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ECONOMIC UPDATE – CONFIDENCE FIRMING

BUSINESS CONDITIONS

Following a series of false starts since the end of the last recession, signs of improving business have emerged following the sharp, weather-induced slowdown this winter. Labor market conditions, while still mixed, have shown further gains with monthly jobs additions now at the highest level since January 2012. Businesses appear to be somewhat more sanguine about hiring new workers. Household spending, the one bright spot in the otherwise dismal first quarter GDP figures, is rising at an encouraging rate. Consumer confidence is at its highest level since last August according to the Conference Board. Both the Institute for Supply Management (ISM) Manufacturing and Non-Manufacturing indices, very reliable forward-looking indicators, are solidly above 50, signaling continued expansion. Readings of other forward-looking measures, including factory orders, are pointing toward a rebound. Counterpoints to these more positive trends, are depressed business spending and a faltering recovery in housing where, following an 18 month rebound from early 2012 through last summer, activity has clearly cooled. Balancing these factors, Federal Reserve officials have concluded there is sufficient underlying strength in the economy to support further improvement in the labor market, allowing it to continue tapering the monthly rate at which it purchases agency mortgage-backed securities and US Treasuries by another $10 billion beginning this month.

Beyond the ebb and flow of quarterly business conditions, a number of headwinds to stronger growth persist. Government fiscal policies (i.e. higher taxes and reduced government outlays) continue to restrain economic growth although the extent of restraint is diminishing. Also important, but difficult to quantify, the lack of growth-oriented tax policies and a dysfunctional Congress remain a wet blanket on the economy. For example, corporate take-overs and mergers have risen to

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their highest level since 2007, driven in part by American companies' departing the US to escape US Corporate tax rates which are among the highest in the world. Currently, Pfizer is rumored to be preparing a bid to acquire the British pharmaceutical firm AstraZeneca for over $106 billion. If completed, this transaction could save Pfizer $1 billion or more annually because of Britain's lower 20% tax rate and other potential breaks. By comparison, Pfizer is currently taxed at 27%. In another example, Walgreens is being lobbied by shareholders to shift its tax domicile to Europe when its right to purchase the remainder of the Alliance Boots chain becomes active next year. Since 2008, about 24 publically held American companies have used mergers to shift their legal residence abroad through the process known as "inversion". That compares with about the same number of such mergers over the previous 25 years. Increasingly sophisticated tax avoidance schemes, driven by tax arbitrage, have helped the share of corporate profits paid in taxes to decline significantly. The recent cross-border transactions often include an additional attraction for companies. To help pay for mergers, American companies utilize cash trapped abroad by rules requiring that a 35% tax be paid to the Treasury on profits brought home. In these and many other instances, current tax policies incentivize non-productive or other undesirable corporate behavior rather than encourage a pro-growth agenda which would add jobs domestically.

Weak 0.1% first quarter 2014 real GDP growth reported last week was largely expected and has essentially been ignored by the financial markets. Instead, investors have focused on the underlying trend in the economy as reflected in consumer spending, business investment and home building which, when aggregated, grew at a 1.9% annual rate in the first quarter, and are up 2.6% in the past 12 months - - well within the range of the past five years.

Overall then, we view the weakness in first quarter GDP to be a backward looking, lagging indicator of economic activity. The Chicago PMI, which rose to 63.0 from 55.9 in March, pending home sales, and housing prices are sending more reliable readings of what is actually happening in the economy - - a continuation of the 2% growth we have experienced for some time. Supporting this view, the latest update of our firm's Economic Model with data received through the end of last month, confirms the current expansion will continue for the foreseeable future, albeit at a rate below which we have seen in prior expansions.

Also noteworthy are the findings of the Fed's latest quarterly survey of Senior Loan Officers. The survey, in which 74 domestic and 23 US units of foreign banks reported, showed banks in the US during the first quarter eased policies for loans to

businesses including real estate companies amid stronger demand for credit. Every domestic bank reported easing standards or terms on commercial and industrial loans cited more aggressive competition from other banks or non-bank lenders as an important reason for having done so the Fed said. Smaller numbers of banks also attributed their easing to a more favorable or less uncertain outlook and increased tolerance for risk. The increased willingness on the part of banks to extend loans has in the past been a very reliable precursor of increased business capital spending nine months hence. Perhaps this Fed survey is also signaling some stirring of the "animal spirits" necessary to kick the economy into a higher gear. Stay tuned.

JOBS

The April *establishments* report showed an unexpectedly large 288,000 gain in employment. Unemployment at 6.3% is now at the lowest level since September 2008. Yes, new jobs are being created and at a more rapid pace than we have seen for years. However, behind the positive headlines are a number of clouds that paint a picture of stagnating wages, no increase in hours worked, and a shrinking labor force. Average hourly earnings held at $24.31 in April, up only 1.9% over the past 12 months, the smallest gain this year. The drop in the April unemployment rate from March's 6.7% stands in contrast with another survey of *households* showing the labor force shrank by more than 800,000 in April. The so-called *participation rate*, which indicates the share of working-age people in the labor force, decreased to 62.8%, matching the lowest level since 1976, from 63.2% a month earlier. Indeed, if the *participation rate* was at 66%, which is about where it hovered for many years prior to the recession, the headline unemployment rate would be about 10.3%, four percentage points higher than is currently reported.

FED POLICY

This month's widely expected $10 billion reduction in monthly bond purchases, the fourth such cut this year, represents the continuation of the policy articulated over the past few months by Fed Chair Janet Yellen, who took over in February, and former chairman Ben Bernacke. Unless the economy departs from its current trajectory, further monthly reductions will continue until QE ends this fall.

The Central Bank has also continued with its guidance on short-term interest rates, indicating rates would remain near zero for a considerable time following the end of its bond buying program later this year. Markets are pricing-in the start of rising rates in mid-2015. However, speculation has already begun over which short-term

rates it will target once credit-tightening begins. Historically, the Fed has moved short-term rates by managing the interbank lending rate known as the federal-funds rate. Recently, the New York Fed has experimented with a program that might lead to a new short-term interest rate target called a "reverse repo" rate which some officials believe would be easier to manage and more effective. Importantly, the Fed needs to update its formal exit strategy from easy-money policies. Three years ago, they agreed on a plan to eventually sell off their large mortgage-backed securities portfolio. Now, many officials believe this strategy is out-of-date. For example, the Fed might choose instead to allow its mortgage bond portfolio to wind-down gradually without sales. A notice on the Fed's website last week confirms it is actively discussing "medium-term monetary policy issues", a euphemism for an "exit" strategy. *Setting* an appropriate exit strategy for the Fed's $4 trillion bond portfolio is certain to raise uncertainties, if for no other reason than the unprecedented magnitude of the undertaking. *Communicating* the strategy and its implications in a manner that avoids serious credit market disruption will require skills which, in the past, the Fed has often failed to demonstrate.

FORECAST

Indications of improving growth in recent *forward-looking* economic data including jobless claims, consumer confidence, factory orders, Institute for Supply Management (ISM) Manufacturing and Non-Manufacturing indexes, Leading Economic Indicators (LEI), and our firm's proprietary Economic Model, support our forecast for a rebound absent a geopolitical shock or some unforeseen exogenous event.

Consumption should continue at the 3% rate of the first quarter. Business investment, which fell 5.5% in the first quarter, is likely to rebound as surveys show publically-traded companies intend to increase their outlays to about 5% in 2014. Leading indicators of business capital spending, which appear monthly in regional Federal Reserve Bank reports, confirm a pick-up as do the findings of the Senior Loan Officers survey. Housing remains a wild card. Residential construction, which was particularly hard-hit by the winter weather, declined by 5.7% in the quarter just ended following a 7.9% drop in the prior three months. While some snap-back in residential construction is likely this quarter, the continued fall in mortgage applications indicates the recovery in residential building will be slow to develop. The industry's recovery has been challenged by higher interest rates, slow wage growth and tight credit which have put home ownership beyond the reach of some would-be buyers. Larger gains in

employment, more rapid wage gains and higher family formation will be necessary to overcome declining affordability.

Abroad, business conditions are also improving. China's GDP exhibits signs of troughing at a 7.5% growth rate. Europe has emerged from its recession. Japan is following expansionary fiscal and monetary policies which have diminished fears of deflation and contributed to a rebound in general economic activity. Globally, central bank policies are highly accommodative and are likely to remain so given high unemployment rates and slack industrial capacity utilization.

All in all then, with consumption expected to remain strong and manufacturing to rebound, we forecast GDP growth to snap-back to about 2.5% this quarter and then to inch up over the balance of the year toward the 3% mark. Inflation, now rising at a 1.3% rate according to the Fed's favorite measure, the Personal Consumption Expenditures Index, (PCE) is expected to remain below the Fed's 2% target, despite some recent anecdotal evidence of growing wage pressures in some industries and higher food commodity prices, providing the Fed with little impetus to raise rates prematurely. The Fed will remain highly accommodative. S&P 500 operating earnings should reach $122 per share this year, rising to $129 per share in 2015. Short-term rates, administered by the Fed, will remain ultra-low until at least mid-2015 and then rise very gradually. Intermediate and longer-term US Treasury rates will not wait for the Fed to reverse its accommodation. Eventually, these rates will normalize with the yield on the 10 year US Treasury bond now at 2.60%, returning to the 4% to 5%+ range. November 2013 will mark the low point in longer-dated US Treasury yields as the secular rise in bond yields plays out.

EQUITY STRATEGY

We remain positive on the outlook for US stocks. The equity portion of portfolios under our supervision remains fully invested within established portfolio management guidelines. Despite strong returns over the past 5 years, averaging 21.1% per annum, and 21.9% over the past four quarters, US equities remain reasonably valued at about 15 times forward operating earnings. American companies are extremely healthy on average and have the capacity to further increase their leverage to pay higher dividends and to repurchase their shares. Accelerating growth beginning this quarter could provide a strong tailwind for fundamentals, supporting higher valuations. There is a high likelihood bond yields will rise over the intermediate term generating negative returns for bondholders, prompting flows into equities. However, a word or two of caution is in order. In recent quarters stock prices have advanced more rapidly than fundamentals. Profit

margins are at all-time highs and could come under pressure as unemployment falls. And, equities are inherently volatile and market moves are not linear. Keep in mind that the US equity market has experienced two severe declines in the past 15 years before making new all-time highs recently.

Clients' stock portfolios remain tilted slightly toward *growth* stocks although we have largely avoided high momentum biotech and the internet shares. Our target for investments in companies domiciled abroad remains15% of the equity portfolio total. Roughly half of this component is allocated to investments in developed markets with the balance in emerging market shares where valuations are compelling in our view. Our diversified core equity portfolio is heavily weighted toward companies we believe will benefit from the improving global business conditions we foresee including investments in diversified industrials, technology companies and financials which account for roughly 50% of the total.

FIXED INCOME

We continue to advise clients to remain extremely cautions with regard to fixed income investments as we are in the early stages of a secular rise in interest rates. The fixed income portions of portfolios under our supervision are, therefore, structured with principal protection as the overriding consideration. Bond durations remain at historical lows, approaching one year. Portfolios are largely structured with a short ladder of high quality, liquid, corporate obligations.

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