Fourth Quarter 2014 Market Review

January 2015

Economic Summary

Federal Open Market Committee (FOMC)
As widely anticipated, the FOMC ended its asset purchase program in October. Then in December, the FOMC took the first step in preparing the market for eventual interest rate increases, i.e., they modified the language in their post meeting statement from interest rates will remain low for a "considerable time" to the Committee will be "patient" in beginning to normalize interest rates.

However, the recent swoon in oil prices combined with a strong U.S. dollar and sluggish overseas economic growth has cast doubt over the timing of any FOMC interest rate action. Economists estimate these factors will slow U.S. economic growth, hold down inflation, and likely cause the Fed to keep interest rates low well into 2015.

Gross Domestic Product (GDP)
GDP increased at an annual rate of +2.6% in the fourth quarter, according to the "advance" estimate released by the Bureau of Economic Analysis. This follows strong GDP growth of +5.0% in the third quarter and +4.6% in the second quarter. These results represent the best back-to-back-to-back quarterly performance since the end of 2003.

Despite coming in below estimate, the fourth quarter GDP results provide encouragement for future growth as consumer spending was reported at its highest level in eight years. The pace of GDP growth should improve in the coming quarters as labor gains and reduced energy costs support additional strengthening of consumer spending.

Economic Data December 31, 2014			
Global Growth	**4Q14**	**3Q14**	**2Q14**
U.S. GDP (1)	2.6%	5.0%	4.6%
Eurozone GDP (2)	1.3%(E)	0.8%	0.8%
Japan GDP (1)	-4.6%(E)	-1.9%	-6.7%
China GDP (2)	7.3%	7.3%	7.5%
U.S. Inflation	**12/14**	**11/14**	**YoY**
Consumer Price Index	-0.4%	-0.3%	0.7%
Core	0.0%	0.1%	1.6%
Key U.S. Economic Data	**12/14**	**11/14**	**12/13**
Leading Economic Index	0.5%	0.4%	0.0%
Durable Goods Orders	-3.4%	-2.1%	-4.8%
ISM Manufacturing	55.5	58.7	56.5
ISM Service	56.2	59.3	53.0
Consumer Confidence	93.1	91.0	77.5
Auto Sales (millions) (3)	16.8	17.1	15.4
Retail Sales	-0.9%	0.4%	0.5%
New Home Sales (millions) (3)	0.48	0.43	0.44
Existing Home Sales (millions) (3)	5.04	4.93	4.87
Unemployment Rate	5.6%	5.8%	6.7%
Under-employment Rate	11.2%	11.4%	13.1%
Labor Force Participation Rate	62.7%	62.9%	62.8%

(E) Investing.com Estimate, (1) Annualized Q/Q % Change, (2) Y/Y % Change, (3) Annualized M/M change

Inflation
U.S. inflation remains benign thanks to the recent decline in energy prices. Economists anticipate this will keep inflation in check during the first half of 2015. The consumer price index (CPI) increased +0.7% in 2014, a decrease from its +1.5% increase in 2013, and well below its +2.1% annual rate over the last ten years. Of particular note during 2014, the energy index fell -10.6% and the food index rose +3.4%. The less volatile core consumer price index (Core CPI), which excludes food and energy, increased +1.6% in 2014, a slight decrease from its +1.7% increase in 2013, and slightly below its +1.9% annual rate over the past ten years. The Fed continues to maintain its target rate for inflation at +2.0% to +2.5%.

Business
According to the Institute for Supply Management (ISM) Manufacturing Report on Business, economic activity in the manufacturing sector expanded in December for the 19th consecutive month and the overall economy grew for the 67th month. The Purchasing Manager's Index (PMI) ended the year with a reading of 55.5%. *(A reading above 50%*

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indicates that the manufacturing economy is generally expanding and a reading below 50% indicates that it is generally contracting.)

According to the Non-manufacturing ISM Report on Business, economic activity in the non-manufacturing sector grew in December for the 59th consecutive month. The Non-manufacturing Index (NMI) ended the year with a reading of 56.2%. *(A reading above 50% indicates that the non-manufacturing economy is generally expanding and a reading below 50% indicates that it is generally contracting.)*

Consumer
Consumer confidence increased to 93.1 in December, driven by consumers' favorable assessment of current economic and labor market conditions; however consumers continue to remain less upbeat about income growth. Retail sales dropped -0.9% in December following a +0.4% gain in November. Total sales for the twelve months ended 2014 were up +4.0% from 2013. Economists are predicting the recent drop in gasoline prices will give consumers incentive to purchase goods and services in coming months.

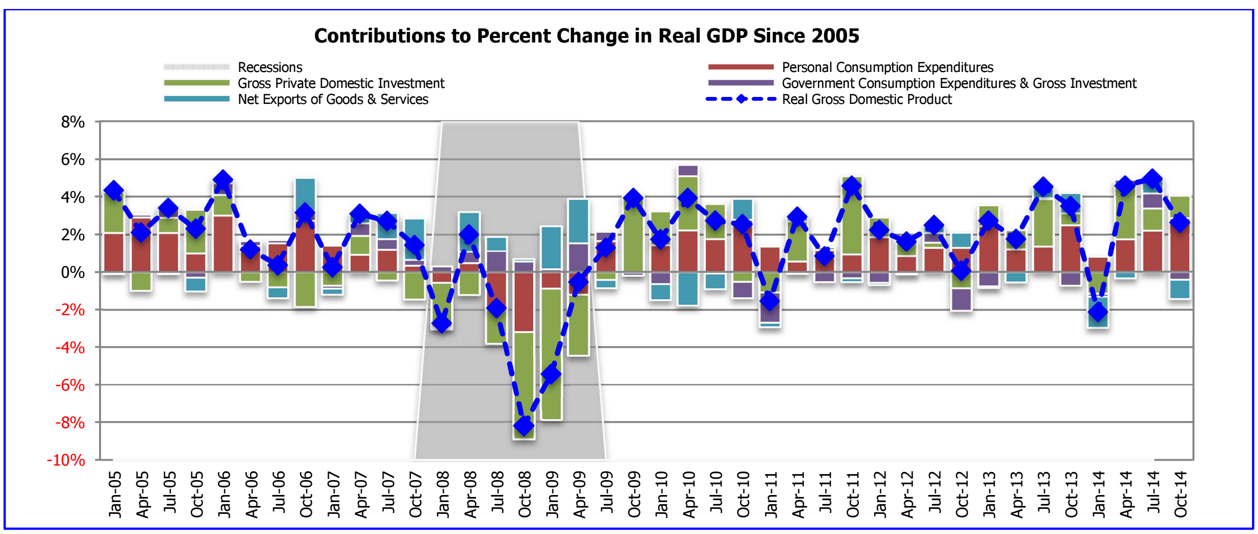
Housing
The housing market continued its trend of modest improvement. Existing-home sales in December were reported at an annualized rate of 5.04 million units. This is up slightly from November's 4.93 million unit rate, and up about 3.5% from December 2013. Economists believe a continued rebound in housing is likely, primarily as a result of attractive mortgage rates and the improvement in employment.

Employment
The employment situation showed dramatic improvement, with an average of 289,000 jobs added each month during the quarter. As a result, the unemployment rate in December fell to 5.6% down from September's 5.9%. In 2014, job growth averaged 246,000 per month, compared with 194,000 per month in 2013. However, the labor force participation rate remained unchanged at 62.7% indicating the rate of new jobs added will need to accelerate going forward in order to keep pace with the growth in the working-age population. Economists believe that steady payroll gains should continue, and that the unemployment rate should trend down toward 5.0% in 2015.

Average hourly earnings of all employees on private nonfarm payrolls fell by 5 cents to $24.57 in December. Over the past 12 months, average hourly earnings increased by +1.7%.

The view forward
Domestically, strong data during the quarter on consumer spending, business investment, payroll gains and tepid inflation indicate the U.S. economy is starting to gain traction. Economists predict the U.S. economy can sustain its recent strength going into the first half of 2015 thanks in part to falling energy prices, lower unemployment and stronger purchasing power. Expectations are for GDP growth to exceed 3% in both 2015 and 2016.

Globally, potential risks to continued improvement in the U.S. economy include further slowing in China's growth, a monetary policy misstep by the Fed once they start to increase interest rates, an inability of the Eurozone policymakers to jump-start the region's growth and/or an escalation in geopolitical tensions.



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Equity Summary

Domestic Equity	Total Return December 31, 2014			
	QTD	YTD	2013	2012
Major Indices				
DJIA	5.2%	10.0%	29.7%	10.2%
S&P 500	4.9%	13.7%	32.4%	16.0%
Nasdaq	5.7%	14.7%	40.2%	17.7%
Market Cap				
Large (1)	4.9%	13.3%	33.1%	16.4%
Mid (2)	5.9%	13.2%	34.8%	17.3%
Small (3)	9.7%	4.9%	38.8%	16.3%
Style (Growth)				
Large	4.8%	13.1%	33.5%	15.3%
Mid	5.8%	11.9%	35.8%	15.8%
Small	10.1%	5.6%	43.3%	14.6%
Style (Value)				
Large	5.0%	13.5%	32.5%	17.5%
Mid	6.1%	14.8%	33.5%	18.5%
Small	9.4%	4.2%	34.5%	18.1%

(1) Russell 1000, (2) Russell Midcap, (3) Russell 2000

Another volatile quarter
Investor concern over weak global growth and the end of the Fed's asset purchase program fueled a sell-off in the domestic equity market during the first two weeks of October with most major equity indices down more than -5.0%. However, strong economic and employment data combined with declining oil prices fueled a strong equity market rally propelling the S&P 500 to a +5.1% quarter-to-date gain through November. The rally subsided in December as the S&P 500 declined -4.5% during the first two weeks of the month before rebounding to close essentially flat for the month and up +4.9% for the quarter. For the year-ended 2014, the S&P 500 gained +13.7%, its sixth consecutive positive year.

Market Cap and Style
During the fourth quarter, small-cap stocks reversed their year-long divergence from large-cap and mid-cap stocks by posting a gain of +9.7%. Large-cap and mid-cap stocks were up +4.9% and +5.9%, respectively. Value stocks outperformed growth stocks in the large and mid-cap universe while growth outperformed value in the small-cap universe.

For the year, small-cap stocks ended up +4.9% while large-cap and mid-cap stocks were up +13.3% and +13.2%, respectively. Value stocks outperformed growth stocks in the large and small-cap universe while growth outperformed value in the mid-cap universe.

Sectors
Once again, the fourth quarter saw a broad dispersion in returns among the ten economic sectors in the S&P 500 index, indicating that sector selection remains important. The utilities sector was the top performer for the quarter, posting a gain of +13.2%; the utilities sector was also the top performer year-to-date with a gain of +29.0%. The consumer discretionary sector also posted solid results for the quarter with a gain of +8.7%. The energy sector was the worst performing sector for the quarter declining -10.7%; the energy sector was also the worst performer year-to-date with a loss of -7.8%. The telecommunication sector also struggled this quarter posting a loss of -4.2%.

Corporate revenue and earnings
According to FactSet, 59% of companies in the S&P 500 reported revenue above estimates in the third quarter and 77% of companies reported earnings above estimates. Third quarter revenue growth came in at +4.0% and earnings growth at +8.0%. Both readings are in line with second quarter results. Fourth quarter projected revenue growth is +1.2% and projected earnings growth is +2.6%.

What to expect in 2015
As predicted, we did not see a significant increase in the expansion in price/earnings multiples during 2014. Instead, stock market returns were driven primarily by corporate earnings growth and dividends. We believe this trend will continue during 2015. For 2015, analysts are projecting aggregate S&P 500 earnings growth of +7.7%. With this thesis in mind, we will continue to watch global economic activity since a stronger U.S. dollar and weakening economic activity in the European Union and Asia have the potential to place pressure on corporate earnings during 2015.

The view forward
We view the overall domestic economic environment as supportive of stock prices subject to periodic bouts of volatility until energy prices and global economies find their equilibrium. In the current environment we will continue favor dividend paying large-cap and mid-cap stocks.

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Taxable Bond Summary

Treasury yields continue to fall
The yield curve continued to flatten as short term rates increased while intermediate and long term rates declined. The yield on the benchmark 10-year Treasury fell to 2.17% during the quarter even as U.S. economic data showed continued strength and the Fed ended its quantitative easing program. The drivers of lower yields were continued weakness in global growth, heightened geopolitical concerns, a slide in oil prices, the strength of the U.S. dollar and a general consensus that inflation is well under control. As a result, U.S. Treasury securities were sought for their safe haven status which placed downward pressure on yields throughout the quarter.

U.S. Treasury Yield Curve (%)				
	Dec14	Sep14	Dec13	Dec12
6 Month	0.12%	0.03%	0.10%	0.11%
2 Year	0.67%	0.58%	0.38%	0.25%
5 Year	1.65%	1.78%	1.75%	0.72%
10 Year	2.17%	2.52%	3.04%	1.78%
30 Year	2.75%	3.21%	3.96%	2.95%

Globally, the yield on the 10-year U.S. Treasury bond continues to look attractive to foreign investors when compared to the 10-year government bonds in Germany (0.5%), Japan (0.3%) and the U.K. (1.7%).

Taxable bonds finish strong
Taxable bond returns recovered nicely after a tepid third quarter as the Barclays Aggregate Bond Index posted a return of +1.8%.

Within the Barclays Aggregate Index, the treasury sector was the top performer for the quarter posting a gain of +1.9% while the corporate sector maintained the lead on a year-to-date basis with a +7.5% return.

Once again, high yield bonds were the weakest component in the index with a return of -1.0% for the quarter. Investors continued to demand increased yield for the credit risk associated with high yield issuers as evident by spreads widening +59 basis points (+0.59%) during the quarter. The high-yield debt results were skewed by the Energy sector, which comprises 13.3% of the high-yield index. Energy sector bonds within the high-yield index declined -10.6% during the quarter; excluding them, high-yield debt rose +0.4%.

Bonds with greater than ten years to maturity outperformed as investors continued their search for yield.

Investors absorb new issues
Investors continue to absorb new debt issues with $260 billion in new investment grade issues, $65 billion in new high yield issues and $337 billion in new issue mortgage-backed securities (securitized) being oversubscribed during the quarter.

On a year-to-date basis, new issuance of investment grade and high yield debt was unchanged from 2013 levels at $1,425 billion and $311 billion, respectively; while new issuance of mortgage-backed securities was down -35.0% from 2013 levels at $1,266 billion.

Domestic Taxable Bonds	Return December 31, 2014			
	QTD	YTD	2013	2012
Index				
Barclays Aggregate	1.8%	6.0%	-2.0%	4.2%
Index Sectors				
Treasury	1.9%	5.1%	-2.8%	2.0%
Agency	0.7%	3.7%	-1.6%	3.0%
Corporate	1.8%	7.5%	-1.5%	9.8%
-Industrial	1.5%	7.6%	-2.6%	7.6%
-Utility	3.4%	11.5%	-3.2%	7.5%
-Finance	1.8%	6.2%	0.9%	14.7%
Securitized	1.8%	5.9%	-1.3%	3.0%
-ABS	0.5%	1.9%	-0.3%	3.7%
-MBS	1.8%	6.1%	-1.4%	2.6%
-CMBS	1.4%	3.9%	0.2%	9.7%
Index Quality				
Aaa	1.8%	5.3%	-2.1%	2.4%
Aa	1.8%	6.1%	-2.0%	5.4%
A	2.2%	7.5%	-1.9%	9.9%
Baa	1.3%	8.2%	-2.0%	11.5%
< Baa	-1.0%	2.5%	7.4%	15.8%
Index Maturity				
1-3 Year	0.2%	0.8%	0.6%	1.3%
3-5 Year	0.9%	2.8%	-0.1%	3.0%
5-7 Year	1.5%	5.0%	-1.6%	4.8%
7-10 Year	2.3%	7.7%	-3.9%	7.3%
10+ Year	5.6%	17.7%	-8.6%	8.8%

The view forward
We continue to underweight Treasury and Agency bonds in favor of Corporate and Securitized bonds. As market conditions allow, and as appropriate for each client, we will look to shorten duration, improve credit quality and increase coupons in anticipation of rising interest rates in the latter half of 2015.

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Municipal Bond Summary

Municipal bonds have a great year
Municipal bonds produced another quarter of solid performance as measured by the +1.4% return of the Barclays Municipal Bond Index. For the year, the Barclays Municipal Bond Index recorded twelve consecutive months of positive returns.

Overall, municipal bonds outperformed Treasury, Agency, Corporate and Securitized debt in 2014. From a technical standpoint, municipal bond issuance continues to run below its five and ten year average while demand remains robust leading to upward price pressure and lower yields. The municipal yield curve continued to flatten as longer-maturity municipal bonds experienced the most significant price increases and yield declines.

Municipal bonds nationwide (Index Largest Issuers) returned above +8.5% this year as municipal credit conditions continue to improve and credit upgrades continue to outnumber downgrades.

Investor demand for yield generally meant that lower-rated longer-dated credits outperformed all others in the index.

One area to note, states whose economies rely heavily on revenues from oil production deserve attention going into 2015. Of particular interest will be Alaska, California, North Dakota, Texas and Wyoming.

Domestic Municipal Bonds	Return December 31, 2014			
	QTD	YTD	2013	2012
Index				
Barclays Muni Bond	1.4%	9.0%	-2.6%	6.8%
Index Bond Type				
General Obligation	1.1%	7.8%	-2.3%	5.6%
Revenue	1.6%	10.1%	-2.9%	7.8%
Index Largest Issuers				
California	1.4%	10.0%	-1.8%	8.2%
Florida	1.4%	8.8%	-1.5%	7.5%
Illinois	2.0%	10.4%	-3.0%	8.1%
New York	1.2%	8.6%	-2.2%	6.2%
Texas	1.4%	9.4%	-2.1%	7.3%
Index Quality				
Aaa	0.9%	6.3%	-1.6%	4.5%
Aa	1.2%	8.2%	-2.1%	6.2%
A	1.7%	10.5%	-2.6%	8.2%
Baa	2.1%	14.5%	-7.2%	9.8%
<Baa	1.2%	13.9%	-5.5%	18.1%
Index Maturity				
1 Year (1-2)	0.0%	0.6%	0.8%	0.8%
3 Year (2-4)	-0.1%	1.2%	1.3%	1.9%
5 Year (4-6)	0.1%	3.2%	0.8%	3.0%
7 Year (6-8)	0.8%	6.1%	-1.0%	4.2%
10 Year (8-12)	1.4%	8.7%	-2.2%	5.7%
15 Year (12-17)	1.9%	11.7%	-3.3%	8.5%
20 Year (17-22)	2.2%	13.0%	-4.4%	10.0%
Long (22+)	2.4%	15.4%	-6.0%	11.3%

Puerto Rico
On June 28th, Puerto Rico's governor signed into law the Puerto Rico Corporation Debt Enforcement and Recovery Act. This Act creates a legal mechanism for certain of Puerto Rico's public corporations, including the Puerto Rico Electric Power Authority (PREPA), the Puerto Rico Aqueduct and Sewer Authority (PRASA), and the Puerto Rico Highways and Transportation Authority (PRHTA) to restructure financial obligations. Puerto Rico bonds rallied in the third quarter based on postponing the restructuring of the Puerto Rico Electric Power Authority (PREPA), but that rally faded quickly. In addition to restructuring PREPA, Puerto Rico must also manage a new bond issuance to support Puerto Rico Aqueduct and Sewer Authority (PRASA), the Government Development Bank's (GDB) liquidity problem and tax reform all in the first quarter of 2015. Investors are rightfully concerned that the government may not be able to handle all of these issues at once.

Detroit, MI and Stockton, CA
Detroit and Stockton exited bankruptcy in October. In both cases, the government opted to leave pensions unchanged and instead opted to substantially discounted payments to bondholders. This development bolsters our position that essential service revenue bonds and highly rated general obligations bonds offer clients the most protection in the municipal marketplace.

The view forward
We continue to favor A-rated general obligation and essential service revenue bonds in the intermediate part of the curve. As market conditions allow, and as appropriate for each client, we will look to shorten duration, improve credit quality an increase coupons in anticipation of rising interest rates in the latter half of 2015.

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