US Equities continued to advance in the second quarter, with the S&P 500 returning 5.2% for the quarter and 7.1% for the first half. Energy was by far the best performing sector in the quarter, returning over 12%. Utilities and Technology stocks also performed well, while Financials and Consumer Discretionary stocks lagged. Although small caps rallied off their lows in the quarter, they continue to underperform large caps this year - the Russell 2000 is essentially flat year-to-date.

Most equity markets outside of the US experienced positive returns in the quarter, with the MSCI All Country World Index ex US up about the same as the S&P 500. Japan, a significant laggard this year after its strong performance in 2013, was up only 2.3% in the quarter and is down over 6% year-to-date. India was the standout, up over 14% in the quarter and almost 20% year-to-date, as hopes have risen that the newly elected leadership will have a positive effect. Russia, up over 9% in the quarter, reversed its first quarter decline as Ukraine tensions eased.

US Fixed Income markets began the year with a widespread conviction that rates were going higher. So far, the consensus has been wrong. We noted in our year-end strategy piece that, based on historical norms, we could see some flattening of the yield curve near-term; in fact, long-term and intermediate interest rates have fallen significantly this year and the spread between short and long rates has narrowed. The yield on the 10-year Treasury declined from about 3.0% at the beginning of the year to 2.53% at the end of the quarter, even as the Fed has continued to taper its bond buying program. Most fixed income categories performed well, including Municipals and High Yield Bonds, up 2.4% and 2.6%, respectively. Some of the decline in rates can be attributed to the steep (and unexpected) decline in GDP in the first quarter, which lowered economic growth projections for 2014. In addition, fixed income markets have experienced large inflows this year as large institutional investors took advantage of the last year's surge in US equities to rebalance back to fixed income.

The US Economy: We've come a long way.

Although there has been concern about the relatively slow pace of economic growth and employment since the economy bottomed in 2009, a look back at the last several years shows how far we have come and helps put today's data in perspective. The tables and charts below show some selected economic statistics for this period along with some indicators of monetary and fiscal policy.

Table 1: Economic Growth Measures

	High 2007	Low 2008/2009	6/30/2014
US GDP (Nominal) ($tn)	14.6	14.3	17.3
S&P/Case-Shiller Home Price Index	204	141	171
Auto Sales (ml)	16.8	9.0	16.7
Household Net Worth ($tn)	69	56	82
Capital Goods New Orders-Nondefense, Exc. Aircraft ($m)	67,286	46,324	70,995
Capacity Utilization (% of Total Capacity)	80.8	66.9	79.1

It is evident from Table 1 that most key economic measures have seen a healthy recovery off of their lows of the 2008-2009 period. Nominal **GDP** is now well above its 2007 peak. **Auto sales**, which were cut in half when the easy credit conditions of 2007 ended, have recovered all lost ground, although credit conditions in this industry may have eased too much. Nevertheless, strong replacement demand should continue to be fueled by higher efficiency standards and improving technology. **Housing** has improved significantly from the lows of 2009, but has yet to get back to 2007 levels. Demand has been slower than expected this year, and rapidly rising home prices, driven by shortages in land, skilled labor and some materials, have slowed the recovery process. Despite recent housing data, we do expect to see more improvement this year as mortgage rates are below a year ago and the Fed is not expected to raise interest rates until 2015. In addition, strength in both autos and housing is tied to the rate of household formation, which has been hit by weak employment, high student loan debt, and weak income growth. We expect this rate to increase with an improving employment and wage picture and more favorable demographics. We are now seeing an increase in the size of the population in the 25 to 35 year old bracket, the key household formation age.

The last two indicators suggest that the business environment is getting better. **Capital goods orders** have been picking up along with commercial and industrial loans by banks. In addition, **Capacity Utilization** in the manufacturing sector is now slightly above its twenty-year average of 78.9%, which means that additional equipment will be necessary to expand production. Although GDP Growth in the first quarter was hurt by the severe weather, we should see a healthy rebound in the second quarter and we continue to expect trendline growth between 2.0% and 2.5%.

Interestingly, inflation as measured by the **CPI** has not changed much since the economy bottomed, despite the massive monetary stimulus. Mild inflation (and risk of deflation) has made it easier for the Fed to be more accommodative. And, as the indicators in **Table 2** show, it has been extremely accommodative. The Fed's **balance sheet** has more than quadrupled since 2007 and the **Fed Funds Rate** has fallen from 4.75% to 0.25%. Despite an improving economy, the **10-year Treasury** remains significantly below where it was in 2007. In contrast, fiscal policy has been a headwind to economic growth since the bottom in 2009. However, ongoing spending cuts along with higher tax revenues and improving economic growth have significantly reduced our deficit as a percent of GDP, which is positive for the economy.

Table 2: Monetary and Fiscal Factors

	High 2007	Low 2008/2009	6/30/2014
Fed Balance Sheet ($tn)	0.9	0.9	4.4
Fed Funds Rate	4.75	0.25	0.25
US Treasury 10 Year	4.04	2.13	2.53
CPI (annual rate)	2.9	1.8	2.1
Unemployment Rate (%)	4.5	9.9	6.2
US Deficit % GDP	1.2	10.1	4.1

Although the Fed has stated its intentions to end its stimulus program in October of this year, investors are now more concerned with when the Fed will actually raise rates. Fed chair Janet Yellen has indicated that the first rate increase would happen sometime in 2015, although the timing will depend on employment and inflation data. As shown in the table above, the unemployment rate has improved significantly off the bottom. The question is how accurately this rate portrays the actual health of the job market. The additional employment indicators shown in the charts below shed more light on the issue of job market health.

Chart 1 looks at the monthly increases in nonfarm payrolls, one of the most watched employment indicators. This number bottomed in the first quarter of 2009 as the economy lost over 800,000 jobs. Since then, it has been trending upward every year and thus far in 2014 we have been adding an average of 210,000 jobs per month. **Chart 2** shows initial jobless claims, which have improved consistently from their peak in 2009.

Chart 1: US Employees on Nonfarm Payrolls
Total Month-Over-Month Net Change Seasonally Adjusted

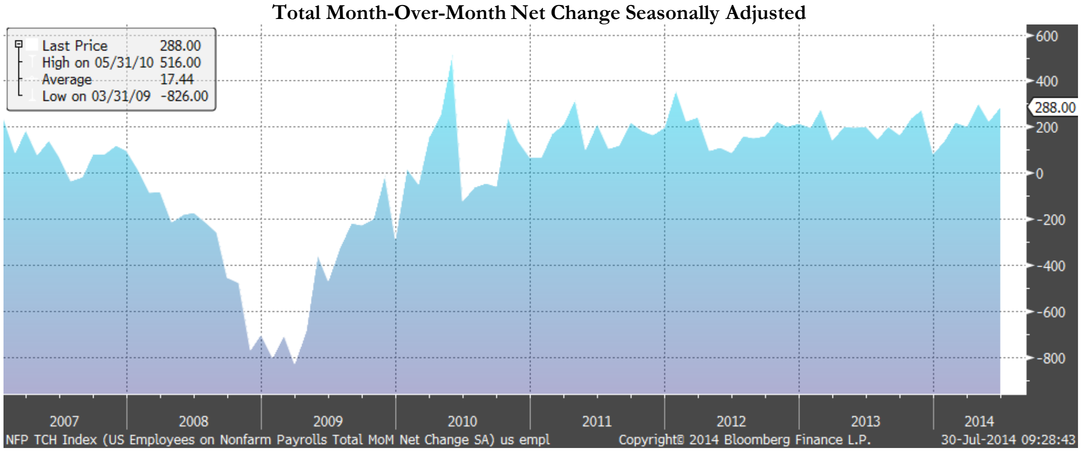
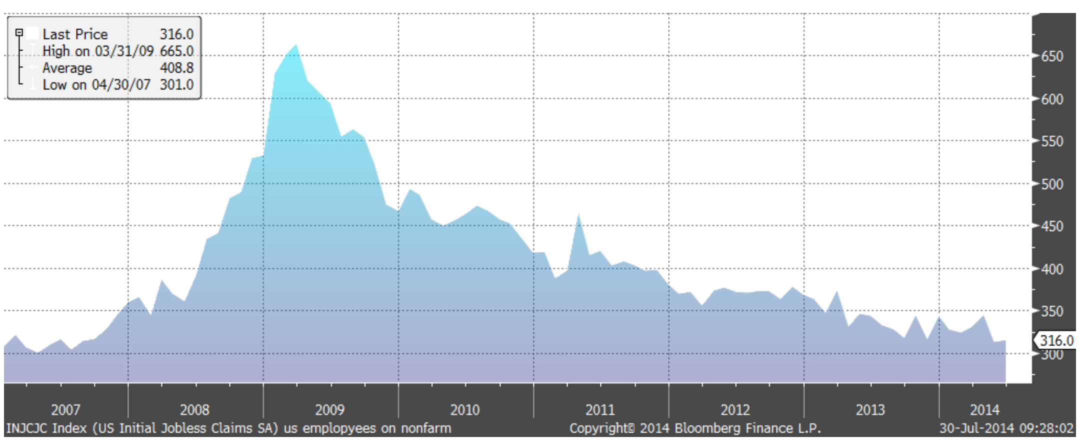
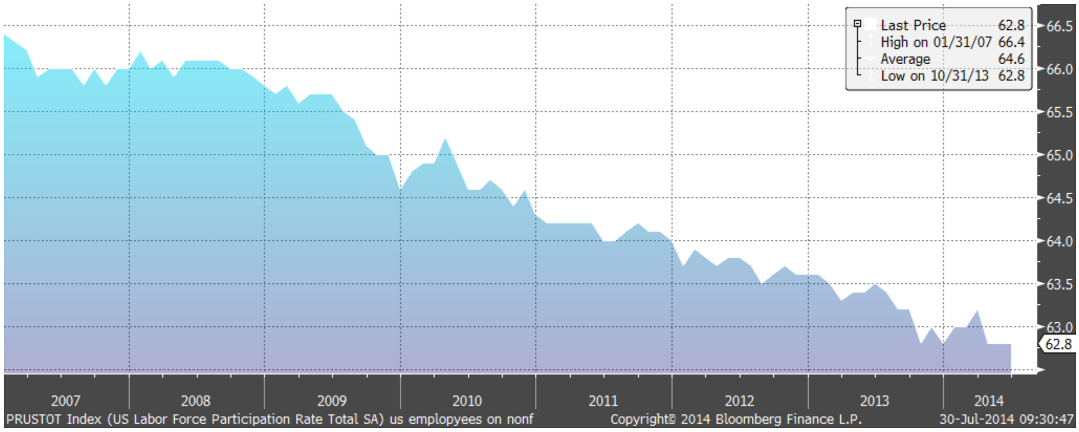


Chart 2: Initial Jobless Claims



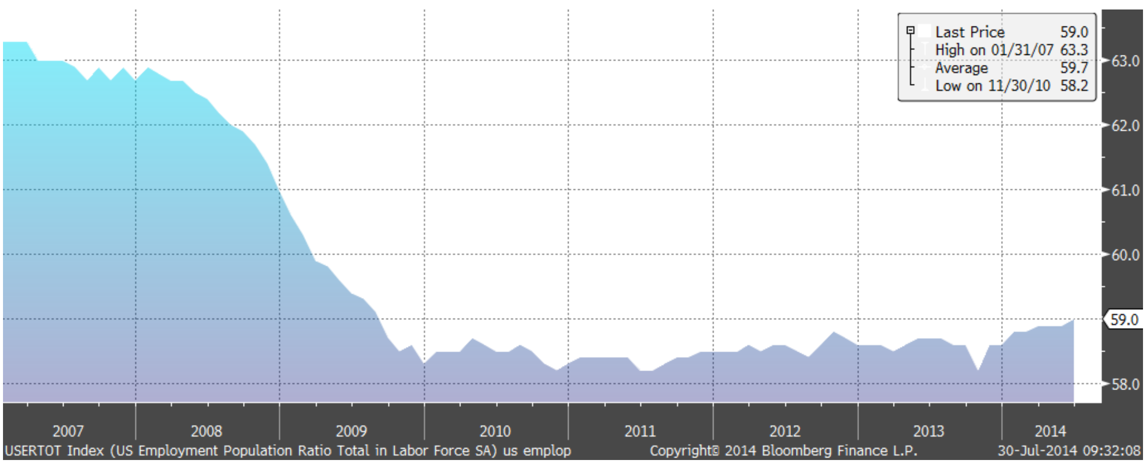
These trends, along with the 6.2% unemployment rate, are encouraging. However, none of these indicators takes into account the growth in the working age population. The unemployment rate expresses unemployment as a percent of the labor force rather than the working age population. As **Chart 3** shows, the percent of the working age population in the labor force has been falling. Known as the "Labor Force Participation Rate", this rate peaked in 2000 and is now at a level not seen since the late Seventies.

Chart 3: US Labor Force Participation Rate
(As a percent of the working age population)



When employment is measured as a percent of the entire working age population, as shown in **Chart 4,** we can see that this rate plunged in 2008-2009 and has not recovered much since then.

Chart 4: US Employment Population Ratio Seasonally Adjusted
(Persons in employment as a percentage of the working age population)



The chart above shows that we need a higher rate of job growth to keep pace with population growth. At the same time, it is not clear how much of the decline in the Labor Force Participation Rate is due to aging demographics (as baby boomers retire early), younger persons entering the work force later (due to continuing education) or discouraged workers leaving the labor force. It is also not clear how much of our unemployment is cyclical (should decline with improving economy) and how much is due to structural factors. For example, both the housing and energy industries have been experiencing severe shortages of skilled labor in certain areas. In the case of housing, a large number of these skilled workers retired or transferred to other industries as the housing bubble burst. In the oil industry, geoscientists and petroleum engineers that were hired before the massive layoffs of the 1980s are now getting close to retirement, and new workers entering the industry simply lack the experience of the older generation. Eventually these structural deficits will lessen, as rising wages attract new workers. Fortunately, structural unemployment due to outsourcing is less of a factor than it has been in the past, as the US has become more competitive in terms of labor and energy costs.

Outlook

The S&P 500 is now up almost 200% from its bottom in 2009 and is 28% above its peak in 2007. The current 12-month forward Price Earnings Ratio is about 15.6, above the 10-year average of 14.1 and the 5 year average of 13.5. Earnings are estimated to have increased 6.5%-7% for the second quarter and are continuing to rise at a faster pace than revenues, as cost-cutting efforts continue (another drag on employment). We have yet to see much of an uptick in wages, which would begin to pressure profit margins. While the S&P does not appear significantly overvalued, we are unlikely to get significant additional multiple expansion. On a valuation basis, we continue to favor European and Japanese equities, both of which are selling at more attractive price earnings ratios relative to expected earnings growth. Although growth has been slowing in China, growth over 7% is still strong relative to most economies. This is positive for Chinese companies, but also benefits companies around the world that sell into this large and growing economy. One market where we are cautious is India. The execution of reform in India is difficult and we are waiting for more tangible signs of progress.

We expect interest rates will drift back slowly to a more normal range of 3% on the 10 year Treasury. Municipal bonds continue to be in short supply, which will help to dampen the effects of an interest rate increase in that market. Although the Fed has indicated it will not raise rates anytime soon, a stronger than expected economy would accelerate a move to policy tightening.