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ECONOMIC UPDATE- - MODERATE EXPANSION AHEAD

Beyond continued robust employment growth and a rebound in business investment, there is scant evidence to-date the US economy has meaningfully accelerated this spring from its first quarter stumble. Despite better weather, an end to the West Coast port slowdown, and more disposable income in consumers' pockets due to lower gasoline prices, the economy now appears to be expanding at an anemic, below-trend pace, well short of the "escape velocity" of a self-sustaining expansion Fed officials and others, including ourselves, had hoped to have emerged by now. Sluggish retail sales, declining industrial output and slowing household spending highlight the under-performance of the economy as we approach summer.

Looking back, several economic headwinds have so far tempered the recovery, and to a degree, continue to impact the outlook. Of great significance was the *housing crash* which left many households with diminished wealth and higher debt burdens, weighing on consumer spending. Many families lost their homes, and many more ended up underwater, owing more on their mortgages than their homes were worth. Analysts have noted that areas of the country that saw a larger boom and bust in housing have subsequently fared worse economically than other areas of the country. In a number of respects, this headwind has diminished. Home prices have appreciated in many regions, alleviating the burden for many homeowners. Nationally, the share of mortgages that are underwater fell by about 50% between 2011 and 2014. However, while credit availability for mortgages has improved, mortgages remain hard to obtain for prospective homeowners who lack strong credit scores.

Another headwind, also largely behind us, came from *changes in fiscal policy* to address budget deficits. At the federal level, the fiscal stimulus of the 2008 – 2009 period supported economic output but as the effects of that stimulus faded by 2011, misguided fiscal policy (i.e. sequestration) became a drag on output growth when recovery was still weak and not self-sustaining. Elsewhere, states and

municipalities faced with serious budget problems due to the recession, and required by law to balance their budgets, were forced to cut spending and raise taxes. The recovery has by now boosted tax revenue in many states, alleviating their budget strains.

A third headwind has been the *restraining influences on the US from the global economy.* Initially, the euro-area crisis was the largest headwind coming from abroad. Supported by monetary stimulus, reduced fiscal drag and some significant institutional response, the recovery in the euro-zone now appears to be on more solid ground. However, growth in many other parts of the world, including China and some other emerging market economies, has slowed. Weak growth abroad, together with its accompanying implications for exchange rates (i.e. a stronger dollar) has hurt US exports and muted domestic inflation, weighing on our economy. This headwind, too, should abate as growth abroad firms, supported by monetary policies that will generally remain highly accommodative.

OUTLOOK

As these headwinds wane, the US economy should continue to expand, albeit at a moderate rate. Households will experience the benefits of the improving jobs market and consumer confidence, while subject to periodic ups and downs, remains solid. In addition, the decline in oil prices which is estimated to produce about a $700 savings per household, is additive to consumers' disposable income. Given the energy savings in addition to job gains, real disposable income has risen almost 4% nationally over the past four quarters. Households and businesses are also benefiting from improved financial conditions, including low borrowing costs and credit availability. Recent readings of the Federal Reserve's quarterly survey of senior bank lending officers, a reliable indicator of future business investment, remain positive. High frequency leading economic indicators, including manufacturing and non-manufacturing from the Institute for Supply Management (ISM), remain well above 50 confirming the expansion will persist.

In our view, the recent softness in the US economy was largely the result of the lingering impact of these headwinds, combined with the confluence of transitory factors noted above. We expect a rebound in economic activity to unfold over the balance of this year. Interestingly, a recent paper published by the Federal Reserve Bank of San Francisco suggests the US economy is not as weak as the 0.2% first-quarter GDP figure would suggest. By running a series of statistical "corrections" for the way government accounts for seasonal variations in output, the paper found a "good chance that underlying economic growth so far this year was substantially

stronger than reported." The San Francisco Fed suggests first-quarter growth may in fact have been closer to 1.8% -- still below the economy's potential but not dramatically so. Elsewhere, findings published last week by economists at the Washington-based Federal Reserve Board argue the opposite: That the recent pattern of first-quarter economic slowdowns is not a reflection of a statistical fluke in the way US GDP is measured. And the government agency charged with calculating the nation's growth rate, the Bureau of Economic Analysis (BEA), has acknowledged problems with its numbers and is "developing methods to address what it has found." First quarter GDP data have been weaker than the other three quarters for the past 30 years and substantially weaker in the past 5 years. In the end, the debate over whether the first-quarter was weaker or stronger than reported will be resolved as GDP revisions are received. Bottom line: Aside from a vigorous job market and a rebound in business spending, the early months of this year have produced disappointing economic results. Although the winter's chill is gone, the headwinds facing our economy have not fully abated.

Looking ahead, several factors are holding the economy back from a more vigorous pace of expansion:

- Despite the recovery in home prices, and a greater number of existing home sales, residential construction activity remains low. Years of a weak jobs market and slow wage gains have apparently induced many people to double-up on housing, with many young adults continuing to live with their parents. These trends are likely to continue so the housing sector is expected to improve only gradually.

- Business investment has also been very modest during this recovery as businesses seem not to have had sufficient confidence in the strength and durability of the recovery to undertake substantial capital expenditures. Dysfunctional government policies at all levels may have contributed to business unwillingness to make these commitments. The fact that many businesses are hoarding large amounts of cash may suggest simple risk aversion is also playing a role.

- Weak investment in the energy sector will also persist, reflecting the negative side to the fall in energy prices. New domestic drilling has fallen off sharply, and there has been a slowdown in activity in sectors that supply oil production companies, including steel and certain types of machinery.

In summary, then, we expect US GDP growth of roughly 2.0% to 2.5% over the balance of this year and into 2016, slightly faster than the average annual pace of the six year recovery. Indeed, both the Leading Economic Indicators (LEI) and our firm's proprietary Economic Model are signaling expansion over the next 6 to 9 months with no recession in sight. Unemployment will fall to below 5.0% by year-end. Inflation is expected to pick up toward the Fed's objective of 2.0% as the economy strengthens and as transitory influences recede.

Beyond the US, we look for modest global GDP growth of about 2.7% this year, similar to last year. China's economy is probably weaker than real GDP data imply, and likely to weaken further near term despite additional monetary easing. Growth in the euro zone should exceed expectations. Bond yields and market-based inflation expectations have risen sharply, leading some analysts to conclude we may be at the beginning of a reflation phase in the global economy with fears of disinflation and deflation giving way to rising positive inflation. We see little economic evidence to suggest reflation is imminent. Global growth is below global potential growth and it is unlikely ECB quantitative easing (QE) or Chinese stimulus measures succeed in raising inflation.

FED POLICY

We take the Fed at its word. If the economy continues to improve, as expected, the initial step toward raising the federal funds rate target and beginning the process of normalizing monetary policy is likely later this year, probably this September. That said, the Fed will defer its initial actions until they see further continued improvement in labor market conditions and they are *confident* inflation, as measured by the Personal Consumption Expenditures Index (PCE), will move back to 2.0% over the medium term. Thereafter, the pace of normalization will be very gradual and depend upon how the economy reacts to the initial rate increase. It will be several years, in our view, before the federal funds rate returns to a more normal, longer-term 3.50% - 4.00% level.

EQUITY INVESTMENT STRATEGY

Little has changed in the prospects for the equity market since our March client letter. Stocks, as measured by the S&P 500, have returned about 3.0% this year. Volatility has been muted. While no longer statistically cheap, US equities remain reasonably priced at about 17.5 times this year's expected earnings per share of about $120. With the US economy likely to improve from its tepid winter pace,

prospects for a long-lived expansion remain good and corporate profits, which drive stock valuations, should respond accordingly. Given the slow pace of expansion, the Fed, while likely to raise its benchmark rate this fall, will remain highly accommodative. Demand for US equities is likely to outstrip supply as US corporations continue to repurchase their shares, individuals add to their stock holdings and foreigners favor US dollar denominated investments, taking advantage of our appreciating currency.

Clearly, uncertainties surrounding the near-term course of corporate profits and fears over possible financial market volatility leading up to the initial Fed rate hike might temporarily cap the advance of the broad market indices or even precipitate a 10% + "correction." Also, recall that all recessions/bear markets since WWII have been triggered by either a spike in energy prices or in response to a Fed-driven inverted yield curve where short term rates exceed those of long term obligations. Neither of these is considered likely.

In a reversal from the past two years, stock markets abroad have this year out-performed US equities by a fairly wide margin as show in the table below:

	------------Total Return----------	
Index	Year-to-Date	Annualized 2 Years Ended 12/31/14
S&P 500 (US Large Cap)	+3.04%	+22.68%
MSCI EAFE (International Developed Markets)	+8.97%	+8.06%
MSCI EEM (International Emerging Markets)	+8.01%	-2.40%
MSCI (All Country World Index)	+5.45%	+13.10%

Equity portfolios under our supervision remain fully invested, tilted slightly toward *growth* vs. value *shares*. Investments domiciled abroad, targeted at 15% of the stock portfolio, remain significantly less expensive than their US counterparts.

Longer term, investors must recognize that the outsized returns from equities of the past few years, where the US market returned over 22% annually, are not likely to

repeat themselves going forward. Our current capital market forecast assumes returns from equities will average about 7.0% per year (5.0% nominal earnings growth plus a 2.0% dividend yield), well above those for bonds, where returns could turn *negative* as rates normalize, or for low yielding cash equivalents.

FIXED INCOME STRATEGY

Open market interest rates have begun to climb as we have moved closer to the first of the Fed's likely rate increases. For example, the 10 year US Treasury yield has risen from a low of 1.64% on January 30 to 2.15% today. We expect rates to continue to drift higher as the economy rebounds. Rising interest rates will be reflected in falling bond prices. We, therefore, continue to invest client's fixed income portfolios with preservation of principal as the overriding consideration. Durations of these portfolios approach one year and are structured with an ultra-short ladder of high quality corporate obligations.

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