Market OUTLOOK

Economic and Financial Market Outlook — January 2015

United States Is Driving Global Economic Growth

Inside:

Market Summary

- *Overall, the U.S. economy appears to have reached a level of self-sustaining growth, and looks particularly good compared to the rest of the world.*
- *The timing and size of the Fed rate hikes are expected to be the key drivers of the bond market.*
- *The positive dynamics that have sent U.S. stocks higher remain intact for 2015, but any sharp rise in short-term interest rates by the Fed could still trigger a pullback.*
- *As long as the U.S. dollar continues to gain against other currencies, international stocks will underperform domestic issues.*
- *Volatility has returned to the investment markets and alternative funds may play a greater role managing market fluctuations.*

INTRODUCTION

Over the past few years, investors have dealt with the ongoing financial crises in Europe, a slowdown in China, subpar U.S. growth, and Middle East turmoil. These conditions have occurred along side surprisingly low global interest rates. In fact, this low-rate environment has been a key factor in the powerful U.S. equity rally since the financial crisis. The Fed has recently exited their asset purchasing program (Quantitative Easing) and is at least considering a tighter monetary policy, while at the same time, much of the rest of the world's central banks are easing their policies. Accordingly, investors will need to stay focused going forward to gauge whether the global economies may continue to diverge or begin to converge next year. This will be an important factor in determining optimal portfolio allocations.

ECONOMIC OUTLOOK

Among the developed nations, the U.S. economy remains the strongest anchor of the global recovery. In fact, U.S. growth rates have recently appeared to "decouple" from the other major world economies. The reasons for the divergence in the various global economies are the differences in the stages of their respective investment, credit and employment cycles. For example, China's economy has been decelerating, Europe's is treading water, and the United States is plowing ahead.

However, the sluggish growth picture in Japan and the Eurozone is likely to look a little better next year. Easing financial conditions, lower oil prices and some relaxation in lending conditions should contribute to better economic growth. As such, the global developed markets picture should improve in 2015. Although China's growth is likely to slow further in underlying terms, other parts of the Emerging Markets should see better

CHART 1
REAL GROSS DOMESTIC PRODUCT
Wide quarter-to-quarter movements for GDP growth, but gaining upward momentum.

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

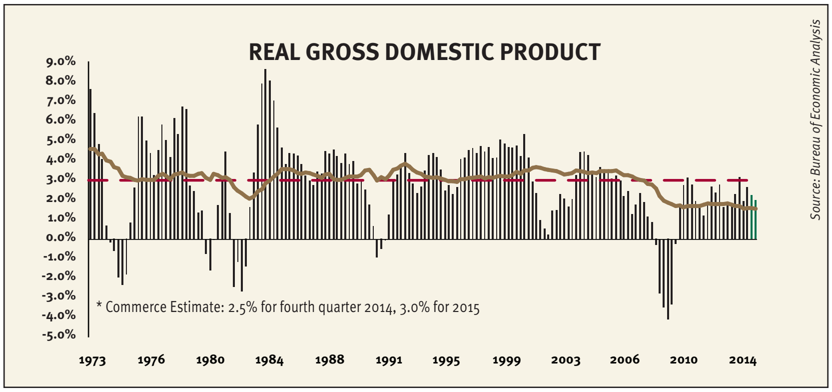


CHART 2
INFLATION
Gradual rise in inflation in 2015 is expected due to less economic slack.

- CPI (YOY) 2.49% Avg.
- Core CPI (YOY) 2.33% Avg.

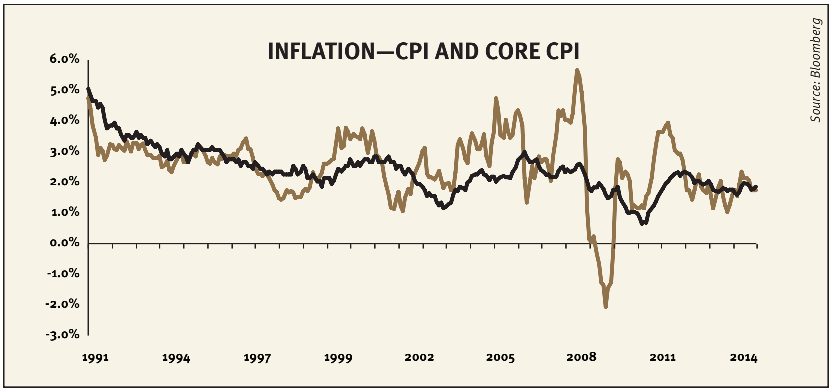
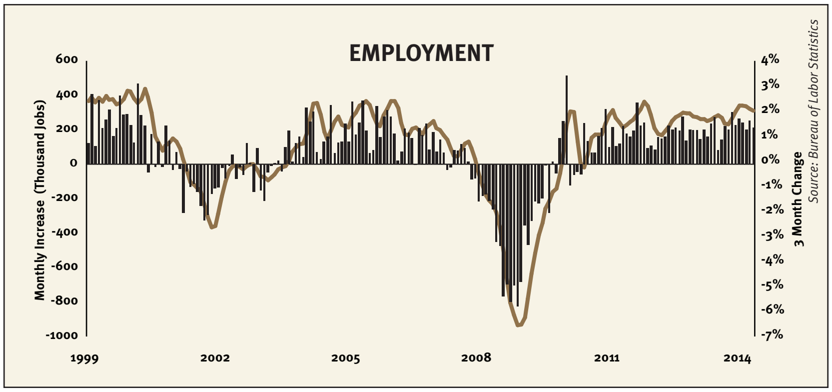


CHART 3
EMPLOYMENT
Payroll numbers are up significantly in 2014 compared to last year.

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



growth as the Developed Markets recovery gradually flows through to the Emerging Market countries. In total, global growth is expected to approach 3.5%, up from 3.3% in 2014.

So far in 2014, we have seen U.S. GDP fall 2.1% in the first quarter (blamed on the harsh weather), then a jump to a strong 4.6% in the second quarter, followed by a solid 3.9% in the third quarter. These wide quarter-to-quarter movements have become the norm over the past few years. GDP growth ranged from a decline of 1.5% to an increase of 4.6% in 2011, from 0.1% to 2.5% in 2012, and from 1.8% to 4.5% in 2013. The swings reveal the inconsistent nature of this extended recovery.

Even so, the U.S. economy has grown by 3.5% or more in four out of the last five quarters, and most indicators show that growth has been gathering momentum that should carry through well into 2015. Recent developments, including a further sharp decline in oil prices, lower long-term yields (both in the United States and abroad), and strong gains in equities, are expected to help near-term momentum. Overall, U.S. GDP growth in 2015 is projected to track near 3%. (**CHART 1**)

A closer look at the recent U.S. data reveals that economic releases have been mixed, but generally consistent with moderate growth in the near-term. Notably, manufacturing, including the capital goods sectors, appears to be trending higher. The ISM Manufacturing Index indicates solid growth at 58.7 (readings above 50 signal expansion). In fact, an underlying production gauge was the strongest in a decade. Similarly the three-month average of the ISM new orders index also reached a cyclical high. Nondefense capital goods and shipments have both experienced solid gains over the last half year or so. Resilient sales of motor vehicles and gains in corporate investment are keeping assembly lines humming.

Also, the housing market is growing at a slow but steady pace on the back of the continued economic recovery in the United States, and is expected to improve further in 2015. While many Americans complain about the high cost of housing, the United States remains one of the most affordable nations in the world for housing prices relative to median income. In other words, Americans spend less on housing relative to income than the citizens of the majority of nations in the world. These conditions provide support for this important economic segment, especially if mortgage rates remain relatively low.

On the inflation front, the 12-month change in the core CPI remained at 1.7% in October. The recent rise in the dollar appears to have helped restrain inflation, along with sagging inflation in other developed economies. Both have allayed fears held by some that inflation was in the process of moving up faster than was previously expected. On the other hand, while deflation has been mentioned frequently when discussing Europe, we do not believe that the trend in inflation in the United States is ebbing. Rather, we think the trend is gradually rising. It is true that elevated utilization slack (high unemployment) and a strong dollar have contributed to softer import prices and have combined to restrain inflation. However, going forward, with diminishing economic slack and inflation expectations projected to remain anchored at 2%, we expect the CPI price index to rise gradually toward 2% later in 2015. (**CHART 2**)

Non-farm payrolls rose a solid 312,000 in November, the strongest gain since January 2012. For the fourth quarter-to-date, the average monthly job gain is 282,000. In the third quarter, payrolls increased 239,000 a month, and the six-month moving average through November was 258,000. Of note, these job numbers are up significantly compared to the same period last year. While the monthly figures are subject to much greater volatility, civilian employment (drawn from the household survey) has also shown solid growth on average, as the unemployment rate declined further to 5.8% in November, the lowest reading since July 2008. Job and wage gains provide an important underpinning to the economy. (**CHART 3**)

The continued recovery in employment reflects solid increases in hours worked, as growth in output has been met with more sluggish growth in productivity over the past three quarters. Near-trend GDP growth of 3% supports solid growth in employment and should result in continued downward pressure on the unemployment rate through 2015. With GDP growth having shifted up over the second half of this year, we expect continued gains in nonfarm payrolls, averaging 225,000 per month in 2015. This remains consistent with a declining trend in the unemployment rate. The unemployment rate is projected to fall from 5.8% in the fourth quarter to 5.4% by the end of 2015.

Overall, the U.S. economy is in decent shape on an absolute basis, and particularly good compared to the rest of the world. The U.S. economy has been expanding at about a 3% rate for the past six months, even as the Fed has pulled back on its stimulus programs. The Fed's two previous Quantitative Easing programs ended abruptly, with growth and equities selling off. This time around, the Fed pulled back much more gradually, allowing the private sector to gain some traction, at least so far. So, while we see this uptrend continuing into 2015 for the United States, we expect global growth to remain very diverse, with global economic decoupling still an important theme.

FIXED INCOME OUTLOOK

At the start of 2014 the consensus expectation was that bond yields would rise, sending bond prices down. This belief was fueled by the Federal Reserve's announcement at the end of 2013 that the central bank would wind down its Quantitative Easing program in 2014. Contrary to expectations, Treasury yields declined as a result of pressure on rates from a number of sources. Geopolitical concerns kept the flight to quality in play (i.e., Russia-Ukraine, Middle East). Foreign purchases of U.S. Treasuries remained high as yields in Japan and many European countries were low. Also, inflation was subdued as energy and other commodity prices declined during the year.

The Treasury yield curve flattened in 2014 as yields declined for intermediate and long maturities (5 to 30 years) and rose for short maturities (3 years and less). The 10-year Treasury yield declined by 77 basis points (100 basis points equals 1%), ending the period at 2.26%. (**CHART 4**) The spread between the 2-year and 30-year Treasuries narrowed from 359 basis points at the start of the year to 245 basis points through November. Steep yields help bond performance by providing longer maturities with a degree of insulation from rising short-term rates. While the curve has flattened significantly over the past 12 months, there is still ample room for these spreads to narrow more. In 2006, the 2- to 30-year Treasury spread was essentially zero.

The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, beat expectations and returned 5.87% year-to-date through November. Average credit spreads, as measured by the Merrill Lynch U.S. Corporate Master Index, moved from 118 basis points to 128 basis points. (**CHART 5**) This risk premium over Treasury yields widened, but not enough to offset the positive impact of lower interest rates realized by most maturities.

All bond sectors are on pace to finish the year in positive territory, with Long Government leading the pack. Despite continued low default rates, High Yield was one of the laggards for the period. (**CHART 6**) The Moody's speculative-grade default rate was 1.9% as of October, still well below its historic average of over 4.0%.

Municipal bonds rebounded this year after being down -2.55% in 2013. The Barclays Municipal Bond Index was up 8.50% year-to-date through the end of November. Municipal bonds benefited from a combination of a benign interest-rate environment, low defaults, and steady investor demand. Overall creditworthiness among state and local issuers of municipal debt remains strong, despite recently weaker revenue growth. Municipal bonds are likely to continue their good run into 2015, but lower returns are expected as state and local municipalities wrestle with heavy pension obligations. Defaults and bankruptcy may claim headlines, but there's good reason to believe they will remain rare.

High Yield is on pace to underperform (on annual basis) relative to investment grade corporate for the first time since 2011. Many investors moved to a risk-adverse mode as they moved out of lower quality holdings. The historic spread on the Merrill Lynch High Yield Index is 583 basis points. The index was as low as 335 basis points at midyear and is 464 basis points at the end of November. After this recent adjustment, market conditions for High Yield look favorable. Future performance is dependent on continued economic growth, low default rates and interest rates staying low.

Emerging Market bonds faced numerous challenges in 2014, ranging from lower commodity prices to the U.S. Federal Reserve's monetary policy. With many Emerging Markets dependent on exporting commodities, concern grew that lower commodity prices would lead to weak economic growth. Some lingering effects of the Fed phasing out Quantitative Easing added some downward price pressure on Emerging Markets. Despite these hurdles, investors' thirst for yield helped move Emerging Market returns into positive territory. Next year's returns are expected to come from opportunities in select countries rather than from the market in general. Emerging Market fundamentals are generally improving, but not universally.

In 2014 the fixed income market saw yields decline for most parts of the Treasury curve and credit spreads widen by a marginal amount. In 2015, the opposite may occur, with spreads tightening modestly and interest rates rising gradually. Positive returns are possible, but likely in the low single digits. The economy needs to continue to show some growth with improvements in jobs and housing for this scenario to occur. Risks include a bigger jump in inflation than expected and unforeseen geopolitical events. Volatility is rising for the bond market, partly due to shrinking liquidity. The new capital rules are discouraging banks who act as dealers. Trading desks are in less of a mood to take bonds on their balance sheet given the constraints they now face. The result is greater fluctuations in price when negative headlines hit the market.

Investors' desire for yield is expected

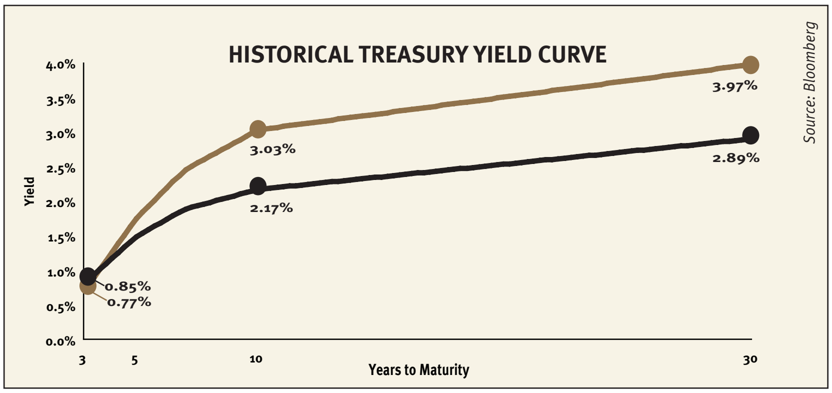


CHART 4
HISTORICAL TREASURY YIELD CURVE
(12/31/2013–11/30/2014)
Yield curve flattened as yields declined for intermediate and long maturities, and rose for short maturities.

- 12/31/2013
- 11/30/2014

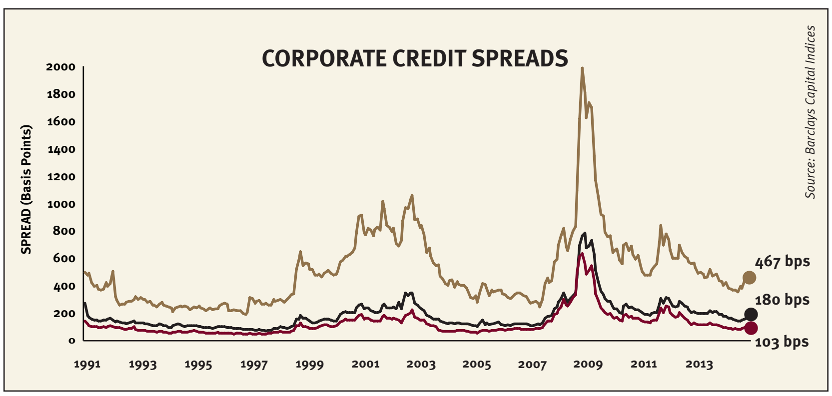


CHART 5
CORPORATE CREDIT SPREADS
(1/31/91 – 11/30/2014)
Corporate spreads widened modestly year-to-date.

- High Yield—Avg. 510 bps
- BBB Rated Corporate Credits Avg. 185 bps
- A Rated Corporate Credits Avg. 126 bps

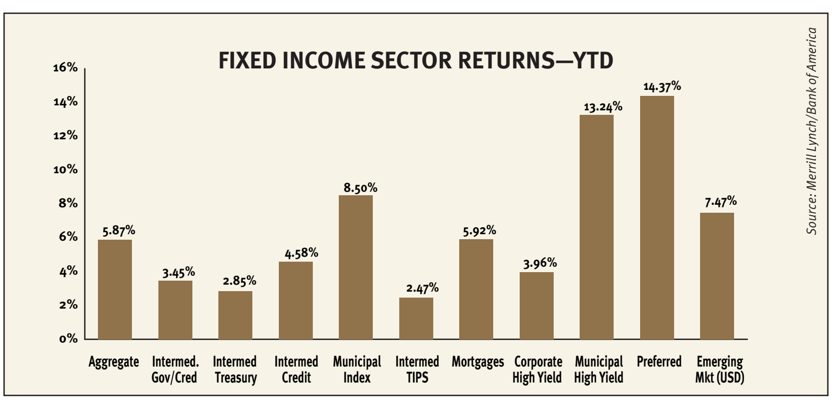


CHART 6
FIXED INCOME SECTOR RETURNS
(As of 11/30/2014)
All Fixed Income sectors are generating a positive return year-to-date.

to help keep a more aggressive investment stance in place for the time being. Corporate bonds (both investment grade and High Yield) should eke out a slight excess return relative to Treasuries in the coming year. Municipal bonds have some upside potential, but not as much as they did at the start of 2014. Emerging Market debt appears to be slightly expensive relative to fundamentals, and a better buying opportunity may develop later in the year once the market starts to get closer to the first Fed rate hike since 2006. The timing and size of the Fed rate hikes are expected to be the key drivers of the bond market. Moving up in quality and maintaining target durations slightly below their benchmark should assist performance in 2015.

EQUITY OUTLOOK

Chalk up another double-digit gain for the S&P 500 in 2014. The S&P 500 has now risen over 240% from the March lows in 2009, so the natural question is what will derail this bull market?

We believe the positive dynamics that have sent stocks higher remain intact for 2015, but we do have some concerns as the year progresses. Our main concern that could trigger a 10% correction is a sharp rise in short-term interest rates. Historically when short-term interest rates have a sharp increase, regardless of the interest rate level, stock prices have experienced weakness. A rise of 0.5% in the 3-year Treasury (currently around 1.00%) over a few months would qualify as a sharp jump. The Fed has hinted that short rates could start to increase in June, but that could be put off until Fall or longer given the relatively low levels of foreign interest rates and benign inflation in the United States. We would not adjust equity allocations in anticipation of rising rates, but wait until it happens.

As we enter 2015, valuation levels no longer are inexpensive and moved to the upper range of normal valuation. With mediocre U.S. economic growth in 2014, the S&P 500 earnings are expected to increase 9% to 10%. The S&P 500 operating earnings ratio stands at 18 times, up from 17.5 times at the beginning of the year. Earnings growth in 2015 is expected to be in the 8% to 10% range, giving investors the possibility of another year with a double-digit return. There is also some further room for Price/Earnings ratios to move higher in light of the low interest rates and inflation.

While we remain quite positive on large- and mid-cap domestic stocks, small-cap domestic stocks underperformed by 10% last year after a strong performance in 2013. Small-cap stock valuations still are trading at the upper end of their historical valuation range, leading to potentially another year of subpar performance. The surge in company buyouts we saw last year was centered in the mid-capitalization range of domestic stocks. With the low interest rates around the world to finance these acquisitions, we see no slowdown in takeovers of mid-cap companies in 2015.

Turning from domestic equities to international equities, the outlook isn't nearly as optimistic. Over the last 23 months ending in November 2015, the MSCI EAFE Index (Europe, Australia and the Far East) has underperformed the S&P 500 Index by nearly 30% and Emerging Markets have fared worse, underperforming by 50%. While international market valuations look quite appealing, we believe this period of underperformance can continue. With the economic slowdown in China and the anemic economy in Europe hurting earnings growth, the real headwind for international stocks is the strength in the U.S. dollar. As long as the dollar gains against other currencies, international stocks will continue to underperform domestic issues.

ALTERNATIVES OUTLOOK

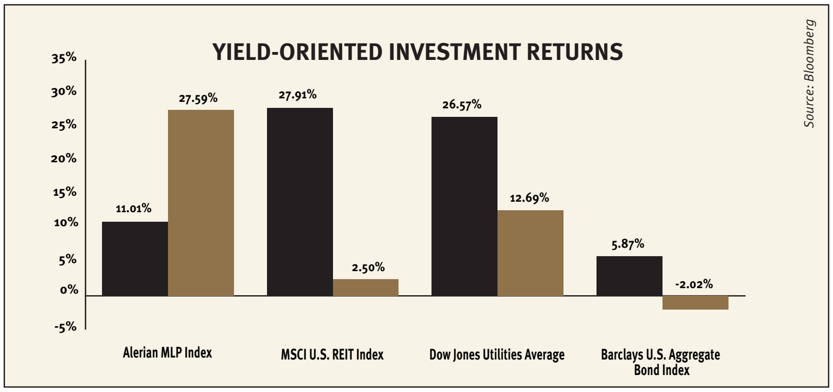
Multi-Strategy, or Fund of Fund, Hedge Fund strategies are positive on a year-to-date basis. The HFRI Fund Weighted Composite Index year-to-date returned 3.73% and the HFRI Fund of Funds Conservative Index returned 2.40% through November 30. Individual strategy hedge fund returns varied with Relative Value and Macro delivering the highest returns, followed by Equity Hedge and Event-Driven. We employ hedge funds to manage the risk, or volatility, in portfolios. In the last few years the returns of conservative hedge funds have been disappointing versus bonds. However, the end of the 30-year bull market for bonds, along with the expected unwinding of central bank intervention, may lead to low or negative returns for bonds. Therefore, hedge funds may play a needed role in reducing portfolio volatility.

Real Estate Investment Trusts (REITs) are one of the best performing assets classes in 2014. The MSCI US REIT Index is up 27.86% through November 30, following subdued performance in 2013. The U.S. real estate market outlook is for above average cash flow in 2015. Supporting REITs are low interest rates, steady job growth, low debt funding costs and a balanced ratio of supply and demand. Real estate performs best when GDP growth is above average and inflation adjusted interest rates ("real" rates) are below average. With our forecast of improving economic growth, and real rates remaining below average, it is reasonable to expect real estate produces results in line with its long-term average.

Infrastructure MLP investing is gaining more acceptance as an asset class. Investors seeking income along

CHART 7
INCOME-ORIENTED INVESTMENT RETURNS YTD (As of 11/30/2014 vs. 2013 Performance)
Alerian MLP Index is on pace for a double digit return for the second consecutive year.

- YTD 2014 Performance
- 2013 Performance



with growth potential allocated more to this sector over the last several years. The Alerian MLP Index is up 11.01% through November 30 following a return of 27.59% in 2013. (**CHART 7**) The major performance drivers for MLPs are growing U.S. energy production and, to a lesser extent, worldwide energy demand. Higher U.S. production means more volume flowing through pipelines, translating into revenue growth and higher dividends for MLPs. The production outlook continues to be bright and the United States currently produces more natural gas than any other country in the world.

Production is expected to continue to increase into 2020 according to the U.S. Energy Information Administration, particularly from offshore and shale drilling. Worldwide energy consumption, on the other hand, is less encouraging. European demand will likely continue to be a headwind due to the region's weak macro outlook.

After a strong start in early 2014, the broad Commodity index has been in a decline since June with the Bloomberg Commodity Index returning -10.18% through November 30.

U.S. dollar strength and an upturn in U.S. interest rates will keep downward pressure on gold prices into next year.

CONCLUSION

The United States is separating itself from the struggling economies of the world, gaining steady and favorable traction based on key economic indicators. Unemployment continues to fall, inflation remains in check and real wage increases may eventually take root. European countries are now following similar accommodative fiscal policies to those of the United States to jump start their economies. Although China's growth is likely to slow further, total global growth is expected to approach 3.8%, up from 3.3% in 2014. Easing financial conditions, lower oil prices and some relaxation in lending conditions should also contribute to most major developed markets in the new year, and maybe even pull some Emerging Markets along. In the United States, the favorable environment for equities remains in place for now. Potential Fed interest rate hikes will be key drivers of bond market returns in 2015.

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