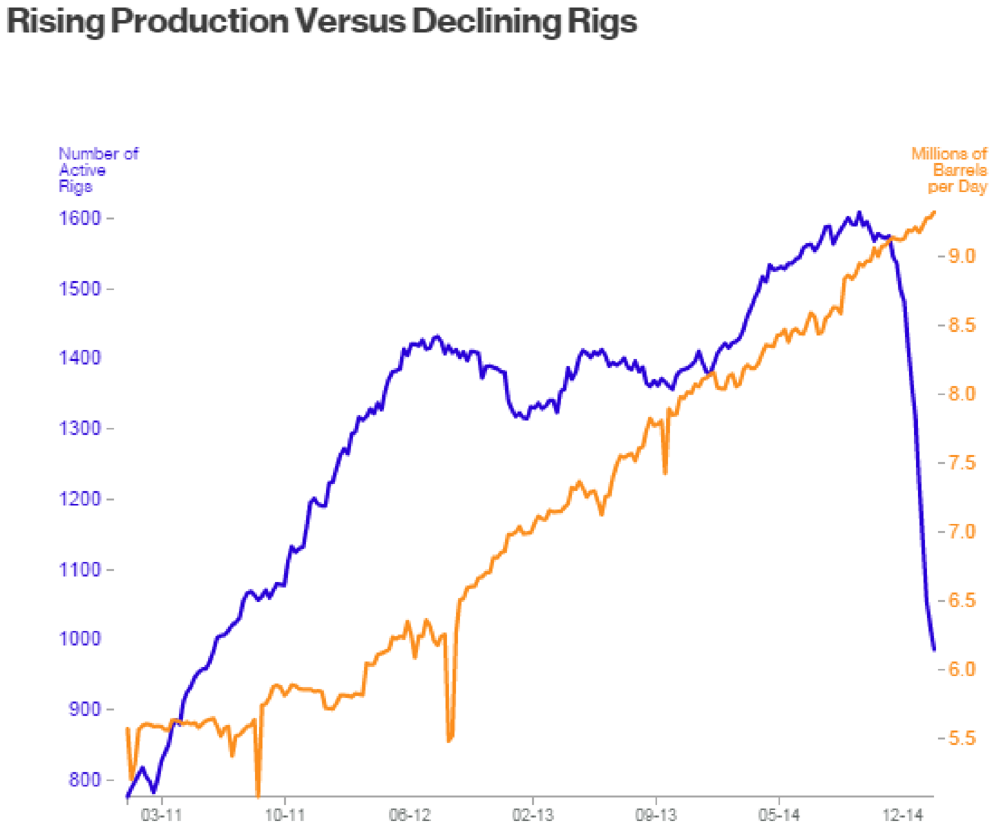
Chart 6: Consumer Costs vs Spending



Source: Strategas

Very few forecasters predicted the March 4th headline, *"US Running out of Room to Store Oil."* Of course oil is susceptible to wild swings and there are plenty of geopolitical scenarios we could think of that would send prices at the pump right back up. But right now, even in the face of declining rig counts, US oil production continues to climb, putting pressure on prices.

Chart 7: US Oil Production vs Rig Counts

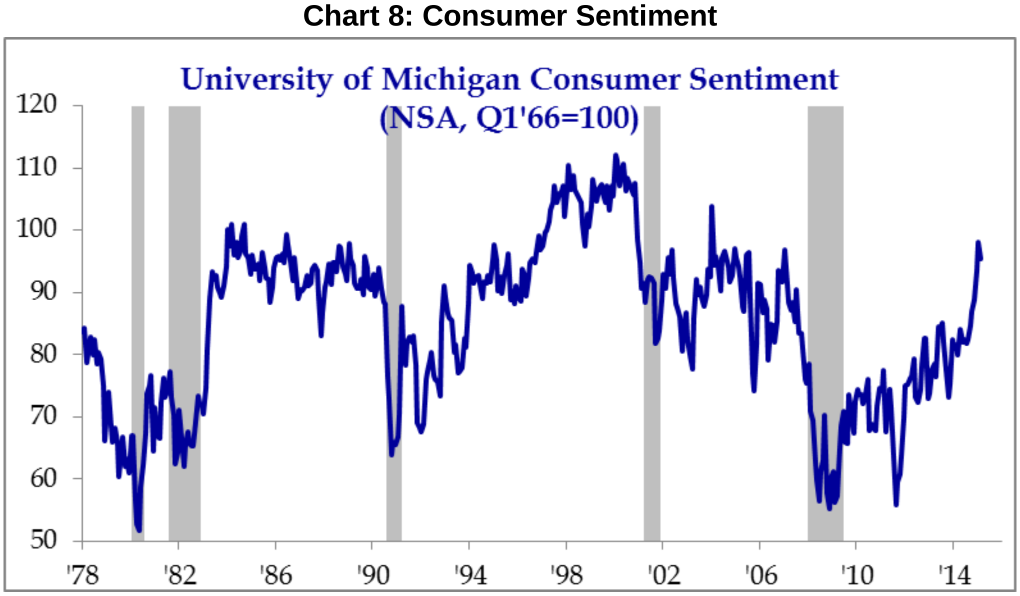


Source: Bloomberg, EIA, Baker Hughes

Sentiment and Outlook

When you add up the effects of lower oil prices, low interest rates, job gains, wage gains and a strong dollar, it's no surprise that consumer confidence reached an 11 year high in January.

Chart 8: Consumer Sentiment

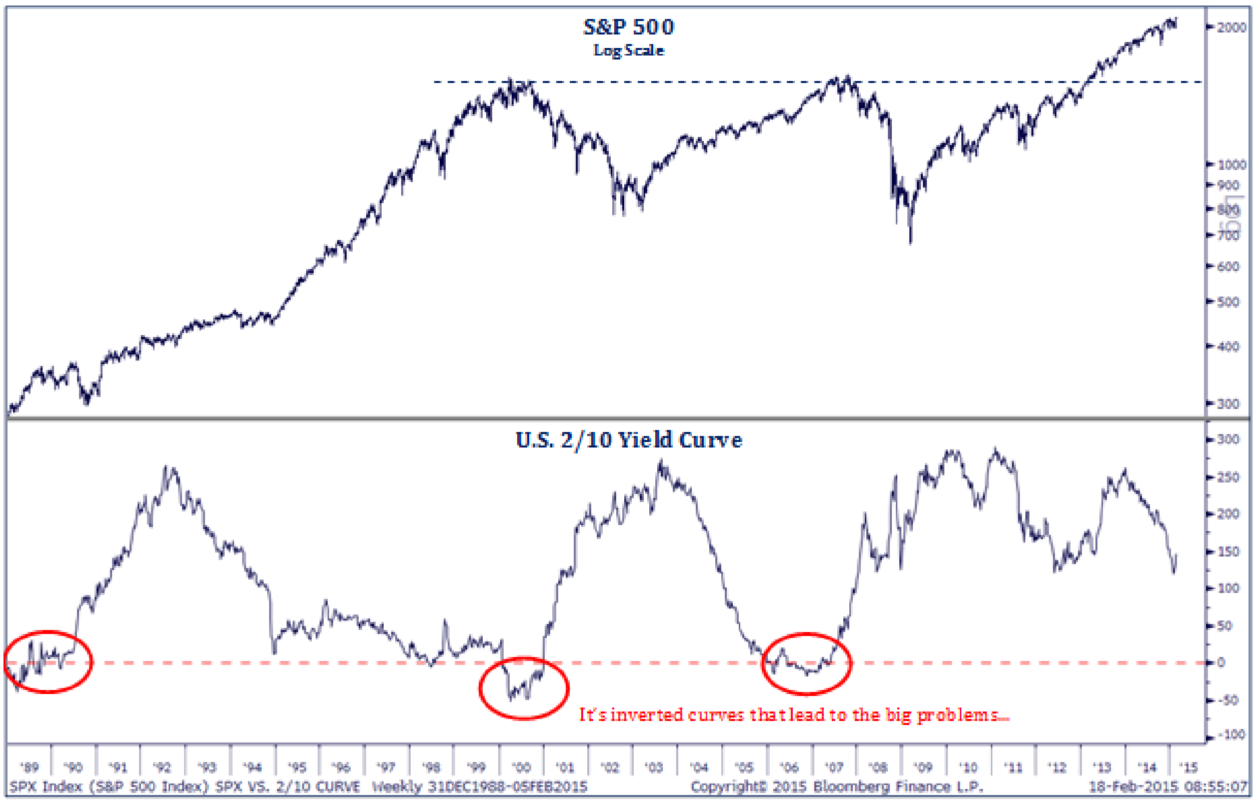


Source: Stragegas

This is an economy that is starting to run out of things to "recover" but has proven that it can remain at full speed for quite some time. We also know that once full employment is attained and rates eventually rise along with inflation expectations we are at the very least past the midpoint of a cycle. We've already noticed the yield curve begin to flatten. This can go on for years of course but we will be watching this to identify potential danger.

Chart 9: Yield Curve Inversions

FLATTER CURVE, BUT INVERSION STILL FAR AWAY



Source: Strategas

Interest Rates and Fixed Income Strategy

By Nick Prillaman

At our last meeting, the stock market had delivered strong returns for November on the back of good corporate earnings and better economic data. Crude oil was in the midst of its trend lower and ultimately fell more after OPEC maintained its output. Treasuries were acting in a benign fashion as low inflation expectations kept yields in check.

The month of December was a volatile one as risk aversion characterized the initial part while risk taking took over in the back-half. Early on, the S&P 500 swooned 5% as the decline in crude oil prices weighed heavily on oil-related securities. This caused longer-dated Treasuries to rally with higher prices as investors fled to less-risky assets. These trends changed in the second part of the month as the stock market recovered and safe-haven assets sold off to reflect a more positive tone. CreditSights said a key factor in the rebound in risk appetite was the “increased certainty…regarding the monetary policy outlook.” At a press conference on December 17th following the Federal Reserve’s 2-day meeting, Chairwoman Yellen said, “The statement that the committee can be patient should be interpreted as meaning that it is unlikely to begin the normalization process for at least the next couple meetings.” To further clarify the Fed’s view, Yellen “described what economic conditions the Fed is looking for in deciding whether to begin raising interest rates for the first time since 2006,” according to Bloomberg News. Besides these comments, strong GDP data provided an additional boost to the market. The Commerce Department said second quarter GDP grew at an annual rate of 5% which Bloomberg News said was the biggest advance since the third quarter of 2003. This environment produced higher rates for a variety of Treasury securities. The 5-year Treasury was at 1.43% in the middle part of the month and closed at 1.65% on December 31st while the 10-year Treasury moved 16 bps higher over that time period. While volatility was experienced for different maturities, the Treasury curve flattened fairly consistently over the month.

From the perspective of spread products, government-related securities performed well while company bonds proved to be generally lackluster. The mortgage index experienced spread tightening for the month of December as the spread over the 5-year Treasury went from 134 to 117 basis points (bps). The Credit Suisse 3-5 Year Agency Index also performed well as the spread went from 18.8 bps to 11.3 bps. For the corporate bond market, December was a challenge as high grade bond spreads widened by 9 bps and posted a -.14% total return. The principal driver of this weakness was the energy sector where crude oil fell $13 for the month. CreditSights said it alone accounted for 5.5 bps of the 9 bp widening as energy comprised a 14% weighting in the high grade index. The high yield market was even worse than the high grade segment, posting a -1.47% total return with 37 bps in spread widening. CCC-rated credits had the hardest time with a -3.23% total return.

Speculative markets turned conservative in January after their run-up in late December. A number of factors contributed to a choppy and lateral stock market performance combined with a very bullish interest rate environment. First, oil prices continued their precipitous drop and did not stop until the price hit $43. This move, again, put downward pressure on various energy names. Second, the Swiss National Bank(SNB) ended the Swiss franc's peg to the Euro which was largely unexpected. It rattled a number of parts in the investment landscape and helped produce a flight-to-quality trade in Treasuries. Besides these two risk-off occurrences, the announcement by the ECB to expand their stimulus was a net-positive factor that affected the markets. The ECB's measures were taken as being bullish by market participants. With all of these crosscurrents in the market, Treasuries put in a stellar performance for the month. The 30-year rallied from 2.75% to 2.22% while the 5-year went from 1.65% to 1.15%. The 2s-10s curve flattened from 1.44% to 1.19% as the front end could not keep pace with their longer duration counterparts.

The Credit Suisse 3-5 Year Agency Index was flat for the month with an overall spread of 11.6 bps. This was impressive given the Treasury move. The mortgage market underperformed both Treasuries and agencies during this time. From a spread perspective, the mortgage index versus the 5-year Treasury widened from 1.14% to 1.27%. The negative convexity profile of mortgage-backed securities was clearly felt in this large Treasury rally. With regards to other spread products, corporate bonds lagged their risk-free companions as high grade spreads widened 8 bps to 153 bps. The Utilities and REITs sectors were the best performers as investors demanded yield over growth according to Bank of America. The two weakest sectors were Oil and Gas and Metals and Mining. Their excess returns were -194 bps and -279 bps. Despite less-than-favorable market conditions, investment grade corporates issued $85.5 billion in USD fixed-rate bonds, which was slightly below last year's level per CreditSights. The high yield segment of the market did achieve a positive total return of .69% for January, but this was in stark contrast to the 2.88% return for Treasuries and the 2.74% return for high grade corporates.

February was a reversal from the previous month as sentiment turned from risk aversion to optimism. It was driven in part by the strong ADP employment number which showed the U.S. adding 213,000 jobs in January. Bank of America said it "showed that economic growth can continue to be very robust despite global weakness." Also, the bloodbath in crude oil finally abated and prices were actually stable for the month. Treasury securities performed poorly in this environment as investor shed riskless assets and added securities with greater upside. The 10-year Treasury went from 1.65% to 1.99% while the 2-year Treasury yield rose from 45 bps to 61 bps. The 2s/10s curve steepened from 1.20% to 1.37%.

The beneficiaries of this optimism in the fixed income markets were spread-dependent securities. The Credit Suisse 3-5 Year Agency Index saw spreads compress from 14 bps to 8 bps while the mortgage index tightened by only 2 bps versus the 5-year Treasury. Corporate bonds posted strong relative performance. High grade bonds tallied an excess return of 115 bps with spreads coming in by 16 bps. The clear winners among the sectors were those that had been pummeled in the previous few months. Metals and Mining credit spreads tightened by 339 bps while Oil and Gas spreads fell by 285 bps. With credit risk falling and interest rates going up, high yield bonds had a great relative month. Their monthly total return was 2.33% versus -.87% for high grade and -1.75% for Treasuries according to Bank of America.

RSA conducted a number of trades over their recent time horizon to take advantage of opportunities in the market. In the Treasury space, we sold our 2015 maturities that yielded .14% and .12%. These yields were so low that it seemed prudent to rid ourselves of them. This trade also reduced our weighting in Treasuries while lengthening the duration of the portfolio. The outlook for this asset class appears lackluster as the potential for interest rate hikes in the back half of the year by the Federal Reserve could dampen the total return for Treasuries. The front end of the curve looks to be moving higher in yield as seen in this chart of the 2-year Treasury.

Source:Bloomberg

For the long end of the curve, the 30-year Treasury seems to be at the lower end of its typical range, so one could easily see an upward technical reaction as deflation fears dissipate. The long term trend is still down, so investors should be cognizant of that before getting overwhelmingly bearish.

Source:Bloomberg

A variety of portfolio enhancing trades were completed in the agency segment in the last few months. For example, we sold a short security at 23 bps and purchased an 8-year callable note yielding 2.565%. This helped lengthen the duration of the agency portfolio which had become shorter than we wanted. Another trade was swapping a June 2020 bond with a yield of 1.64% for a November 2019 security yielding 1.73%. We were able to monetize a large gain, add liquidity, and pick up yield with a shorter maturity. Our view going forward in this space is mixed. Non-callable agencies are trading at an extremely tight level of 6 bps for the Credit Suisse 3-5 Year Agency Index. Clearly, the upside is limited here. On the other hand, callable agencies offer decently higher spreads to Treasuries, so this structure would be the most attractive opportunity within this segment.

On the mortgage front, we purchased multiple 30-year securities that consisted primarily of 3.0% coupons while also adding a 3.5% coupon. These were completed to reinvest prepayments and to add money to the sector. One of the trades was funded by the proceeds from a called agency security as a relative value play. The low coupon securities we purchased offered a fair amount of duration to help increase yield in this low interest rate environment. Our perspective, currently, on MBS is positive versus other government-related bonds. A spread of 70 bps over the 10-year Treasury is fairly attractive while prepayments should be lower than other previous low rate periods due to a burnout in refinancing.

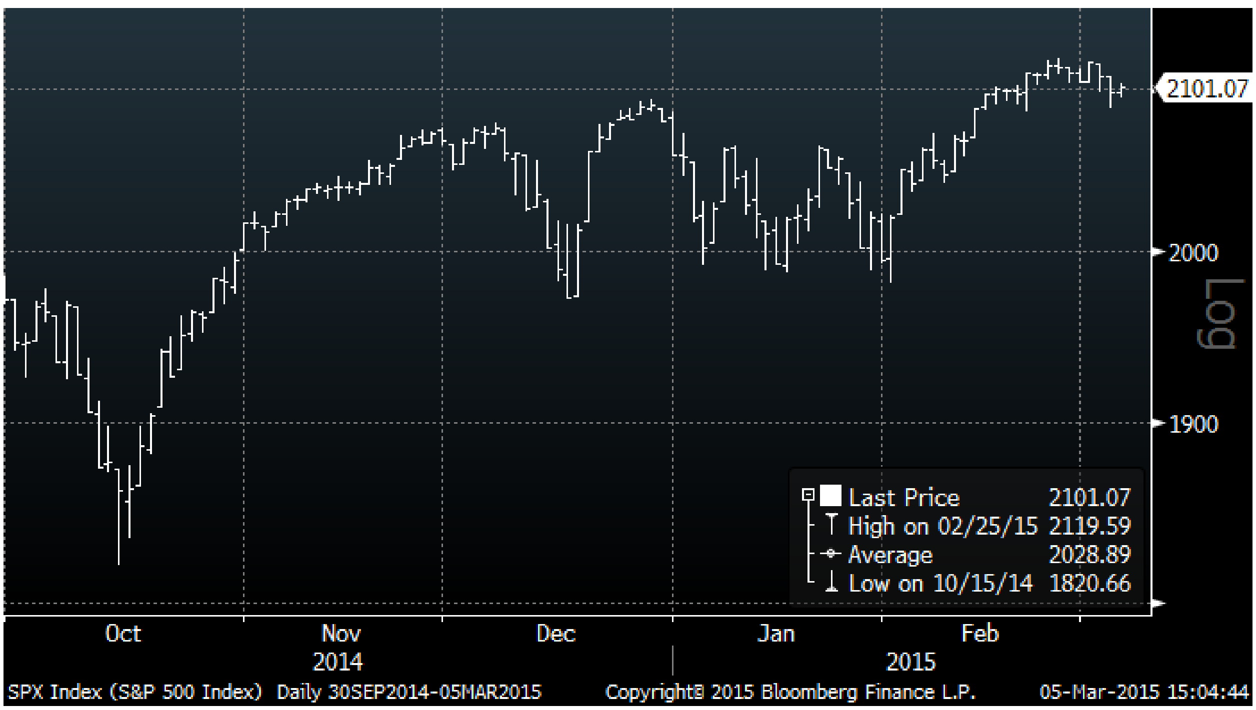
Activity in the corporate bond portfolio was decent as we participated in a number of new issue deals. For example, we purchased a portion of Bank of America’s new 10-year subordinated debt which came at a 25 bp concession to their outstanding sub debt. Another one was Actavis’ new issuance where we bought the 5-year and the 20-year maturities. The company issued bonds to help fund its acquisition of Allergan. We also had activity in the secondary market where we added to our existing British Petroleum (BP) position to take advantage of the drop in oil prices. The corporate bond market continues to be the best place to invest in fixed income. Option-adjusted spreads in high grade and high yield corporates were sitting at 127 bps and 479 bps at the end of February according to Wells Fargo. Over time, these spreads should help corporates outperform. The areas of value seem to be in the metals and mining and oil-related sectors excluding the refiners. While these sectors saw excellent spread tightening in February, their option-adjusted spreads are still among the widest in investment grade corporates. If commodities can stabilize, a number of names in these sectors could perform well.

Domestic Equity Strategy

By Kevin Gamble

What is interesting is that I wrote this equity strategy piece exactly a year ago and the general setup is very much the same as it was a year ago (except for the fact the S&P 500 is now at 2100 versus close to 1900). 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 2015, the domestic equity market has largely been consolidating its gains calendar year-to-date with the SPX slightly positive on the year (up 2.4% calendar year-to-date). Volatility continues to remain subdued beneath the 15 level on the VIX indicating we are certainly not in a fearful equity market environment, but rather a steady-as-she-goes environment.

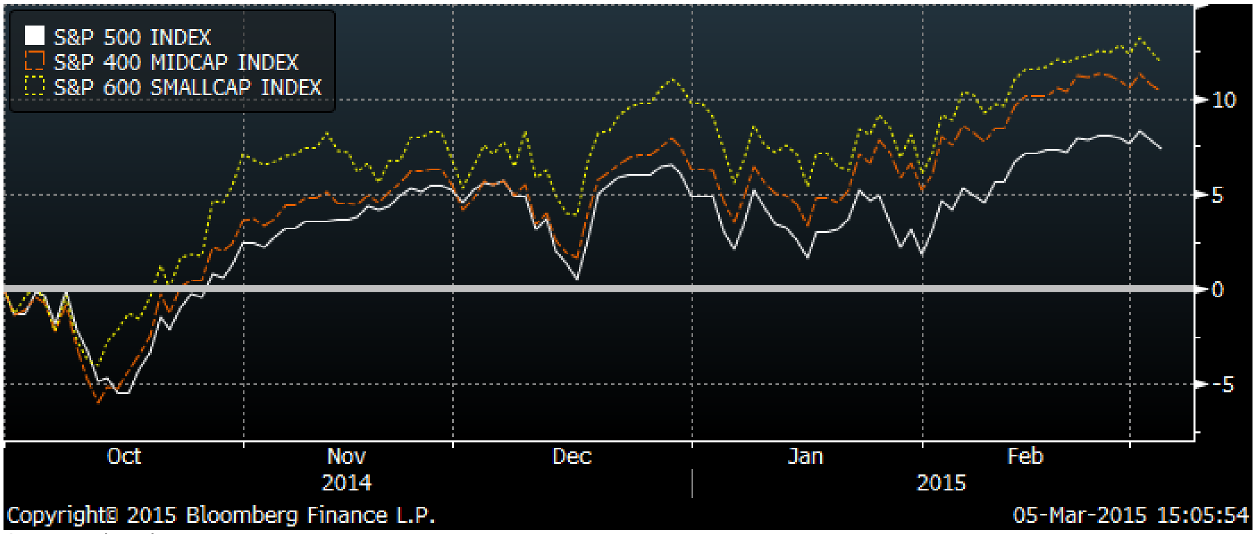
Exhibit 1: S&P 500 Fiscal Year-To-Date



Source: Bloomberg

After underperforming substantially last fiscal year, the smaller market capitalization stocks have staged a slight performance comeback with the S&P 600 up 11.8% fiscal year-to-date versus the larger cap S&P 500 which is up just a little over 7%. The S&P 400 midcap index performance has fallen in the middle with a slightly north of 10% return fiscal year-to-date.

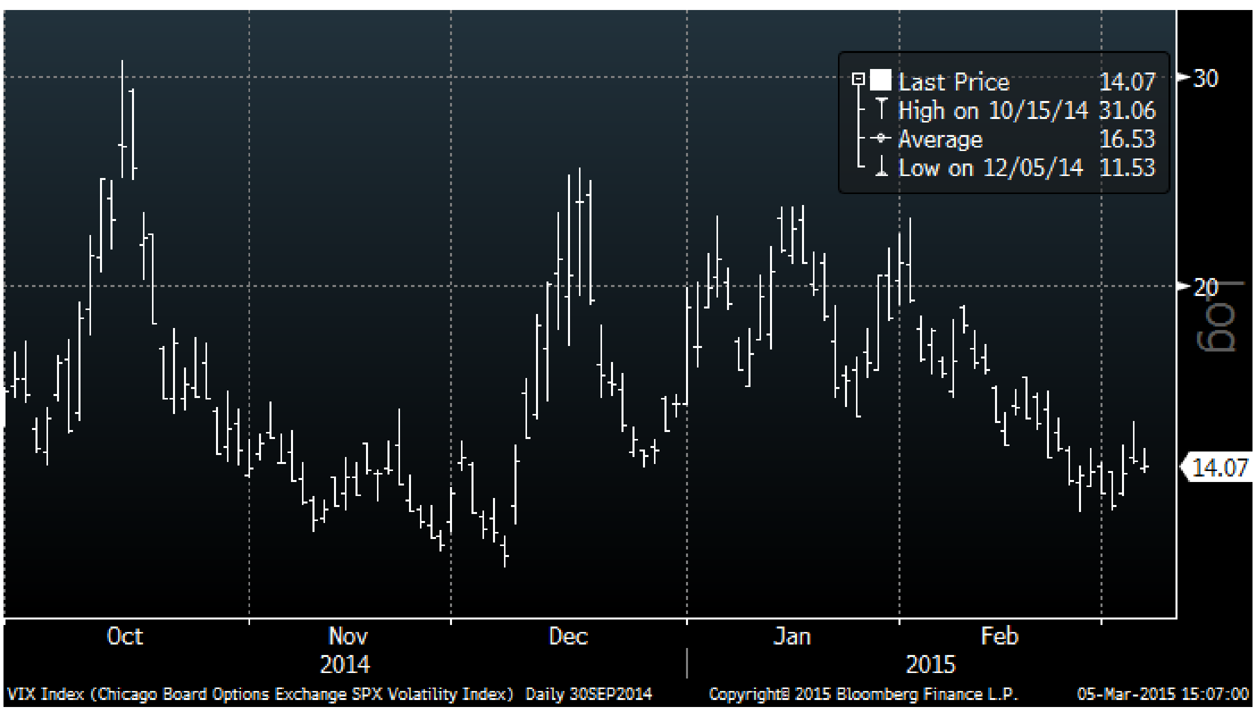
Exhibit 2: Fiscal Year-to-Date Performance Comparison of S&P 500, 400, 600



Source: Bloomberg

All in all, we are certainly encouraged and pleased by the way the fiscal year has started on the equity side of the ledger.

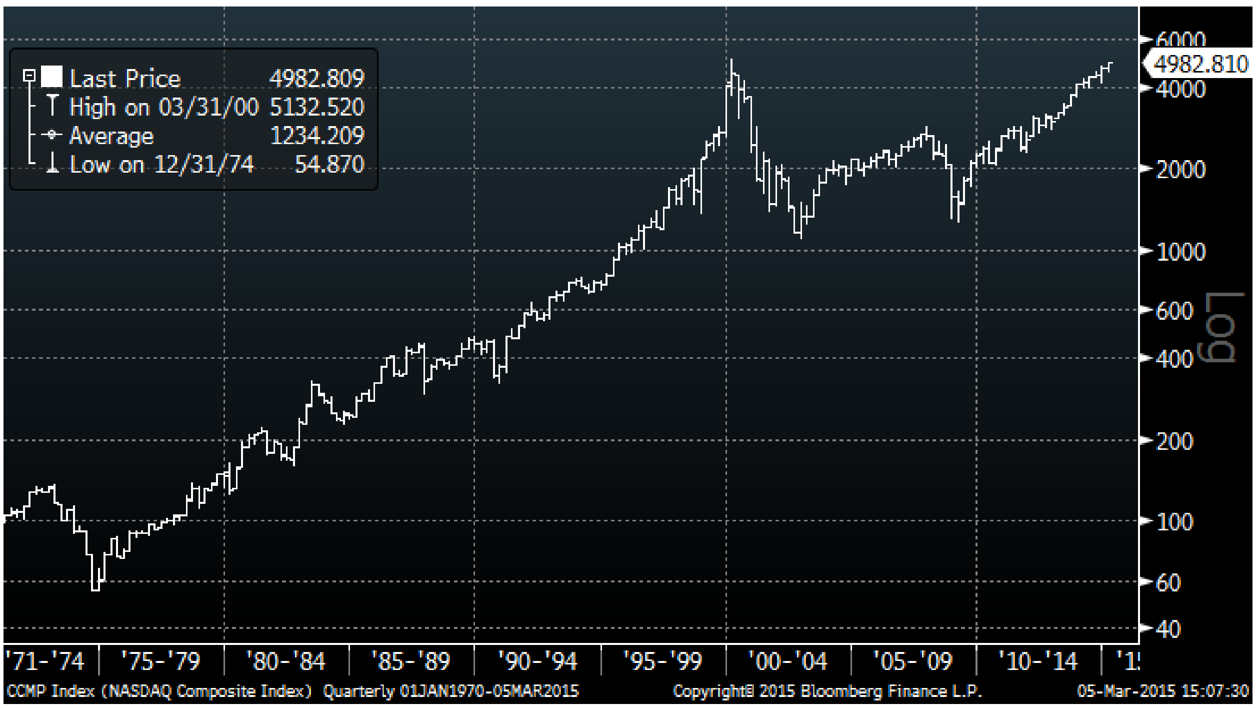
Exhibit 3: VIX Index Fiscal Year-to-Date



Source: Bloomberg

On March 2nd the NASDAQ actually closed above the 5000 mark for the first time since the collapse of the technology bubble which ended the technology bull market in 2000. Valuations are obviously much more attractive today on the technology sector as a whole as the underlying businesses have grown into this valuation level and we continue to like the technology space for investment moving forward as we detailed in our equity strategy piece exactly a year ago. CNBC recently interviewed the former CEO of Pets.com which was a little bit of a posterchild for this era and she rightly said companies at the time were being valued on "promise and not predictability." Definitely a different environment today in which technology companies are some of the most attractively valued stocks with great balance sheets and high returns on capital and strong profit margins. We just have a very different setup all around versus 15 years ago.

Exhibit 4: Chart of the NASDAQ



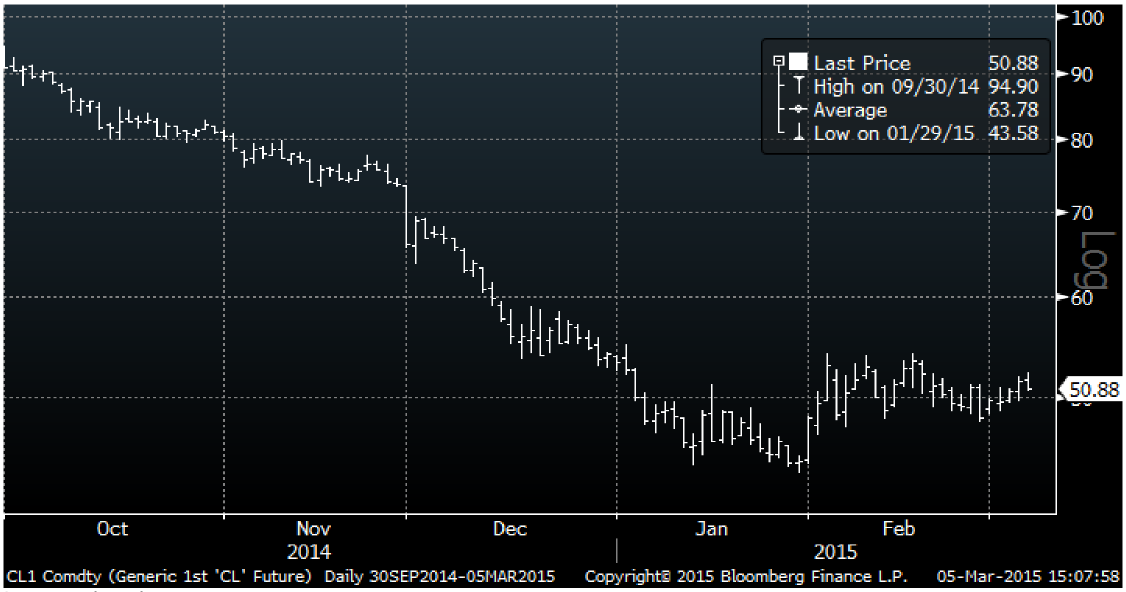
Source: Bloomberg

Relief at the Pump

Without a doubt, the financial market development which has been the most interesting fiscal year-to-date has been the collapse of the global oil price. As we entered the current fiscal year, the price of a barrel of oil stood at north of $90. This has been roughly cut in half since then and we are not even halfway through the year! The price of WTI oil today is around $50 barrel and gasoline now stands at close to $2/gallon in many parts of the United States.

While this development has not been a positive for the energy sector as a whole, it certainly has a positive offset for an economy which is approximately 70% driven by consumption!

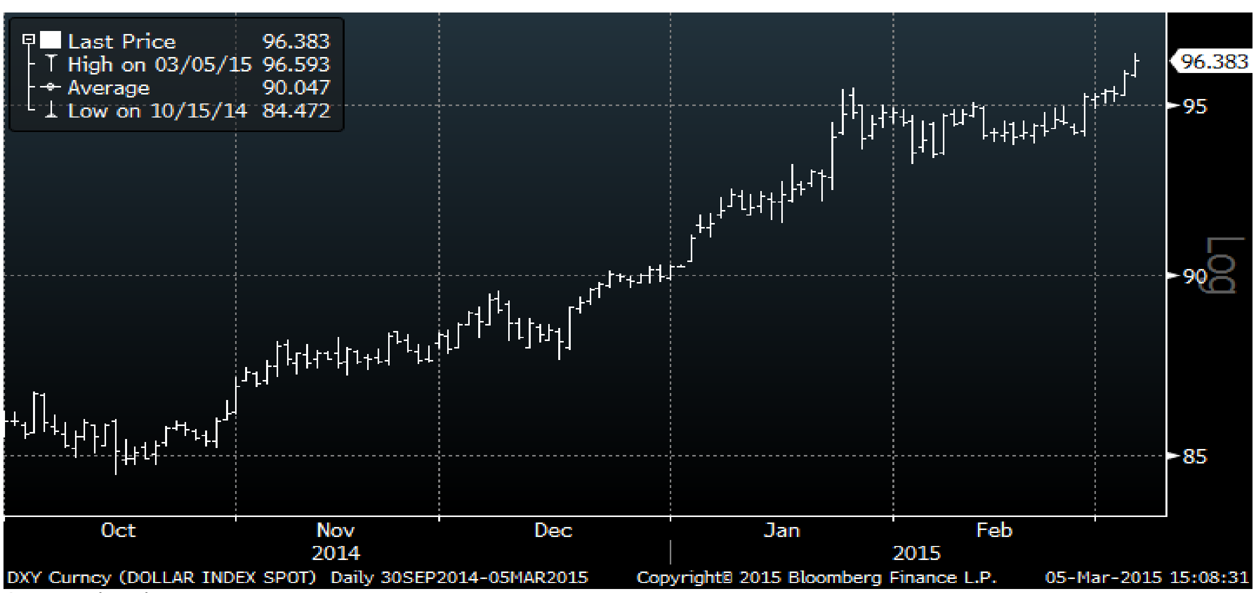
Exhibit 5: Price of WTI Oil Fiscal Year-to-Date



Source: Bloomberg

The reason for the fall in price is largely supply/demand driven as global supply continues to move higher given the fracking technology innovations while demand remains constrained due to weak global economies and improving fuel efficiency in many machines and cars which utilize oil/gas. The fact the U.S. dollar has rallied substantially has also pressured the price given commodities are priced in U.S. dollars.

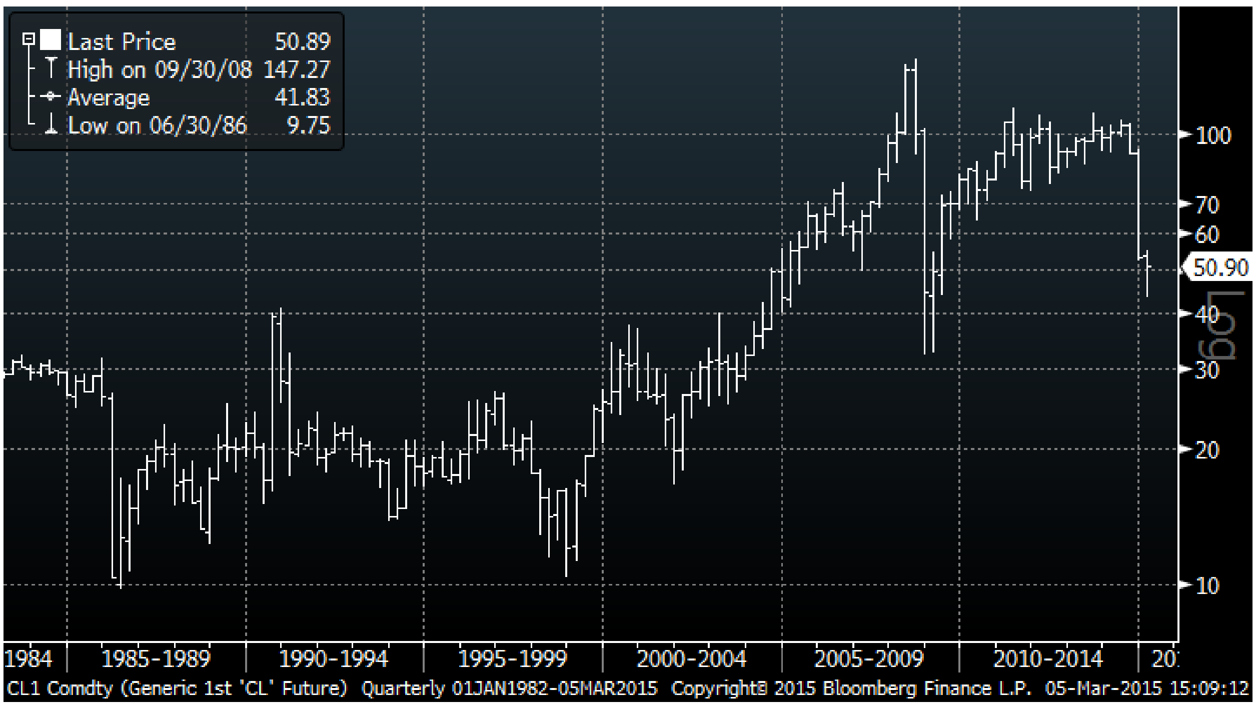
Exhibit 6: U.S. Dollar Fiscal Year-to-Date



Source: Bloomberg

While the rising U.S. dollar has pressured the oil price, it also has its other effects. With 40% of the operating profits of the S&P 500 coming from outside the United States, this has put pressure on the profits of many large, multinationals based on the translation effect on earnings. Offsetting this negative effect are the positive global flows to U.S. based assets by global investors who now receive a positive currency return on their investments. This makes U.S. based investing look much better relative to international equity investing for those who do not hedge their currency exposure as many don't, including us. Given the fact the U.S. quantitative easing is nearing its end for the time being at least and quantitative easing is just beginning in other areas of the world such as Europe, it is not completely surprising that the U.S. dollar is rallying on a relative basis to a basket of other foreign currencies.

Exhibit 7: A Look at the Price of a Barrel of Oil Over Time



Source: Bloomberg

The last time we had a similar correction in the oil price during which we were not in a recession was the correction in the 1998.

Equity Strategy Moving Forward

We continue to believe we will likely see more of the same in the equity markets as we move forward for the remainder of the year. We expect the equity markets will back and fill in a generally positive direction. We expect the Federal Reserve to continue to monitor financial market conditions and to be very measured with any change in policy stance. We expect companies to continue to invest in their shares, authorize slight dividend increases, as well as continue to look for strategic M&A in which to grow in a fairly low growth environment. We expect companies to continue to invest in automation and things which allow them to preserve their relatively high margin structures they currently enjoy. We see earnings growth as relatively modest moving forward, especially given the reduction in earnings expectations for the energy sector as a whole. We expect to see larger cap companies close the performance gap with smaller cap performance as we move through the remainder of the year given higher dividend yields and more attractive valuations with a little more room for multiple expansions in a low earnings growth environment. We continue to expect selective consumer companies to benefit from the lower gasoline prices consumers are now enjoying. We continue to expect oil companies to cut back on their capital expenditure plans given the steep decline in oil prices.

While these are our expectations, clearly there are risks and none of us know exactly what the future holds. We don't need to look any further than Prime Minister Netanyahu's recent speech to Congress, interestingly without President Obama's knowledge or approval, in which he said "the marriage of militant Islam with nuclear weapons is the greatest threat to the world." Clearly we are not operating in a world without risk and potential black swans.

We did execute two equity linked notes of $250 million apiece with Morgan Stanley during the quarter which provides us with some slight downside protection (2% protection in drawdown scenario) in exchange for giving up gains beyond 9% between now and the end of the fiscal year. As part of the note agreement, we get 2x levered returns in the 0%-9% range adding additional return should we continue in the slow grind higher which we expect.

We also launched a new equity fund (Largecap Policy Fund) designed to capture the positive alpha correlation between those companies which spend heavily on lobbying efforts in Washington D.C. and the historical positive implications for stock prices. We are fortunately able to take advantage of public lobbying data that has been back tested to have outperformed the general equity market for the last 16 years. In general, the thesis behind the fund is that companies tend to spend more money to protect important strategic advantages such as Amazon protecting Internet sales tax privileges or pharma companies protecting patents and these investments have proven to pay off over time. They tend to spend this increased amount of money at strategically important times and the money has proven to have a high return as measured in stock price performance moving forward.

Exhibit 8: 10 Reasons to Stay Long the S&P 500 According to BofA/Merrill Lynch Strategist

1) Sentiment is far from euphoric Wall Street sentiment is at bearish extremes, with strategists recommending just a 52% stock allocation. When strategists have been as or more bearish in the past, the S&P 500 has gone up over the next 12 months 98% of the time, with average returns of 27%.

2) Fund managers are close to 5% cash
BofA/ML latest Global Fund Manager Survey suggests cash balances remain high at 4.7%, still in "buy" territory and represent money waiting to be put to use.

3) The Great Rotation hasn't happened yet
Since 2009, equities have seen less than $500 billion in inflows, compared to over $900 billion for bonds. The Great Rotation out of bonds into stocks has more to go.

4) S&P is 60% less levered than at prior market peaks
The S&P 500 has cut its leverage ratio to just above a third of its '00 and '07 levels.

5) US corporates are awash in cash
Unlike the US government or consumer, US corporates have delevered and are flush with cash.

6) Best income growth story around
Nearly half of the S&P 500 pays a dividend yield above the 10-year Treasury yield, close to its 3-decade high, and the S&P 500 payout ratio sits near century lows.

7) Valuations aren't stretched
The S&P is trading above average on P/E, which concerns investors. But on Price to Free Cash Flow, Price to Normalized Earnings (a more predictive valuation metric) and EV/EBITDA, the S&P 500 still looks attractive.

8) US is the biggest innovator…and innovation adds alpha
US R&D to GDP has been rising over time, and the US spends more on R&D than any other country including China. And R&D spenders typically outperform.

9) Best-in-breed equity index
US stocks trade at about a 10% premium to global equities, but in our view that premium is warranted: the US has a higher ROE, lower beta, and has a significantly higher proportion of "B+ or Better" ranked stocks (stable earners) than global benchmarks.

10) Lower oil and Global QE bode well for future earnings
If lower oil prices and further easing from global central banks can stimulate global growth and reduce the risk of a global slowdown, we believe this is likely to more than offset much of the short-term hit to Energy profits.

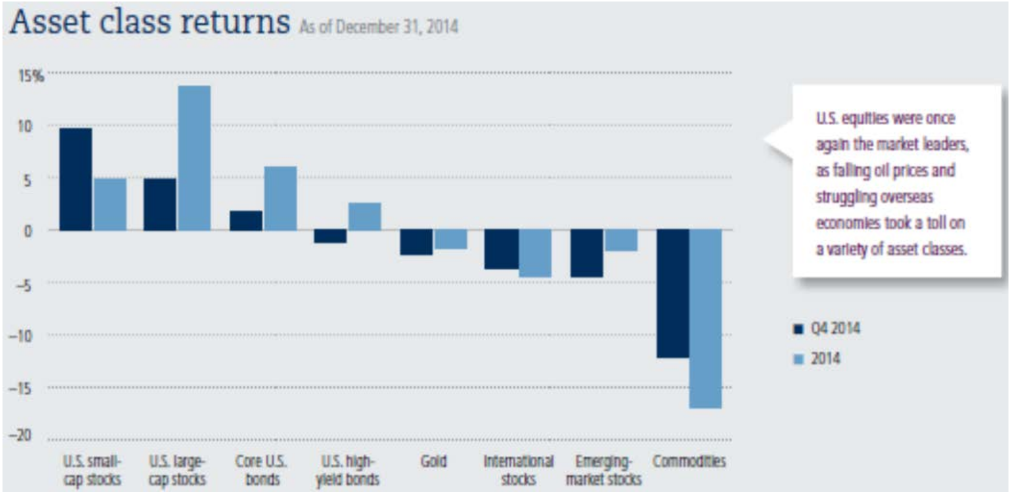
Source: Bank of America/Merrill Lynch

Our equity positioning is very much aligned with this strategist moving forward.

International Equity Strategy

By Steve Lambdin

International equity markets continued to struggle in the fourth quarter of 2014 as most markets were quite volatile as falling oil prices and weaker than expected growth took their toll on investors. The U.S. Dollar continued to strengthen during the period, which negated positive local market returns in many of the global equity markets. Europe continued to struggle with low growth, high unemployment, and the constant threat of deflation. This makes the common currency union an increasingly difficult union to manage. Some countries are experiencing modest levels of growth, while other countries are contracting. Also, the employment situation looks good in some countries, while in other regions it remains a “train wreck.” In addition, the need for austerity varies from country to country. As a result, interest rates continued to fall across the region and pushed many bond yields to fresh new lows. In fact, Germany and Switzerland have imposed negative interest rates on some bank deposits in late 2014. Who would have ever thought it would have come to this just a few short years ago? Monetary policies are still quite divergent from region to region, as the U.S. Federal Reserve (FED) and the Bank of England (BOE) are clearly biased toward hiking interest rates sometime in 2015, while the Bank of Japan (BOJ), the People’s Bank of China (PBOC), and the European Central Bank (ECB) are clearly in the camp of increased stimulative actions. In regard to China, future growth targets continue to trend ever so slightly downward. It’s quite clear the leadership in China remains very focused on some type of managed soft landing in the economy. However, with so many excesses still in this economy, this could prove to be very challenging over the long term. The Japanese equity market was very strong in the quarter as the impact of falling energy prices, increased rhetoric around further stimulus actions, and postponement of the next consumption tax increase were well received by investors. However, the positive market actions were limited to local returns only, as the continued weakening of the Yen pushed returns into negative territory for unhedged U.S. investors. On the geo-political front, the Russian/Ukraine situation still remains very tense, ISIS continues to be a growing threat likely requiring more action, and the Iranian nuclear factor remains a problem in the Middle East. As we begin 2015, we believe the outlook seems marginally better across the Eurozone and Japanese regions with the heavy stimulus actions continuing. The emerging markets look to be a very mixed bag at the moment as divergence across many of these markets remains quite wide at the moment.



Source: Morningstar Direct and John Hancock Investments

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -3.57% and -4.5%, respectively during the fourth quarter of 2014 vs.
+4.93% for the S&P 500 Index. For the calendar year 2014, the MSCI EAFE Index and MSCI Emerging Markets Index returned -4.90% vs. -2.19%, respectively vs. +13.69 for the S&P 500 Index. U.S. equities continued to shine in 2014 as growth prospects appear solid in the U.S. economy. For the second straight quarter, the U.S. Dollar Index was significantly stronger as the U.S. Dollar rose +3.5% against the Euro, +3.7% against the British Pound, and +8.9% against the Japanese Yen. This continues to be a major detractor of returns for unhedged U.S. investors. For the second straight quarter, the Pacific region was a bit stronger than the European region as the Japanese market was quite strong during the quarter on a local currency basis. From an economic sector standpoint, Consumer Discretionary and Technology were relatively stronger, while Energy and Materials were the weakest again. Crude oil continued its slide, falling -41% in the quarter as this explained the weakness in the Energy sector.

So far into the first quarter of 2015, global equity markets have reversed course and posted decent results. Many indexes around the globe are posting record highs on a local basis. This has been a bit of welcomed relief thus far for international equity investors. The ECB's recently announced massive stimulus package that exceeded most investors' expectations and should push inflation higher and put deflation concerns off the table. We would expect the export climate in the Japanese and Eurozone economies to be the bright spot as the euro and yen have both fallen approximately -20% since May of last year and should boost demand going forward. However, both still suffer from weak domestic demand. In addition, the emerging market economies remain a mixed bag at present. We have some regions that will benefit from weak energy prices since they are an importer of energy, while others that depend on energy and commodity exports will suffer. The growth outlook in the U.S. seems okay at the present time, which should also be beneficial on the global front since the U.S. remains the world's largest economy by a wide margin.

Source: Capital Economics and IMF

Asia Update

Even though the MSCI Pacific region posted another negative return in the quarter, this region still wound up being the best performing region in the MSCI EAFE Index, down -2.1%. The Chinese equity market was very strong once again. More monetary stimulus actions and interest rate cuts pushed equity markets higher in the region. This coupled with growth readings that were about in line with expectations provided a nice backdrop for equity investors. The Japanese equity market continued its recent trend with a robust local return in the quarter of +6.64% that was completely zapped away by the movement of the U.S. Dollar against the Yen, putting the U.S. Dollar return of this market at -2.4%. Aggressive stimulus actions still seem to be working in this economy. Australian equities continue to be shunned by many global investors as commodities remained out of favor with most equity investors. Thus far into 2015, it is clear investors are not too concerned over a slowing growth rate in China and a still sputtering economy in Japan. As long as the smell of stimulus is in the air, investors seem happy and this is reflected in the local market returns thus far. Developments on this front should be watched carefully for the future direction of markets.

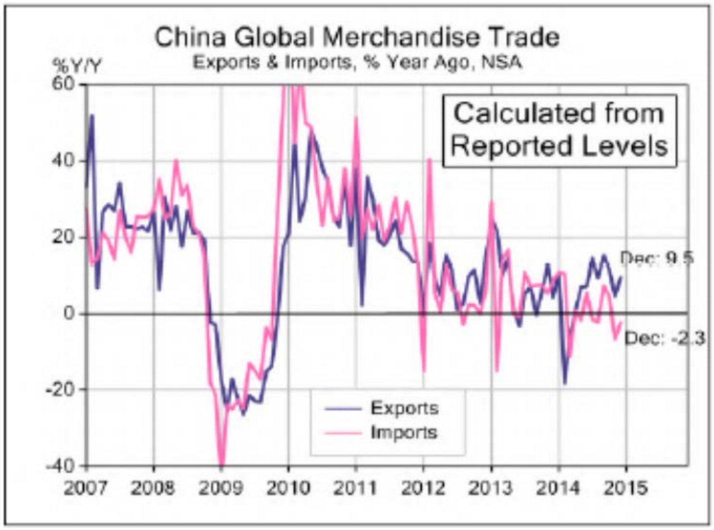
Market Performance

Data as of: 31-Dec-2014

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI China	1.16	7.17	7.96
MSCI Hong Kong	-4.12	3.10	5.07
MSCI Taiwan	-2.18	1.70	9.36
MSCI Philippines	0.04	0.67	25.59
MSCI Singapore	-0.56	-0.46	3.03
MSCI Pacific	-1.83	-2.08	-2.70
MSCI Japan	-1.43	-2.42	-4.02
MSCI Australia	-2.32	-3.63	-3.41

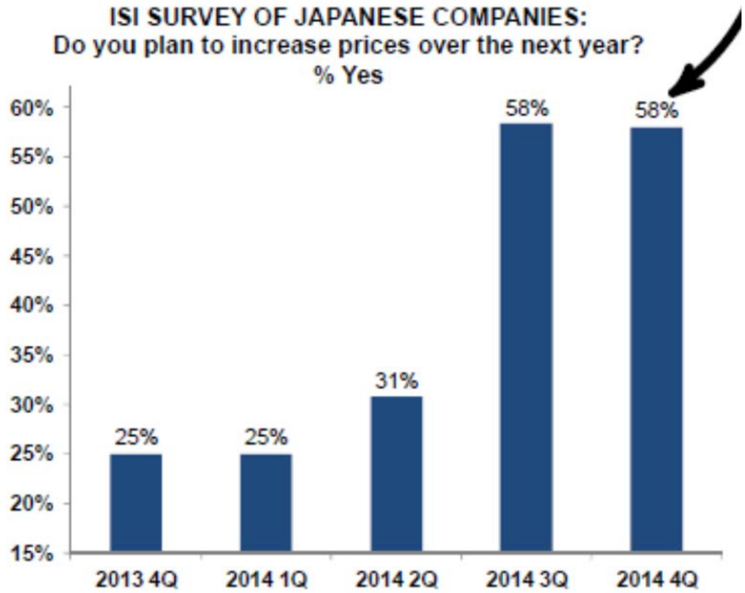
Source: Factset

The Chinese economy literally surprised no one in the fourth quarter of 2014. Gross Domestic Product (GDP) in China rose +7.3% from the year earlier period, unchanged from the previous quarter. This actually was slightly above most economists' expectations. For all of 2014, GDP growth of +7.4% was right in line with government projections, but the slowest pace of expansion since 1990. Unfortunately, this growth came at the expense of more reliance on credit, as outstanding loans are now twice the size of GDP. Policy makers are continuing to add stimulus as well as a recent interest rate cut in order to achieve its desired soft landing. We continue to expect these pro-market policies to aid in China's rebalancing of its economic structure. Industrial production rose +7.9% in December from the year earlier, which was at the highest rate in the quarter. Fixed asset investment continues to slowdown and was reported up +15.7% for all of 2014, well below the pace of the previous year. Officials are still reining in spending on the property markets in an effort to address overcapacity on this front. Exports continue to benefit from overseas demand, as they rose +9.7% in December from a year earlier. Obviously a better growth environment outside of China can only help China's export business. Retail sales were healthy in late 2014, as December sales were reported up +11.9%, a bit better than many forecast as China attempts to grow more internal demand. Inflation continues to drop as consumer prices only rose +.8% in January, well below targeted rates. Falling oil and metal prices are pushing inflation to very low levels, which will probably force more stimulus measures at some point. At the present time, we expect growth in 2015 to fall in the +6.7% to 7% range, which would continue China's slowing rate of growth strategy. While many still expect a hard landing in this economy, we still see a measured slowing being the base case at this point. But we do acknowledge that we are not as confident in that scenario as we were several months ago.



Source: Evercore/ISI

The technical recession in Japan looks to have been short-lived as GDP in the Japanese economy grew by +2.2% in the fourth quarter of 2014. However, this growth was much weaker than many had expected. The rebound appears to be soft as capital spending and household consumption were disappointing in the quarter. However, we did see a contribution from an inventory build as well as export growth of +11.4%, which was very robust. This is not all that surprising considering the Yen has weakened -28% against the U.S. Dollar over the last two years. The recent sales tax increase appears to have been digested by the economy at this point at the expense of a short recession. Abenomics is set to continue in the region for the foreseeable future in an effort to further stimulate the economy. Industrial production was generally weak in the fourth quarter but was reported up +1.0% in December from a month earlier. However, we still see the trend being very erratic in early 2015 as no clear direction has emerged. Small business confidence has weakened in the last couple of months and was reported at 46.3 in January, the weakest reading in nearly a year. This has spilled over to consumer confidence as well, as the December reading came in at 38.8, a bit weaker than the level seen in the third quarter. While the weak Yen is helping exporters, it has increased the cost of imports and has dampened consumer sentiment. As one would expect, retail sales fell in November and again in December. In order to make Abenomics successful, we must see the consumer get back to spending. Core prices rose +2.3% in January from the year earlier, which is at a decelerating pace from the previous quarter. While certainly better than deflation, we do not like the developing trend with this data point. The labor markets seem relatively stable at the moment as the employment situation in Japan has remained steady over the last few months as the December unemployment rate was reported at 3.4%, which is another new low for this region. The jobs-to-applicant ratio continues to look good, rising to 1.15 in December. We are optimistic that we should finally see some upward wage pressure as the spring wage negotiations get underway. Rising wages are key to the BOJ's plan for reflating this economy. As the reflation strategy of the BOJ unfolds, we are optimistic on economic growth in the region and feel the equity markets should remain in an upward trend over this time frame, mainly on a local currency basis.



Source: Evercore ISI

Europe Update

The Eurozone region continued to flounder and flop around like a fish trying to find its way back into the water in the fourth quarter of 2014. Economic readings in the quarter were a mixed bag of news. Overall confidence looked weak during the period. The region continued to flirt with deflation, as inflation remained nearly non-existent in the period. Falling crude oil prices served to only make this issue even worse. As a result of this, ten-year bond yields in France, Spain, and Italy all hit historic lows in the quarter. News flow around the European Union was not positive in the period as a potential exit of Greece from the Euro continued to be an issue. The ECB was forced into action recently and responded with a large scale quantitative program that will run over the next 18 months with bond purchases of 60 billion euro a month set to begin in March. Most find this action to be very aggressive and above most investors' expectations. This has pushed the Euro down below 1.10 to the U.S. Dollar, which is at an 11 year low.

The MSCI European Index (ex. U.K.) posted a loss of -4.4% in the fourth quarter. While many of the markets in the Eurozone are hitting new highs on a local basis, the strengthening U.S. Dollar pushed returns into negative territory for U.S. investors. The movement of the Euro should be good news for exporting countries in the region, but won't be much help for the domestic consumer in some regions. At this point, we would expect the aggressive actions by the ECB to provide good support for the European economy in 2015, which should push growth in 2015 ahead of levels seen in 2014. Also, this should be good news for the equity markets on a local basis and bring some level of stability to the region.

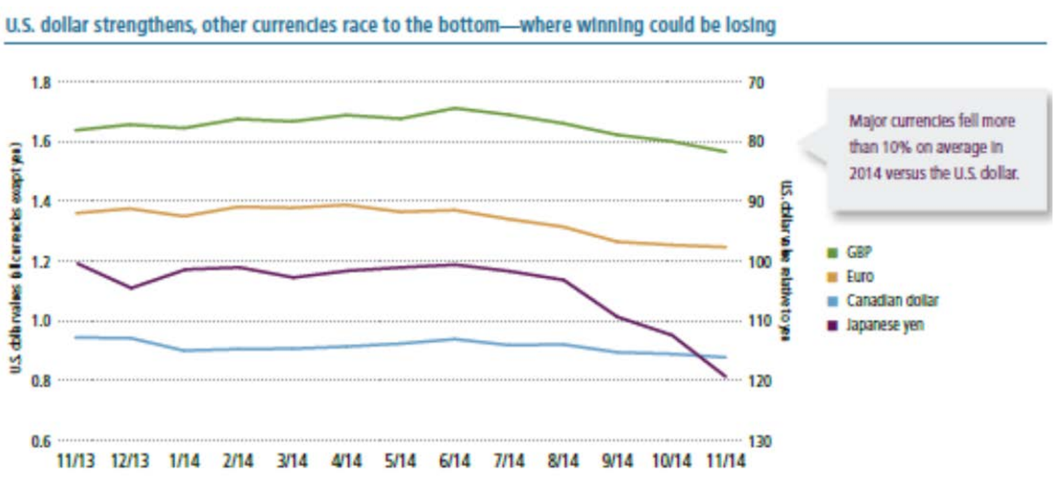
Market Performance

Data as of: 31-Dec-2014

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Netherlands	-3.41	-0.27	-3.46
MSCI Germany	-4.42	-0.39	-10.36
MSCI Switzerland	-4.67	-2.23	-0.09
MSCI United Kingdom	-2.69	-4.24	-5.39
MSCI Europe ex UK	-5.05	-4.40	-6.55
MSCI France	-5.03	-6.06	-9.92
MSCI Spain	-7.23	-8.22	-4.65
MSCI Italy	-8.13	-13.41	-9.53

Source: Factset

The Euroland economy still looks like it's stuck in the mud, but could be getting better soon. Fourth quarter GDP rose +.3% from the previous quarter, or +.9% from the year earlier period. The German economy re-asserted itself as the Eurozone's growth engine reported as this economy reported growth of +.7% from the previous quarter, or +1.5% from a year earlier. In a bit of a surprise, the Spanish economy grew by +.7% from the previous quarter, which was the fastest pace in nearly seven years. Italy posted no growth in the quarter after two straight quarters of negative growth. Many are asking if this is the beginning of a recovery. Perhaps so, but we need to see more positive data points to make that case. While exports fell in most countries in December, Germany still managed decent growth in its balance of trade as exports fell significantly less than imports. We believe the sharp fall of the Euro will help the export economy of the region going forward. The European Commission just recently increased its growth outlook for 2015 on the heels of the ECB's announcement of its 1.1 trillion euro quantitative easing program. This program should push down bond yields as well as the Euro, which will be good for exporters. Industrial production continued to struggle in the quarter as December recoded no growth in this key metric. The index of executive and consumer sentiment continues to rise, reaching 102.1 in February, the highest level in nearly a year. This seems to be further evidence of a turnaround in the region. Retail sales continue the recent trend of slow growth and rose +.3% in December from November, or +2.8% from a year earlier, as strength continues in the non-food products sector. We need to see this key statistic accelerate from here to get more positive on any kind of a turnaround. The employment trends are still weak, but stable at the present time. The December unemployment rate was reported at 11.4%, which is a slight improvement versus the last few months. If the region's economic outlook is indeed improving, then we should begin to see improvements in the employment situation very soon. Inflation continues to be non-existent, as consumer prices recorded its third straight month of being in negative territory with -.3% in February. However, the core CPI still remains positive as this excludes the drastic fall in energy prices over the last few months. The ECB kept interest rates at record lows in the period as we wait to see what effect the recently announced quantitative program will have on the region. We are expecting a positive reaction.



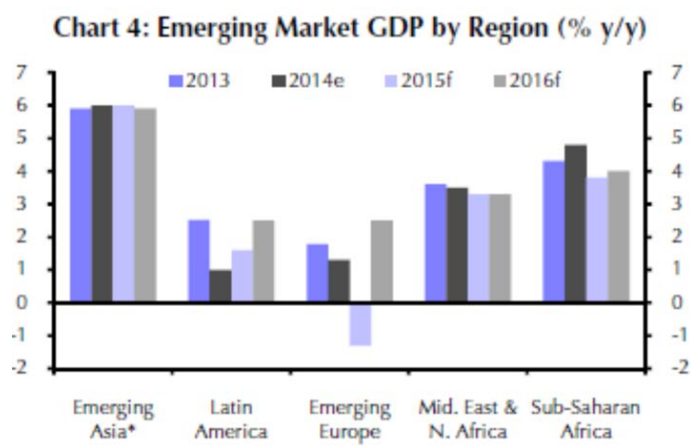
Source: John Hancock Investments and Bloomberg

While slipping a little from the previous quarter, the U.K. economy continued to be a growth engine vs. many of the other large economies around the globe in the fourth quarter. GDP grew by +.5% in the quarter from the previous quarter, or +2.7% from the year earlier period. Household consumption and net exports made a nice contribution to growth in the quarter, while business investment and inventories were the weak spots. It was good to see net trade make a comeback after being a drag last quarter. Industrial production was weak in the fourth quarter as December fell -.2% from a month earlier, but rose +.5% on an annual basis. This was not much of a surprise as the oil & gas sector was real weak as the impact from crude oil was too much to overcome. However, the manufacturing sector did manage to post a gain and looks firm heading into 2015. Retail sales still look to be solid in December, rising +.4% from the previous quarter, or +4.3% from the year earlier. It looked like the consumer took advantage of falling energy prices to purchase more food and electronics. Just as we have seen in almost every other region of the world, inflation continued to fall and was reported to be up only +.3% in January from the year earlier period. However, core CPI was up +1.4% during this period. Even though this has fallen rather sharply, we are not worried about deflation in this economy as we are in the Eurozone. At its early February meeting and coming as no surprise, the Monetary Policy Committee (MPC) kept interest rates at a record low of .50% and its bond purchase target remained at 375 billion pounds. The MPC still believes there is no immediate need to raise short term interest rates. Perhaps this will change at some point over the summer. The employment situation continued to improve as the unemployment rate fell to 5.7% in the three month period through December, a nice drop from the previous period and the lowest rate in six years. Employment rose by 103,000 in the three month period ending in December, to yet another record of 30.9 million. Wage growth still seems a bit light in this economy, hovering right around the +2.0% level on a year over year basis. As the unemployment rate moves toward the key 5% level, we are expecting pressure on wages and this could lead to an increase in interest rates. The U.K. economy looks to be on sound footing at the moment, but we do expect a bit weaker outlook in 2015 vs. 2014. However, we still see this economy as one of the better performing economies around the globe and certainly much stronger than the Eurozone economy in 2015.

Source: Evercore/ISI

Emerging Markets

For the second straight quarter, emerging market equities posted negative returns for U.S. investors. Severely declining commodity prices, a strengthening U.S. dollar, geo-political tensions, and the perception of future rising U.S. interest rates were simply too much to overcome for emerging market equities. The MSCI EM Index (net) declined -4.50% in U.S. Dollar terms in the fourth quarter of 2014. Chinese equities were strong in the quarter as investors raced back into this market as valuations are generally considered cheap and many believe the slowing growth rate of the economy will be very managed by the leadership and not surprise to the downside. In addition, Indian equities were strong on the prospects of future economic growth and reforms under the new leadership of Prime Minister Narendra Modi. However, Russian equities continue to suffer from the economic sanctions put on by the West from the Ukraine conflict. Brazil also continues to suffer under the weight of the weakening commodity markets. We still believe the headwinds mentioned above will make emerging market equities a tough place to be in early to mid-2015. The best opportunities will be in countries where commodities will be a tailwind for growth as well as any "self-help" type stories that will develop. With these issues in mind, equities outside of emerging markets seem to have the best chance for appreciation over the near term.



Source: Capital Economics

International Equity Activity/Strategy

We are still keeping a positive bias toward the global equity markets as we move into early 2015. From a very broad perspective, global equities seem to have more potential for upside over the near to medium term relative to the fixed income, commodity, and real estate markets. Digging deeper into just global equities, while the outlook for large cap international equities seems to be just a bit better than a few months ago on the heels of slightly better growth in Japan and the Eurozone, the outlook for U.S. equities looks hard to beat. Investors seem more comfortable with the outlook for growth in the U.S. than in other parts of the world. However, while China always remains a wildcard, we do like what we see coming out of the Eurozone as well as Japan. As has been the case over the last couple of quarters, future strengthening of the U.S. Dollar will hurt unhedged international equity returns. The key bullish points that we have mentioned before with regard to equities are still alive and well; rising corporate earnings, robust free cash flow, good balance sheets, increasing M&A activity, rising margins, and increasing dividends and share repurchase. As always is the case with equities, the geo-political environment has plenty of issues which could flare up at any moment to wreck the outlook. While equity valuations have continued to rise over the last few months, we still believe they are not at significant problematic levels that we have witnessed at some points over the last 20 years.

We did add approximately $40 million to our emerging markets index portfolio in December as some of our written puts did expire below the respective strike price. We still continue to sell put options on emerging markets ETF in an effort to buy some exposure into a weak emerging markets index if the market turns a bit southward. Premiums for doing this still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.50% of total assets and approximately 12.0% for MSCI EAFE equities. *(Charts provided by Capital Economics, IMF, Factset, TIAA-Cref Financial Services, John Hancock Investments, Morningstar Direct, Bloomberg, Evercore ISI)*

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2015

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	2,297,724,994	-3.54	-0.87	-3.54	1.30	14.57	16.19	14.35	7.13	Oct-94
TRS S&P 500 FUND	6,378,003,304	-2.99	-0.63	-2.99	1.80	14.28	17.33	15.58	7.67	Oct-94
TRS MID CAP INDEX	1,302,764,819	-1.11	1.61	-1.11	5.26	11.01	17.22	17.11	9.95	Oct-94
TRS S&P SMALL CAP INDEX	815,344,097	-3.45	-0.90	-3.45	6.14	6.63	17.06	17.86	9.33	Mar-01
TRS MIDCAP ACTIVE FUND (SSF)	832,301,050	-1.52	1.40	-1.52	4.98	10.42	15.54	16.87	9.74	Oct-94
TRS LARGE CAP POLICY FUND	65,535,247	0.00		0.00						Jan-15
TRS TOTAL DOMESTIC EQUITY	11,691,673,510	-2.81	-0.29	-2.81	2.61	13.13	16.91	15.51	7.85	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		-2.70	-0.28	-2.70	2.67	13.00	17.34	15.96	8.04	
S&P 500		-3.00	-0.64	-3.00	1.78	14.22	17.47	15.60	7.61	
S&P MID CAP 400		-1.12	1.54	-1.12	5.16	10.89	17.01	17.04	9.87	
S&P SMALLCAP 600		-3.49	-1.01	-3.49	6.01	6.15	16.33	17.25	8.89	
INTERNATIONAL EQUITY										
TRS EMERGING MARKETS FUND	320,459,167	-0.67	-6.00	-0.67	-4.49	5.52	0.30			Oct-11
TRS INTERNATIONAL EQUITIES	2,595,107,259	0.59	-1.64	0.59	-2.99	0.35	9.88	7.00	5.17	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	2,915,566,426	0.45	-2.12	0.45	-3.16	0.82	8.81	6.47	5.19	Nov-94
TRS CUSTOM INTERNATIONAL EQUITY IND		0.50	-2.03	0.50	-3.19	0.11				
MSCI EAFE (NET)		0.49	-1.67	0.49	-3.10	-0.43	9.33	6.39	4.68	
MSCI EMERGING MARKETS		0.60	-5.05	0.60	-3.93	5.23	0.58	3.08	8.47	

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	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TRS TOTAL GLOBAL EQUITY	14,607,239,936	-2.18	-0.66	-2.18	1.40	10.45	15.12	13.37	7.25	Oct-75
TRS CUSTOM GLOBAL EQUITY INDEX		-2.07	-0.63	-2.07	1.45	10.18	15.36	13.56	7.21	
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,573,263,205	2.15	2.77	2.15	3.74	6.38	3.84	5.40	5.73	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		2.43	3.23	2.43	4.23	7.16	3.72	5.19	5.17	
TRS TOTAL FIXED (ex. Private Placements)	2,573,263,205	2.15	2.77	2.15	3.74	6.38	3.84	5.40	5.73	Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		2.43	3.23	2.43	4.23	7.16	3.72	5.19	5.16	
Barclays Aggregate Bond		2.10	2.92	2.10	3.93	6.61	3.07	4.57	4.86	
TRS PRIVATE PLACEMENTS	2,301,886,531	0.48	1.58	0.48	2.08	13.59	16.05	15.14	7.66	Aug-99
TRS TOTAL FIXED INCOME	4,875,149,736	1.35	2.21	1.35	2.95	9.57	9.17	9.50	6.48	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED STOCK	348,634,280	4.88	5.48	4.88	4.94	22.69	28.53	15.81	-8.54	Sep-03
TRS REAL ESTATE	2,084,616,657	0.02	0.03	0.02	0.03	8.50	4.45	2.55	2.34	Oct-03
TRS TOTAL ALTERNATIVES	2,433,250,937	0.70	0.78	0.70	0.69	9.09	6.55	3.72	-0.11	Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,308,400,673	1.14	1.72	1.14	2.17	9.44	8.22	7.54	4.37	Oct-93

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING January 31, 2015

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
CASH										
TRS CASH ACCOUNT	157,127,349	0.01	0.02	0.01	0.03	0.09	0.13	0.16	1.78	Sep-03
TRS SHORT TERM INVESTMENTS	210,037,200	0.04	0.10	0.04	0.12	0.31	0.36	0.36	2.12	Oct-03
TRS TOTAL CASH	367,164,549	0.03	0.08	0.03	0.10					Oct-14
TOTAL PLAN										
TRS TOTAL PLAN	22,282,805,158	-1.07	0.12	-1.07	1.61	9.97	12.35	10.94	6.02	Oct-87
TRS TOTAL PLAN POLICY		-0.90	0.26	-0.90	1.89	8.81	11.06	10.11	6.01	