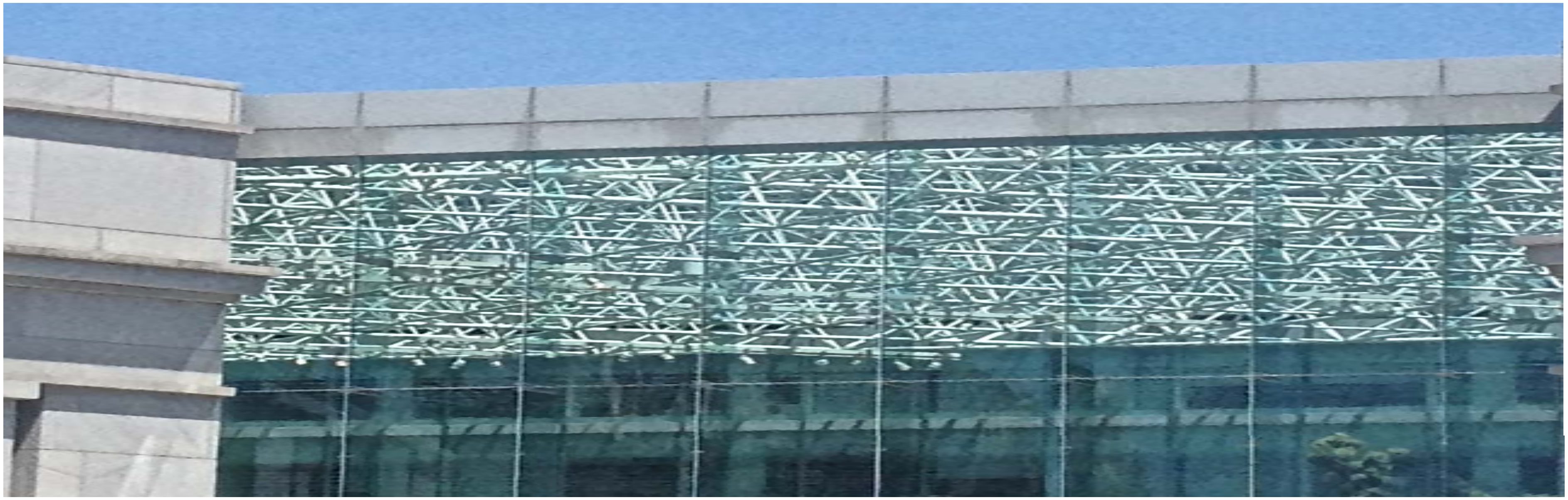

Quarterly Update & Economic Commentary—June 30, 2014

Quarter in Review

After a sluggish start to the year, the equity markets picked up momentum during the second quarter. The S&P 500 returned 5.23 percent during the second quarter and is now positive by 7.14 percent year-to-date. The broad index, often looked at as a barometer for the stock market, has now reported positive returns for six straight quarters. The smaller capitalization indices did not perform as well as the large cap index but were able to move higher through the quarter, extending their positive performance streak to eight consecutive quarters. The S&P SmallCap 600 returned 2.07 percent for the quarter and now sits positive by 3.22 percent for the year.

Similar to the performance of U.S. equity markets, international markets - both developed and emerging - had a strong quarter. Emerging markets outperformed both international developed and U.S. markets for the quarter, finishing the quarter positive by over six percent. After a flat first quarter, emerging markets are also positive by over six percent year-to-date. Developed international equities, as represented by the MSCI EAFE, were up over four percent for the quarter, and are positive by 4.78 percent year-to-date.

The Energy sector was the top performing U.S. large cap sector for the quarter, benefiting from rising oil prices as a direct result of escalating violence in Iraq. The Utility sector, which was the leader during the first quarter, had another strong quarter, finishing positive by over seven percent. The Utility sector is also the leader through the first half of the year with an astounding 18.65 percent return. Joining the Utility sector with double-digit returns through the first half of the year are the Energy and Health Care sectors. Information Technology was also a strong performer during the second quarter, returning over six percent. All broad sectors are positive through the first six months of 2014. Consumer Discretionary was the worst performing sector so far, with a return of less than one percent.

Longer-term interest rates continued to fall during the second quarter, with the 10-year treasury falling to 2.51 percent. Bond price performance was driven by falling interest rates through the quarter resulting in long-term bonds outperforming shorter duration bonds. The broadlyfocused Barclays Aggregate Bond Index returned 1.94 percent during the second quarter and finished the quarter positive by almost four percent year-to-date. Lower-quality fixed income continued to outperform higher credit quality peers. The Barclays US Corporate High Yield Index returned 2.41 percent during the quarter and is positive by 5.46 percent year-to-date.

Oil prices drifted higher throughout the quarter as a Civil War in Iraq caused tensions to rise in the Middle East. The price movement was a modest four percent increase, but given the circumstances, the movement could have been more significant. Gold had a strong June, allowing it to post consecutive quarterly gains for the first time since 2011. Gold is now positive by almost 10 percent through the first two quarters of the year. Coffee prices retreated slightly during the second quarter after significant increases during the first quarter. Coffee prices are still up over 55 percent for the year, which is due to an unprecedented drought in Brazil. Increasing coffee prices caused retail giant JM Smucker, maker of Folgers, to announce they would pass on part of this price increase to consumers.

Many television "talking heads" have been referring to this recent market rally as the most hated bull market in decades - maybe ever. There are many reasons to be skeptical of this rally:

- It has been over two years since the S&P 500 experienced a 10 percent correction .
- A major catalyst for the market rally has been artificially low interest rates, driven by the Fed's unprecedented and unsustainable monetary policy.
- The final reading for first quarter GDP growth was **negative** 2.9 percent.
- Too many Americans are either underemployed or unemployed.
- Geo-political risks are rising with continued tension in Russia/Ukraine and most recently Iraq.
- U.S. equities are trading at earnings multiples slightly above historical averages.
- Many investors have been underweight equities for much of the rally, causing those who missed the rally to justify their decision making by calling this market unjustified.

The fact that there remains a number of market participants not sold on the sustainability of the current bull market might be a prime reason that the rally could continue. When investors are all on the same side of trade, either bullish or bearish, it is probably a good time to take the other side of the trade, however, this market is seeing its fair share of both bulls and bears.

The headline economic reading in the U.S. during the first quarter was an abysmal 2.9 percent decline in Gross Domestic Product (GDP). The expectations for this reading were low, but the final reading was far lower than expected. The poor reading was driven by the harsh winter, inventory drawdowns and the yet- to-be-explained lower health care spending. Although the GDP was disappointing, it was comforting to see that many other economic indicators contradicted the poor GDP print.

The unemployment reports released during the second quarter continued to show strong job growth. The May report indicated nonfarm payrolls increased by 217,000 jobs, and the 12-month average showed employment growth of 197,000 jobs. The unemployment rate dropped to 6.3 percent. In addition to more jobs being created, 12-month average hourly earnings rose by 2.1 percent. Durable Goods orders were encouraging throughout the quarter despite the negative one-percent drop in May, which was skewed by defense orders.

Business and consumer confidence showed signs of strengthening throughout the quarter. According to the Thompson Reuters/ University of Michigan U.S. consumer sentiment survey, consumers are feeling optimistic. The final June reading came in at 82.5, which was 0.6 points higher than the last month. Consumer confidence was also evidenced by the significant rise in lightweight vehicle sales, which saw a surge to an annualized rate of 16.8 million units in May, the highest seasonally adjusted annual rate since July 2006. The housing sector indicators were mixed throughout the quarter. The trend in housing continues to look positive, but the numbers are not as consistent or robust as we have expected.

Merger and Acquisition (M&A) activity has been extremely strong as acquiring companies are taking advantage of higher stock prices, ample stock reserves and cheap financing. Year-to -date global M&A deal volume as of June 26 surged to $1.75 trillion, its highest level since June 2007, according to Thomson Reuters. Some of these deals are inversions by U.S. companies, which allow them to be domiciled in countries that have a lower corporate tax rate. Yet another sign of business and investor confidence is witnessed in the strength of the Initial Public Offering (IPO) market. According to Renaissance Capital, the second quarter of 2014 trumped the first quarter, which was previously the most active quarter since the first quarter of 2000. The second quarter's activity was much more diversified than the first quarter's biotechnology-driven activity. The second quarter saw more activity from the technology, energy, financial and consumer sectors. One hundred and seventeen companies filed for IPO's in the second quarter, a 19 percent increase over last quarter and a 54 percent increase over second quarter of 2013.

The Federal Reserve continued to wind down quantitative easing by reducing monthly bond purchases by another $10 billion. Beginning in July, the Fed will have reduced the monthly purchases to $35 billion and remain on pace to end the bond purchases before year end. Newly-appointed Fed Chair, Janet Yellen, had some bumps along the way, but overall her first six months on the job have been successful.

The most anticipated - and probably most significant - news of the quarter came out of the European Central Bank's (ECB) meeting in May. The markets have been waiting and expecting further stimulus, which was finally announced. The ECB cut key interest rates 10 basis points from 0.25 to 0.15, and announced further measures to combat the Euro zone's disinflation fears. The ECB also cut its deposit facility rate to -0.10 from 0 percent. By taking the rate negative, it essentially means banks will be charged to park money with the ECB. The ECB also announced targeted longer-term refinancing operations (LTROs), in where the ECB lends to banks at low interest rates in order to encourage them to lend to households and non-financial corporations or to invest in higher-yielding assets. Mario Drahgi, President of the ECB, did not stop there; he announced they would begin "preparatory work" to be able to conduct Federal Reserve-style asset purchases in asset-backed securities. He also announced they would stop "sterilizing" past bond purchases, which has the effect of injecting more reserves into the banking system. Last but not least, during Mario Draghi's press conference he asserted himself: "Are we finished? The answer is no." We consider this an aggressive first step.

After trailing other equity markets for much of 2013 and into 2014, emerging markets have rebounded to be a top performer during the second quarter. India's stock market has led the way as investors applauded the newly-elected prime minister who has promised to create jobs, revitalize the economy, and improve governance inside and outside the capital. Thailand's military staged a coup in April and took control of the government. The markets actually applauded the action, as they hoped the shift in control would resolve some of the political deadlock. Russia's stock market performed well during the quarter. The MSCI Russia Index gained over ten percent for the quarter; performance was driven by the easing of tensions between Russia and Ukraine. The Index remains negative for the year by over five percent.

A Look at the Numbers

Index	2nd Quarter 2014 (%)	Year to Date (%)
DJ Industrial Average TR USD	2.83	2.68
S&P 500 TR USD	5.23	7.14
S&P MidCap 400 TR	4.33	7.50
S&P SmallCap 600 TR USD	2.07	3.22
NASDAQ Composite TR USD	5.31	6.18
MSCI EAFE NR USD	4.09	4.78
Barclays US Agg Bond TR USD	2.04	3.93
Wilshire US REIT TR USD	7.22	18.08
IA SBBI US 30 Day TBill TR USD	0.00	0.01

Forecast in Brief

The focus in the second half of the year will be on the strength of the U.S. economy, and in particular, the release of the second quarter GDP report. We are expecting to see a significant snap back following the disappointing -2.9 percent decline in the first quarter. Based on some of the other economic numbers released during the first quarter and a perceived outlier in first quarter release, we expect to see an annualized growth rate of between three and four percent for the second quarter.

There are no real surprises expected from the U.S. Federal Reserve. The consensus is that they will continue to taper the monthly bond purchases until it is completely withdrawn, which is expected to conclude in October. As long as the economy continues to grow as expected, the Fed's main attention will be on inflation. The U.S. inflation rate has been below the Fed's targeted level for years, which will allow the rate to get above the long-term targeted rate of two percent without forcing any swift action. The release of the Fed's minutes and interviews given by the different district Presidents will be closely watched for clues on how soon into 2015 the Fed will begin raising interest rates.

Earnings season is always an important part of the quarter and second quarter results will be no different. Analysts and investors will be anxious to see how companies are performing coming off last quarter's negative operating earnings growth for the S&P 500. According to FactSet, 84 companies have issued negative Earnings per Share (EPS) guidance and 27 companies have issued positive guidance for the second quarter. This is actually a positive sign when compared to past quarters; the numbers represent the second consecutive quarter that negative preannouncements declined and positive preannouncements increased.

Many investors and analysts expected to see interest rates rise during 2014. In fact, the opposite has occurred through the first half of the year. We believe interest rates will rise during the second half of the year on better and more consistent economic news. We do not expect to see rates rise at a rate that would have a significant adverse impact on shorter-term bond holders or derail the economic recovery. We look for rates to move closer to the three percent mark between now and year end. In conjunction with watching interest rate levels, fixed income investors will also be paying close attention to credit spreads, which have tightened over the last couple of years. With rates threatening to rise and limited return coming from additional credit tightening, fixed income investors can expect returns consistent with interest rate returns, minus any loss in principal from increasing interest rates.

We continue to feel the geopolitical issues in Russia/Ukraine and in Iraq are in a state of uncertainty which could lead to heightened market volatility if either situation escalates. Since the fighting in Iraq started, we have seen a jump in oil prices translating into higher gas prices at the pump. Should oil prices stay elevated or significantly increase, it could become a burden on the U.S. consumer and, ultimately, be a drag on the economy. We do not see either situation causing a major disruption to the U.S. recovery, but both situations need to be monitored as they do pose a risk.

We expect more of the same from Europe: slow growth and a continued risk of deflation. The newly announced "easy money" policies will be beneficial but will fail to produce any large, swift changes to the economy. A weaker Euro was expected from the newly announced measures, which could help European exporters. However, the Euro has been resilient and stabilized at the 1.36 level, which is only slightly weaker than the beginning of the year level of 1.38. The ECB could announce additional measures but the timing is uncertain. Unless the economy takes a significant turn for the worse, additional steps may not be taken until sometime in the fourth quarter or possibly in 2015.

Many emerging-market countries continue to look attractive from a valuation perspective but they also carry additional risks. A number of emerging market countries should benefit from increased demand from developed economies, like the U.S. and Europe. India's recent performance is attributed to the election results and expectations around future growth; however, current economic readings have been disappointing, increasing the risk of the market beginning to trade on economic news and not political results. Brazil is expected to see elevated volatility heading into their October elections. Brazil's valuations are attractive but low growth and high inflation remain as risks in the months ahead. Recent economic news out of China has been inconsistent, but the government has been actively trying targeted liquidity and credit easing to support the potentially weakening economy. China may see some bumps along the way but we are not expecting a hard landing. Indonesia is coming off a strong first half of the year with returns in the high double-digits; however, Indonesia will have their presidential elections in July, which are expected to impact short-term performance.

Our sentiment continues to be bullish on the U.S., and to a lesser extent, the global recovery, which leads us to favor equities over fixed income from an opportunity and valuation perspective. However, and **most importantly,** an investor's asset allocation and investment decisions should be based on risk tolerance and financial goals not on past or forecasted stock market movements. Investors in equities should continue to expect more price volatility and can encounter a much larger draw-down than many fixed income investments.

If anything in your financial situation has changed, please let us know so we can determine whether a change in your portfolio is necessary.

— Robert Moyer, CFA, CFP®
Director of Research

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