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ECONOMIC UPDATE - - INDICATORS LOOKING GOOD

Despite chronic job market weakness and fiscal headwinds, several favorable but largely overlooked longer-term trends are underpinning the expansion, minimizing the odds of a return to recession. Taken together, the boom in shale oil and gas production, dramatically improved manufacturing competitiveness versus Asia, the impact of mobile computing on technology and the related need for expanding wireless, and the upturn in new home sales have offset what until recently has been lack-luster consumption which accounts for 65% of GDP. Recently released data showing a gearing-up in hiring could be signaling stronger consumption in the next phase of this expansion.

Last Friday the Labor Department reported total non-farm payroll employment surprisingly increased in February by 236,000, well above the 191,000 average of employment gains in the past three months. In addition, the unemployment rate fell to 7.7%, down from 7.9% in January, the lowest level since December, 2008. While we believe this better-than-expected jobs report could be an early indicator of an acceleration in growth, it may be premature to celebrate. Many economists and the White House are warning the stronger employment gains across a wide range of industries are being put at risk by sequestration, the automatic spending cuts being imposed by the federal government, and other tax increases which went into effect at the beginning of the year. Stay tuned!!

As we see it, the employment gains of February combined with the steadily rising path of personal income, when adjusted for the ongoing drag from fading past stimulus and new permanent tax increases, are encouraging from a longer-term perspective. Importantly, payroll data we have seen imply a solid rise in wage and salary income in February with increases in both hours worked and earnings. These earnings gains are undoubtedly behind the strong February retail sales figures discussed below. Nevertheless, near term, the new tax hikes are expected to exert a drag on the economy taking a bite out of consumer spending growth this spring, though there has been no noticeable effect so far. Looking ahead, the

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income growth implied in continuing employment gains should begin to outweigh the temporary drag from tax increases sometime around mid-year. As a result, we expect improving consumer spending growth in the second half of the year, on the order of 2.5% to 3.0%, which supports our GDP forecast of 2.0% to 2.5% for the full year.

Aside from the better employment picture and payroll numbers, many of the high-frequency, *forward-looking* economic indicators we monitor are pointing toward a stronger economy.

- The Federal Reserve's January *Senior Loan Officer Opinion Summary* on bank lending practices, the most reliable indicator of future business activity we follow, showed that banks had eased their lending standards across nearly all loan categories in the fourth quarter of 2012 indicating their greater willingness to lend in response to stronger loan demand from both businesses and households.

- The all-important Institute for Supply Management (ISM) *Manufacturing Index* rose for the third consecutive month to 54% in February from 53.1% in January. An index reading above 50 signals expansion. Last month's index figure reflects the highest Purchasing Managers Index (PMI) since June 2011. Importantly, the New Orders Index registered 57.8 percent, indicating growth in new orders for the second consecutive month as was the case in January. All five of the PMI's component indexes (new orders, production, employment, supplier deliveries and inventories) registered in positive territory in February. In addition, the Backlog Orders, Exports, and Imports Indexes all grew in February, relative to January.

- The ISM's *Non-manufacturing Index* rose to 56 last month from 55.2 in January, the 38th consecutive monthly increase. Readings above 50 signal expansion in the non-manufacturing industries comprising 90% of the economy. The fastest pace of new home sales since 2008 is benefiting the services sector.

- *Leading Economic Indicators* (LEI) rose in January showing the economy is on track to sustain its expansion for at least the next six months. Six of the 10 components in the LEI Index contributed to the increase including stock prices and the interest-rate spread between the federal funds rate and 10-year US Treasury notes. The biggest positive factor in the LEI's strength is housing.

- *Consumer confidence* continues to rise despite the political mess in Washington. The Thomson Reuters/University of Michigan Index of US Consumer Sentiment for February rose to 77.6 from 73.8 at the end of January. This index averaged 64.2 during the last recession and 89 in the 5 years before the 18 month economic slump that ended in June 2009.

- *Non-defense capital goods orders* (excluding aircraft) rose 7.2%, the largest increase in over a year in February.

- Our firm's proprietary Economic Model, a copy of which is enclosed, is pointing toward continued expansion.

Beyond these leading indicators, a number of coincident indicators are showing strength:

- Most importantly, retail sales, referred to above, rose 1.1% in February, the largest gain in five months as the improved jobs market and stronger household finances cushioned the effect of the two percentage point increase in payroll taxes that help fund Social Security. The February advance exceeded expectations by a wide margin. Clearly, the boosts to household wealth from rising home values and stock prices are helping consumers maintain their spending in the face of higher taxes and fuel prices, revealing steady underlying economic strength.

- Industrial Production rose more in February than forecast rising 0.7%, the largest increase in three months, spurring consumer demand, increased capital spending and leading to lean inventories.

- Corporate earnings are at record levels. The S&P 500 operating earnings rose last year to a record high of $103.76 per share, up 6.1% from 2011. Analysts' consensus for 52-week forward earnings are at a record high of $114.66.

- Corporate cash balances are at record highs. The Federal Reserve's Flow of Funds (FOF) Report for the 4th quarter of 2012 report shows that liquid assets held by non-financial corporations rose to a record high of $1.79 trillion at the end of 2012. Their cash flow totaled $1.56 trillion during the third quarter of 2012, near the record high reached in the fourth quarter of 2005.

- The Federal Reserve will remain highly accommodative despite the improving jobs market. The Fed has unambiguously stated they intend to maintain their ultra-easy monetary policy and, despite one or two dissenters, are not inclined to phase-out their quantitative easing (QE) program until the unemployment rate drops significantly below the current level.

- Wealth is expected to continue to inflate as Fed officials believe they are creating a positive " wealth affect" which should boost consumer and business spending, and stimulate housing and construction activity.

- Housing activity is rebounding. The months' supplies of new and existing single-family homes are down sharply to 4.1 months and 4.3 months from their recession highs of 11+ months. Construction employment increased in February by 349,000 since it bottomed during January 2011.

- Transportation is showing signs of strengthening. Employment in transportation and warehousing has increased 88,000 over the past 12 months. Truck tonnage rose 6.5% year over year in January, the best gain in over a year.

- Business is restocking inventories and is borrowing to do so. While these variables tend to be lagging indicators, they are confirming the economy's trend.

OUTLOOK

Based upon the data available, we expect the US economy to continue to expand at a moderate 2.0% - 2.5% rate this year. Inflation is forecast to remain well below the Fed's 2.5% trigger-point for tightening. The Fed will keep short term rates on hold at their current historically low levels until well into next year. Longer-term interest rates should drift higher as investors demand higher returns to compensate them for the longer term inflation risks inherent in the pricing of longer-dated bonds. Ten year US Treasury Bond yields, now slightly above 2.0%, are expected to range between 1.8% and 2.25% this year. The unemployment rate will decline only stubbornly, possibly reaching 7.0% by year-end.

Abroad, Japan's new government is clearly on a path toward reflation, a positive for that country whose economy has stagnated for the past 20 years, and for global trade in general. China's economy is currently showing mixed signs due to seasonal distortions, largely, due to the timing of the Chinese New Year. The adjusted data, after allowing for the distortions, remains supportive of the trend of a modest recovery since the fourth quarter of last year. We continue to expect 8.0% year-over-year growth this year. The largest downside risk to our outlook for China is that manufacturers and property developers may defer their capital spending until they have greater clarity about policy and reform coming from their new government leadership. This period of waiting could extend until the 3rd Plenary Session of the 18th Party Congress in October of this year. We expect China's monetary policy to gradually shift to neutral from last year's expansionary approach as the pace of economic growth quickens later this year.

The Euro zone economies remain in recession. However, there are some signs of an emerging bottoming in economic activity that should bear fruit by year-end.

The Organization for Economic Cooperation and Development (OECD) has recently noted its key economic indicators for the Euro zone, designed to identify turning points in the business cycle, show signs of an upturn in business activity. Improving data from Germany and indications that Italy's economy has entered a stabilizing phase following a recent period of decline, are behind the improvement. Also of interest, and by contrast, the OECD noted their business job indicators point towards sustained growth in the US and Japan. Emerging economies such as China, India and Brazil are also picking up according to the OECD, but still at a below-trend pace. Structurally, the Euro zone financial crisis has abated substantially as the EU follows its long and politically uncertain path toward an eventual financial union.

INVESTMENT STRATEGY

We remain convinced that a balanced, globally diversified equity strategy that is opportunistic and focuses on quality and income generation remains the best approach for the long-term growth of capital. The road to global economic recovery should continue, not without a few bumps along the way. Periodic stock market corrections of 5 to 10% are to be expected. Despite a strong equity market advance since last fall, we believe large cap US equities to be attractively valued at 14 times earnings given their strong cash flow generation, solid balance sheets and reasonable valuations. Other metrics of stock market valuation we follow confirm the statistical cheapness of US equities. In addition, many major institutions and wealthy individuals remain under-committed to equities and are likely to shift the mix of their holdings further toward equities as the market indices reach new all-time highs. Furthermore, bonds yielding 1% or less provide little competition for the earnings and dividend power of large cap US stocks. The equity portions of client's portfolios under our supervision, therefore, remain fully invested as they have been since March 2009.

We have increased conviction that owners of long-dated bonds, particularly US Treasury obligations, are in for a rough ride ahead as improving sentiment and increasing growth prospects drive open market rates higher. We have, therefore, limited bond maturities in client accounts, where durations are at record lows, currently just below one year.

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