MARKET PERSPECTIVE

APRIL, 2015

"When everything seems to be going against you, remember that the airplane takes off against the wind, not with it."

Henry Ford

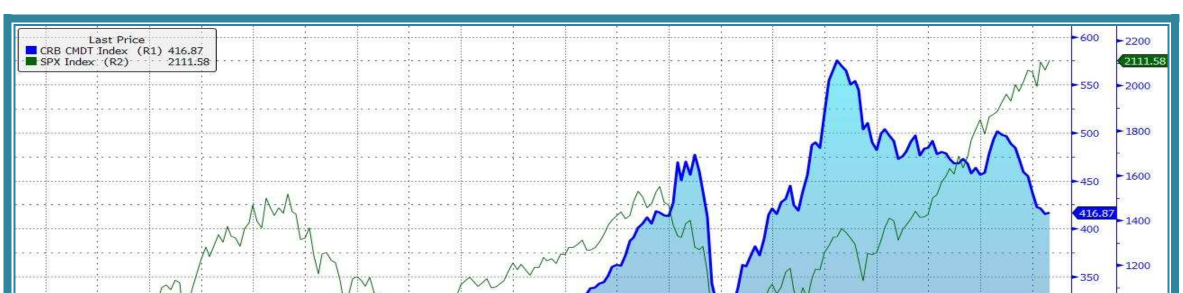
IN VIEW

The consensus forecast of economists polled by the *Economist* magazine for real GDP growth in 2015 has been moving down. At the end of March it was at 3.2% and now at 3.0% - and the Bloomberg poll is even lower. (1) Given the expected weakness in Q1, we revised our own forecast for growth this year to 2.8%, which compares to 2.4% posted in 2014. Similar to last year, first quarter growth is getting off to a slow start because of severe weather combined with the effects of the west coast port strike that recently ended. At present, we believe that first quarter growth in real GDP will be approximately 1.5%, as industrial production and retail sales combined with housing activity have all slowed in recent months. In addition, the strong U.S. dollar, against the backdrop of weaker foreign economies, has hurt export growth. This slowing economic activity has occurred despite record low interest rates and strong employment growth - adding an additional 3.3 million workers over the past year. The unemployment rate released in March was 5.5% as the business expansion reaches its 6th anniversary in June.

The current slowdown complicates the Federal Reserve's decision of when to raise interest rates, as it attempts to end its zero interest rate policy. The zero interest rate monetary policy, combined earlier with the quantitative easing program, was initiated to prevent a financial collapse during the Great Recession of 2008-2009. However, as the program lengthens it has the potential to structurally damage financial markets removing the natural pricing system of a free market. The duration of this dovish policy has inadvertently increased the moral hazard associated with lending activity, hindered the growth of pension assets and hence the livelihood of the retiree, as well as affected the prices of assets such as bonds, stocks and real estate. So far however, the excessive printing of money has not raised the inflation rate in the real economy or the inherent risk of damaging the purchasing power of the U.S. dollar. In fact, quite the opposite has resulted with much pain in the commodity pits as of late. While the price of crude oil has rebounded significantly from a low of $46 a barrel to $62.84 on the last reading, the CRB raw industrial spot price index continues to weaken. Exhibit I below shows the inverse correlation of the stock market versus commodities since the 2nd quarter of 2014.

EXHBIT I

Commodity Research Bureau versus Standard and Poor's 500



Source: Bloomberg and Altman Research

(1) The *Economist*, April 25th-May1st, 2015 issue and Bloomberg Mean GDP Street estimates are at 2.8% YoY as of April 28th.

In the past, weakness in the CRB index would have been a bearish indicator for stock prices. We are not yet convinced that this relationship has been completely scuttled, but the monetary liquidity that still hasn't boosted global economic growth along with commodity prices is feeding a bull market in stocks and bonds. A good example of this divergence is evident since mid-November when the Peoples Bank of China started to ease monetary policy, the Shanghai SE Composite Index led the other Emerging Markets and melted up. This generated outsized gains of 80.6% through end of April as compared to a gain of 6.1% by the MSCI World Index (Developed markets) over the same time period. The lack of consumption growth in China has created a huge domestic savings rate averaging 29.5% since 2005 according to some economists - resulting in a $19.5 trillion surplus. That's more than the United States, Japan and India combined. Although this excess cash is flowing into investment and existing assets, this is unsustainable unless consumption patterns in China change.

U.S. Interest Rate Policy in a Slow Growth Environment

On the assumption that economic activity will increase in the second and third quarters, we believe that the Federal Reserve will raise the federal funds rate by 25 basis points in September. Despite the liberal bias towards monetary easing among the majority of the Federal Reserve members, we believe that they would like to normalize policy as the economy strengthens in order to remove the inherent structural deficiencies.

The Federal Reserve's policy guidance after the mid-March FOMC meeting indicated that "patience" regarding the likely timing of an increase in the Fed Funds rate from near zero (where it has been maintained since December 2008) is no longer necessary. Subsequent commentary by Chairwoman Yellen suggested that a move is probable this year, but contingent on the Fed's assessment of U.S. economic strength and inflation. Lethargic economic growth and little price stability keep the Fed policy accommodative. Despite recent signs of slackness, our working assumption is that moderate growth will prevail in the coming months prompting one, or possibly two, modest increases in the targeted Fed Funds rate during the second half of this year. Additional rate hikes next year will again be dependent on the Fed's appraisal of the economic landscape at that time. Once the process of moving rates higher begins, we anticipate that the impact of each adjustment will be critically analyzed before a subsequent move is made. A "normalized" Fed Funds rate (some level above the prevailing inflation rate) seems unlikely for a year or more.

The measured tightening process we anticipate contrasts with the approach the Fed has typically taken in the past. There have been three periods of monetary tightening over the past twenty plus years, each with significant increases in the Fed Funds rate over relatively short time periods: (1) February, 1994 to February, 1995 (300 basis points from 3.0-6.0%); (2) June, 1999 to May, 2000 (175 basis points from 4.75% to 6.50%); and (3) June, 2004 to June, 2006 (425 basis points from 1.0% -5.25%).

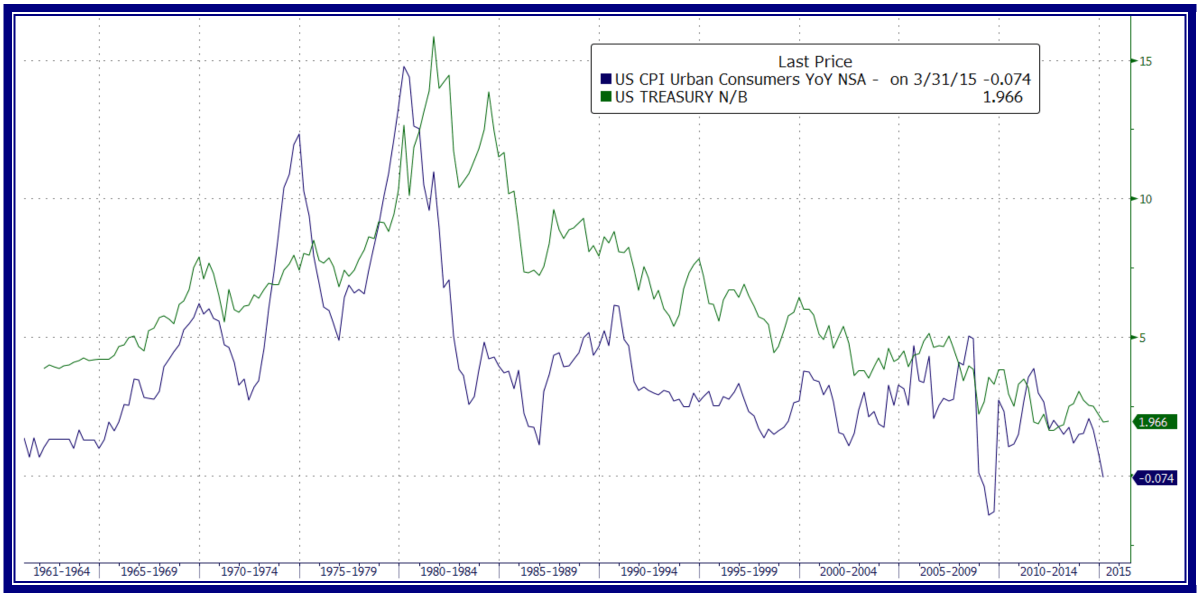
One of the Fed's current goals is a 2% annual inflation rate. The year-over-year increase in the core inflation rate (excluding food and energy) was 1.4% as of April 9th according to a Bloomberg survey. Current forecasts do not indicate much, if any, increase from this level. In fact, price pressures could subside somewhat in the coming months, in response to limited U.S. wage growth and global sluggishness. A targeted Fed Funds rate above 1.5% to 2.0% seems unlikely in the foreseeable future.

Will Fed tightening push longer rates higher? Perhaps modestly, but we doubt there will be a dramatic impact. A backdrop of modest economic growth and limited inflation - combined with the safe harbor appeal of the U.S. markets in an unsettled world - argues for limited rate pressure. In addition, minimal returns offered in Europe and Japan (ten year German and Japanese government bonds are yielding, respectively, 0.20% and 0.37%) and the strength of the dollar continue to attract foreign investors. This added demand is acting to further restrain U.S. interest rate pressures.

Despite this benign rate outlook, caution is warranted in the low prevailing yield environment. As illustrated in EXHIBIT II, the ten-year Treasury yield since the end of 2009 depicts several significant rate surges. An inflation surprise, or stronger than expected growth, could precipitate a rate jump. Portfolio durations remain targeted at slightly over three years, down from a neutral position of about four years. As a result, our fixed income strategy remains focused on principal protection.

EXHIBIT II

Consumer Price Index versus US Government Bond Yields

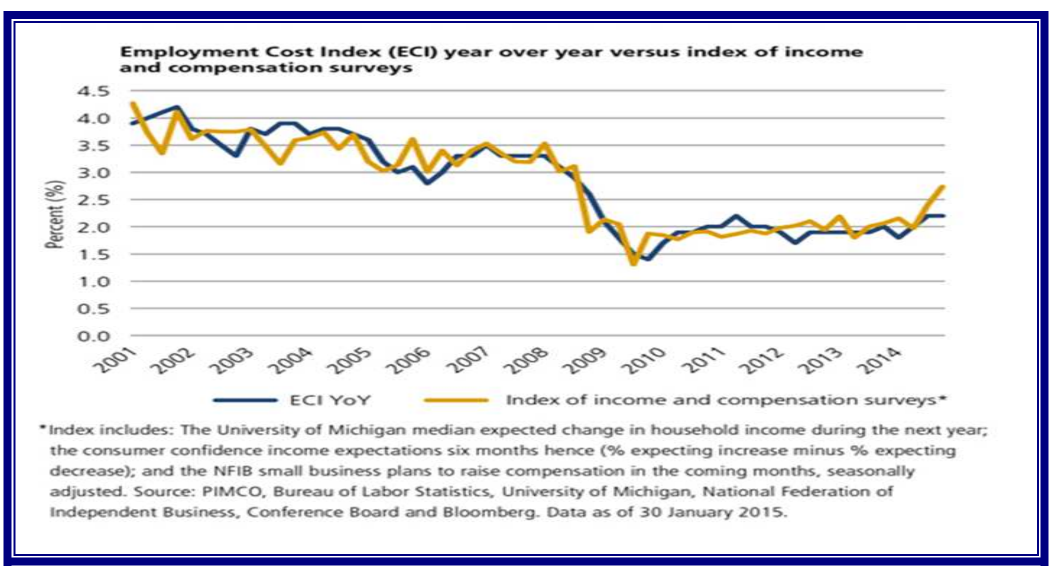


Source: Bloomberg and Altman Research

During the first quarter, the Federal Reserve shifted its focus towards inflation, away from the status of the labor market, as the primary indicator for lifting rates. They are now comfortable with the possibility of changing interest rates at any of the upcoming meetings, depending upon their confidence in the rate/level of inflation. The current disinflationary risk from a stronger U.S. Dollar and lower oil prices is characterized as transitory by Janet Yellen. The theory is based on consumers benefiting from lower energy prices as oil input costs diminish making goods more affordable. This should in turn support economic growth and lift inflation. The Fed also anticipates wage growth lending support to the already improving labor market. EXHIBIT III amplifies the rate of change of income rising faster than employment costs over the past several months.

EXHBIT III

Employment Cost Index versus Income and Compensation



Source: Bloomberg and Altman Research

We are expecting that the Federal Reserve Board begins to lift target rates in the 4th quarter of 2015. The risk to this view is that a slower than anticipated wage growth fails to support labor markets. We are aware that labor market strength has been overstated, due to low participation rates and rising part time employment, and/or the dollar weakens. That being said, during the past four years inflation hovered near the Fed's 2% target in the first quarter, only to taper off through the remainder of the year. However, with each subsequent year, as the labor market improved modestly, disinflation became less prominent.

The Fed inflation forecasts for the current year ranges between 1.1% and 2.9%. (2) Bill Dudley's and Stanley Fischer's recent upbeat remarks in mid-April concerning their expectation of resumption in the U.S. economic growth path could indicate that in fact the dollar may be peaking. This should confirm our expectation that the Fed's policy stance over interest rates over the rest of the year is more likely to be "one and done". The president of the NY Fed commented that "most of the impact from the decline in energy prices that has weighed down overall inflation is likely over" and that inflation should move higher over time. The implication this had on investor sentiment on the energy markets pushed share prices up close to 10% since mid-March, versus a 1.8% advance by the Standard and Poor's 500 over the same time period.

A plausible explanation for the bottoming of oil prices coincident with the apparent peaking in the trade weighted dollar is because rising oil prices increases dollar revenues to oil exporting countries. These countries prefer to diversify their currency holdings so when they receive excessive dollars they tend to convert them to other currencies which has the effect of weakening the dollar. The reverse happens when they earn fewer dollars on their exports.

CLOSE-UP: The Economic Landscape

There are lots of correlations between S&P 500 forward earnings and several key economic indicators. The former dropped sharply late last year and early this year as Energy industry analysts slashed their earnings estimates for this year and next year. While the plunge in oil prices accounts for much of the weakness in forward earnings since last fall, the soaring dollar has also weighed on earnings. Corporate profits tend to be the key driver of employment and capital spending. Profitable companies tend to expand their payrolls and capacity. Unprofitable companies don't do so. This explains why there is such a good correlation between the y/y growth rates of forward earnings and aggregate Weekly Hours. Forward earnings are also highly correlated with total factory orders as well as nondefense capital goods orders excluding aircraft. The weakness in forward earnings confirms that the slowdown in U.S. economic growth so far this year wasn't attributable just to the icy winter. Spring's economic indicators remain disappointing so far. The profits picture should brighten a bit, if the dollar has peaked and oil prices have bottomed. The U.S. economic outlook should also brighten in this scenario. However, we don't expect the economy to boom.

In terms of some specific economic indicators, the March employment report was strong as nonfarm payrolls increased by 295,000, with average hourly earnings rising by 0.1% for an annual increase of 2.0% y/y. Personal income rose 0.3% in January for a 4.6% annual gain, while private sector salaries were up 5.5% y/y. Personal spending fell 0.2% (+3.6% y/y) as gasoline sales fell 16.9%. If we looked at overall spending ex-gasoline, the figure rose 0.3% or 4.8% y/y. In January, the personal savings rate advanced to 5.5% from 5.0% in December. This is a healthy development as it suggests consumers are less reliant on debt financing. Through February, the producer price index is down 0.6% y/y and the consumer price index is flat y/y. We do not expect the modest deflation to last, as the negative numbers are unduly affected by the sharp fall in energy prices. In February, the ISM Manufacturing Index edged down to 52.9 from 53.5 in January, while the Non-Manufacturing (services) index increased slightly in January to 56.9. Numbers above 50 represent growth. Orders, production and employment, while slowing, are still advancing across a broad base of industries. Our main concern is capital spending - as growth in equipment and software was only 0.9% in the fourth quarter.

(2) Summary of Economic Projections of the Meeting of March 17-18, 2015 FOMC

The weakness in regional orders was recently confirmed in the March durable goods orders. While the overall number rose 4.0% m/m, boosted by a surge in aircraft orders, nondefense capital goods orders excluding aircraft fell for the seventh month by a total 6.7%. Orders have been especially weak in fabricated metal products, machinery, electrical equipment, appliances and components. That probably reflects the combined depressing impact of lower oil prices on the Energy industry and the high dollar on exports. It is private capital spending combined with savings which creates prosperity not government spending. All in all, while a slowdown is currently unfolding, we remain optimistic for the future and believe that the most recent weather-related weakness will rebound, similar to last year, and the subpar capital spending will reverse in the months ahead.

The Outlook for the Financial Markets

In the last month of the first quarter, bonds again rallied, commodities weakened, and stocks, despite much daily volatility, moved sideways. In recent weeks following quarter end, the 10-year Treasury yields broke the 2.0% level coincident with a rising equity market. Long-term high quality corporate bonds yield 3.7%, and long-term municipal bonds yields are flat at 3% as compared to quarter end. 30-year mortgage bond yields have dropped currently at 3.84% versus 3.93% at the start of the year. The rally in bonds occurred after the Federal Reserve Board meeting when the word "patience" was removed from language, suggesting possible changes in the federal funds rate later in the year. However, in the first quarter, the bond market focused more on the recent weaker economic statistics and concluded that a June rate hike was taken off the table despite the change in the Federal Reserve's language. It also took into account that the Federal Reserve changed its forecast for economic growth in 2015 to a range of 2.3%-2.7%, rather than its plus 3.0% earlier forecast. Keep in mind that the U.S. dollar has been exceptionally strong against a backdrop of weak foreign growth forecasts and also favors bond investing. Nevertheless, while deflationary forces are currently ascendant, we believe that by the third quarter higher growth rates will again resume.

Through the first quarter, commodities - led by oil - have been the leading edge of the deflation. While the CRB index of commodities closed the quarter at 414 falling 5.9% since year end, it's down 17.5% since last April. Oil led the charge down over 10% during March to $44 per barrel and down 56% over the past year. Copper ($2.67 per lb.) is still down 12% over the past year and gold at $1167 per ounce fell close to 24% over the past year. Commodities have fallen because of additional capacity at a time when demand fell because of a slowing Chinese economy and a near recession in Europe. Also, since many commodities are priced in dollars, the 23.8% rise in the U.S. dollar index over the past year has hurt commodity prices. The real economic problem for many emerging markets is that while their currencies have fallen, many of their borrowings have been priced in U.S. dollars and in many cases that borrowing has been excessive. As a result, the risk of foreign bankruptcies has risen.

Stocks, as measured by the S&P 500 index, closed the quarter at 2051 - but rallied back close to the old record high on April 24th closing the week at 2114. The performance of the U.S. stock market is quite impressive considering that there isn't much of a recovery this spring in the latest batch of economic indicators. When the 1st quarter GDP growth is released, investors will remain skeptical that stock prices appear somewhat stretched in valuation at a time when near-term earnings for the first and possibly second quarters are negatively impacted by the severe decline in energy earnings combined with both slowing economic statistics and a strong U.S. dollar. As of the end of April, energy stocks represent 8.4% of the S&P 500 index so their earnings will have some impact on total earnings, although not a major one. Earnings for the S&P 500 index came in at $117 per share for 2014 consistent with our estimate established earlier in the year. As April closes, the S&P 500 (2114) sells at 18 times the $117 earnings for 2014 and at 17.2 times our estimate of $123 per share for 2015, a 5.1% gain versus 2014. Historically, forward P/E ratios are about 16.5 times earnings although there is a great deal of variability. Since 1985, the average P/E on current year earnings is 18.8.

EXHIBIT IV
S&P 500's Trailing 12 month Price to Earnings Ratio
1985 to Present

Source: Bloomberg and Altman Research

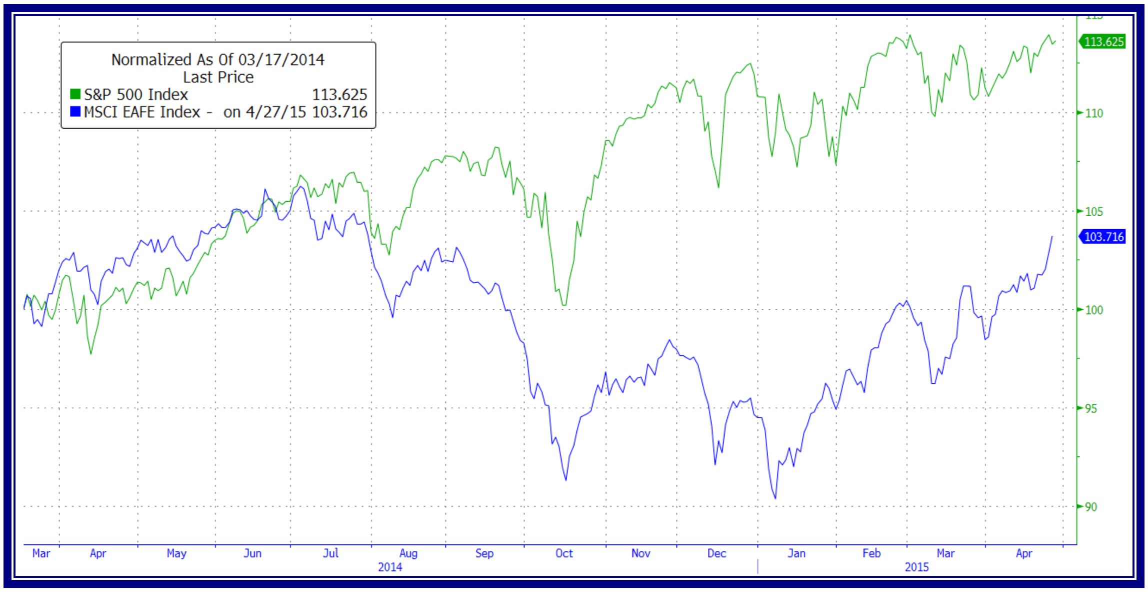
Looking ahead to 2016, we would expect earnings to grow 7.0% as economic growth continues to expand after the brief hiccup in the first six months of 2015. While the market climbs a wall of worry, the numbers of uncertainties of late have been ignored. Complacency is always a concern and needs to be monitored, particularly when the market hasn't had a 10% decline since 2011.

In addition to the current economic and earnings slowdown, geopolitical risks are mounting - particularly involving Russia, and to a degree the disagreements with Greece over the continuing reform of their economy. One could also add that the continuing lack of cooperation between the two political parties increases uncertainty, as the election of 2016 nears. Although current price earnings ratios are elevated on a free cash flow basis, the markets still appear reasonable. If valuations are not in the extreme and recent market cycles have gotten longer over time, we are encouraged by strong balance sheets, high operating margins and low wage gains. As the U.S. enters into a period of regime change, we would expect the uncertainty to compress multiples in the short term and advise caution when establishing new investment positions at the present time.

In our January commentary, we cautioned investors concerning the possible earnings headwinds in the first quarter releases - but believed that this was only a temporary slowdown that analyst and managements should have figured into their yearend estimates. Since the markets are a discounting mechanism and have already digested this soft patch, a resumption of 7.0% growth path in earnings should drive the markets higher. Keep in mind that even in recessionary periods, the Standard and Poor's 500 had positive returns 75% of the time when earnings growth was negative.

EXHIBIT V

Standard and Poor's 500 versus The Morgan Stanley Europe Asia and the Far East Index



Source: Bloomberg and Altman Research

We encourage our investors to keep in mind that despite modest returns in the first quarter of 2015, the broad U.S. market has recorded substantial gains since bottoming in March 2009. The annualized total return for the S&P 500® Index, since that time, has been 19.7%. Since the bottom, the markets posted a cumulative gain of 194% - or 247% if we include dividends reinvested. Given the opportunities for outsized gains, starting the year with higher valuations of course decreases the likelihood of continued record returns in subsequent years.

We are still anticipating mid-single-digit annualized returns, and the compounding effect of these smaller changes is still material over time. Time is on your side as an investor because of the magic of compounding. Despite the recent volatility this year, and historically high valuations caused by headwinds to growth estimates - a strong dollar, weak commodity prices, a flat yield curve, and slow global economic growth - bond yields are still at historic lows.

On the positive side, the plunge in oil prices should begin boosting consumer confidence and spending. Will investors retain their positive bias towards U.S. stocks because of the relative strength of the economy, or will the prospect of higher interest rates and weaker earnings growth in the U.S. take the markets hostage? Or will the highly accommodative central bank policies in other regions draw more investors to other markets and asset classes and compress market prospects in the U.S.? Only time will tell how this gets resolved. In any event, we think owning what we view as higher-quality U.S. stocks with attractive valuations and favorable risk/reward profiles improves the likelihood that we can continue to deliver competitive returns. Under separate commentary, titled *Equity Strategy Focus*, we outline the specifics of our portfolio strategy for 2015 along with our selection bias that we believe positions our investors to achieve relative outperformance.