Quarterly Economic Update

August 27, 2013

MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

The Federal Open Market Committee (FOMC) has made no change to their target range for the federal funds rate of 0 to ¼ percent and has maintained their guidance that this low range is likely appropriate as long as the unemployment rate remains above 6 ½ percent and inflation projections one to two years ahead run below 2 ½ percent with longer-term inflation expectations well anchored. FOMC members remain concerned about the pace of improvement in labor markets, but seem to agree that general economic conditions are improving and downside risks have diminished. Some worries exist that more optimistic growth outlooks could falter, but underlying support for a broader and sustainable economic recovery seem to have developed. As economic conditions continue to gradually improve, current monetary policy chatter is dominated by two questions. When will the FOMC begin tapering large scale asset purchases? And who will be the next Federal Reserve Chairman?

Following the June 19th FOMC meeting and Chairman Bernanke's press conference, the market has viewed it increasingly likely that the FOMC will begin tapering their large scale asset purchases sooner rather than later. The FOMC has been purchasing $45 billion in Treasury securities and $40 billion in agency mortgage-backed securities per month. The current large scale asset purchase program has differed from prior purchase programs in that these purchases have had an open ended horizon. Prior programs have been implemented with a specific time horizon for purchases to be completed versus the open ended horizon that allows purchases to continue until labor market conditions have improved as deemed by the FOMC. While there had been discussion already around tapering the amount of monthly purchases and the prior FOMC statement had included new language highlighting that they were prepared to increase or reduce the pace of purchases based on incoming economic data and changes to their outlook, Chairman Bernanke's press conference comments alluded to the FOMC's view that the data and outlook has improved to the point where a reduction in the monthly amount of securities purchases would likely be appropriate later this year. He specifically stated this would allow them to steadily reduce the pace of purchases through the first half of next year and would end the purchases around midyear when the committee's economic projections expect the unemployment rate to approach the 7 percent level. This 7 percent unemployment rate is not a threshold level or a level meant to automatically trigger a shift in policy, but it can be interpreted as a level the FOMC views internally as a stage in the recovery where support from additional large scale asset purchases would no longer be needed or beneficial.

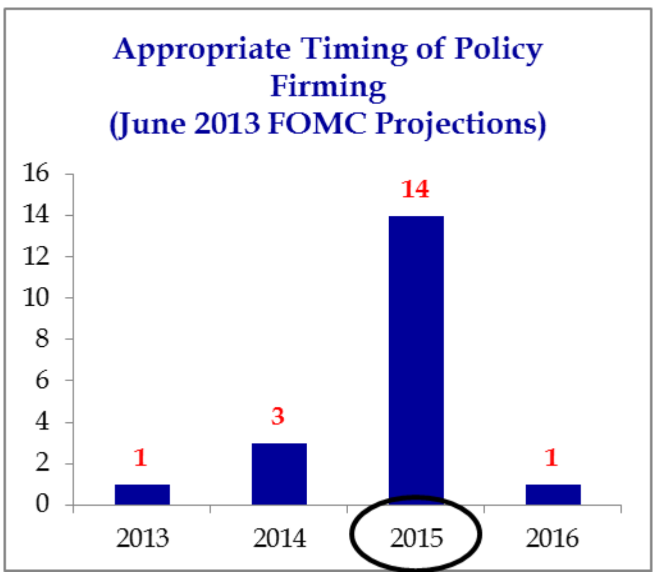
Chairman Bernanke and other FOMC members, in the June 19th press conference and subsequent speeches and testimony, have stressed that a reduction in the amount of additional purchases is in no way a shift to tighter monetary policy and should be viewed independently from their forward guidance on the target level for the federal funds rate. They have also emphasized that the pace of additional asset purchases is data dependent and subject to their evolving outlook on growth and employment in light of inflation expectations. If growth and employment improve at a faster rate than their current outlook, they would be inclined to reduce the pace of additional purchases quicker. If the rate of improvement slowed, they have stated they can delay a reduction in the pace of purchases or even increase the amount of purchases. The point being they do not have a predefined plan to exit their large scale asset purchase program and it remains data dependent based on their evolving outlook even as they discuss reductions and the discontinuance of additional purchases. It does seem clear that if conditions weakened and their outlook became less favorable, they are much more inclined to delay reductions in the pace of purchases than to increase the amount. While they maintain that this option remains on the table, there seem to be varying opinions within the FOMC on the benefits of additional purchases relative the costs that would likely make increasing the pace of purchases difficult.

Chairman Bernanke has repeatedly emphasized that reducing the pace of purchases is not tightening policy and that they would still be increasing the amount of securities carried on the Federal Reserve's balance sheet. They continue to reinvest maturities and principal payments from the portfolio and even if they discontinue additional purchases they could maintain the level of securities held and the current accommodation for some time. While the increasing discussion according to Chairman Bernanke's comments and as indicated in the FOMC minutes shows that a reduction in the pace of additional purchases is a near term focus, the minutes have shown little additional discussion around removing accommodation through a reduction of securities held on the Federal Reserve's balance sheet. There has been some discussion on the eventual normalization of monetary policy and how they may exit current policy accommodation, but not much in the way of additional details and it has been noted that this will likely depend on current conditions at the time. The June 19th meeting minutes did record that most participants thought that they would not sell agency mortgage-backed securities as part of the normalization process.

Most market participants are looking for the FOMC to announce that they will taper additional purchases at the September 18th meeting. This meeting includes updated economic projections and a press conference following the meeting making it ideal for a tapering announcement. The next meeting is a regular meeting at the end of October and then a December meeting with updated economic projections followed by a press conference. Given the FOMC's focus on communication and concerns about how changes to policy are received and interpreted by market participants, it makes sense that they would likely implement any adjustments to the current large scale asset purchase program at a meeting where Bernanke could provide additional commentary on any changes. You would also expect any changes to policy to be supported by updated economic projections. A change to the monthly amount of purchases would likely be small initially and an earlier start would allow for a gradual pace of tapering.

Another issue that could factor in to the FOMC's decision to taper purchases is that Treasury issuances are down significantly due to an improving budget situation and limits from the debt ceiling. According to Strategas Research Partners, Treasury issuance is down more than 33 percent since December and the Federal Reserve owns the largest percentage of Treasuries outstanding since 1982. The Federal Reserve currently owns 11.8 percent of outstanding Treasuries and Strategas estimates that this could rise to 12.7 percent by the end of October if the FOMC continues with the current pace of purchases. This is not likely to be discussed openly by the FOMC, but it could play a role in their decisions behind the scenes.

The updated Summary of Economic Projections from the June FOMC meeting showed that participants thought that GDP would continue to improve with central tendency projections of 2.3 to 2.6 percent in 2013, 3.0 to 3.5 percent in 2014, and 2.9 to 3.6 percent in 2015, roughly in line with the participants March projections. The unemployment rate projections did indicate an improved outlook from the March projections, with 2013 projections moving from 7.3 to 7.5 percent down to 7.2 to 7.3 percent, 2014 projections moving from 6.7 to 7.0 percent down to 6.5 to 6.8 percent, and 2015 projections moving from 6.0 to 6.5 percent down to 5.8 to 6.2 percent. The improvement in the unemployment outlook by FOMC participants is likely the motivating factor to begin tapering their asset purchases sooner. PCE inflation projections did come down a little which could support an argument to delay tapering purchases, but the FOMC statement and minutes referred to the lower inflation as due to transitory influences and has stated that longer-term inflation expectations remain stable. The majority of participants continue to see 2015 as the appropriate timing of an initial increase in the federal funds target rate.

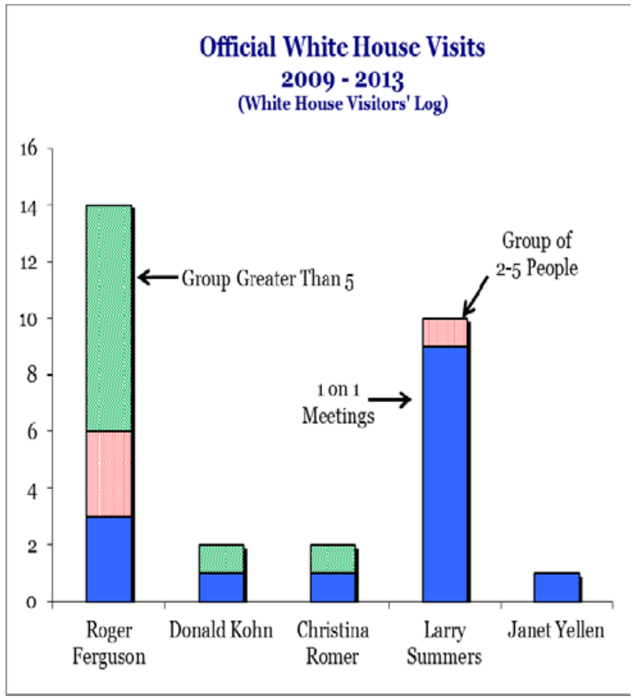


Source: Strategas Research Partners

The other big question lingering out there is who will be the next Federal Reserve Chairman. Chairman Bernanke's second term as Chairman ends on January 31, 2014. He has declined to comment on whether or not he would be willing to serve a third term, but it is being assumed he has no interest in another term. President Obama has openly discussed evaluating other candidates for the position, so it appears extremely likely that either Bernanke does not want to serve a third term or that he is not being asked by the President to serve another term as Chairman. This has left the financial news media and market participants to speculate on who will be appointed as the next Federal Reserve Chairman and what impact that could have on future monetary policy. In a recent New York Times interview, President Obama described what he is looking for in the next Federal Reserve Chairman as someone who "understands the Fed has a dual mandate . . . that it is very important to keep inflation in check, to keep our dollar sound, and to ensure stability in the markets. But the idea is not just to promote those things in the abstract. The idea is to promote those things in service of the lives of ordinary Americans getter better." The President went on to commend Chairman Bernanke and expressed his support for the current Chairman's recent testimony that "our priority needs to be growing the economy faster and strengthening incomes for ordinary Americans."

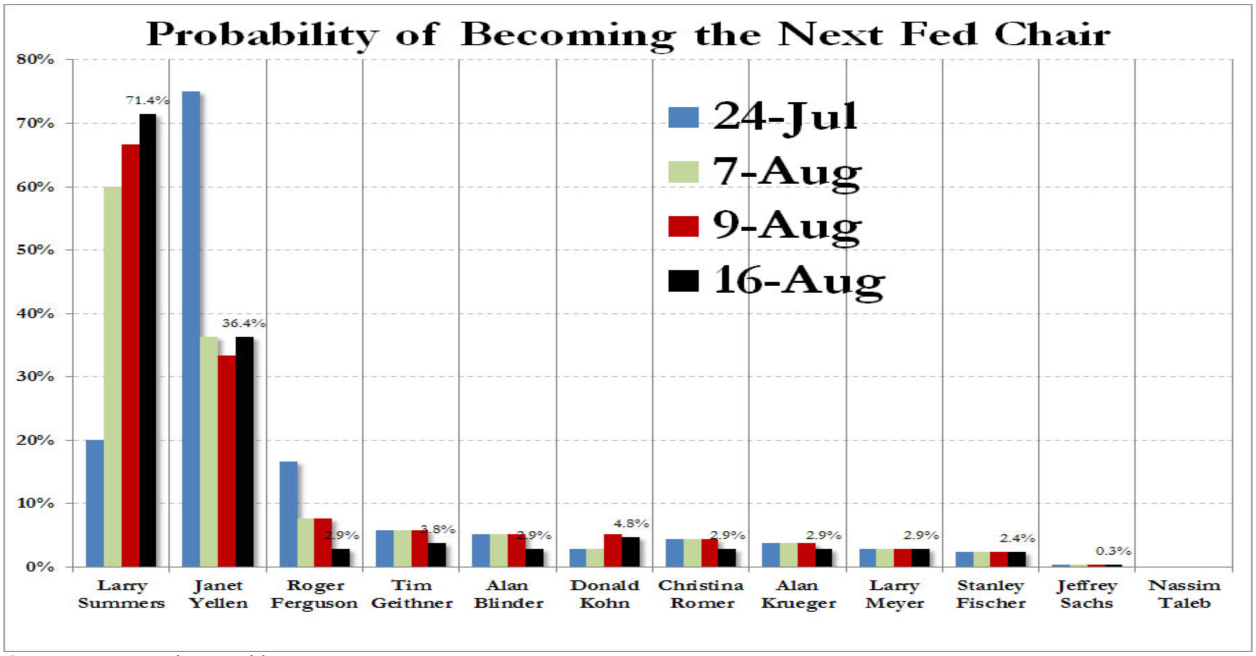
The names that have garnered the most attention as potential candidates for the job are: Janet Yellen – current Vice Chairman of the Federal Reserve, former president of the San Francisco Federal Reserve Bank, and former chairman of the White House Council of Economic Advisers under President Clinton; Lawrence Summers – former Treasury Secretary under President Clinton and former head of President Obama's National Economic Council; Donald Kohn – former Federal Reserve Vice Chairman; Roger Ferguson – former Federal Reserve Vice Chairman and current president and CEO of TIAA-CREF; Timothy Geithner – former Treasury Secretary under President Obama and former president of the Federal Reserve Bank of New York; and Stanley Fischer – former chief economist at the World Bank, former governor of the Bank of Israel, and former deputy managing director of the International Monetary Fund. There are a few others, but these seem to have been talked about the most.

The two names that have generated the most attention as likely candidates are Janet Yellen and Larry Summers. A recent Bloomberg News survey conducted August 9-13th of 63 economists thought that President Obama was most likely to pick Janet Yellen as the next Federal Reserve Chairman getting 65 percent of the vote. Larry Summers was second with 25 percent of the vote. Janet Yellen, serving as the current vice chairman, is considered somewhat as a known factor and it is expected that her policies would deviate little from current policy. Larry Summers is considered a bit more as an unknown even though he has expressed support for much of the current policy. There are some differing views and he is a little more of a wild card. Summers has a more controversial history and can be a more divisive leader versus a consensus builder. A group of democratic senators sent a letter recently to President Obama expressing their support for Janet Yellen and there have been concerns voiced around Larry Summers' stance and past roles he has played in deregulation. President Obama does remain close to Larry Summers and he has a strong relationship with the current administration. He recently defended Summers to a group of House Democrats and has expressed his confidence and appreciation of him as an economic advisor. Strategas Research Partners recently highlighted his close relationship with President Obama and the current administration in the chart on the right showing his frequent one on one meetings with the White House.



Source: Strategas Research Partners

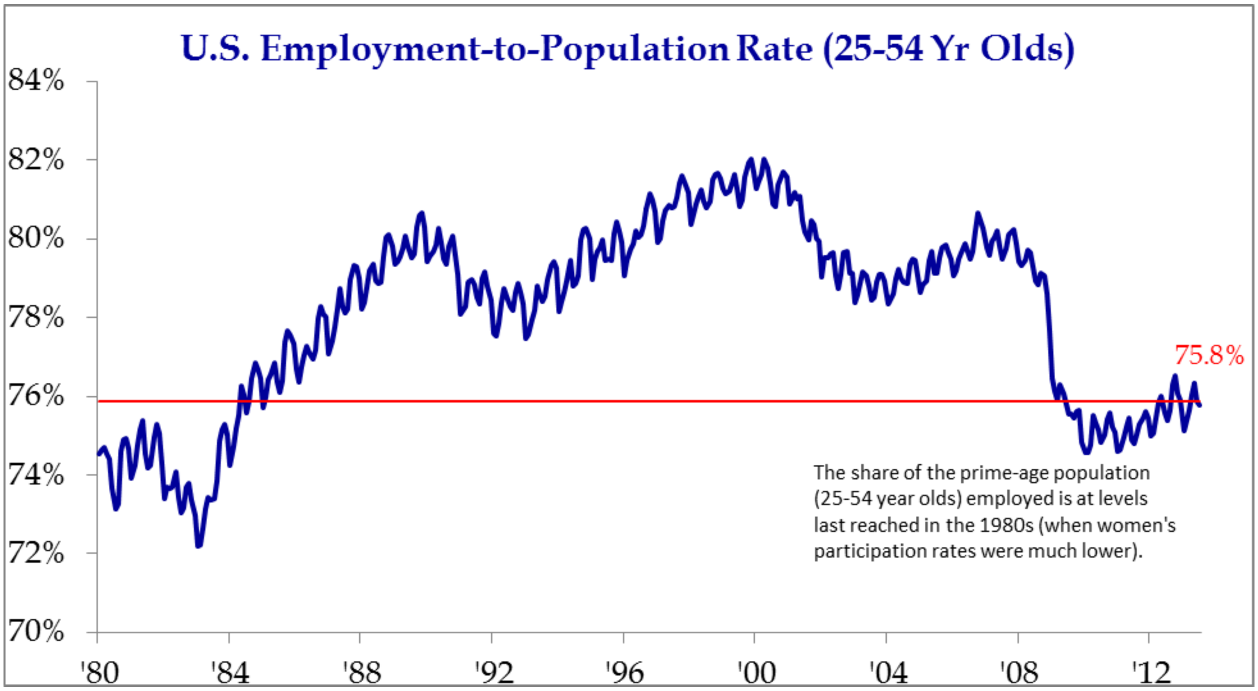
There have been some questions whether Larry Summers would have a difficult time getting through the confirmation process if nominated. While some Democratic senators have expressed support for Janet Yellen publically and behind the scenes expressed some reservations around Larry Summers, many have said they ultimately would support whomever the President selects. No one really knows who the front runners are in President Obama's mind and he is not likely to share any details with us on who he is considering. In his recent New York Times interview, he said we could anticipate a decision over the next couple of months. While Janet Yellen has been viewed as the front runner by much of the financial press and was clearly favored in the Bloomberg News survey mentioned above, other polls show Larry Summers has gained significant ground recently. The chart below from online bookmaker Paddy Power shows how the odds have shifted over the past several weeks and now places much greater odds on Larry Summers becoming the next Federal Reserve Chairman.



Source: Zero Hedge, Paddy Power

Regardless of when the FOMC begins to taper asset purchases or who will be the next Federal Reserve Chairman, the one thing we do know is that the FOMC has been very transparent on what they intend to do. They have stated when they do begin to taper asset purchases, they will gradually reduce the pace of purchases. The have also stated that "a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens." They have been clear that there is a focus on employment and that they intend to keep the federal funds target rate at the current low range until the unemployment rate declines to 6 ½ percent. This is conditional on one to two year inflation running below 2 ½ percent and current inflation is running well below this with little pressure evident to push it higher. Once the unemployment rate reaches the 6 ½ percent level, they have been clear that it will not trigger an automatic rate hike but will be a level where they will begin to access whether tighter policy is appropriate in light of various economic and employment information. While a new chairman could lead the FOMC in a different direction, it is highly unlikely they would deviate from current policy until the economic recovery and employment has strengthened to the quantitative levels they have outlined. The new chairman will play a much more influential role on how we exit the current extraordinary accommodative policy once we do reach that bridge, but will not likely influence current policy in a different direction.

Many investors and market participants may be underestimating the FOMC's concerns and focus on unemployment. There are some big concerns in the eyes of many FOMC members around long term unemployment and permanent damage to the workforce. While we have been seeing steady improvement to the unemployment rate, workforce participation rates and part time employment remain at unattractive levels with little improvement.



Source: Strategas Research Partners

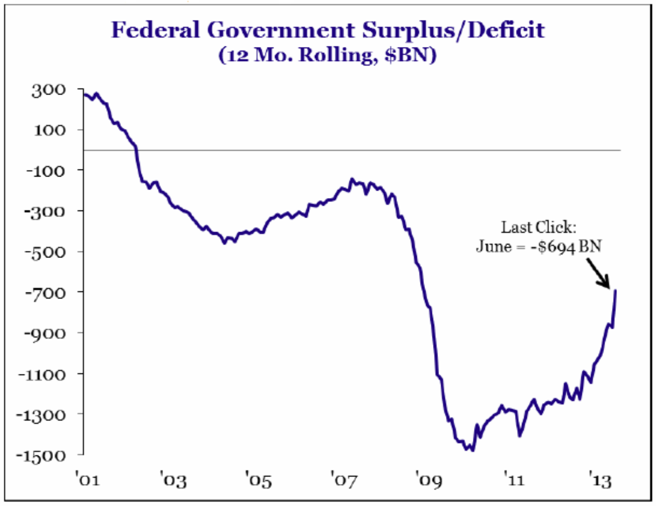
Fed Governor Jerome Powell summed up these concerns best in a recent speech at the Bipartisan Policy Center in Washington D.C. with his comments, "long-term unemployment remains very high – 4.4 million Americans or about 37 percent of the unemployed have been out of work for six months or more. These numbers represent tragedy and hardship for these workers and their families, of course, but they also represent a crucial economic challenge. The longer workers are unemployed, the greater the likelihood that their skills will erode and workers will lose attachment to the labor force, permanently damaging the economy's dynamism and potential output." This is the major focus of Chairman Bernanke and the FOMC and will continue to drive policy decisions.

Fiscal Policy

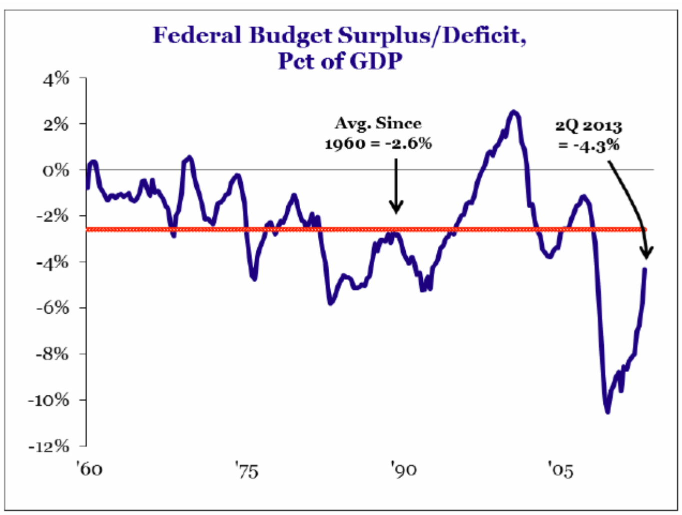
By Michael McNair

One of the more surprising developments over the past year is the rate at which the federal budget deficit has declined. Last June the 12 month rolling deficit was $1.23 trillion but over the past year the deficit has fallen a remarkable 43% and today stands at "just" $649 billion. In fact, in the month of June the government ran a $116 billion surplus verse a $60 billion deficit a year ago. While some of the improvement is due to temporary one-time factors, such as a payment by Fannie

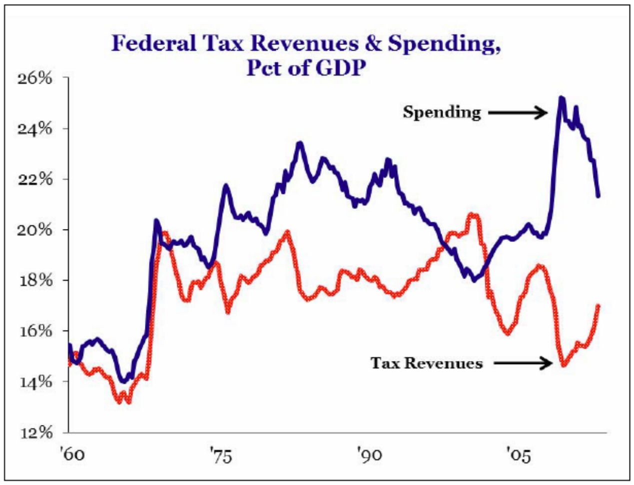
Mae to the US government, the scale of the reduction in the deficit is striking nonetheless.



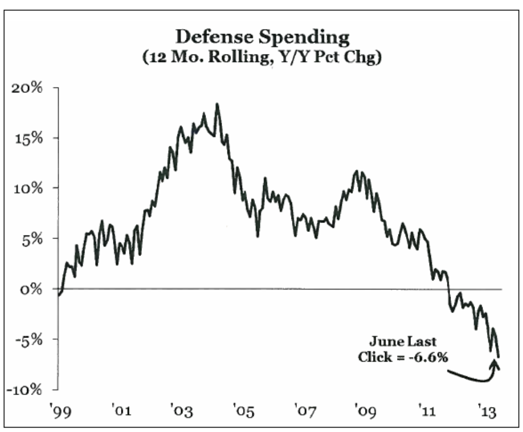
In the chart below you can see that the budget deficit has even improved relative to GDP and currently stands at 4.3% of GDP:

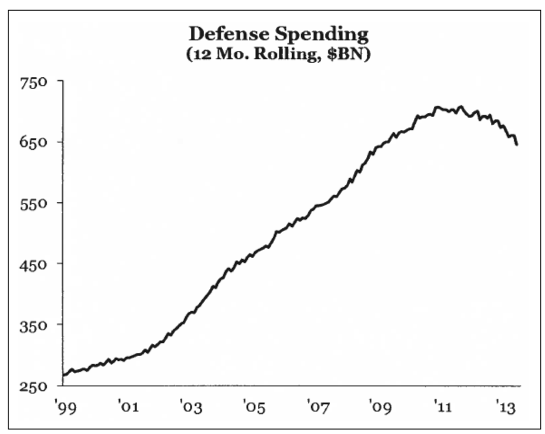


The improvement in the deficit has come from both a reduction in spending as well as an increase in tax revenue:



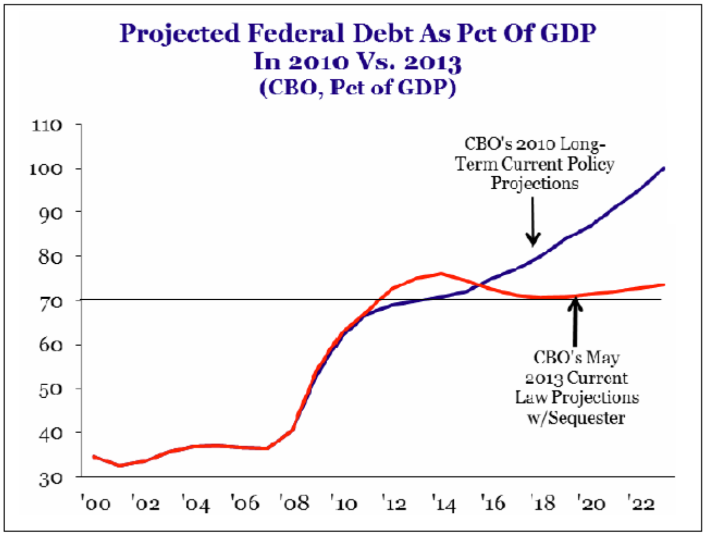
Defense is taking the brunt of the reduction in federal spending. Even with the bulk of the sequester related cuts yet to take place, defense spending is down 6.6% this year as a result of a withdrawal of troops from Iraq and Afghanistan and the caps on base budgets, which was part of the 2011 debt ceiling deal. The pressure on defense spending will only get worse as the full effects of the sequester kick in during the 3rd quarter of 2013.



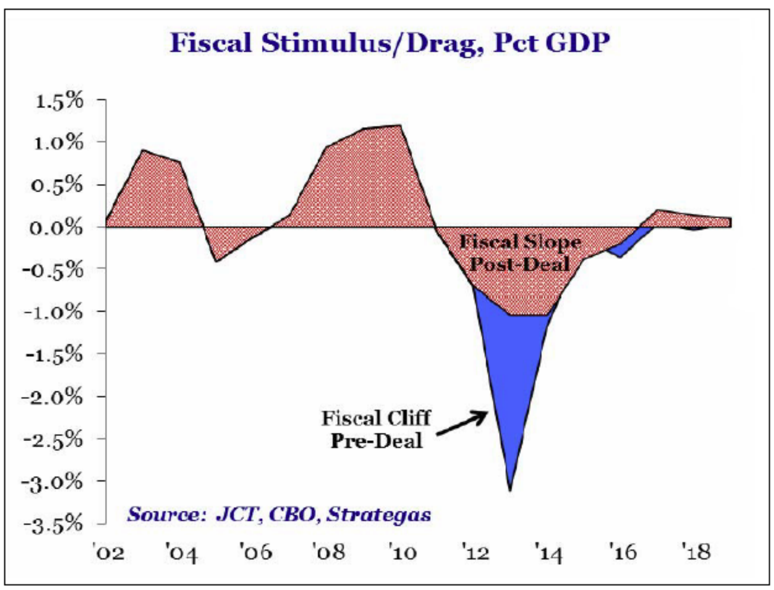


The Congressional Budget Office (CBO) now expects the deficit to decline to 4% of GDP by the end of the year, down from their February estimate of 5.3% of GDP. Looking out even further, the CBO projects the budget deficit to average just 3% of GDP from 2014-2023.

The improvement in the budget deficit has also caused the CBO to change their projections on the future debt to GDP ratios for the US. The CBO now estimates that debt/GDP will stabilize around 70% until 2023, when changing demographics are expected to put increased pressure on federal budgets.



While the reduction in the federal budget deficit has reduced the need for debt issuance, the bad news is that the combination of spending cuts and tax increases that has lowered the budget deficit has also kept the US economy from growing at a higher rate. In fact, federal fiscal policy has been a restraint on economic growth since 2011. The chart below shows Strategas economists' estimate of the impact of fiscal policy on US GDP growth:



Strategas estimates that GDP growth would be 1% higher in 2013 absent the drag from fiscal policy (had Congress not reached a last minute deal to lessen the impact of the "fiscal cliff" GDP growth would have been 3% lower). We believe that Strategas' estimates understate the drag/stimulus from fiscal policy due to their use of overly conservative fiscal multipliers. We believe the actual drag will be closer to the estimates by JP Morgan economists who estimate that fiscal policy will drag down GDP by 1.75% this year. The table below shows JP Morgan's economics team's estimate for GDP growth and the fiscal drag for 2013 and 2014.

GDP growth and fiscal drag

Q/q, saar	GDP, actual and forecast	Fiscal drag	Implied ex-fiscal GDP
1Q13	1.78	2.00	3.78
2Q13	2.00	2.25	4.25
3Q13	2.00	1.50	3.50
4Q13	2.50	1.25	3.75
1Q14	2.25	1.00	3.25
2Q14	2.50	0.90	3.40
3Q14	3.00	0.80	3.80
4Q14	3.00	0.70	3.70

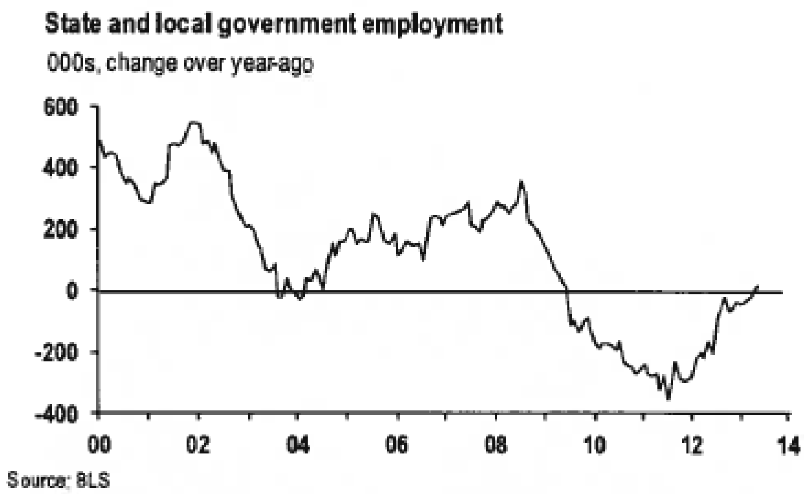
Source: J.P. Morgan

In 2Q 2013, GDP grew 2% but would have grown 4.25% had fiscal policy not dragged down growth by 2.25%

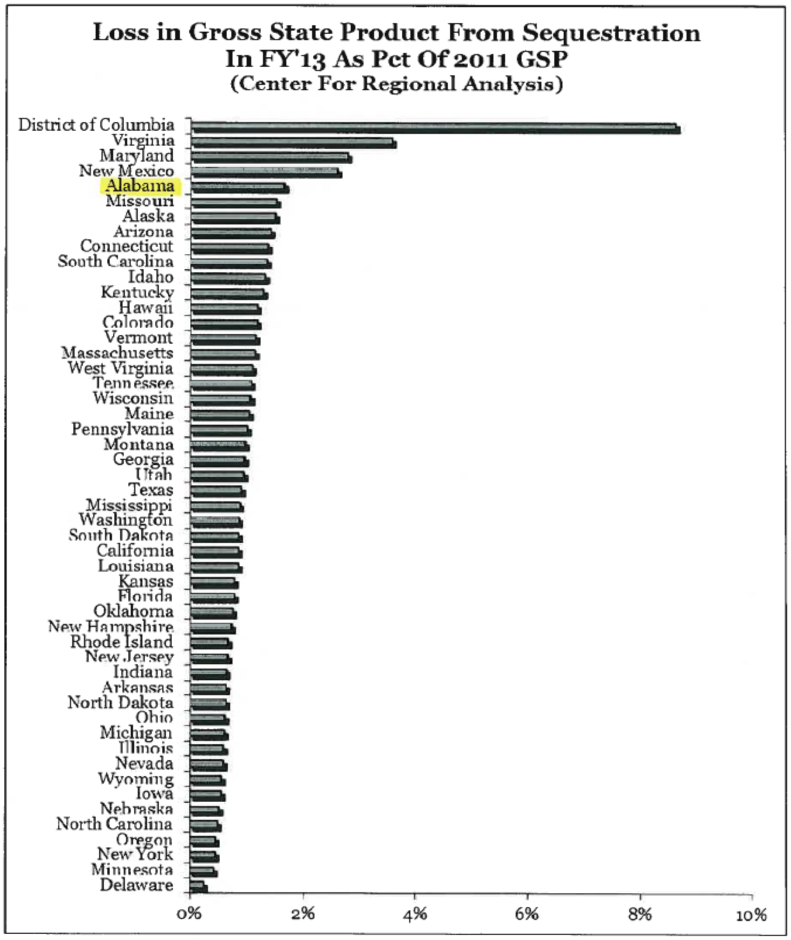
As you can see above, the team at JP Morgan believes that the fiscal drag peaked this past quarter (2Q13); yet, they admit that determining the exact timing is particularly difficult this year due to the uncertainty surrounding the timing of sequester related spending cuts which are expected to drag down growth 0.5%. However, research by Strategas shows that that the fiscal drag will actually reach a nadir in the current quarter (3Q13). Strategas' Dan Clifton explains, "Sequestration technically began on March 1st but agency budgets did not get slashed immediately. In fact, sequestration for Fiscal Year 2013 imposed $85 billion of spending cuts but the Congressional Budget Office found that only half of these cuts, $43 billion, would actually be implemented this Fiscal Year. Federal spending has been a drag on GDP for the past several quarters which creates the impression that sequestration has already been implemented. But a more careful review suggests the decline in federal spending has been coming from Defense and mostly from the drawdown of war spending in Iraq and Afghanistan. This funding dropped from $160 billion in fiscal year 2011 to about $90 billion in fiscal year 2013. We estimate that in the first four months only about $10 billion in cuts actually have been implemented to date. The bulk of the cuts, about $30 billion, will come in 3Q." The exact timing of the spending cuts may seem insignificant but stock market returns are strongly correlated with economic data surprises and we believe that in the near term sequester related cuts could cause economic data to undershoot expectations because the consensus believes that most of the spending cuts have already taken place. The market would likely shake off any weakness in the data due to sequester related spending cuts because they are considered as more of a one-time event. However, it will be difficult to know that the weak data was due to sequestration because the bulk of these cuts are coming in the form of federal agencies furloughing employees (reducing working hours) rather than cutting jobs and the monthly employment data only reports government employment and not hours worked. Thus, there is a risk that government spending cuts could create some pressure on short term economic growth and market participants might mistake this weakness as a private sector related slowdown due to higher interest rates, for example.

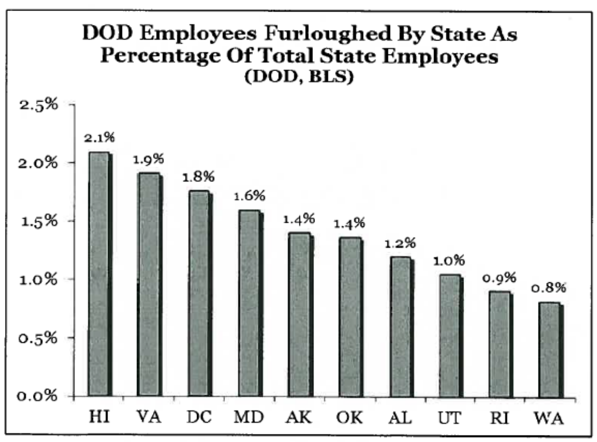
While timing issues around the sequester spending cuts pose a small risk to the short term, the more important issue is that by the end of the 3rd quarter we will finally have **the worst of the fiscal drag behind us**. Fiscal policy will continue to be a restraint on economic growth for the next couple of years but the magnitude of the headwind will significantly subside as the fiscal drag is forecast to subtract around 0.85% from GDP growth in 2014 compared to 1.75% this year.

While fiscal policy at the federal level has been hindering the economic recovery since 2011, state and local government budgets have been a drag on growth since 2009. State and local governments are unable to run large budget deficits; therefore, they were forced to make cuts to spending as the weak economy and busting of the housing bubble caused a significant drop in tax revenue. As a result, state and local governments have been forced to cut over 800,000 jobs since 2008. Cuts by state and local governments have, on average, restrained economic growth by 0.3% per quarter since late 2009. However, in May, state and local governments added 15,000 jobs and posted the first year over year increase since the recession. We believe that the fiscal drag from state and local governments has finally subsided and they will actually begin to have a positive contribution to economic growth for at least the next couple of years.

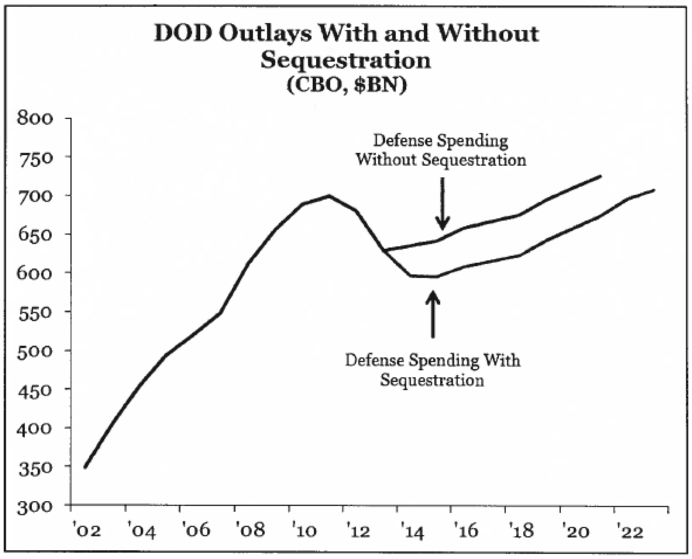


However, we believe the sequester will have a disproportionate effect on certain states, especially those with large exposure to the military.





Defense spending cuts will accelerate through 2013 and they are also scheduled to drop again in 2014. However, we believe there is a strong possibility that congressional Republicans, from states disproportionately affected by these Defense cuts, will come to an agreement with the White House to repeal the sequester and replace the harsh mandated cuts to Defense with savings elsewhere in the budget. Such an agreement would alleviate the strong regional bias to the fiscal drag without increasing the size of the budget deficit.



Regardless of any action on the sequester, the worst of the fiscal drag on the US economy is almost behind us. We believe state and local governments will now positively contribute to growth and while fiscal policy at the federal level will continue to act as a restraint on economic growth for the next two years, the magnitude of the headwind will be significantly reduced over the next year. In most instances we would be highly pessimistic about the current sub 2% GDP growth; however, in this case we are strangely impressed given the magnitude of the fiscal drag currently weighing on the economy. The US private sector has been remarkably resilient over the past year and, with the fiscal policy headwinds set to subside, we believe the stage is set for a reacceleration in economic growth in the US.

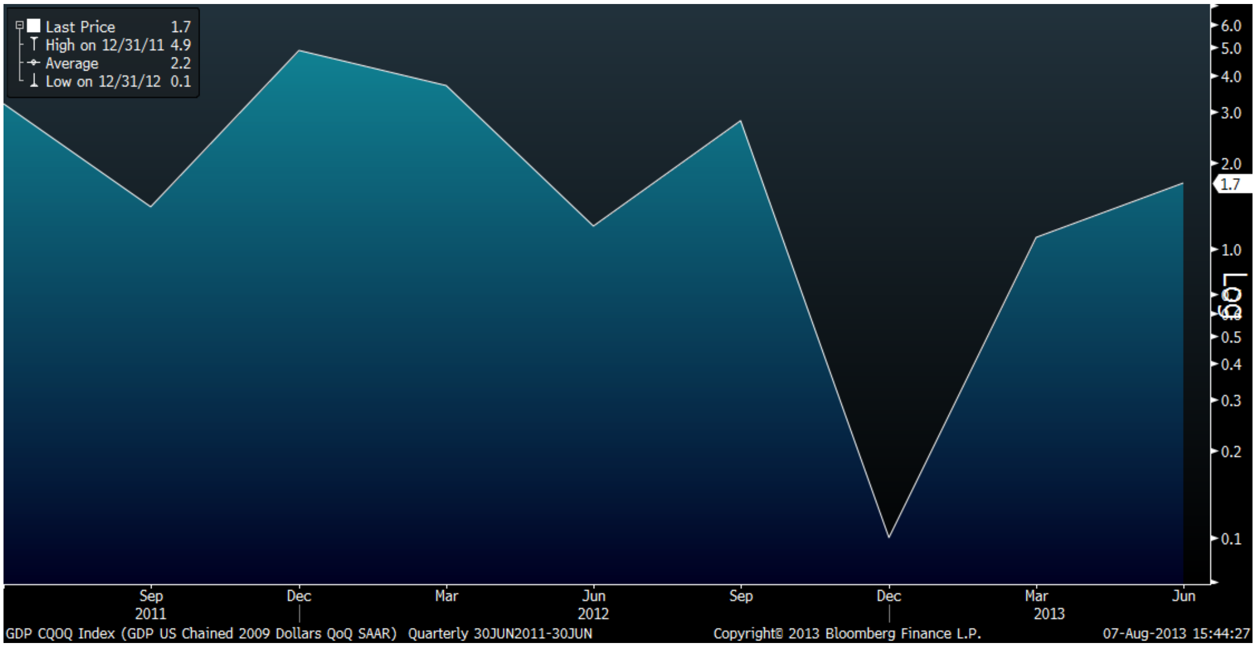
Economic Outlook

By Adam Rogers

Growth

Real GDP advanced 1.7% for the second quarter, the strongest posting of the last three quarters, albeit still tepid growth. We did receive downward revisions for the previous two quarters, but both importantly remained in positive territory. Q1 was revised down from 1.8% to 1.1% and Q4 of last year was revised down from 0.4% to 0.1%. The optimist sees acceleration while the pessimist sees a lower base. No matter how you take it, growth is slightly positive and has been for a while.

GDP US Chained 2009 Dollars QoQ SAAR



Source: Bloomberg

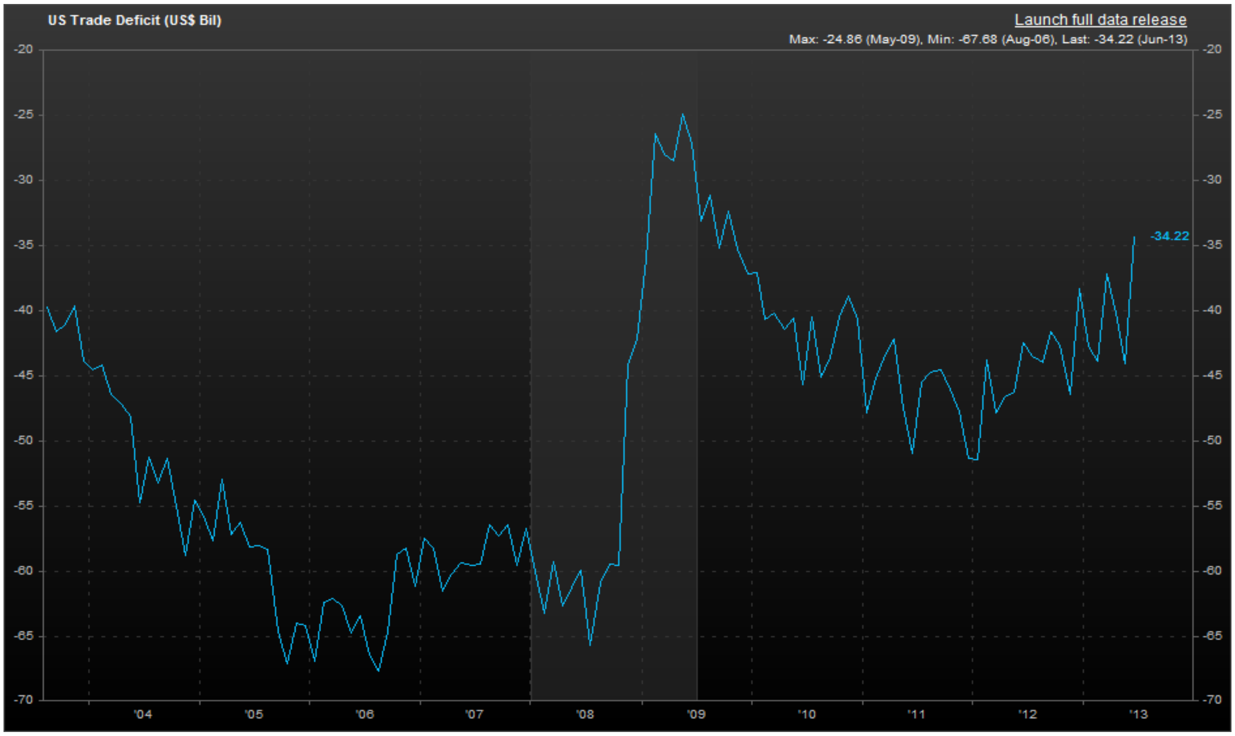
Consumers have powered much of the recovery over the past few quarters. However, this quarter the pace of spending slowed marginally from the consumer side while business spending ticked up more than expected. Personal consumption increased at a 1.8% rate, slowed in part by a 0.4% decline in vehicle purchases which had been a source of strength for the past three quarters. Business fixed investment grew 4.6%, recovering its decline from the first quarter. Residential investment is still building with a 13.4% growth rate. Government is still a drag, contracting for the third straight quarter. Given the sequester budget cuts this surprised no one. The fiscal drag is beginning to slow, however, and state and local government spending actually grew a little for the first time in over a year.

This quarter the Commerce Department also released long run revisions to past growth data. Data going all the way back to 1929 was revised. While not highly instructive to near term outlooks, they don't do this very often so it is worth mentioning. The economy grew 2.8% last year, an upward revision from 2.2%, and earlier years also look better than we previously thought. Unfortunately, despite the upward revisions, these past few years still hold the title of slowest economic recovery since WWII.

Second quarter preliminary growth estimates are scheduled to be revised on August 29th. One data point worth exploring that could provide a late boost is trade. On Tuesday, August 6th, the Commerce Department reported the U.S. trade gap fell to $34.2 billion, the lowest level since October 2009 and a decline of over 20%. Exports of items such as heavy machinery and telecommunications equipment rose 2.2% to $191.2 billion, a record high. Imports fell 2.2% to $225.4

billion. If all else is held constant, some economists are estimating we could see a sizeable upward revision to second quarter growth to somewhere in the neighborhood of 2.5%.

Trade

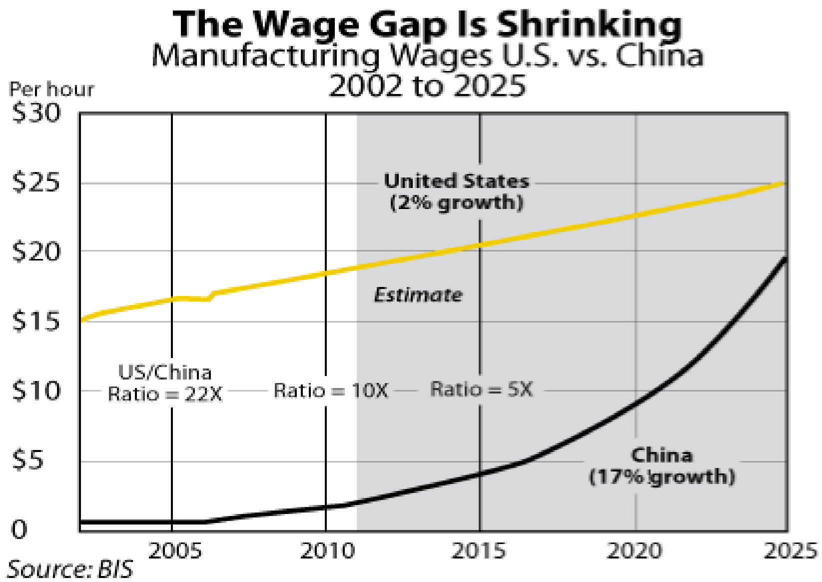


Source: Factset

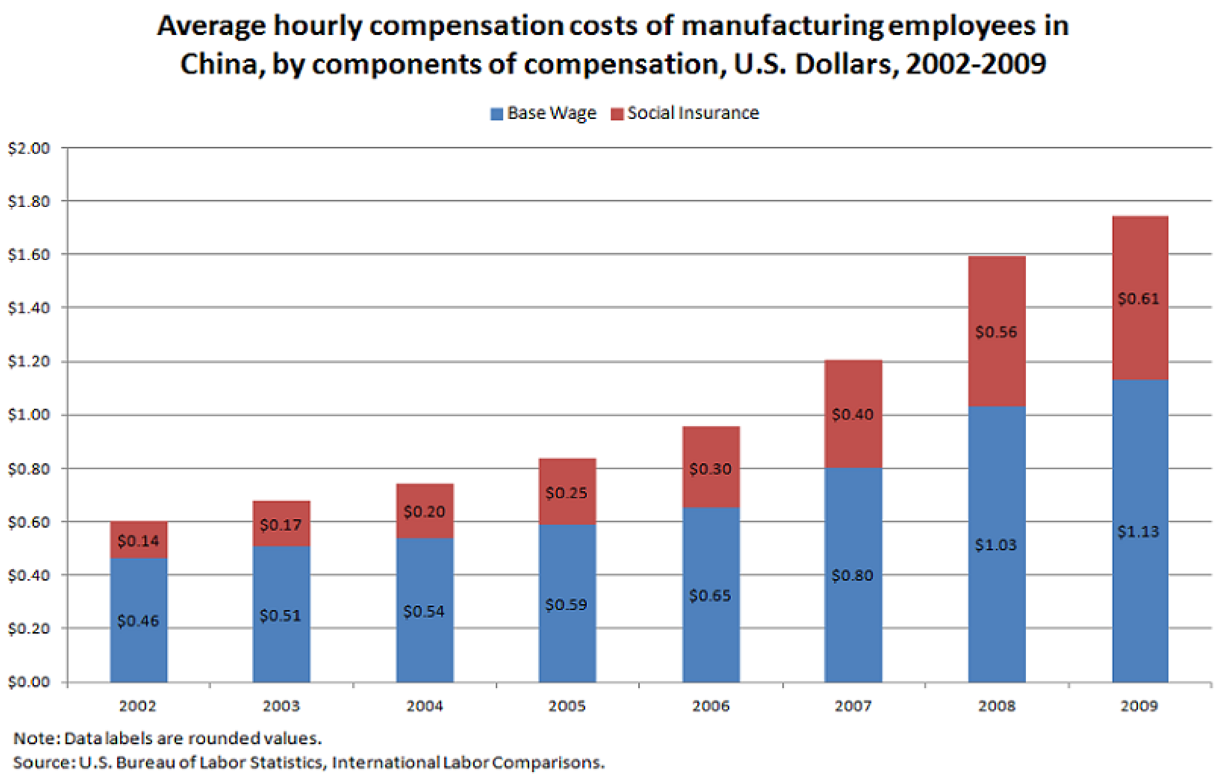
Currency valuation is always the first place you look and usually fully explains notable changes in global trade data. Year-to-date, China accounts for 13.6% of our foreign trade and the Renminbi has steadily appreciated relative to the dollar for the past three years. This explains some of it. However, as a whole, the trade weighted dollar has been relatively stable over the past year and year-to-date has actually increased in value. So obviously dollar devaluation cannot explain why the U.S. is eating away at its trade deficit. I think there are two fairly powerful developments taking place that suggest this is a trend that has some legs: wage pressures in China and the U.S. shale oil boom.

Wage Pressures in China

American companies have been increasingly outsourcing manufacturing to China and other developing economies due to the cheap labor available in these markets. China has been considered the "world's factory" for years, a status which is now being threatened by social unrest and inflation. Many cities in China have already begun to raise minimum wages amid complaints that factory owners are underpaying workers. Well-known Foxconn, who produces everyone's iPhones and iPads, has already doubled its 800,000 workers' salaries over the past few years and has made comments the raises will continue. I don't usually like to use charts with future data but this one at least shows the historical trend in the gap between US and Chinese manufacturing wages. The future of course always remains to be seen.



The big takeaway here is that we've gone from US workers earnings 22x Chinese workers in 2005 to 10x in 2010. The trend has continued into 2013 and just going by anecdotal evidence has likely accelerated, though exact data is tough to come by.

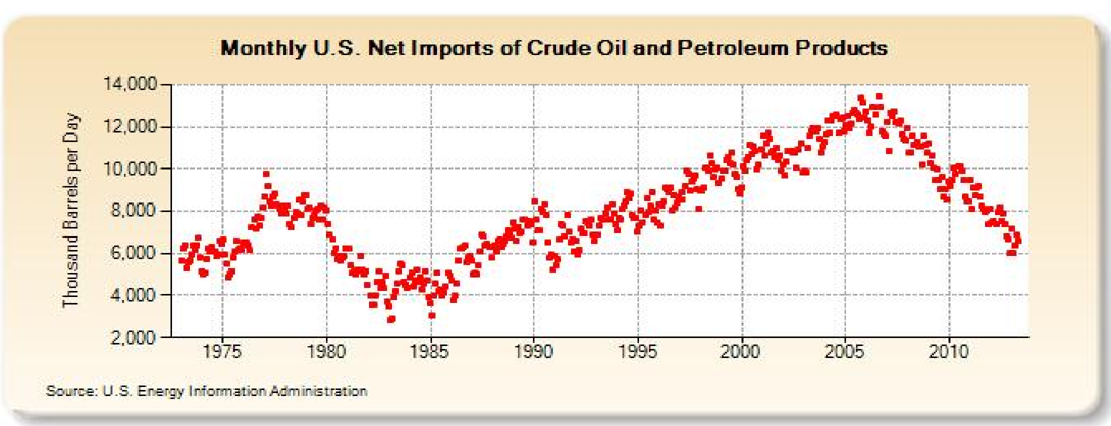


The initial response from some American companies has been to shift operations to other countries that remain cheap such as Vietnam, Bangladesh, and Sri Lanka. Others are moving some operations back to the US. As examples, GE moved manufacturing of washing machines from China to Kentucky, Google is making its Nexus Q media streamer in San Jose, and Caterpillar just opened a factory in Texas to make excavators. Of course any operations brought back home are highly publicized given political pressure to do so. Even with a skeptical eye, the shift is definitely underway. In a survey of American manufacturing companies in April of 2012, Boston Consulting Group found 37% of those with annual sales above $1 billion are planning or considering shifting operations from China to America. Among the bigger companies with sales over $10 billion, the number is 48%. The most common reason given is Chinese labor costs. I'm sure the image of Chip Starnes, American co-owner of Specialty Medical Supplies, being held hostage by his workers in Beijing influences these decisions as well.

U.S. Shale Oil

One of the more exciting developments in our economy has been the emergence of US shale oil production. As long as crude oil prices stay above $65/barrel, it makes financial sense for companies to dig up, heat and extract liquid hydrocarbons from oil shale, a fine grained rock that contains a mixture of organic chemical compounds. It's an expensive process but serves as a viable substitute to traditional crude oil production at higher prices. America may not have the crude oil patches in abundance that others do, but we have a huge supply of shale and natural gas (LNG costs 4x more in Japan than it does here). Over the past three years Texas has doubled its oil production and North Dakota's has tripled.

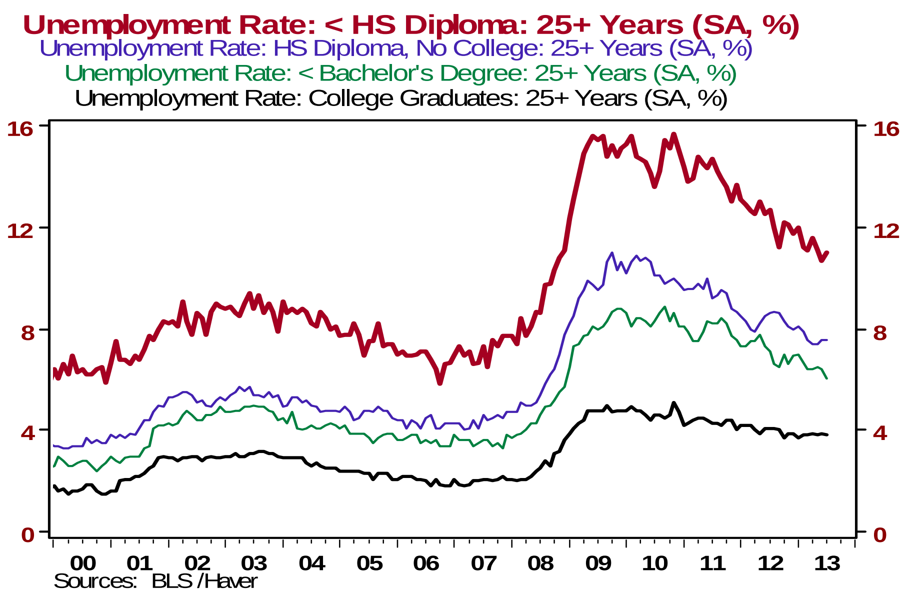
Creating an export industry for fossil fuels is not only positive for our trade balance, but it also creates a lot of middle class jobs. The EIA estimates we have over 200 billion barrels of recoverable oil using these new drilling technologies. This is 10x the amount of proven crude reserves we have (only 2% of the world's total).



Employment and QE

Taking Bernanke at his word, the labor market is on pace to trigger a reduction of Fed purchases in the fall. In July, we added 162,000 jobs while May and June payroll gains were revised down by a combined 26,000. Despite this disappointing report, the trend growth of 170-180k jobs per month is still holding. This very shallow upward trend combined with a falling labor participation rate contributed to a drop in the unemployment rate from 7.6% to 7.4%, getting close to the 7% Bernanke mentioned he would like to see before tapering. One would think with inflation still low, wage inflation in particular non-existent and employment still below pre-crisis trend, the Fed has no real reason to taper. But if the current trend remains in place, we expect a tapering announcement within the next few months.

America's movement away from manufacturing and outsourcing to lower cost countries has played a big part in the structure of our labor force. As the chart below shows, there is a wide gap between the unemployment rates of those with a college degree and those without. Those without a college education are almost three times as likely to be unemployed. Everyone can't write software for Facebook or be a manager somewhere. We've changed from a country with manufacturing industry available to provide work for those lacking higher education. Young people today are faced with the choice of going to college and coming out under a mountain of student debt, or being completely left behind. This is a dangerous course and is exacerbating our wealth gap.



The good news is the two items mentioned previously, wage pressures in China and the US energy industry, are forces countering this trend, bringing middle class jobs to the US that soak up our large population of potential workers.

In summary, our economy remains in somewhat of a holding pattern. Growth and employment gains are slow but steadily positive, inflation isn't a major concern and still below 2%, and accommodative monetary policy appears to be balancing out the drag from the fiscal side. Corporate profits are at all-time highs, the dollar is stable and housing prices nationally have recovered to the long run averages. This steady-as-she-goes recovery has certainly been different than any we've experienced as a nation since WWII and we expect something will come along to shake it up one way or the other soon.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Nick Prillaman

At our last meeting, interest rates were much lower with the 10-year Treasury at 1.81% on May 9th versus 2.83% on August 20th. Economic data was coming in below expectations and bond investors felt the Federal Reserve would keep stimulating the economy for a while longer. This was the period of calm before the interest rate storm.

In May, fears surrounding the reduction of quantitative easing (QE) by the Federal Reserve along with positive economic data produced a vigorous rise in interest rates. At Ben Bernanke's testimony to Congress, he said the "Fed could reduce bond purchases in next few meetings if data supports it" which the market interpreted as signaling a possible change in monetary policy. With the idea of tapering stimulus at the forefront of investors' minds, the strong economic data announced in the latter part of the month further helped to suppress bond prices. For example, the S&P/Case-Shiller Home Price Index saw prices rise for the 20-City Composite by 10.9% on an annual basis to March according to S&P Dow Jones Indices. Factors like these caused a 46 basis point rise in the 10-year Treasury to 2.13%. The front-end of the Treasury curve remained largely anchored during this time as the Federal Reserve made no changes to federal funds rate.

In the mortgage-backed securities sector, spreads relative to the 5-year Treasury widened throughout the month from 163 bps to 192 bps, which is indicated in the graph below. With the Federal Reserve purchasing $40 billion worth of mortgage-backed securities per month, mortgage investors became very concerned when Ben Bernanke indicated the potential to curtail these purchases, so they started to reduce their positions. Also, mortgage pools have a tendency to extend their durations in a rising interest rate scenario due to slower prepayments, and this fact made investors less willing to hold mortgages in a bond sell-off. While mortgages were widening, the agency space was quiet as the Credit Suisse 3-5 year Agency Index saw spreads remain stable around 10 bps.

Source: Bloomberg

With interest rates rising, monthly total returns for high grade corporate bonds totaled -2.28% versus -2.01% for treasuries and -.53% for high yield corporates per Bank of America Merrill Lynch. Among high grade corporates, the financial sector outperformed both the industrial and the utility sectors on a total return basis as the lower duration of financial bonds provided a greater cushion against adverse interest rate movements. Regional bank bonds lost the least among the financial subsectors as their duration was almost a year short versus the sector index. The high yield market also benefitted from lower duration combined with more lucrative yields, according to CreditSights.

In June, the bearish trend in interest rates continued as comments from Ben Bernanke on June 19th ignited a wave of selling in bonds. At a press conference, he said “if the incoming data are broadly consistent with this forecast, the committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year.” The bond market clearly did not think tapering was coming that soon, because the 10-year Treasury yield rose by 17 bps on that day. As one can see in the chart below, investors were not willing to hold treasuries when a reduction in quantitative easing was potentially around the corner.

Source: Bloomberg

After mortgage spreads widened materially in May, the space was mostly quiet. The story was the opposite in the agency sector. As shown in the chart below, the Credit Suisse 3-5 year Agency Index saw spreads remain stable in May, but then rose significantly by over 10 bps in June. Like agencies, the corporate bond market became caught in the wave of fixed-income pessimism. Bank of America Merrill Lynch said the total return for high grade corporate bonds was -2.76% versus -2.64% for high yield and -1.26% for Treasuries. Corporate supply volumes slowed to a trickle as higher yields and elevated volatility kept issuers from coming to market. Volumes were just $39 billion in June versus $112 billion in May with only $3.2 billion in the final week of June, per Bank of America Merrill Lynch.

Source: Bloomberg

The pace of the bearish trend in the Treasury market slowed in July and turned into a period of volatility as conflicting events caused yields to fluctuate. Positive economic data like the report by the U.S. Bureau of Labor Statistics showing a 195,000 increase in June nonfarm payroll employment pushed interest rates higher in the early part of the month. The yield rise was then tempered by Ben Bernanke's soothing remarks regarding monetary tightening fears by saying that "highly accommodative monetary policy for the foreseeable future is what's needed in the U.S. economy." With Treasury yields oscillating, the agency and mortgage markets were stable while the riskier parts of the market performed well. Bank of America Merrill Lynch said high grade corporates returned .74% while high yield delivered a 1.88% total return. High grade issuance volumes were able to rebound to $81 billion after a dismal June.

Volatility in a number of asset classes has been seen during the initial part of August. Positive economic data like the Institute of Supply Management reporting an increase in the non-manufacturing purchasing manager's index from 52.2 in June to 56.0 in July and the U.S. Census Bureau announcing July retail trade sales rising 0.1% from June 2013 showed a growing economy which ultimately reinforced a general fear among investors that the Federal Reserve would start tapering fairly soon. This has caused Treasury yields to resume their uptrend after a multi-week pause. Equity prices have responded poorly to the higher yields as the

S&P 500 is negative so far this month. Agency, mortgage, and corporate credit spreads have all slightly weakened due to general risk aversion.

Strategic shifts in the Treasury portion of RSA's fixed income portfolio were largely centered around using the backup in interest rates to extend the duration of various Treasury holdings. Typically, the fixed income portfolio outperforms its peers in a rising interest rate environment as we are underweight the index with regard to Treasuries, but are somewhat exposed when rates drop. Because of this, we felt it was prudent to extend the duration on two different occasions to help hedge against a fall in rates while also picking up incremental yield in the process. The outlook over the near term is that rates have risen a little too fast and could partially retrace the previous move. At some point, dramatic increases in interest rates produce economic slowdowns. If this occurs, investors will temporarily move into Treasuries as they shed risk. From a longer term perspective, a bear market in bonds will eventually materialize as investors find greater upside in other asset classes.

In the agency space, RSA replaced a called note with a new intermediate callable bond in an effort to take advantage of higher yields. A swap out of a short agency note and into a longer callable bond was completed to pick up roughly 67 bps while monetizing a decent gain. We also sold an agency security on an outright basis to reduce the weighting of the agency portfolio as spreads looked fully valued at the time. On a going forward basis, spreads appear to be range bound and do not offer much upside versus other spread products. Within the agency space, callable bonds appear to be more attractive as they have lagged in the recent tightening episode when compared with bullet bonds.

On the mortgage front, a handful of trades were completed over the last few months that were dictated by occurrences in the Treasury market. In early May when interest rates were very low, fast prepayments were eroding the returns of numerous pools. Because of this, RSA swapped out of a few 30-year 4.5% and 5.0% coupon pools and reinvested the proceeds into multiple 15-year 2.0% coupon mortgages. These swaps provided us with prepayment protection while also mitigating extension risk. Also, RSA's mortgage portfolio achieved a higher percentage of 15-year loans versus the mortgage portion of the Barclays Aggregate Index which helped greatly given what interest rates have done. Then as Treasury yields moved higher, we purchased various specified 30-year 3.5% coupon pools at different times to take advantage of higher rates and depressed prepayment protection levels. These moves increased the portfolio's duration and improved the convexity profile in order to partially hedge against a retracement rally in Treasuries. The outlook for mortgages is uncertain as the concern over what happens to the mortgage market when the Federal Reserve stops buying $40 billion a month in MBS weighs on investors' minds. Hopefully, the Federal Reserve will slowly taper their purchases so the MBS market can normalize in an efficient manner. Another area of concern is the fear of duration extension which happens as interest rates rise. To combat this, owning 15-year pools with low payups should outperform 30-year mortgages.

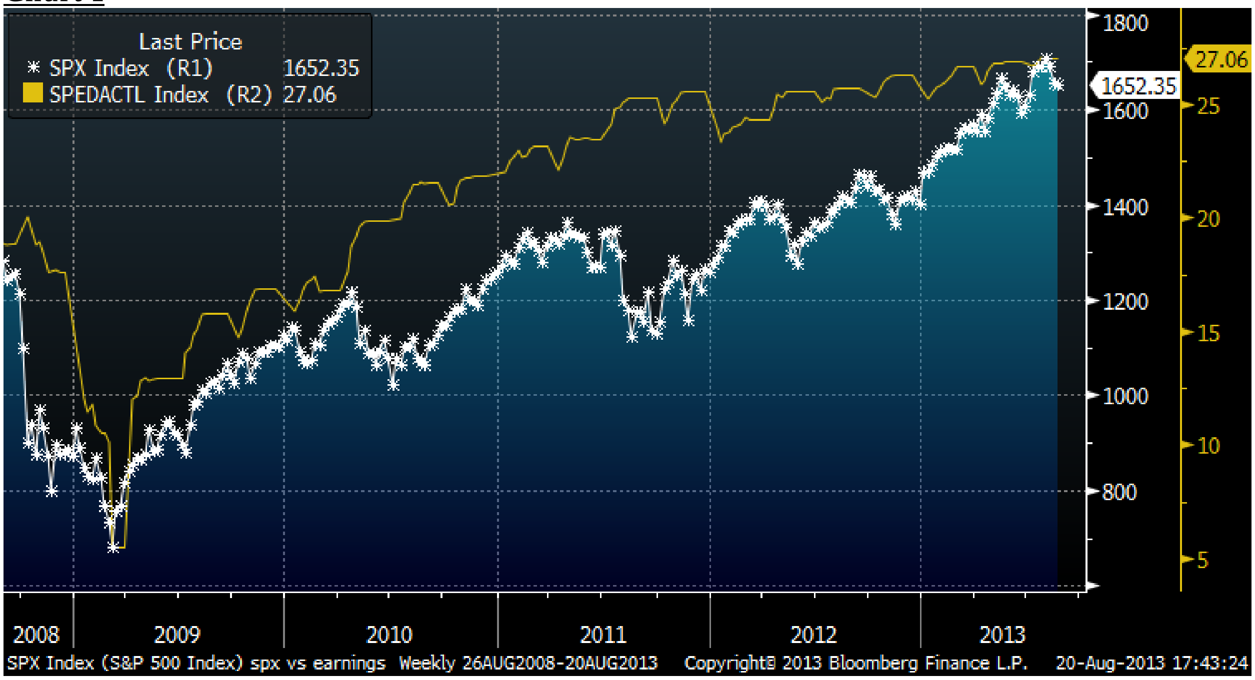
A number of actions were taken in the corporate bond portfolio over the last few months to enhance the fund's performance. RSA enacted some opportunistic buying in various names as spreads widened for a myriad of reasons. New issue concessions along with chatter surrounding the potential consolidation of the cable sector were a few of the causes for spread widening. We also purchased two floating-rate notes in May as a way to hedge against rising rates. Both of the floaters have maturities in the vicinity of 2018-2019 which should allow ample time for short-term rates to rise. Overall, we maintained our short duration position combined with an overweight versus the index. In the future, the short duration stance will aid returns as interest rates revert to historical levels. With high grade corporate credit spreads ending July at 153 bps according to CreditSights, this portion of the bond market appears better positioned than other fixed income products. Credit spreads have been tight for some time, so there is widening risk if a recession occurs or if large outflows from corporate bond funds/ETFs cause distortions in the market. Because of this, high grade bonds appear more attractive than high yield bonds.

Domestic Equity Strategy

By Marc Green

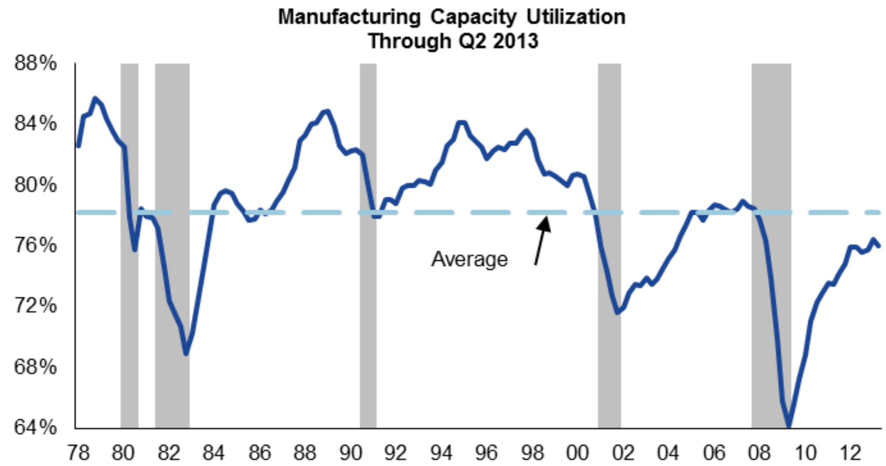
The market is in a peculiar spot at the moment, caught between lukewarm economic data and the prospect of the Fed beginning to taper down on quantitative easing. It has been the trend during prior QE transitions for the market to get jittery. Unlike prior times, the Fed is not stopping their QE program, they are cutting it back from the announced $85 billion run rate to some lesser amount. As has been the case in prior summers, we have seen some degradation in various economic indicators. As we talked about in our last quarterly update, we are still seeing somewhat of a disconnect between the economy and corporate profitability. Although GDP growth has been subpar, earnings growth has continued to come in as expected to possibly slightly better than expected. The following chart shows the S&P 500 index overlayed with the quarterly EPS run rate for the index. This shows that for the first time since the financial crisis in 2008 that the market has caught up with earnings.

Chart 1



The major takeaway from this chart is that we have seen the market multiple expand as earnings growth has flattened out. The bigger question is what is the outlook going forward for earnings growth? We don't think that the setup is there to see a sharp drop off in earnings, yet it is hard to make a case for any big reacceleration in earnings growth on a going forward basis. First, let's address why earnings growth is likely to stay relatively subdued. GDP growth estimates continue to be ratcheted down by both the street as well as government economists. With subpar global GDP and the cost cutting measures that we have experienced for the entire period since the crisis, there is not much of an argument to be made for further productivity gains. However, if you back out technology companies, we are still not back to peak margins experienced in the last cycle. We also are seeing more trouble developing in emerging markets as their economies are experiencing troubles on a couple of fronts. At the same time, it seems that Europe has stabilized somewhat, posting positive GDP growth in the most recent quarter. However, some of the variables you would expect to see that indicate the end of a cycle are not in place. Corporate management teams have been very cautious regarding capital deployment, and with good reason. Capacity utilization is still at relatively low levels considering we are nearly five years into this anemic recovery. The following chart provided by Morgan Stanley shows that utilization trends have continued to run below the long term average of the past 35 years. This supports the argument that we won't see much margin degradation as managements shouldn't feel the need to ramp up capex because there is plenty of excess capacity in the system.

Chart 2



Another worry in the marketplace is that investor sentiment is too bullish and investors are overexposed to equities. We have not found any good statistical measures that you can rely on to provide a good measure of investor confidence. Two commonly cited charts are the AAII Investor Confidence Index and the State Street Investor Confidence Index. Neither of these charts are showing either excessive bullishness or bearishness at the moment, although the State Street chart has bounced back substantially from the lows seen at the end of 2012. This does give you some pause considering the run year-to-date, but positioning around these sentiment measures has proven to be a futile drill.

Chart 3

AAII Bullishness Index

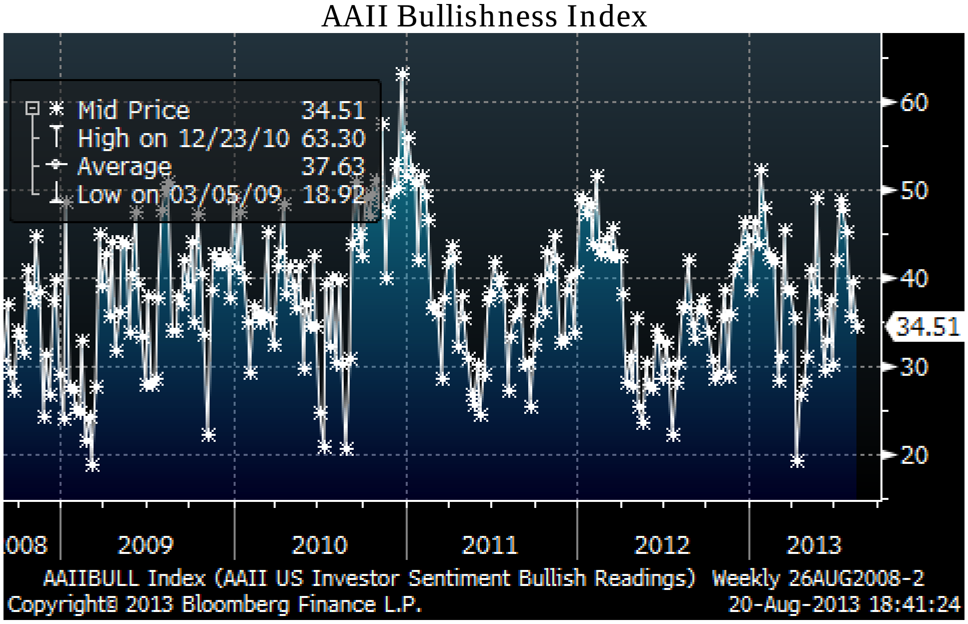
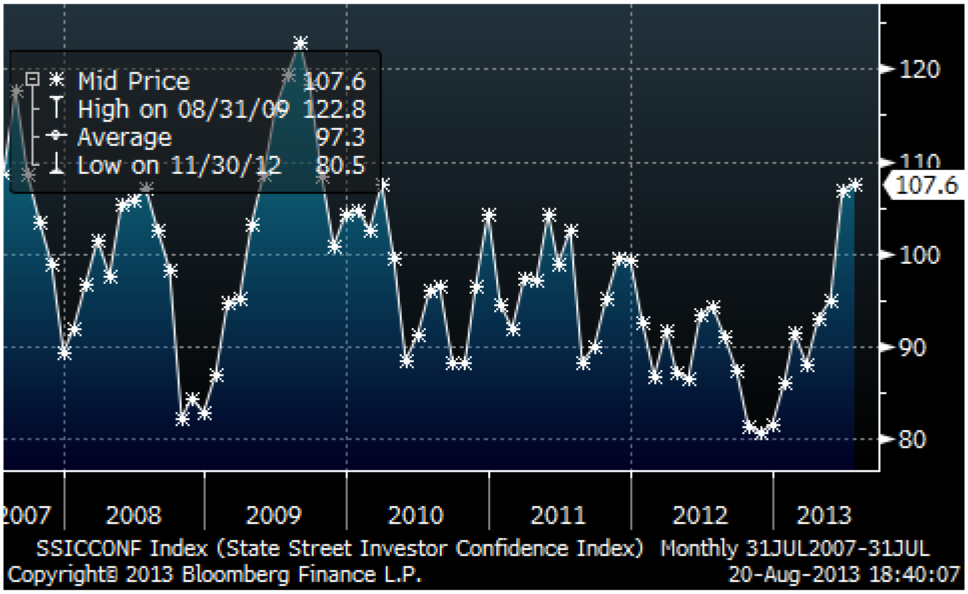


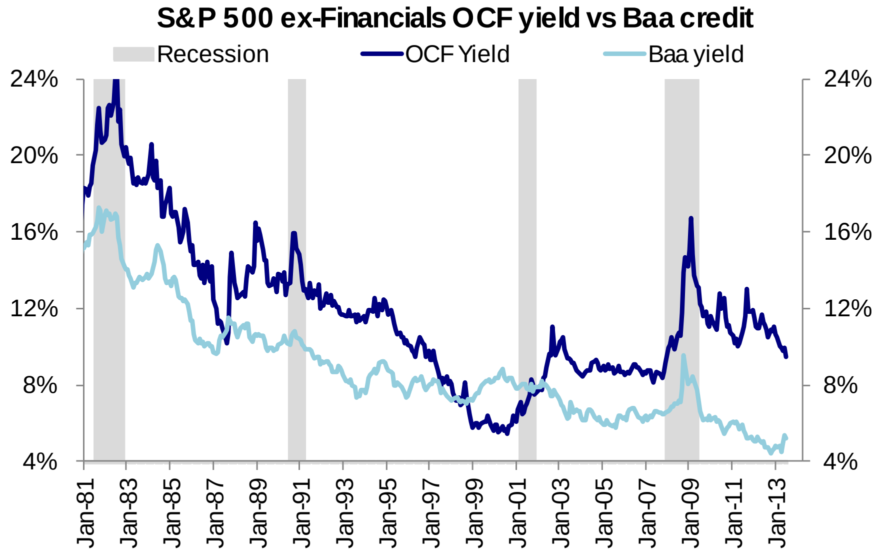
Chart 4

State Street Investor Confidence Index



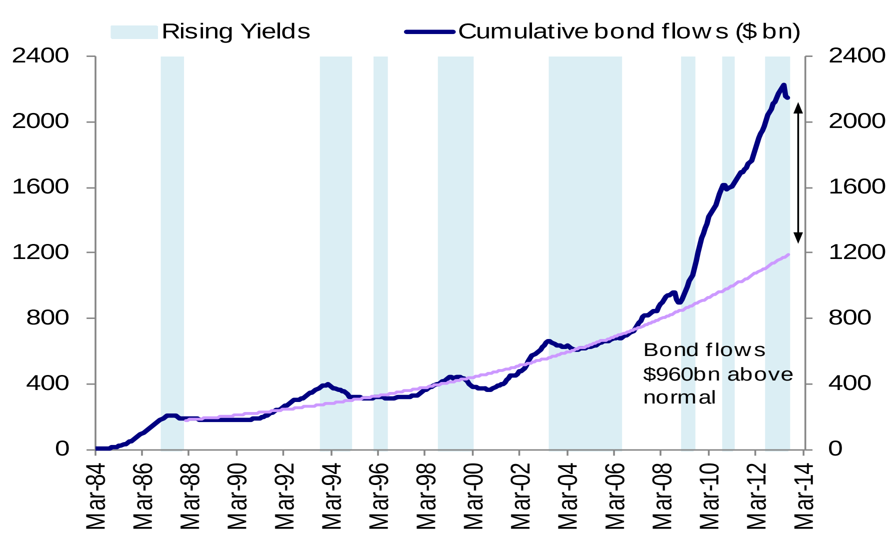
So, we can surmise that barring another recession in the immediate term that earnings growth will likely be in the mid-single digits, companies still have strong balance sheets, and have been more shareholder friendly with their cash. We have seen some merger and acquisition activity, but not at a pace that is either scary (frenzied pace) or enough to drive the market. This leaves us with whether the market can continue to see some gradual multiple expansion going forward. This is obviously the trillion dollar question and the one most hard to quantify. The market has been anything but normal the past several years. It seems most investors are opting to believe that the growth in earnings we have experienced post the recession has all been “manufactured earnings.” At the end of the day, cash is cash, and cash flow yields on stocks relative to bonds are still attractive, even if rates continue to back up some. The market has recently broken through its long term forward earnings multiple, which takes away some of the cushion we may have had, but one can argue that considering the dislocated world we have come from that multiples can continue to move higher. If you compare cash flow yields on the stock market relative to bonds, it shows that stocks still appear to be cheap. The following chart provided by Deutsche Bank depicts this spread.

Chart 5



We have been in an extended period where fund flows have been lopsided towards fixed income relative to equities. If we do return to a more normal environment where the economy becomes more self-sustaining, the Fed backs off of ZIRP, and bond yields rise as a result of stronger economic growth, this is when you should see cash flows back into equities. We don't see an environment of continued rising interest rates, the Fed changing their policy stance, and growth continuing to be below expectations. Either growth picks up or the Fed has to change course and back off of its taper plans. If we do get back to a more normal marketplace, there is a ton of money sitting in bond funds and money market accounts that may be partially reallocated back into equities. The following chart provided by Deutsche Bank shows their estimate of how far above trendline investors have been putting money into fixed income funds.

Chart 6



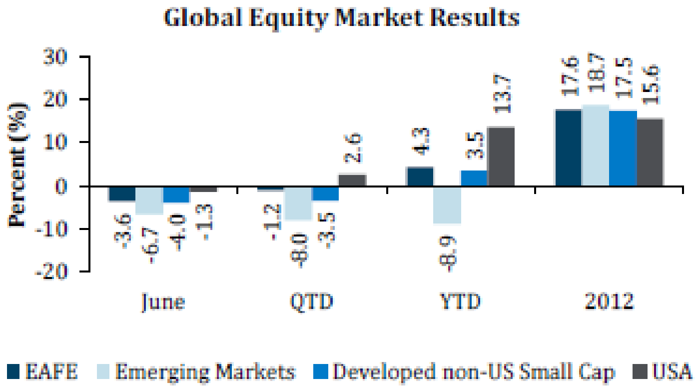
Obviously, we have been in a flight to safety mode since the Great Recession, but that trade will be unwound at some point. And without belaboring the point, there is a similar chart that show flows into stocks to be $1 trillion plus below trendline. Our guess is that like the prior three years, growth will reaccelerate as we move into the second half. With that said, September is a very busy month on the policy front with the prospect of Fed tapering and Congress needing to pass a new budget as well as addressing the debt ceiling.

To conclude, we have been staying the course with our current exposure to the stock market. Our overweight position in large capitalization stocks has worked against us somewhat this year as the mid and small caps have sizably outperformed. We have placed hedges on the smallcap active fund as we view smallcaps as richly priced at roughly 25X forward earnings. We also have about 6% of our large cap hedged, although the put protection is some ways away after the run in the market. We are researching what makes the most sense to protect some of the gains we have experienced year-to-date, while keeping in mind that we want to maintain our current allocations longer term. With volatility at low levels on shorter dated options, the put-spread collars we generally use are not priced very attractively at the moment in our view. One possibility is to spend some premium to buy some puts outright to protect some of the gains. With negative returns likely in the bond portfolio for the year, some thought has to be given to our absolute returns.

International Equity Strategy

By Steve Lambdin

Most global equity markets cooled off quite a bit in the second quarter of 2013, as many markets began to react to potentially higher interest rates down the road, political unrest in many parts of the world, and growth concerns in many of the emerging market economies. Economic data points seem to be a mixed bag around the globe, as some areas are experiencing very modest levels of growth, while other parts of the globe are still slowing down. In the equity markets, Japanese equities did manage to cool off in the second quarter from the pace of the previous six months. However, the big news in the quarter was the significant underperformance of emerging market equities from developed market equities. This sell off took place in May as the U.S. Federal Reserve signaled a change in the quantitative easing strategy that has been in place for some time and we saw a mass selling of emerging market equities. This resulted in significant pressure in the currency markets, as most emerging market currencies weakened against the U.S. Dollar. In addition, China continues to be a well talked about region with investors. We continue to see the rate of growth being slow in the country, and with this being the largest economy in the emerging markets, this has put a giant damper on the emerging markets story over the near term. On a brighter note, it does look like the Eurozone has moved away from the recession, but growth remains very subdued. At this point, we see investors over the next couple of months focusing on the U.S. Fed, a slowing of growth in the emerging markets, the geo-political tensions in many parts of the world, and whether the strength in Japan is sustainable over the medium term. We feel these issues will shape global equity market returns over the next couple of months.



Source: William Blair

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -.98% and -8.08%, respectively, during the second quarter of 2013 vs. +2.91% for the S&P 500 Index. U.S. stocks seemed to be the place to be as sentiment was a bit chilly outside of the U.S. Investors just seem a bit more comfortable owning equities in the U.S. when considering the growth picture around the globe at present. The U.S. Dollar Index did rise slightly in the quarter, but was not a major factor in returns across the developed markets. The European region performed better than the Asian region, as the Asian equity markets outside of Japan were very weak in the quarter. From an economic sector standpoint, Consumer Discretionary, Telecom, and Utilities were positive, while Materials, Staples, and Energy were weaker on a relative basis.

So far into the third quarter of 2013, equities have continued their upward ascent, with many posting new highs. Better growth prospects going forward seem to have calmed investor anxiety and this has pushed many into riskier assets, such as equities. The MSCI EAFE Index, Emerging Markets Index, and the S&P 500 Index posted returns of +8.00%, +2.30%, and +3.40% respectively thru mid- August. As we look out to the latter part of 2013, the economic recovery still seems weak to us, but looks to be getting better on the margin. Large cap global equities continue to have a most impressive fiscal year for us, while emerging market equities remain slightly negative for our fiscal year.

Global Economic Forecast

	Real GDP			Inflation			Stock Market Earnings[1]		
	2012[2]	2013	2014	2012[2]	2013	2014	2012	2013	2014
US	2.2%	2.0%	3.0%	2.1%	2.5%	2.5%	7%	8%	12%
Euro Area	-0.5	0.0	1.2	2.5	1.5	1.3	-9	16	14
UK	0.2	1.0	2.0	3.2	2.7	2.7	-5	6	10
Japan[2]	2.0	1.2	1.2	0.0	0.0	1.8	17	45	19
China	7.8	7.8	8.5	2.6	3.4	3.5			
World	2.7	2.7	3.5	3.3	3.3	3.3			

[1]FactSet, based on IBES estimates
[2]Consensus Economics
Sources: Wellington Management, Consensus Economics, FactSet

Source: Wellington Economic Outlook

Asia Update

Equity market returns in the Asian region were a mixed bag of performance in the second quarter of 2013. The Japanese equity market continued its hot streak and rose +4.4% in USD terms as the reflation strategy continues to be viewed positively by investors and corporate earnings revisions have recently been strong. On the other hand, Australian and Chinese equity markets were very weak as the former struggles with its basic resources economy and China continues to be hampered with future growth concerns. The broader MSCI Pacific Basin finished down -1.74% in USD in the quarter. Currency movements continued to be a detractor of performance for unhedged U.S. investors across the region.

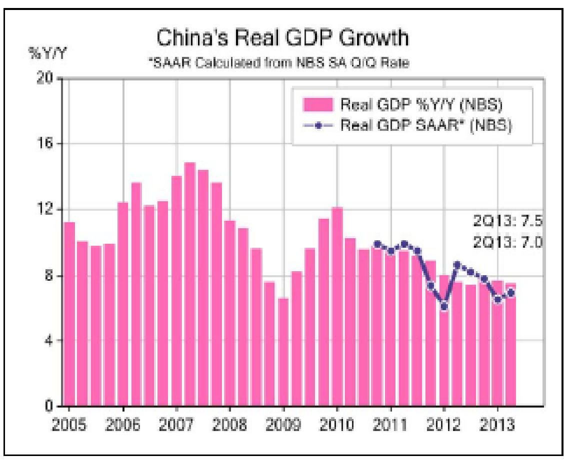
Market Performance

Data as of: 28-Jun-2013

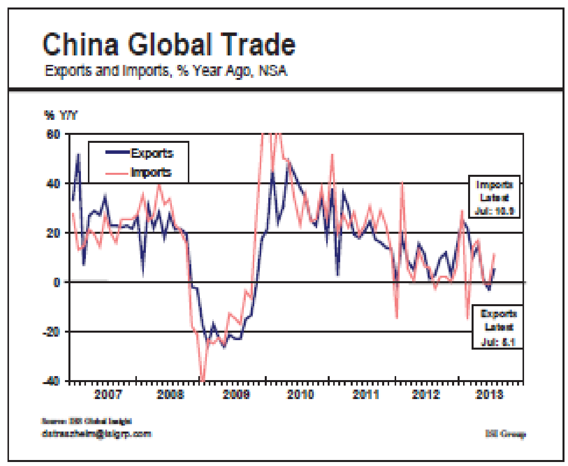
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Japan	1.75	4.40	16.55
MSCI Taiwan	-2.27	1.59	1.38
MSCI Pacific	-1.19	-1.74	7.83
MSCI Hong Kong	-5.40	-4.61	-1.28
MSCI Singapore	-4.70	-6.33	-3.51
MSCI China	-6.99	-6.76	-10.99
MSCI Philippines	-8.38	-8.82	8.17
MSCI Australia	-6.45	-13.93	-6.13

Source: Factset

The Chinese economy continued to slowdown in the second quarter of 2013. Gross Domestic Product (GDP) rose +7.5% from the year earlier period, which puts growth at the slowest pace since the recession of 2009. No doubt, the government's own +7.5% growth rate forecast for all of 2013 is certainly questionable at this point, especially as the International Monetary Fund (IMF) continues to cut its outlook for global growth. This will certainly be a confidence check for Premier Li Keqiang. However, we do see some measures of the economy beginning to improve. Industrial production rose +9.7% in July, well above many forecasts. In addition, retail sales rose +13.2 in July, above the levels seen a few months back. These are both measures seen as stabilizing the outlook for the region. Exports rose +5.1% in July while imports rose +10.9%, as both measures were decent, but could be better. Automobile sales were strong with an increase of +10.5% in July as discounts to clear inventory seemed to spur the consumer. Fixed asset investment continues to be relatively stable and was reported up +20.1% in July, much in line with expectations. Consumer prices, while rising to +2.7% from the year earlier, do not seem to be presenting a problem over the near term and still remain well below the government's official threshold. This still gives the government plenty of room for stimulative policies before inflation becomes any type of issue. At the present time, we see the Chinese economy trudging along the bottom of acceptable growth. While the margin of error is certainly less than it was a few months ago, we still do not see growth falling too much below the official government target. We also believe the re-shaping of the economy away from manufacturing toward more services as necessary and part of a normal process to move through over time. However, this puts global growth at risk, since China accounts for a large part of global growth. As other parts of the world begin to stabilize, we see this as beneficial for the Chinese economy and should help the case for at least +7.5% GDP growth in 2013. Perhaps this can push the equity markets upward in the region at some point.

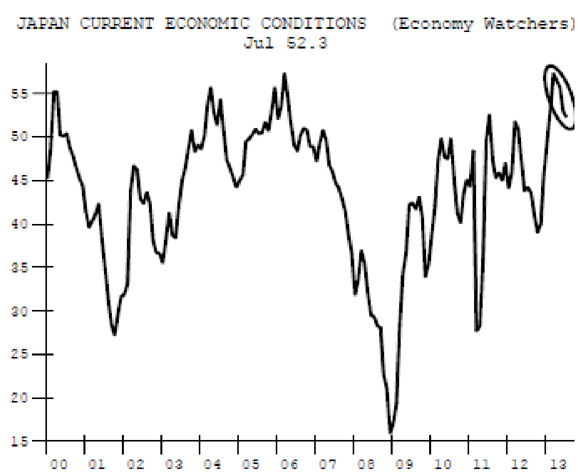


Source: ISI

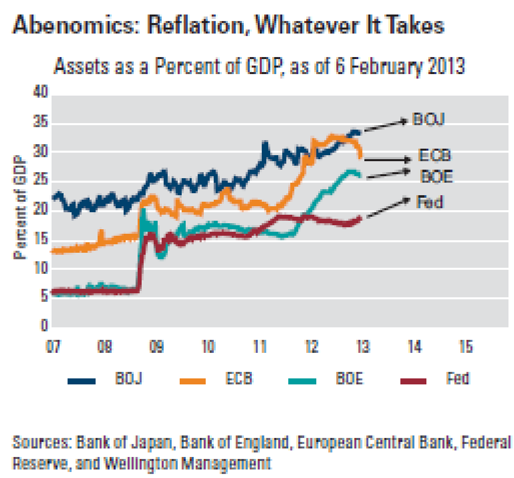


Source: ISI

The rhetoric surrounding Japan's economy continues to garner attention with investors. Prime Minster Abe continues his march to make this economy among the world's strongest again using "reflation" as its centerpiece. The Bank of Japan (BOJ) remains supportive of this as it embarks on an aggressive quantitative easing program to weaken the yen. No doubt, turning this deflationary ship around will take time. First quarter GDP rose +2.6% on a year over year basis, below the levels we saw in the previous quarter. However, we are seeing evidence the deflation battle is starting to turn, as the GDP deflator recorded the smallest drop since early 2009. We will have to wait and see if this is a sustaining trend or temporary in nature. In a positive signal for the economy, core machinery orders rose +4.9% in June from a year ago, much better than what many had expected. Corporate profits have been robust here, as most companies have had little trouble beating expectations in the current reflation environment. Business confidence continues to improve, as a recent survey in June was reported at the highest rate in a couple of years. The consumer appears to be remaining upbeat, as consumer confidence in the second quarter was above levels seen in the first quarter. Also, consumer spending contributed a sizable amount to the second quarter GDP growth rate, which is another sign of the confidence of the consumer. In addition, retail sales have turned the corner and were up on a year over year basis in May and June, the first two-month positive swing in quite some time. The economy continues to reflate, as consumer prices rose the most in five years in June. The employment picture continues to improve in Japan, as the June unemployment rate was reported at 3.9%, the lowest rate we can remember in many years. Also, the job to applicant ratio continues to be very positive, and moved upward to .92 in June, from .90 the month before. As we review the multitude of economic data points over the last couple of months, the economic picture in Japan continues to look better. Abenomics seem to be having the desired effects on the region's economy. Thus far, investors have been supportive, as equity markets in Japan have been strong over the last year. However, one of the biggest issues facing the leaders here is whether the economy is strong enough to withstand the 3% increase in sales tax scheduled to go into effect in April 2014. No doubt, this will be subject of much contention and debate among the political and economic leadership of the country.



Source: ISI



Source: Wellington Mgmt. Economic Outlook

Europe Update

After garnering most of the attention over the last couple of years, the Eurozone was relatively quiet during the second quarter. This was also reflected in the equity markets across the region, as the MSCI European (ex U.K.) managed to just squeeze out a very small positive return of +.35% in the quarter. But make no mistake, even though the political landscape has been quiet as of late, the issues this region faces going forward are very "long in the tooth" and will not go away anytime soon. Sentiment toward the region by investors seems much better, with many now actively looking for deep value opportunities across the land. Even revisions to corporate earnings have not been as severe as a few quarters ago. However, this economy still remains among the weakest around the globe, with growth at a virtual standstill at this point. We see no need for the European Central Bank (ECB) to withdraw supportive actions at this point, even as credit and fiscal conditions are improving. We do expect a recovery going forward, albeit at a slow pace. Many countries have done a tremendous job on the fiscal adjustment front. We feel as southern Europe progresses, this should give more confidence to investors and perhaps this can lead to higher equity markets.

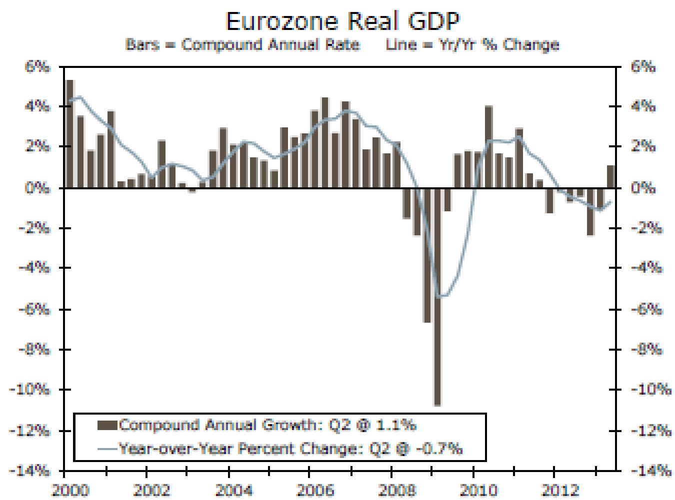
Market Performance

Data as of: 28-Jun-2013

Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Netherlands	-3.60	2.83	5.31
MSCI Germany	-4.12	2.71	2.89
MSCI France	-4.84	2.66	3.23
MSCI Italy	-11.08	0.82	-9.04
MSCI Europe ex UK	-4.64	0.35	3.19
MSCI Switzerland	-1.91	-0.29	10.92
MSCI Spain	-7.25	-0.64	-6.18
MSCI United Kingdom	-5.20	-2.16	0.27

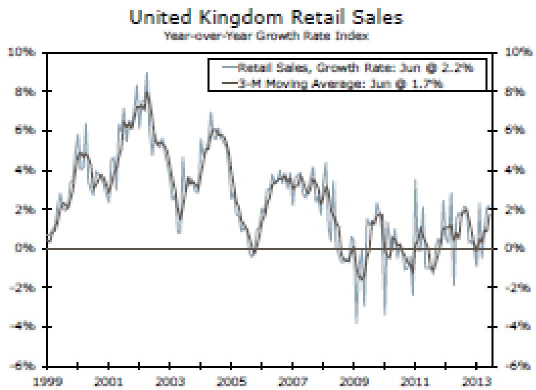
Source: Factset

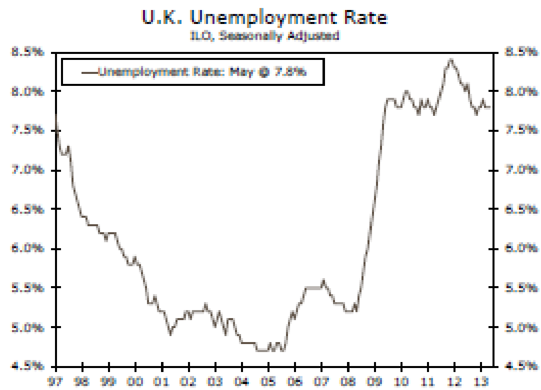
Officially, the Euroland economy exited from a record long recession in the second quarter, even though it certainly does not feel like so. After six straight quarters of negative growth in the economy, second quarter GDP rose +.3% in the region. As usual, the French and German economies led the way as both posted faster than expected growth in the quarter. Export growth led the way in France and Germany, as this masked the weakness in the southern Eurozone countries. Even as weakness persists in many countries, nevertheless, this gives many investors a glimmer of hope that we have seen the worst across the region. A recent composite index of manufacturing and services moved above the critical 50 level in July, which is the first time since early 2012. Manufacturing capacity usage continues to climb higher, which is yet another sign of a healthier economy ahead. The index of executive and consumer sentiment reached 92.5 in July, which is the highest level in 15 months. Many companies with a global reach based in Europe, such as Peugeot, Allianz SE, and Henkel AG, have reported relatively healthy earnings and believe the worst may be behind us. Unfortunately, in the early stages of a recovery, not everything is positive. Retail sales continue to be tough, and fell -.9% in June from the year earlier as consumers remain very skeptical of this early shallow recovery that could be developing. The Euroland unemployment rate has held steady lately, and was reported at 12.1% in June, which remains at record levels. The latest estimate puts approximately 19.3 million people out of work in this region in June, slightly below the level seen in May. Perhaps companies will re-think their respective hiring plans as the region embarks on an exit from the long recession. Inflation remains well contained in the Euroland economy, and was reported at +1.6% in June, well below targeted levels by the ECB. The ECB kept its key refi rate at .50% at its early August meeting. The ECB aims to keep interest rates at the current or lower levels for an extended period of time. They are able to say this as inflation is expected to remain at or below targeted levels extending into the medium term. Looking ahead for the region, we do feel better on the margin about the regions' outlook going forward. However, it's so early in a potential recovery that almost anything can happen at this point.



Source: Wells Fargo

The modest recovery we saw in the U.K. economy in the first quarter of 2013, has given way to a broader recovery in the second quarter. GDP grew +.6% in the second quarter of 2013 from the previous quarter, or +1.4% from the year earlier period. The recovery has firmed up in this region as services, construction, and manufacturing all contributed to growth in the quarter. Industrial production continued to show strength and was reported up +1.1 in June from May. These are some of the best readings we have seen in a while. Retail sales were strong in the quarter, as sales surged +1.2% in May and another +.2% in June. This is the first consecutive monthly increase in this data point in a year and a sign the consumer is beginning to feel better. Wage growth actually accelerated +2.1% year over year in the second quarter, mainly due to delayed bonus payments. This is a very encouraging sign for this economy. Inflation remained a little sticky lately, but managed to stay at +2.8% in July from a year earlier. This rate is still above the 2% level sought by The Bank of England (BOE), but we feel this could come down some later this year if we see some weakness in crude oil prices. At its August meeting, The Monetary Policy Committee (MPC) kept interest rates at a record low of .50% and its bond purchase target remained at 375 billion pounds as we expected. New BOE Governor, Mark Carney, will present the current assessment of the MPC's view, but we expect not to see much change in this view. The employment picture, while still weak, may have actually improved ever so slightly in the second quarter. The unemployment rate fell to 7.8% in the second quarter, as employment rose by 69,000 in the quarter. In addition, as mentioned above, wage growth was a positive surprise as well. As we add up the scorecard in this region, we do feel better about what we are seeing in the U.K economy. However, the recovery remains shallow and can turn in the other direction fairly quickly. A strengthening Euroland economy will only help the situation here and could be a key to further gains for the balance of 2013.



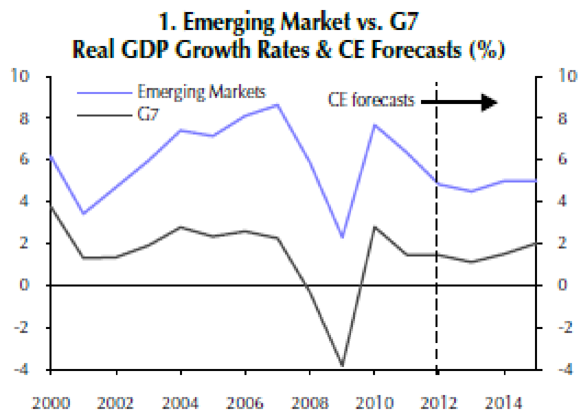


Source: IHS Global Insight and Wells Fargo Securities, LLC

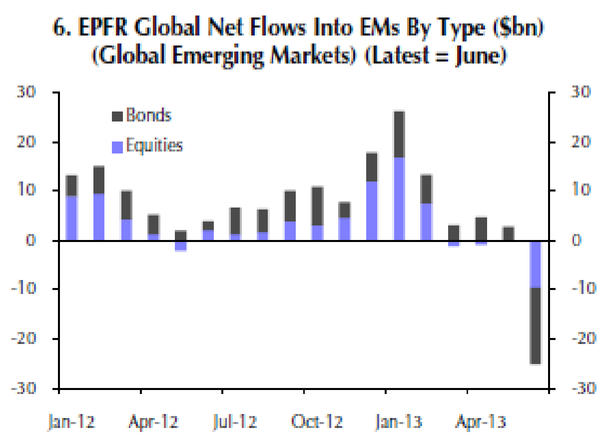
Emerging Markets

Over the last few months, it has been hard to find much positive to mention about emerging market equities in the press and investment research. We have witnessed a severe turn in investor sentiment not witnessed since the late 1990's. Two issues putting significant pressure on the equity markets lately have been the U.S. Fed tapering strategy and the slowdown in the growth rate of the Chinese economy. As with the impending change in Fed policy or any other major change of direction of central bank policy, investors have to adjust expectations going forward, and we feel most violent moves happen at the beginning of a change in strategy. Our sense is that this could be what is happening with emerging market equities at present. No doubt, this will certainly adversely affect capital flows into these regions. However, once investors become acclimated to the "new normal" for Fed policy over the next few quarters, we could see renewed interest in these equities by investors. As far as China, the rebalancing of the economy toward more internal consumption and less dependence on exporting is a long process. China is the second largest economy in the world and the largest within the emerging markets. An adjustment of this magnitude will be felt by nearly every economy to some degree. It will result in a slower growth profile going forward, but it is necessary for the long term stability of this economy. This is already underway, and investors have to re-calibrate their respective expectations for this economy going forward for the long term. Again, this can be painful in the beginning until the “new normal” establishes itself. As this process unfolds, old leaders in the emerging markets will be replaced with new ones.

With this being said, we still find the growth rates in the emerging market economies to be superior to that of the developed markets over the long term, just not to the degree we have witnessed in the past. Periods of outperformance and underperformance of these equities vs. the developed markets tend to be medium to long term in nature. We are in a period of long term underperformance at the present time. This has pushed valuations and dividend yields to what we feel are attractive levels at the present time.



Source: Thomson Datastream, CEIC, EPFR Global



Source: Thomson Datastream, CEIC, EPFR Global

International Equity Activity/Strategy

With only one and half months left in our current fiscal year, large cap global equity returns have been most impressive, while emerging markets returns are still negative on the year. It's been the tale of two worlds. In the developed markets, you have an economic picture seemingly getting slightly better by each passing month, a European financial situation which is not the most talked about topic in the financial press anymore, and a relatively calm geo-political climate. On the other hand, in many of the emerging economies, we have a slowing economic outlook over the near term, massive geo-political upheaval, an unwinding carry trade problem, and some wild swings in the currency markets. This has made for a very nervous investor when it comes to emerging market equities. However, we still believe the long-term outlook remains fairly strong in many of the emerging markets as we move through an adjustment period in these markets. Eventually, this should lead to a more balanced and sustainable economic picture in many of these regions. But all in all, global equities do seem to paint a good picture as we move through the late summer. Corporate earnings growth is relatively good at this juncture in the economic landscape, as margins seem to be quite resilient. The European region appears to be through the worst of its crisis, even though many obstacles remain. Japan seems to be looking different going forward, at least in the near term. China still remains a wildcard card going forward. Developed market valuations still look attractive, even after the moves we have seen in the markets over the last few years. Most investors will be watching developments with the tapering of quantitative easing in the U.S. over the next couple months. This alone could set the tone and direction of global equity markets over the near term.

We did add approximately $75 million to our emerging markets equity ETF in late June as the price of this ETF moved below our strike price on our written puts. We still remain very active in the option space, as we continue to sell call and put options on this index in an effort to sell some exposure into a quick rally as well as adding money to this index at attractive levels 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 1.65% of total assets and approximately 12.2% for MSCI EAFE equities. *(Charts provided by William Blair, ISI, Wellington Management, Factset, IHS Global Insight, Wells Fargo, Thomson Datastream, CEIC, EPFR Global)*

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 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	1,963,866,907	5.26	5.99	19.73	20.15	25.56	16.06	6.99	7.16	Oct-94
TRS S&P 500 FUND	5,263,453,032	4.80	5.80	18.76	18.34	23.99	17.57	8.21	7.67	Oct-94
TRS MID CAP INDEX	1,117,495,994	6.19	6.63	21.71	26.08	32.88	19.24	10.76	11.08	Oct-94
TRS S&P SMALL CAP INDEX	696,771,952	6.90	11.51	24.61	27.68	35.80	21.11	11.67	11.22	Mar-01
TRS SMALLCAP ACTIVE FUND	161,164,276	4.27	7.12	17.84	18.16	19.64	15.19	7.61		Jun-06
TRS MIDCAP ACTIVE FUND (SSF)	742,919,845	5.72	5.73	18.84	21.80	29.52	18.80	10.69	10.33	Oct-94
TRS TOTAL DOMESTIC EQUITY	9,945,672,006	5.25	6.33	19.66	20.41	26.36	17.53	8.25	8.13	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		5.44	6.62	20.38	21.05	27.24	18.22	8.84	8.38	
S&P 500		5.09	6.10	19.62	19.16	25.00	17.74	8.26	7.64	
S&P 400 MIDCAP		6.20	6.59	21.69	26.08	33.00	19.18	10.64	11.02	
S&P 600 SMALL CAP		6.84	11.33	24.15	26.90	34.78	20.46	10.96	10.94	
INTERNATIONAL EQUITY										
TRS EMERGING MARKETS FUND	314,195,448	1.17	-9.29	-11.13	-3.77	1.73				Oct-11
TRS INTERNATIONAL EQUITIES	2,527,044,312	5.26	-0.58	9.99	17.24	24.13	9.23	1.59	8.43	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	2,841,239,760	4.79	-1.55	7.51	14.80	21.53	8.32	1.38	8.48	Nov-94
TRS CUSTOM INTERNATIONAL EQUITY IND		4.79	-1.68	7.49	14.43					
MSCI EAFE (NET)		5.28	-0.92	9.60	16.80	23.48	8.61	1.05	7.97	
MSCI EMERGING MARKETS (NET)		1.04	-7.81	-8.62	-3.53	1.95	1.01	0.55	13.10	

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 31, 2013

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	12,786,911,766	5.15	4.49	16.76	19.14	25.27	15.28	6.54	8.15	Oct-75
TRS CUSTOM GLOBAL EQUITY INDEX		5.30	4.68	17.30	19.54	25.82	15.68	6.79		
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,441,361,790	0.17	-3.16	-1.71	-1.18	-0.62	4.28	6.47	6.35	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		0.35	-3.39	-2.30	-1.86	-1.48	3.81	6.06	5.22	
TRS TOTAL FIXED (ex. Private Placements)	2,441,361,790	0.17	-3.16	-1.71	-1.18	-0.62	4.28	6.47		Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		0.35	-3.39	-2.30	-1.86	-1.48	3.81	6.06		
Barclays Aggregate Bond		0.14	-3.17	-2.31	-2.10	-1.91	3.19	5.23	4.89	
TRS PRIVATE PLACEMENTS	2,222,490,861	0.62	3.68	7.62	9.22	17.97	12.09	3.13	7.07	Aug-99
TRS CASH ACCOUNT	104,028,059	0.01	0.03	0.07	0.11	0.14	0.18	0.40		Sep-03
TRS TOTAL FIXED INCOME	4,767,880,710	0.39	0.03	2.54	3.52	7.35	7.43	4.52	6.49	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED STOCK	399,238,781	0.28	-14.91	-6.89	-6.99	-0.20	8.58	-25.62		Sep-03
TRS REAL ESTATE	1,980,487,887	0.01	0.01	-0.95	-0.94	3.76	1.12	0.44		Oct-03
TRS SHORT TERM INVESTMENTS	329,740,782	0.03	0.08	0.21	0.33	0.40	0.40	0.93		Oct-03
TRS TOTAL ALTERNATIVES	2,709,467,449	0.05	-2.09	-1.59	-1.58	2.48	1.56	-5.25		Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,477,348,160	0.27	-0.74	1.00	1.62	5.53	5.22	1.30	4.26	Oct-93

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 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	20,264,259,926	3.28	2.48	10.30	11.89	17.04	10.99	4.30	6.36	Oct-87
TRS TOTAL PLAN POLICY		4.45	3.31	13.48	15.31	20.13	12.20	6.60		

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - 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										
ERS CORE FUND	1,057,900,104	5.27	6.01	19.76	20.19	25.60	16.09	7.01	7.17	Oct-94
ERS S&P 500 FUND	2,381,330,283	4.79	5.80	18.75	18.33	23.96	17.57	8.21	7.70	Oct-94
ERS MID CAP INDEX	494,297,185	6.19	6.63	21.71	26.08	32.88	19.25	10.77	11.10	Oct-94
ERS S&P SMALL CAP INDEX	286,555,288	6.90	11.51	24.61	27.68	35.80	21.11	11.67	11.19	Mar-01
ERS SMALLCAP ACTIVE FUND	79,458,736	4.23	7.12	17.84	18.15	19.64	15.20	7.62		Jun-06
ERS MIDCAP ACTIVE FUND (SSF)	398,981,721	5.71	5.73	18.79	21.80	29.53	18.80	10.71	10.40	Oct-94
ERS TOTAL DOMESTIC EQUITY	4,698,523,317	5.24	6.28	19.61	20.36	26.29	17.47	8.21	8.12	Oct-93
ERS CUSTOM DOMESTIC EQUITY INDEX		5.43	6.58	20.35	21.01	27.18	18.20	8.82	8.36	
S&P 500		5.09	6.10	19.62	19.16	25.00	17.74	8.26	7.64	
S&P 400 MIDCAP		6.20	6.59	21.69	26.08	33.00	19.18	10.64	11.02	
S&P 600 SMALL CAP		6.84	11.33	24.15	26.90	34.78	20.46	10.96	10.94	
INTERNATIONAL EQUITY										
ERS EMERGING MARKETS FUND	150,044,195	1.17	-9.30	-11.13	-3.77	1.73				Oct-11
ERS INTERNATIONAL EQUITIES	1,110,749,587	5.26	-0.58	9.98	17.23	24.12	9.25	1.60	8.41	Nov-94
ERS TOTAL INTERNATIONAL EQUITY	1,260,793,782	4.75	-1.63	7.32	14.61	21.33	8.26	1.38	8.47	Nov-94
ERS CUSTOM INTERNATIONAL EQUITY IND		4.75	-1.74	7.33	14.25					
MSCI EAFE (NET)		5.28	-0.92	9.60	16.80	23.48	8.61	1.05	7.97	
MSCI EMERGING MARKETS (NET)		1.04	-7.81	-8.62	-3.53	1.95	1.01	0.55	13.10	

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
ERS TOTAL GLOBAL EQUITY	5,959,317,099	5.14	4.52	16.81	19.12	25.23	15.33	6.59	8.16	Oct-93
ERS CUSTOM GLOBAL EQUITY INDEX		5.29	4.73	17.38	19.54	25.80	15.78	6.87		
FIXED INCOME										
ERS DOMESTIC FIXED INCOME	1,110,622,144	0.17	-3.18	-1.74	-1.20	-0.65	4.27	6.46	6.38	Sep-99
ERS CUSTOM DOMESTIC FIXED INDEX		0.35	-3.40	-2.31	-1.86	-1.48	3.82	6.05	5.21	
ERS TOTAL FIXED (ex. Private Placements)	1,110,622,144	0.17	-3.18	-1.74	-1.20	-0.65	4.27	6.46		Oct-03
ERS CUSTOM GLOBAL FIXED INDEX		0.35	-3.40	-2.31	-1.86	-1.48	3.82	6.05		
Barclays Aggregate Bond		0.14	-3.17	-2.31	-2.10	-1.91	3.19	5.23	4.89	
ERS PRIVATE PLACEMENTS	1,103,354,234	0.62	3.69	7.64	9.23	17.79	12.02	3.02	6.97	Aug-99
ERS CASH ACCOUNT	69,909,078	0.01	0.03	0.07	0.12	0.15	0.19	0.40		Sep-03
ERS TOTAL FIXED INCOME	2,283,885,456	0.40	0.16	2.70	3.69	7.59	7.49	4.39	6.46	Oct-93
ALTERNATIVE INVESTMENTS										
ERS PREFERRED STOCK	277,776,082	0.20	-10.30	0.02	-0.33	8.10	12.58	-19.98		Sep-03
ERS REAL ESTATE	961,791,779	0.01	0.01	-0.96	-0.95	3.70	0.99	0.35		Oct-03
ERS SHORT TERM INVESTMENTS	321,024,666	0.03	0.08	0.19	0.31	0.38	0.39	0.92		Oct-03
ERS TOTAL ALTERNATIVES	1,560,592,527	0.05	-1.74	-0.59	-0.62	3.54	2.23	-6.57		Oct-03
ERS TOTAL F.I. PLUS ALTERNATIVES	3,844,477,983	0.26	-0.62	1.34	1.91	5.91	5.36	0.48	3.90	Oct-93

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
ERS TOTAL PLAN	9,803,795,083	3.16	2.43	10.12	11.62	16.75	10.87	3.80	6.05	Oct-87
ERS TOTAL PLAN POLICY		4.45	3.37	13.53	15.28	20.08	12.15	6.58		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - 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										
JRF S&P 500 FUND	123,453,484	4.99	6.00	19.11	18.69	24.45	17.69	8.32	7.72	Oct-94
JRF S&P MID CAP INDEX	14,824,432	6.19	6.63	21.72	26.08	33.01	19.24	10.78	11.08	Oct-94
JRF S&P SMALL CAP INDEX	6,275,594	6.90	11.50	24.61	27.68	35.80	21.11	11.67	11.33	Mar-01
JRF TOTAL DOMESTIC EQUITY	144,553,511	5.20	6.29	19.61	19.79	25.74	17.98	8.72	8.16	Oct-93
JRF CUSTOM DOMESTIC EQUITY INDEX		5.28	6.37	20.02	20.17	26.18	18.00	8.56	8.03	
S&P 500		5.09	6.10	19.62	19.16	25.00	17.74	8.26	7.64	
S&P 400 MIDCAP		6.20	6.59	21.69	26.08	33.00	19.18	10.64	11.02	
S&P 600 SMALL CAP		6.84	11.33	24.15	26.90	34.78	20.46	10.96	10.94	
INTERNATIONAL EQUITY										
JRF EMERGING MARKETS FUND	4,662,068	1.17	-9.30	-11.13	-3.77	1.73				Oct-11
JRF INTERNATIONAL EQUITIES	33,260,589	5.22	-0.61	10.00	17.29	24.16	9.25	1.78		Nov-06
JRF TOTAL INTERNATIONAL EQUITY	37,922,657	4.71	-1.69	7.24	14.57	21.26	8.17	1.83		Nov-06
JRF CUSTOM INTERNATIONAL EQUITY IND		4.73	-1.77	7.25	14.16					
MSCI EAFE (NET)		5.28	-0.92	9.60	16.80	23.48	8.61	1.05	7.97	
MSCI EMERGING MARKETS (NET)		1.04	-7.81	-8.62	-3.53	1.95	1.01	0.55	13.10	
JRF TOTAL GLOBAL EQUITY	182,476,167	5.10	4.55	16.84	18.69	24.81	15.77	7.43	7.66	Oct-93
JRF CUSTOM GLOBAL EQUITY INDEX		5.16	4.59	17.16	18.89	25.03	15.68	7.05		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 31, 2013

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
DOMESTIC FIXED INCOME										
JRF DOMESTIC FIXED INCOME	58,123,670	0.20	-3.05	-1.47	-0.91	-0.26	4.19	6.54	6.18	Oct-93
JRF CUSTOM DOMESTIC FIXED INDEX		0.34	-3.37	-2.28	-1.84	-1.46	3.72	5.88	5.15	
Barclays Aggregate Bond		0.14	-3.17	-2.31	-2.10	-1.91	3.19	5.23	4.89	
JRF PRIVATE PLACEMENTS	3,229,304	0.54	10.62	10.28	12.98	10.42	5.40	2.97	7.36	Oct-01
JRF CASH ACCOUNT	3,672,542	0.01	0.03	0.07	0.10	0.14	0.18	0.40		Sep-03
JRF TOTAL FIXED INCOME	65,025,516	0.22	-2.21	-0.78	-0.14	0.34	4.03	5.73	6.27	Oct-93
ALTERNATIVE INVESTMENTS										
JRF REAL ESTATE	3,135,900	0.00	0.00	0.00	0.00	8.00	13.07	8.50		Oct-03
JRF SHORT TERM INVESTMENTS	1,999,668	0.02	0.08	0.19	0.34	0.45	0.46	0.98		Oct-03
JRF TOTAL ALTERNATIVES	5,135,567	0.01	0.04	0.13	0.44	2.86	4.68	3.10		Oct-03
JRF TOTAL F.I. PLUS ALTERNATIVES	70,161,083	0.20	-1.95	-0.64	-0.05	0.65	4.17	5.41	6.01	Oct-93

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING July 31, 2013

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
<u>TOTAL PLAN</u>										
JRF TOTAL PLAN	252,637,250	3.66	2.61	11.15	12.55	16.62	11.76	6.99	7.15	Oct-93
JRF TOTAL PLAN POLICY		5.28	3.38	12.46	13.77	17.89	12.06	6.81		