MID-YEAR REPORT, JUNE 2013

Market Update

Economic and Financial Market Outlook — Mid-Year Update

Economic Refrain: 'Don't Fear the Taper'

Market Summary

- *Treasury yields are drifting upward as the Fed considers tapering their bond purchase programs.*
- *The FOMC is anticipating no Fed Funds rate hikes until the second half of 2015.*
- *The S&P 500 has gotten off to a robust start in the first five months, rising approximately 15%.*
- *We believe equities could see an additional 5% to 7% on the upside in 2013. Valuation levels for the market remain reasonable.*
- *The housing sector is now well into what appears to be a strong and sustained recovery.*
- *Looking outside the United States, global headwinds persist. The Eurozone is likely to remain the weakest of the developed economies.*
- *We project that U.S. GDP will grow in the range of 2% to 2.5% for 2013, with the unemployment rate declining modestly.*

INTRODUCTION

Over the last 12 months, we have experienced a start and stop economy with U.S. Gross Domestic Product (GDP) moving ahead one quarter and struggling the next. While labor markets are showing signs of gradual improvement, we are still well below full employment. Recent talk of Fed "tapering" has been a drag on equity markets in the very near-term. The perceived threat of higher interest rates, near-zero growth in the Eurozone, and slowing growth in China has been cause for concern. Despite this, with the help of massive monetary infusion and low interest rates, we believe the U.S. economy has likely entered a self-sustaining moderate recovery with smoother roads ahead.

ECONOMIC OUTLOOK

As we head into the second half of 2013, the pendulum of the U.S. economy continues to swing back and forth, just as it has for much of the past few years. For example, in the third quarter of 2012, GDP rose 3.1%, but growth nearly vanished in the fourth quarter of 2012, increasing only 0.4%. Then, in the first quarter of 2013, GDP growth came in at a still-disappointing 2.4%, while second quarter 2013 growth is expected to be less than 2%. **(Chart 1)** But even with subpar growth relative to historic norms, the economy has likely entered a modest expansion, and eventually a steadier trail will be blazed.

Massive monetary policy accommodation (here and abroad) has significantly lowered interest rates and helped to support aggregate demand for goods and services, while reducing downside risks. In addition, deleveraging (paying off, refinancing and otherwise reducing debt) has improved both corporate and consumer balance sheets. At the same time, deleveraging also reduces spending relative to income while it is

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CHART 1
REAL GROSS
DOMESTIC PRODUCT
Despite swinging back and forth, GDP has been able to maintain modest positive growth.

- Year over Year Change
- Year over Year (Estimate)*
- 10 Year
- "Sustainable Growth" Trend

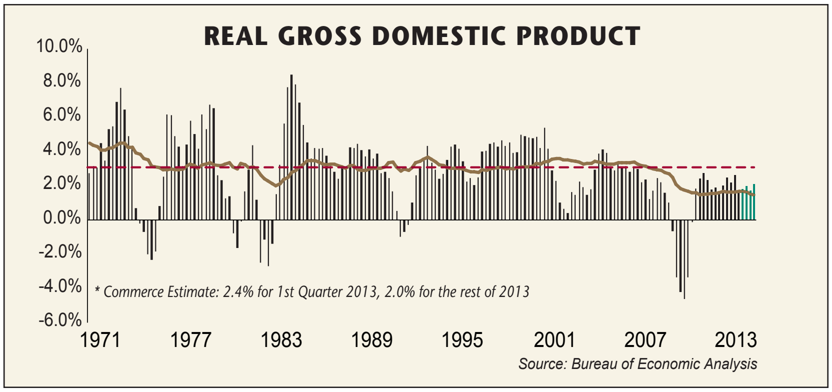


CHART 2
INFLATION
Low energy prices and subpar economic growth have helped keep inflation subdued.

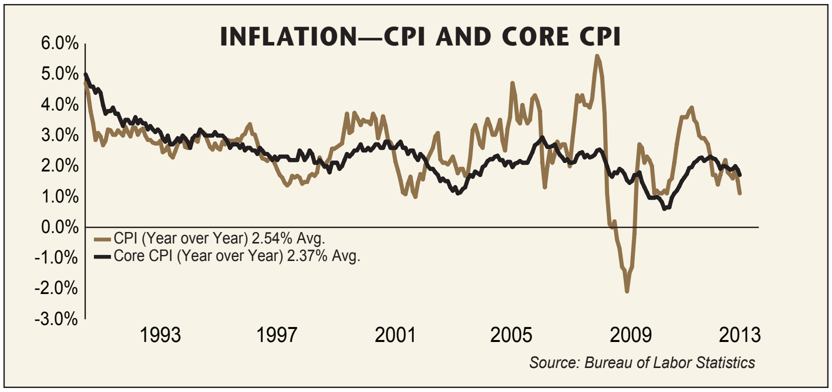


CHART 3
EMPLOYMENT
Slow labor market recovery has resulted in gradual downward drift for the unemployment rate.

- Monthly Increase (Left Axis)
- 3-Month Change (Right Axis)

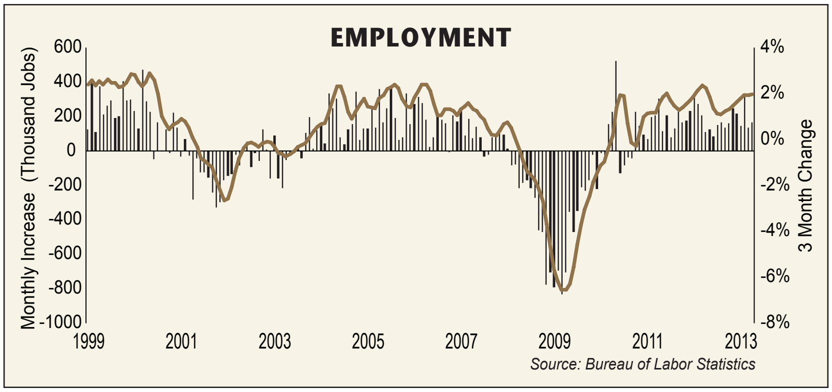
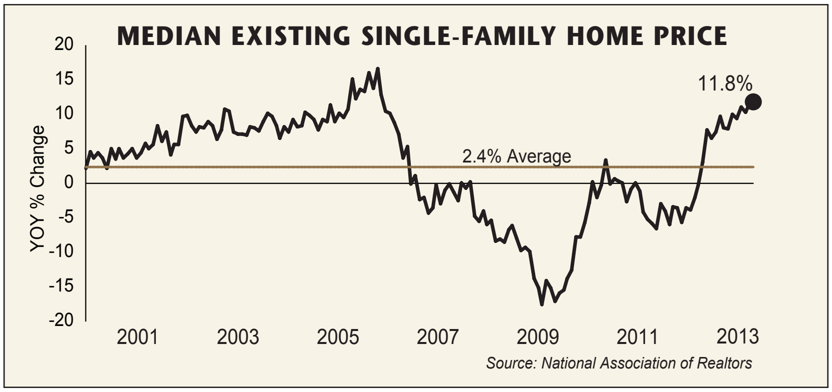


CHART 4
MEDIAN EXISTING SINGLE-FAMILY HOME PRICE
Existing home prices continue to rise, confirming a sustained recovery in the housing sector.

- YOY % Change
- Average



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underway. But eventually balance sheets improve to the point where the pace of deleveraging slows and the drag on spending diminishes. We are steadily approaching that point now, although the Federal government has yet to significantly address this issue.

With inflation trending well below the Fed's target (Chart 2) and unemployment remaining well above the level of "full employment," the Fed is missing on both ends of its dual mandate. Further, with only gradual improvement in the labor market expected this year and inflation projected to remain contained, it appears that QE3 (the Fed's MBS and Treasury purchase program) will continue at least through the end of this year.

As such, we continue to anticipate that labor markets will recover slowly. In particular, we anticipate that the unemployment rate will gradually drift down, from 7.5% in April, to an average of 7.3% in the fourth quarter of 2013 **(Chart 3)**, and further to below 7% by late 2014. Average monthly gains in nonfarm payrolls have been 208,000 over the last six months and we project continued gains in the 170,000-190,000 range over the remainder of 2013.

Recent weeks have brought a change in tone from the Fed, with a number of Federal Open Market Committee (FOMC) policymakers indicating a willingness to slow the pace of the $85 billion monthly asset purchases (so called "tapering") in the coming months. And the Fed has made it clear that it is willing to adjust the pace of purchases, if the data warrants. But so far, the majority of FOMC participants expect no Fed Funds rate hikes until the second half of 2015, and the presence of considerable fiscal drag suggests that position has not changed markedly.

For the immediate term, however, this policy helps to keep downward pressure on long-term yields, but those yields nevertheless are expected to gradually rise over the next several quarters. This rise is likely to occur as we approach the expected date of the first tightening. In addition, a move toward a more normal term premium (additional yield provided for holding longer maturity bonds) also is expected to contribute to the upward drift in long-term yields. The term premium is presently exceptionally narrow, due in part to QE3, and due in part to flight to safety considerations.

Over the past several quarters, there has been evidence of an underlying improvement in U.S. corporate investment. This is being supported by very strong corporate balance sheets and retained earnings, as well as ongoing spending in the U.S. energy sectors. Whereas bank loans account for only a portion of total financing of the U.S. corporate sector, solid expansion continues in U.S. C&I (commercial and industrial) loans, which have risen by 10% year-over-year through May.

The housing sector is now well into what appears to be a strong and sustained recovery. Over the last several years, housing starts had been constrained by elevated vacancies, tight lending conditions, and declining home prices. These sources of drag are gradually giving way to more favorable conditions, allowing housing starts, sales and prices to move up. **(Chart 4)** These metrics are keys to a sustained and strong recovery. April pending home sales and the Case-Shiller house price index are both up over 10% year-over-year. This is a welcome development in a sector with plenty of room for recovery.

Importantly, the U.S. economy has continued to move ahead even in light of the rise in payroll and income taxes that occurred January 1. Private domestic purchases came in stronger than expected at a solid 3.4% in the first quarter of 2013, and points to just how resilient the household sector has become. However the "sequester" is expected to be a drag on growth over the next two quarters. And it's estimated that this will trim roughly a percentage point from second-quarter growth and another half a point off of third-quarter growth.

Looking outside the United States, global headwinds persist. In Europe, over the past few months, there has been a noticeable shift in the stance of the European Commission (EC) away from a focus on swift fiscal consolidation and toward economic growth-enhancing measures. Consistent with this, the recommendations outlined by the EC have been more pressing, precise and achievable, and with a greater focus on growth-generating reforms. Nevertheless, the Eurozone is likely to remain the weakest of the developed economies at near-zero growth year-over-year.

That story from Asia has been mixed. While Japan's economy is clearly improving, due largely to its enormous QE initiatives, the data coming from China continues to be soft. Chinese leaders have even signaled a tolerance for slower growth. Accordingly, the expectation for China growth is around 7% for 2013.

So, despite the weaker-than-expected start to the year, we project that U.S. GDP will grow in the range of 2% to 2.5% for 2013, with the unemployment rate declining modestly, from 7.5% to 7.3% by year's end. Global growth is projected to be somewhat higher, in the range of 3% to 3.5%.

FIXED INCOME UPDATE

The year started with investors expressing concern about the "Fiscal Cliff" (tax cuts expiring and spending cuts applied), followed by another flare up in the Eurozone. Congress dealt with a part of the Fiscal Cliff by passing a limited tax increase; however, lawmakers' attempts to prevent sequestration from starting fell short. The polarizing nature of U.S. politics initially was a primary factor impacting the investment markets, but as the year progressed it held less importance.

Fears of contagion in the Eurozone returned in the first quarter as Cyprus became the next country threatened with a collapse of its banks. The European Central Bank helped orchestrate a bailout, making Cyprus the fifth country (after Greece, Ireland, Portugal, and Spain) to receive aid.

Resolution of the financial problems in Cyprus and part of the Fiscal Cliff issues left Treasury yields range-bound, with the 10-year U.S. Treasury note yield moving between 1.65% and 2.00%. **(Chart 5)** On a historic basis, Treasury yields remain low, but have started to move off the lows reached last July 2012 (10-year Treasury yield hit a low of 1.39%). At the end of May the 10-year yield broke through 2.00%. Over the past 21 months when rates have drifted above 2%, usually the overseas market erupts and sparks a flight to safety. For now, global markets appear to be calm, but rates have the potential to drift higher from these low levels.

The gap between yields of investment grade corporate bonds and Treasuries represents the extra premium investors demand due to the greater risk associated with corporate bonds. This risk premium (i.e., spread level) gradually tightened in the first five months of the year. Steady, but slow, improvement in the economy led spread levels to move from 141 basis points to 132 basis points based on Merrill Lynch's U.S. Corporate Master Index. This level is below the index's 12-month average of 159 basis points. **(Chart 6)**

The bond market has been supported by the demand side as inflows continued into mutual funds and ETFs. Coming into the year, the consensus expectation was for a "Great Rotation" out of bonds and into stocks. While stock funds did in fact experience a surge in investor cash inflows, bond funds continued to see inflows of their own – showing that investors continue to have an appetite for fixed income despite all the talk of a bond market bubble.

The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, returned -0.91% for the first five months of 2013. Investor demand helped contribute to spread-tightening, but it was not enough to offset the negative impact of higher interest rates. The entire investment grade fixed income sectors have declined year-to-date. **(Chart 7)**

Due to low default rates, the High Yield sector is one of the few areas still showing positive results, up 4.15% through the end of May. Since the domestic financial crisis, High Yield and Emerging Market Debt performance were moving in unison, until this year. Emerging Market Debt has been underperforming on a relative basis. Most Emerging Market Debt is U.S. Dollar denominated; however, spreads tend to track currency changes. A stronger U.S. Dollar has resulted in wider spreads, driving bond prices down for this sector.

The Barclays Municipal Bond Index was up 0.15% through the end of May. Lower rated BBB and High Yield segments of the municipal bond market continued to do better than the AAA/AA rated bonds. During the first quarter of this year, sequester fears and questions about the fate of municipal bonds' tax exemption status led to net outflows from municipal bond funds. Recently positive inflows resumed as pressure to limit the tax exemption waned.

We plan to remain overweight in spread-based fixed income sectors, such as investment grade corporate and municipal bonds. Exposure to High Yield will be maintained at current levels, as default rates remain low. Emerging Market bonds are likely to continue to falter as the tailwind provided by interest rate cuts in the developing world diminishes. With the cycle of interest rate cuts in the developing world having largely run its course, Emerging Market Debt may be vulnerable to rate increases.

As previously mentioned, investors have started to lose some of their enthusiasm for bond funds. Reduced customer inflows make the bond market more susceptible to additional selling pressure. As long as the Euro crisis remains in abeyance, the flight to safety will continue to be unwound, leading to downward pressure on Treasury prices. Also,

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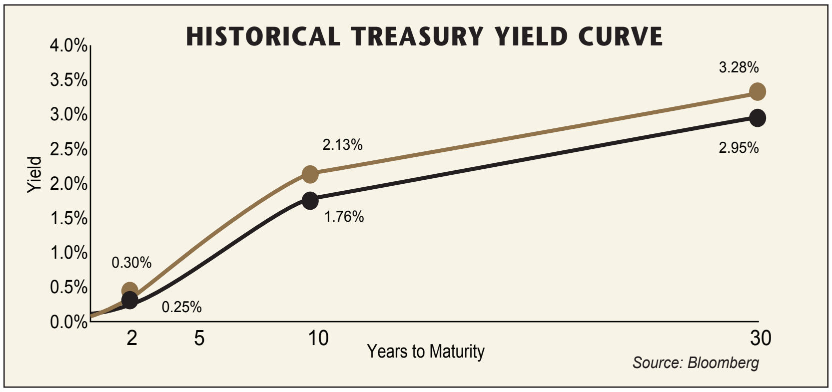

CHART 5
HISTORICAL TREASURY YIELD CURVE
(12/31/2012–05/31/2013)
Treasury yields have been rising across the yield curve.

- 12/31/2012
- 05/31/2013

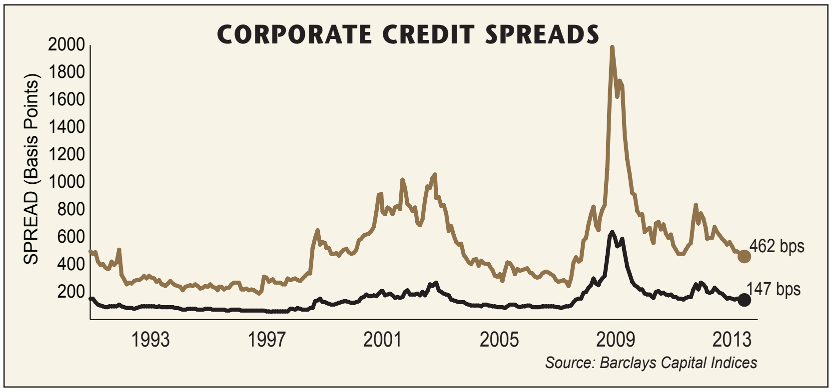

CHART 6
CORPORATE CREDIT SPREADS
(1/31/91–05/31/2013)
Credit spreads have recently started to move up, but are still near their historic average.

- High Yield—Avg. 515 bps
- Investment Grade—Avg. 146 bps

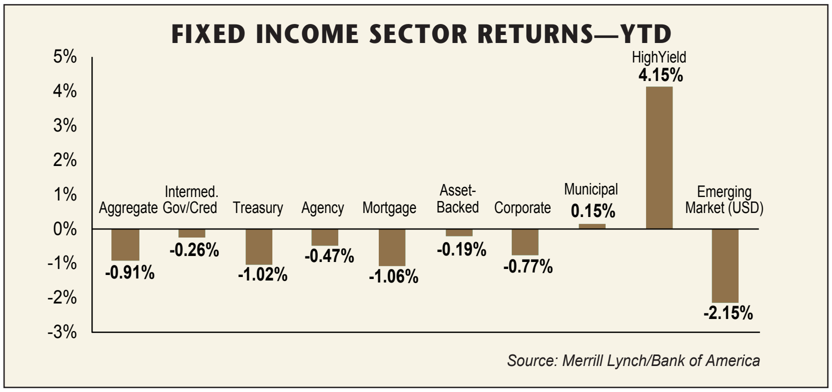

CHART 7
FIXED INCOME SECTOR RETURNS
(As of 05/31/2013)
High Yield and Municipal bonds are the only sectors with a positive return year-to-date.

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Treasury yields are at risk of rising as the economy gathers more momentum and political uncertainty continues to diminish. As a result, we are maintaining a slightly shorter duration/maturity position relative to the benchmark.

The Fed and political leaders will have opportunities to either positively or negatively impact the investment markets before the year is done. The U.S. government has negotiations over the budget and the debt ceiling, with deadlines approaching in the fall. Fed plans to slow down its bond-buying programs will add some uncertainty to the market. The timing of when the Fed will start the tapering has become less predictable. We are watching for signs that it may happen sooner rather than later, due to improving economic fundamentals. The remaining six months of the year could be volatile for the bond market.

EQUITY UPDATE

The S&P 500 has gotten off to a robust start in the first five months, rising approximately 15% and reaching a new all-time high, breaking through previous highs set in 2000 and 2007. Most clients remember the period following the previous highs were not too favorable for equity investors, so the natural question is whether it is time to reduce our overweight position to equities. Our answer is no, since we believe equities could see an additional 5% to 7% on the upside in 2013. Even with the strong gains this year, the valuation levels for the market remain reasonable with the S&P 500 Price/Operating Earnings Ratio at 16.6 times earnings and only 0.5 above the 50-year average of 16.1 times. Given the low level of interest rates we could see the multiple expand to 18 times. Reported earnings for the remainder of the year will accelerate and should surpass 10% growth versus 2012. Another favorable wind behind rising stock prices is the 12-month rate of inflation, which is currently at 1.1% after having declined from 3.9% in October 2011. Historically, periods of falling or stable inflation have translated into rising stock prices. Stock prices don't run into trouble until inflation makes a sharp jump higher.

One last factor supporting our positive outlook is a potential breakout of consumer confidence that has been at previous recession lows nearly four years after the economic recovery began. Yes, there has been a long list of potential problems to worry about over the past four years, but we are sensing a bit more optimism developing. The public has been selling equity mutual funds and money market funds over the last four years and pouring the money into fixed income funds. Over the remainder of the year we anticipate money will begin to shift from fixed income funds over to equity funds as investors notice their fixed income returns dwindling. Just in the last four months equity mutual funds have seen inflows during two of those months. Over the last four years corporations and foreign investors have been net buyers of equities and when the public turns to equities, stock prices will move higher.

Unfortunately, the strength in domestic equities has not been shared equally around the world. The MSCI EAFE (Europe, Australia and the Far East) is only up 8% and the MSCI Emerging Markets continue their dismal performance, declining over 3%. Over the last 10 years emerging markets have doubled the 8% annual return for the S&P 500. The last 25 months though have been a different story with the MSCI Emerging Markets Index underperforming the S&P 500 index by 36%. We continue to recommend maintaining an exposure to large- and small-cap developed international and emerging markets. These markets are trading at attractive valuation levels along with providing higher dividend yields than domestic markets.

ALTERNATIVE INVESTMENTS

Commodities remain the worst performing asset class on a total return basis in 2013 with the DJ-UBS Commodity Index down 6.1% through May 31. They are being strained by the expectations of a scaling back of quantitative easing by the Fed. The possible withdrawal of quantitative easing means commodities will need to seek out asset-specific fundamentals for support. This lack of correlation with the equity markets is an important development. The case for a strategic allocation to commodities as an independent asset class is their low correlation to the broader financial markets. Supply constraints and surging demand from emerging markets such as China and commodity producing markets have either reversed or have become more balanced. With the current business cycle exhibiting excess capacity and slow growth, low commodity returns and volatility should be expected.

Gold has seen a dramatic reversal since last fall. ETF holdings saw large declines. Gold will be vulnerable to U.S. Dollar strength and if a reacceleration in U.S. growth unfolds later this year. Oil demand is leveling off as a result of improving vehicle efficiency and widespread displacement of oil with cheap and abundant natural gas. Increased production of oil and gas in the United States has long-term implications for the sector.

Investment Policy Committee
June 11, 2013

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