Second Quarter 2014 Market Review

July 2014

Equity Summary

Domestic Equity	Total Return (%) June 30, 2014			
	QTD	YTD	2013	2012
DJIA	2.8	2.7	29.7	10.2
S&P 500	5.2	7.1	32.4	16.0
Nasdaq	5.3	6.2	40.2	17.7
Large Cap	5.1	7.3	33.1	16.4
Large Cap Growth	5.1	6.3	33.5	15.3
Large Cap Value	5.1	8.3	32.5	17.5
Midcap	5.0	8.7	34.8	17.3
Midcap Growth	4.4	6.5	35.8	15.8
Midcap Value	5.6	11.1	33.5	18.5
Small Cap	2.0	3.2	38.8	16.3
Small Cap Growth	1.7	2.2	43.3	14.6
Small Cap Value	2.4	4.2	34.5	18.1
All Cap	4.9	6.9	33.6	16.4
All Cap Growth	4.9	6.0	34.2	15.2
All Cap Value	4.9	7.9	32.7	17.6

Stocks post impressive gains

Equity markets continued their march higher in the second quarter as investors shrugged of geopolitical turmoil in Iraq, Syria, Israel and the Ukraine and appeared to embrace the likelihood of prolonged central-bank support for low interest rates and gradually improving global economic growth.

Market Cap and Style

U.S. large-cap and mid-cap stocks returned ~5% whereas small-cap stocks lagged behind at ~2%. This trend also holds true year-to-date as Mid-Cap stocks have returned ~9% while Small-Cap stocks have returned ~3%. Value stocks maintained their advantage over Growth stocks during the second quarter although not as pronounced as the first quarter.

Sectors

The Energy sector dominated all other sectors in the S&P 500 index during the second quarter with a return of ~12% while the Utilities sector was a distant second at ~8%. Consumer Discretionary and Financials were the laggards returning ~3% and ~2%, respectively. All sectors of the S&P 500 closed the second quarter in positive territory. Year-to-date, the Utilities sector takes the top spot with a return of ~19% followed by the Energy sector at ~13% while the Industrials and Consumer Discretionary sectors brought up the rear returning ~4% and ~1%, respectively.

Corporate earnings and revenue

According to FactSet, 74% of companies in the S&P 500 reported earnings above estimates in the first quarter. However, only 53% of companies in the S&P 500 reported revenues above estimates. First quarter, revenue growth came in at ~3% and earnings growth at ~2%. With second quarter projected earnings growth of ~5% rising at a faster rate than projected revenue growth of ~3%, companies have continued cost-cutting initiatives to maintain earnings growth rates and profit margins.

The bull market appears to have room to run

We don't expect to see a repeat of the expansion in price/earnings multiples that drove stocks last year. Stocks are more likely to be influenced by corporate earnings growth, which we think will continue at a moderate pace through the rest of the year. Stock market performance should be more or less in line with the rate of earnings growth.

The view forward

While we would not be surprised to see a correction in the equity market, we view the overall environment as supportive of stock prices through year-end. We continue to favor dividend paying large-cap and mid-cap stocks.

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Taxable Bond Summary

Treasury yields continue to surprise

U.S. Treasury Yield Curve (%)				
	Jun14	Mar14	Dec13	Dec12
6 Month	0.07	0.07	0.10	0.11
2 Year	0.47	0.44	0.38	0.25
5 Year	1.62	1.73	1.75	0.72
10 Year	2.53	2.73	3.04	1.78
30 Year	3.34	3.56	3.96	2.95

The yield curve flattened as Treasury bonds with greater than five years to maturity experienced the most significant price increases and yield declines. The decrease in yields was the result of weaker than expected first quarter GDP, increased geopolitical unrest and mixed global economic data. From a global perspective, the 2.5% yield on our 10 year Treasury bond continues to look attractive to foreign investors when compared to the yield on 10 year government issues in Germany (1.2%), Japan (0.6%) and the U.K. (2.7%).

Taxable bond market posts solid returns

Confounding the pundits once again, the taxable bond market posted positive rates of return across the board in the second quarter as investors appeared to embrace the likelihood of prolonged central-bank support for low interest rates and gradually improving global economic growth.

Domestic Taxable Bonds	Total Return (%) June 30, 2014			
	QTD	YTD	2013	2012
Aggregate	2.0	3.9	-2.0	4.2
Aggregate Inter.	1.6	2.9	-1.0	3.6
Treasury	1.4	2.7	-2.8	2.0
Agency	1.5	2.8	-1.6	3.0
Corporate	2.7	5.7	-1.5	9.8
Industrial	2.8	6.1	-2.6	7.6
Utility	3.4	7.3	-3.2	7.5
Finance	2.3	4.4	0.9	14.7
Securitized	2.3	3.9	-1.3	3.0
ABS	0.7	1.3	-0.3	3.7
MBS	2.4	4.0	-1.4	2.6
CMBS	1.3	2.6	0.2	9.7
Aaa	1.8	3.2	-2.1	2.4
Aa	1.9	4.0	-2.0	5.4
A	2.4	5.2	-1.9	9.9
Baa	3.4	7.1	-2.0	11.5
< Baa	2.4	5.5	7.4	15.8
1-3 Year	0.3	0.6	0.6	1.3
3-5 Year	1.2	2.0	-0.1	3.0
5-7 Year	2.1	3.5	-1.6	4.8
7-10 Year	2.8	5.1	-3.9	7.3
10+ Year	4.7	10.3	-8.6	8.8

Corporate bonds benefit from strong demand

Investment-grade corporate bonds returned ~3% as a result of the decline in Treasury yields and narrowing credit spreads. Longer-term corporate bonds with greater than seven years to maturity outperformed as investors continued their search for yield. This trend narrowed the corporate bond spread to 99 basis points (0.99%) during the quarter. High yield corporate bonds performed well as their attractive yields and relatively strong financial condition continued to lure investors. Demand for corporate bonds could also be seen in new issuance, with $300 billion in new investment grade issues and $110 billion in new high yield issues.

Securitized bonds keep pace despite Fed tapering

Agency mortgage-backed securities (MBS) were able to overcome the Feds continued tapering of purchases in the second quarter and return ~2% as a result of the rally in Treasuries as well as the limited amount of new supply reaching the market. We maintain our thesis that the Feds tapering of MBS purchases should ultimately balance the mismatch between new issuance and demand and bring the market back to a more normalized spread and trading environment.

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 rates going into 2015.

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Municipal Bond Summary

Municipal bonds provide competitive returns

Municipal bonds enjoyed the same fortune as their taxable counterparts. Overall, municipal bonds outperformed Treasuries and were on par with corporate bonds. From a technical standpoint, municipal bond issuance continues to run below its five year average while demand remains robust leading to upward price pressure and lower yields. The municipal yield curve flattened as longer-maturity municipal bonds experienced the most significant price increases and yield declines.

While investor demand for yield generally meant that lower-rated credits outperformed, high-yield debt results were skewed by Puerto Rico, which comprised nearly one-fourth of the high-yield index. Puerto Rico bonds within the high-yield index declined ~7% during the quarter; excluding them, high-yield debt rose ~5%.

Municipal bonds nationwide have returned above 5% this year, ahead of most of their taxable counterparts. Credit conditions for most municipalities continue to improve with rising tax receipts, and credit upgrades are outnumbering downgrades by a wide margin. The market appears to have absorbed the default of Detroit. However, the financial situation in Puerto Rico has deteriorated further and a default on this triple tax exempt credit looks likely. The good news is the overall municipal market has not been impacted in a negative way and the problem appears isolated.

Domestic Municipal Bonds	Total Return (%) June 30, 2014			
	QTD	YTD	2013	2012
Municipal Bond	2.6	6.0	-2.6	6.8
Municipal Inter. Ins.	1.4	2.6	0.1	2.9
General Obligation	2.2	5.3	-2.3	5.6
Revenue	2.9	6.6	-2.9	7.8
California	2.8	6.7	-1.8	8.2
Florida	2.6	5.8	-1.5	7.5
Illinois	2.7	6.9	-3.0	8.1
New York	2.5	5.5	-2.2	6.2
Texas	2.8	6.2	-2.1	7.3
Aaa	2.0	4.2	-1.6	4.5
Aa	2.4	5.4	-2.1	6.2
A	2.9	7.0	-2.6	8.2
Baa	4.0	9.8	-7.2	9.8
<Baa	1.5	7.5	-5.5	18.1
1 Year (1-2)	0.2	0.5	0.8	0.8
3 Year (2-4)	0.7	1.0	1.3	1.9
5 Year (4-6)	1.3	2.3	0.8	3.0
7 Year (6-8)	2.2	4.2	-1.0	4.2
10 Year (8-12)	2.5	5.7	-2.2	5.7
15 Year (12-17)	3.0	7.5	-3.3	8.5
20 Year (17-22)	3.5	8.4	-4.4	10.0
Long (22+)	4.1	10.2	-6.0	11.3

Puerto Rico continues to struggle

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. I n total, the law applies to ~$20 billion in Puerto Rico bonds. Puerto Rico GO, COFINA, and Government Development Bank (GDB) bonds are explicitly insulated from impairment under this Act. This Act underscores that Puerto Rico's financial condition is dire.

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 rates going into 2015.

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Economic Summary

Quarterly U.S. Economic Data				
Growth	**2Q14**	**1Q14**	**4Q13**	**3Q13**
U.S. GDP	2.8e	-2.9	2.6	4.1
Inflation	**6/14**	**5/14**	**4/14**	**3/14**
Consumer Price Index	2.1	2.1	2.0	1.5
Core	1.9	2.0	1.8	1.7
Business				
Leading Economic Index	102.2	101.9	101.2	100.9
Capacity Utilization	79.1	79.1	79.0	79.1
Durable Goods Orders	0.7	-1.0	0.9	3.7
ISM Manufacturing	55.3	55.4	54.9	53.7
ISM Service	56.0	56.3	55.2	53.1
Consumer				
Consumer Confidence	85.2	82.2	81.7	83.9
Auto Sales (millions)	13.3	13.1	12.7	12.8
Retail Sales	4.3	4.6	4.7	4.1
Housing				
Starts (millions)	0.9	1.0	1.1	0.9
New Home Sales (millions)	0.4	0.5	0.4	0.4
Existing Home Sales (millions)	5.0	4.9	4.7	4.6
Labor				
Unemployment Rate (U3)	6.1	6.3	6.3	6.7
Unemployment Rate (U6)	12.1	12.2	12.3	12.7
Labor Force Participation Rate	62.8	62.8	62.8	63.2

e-Bloomberg survey estimate

Federal Open Market Committee (FOMC)

The FOMC made few changes during the second quarter other than further reductions in its asset purchase program. As the FOMC's asset purchase program winds down, attention is being paid to when the committee will refrain from reinvesting the principal payments from the debt it holds so that its balance sheet will be reduced. Fed-watchers believe that not reinvesting these payments will be the next logical step in the process prior to an increase in short-term interest rates.

Gross Domestic Product (GDP)

The domestic economic environment in the second quarter remained mixed. The Bureau of Economic Analysis lowered its third estimate of first quarter GDP to -2.9%, reflecting a broad-based contraction in many areas of the economy, including consumer spending, exports and business investment. While the GDP result was discouraging, economists generally believe that the lower inventory accumulation will eventually lead to accelerated growth in coming quarters.

Inflation

Inflation remained relatively benign, with the consumer price index (CPI) gaining ~2% year-over-year. The consensus among economists is that the economy has strengthened significantly since the first quarter, and the improving employment numbers seem to validate this notion. As a result, economists expect GDP to accelerate to 3% for the remainder of this year.

Business

For the quarter, the Institute for Supply Management Manufacturing survey increased from 53.7 to 55.3, while the Services survey increased from 53.1 to 56.0. Both readings indicate an increase in business activity. Respondents to both surveys cited improving business conditions in the second quarter.

Consumer

For the quarter, consumer confidence increased from 83.9 to 85.2 points, its highest level since the end of the recession. The increase was driven by improving expectations on the general economy and job prospects; however consumers remain less upbeat about income growth.

Housing

The housing segment proved to be a bright spot in the second quarter. Existing-home sales averaged annualized rate of 4.8 million units. However, the pace of sales remains below the 5 million unit rate established in 2013. Economists believe a continued rebound in housing is likely, primarily as a result of attractive mortgage rates and the improvement in employment.

Labor

The employment situation continued its trend of modest improvement, with an average of about 270,000 jobs added each month during the quarter. In addition, payroll employment finally exceeded the pre-financial crisis peak, having

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recovered the 8.7 million jobs lost in the recession. As a result, the unemployment rate in June fell to 6.1% down from March's 6.7%. And the labor force participation rate fell to 62.8% in June down from March's 63.2 reading. While total payrolls now exceed the pre-recession peak, 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.

The view forward

The negative first quarter GDP data notwithstanding, the economy seems poised to accelerate in the coming months. However, it is difficult to tell how much of the current activity reflects a make-up from earlier in the year, and how much is reflective of the underlying trend in the economy. Potential risks to an improving economic and financial markets outlook include a faltering housing recovery, a monetary policy misstep, an inability of China's policymakers to maintain growth while also removing excesses from their economy, and an escalation in geopolitical tensions.

Globally, the themes remained similar to those that prevailed in the first quarter. The Eurozone's recovery continued to be tepid, prompting the European Central Bank (ECB) in June to take the aggressive step of lowering its deposit rate to -0.10%. Real GDP in the Eurozone region increased a meager +0.9% year-over-year. In China, policymakers continue to attempt to rein in credit while avoiding an economic slowdown. China's annualized GDP growth in the first quarter was +7.4%, the lowest in almost two years.

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