equity market review & outlook

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second quarter 2014

STOCKS CONTINUED TO MARCH HIGHER IN THE QUARTER AND FIRST HALF

Stocks continued to move higher with few interruptions in the second quarter as the S&P 500® Index generated a return of 5.23%. The broader Russell 1000® Index produced a similar return, and Russell's large cap growth and value indices performed almost identically. Mid cap stocks also performed well with a return of 4.97%. Small cap stocks lagged somewhat for the quarter and year to date as they experienced a meaningful correction of about 10% in the March – May time frame. Large cap stocks pulled back just modestly and resumed their string of record highs in late May. Encouragingly, small cap stocks did reach a new record in early July. The US has been well ahead of Europe and Japan in terms of economic recovery and growth. As a result, US company earnings are not only growing faster than other parts of the world, but domestic companies have also been able to return capital to shareholders in the form of stock repurchases and dividends. This capital return story continues to be a critical factor supporting the case for equities in this time of low yields on many classes of fixed income securities.

KEY TAKEAWAYS

- Global equities continued to move higher in the second quarter including good performance from emerging market equities. US small cap stocks lagged somewhat but still posted modest gains.
- Equity markets do not appear troubled by the Fed continuing to taper its QE program. While interest rates are expected to move higher in the quarters ahead, we do not see this as a major headwind to equity market prospects.
- We see signs of stronger economic growth around the world, the poor first quarter US GDP report notwithstanding. Anticipate more records ahead supported by continuing growth in earnings, dividends and a resurgence of merger and acquisition activity.

Global equities are performing respectably in 2014, although major global indices have been moderate underperformers over the past few years. For the second quarter, European equities, as measured by the MSCI Europe Index in US dollar terms, returned 3.65% and nearly 6% year to date. While some smaller European equity markets posted stronger returns, the largest representatives of the MSCI Europe Index were less buoyant. European equities are beginning to discount a potentially improving set of conditions

MAJOR INDICES POSTED GAINS ACROSS THE BOARD AND SHOW STRONG DOUBLE-DIGIT ONE-YEAR RETURNS

INDEX TOTAL RETURNS

	Second Quarter 2014	YTD 2014	1 Year	3 Year	5 Year	10 Year
S&P 500®	5.23%	7.14%	24.61%	16.58%	18.83%	7.78%
Russell 1000®	5.12	7.27	25.35	16.63	19.25	8.19
Growth	5.13	6.31	26.92	16.26	19.24	8.20
Value	5.10	8.28	23.81	16.92	19.23	8.03
Russell Midcap®	4.97	8.67	26.85	16.09	22.07	10.43
Growth	4.37	6.51	26.04	14.54	21.16	9.83
Value	5.62	11.14	27.76	17.56	22.97	10.66
Russell 2000®	2.05	3.19	23.64	14.57	20.21	8.70
Growth	1.72	2.22	24.73	14.49	20.50	9.04
Value	2.38	4.20	22.54	14.65	19.88	8.24
MSCI All Country World	5.23	6.50	23.58	10.85	14.88	8.02
MSCI Emerging Markets	6.71	6.32	14.68	(0.06)	9.58	12.30
MSCI Europe	3.65	5.95	29.95	9.33	13.71	8.15
MSCI Pacific	5.81	3.26	13.33	7.28	9.75	6.03

Source: FactSet, data as of June 30, 2014. All returns quoted in USD. Performance for three year, five year and ten year time periods are annualized.

due in part to increasingly proactive policy actions from the European Central Bank. The MSCI Pacific Index's quarterly gain of almost 6% reflected a strong bounce back in Japanese equities after a few months of weaker performance, although it remains a bit of a laggard year to date. The Japan stock market has been somewhat range bound following strong gains in the first half of 2013. Both current earnings growth and relative valuations of Japanese equities are important positives in their medium term outlook.

Coming out of a decline earlier this year, emerging market equities posted a good quarter, although stocks are still about flat over the past three years. This creates a potential long-term opportunity as this volatile asset class has a history of strong returns after periods of mixed results. Recently, energy and industrial commodities have been somewhat firmer, so the commodity-heavy MSCI Emerging Markets Index has benefited from this firming trend. China remains the largest fundamental weighting in emerging market equities; we continue to see signs that China's growth may be stabilizing at somewhat lower levels. Copper prices, one of the most frequently cited indicators of emerging market health in Asia, have stabilized above the $3.00 per pound level, a sign of greater demand and considered by many to be a useful economic indicator.

Taken as a whole, we see signs of stronger economic growth around the world for perhaps the first time since the financial crisis. Although US GDP data for the first quarter was negative, more recent economic data appears constructive, especially the consistent improvement in employment conditions in the US. While Europe has a long road ahead to resume a growth trajectory, low interest rates evident throughout the continent are one important factor in rebuilding consumer and business confidence over the medium term. As such, we believe that the current bull market in global equities may be around for awhile.

ENERGY & UTILITIES PERFORMED WELL, CONSUMER DISCRETIONARY LAGGED

Sector performance followed the quarter's major narratives to a considerable degree. Long-term interest rates continued to surprise on the downside, making dividend income more appealing. Large cap energy stocks tend to have relatively strong dividend yields, and utilities can be a sector for reliable dividend income. Tensions in the Middle East once again caused oil prices to firm, which also helped support other commodity prices. The attendant demand for energy from a strengthening global economy is another fundamental support for the energy sector.

On the other hand, firmer energy prices are often a precursor of higher gasoline prices, a potential drag

ENERGY AND TECHNOLOGY WERE STRONG QUARTERLY PERFORMERS AND UTILITIES BUILT ON FIRST QUARTER GAINS

SECTOR PERFORMANCE ATTRIBUTION

	S&P 500® Index					Russell 2000® Index			
	Q2 2014*	YTD 2014	3 Year	5 Year		Q2 2014*	YTD 2014	3 Year	5 Year
Energy	12.10%	13.03%	11.59%	16.74%	Energy	11.34%	16.75%	6.68%	19.82%
Utilities	7.77	18.54	14.34	14.40	Utilities	8.90	14.76	15.17	17.23
Info Tech	6.48	9.09	16.66	18.39	Materials	1.92	2.73	9.18	22.36
Materials	5.60	8.62	10.98	17.64	Info Tech	1.91	2.37	11.85	20.07
Consumer Staples	4.65	5.18	15.76	17.44	Financials	1.71	3.10	15.86	17.89
Healthcare	4.51	10.60	22.12	20.57	Consumer Disc	1.21	(2.01)	16.03	23.30
Industrials	3.85	4.00	15.63	21.95	Healthcare	0.98	4.77	18.78	21.03
Telecom	3.78	3.84	10.97	14.58	Consumer Staples	0.86	2.83	17.36	21.06
Consumer Disc	3.50	0.60	20.37	25.72	Industrials	0.04	0.85	16.00	20.97
Financials	2.30	5.03	16.28	15.71	Telecom	(3.08)	(0.16)	5.21	12.20
Total Return	5.23	7.14	16.58	18.83	Total Return	2.05	3.19	14.57	20.21

Source: FactSet, data as of June 30, 2014. Performance for three year and five year time periods are annualized.
**Sorted by S&P 500 or Russell 2000 quarter returns.*

on the consumer wallet. Consumer discretionary shares have lagged for both the quarter and year to date. Several retail stocks missed or lowered forecasts for revenue, earnings or both. While consumer discretionary remains the top-performing sector over the past five years, recent fundamental performance has been notably weaker. Commodity, dividend-oriented, and large cap technology stocks (many of which have healthy dividends, large buybacks, or both) have assumed leadership. The financial sector has also been a modest underperformer this year as expectations of higher interest rates, with an associated positive implication for financial company revenues, has not yet come to pass. In a somewhat uncommon circumstance, sector attribution within the Russell 2000® Index is fairly similar to that of the large cap stocks this quarter.

WHAT DO WE EXPECT IN THE SECOND HALF?

The Federal Reserve (the Fed) has continued to taper its quantitative easing (QE) program, and equity markets do not appear the least bit troubled so far. Signals clearly point to the Fed beginning to raise the Federal funds rate sometime in 2015, although exact timing remains uncertain. In our opinion, the cost of equity capital is attractive today, and a moderate increase in interest rates associated with a growing economy would not negatively impact the global equity outlook. An unexpected surge in inflation, which could bring about a more aggressive Fed policy than currently anticipated, may have a negative impact. We believe interest rates will likely remain within a band that allows businesses to function smoothly and should not be a major fundamental challenge for stocks in the medium term.

This bull market is supported by several important fundamental factors beyond earnings growth and low interest rates. In recent quarters, the dividend yield on the S&P 500 has remained around the 2% level more often than not, with both dividends and stock prices rising. Dividends are on track to grow more than 10% this year, continuing the trend of double digit annual dividend growth since 2011. Well over 400 of the S&P 500 companies now pay cash dividends, the highest number in years. Share repurchases, combined with dividends, also reached a record level in the first quarter. The dividend growth story should continue to build as the economic expansion continues. We expect there will be more records ahead as business conditions remain healthy with low inflation and increasing dividends adding to the relative appeal of the equity market.

Merger and acquisition (M&A) activity worldwide is surging, another sign of increasing CEO confidence. According to Bloomberg, announced M&A activity is up more than 75% in the first half of 2014 compared to last year, with a notional transaction value of $2.2 trillion. Of course, not every proposed transaction will be completed. But the fact that so many CEOs are talking to other CEOs (and actually making deals) is a relatively new feature of this cycle, typically indicative of greater confidence in the global business outlook. Certainly, it is much easier to get transactions done with low interest rates and with stock prices at or near cycle highs. Investors are embracing this development as we have seen several cases where both the target and acquirer shares rise upon an announced transaction. When the buyer is rewarded by investors for making a deal, we can likely expect more deals to come. This self-reinforcing process benefits stakeholders across the board. The trend can continue for quite some time as long as transactions make good fundamental and strategic sense without signs of overreaching.

Investors have recognized this favorable investment backdrop, and valuation expansion has been significant. The S&P 500 traded around 12x-14x forward earnings during much of 2010 through 2013. Today, with the S&P 500 setting frequent record highs, large cap stocks are valued between 15.5x and 16x consensus estimates for 2015. Most of this multiple expansion occurred in 2013. As second quarter earnings season approaches, it is important that we see some acceleration in earnings growth from the first quarter's weather-impaired results. It is encouraging that analyst earnings revisions have been relatively stable in the past several weeks (compared to the typical moderately negative trend). As we head into the summer reporting season, negative preannouncements have been somewhat lighter than in recent quarters. We continue to expect mid-to-high single-digit operating earnings growth this year compared to 2013. A similar gain is possible in 2015 if the economy continues to track in line with the slow but steady recovery path witnessed in recent years.

Considering the exceptional gains of 2013, year-to-date results have been a pleasant surprise. If earnings pick up in the second half, as we anticipate, stocks will likely be able to grow into current valuations and build on gains in the quarters ahead. While valuations are high compared to recent years, we do not believe they are excessive. Valuations are supported by double-digit dividend growth, strong share repurchase activity and a pick-up in M&A activity. Certainly it is possible for price-to-earnings multiples to expand from here as they did in the late 1990s; however, we prefer a slower and steadier advance to a rapid and potentially unsustainable one. Were stock valuations to broadly accelerate, the risk of a significant 10% or greater correction could come to pass later this year or in 2015. Combining the plusses and the minuses, we come down firmly on the constructive side of the ledger and hold the opinion that moderate stock price corrections should create selective buying opportunities, as they have during the better part of the past five years.

INDEX DEFINITIONS

Russell 1000® Index *measures the performance of the large cap segment of the US equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.*

Russell 2000® Index *measures the performance of the small cap segment of the US equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

Russell 1000® Growth Index *measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.*

Russell 2000® Growth Index *measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.*

Russell 1000® Value Index *measures the performance of the large cap value segment of the US equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.*

Russell 2000® Value Index *measures the performance of small cap value segment of the US equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.*

Russell Midcap® Index *measures the performance of the mid cap segment of the US equity universe. The Russell Midcap is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.*

Russell Midcap® Growth Index *measures the performance of the mid cap growth segment of the US equity universe. It includes those Russell Midcap Index companies with higher price-to-book ratios and higher forecasted growth values.*

Russell Midcap® Value Index *measures the performance of the mid cap value segment of the US equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.*

Standard & Poor's (S&P 500®) Index *is a market capitalization-weighted Index of 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance.*

MSCI World Index *is an unmanaged index measuring global developed market equity performance.*

MSCI Emerging Markets Index *is a free float-adjusted market cap index measuring equity market performance of emerging markets.*

MSCI All Country World *is a market cap weighted index of stocks from developed and emerging markets providing a broad measure of global equity-market performance.*

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