COMMENTARY 2013 Q2

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During the quarter, equity markets continued to rally. In May, the S&P 500 Index reached an all-time high of 1,669, joining the Dow Jones Index, which reached an all-time high during the prior quarter. Over the last 12 months, the S&P 500 has returned 25.8%, including dividends, with only minor pullbacks along the way. In June, the market retreated slightly after comments by the Federal Reserve Board that signaled some "tapering" of its latest QE program if the economy continues to improve. Interest rate– and inflation-sensitive sectors witnessed the biggest moves. Given a continued slow-growth global environment and the inevitability of reduced support from the Fed sometime in the future, we are incrementally more cautious on the equity market.

The S&P 500 Index gained 2.9% on a total return basis for the quarter and is up 13.8% for 2013. From a sector perspective, the Financials and Consumer Discretionary sectors led the way this quarter, while performance for the Energy, Basic Materials, and Utilities sectors was negative.

From a global perspective, Japan continued to outpace the U.S., although it suffered a major price correction during the quarter. Even after that decline, the Nikkei is still up 15.1% for the year. Europe generally performed in line with the U.S. for the quarter, although most individual markets are still trailing for the year. The German DAX is up 3.9% for the year, and the French CAC is up 2.5%. Emerging markets, led by China, had a very tough quarter. The Shanghai Composite was down 9.3% for the quarter and is down 10.7% for the year. The Brazilian Bovespa was down 23% for the quarter and down 28.4% for the year.

The U.S. Economy Continues to Slowly Heal

Slow but steady progress for the U.S. economy is likely to persist. The domestic economy as measured by the Gross Domestic Product (GDP) expanded at an annual rate of 1.8% in the first quarter of 2013, up from the fourth quarter 2012 rate of 0.4%. GDP is expected to grow 1.9% for all of 2013 and 2.7% for 2014. Although these are not robust growth rates, the mix is fairly broad based, and most recent economic indicators have modestly surprised to the upside.

Housing trends have been improving, and this progress has helped drive increased consumer confidence and spending. The S&P/Case-Shiller 20-City Composite Home Price Index rose for the 15th straight month in April, and yet it remains almost 25% below its peak, signaling an opportunity to rise further. On a year-over-year basis, prices have risen nearly 12%, the fastest pace since March 2006. Homes represent about 25% of the assets on the average American's balance sheet. With the price of this asset now increasing, many Americans are feeling wealthier, which should encourage spending.

Strong consumer spending is critical for a continuing economic recovery, since the consumer represents about 70% of GDP. The Conference Board Consumer Confidence Index rose to 81.4 in June, the highest level since January 2008. Consumers remain upbeat despite the impact of higher payroll and income taxes this year.

Non-farm private payrolls have continued to grow slowly but steadily, more than offsetting recent cuts in government workers. The unemployment rate has declined over the last three years, but so has the labor force participation rate, as many potential workers have opted to not seek employment. Overall trends point to a modestly improving labor market and a slow-growth economy, which certainly keeps inflation low and should allow the Federal Reserve to keep the zero interest rate policy in effect for some time.

Will the Fed Be Able to Find the Exit?

Since the end of the Great Recession in 2009, markets have been influenced by the actions of the U.S. Federal Reserve, the European Central Bank, the Bank of Japan, and The People's Bank of China. Bad news (lackluster economic growth) has often been viewed as good news for stocks, since global central banks have been more inclined to respond by lowering rates and pursuing more aggressive quantitative easing to stimulate growth.

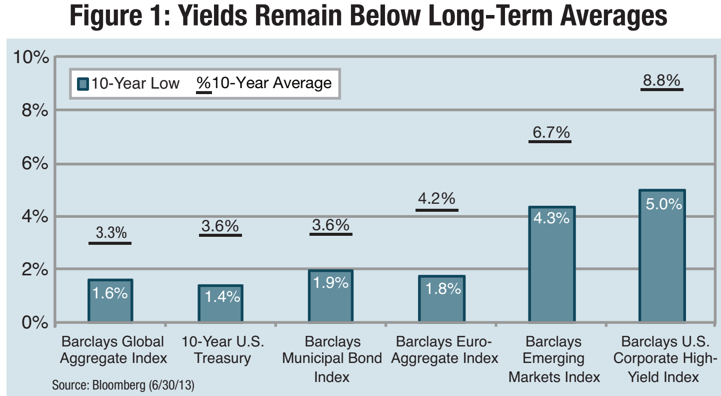
Last September, the Federal Reserve announced its latest quantitative easing program, commonly known as QE3. Unable to lower the Federal Funds Rate below 0%, the Fed had to establish other methods to stimulate the economy. QE3 involves the Fed buying $85 billion of mortgage-backed securities and long-term government bonds each month. With this program in place, the Federal Reserve has become the largest buyer of market debt with a goal of boosting housing, share prices, and the broader economy.

As investors have pursued "safety" and income following the stock market turmoil of late 2008 and early 2009, bond prices have been driven up and yields have fallen in all sectors of the fixed income market. QE3 drove many of these yields to even lower levels. Figure 1 highlights how low current yields are on various fixed income investments compared to the 10-year historical averages.

With the economy continuing to improve, the goals of QE3 (2% inflation and unemployment below 6.5%) are slowly moving closer to reality, which means that this program may gradually be wound down. Consensus estimates expect an unemployment rate below 7% by the middle of next year. In his latest comments, Fed chairman Ben Bernanke made a similar forecast. As the Federal Reserve eventually begins to shift its policy towards a more "normal" environment, investors may become increasingly jittery, and security price volatility may increase.

Although we continue to believe that an increase in the Federal Funds Rate is not likely before 2015, the anticipation that the Fed may begin to scale back its purchases is one of the factors that has led to a recent slide in many asset classes. The price of gold is down 26% for the year and is 36% below

Figure 1: Yields Remain Below Long-Term Averages



its 2011 peak. The yield on the 10-year Treasury bond has steadily risen from its low level on May 1 of 1.61% to a recent peak of 2.66%, which resulted in a 7.6% decline in the price of these bonds. Prices also declined for many industrial commodities, corporate bonds, emerging market equities and debt, and U.S. equities.

Fixed income markets which saw large inflows of capital over the last few years, had a record $80 billion pulled out of bond mutual funds and exchange-traded funds during the month of June. Given structural changes in the fixed income market since 2008, liquidity (the ability to find willing buyers) may prove challenging, and we may experience some dislocations or sharply lower bond prices. Importantly, interest rates have increased recently because the economy is improving, not because inflation is accelerating.

No Place Like Home

Although the United States is still struggling with high unemployment, low growth, and unsustainable government debt levels, we have gradually seen improvement on a number of metrics. Many financial market observers comment that the U.S. is "the cleanest dirty shirt," and most investors continue to view the U.S. as the safest haven in which to be invested.

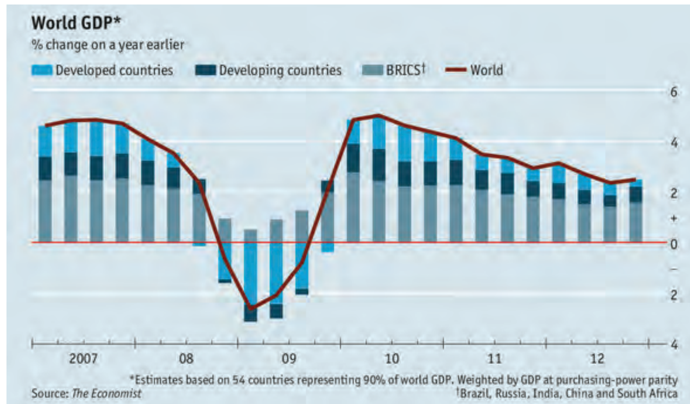
The Japanese stock market peaked in 1989 at 38,915. That market stands at 13,677 today, down 65% from the high reached 24 years ago. As we highlighted in last quarter's commentary, Prime Minister Shinzo Abe and his team are aggressively engaging in a U.S.-style quantitative easing program to drive economic growth higher and to defeat deflation (falling prices). As a result, Japan has recently seen GDP growth accelerate materially, with the first quarter annualizing at a 4.1% rate. Bank lending is increasing, and so is consumer confidence, but structural reform is required to make lasting changes in the Japanese economy. So far, Abe has failed to announce meaningful changes, but many observers are hopeful that reforms will be announced after the elections on July 21.

In several large European countries, including Spain, Italy, and France, the recent rise in interest rates could lead to further problems. These countries have high debt burdens, and increased interest expense will consume an even greater part of their already stretched government budgets. Some believe Europe's recession may be ending, but the Purchasing Managers' Index (PMI) for EU manufacturing remains below 50 (signaling economic contraction), and unemployment remains severely elevated in a number of countries.

China grew at "only" a 6.6% annual rate during the first quarter—high compared to other large countries, but well below its 15-year historical average growth rate of 9.7%. At the end of June, China's PMI dropped from 50.8 to 50.1, signaling a further slowing in economic growth. The Shanghai Composite is back to 2009 levels, and it seems that the Chinese government either has been surprised by the most recent weakness or is willing to tolerate it in an attempt to clean up excesses from a multiyear credit binge. Since 2009, China has experienced rapid credit growth as it attempts to transform an agrarian economy into an urban, consumer-driven economy. Unfortunately, excess capital found its way into Chinese real estate, high-speed rail and other infrastructure projects that are not being fully utilized. As these excesses are worked off, growth may stay below trend for a while.

In Figure 2, we highlight that a large portion of global growth over the last 15 years has come from the BRICs (Brazil, Russia, India, and China) and other emerging market countries. Slower growth in China and the developed markets (i.e. rich countries) is impacting growth in many emerging markets. Brazil seems to be suffering the most, as it has depended on China to buy its natural resources. U.S.-based multinational companies benefitted from these higher emerging market growth rates through multiple new business opportunities. Growth in many of these countries has now slowed to 3% from 8% in 2010, and this trend may represent a headwind for some companies.

Figure 2: Contributions to World GDP, Jan. 2007–Mar. 2013



Course of Action

We are incrementally more cautious on the global financial markets, given the continued slow-growth environment and the simultaneous possibility of less support from the Federal Reserve. In addition to these factors, we continue to believe that corporate profit margins could be squeezed by higher taxes, increased health care expenses, and eventual wage pressure.

While the overall valuation of U.S. equity securities continues to be below long-term historical averages, corporate revenue growth remains challenged, with revenues declining 0.3% in the first quarter and estimated revenue growth for the second quarter of only 1.2%. Anemic growth should help keep the Fed accommodative for some time to come. It is not the economic impact of an inevitably less supportive Fed that worries us, but rather the possibility that investors' anticipation of a change in Fed policy will cause financial markets to become more volatile and perhaps to stagnate for a period of time. It could be that the financial markets simply have to become comfortable with the idea of less Fed support before stock prices can move appreciably higher again.

Within equity portfolios, we are generally underweight the more economically sensitive Energy and Basic Materials sectors. Many of the companies in these sectors have an outsized exposure to China and other emerging markets, which are clearly experiencing slower growth. We continue to have significant exposure to consumer companies that are benefitting from improving domestic consumer confidence levels.

We continue to seek investments in growth areas that are more insulated from some of the global economic factors—such as companies that should benefit from a possible renaissance in American manufacturing and those that find advantages in a constantly connected world.

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