Global Economic Commentary

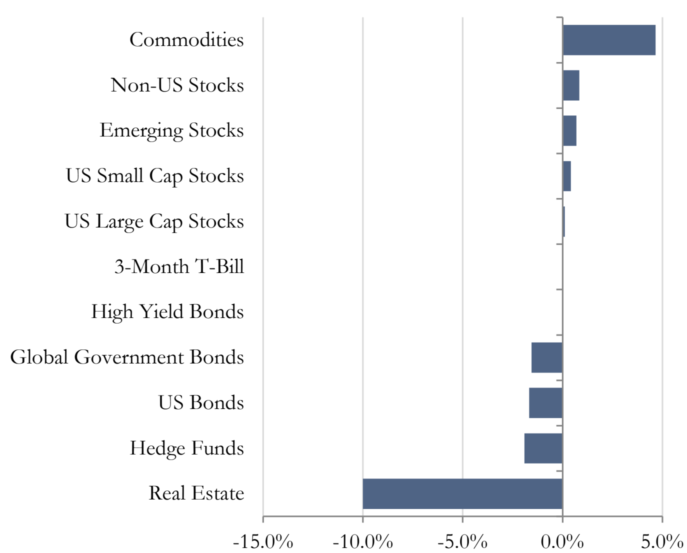
Second Quarter 2015

"The gods had condemned Sisyphus to ceaselessly roll a rock to the top of a mountain, whence the stone would fall back of its own weight. They had thought with some reason that there is no more dreadful punishment than futile and hopeless labor."

– 'The Myth of Sisyphus' by Albert Camus

While China and Greece dominated the global headlines for much of the second quarter, modest growth across developed economies generally supported stock and credit markets. However, despite the perceived risks of a Greek exit from the euro, the seemingly futile efforts to keep it in and the concerns surrounding the Chinese government's effort to prop up its stock market following a precipitous decline, economic fundamentals in both the U.S. and Europe remain quite stable and are actually beginning to improve. While the U.S. stock market has not really moved this year, up 1.2% through June 30 according to the S&P 500 Index, it has not given back much either. By the end of the second quarter, the S&P 500 was near its record high and is up over 200% since its trough in March 2009. Many measures of expected market volatility remain at very low levels, which suggests that market participants remain relatively complacent. On a recent trip to Europe and the UK, we had the opportunity to meet with our investment partners to explore the key drivers of global capital markets in more detail. The overriding common theme among many of our partners is that their search for good quality investments at attractive prices is even more important at this stage of the economic and market cycle.

Global Market Performance
For the Quarter Ended June 30, 2015



Source: Russell 1000, Russell 2000, MSCI EAFE Index, MSCI Emerging Markets Index, Barclays Capital U.S. Aggregate Index, Barclays Capital U.S. High Yield Index, Citigroup World Government Bond Index, Vanguard REIT Index Fund, Dow Jones UBS Commodity Index, Credit Suisse AllHedge Index, ML 3-Month T-Bill. All returns in U.S. Dollar terms.

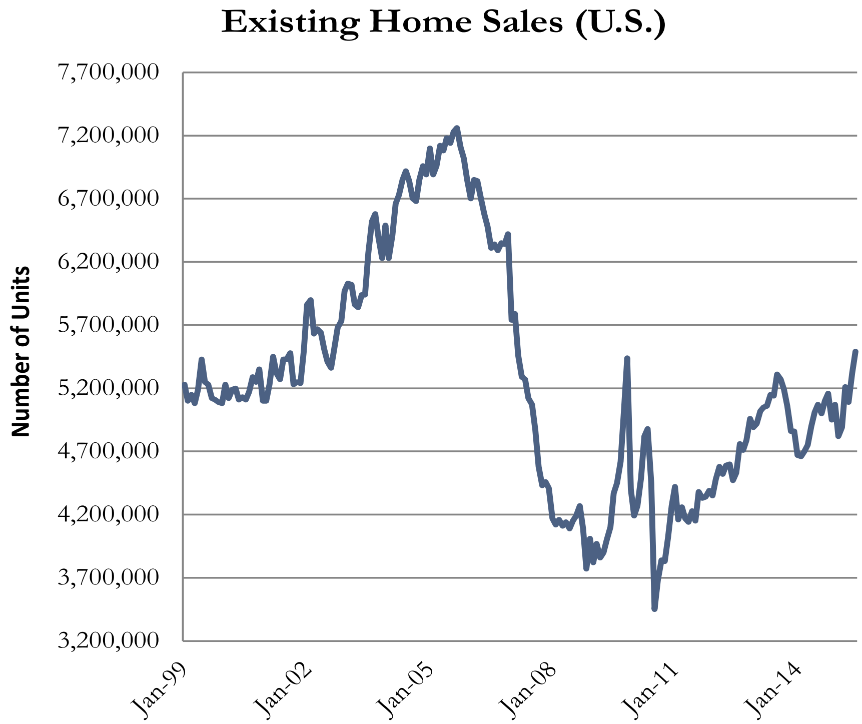
The U.S. Economy

The U.S. economy was very weak in the first quarter of 2015 because of severe winter weather in parts of the Northeast, a West Coast ports strike crippling trade between the U.S. and Asia and the sharp rise in the U.S. dollar. The largest impacts were on consumer spending, up only 2.1%, and on exports, which by themselves subtracted 1.9% from GDP. Early second-quarter trade data indicate a month to month recovery although non-petroleum exports were still down on a year-over-year basis in May. The manufacturing and service sector Purchasing Manager Indices were strong in the second quarter according to the institute of supply management.

Following the 0.2% contraction in U.S. GDP in the first quarter, the Organization for Economic Cooperation and Development (OECD) revised its forecast for U.S. growth down significantly to 2.0% in 2015 and 2.8% in 2016 compared to 3.1% and 3.0%, respectively, in its November forecast. Wall Street is now predicting that 2015 growth will approximate 2.25%, which is consistent with the post-recession average. Thus far in the second quarter, there has been an upswing in consumer spending as indicated by the 2.9% growth in U.S. Personal Consumption Expenditure (PCE). This gives us confidence that the first quarter was an outlier. Given the longer term deceleration in our growth potential, we feel we are on a cyclical upswing. We look for second-quarter GDP to approximate 2.75% to 3% and see a solid second half of 2015 with growth above 3.0%. Our full-year forecast has been reduced to 2.5% but is still above consensus.

U.S. corporations continue to hire employees. The U.S. unemployment rate fell to 5.3% in June 2015, where it was before the financial crisis. The unemployment rate was also at 5.3% seventy-two weeks after its peak in the 1982 recession. In other words, 72 weeks subsequent to the trough of the two deepest recessions in the post war period, the unemployment rate is quite similar. However, a broader measure of unemployment, U-6, that includes those workers who are discouraged, marginally attached and working part-time because no full-time opportunities are available is still quite high relative to where it has been in the past, although it has also declined to 10.3% by the end of the second quarter.[1] The increase in the wage bill as a result of employment growth, combined with some real wage gains, bodes well for future consumer spending. The U.S. consumer has had an increasing ability to spend although the propensity to do so is less obvious. With lower inflation, real incomes are growing. Real disposable personal income is now increasing at an annualized rate of 5.3% in the first quarter versus 3.7% year-over-year with a tightening labor market, improved real disposable income and a savings rate that has increased from 4.7% to 5.1% in May 2015. Private sector wages and salaries should increase by over 3.0% and are likely to stimulate the economy for the balance of the year.[2]

[1] Federal Reserve Bank of St. Louis, Bureau of Labor Statistics, Employment Situation June 2015
[2] Bureau of Economic Analysis, U.S. Department of Commerce, Personal Income and Outlays, May 2015



Source: St. Louis Federal Reserve (FRED)

The recent rebound in household formation and gains in employment for the 25 to 34 year old first-time homebuyers should continue to be bullish for new and existing home sales. According to the National Association of Realtors, the latest pace (as of May 2015) of 546,000 annualized new home sales is the highest monthly tally since early 2008. In addition, total existing home sales have increased by 8.0% year over year for the period ended June 30, 2015 versus a 2.0% decline for the year ended June 2014[3]. One of the main constraints on housing growth is a lack of supply which means that housing starts should pick up substantially.

The most robust area of consumer spending continues to be the auto market. According to Auto Data, car sales in the second quarter moved to the highest level in almost ten years at an annualized rate of 17.1 million, which is above the first quarter average of 16.7 million cars. Car pricing rose by 4.4% in June compared with last year.[4]

A major factor holding back U.S. growth in 2015 has been the rise in the dollar on a trade weighted basis. This has significantly reduced the international competitiveness of U.S. exports and caused them to decline. At this stage, the U.S. dollar is overvalued in relation to the Japanese yen and the euro as well as most emerging-market currencies, on a purchasing power parity basis. For this reason, we believe that the dollar will stabilize this year and start to depreciate.

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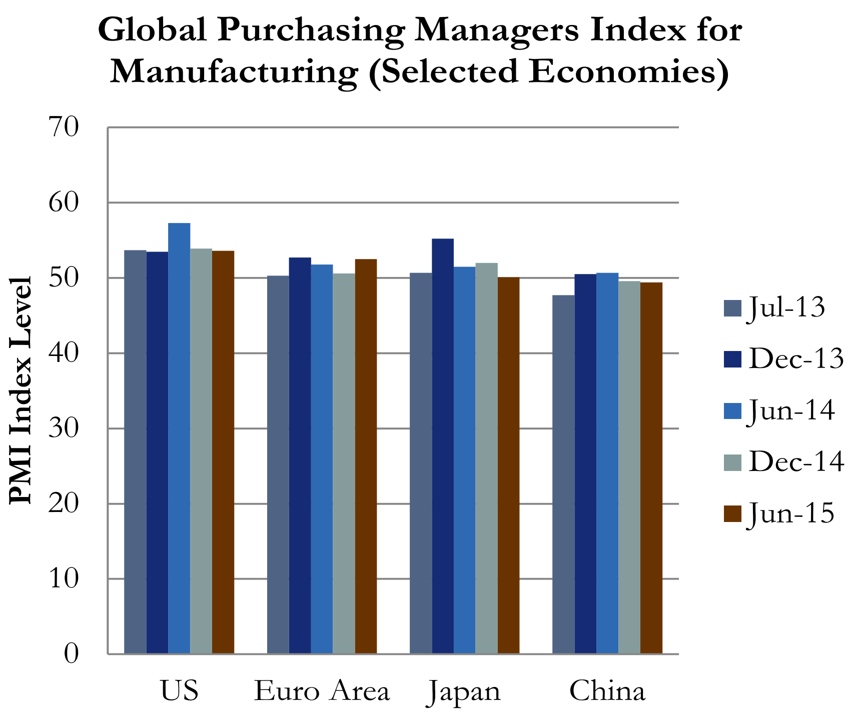
[3] National Association of Realtors, Summary of June 2015 Existing Home Sales Statistics and Latest New Home Sales (May 2015)

[4] Motorintellegence.com, Auto Data, U.S. Market Light Vehicle Deliveries - June 2015

Non-U.S. Economies

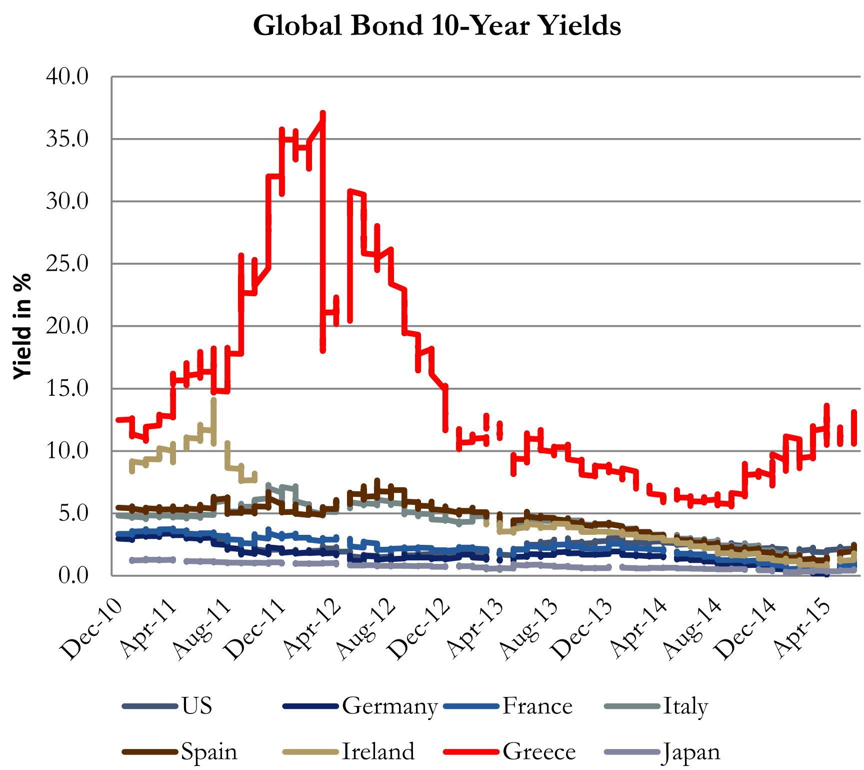
European economic growth is improving despite the distraction of the Greek debt situation. As discussed in previous commentaries, the lower euro, lower oil prices and supportive monetary policies of the European central bank have enabled the European economy to grow as evidenced by improving business activity and output across core Europe, Germany, France, and some other peripheral markets, such as Ireland, Italy and Spain. The lower borrowing costs in Europe, combined with the improvement in balance sheets of the banks that completed their recapitalization, have started to positively impact credit demand, particularly housing loans and consumer credit. While conditions are improving in the underlying economies, the uncertainties surrounding Greece and its ability to implement the tentatively agreed third bailout plan, as discussed in our three recent special commentaries, will continue to have an impact on confidence.



Source: Markit, J.P. Morgan Asset Management. Guide to the Markets – U.S. Data are as of June 30, 2015.

Many observers feel that Greece is an anomaly and that the rest of the countries within the Eurozone are not facing the same situation. However, if larger countries, such as Italy, run into debt trouble and are unable to move through needed economic reforms to improve their growth prospects, the impact on global markets would be much more serious. We believe that this is highly unlikely in 2015 given the solid improvement in the debt challenged periphery. In these countries, debt loads, though still high, have stabilized, fiscal balances have improved and growth has reemerged.

As we discussed in one of our recent Greek crisis pieces, in the long-term, a sans Greece Eurozone might merit a stronger currency, but markets want to see more evidence that other members with excessive external debt will not be inspired to drop out before this happens. It is important to note that the European Central Bank (ECB) is being quite supportive and is going to make it clear that it will not allow the Greek situation to spill over into other financial markets by supplying ample doses of liquidity.



Source: Bloomberg

Growth in the Japanese economy has stalled of late despite the pickup in exports due to the weaker yen. Japanese GDP rose by about 3.5% in the first quarter but is likely to be flat in the second. However, the weaker currency and the Bank of Japan's easy monetary policies helped move inflation expectations higher, which is a significant shift from the deflationary environment that has persisted for nearly two decades. The two largest contributors to deflation, falling land prices and corporate deleveraging, have run their course. Other trends in Japan that are important to watch include plan rebalancing within the Japanese pension fund, which is shifting significant assets out of the bond market and into the equity market. These technical factors should put a floor on Japanese equities.

The second trend to watch is the Japanese corporate sector's emphasis on increasing return on equity, which is a measure of how much profit companies generate on shareholders' capital. In November 2014, a new index was created in Japan and it includes companies that rank in the top 400 of the Tokyo Stock exchange on ROE, operating profit and market expectations. The two trends are related in that the Japanese pension fund has now benchmarked itself to this new index. The result has been more focus on profitability. We believe that the structural reforms underway in Japan, particularly the substantial increase in female labor force participation, will make it possible for Japan to sustain growth. In addition, higher returns on capital and a lower cost of capital should stimulate capital expenditure.

With respect to emerging economies, China is the most important. The HSBC Purchasing Managers Index, which is a composite indicator designed to provide a single figure snapshot of operating conditions in the manufacturing sector, posted 49.4 in June. This was the fourth successive month that the PMI has registered a level in contractionary territory. In response, the Chinese government is again ramping up fiscal stimulus and encouraging local governments to spend what has been allocated to them and monetary stimulus as evidenced by the further reduction in interest rates and reserve requirements. These are intended to support the system in the midst of an economic reform program initiated over two years ago. The aim of the reforms is to move China toward a more "market-driven" economy from a command economy, especially as the country's growth rate falls from an unsustainable double-digit rate toward more manageable levels.

Investors in China's local stock market, which is referred to as the A share market, had anticipated the potential benefits of these reforms, opened brokerage accounts and pushed stocks listed in Shanghai and Shenzen to dizzying heights, often with significant borrowing behind their position. For example, the Chinese Shanghai stock composite index appreciated by over 150% from June of 2014 through mid-June of this year. Since then, the market has collapsed over 30% from the high reached on June 12. As of July 8, 2015, trading has been halted on almost 50% of the equities listed on the index, new IPOs have been suspended, and the Chinese government has stepped in to provide massive support for the A share market. The percentage increase in Chinese shares listed on the Hong Kong stock exchange (H Shares) was far less than that of those listed in Shanghai (A Shares). The H Shares are held mainly by non-Chinese investors and institutions.

The large swings in the Chinese A Share stock market are the product of several factors. First, the A Share market is dominated by retail investors. Many of these investors are unsophisticated. The use of margin debt has caused further downward pressure on the A Share market. According to the Wall Street Journal, margin debt in this market is now 9% of the total value of the listed shares outstanding (and a much higher percentage of the actual float) which is at the high end of historical observations of other markets in the past. In addition, 80% of this margin financing has been provided to retail investors.[5]

[5] The Wall Street Journal, "China's Stock Plunge Is Scarier Than Greece", July 7, 2015

We believe there are several possible outcomes from the current market declines and policy responses. If the Chinese population loses trust in the equity markets and if they are unable to access its savings, this could lead to a sharp drop in consumer spending and a slowdown in economic growth. This is our greatest concern in the current environment, as global GDP growth over the last several years has been driven by China. A slowdown in China's GDP growth could put further pressure on commodities prices and commodity-linked currencies. We expect the government to utilize fiscal policy to partially offset any decline in consumer spending. Finally, this equity market volatility may delay the liberalization of Chinese equities markets. Over the last year, China has opened the Shanghai market to outside investors and eased the restrictions on Chinese citizens' ability to invest abroad. One of our managers indicated that they expected additional markets to open over the next year. However, if the government feels they are unable to control the market to the extent they prefer, this liberalization may be delayed. Already China has lost substantial foreign exchange reserves as a result of capital outflows.

Our base case scenario remains a stabilization in Chinese growth during the remainder of the year. The latest GDP release indicates that the Chinese economy grew at a 7.0% year-over-year rate in the second quarter. However, on a quarter to quarter basis, the Chinese annualized growth rate was only 5.5%.[6] The Chinese government is again tapping into its arsenal of monetary policy tools to prevent a hard landing. Toward the end of June, the People's Bank of China cut both its main lending rate to a record low of 4.85% and reduced the reserve requirements for banks to stimulate lending. In the long term China will benefit from a whole series of structural reforms which we discussed in detail in our prior quarter's economic outlook.

The performance of other emerging market economies during the remainder of 2015 is likely to be mixed. According to the Bank of International Settlements, emerging markets have borrowed over 9 trillion in dollar-denominated debt, up from 2 trillion at the turn-of-the-century. As the dollar has risen over 25% versus many of these currencies, these debts will be more expensive to repay and the next five years represent periods of heavy scheduled redemptions. As much of this debt has been incurred by private companies and not governments, major financial stability risk is not elevated at this time, though internal economic issues may be heightened.

Economic performance across these countries will be very uneven with the commodity exporters, Brazil, South Africa and Indonesia, struggling while the large fall in oil prices may benefit the net commodity importers, emerging Asia, and the manufactured goods exporters, India and Turkey. This is already having a major impact on the growth prospects of Latin America. For instance, Brazil is now going into recession, with inflation rising to 9% with a current account deficit still above 4%.[7] Quite a few commodity producers and exporters are at risk from rising short-term dollar interest rates during a period of declining global demand for their exports.

[6] Trading Economics, July 2015
[7] Trading Economics, July 2015

The International Monetary Fund projects economic growth in emerging economies should approximate 4.3% this year. Though this still is well above the estimate of 2.4% growth for advanced economies, it is a major slowdown from economies that grew as much as 8.0% collectively as recently as 2007. There is a high probability that the 2015 growth rate could be below 4% given the degree of deleveraging required in many emerging-market economies.

Equity Market Outlook

Our general view on global equity markets remains unchanged. Despite the uncertainties created by both Greece and China, the U.S. equity market is still trading near its all-time high from a price perspective and is fully valued on a number of valuation measures such as forward price to earnings ratio of 16.4x, Shiller's P/E (which is the cyclically-adjusted price to earnings ratio or CAPE) of 27.2x and dividend yield which is at 2.0%.[8] While these valuation measures suggest that the market is trading at or above their long term averages, they do not suggest that the U.S. stock market is in "bubble territory" in our view. When the stock market's earnings yield (the inverse of the price to earnings ratio) is compared to the yield on corporate bonds (Baa rated), the stock market still looks attractive on a relative basis. Still, the U.S. market looks expensive as compared to developed markets, such as Germany, France, the UK and Japan, and certain emerging market economies, such as China, Brazil, Korea and Taiwan. For this reason, we remain cautious on the U.S. market and constructive on the developed non-U.S. markets and China on an opportunistic basis.

From a style perspective, value has performed poorly relative to growth as technology and healthcare names have produced strong top line revenues while cyclical and interest rate sensitive sectors such as energy, materials and utilities have been under pressure. This has led to a strong momentum effect in the markets that has only recently been interrupted. For this reason, we anticipate that value should improve relative to growth in the U.S. and developed country markets. We believe that the earnings growth of these companies will start to pick up in the second half of the year.

Within the U.S., corporate earnings expectations have been coming down largely due to two factors. The first is the negative earnings impact on the energy sector due to the decline in the oil price and the second is the impact on corporate earnings from a stronger U.S. dollar. According to JP Morgan research, year over year earnings growth for the period ended March 31, 2015 was -5.6% for companies in the S&P 500 Index. However, when energy was excluded, S&P 500 earnings actually grew by 8.5%.[9] Energy stocks are close to fair value because in free market equilibrium the break-even cost of the marginal producer will determine the price of oil. The present break-even cost is that for the shale producers which the Bank Credit Analyst has estimated at $50-$55 per

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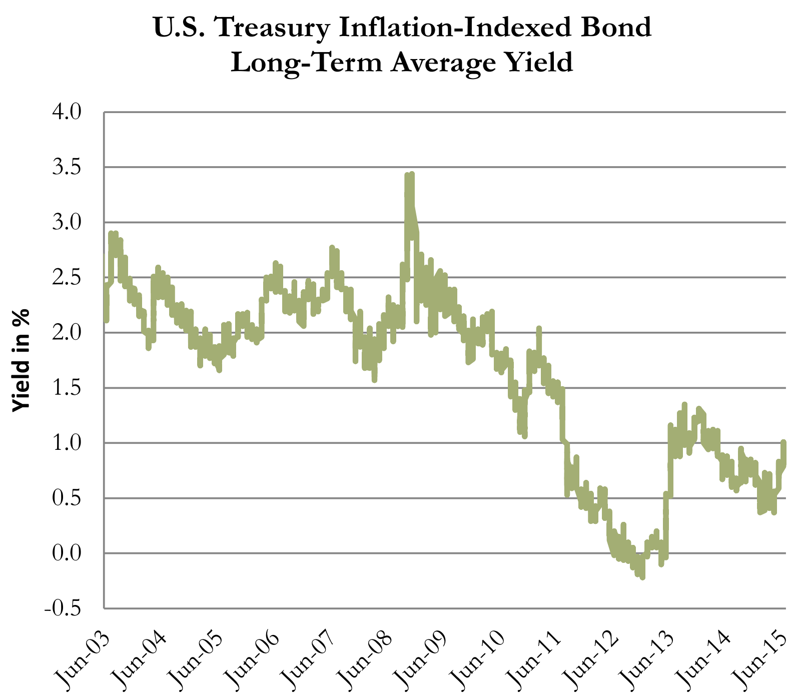
[8] JP Morgan, Guide to the Markets, June 30, 2015, page 52.
[9] JP Morgan, Guide to the Markets, June 30, 2015, page 8

barrel. In the short term however, oil prices can fall below this price partly because Iranian exports are likely to increase and because inventories are excessive.

The currency impact on U.S. corporate earnings is important because just under half of the S&P 500 revenues come from overseas.[10] Thus, the nearly 18% increase in the U.S. dollar index against other major currencies over the past year has been a significant headwind, particularly for the large cap industrial and consumer staples companies. While these two factors were a negative over the past year, we do not anticipate that the impacts will be as large going forward.

Fixed Income Markets

Returns for the U.S. bond market have been slightly negative this year according to Barclay's Capital U.S. Aggregate Index. Concerns over the potential for higher interest rates in the U.S. and the desire for safe haven assets in the face of uncertainty in Europe have kept U.S. treasuries in a trading range while investment grade and below investment corporate bonds have sold off on energy-related concerns.



Source: Federal Reserve Bank of St. Louis (FRED)

Despite the relatively low yield environment the returns to U.S. bonds may still be positive if the lift off in the U.S. federal funds rate is modest, as most market participants expect.

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[10] JP Morgan, Guide to the Markets, June 30, 2015

If global growth slows further and if inflation remains in check, the demand for bonds may continue to keep a lid on yields and therefore provide some support for prices. In addition, the equilibrium term premium on long term bonds may be less than it has been in the past according to the Bank Credit Analyst.[11]

We are monitoring the fundamentals within the credit market carefully. The amount of new issuance in the U.S. corporate bond market is rising quickly as companies race to raise capital before borrowing costs rise. However, the borrowed capital is being used to finance stock repurchases and in some cases for merger and acquisition activity and not being used for refinancing existing debt or for capital expenditure reasons. Therefore, the quality of balance sheets in the U.S. corporate market may be declining at the margin and it is a risk factor we are evaluating.

We expect U.S. and non-U.S. long-term sovereign yields to rise only slightly in the second half of 2015. However, the consensus is calling for a higher increase and has caused some to question the wisdom of even owning bonds. This is definitely an overreaction. First, as pointed out in our prior outlook, in recent years long-term bonds have been an excellent hedge against equity market declines. In addition, an environment in which rates are expected to rise, ladders of

short-term bonds or a combination of short-term and intermediate-term bonds can provide decent returns. A typical example of a bond ladder features rungs of one, two and three-year bonds. The idea is that when the one-year notes come due, the proceeds can be used to purchase new bond offerings at higher yields. Within bond types, we are using a combination of Treasuries, investment grade corporates and federally-backed mortgage securities. The average duration of our bond portfolios is less than that of their benchmarks to minimize the downside risk of higher interest rates. Finally, we remain wary of the quality of newly issued high yield bonds and as a result, remain focused on short duration securities whose managements are dedicated to reducing the debt load on their balance sheets.

We are also monitoring the municipal bond market carefully. There was substantial movement in tax-exempt bond yields during the weeks prior to the end of the second quarter. The ten-year benchmark AAA rated municipal bond yield was up 18 basis points to 2.19%, while the yield on the ten-year Treasury was 14 basis points higher. The ratio of the yield on a ten-year AAA municipal bond to the yield on a ten-year U.S. Treasury (the Bloomberg MUNSMT10 Index) fell briefly into the 90% to 100% range but was still 105% at the end of the quarter, which meant that the yield on a top-rated tax-free bond was higher than that on a comparable U.S. Treasury.[12] We expect the fear of rising interest rates and seasonal factors could lead to higher tax-free yields in the next two months. Concern about rising rates causes issuers to rush to lock in present rates and thus

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[11] Bank Credit Analyst ,"Strategy Outlook Third Quarter 2015", page 14
[12] Bloomberg, As of June 30, 2015

increases the yields as well as the supply of new bonds. There is a tendency for refunding issues to be much higher than normal in the summer which may create a buying opportunity.

There also have been important developments on the municipal bond credit front. On May 5, the Illinois Supreme Court ruled that the state's pension fund reform plan was not in compliance with the constitutional protection of pensioners. That was not unexpected. However, what was not widely anticipated was how swiftly the city of Chicago's bond issues were downgraded. Chicago has excessive pension liabilities which it is now trying to reduce. We believe that the Illinois ruling and Chicago's troubles could be the beginning of a renewed focus on municipal financing and the impact of underfunded pensions on credit quality.[13]

We regard Puerto Rico, with a total of as much as $72 billion in total debt at risk of default, to likely be a major concern for tax-free investors. Unlike the debt of Greece, these bonds are held by many investors individually and via mutual funds and therefore could have a direct impact on the private sector. In addition, many hedge funds thought it wise to accentuate the trade via additional use of leverage and this could have a negative impact on the market as these funds exit their positions. We believe that the Illinois ruling, Chicago's troubles, and the

Puerto Rican default could cause those concerned about the creditworthiness of tax-free issuers to be taken much more seriously. These developments support our view that the muni market is moving away from its rate-sensitive, homogeneous origins and toward a quirky, credit-sensitive space more comparable to U.S. corporates. For this reason, we are increasingly using third-party municipal specialists to manage our client portfolios.[14]

Summary

While China and Greece dominated the global headlines for much of the second quarter, modest growth across developed economies is likely to continue in 2015. The global economy continues to benefit from low borrowing costs, low inflation and lower commodity import prices though excess leverage is still a problem, particularly in peripheral Europe and the emerging market economies. In the U.S. the employment situation continues to improve, but has more to go, especially if the marginally attached and part time workers are counted. This is likely to keep any interest rate increases in the U.S. in 2015 to a minimum and as a result, U.S. monetary policy should remain quite accommodative to growth. The increase in the trade-weighted dollar which has been a major drag on U.S. multinational corporations is likely to abate as the dollar becomes increasingly overvalued in relation to major currencies.

[13] www.Illinoispolicy.org/chicago-2-junk-bond-status, May 12, 2015

[14] www.wsj.com/mutualfunds are front and center in Puerto Rico talk. See Also Morgan Stanley, "On the Market/Strategy, Wealth Management, June 2015.

European markets will continue to be influenced by the question surrounding Greece and whether it will eventually leave the Eurozone. This has had the effect of keeping valuation multiples lower than that of other developed markets. However, there are positive signs of improvement in many core and peripheral European economies that could continue to push stock markets higher. In addition, the support from the European Central Bank in terms of low interest rates and their newly established bond buying program should continue to support the financial system in Europe during this period of uncertainty.

While the impact of a lower oil price on S&P earnings may be a negative, it is a positive for consumers and non-energy producing corporates. While we haven't seen the full benefit of lower oil prices filter through into higher consumer spending or higher corporate profits, the more stable the prices are the more likely that this will begin to impact behavior and ultimately the bottom line for consumers and businesses alike. Our conclusions are subject to a number of risks, most of which are on the downside. These include:

1. A hard landing in China as a result of a failure of monetary easing in the presence of investment and credit bubbles. This would result in lower than expected global growth, disappointing multi-national corporate earnings and a continued decline in commodity prices.[15]

2. Greater than expected oil price declines which in the short term could seriously damage shale producers. The additional real income associated with oil price declines tend to be saved in the short run and if sustained, spent in the long run.

3. Greater than expected U.S. dollar strength, contrary to purchasing power parity measures, which would further depress earnings of U.S. multi-national corporations and jeopardize emerging market economies dependent on U.S. dollar debt. According to the IMF, a higher dollar would also negatively impact U.S. GDP growth.

We thank you for your continued confidence in us. If you have any questions, please do not hesitate to contact us.

Sincerely,

James L. McCabe, Ph.D. Mark E. McCarron, CFA

[15] Bridgewater Associates estimates that the collapse of China's equity bubble could reduce real GDP growth by 2.5% per annum for the next three years. We are less certain for three reasons: 1. Only a disorderly correction not a reversal has occurred this far; 2. The October 1987 crash in the U.S. market and its minimal effect on the real economy is not considered; 3. Chinese government intervention to stabilize the market could be effective like that of the Hong Kong government in 1998.

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