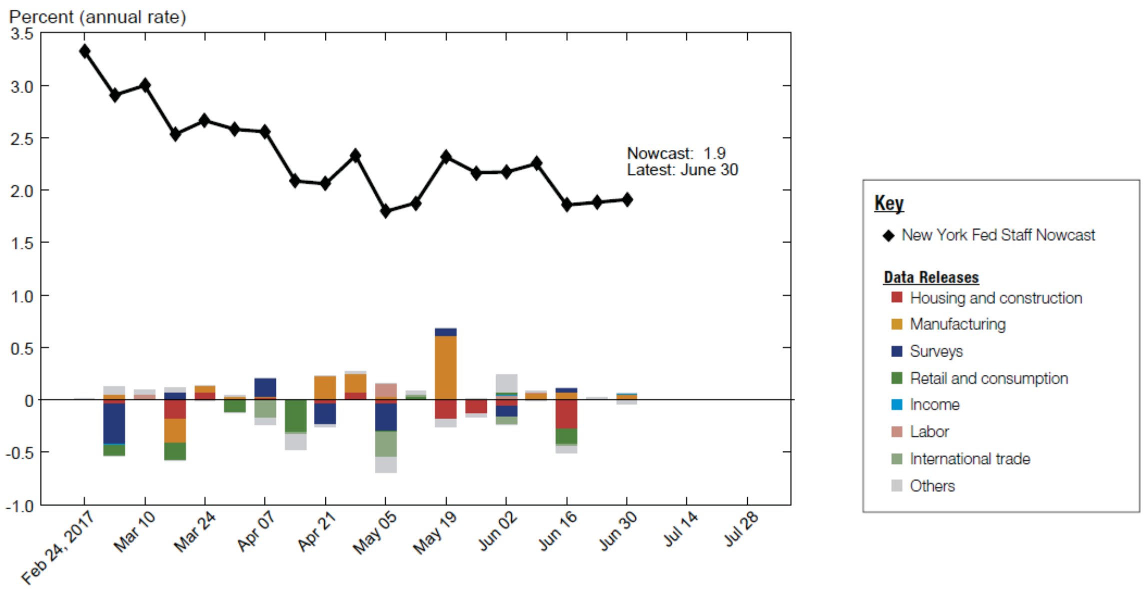
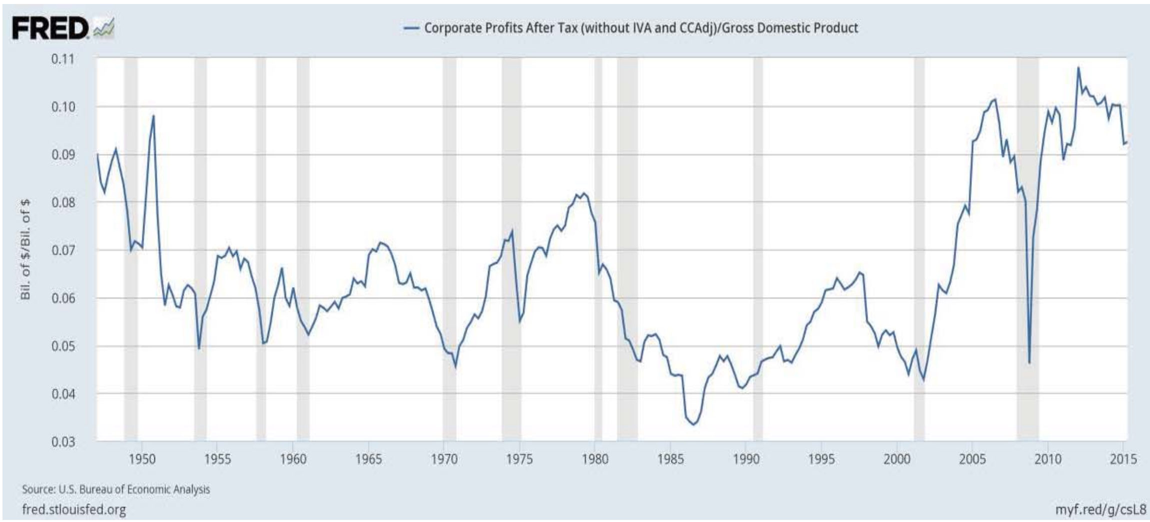
INVESTMENT STRATEGY THEMES

<u>The trend in U.S. Economic growth will average close to 2%.</u> After a weak 1.4% in the first quarter, second quarter growth will be between 1.9% and 2.7%, based on "nowcasting" estimates. The structural reasons for slow growth include an aging population, low labor force growth, high debt levels, and the trade deficit. Despite a low unemployment rate, wage gains and spending increases have been modest.

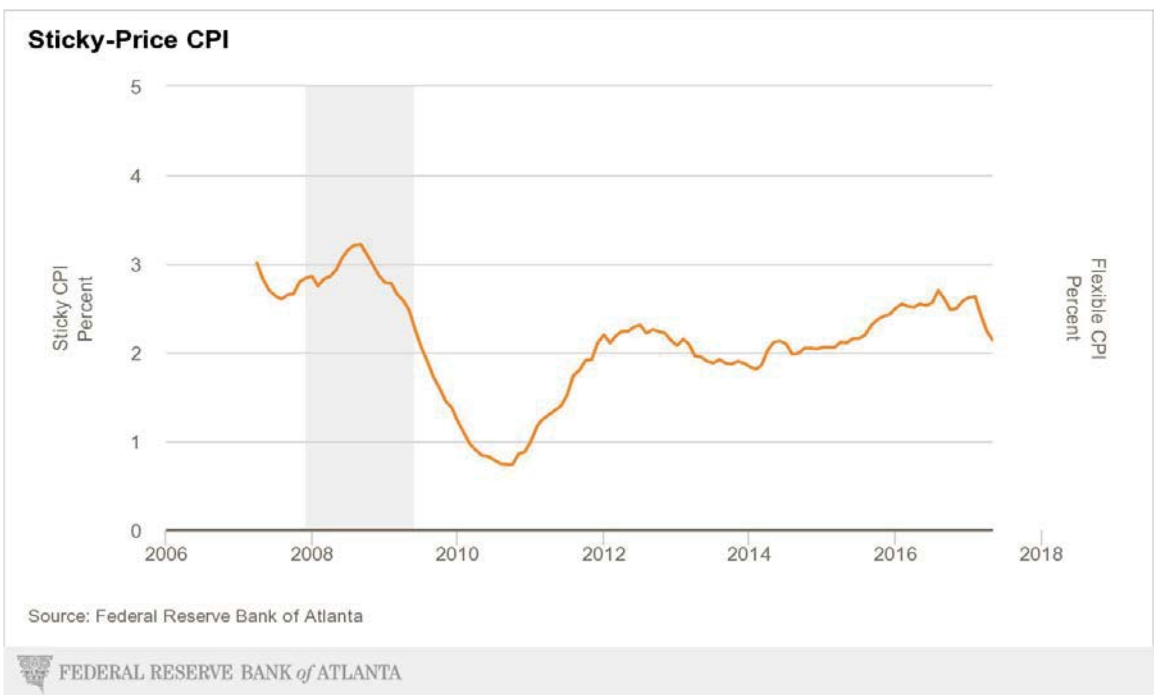


<u>Commodity prices have stabilized but could be range bound for an extended period of time.</u> Continuing growth in U.S. production and persistently high inventories have sent oil prices back down into the low $40 range. Furthermore, the potential for new sources of oil and gas, especially from shale, not only within the US but also globally, suggest long-term supply pressures as these technologies are replicated. Therefore, energy prices will be range bound for some years to come.

Profit margins are historically high (as illustrated below). Margins have expanded because costs, particularly the cost of labor, have been held down, while sales prices have increased. Presently, profit margins are at risk with wage inflation picking up, tepid inflation limiting revenue growth, and globalization under attack.



Inflation remains low. Although labor prices have picked up to 2.5% on a year over year basis, retail prices have been weak, while producer price increases have been modest. Structural factors that have kept economic growth weak have also kept inflation low.

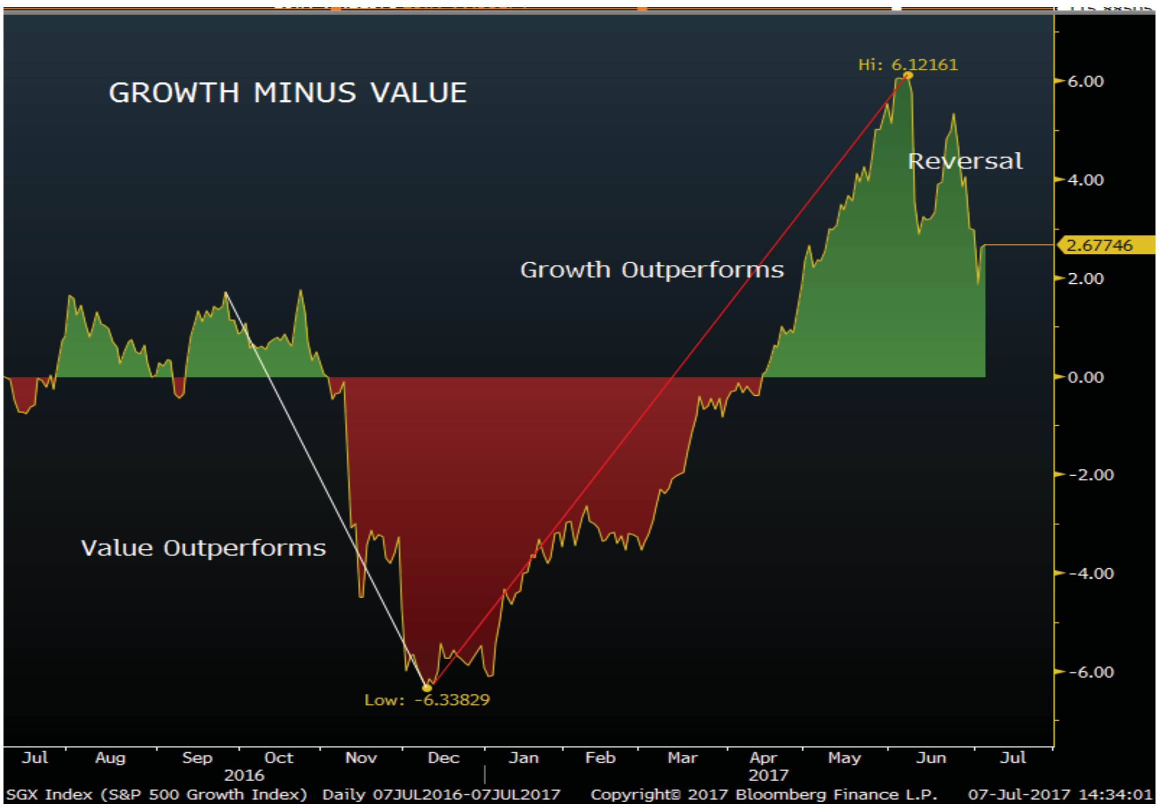


Out-performance of U.S. stocks over international stocks, which occurs over long cycles, appears to be peaking. As we have noted previously, the length and extent of the current cycle is comparable to past cycles. Past style reversals have begun near market peaks. Finally, valuations of foreign stocks are more attractive than U.S. stock market valuations. As expected, the US Dollar has pulled back relative to other currencies, which has boosted the returns for foreign investments.

Stock and bond valuations are high, implying low prospective returns. Stock market valuations remain high as prices continued to make gains. Thus, current valuations in the stock market imply that returns over an extended period will be in the low single digits. The 10 year government bond yield is near 2.3%, implying a break-even return over a 5 year horizon, based on the last 60 years of bond yields.

Fund flows are driving returns. For the last several years, new investments have overwhelmingly favored exchange traded funds (ETFs) that invest in broad capitalization weighted indices. With a capitalization weighted index, bigger companies are weighted more heavily. For example, in the S&P 500 11.4% of every dollar invested goes into the top 5 companies, while less than 0.1% goes into the bottom 5 companies. Thus, investors keep buying the most highly valued stocks. And investors have been liquidating actively managed funds that tend to invest in smaller, better valued stocks, which accentuate the effect. This pattern parallels prior booms where investors indiscriminately buy whatever is doing well at the time.

Value stocks have corrected relative to growth stocks. Value stocks led the market before the election and then rapidly advanced after the election. However, many of the election themes fizzled when Washington realities set in. Since early June, growth stocks have under-performed value stocks, reversing the trend since the beginning of the year. The shift into value stocks not only reflects better valuations but also under-owned stock groups such as financials.



Our Stock Market Dashboard Indicates Positive Market Trends. While stock valuations are flashing a warning sign, other market indicators are neutral or positive, as shown below. Therefore, our overall market gauge remains positive (3.4 out of 5.0). Corporate earnings have been recovering from an earnings recession, market momentum is strong, there is ample liquidity in the markets, and investor sentiment is currently neutral. Next quarter, we will provide more details on the data underlying these gauges, as well as the historical trends and predictive nature of the data.