MARKET PERSPECTIVE

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> *"Psychology is probably the most important factor in the market –*
> *And one that is least understood."*
> David Dreman

IN VIEW: The U.S. Recovery Remains on Course

In the past, we have made the case that this secular bull market in stocks was based on the premise that subpar economic growth in the U.S. and around the world reduces the likelihood that the central bankers would contract money supply - thereby tipping fragile economies into recessions. The primary reason that the bankers would stay the current course of easy monetary policy is encouraged by the slow growth scenario that keeps a lid on inflation. The current economic expansion has approached the average length of 11 previous ones since World War II. So far, real GDP is up 11% since the trough of the last recession and establishes the fact that this recovery has been the weakest on record, as compared to the previous six expansionary periods.

So why is the recovery so anemic? Again Congress remains divided with Republicans blaming Democrats for burdening the economic expansion with taxes, debt and regulation. Others argue that our two party system has failed miserably in producing more fiscal spending that would positively impact business and consumer confidence. And idle threats of collapsing our government using the debt ceiling card haven't helped matters either. Many economists have cited the secular stagnation as the result of income inequality, demographics and structural impediments related to the labor market. Without a doubt, powerful deflationary forces continue to influence business models that address the ever-increasing globalization and technological innovation.

Nonetheless, there is no hint of recession on the horizon, as the Index of leading Economic Indicators continues to rise to a new cyclical high in March and the Index of Coincident Indicators has been hovering in record high territory since last summer.

CLOSE-UP: The Economic Landscape

The final revision for real GDP in the fourth quarter of 2013 was growth of 2.6%, somewhat better than the 2.4% reported in the latest revision. The significant change was growth in consumption of 3.3% versus the earlier reported 2.6%. In contrast, domestic investment fell from growth of 4.5% to 2.5%. The other sectors of the economy such as trade and government expenditures were basically unchanged. As a result, the final overall growth for the year was left unchanged at 1.9%, compared to 2.8% in 2012. As mentioned in earlier *Market Perspectives*, the reason for slower economic growth was a significant fall in government expenditures and higher taxes rates on higher income producers.

Our latest calculations indicate that first-quarter GDP growth slowed to a modest 1.8% annualized, but will resume a much stronger annualized rate as the year progresses, solidifying our earlier expectations of a much stronger GDP gain approaching 3.5% in second-quarter. However, we do expect GDP growth to settle back in the second half to a still robust 2.75% annualized pace as any fiscal drag continues to fade and the Fed errs on the side of providing too much rather than too little monetary accommodation. Confirming our rebound forecast for real GDP growth in Q2, incoming data over the past several weeks such as industrial production, retail sales, and employment all point to a stronger March.

The main impediment to a more normal growth rate of 3% economic growth at present is the fact that cash rich corporations operating at historically high profit margins are reluctant to invest in capital equipment and hire more people, because of increasing government regulations on business activity combined with high tax levels. As a result, there is a tendency for corporations to hoard cash and engage in record amounts of stock buybacks. While the latter activity accounts for as much as 1/3 of our forecasted per share earnings growth for the Standard & Poor's 500 Stock Index, it does not necessarily stimulate increased employment and capital expansion.

In the past, we have mentioned other structural problems regarding the mediocre employment picture, such as inadequate training, growing disability rolls, and increasing entitlements that discourage the work ethic. Longer term solutions lie in the legislative reform process favoring a work ethic as opposed to leisure. We believe the solution to both the corporate investment and employment problems are hampered by the political process in Washington. On a state level, those states that have addressed the right to work laws - and have solved the growing pension and health care liability problems - are benefitting from higher economic growth rates versus those states which are unwilling to reform.

One factor helping economic growth at present is the low rate of inflation. At the end of March, the producer price index is at 1.7% over the prior year with the consumer price index at 1.5%. Industrial production is up 2.8% in March year-over-year with retail sales advancing 1.5%. Consumer confidence, as measured by the Conference Board survey, reached 82.3 this past month versus 78.3 in February, suggesting higher consumption levels ahead. The leading indicators at the end of March were 6.2% ahead of the previous year. March's durable goods orders increased 2.6% following February's recovery. However, the details of the survey suggest that the growth rate of business investment in equipment did slow to roughly a 2.0% annualized rate in the first quarter. This supports our view that, in part due to the unseasonably bad weather, GDP growth had decelerated to an estimated 1.8%. Orders for non-defense capital goods (excluding aircraft) recovered after falling in February. Generally, this statistic has been disappointing for some time reflecting the weakness in capital spending mentioned above. The March employment report improved with monthly gains in payroll employment expected to soon rise above the 200,000 that has been the norm for most of the past year. This would be partly due to some catch-up after the recent extreme winter weather and partly due to a strengthening in economic conditions. Our econometric model points to an increase of around 230,000 in April, which would reduce the unemployment rate to 6.6% from 6.7% in March.

Housing statistics have been generally weak with housing starts -1.68% month-over-month, and new home sales declining as well. These recent results do raise some investor concern about the sustainability of the housing recovery, but are being shrugged off as other parts of the economy show encouraging signs following the winter malaise. The affordability, mortgage availability, and supply issues continue to negatively impact some housing statistics and need to be watched vigilantly.

While economic growth continues at below historic levels of a more typical economic recovery, we believe that in 2014, despite a slow start, real GDP should approach 2.75% growth for the year. We think that inflation will rise from the very low levels at present to a 2.5% rate and that corporate profits will increase by 7.0%. The S&P 500 Index per share profits could advance somewhat faster than our earlier forecast of 7.0% because of corporate buybacks. Corporate buybacks tend to rise when executive compensation practices move from a more traditional salary and bonus system to a more profit-oriented system based on the price of a corporation's share. Finally, we believe that the current business cycle - which will approach a 5-year duration this June - will be a long one that extends to possibly 7-8 years. As we approach this last phase of the expansionary cycle, we would expect that both inflation and interest rates begin to rise as early as the first quarter of 2015.

The Outlook for the Financial Markets

As expected, the Federal Reserve announced at its March meeting another $10 billion per month reduction in its bond buying program to $55 billion per month. The stated intent is to end the quantitative easing program by the end of the year and to possibly raise short-term interest rates by about mid-2015. The latter action, however, will be subject to the state of the economy and its outlook at that time. Since we believe that the economy will be growing at approximately 3% by the end of the year and into 2015, it would be our view that a modest 0.25 basis point increase could occur in the second quarter of 2015. The controlling factor should be the inflation rate since at present there are approximately $2.6 trillion of excess reserves sitting at the Federal Reserve which could be activated by the various banks when loan demand accelerates. It would be at that point when inflation could accelerate as money velocity, now stable, picks up. We believe that by 2015 most of the deflationary forces will have dissipated by then, as the economy continues to grow.

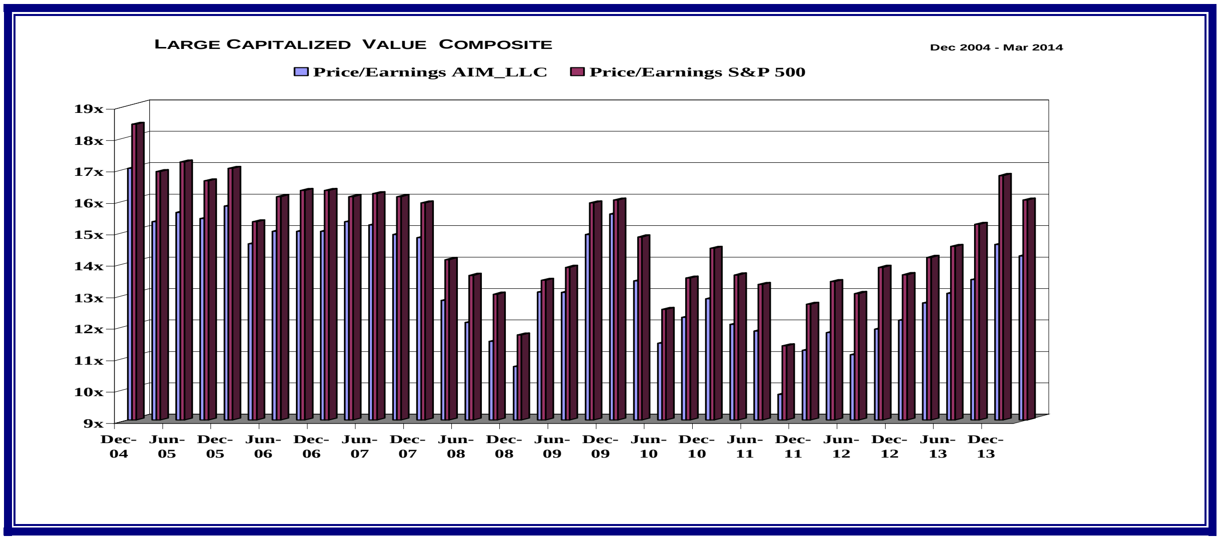
At present, the S&P 500 Stock Index (1880) is essentially flat with the quarter end levels. The volatility of the stock market has increased after a remarkable 32% rise in the S&P in 2013. A number of increasing uncertainties has arisen, led by the Russian surprise invasion of the Crimea, thereby shattering the post-cold war world order since the collapse of the Soviet Union in 1991. The possible isolation of Russia by western countries is likely to occur if it continues on its path of attempted hegemony over countries on its borders with large Russian minority populations. This could economically destabilize countries in eastern and western Europe, and to some extent all countries in an increasingly global world.

Also, with earnings growing 5.8% in 2013, the stock market's price gains were largely P/E ratio driven. At first blush, a P/E expansion to 17 times from about 15 times in early 2013 has added some downside risk potential to stocks, if earnings disappoint in 2014. This risk, in our opinion, is less with the S&P at current levels but more with many of the momentum stocks in the technology and biotech sectors, as well as the smaller capitalization stocks which now sell at considerably higher price-to-earnings ratios than the market averages. The new issue market has also become very speculative with average price gains in 2014 in excess of 20% on the day of issue. Our earnings forecast in 2014 remains at $117 per share for the S&P, up 7% compared to $109 per share for 2013. The P/E ratio for 2014 is currently at 16 or 17 based on trailing 12 month earnings.

The Standard and Poor's Valuation Characteristics - Overview

The Price to Earnings (P/E) multiple for the S&P 500 contracted in the first quarter. Earnings per share grew at a rate of 9.75% during the latest earnings cycle exceeding the rise in market prices. The following chart demonstrates our continual discipline of maintaining a below market valuation (P/E ratio) to lower risk in our client portfolios.

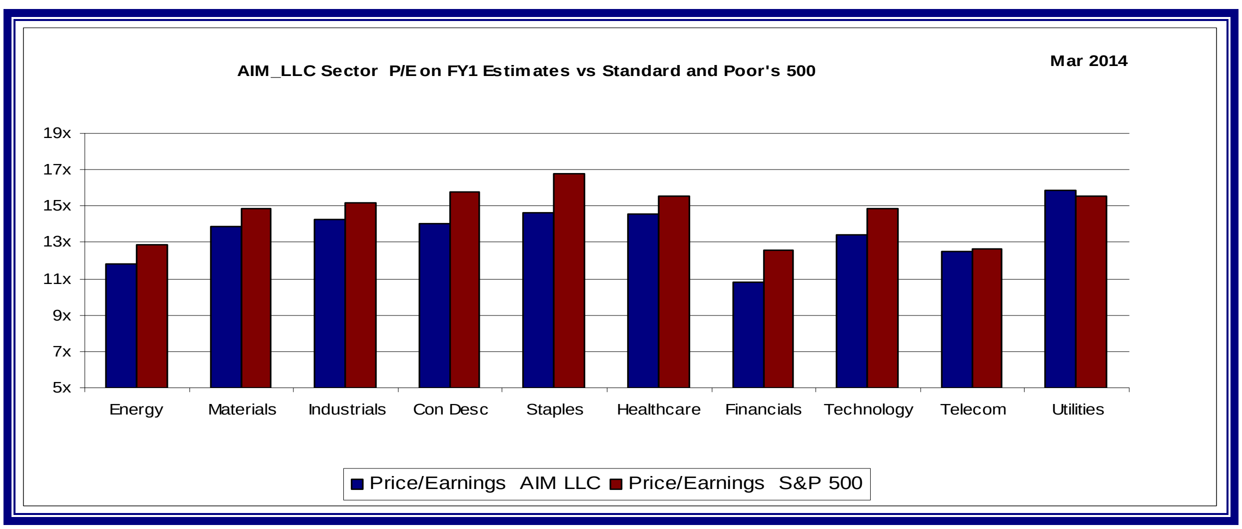
Exhibit I



Source: Altman Investment Management Research and Bloomberg

On a sector basis, forward P/E ratios contracted in all but two market sectors, Utilities and Consumer Staples. We believe these sectors represent the least attractive valuations at this time and are underweighted in our client portfolios.

Exhibit II



Source: Altman Investment Management Research and Bloomberg

A Note on Inflation and the Credit Markets

During the quarter, the bond market prices have modestly improved, due in part to investors searching for safety against a forecast of continued low inflation. With 3-month Treasury bills unchanged, The Treasury Index yield at the end of the quarter was 1.6 versus .83% a year ago. Long-term high quality corporate bonds currently yield 3.2%, compared to 3.3% a quarter ago and 3.2% a year ago. Long-term municipal bonds yield 3.1%, versus 3.4% a quarter ago and 3.1% a year ago. And 30-year mortgage bonds yielding 3.0% compare to 3.2% a quarter ago and 3.0% a year ago. The U.S. dollar index has been stable at 80 but down 3.6% from a year ago. The Commodities Research Bureau (CRB) Index at 500, led by food, has increased 5.3% in the first quarter, largely accounted for by the drought in California as well as in other parts of the world.

In contrast, metals led by copper have weakened over the past month, with copper down close to 10% since the start of the year. This was caused by the current slowdown in China which accounts for 40% of the demand for copper as well as a large share of other metals. Oil at $102 per barrel has been stable with excess supplies offset by geopolitical worries in the Middle East and Russia. Gold ($1290 per ounce) has fallen 2.4% over the past month after a rebound from tax selling during the first two months of the year. As the U.S. economy continues to expand along with the rest of the world, commodities should rally in 2014.

EXHIBIT III

Fixed Income Sector Performance – Q1-2014

Fixed Income Sector Performance – 2014 Q2- Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price Spread Avg**	**Trailing1 12Month Total Return**
Treasury	Aaa/AAA	7.2	5.60	1.6%	N/A	$103.6	(1.53)%
Agency	Aaa/AA+	5.33	3.93	1.5%	5	$105.2	(.62)%
MBS	Aaa/AAA	6.60	5.50	3.0%	140	$103.8	.2%
Municipal	Aa3/A+	13.54	5.00	3.1%	150	$103.0	.3%
Corporate	A2/A-	9.80	6.50	3.2%	160	$107.4	1.40%
High Yield	B1/B	6.10	2.90	6.1%	450	$106.3	7.4%

Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

We continue to believe that equities are the investment of choice in the long-term, despite the above average returns delivered in 2013. We remain focused on shares of companies that have strong cash flows, relatively low debt, and diversified business models that maintain consistent dividend policies. The investments we hold in portfolios represent superior quality in a more challenging environment, and should retain their value in the form of relative and absolute returns versus their alternatives.