

## ECONOMIC OUTLOOK

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### *Summary*

The economy experienced its strongest second-half growth since 2003, as real GDP rose in the fourth quarter at a 3.2% annual rate, which brought its growth for the six months to 3.7%. Stronger spending by consumers and businesses, as well as improved exports, were the positives in the quarter. These positives helped offset declines tied to housing and the federal government. While inventories rose in the fourth quarter, they were not as strong as in the third quarter. Personal consumption and retail sales both rose in December, followed in January by an increase in the Conference Board's consumer confidence index. The bad winter weather appears to have had a negative impact on spending and on housing so far in 2014, which followed a big dip in housing starts in December. The weather also has been a factor in the ISM manufacturing index. It declined almost 10% in January, hitting an eight-month low. Since weather was a big part of the decline, it should end up being a temporary issue as we gradually move out of the deep freeze and into the spring.

The labor market, a significant influence on consumer behavior, struggled over the past several months, and this struggle continued in January. In addition to slower job creation, the government sector has downsized and retail jobs were lost after the holidays. There was growth in construction and manufacturing, however. The unemployment rate has continued to fall though as workers have exited the workforce. The Fed apparently sees positives ahead, as evidenced by the decision to make another cut to its bond-purchase program at its January meeting.

While news on the labor market is a bit mixed, there are positives in other segments of the economy, especially with the consumer.

While not overly strong, we expect growth to continue and even improve as the year progresses and we are able to get through the winter, get past the uncertainties of the health care legislation, arrive at a debt limit amount, and housing and labor both get back on track.

### *Positives*

Conference Board's consumer confidence index rose nicely in January

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ISM nonmanufacturing index turned in January and showed some growth

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Construction spending rose in December to its highest level since March 2009

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### *Negatives*

Sharp decline in ISM manufacturing index

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Housing market has continued to show signs of slowing

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Factory orders and durable goods orders fell in December

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### *Unknowns*

Affordable Care Act's ultimate impact on the labor market and on the overall economy

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## EQUITY OUTLOOK

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### *Summary*

Ouch! After the big run in stocks last year, traders appeared to be searching for a reason to sell, and weakness in emerging markets gladly accommodated them. While the S&P 500 slipped 3.5% last month, the MCSI index of emerging markets (EEM) tumbled 8.6%.

At home, only the utility and health care sectors were positive for the month, up 2.9% and 0.9%, respectively. Utilities are very interest-rate-sensitive, and U.S. Treasury notes rallied significantly in January. The energy and consumer sectors were hardest hit, falling 6.3% and 5.9%, respectively (price only).

In defense of this market volatility, which continues into February, investor sentiment had been approaching very euphoric levels and stock valuations were not as attractive as they were at the beginning of 2013. Currently, we anticipate a correction from an overbought condition, and not something more severe.

As flare-ups in China, Brazil and Turkey recede, we expect headwinds to economic activity stemming from the impact of the brutally cold winter weather the United States is experiencing. Don't expect good headline news from the upcoming jobs reports, retail sales, auto sales, housing starts, etc. Eventually, this stall in economic activity will translate into weaker-than-expected corporate earnings and GDP in the first quarter.

However, there do not appear to be structural impediments to a return to business as usual and an increase in economic activity from pent up demand once we exit the deep freeze. Interest rate policy continues to be accommodative despite the Fed's

exit from its program of quantitative easing. Economic metrics in both the United States and Europe were improving markedly going into the year-end, and the political climate is benign now.

Given the recent decline in stock prices and bond yields, our preference is to tilt portfolios toward greater equity exposure at the expense of bonds, and we believe this is an opportune time to do so.

### *Positives*

Accommodative Fed

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No structural headwinds

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### *Negatives*

Short-term weather-induced economic hiccups

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Slowing demand from emerging markets

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### *Unknowns*

Potential impact from Obamacare insurance costs to consumers

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## FIXED INCOME OUTLOOK

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### *Summary*

Interest rate volatility continued in January as rates dropped by almost as much as they rose in November and December. The rally in bond prices was fueled by weaker economic data, a declining stock market and increased concern about emerging economies, particularly China's. It also appears that many investors rebalanced their portfolios after experiencing large gains in the stock market last year. Bond mutual funds experienced large inflows, while equity funds had similarly large redemptions. Overall, the yield curve flattened, with longer rates declining more than shorter rates. The 10-year notes declined 38 basis points, while the 5-year and 2-year declined 25bp and 5bp, respectively. Corporate credit and mortgage-backed securities outperformed Treasury debt. Within corporates, industrial company debt delivered higher returns than financial company bonds.

Entering the new year, we did not expect rates to rise significantly from the prevailing levels even if the trend of economic data continued to suggest faster growth. We believed rates had already normalized and reflected the eventual termination of the Fed's bond-buying program, known as QE3. The lower yields today have us a bit more cautious, but we believe the outlook remains about the same. While the drop in yields primarily reflects that the economy may not be as robust as previously believed, overall the data is still mixed and variable. As economic data and investor sentiment oscillate, we expect rates could return to beginning-of-the-year levels, but still see little reason for rates to move sharply higher from there. A total return analysis incorporating the appreciation in price as bonds age and "roll" suggests longer rates can only rise so much if short rates remain fairly well anchored. Corporate credit should continue to perform well as debt levels are relatively low compared with cash flow on a historical basis.

### *Positives*

Inflation and growth in the labor market remain below the Fed's targets

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The historically steep yield curve provides increased return potential from bonds aging or rolling down the yield curve

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Demand for fixed income should continue as portfolios are rebalanced away from the strong equity market performance of last year

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### *Negatives*

Economic data is likely to remain mixed. A period of strong data could lead to fears about the Fed tightening monetary policy

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Investors are accepting negative real returns on government bonds shorter than 5 years to maturity and only about 50bp of return above the rate of inflation on 10-year bonds. Required real returns could increase

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### *Unknowns*

International demand for U.S. investments

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Full impact of Fed's tapering of purchases

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