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ECONOMIC UPDATE - - FURTHER GRADUAL IMPROVEMENT

Despite numerous geopolitical issues, a dysfunctional government and fiscal headwinds, the US economy showed continued improvement as last year progressed. Solid gains were made toward the Federal Reserves' dual goals of an unemployment rate in the 5.2 percent to 5.5 percent range and inflation, as measured by the Personal Consumption Expenditures Chain Price Index (PCE) at 2 percent, allowing the Fed to conclude QE, one leg of its unconventional monetary policies. By ending this program of bond purchases the Fed did not tighten market. But it did mean the Fed judged added pressure on long-term rates was no longer needed to support the economic expansion which they now view as self-sustaining. We share this view.

The pace of job creation picked up from around 195,000 per month in 2013 to around 240,000 per month in 2014 as the headline unemployment rate fell from 6.7 percent at the end of 2013 to 5.6 percent last December, and from 13.1 percent to 11.4 percent according to a broader measure (U6) which includes discouraged workers and those working only part-time for economic reasons. Headline inflation, as measured by the CPI, fell from 1.5 percent to 0.8 percent relative to a year ago on the back of a sharp decline in energy prices. Removing food and energy, "core" inflation rose a healthy 3.4 percent. Behind the improvement in the labor markets and stable-to-firming underlying inflation were several factors. First, households, which had reduced their debt levels relative to income during and subsequent to the financial crisis, were experiencing rising wealth as equity and home prices increased under the impetus of very low interest rates. Consumers were, therefore, better positioned to step up borrowing and spending. Second, lenders, having largely recovered from the losses of the recession, saw stronger demand for loans and, trying to find higher yields in the low interest rate environment, increased the supply of credit, loosening the terms and standards they imposed on loans. Third, government at all levels stopped raising taxes and reduced spending as fiscal policy, which turned from negative to neutral, was no longer a drag on growth. Finally, as the amount of slack in the labor markets and

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the economy gradually eroded, we found scattered early signs that wage and compensation rates might be picking up, supporting expectations of a very gradual upward movement to 2 percent inflation.

Looking ahead, these factors, along with seven year highs in US consumer confidence, are expected to add momentum to the expansion in 2015, providing the basis for sustained growth and a pick-up in the rate of underlying inflation. Brightening American consumer attitudes are leading to gains in purchases of big-ticket items such as automobiles and appliances that can ripple through the economy and underpin manufacturing. In addition, if sustained, the recent sharp drop in energy prices will add to consumers' purchasing power, supporting greater spending which might have grown as rapidly as 4 percent in the last quarter.

UNCERTAINTIES

Clearly, there are uncertainties that raise doubts about whether incoming economic data over the next two quarters will support the Fed's withdrawal from its zero interest rate policy. These uncertainties stem largely from the sharp rise in the value of the dollar and troubling developments abroad, where global growth slowed in 2014. Both Japan and the Euro area experienced quarters of declining GDP. While monetary ease has been stepped up in both areas, and the EU recently announced what could amount to a $1trillion QE of its own, it remains to be seen whether these accommodative measures will be sufficient to restore desired growth.

Also, a number of emerging market economies are facing challenges. China, the largest of these, has experienced slower than expected growth as their economy transitions from export-led to domestic demand-driven growth and from investment to consumption within domestic demand. Concurrently, China has undertaken the large task of trying to move its shadow banking system back to the books of its banks and to further liberalize their financial system. Brazil and other large emerging market economies are also coping with disappointing economic performance. And Russia is reeling from the effects of both western sanctions and the plunge in oil prices. Back in the US, orders for business equipment unexpectedly fell in December for a fourth month, signaling the global growth slowdown is weighing on American companies as slackening demand from Europe and some emerging markets is probably impacting orders, making companies less willing to invest in new equipment.

Reflecting these uncertainties, financial markets have experienced heightened volatility early this year as investors began to question anew the sustainability of global growth and the possible adverse consequences of the decline in oil prices. With slower growth and lower oil prices, the prospects for entering a deflationary spiral appear to some to have increased. To date, these worries seem mostly about downside risks to the expansion rather than about changing the most likely course of the US economy, but they do point to the possibility the Fed could find itself making less than anticipated progress toward its goals and consequently delaying the date of its first tightening to this fall or even later. Currently, most forecasts assume the Fed will make its initial interest rate increase at midyear. In our view, the timing is a close call and will depend on data to be released this winter and spring.

OUTLOOK

Our analysis suggests that fourth quarter GDP growth was in line with our earlier expectations of about 3 percent although a surprising 3.2 percent decline in non-defense capital goods shipments in December might bring that number down a bit. While 3 percent would represent a slowdown following the unusually strong 5.0 percent gain in the third quarter, it would still be significantly stronger than the lackluster 2 percent pace that characterized the earlier stages of the recovery.

Alongside the weakness of overseas demand, where our exports represent less than 8 percent of GDP, the dollar's recent surge does mean that external trade will probably be a modest drag on US real economic growth this year. At the same time, however, the collapse in global oil prices and the decline in long-term interest rates will provide a further boost to US domestic demand growth in the first half of this year. In fact, the collapse in gasoline prices will reduce the nominal amount that households spend on gasoline by at least $80 billion. Assuming households spend their savings on other goods and services, the $80 billion would boost real consumption by close to 0.8 percent. Keep in mind that household consumption accounts for close to 70 percent of GDP. The fall in long-term interest rates, including fixed rate mortgages, has also triggered a renewed surge in refinancing applications which, at the margin, will boost consumption growth.

On balance, then, the overall impact of recent developments is likely to be positive. Indeed, both our firm's proprietary Economic Model and the Leading Economic Indicators (LEI) continue to signal expansion in the months ahead. We see inflation as measured by the PCE remaining below the Fed's desired 2 percent rate.

Underpinning the US expansion will be rising consumer outlays, steady improvement in residential construction spurred by low mortgage rates, and the abatement of fiscal policies which have held back the economy since 2009. Dollar strength will be a headwind for US exporters.

OIL

The price of oil is a key variable for the world economy, many industries and the global investment environment. As investors, it is important to be aware of potential benefits and pitfalls of the rapid change that we have witnessed in just a few months' time.

We can only speculate about the Saudi's reasons and intended goals for creating an oversupply of oil. Possibly it is to punish cheating OPEC producers. Perhaps it is targeted to weakening Iran or an effort to get Russia to the bargaining table on several geopolitical and strategic energy topics. It may be to simply protect the long-term market for fossil fuels by weakening alternative energy sources. Perhaps it is the weakening of the oil shale upswing in the US. Whatever the reasons, the world is now in over-supply, and since global economic growth is slow at best and energy efficiency has risen quite sharply for some years, the oversupply will persist until global production is reduced substantially. It will most likely play out as in 1986 when the Saudis disciplined OPEC by applying a similar strategy which the global economy survived but not without a few bumps and bruises.

Most affected are high-price producers like Canadian tar sands, US shale oil, Brazilian deepwater oil, and part of Mexico's high-cost production. Many high-cost projects for future production are now in jeopardy. Several major oil companies have made 20 to 40 percent cuts to their capital spending plans for next year. For smaller producers, particularly those with high cost bases, there will be a fight for survival. It is also clear that for many oil-producing nations their revenue shortfall will be dramatic, impacting their budgets decisively. Countries with large capital reserves like Saudi Arabia can hold out for a long time. As the current situation becomes more and more painful and pressures mount, OPEC may decide to meet prior to their next scheduled meeting in June to change its policy. On the other hand, the Saudis must continue to pressure prices to achieve their goals. While prices could fall below recent levels, the damage has been done, and the market forces of reversal will at some time begin to work but probably not before later this year or 2016. The spot and futures oil market may climax to the

downside, setting the stage for a quick rebound followed by a lengthy bottoming process at depressed levels, possibly for most of this year.

The 50 percent decline in oil prices since last summer's peak could benefit the global economy by as much as $1.5 trillion on an annualized basis if sustained. However, there will be losers and winners in this process. Consumers are clear beneficiaries while producers and all related to them are losers. It will be important, however, to see whether consumers spend or save their "benefit". With US interest rates at historically low levels and rates abroad likely to fall further as central banks ease monetary policies, consumers may realize they need to save more to achieve their retirement savings goals and, accordingly, add to savings. Stay tuned!!

EQUITY PORTFOLIO STRATEGY

Although now no longer undervalued, US equities remain the asset class of choice in our view. Stock portfolios under our supervision remain fully invested - - broadly diversified and balanced between *growth* and *value* shares - - within pre-established portfolio policy guidelines. We believe there remains further upside to stocks despite the likelihood of increased volatility this spring in share prices as the market grapples with the possible consequences of Fed rate hikes and digests exogenous events out of the Middle East and elsewhere.

Our constructive outlook for equities is supported by a base case of 7 percent earnings growth this year, by more than a 2 percent net buyback of shares outstanding, and an additional 2 percent dividend yield. The US economy is improving and the prospects for a long-lived expansion remain good. Global GDP will be modestly higher in 2015 as Japan expands, Europe stabilizes, and problems in the emerging markets are not significant enough to diminish the global outlook. Prospective returns from equities, therefore, far outweigh those of low yielding fixed income alternatives despite the high likelihood of a 10+ percent stock market correction along the way. As for stock market valuation, the S&P 500 is trading at roughly 16 times this year's expected operating earnings, a valuation not far above the long-term mean. Shares of companies domiciled abroad, which we target at 15 percent of the stock portfolio, remain less expensive than their US-based counterparts. Likely global demand for US equities over the intermediate to longer-term will outweigh supply, in our view, due to corporate buybacks, demand from foreign investors and reallocation from fixed income to equities as interest rates normalize. We see few, if any, speculative excesses in the stock market as

the “animal spirits” that inevitably rise in the late stages of a bull market are not in evidence.

FIXED INCOME POLICY

Clients’ fixed income investments remain cautiously invested with preservation of principal the overriding consideration. Durations of fixed income portfolios under our supervision approach 1 year. Portfolios are largely structured with an ultra-short ladder of high quality, liquid, corporate obligations.

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