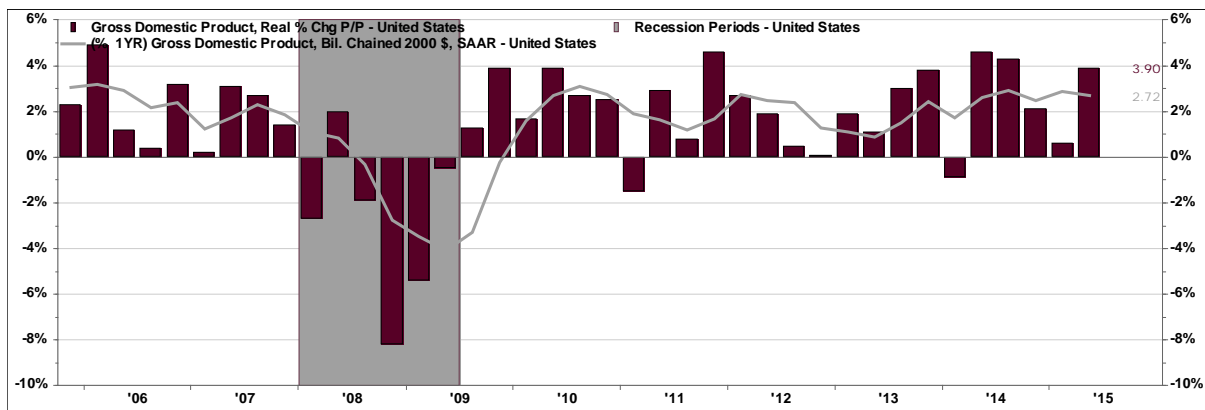


October 2015

THE ECONOMY

After very tepid growth of 0.60% in the first quarter of this year due to harsh winter weather, the U.S. economy bounced back and grew at a 3.9% annual rate in second quarter of 2015. GDP growth was broad-based as most components had solid gains. The Federal Reserve estimates the economy grew 2.3% in the first half of the year. So far, reported third quarter economic data reflects overall underlying trends remaining positive but tempered by dollar strength and a very weak energy sector.



Consumer spending, which makes up two-thirds of the U.S. economy, rose during the quarter. Retail sales as well as personal consumption expenditures rose for the quarter. Auto sales have done particularly well recently and came in at an 18.1 million unit annualized pace in September, a level not seen since July 2005. Job growth, lower oil prices, attractive consumer loan rates, housing price gains, and increased confidence should bode well for near-term consumer and household spending.

The U.S. housing market continued to trend upward last quarter. According to the Federal Housing Finance Agency, home prices gained 1.2% in the second quarter of this year and are up 5.4% from a year ago. This is the sixteenth consecutive quarter of price increases. Existing homes sales have been greater than five million units for the past six months and have had eleven months of year-over-year growth. Tight inventory levels have impacted new and existing home sales. The National Association of Home Builders expects “housing to keep moving forward at a steady, modest rate through the end of the year.”

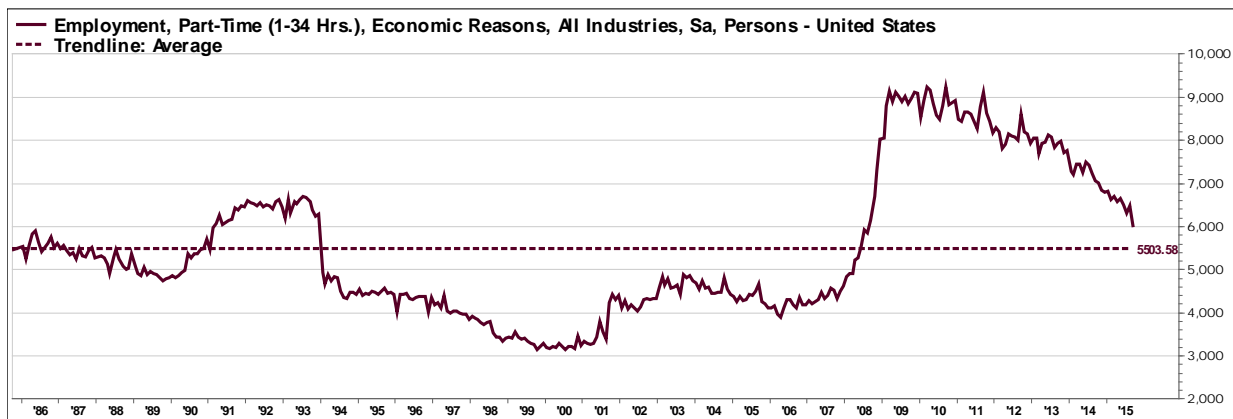
Survey indicators were mostly positive and suggest modest economic growth near-term. The Conference Board Consumer Confidence Index rose in September to 103, which is 13.6 points higher than the September 2014 reading of 89.4. The National Federation of Independent Business Small Business Optimism Index rose in August to 95.9, but still remains below the historical average of 98.0. The chief concerns for small business remain taxes and regulations. The Institute for Supply Management (ISM) Manufacturing survey posted a measure of 50.2 for September, which is the lowest reading since May of 2013. Survey respondents said the strong

October 2015

dollar is negatively impacting export sales and also noted weakness in the Chinese economy, but domestic business remains steady. In August, the ISM Non-Manufacturing (Services) survey grew for the 67th consecutive month with a reading of 59.0. A broad base of survey respondents note positive business and sales trends. For the ISM surveys, readings above 50 are considered expansionary and below 50 contractionary. Finally, the Conference Board Leading Economic Index (LEI) rose in August to 123.7, 4.4% higher than the August 2014 level of 118.5%.

Employment measures during the quarter point to an overall steady labor market. In September, the unemployment rate stood at 5.1%, which is the lowest rate of unemployment since March 2008, and monthly job gains have been positive since October of 2010. Job gains are likely to continue near-term as initial unemployment claims remain subdued. According to the U.S. Labor Department's JOLT report, job postings hit an all-time high of 5.8 million in July. Many employers are finding it difficult to find qualified workers, while others are having difficulty just filling their open positions.

Despite much improvement, the labor market is one of the more perplexing and interesting areas of economic study due to prolonged cyclical and structural issues and their effect on maximum employment. Cyclical labor issues are normally considered transitory and wax and wane with the economy, while structural labor issues are typically considered a prolonged or permanent change, regardless of the economy cycle. Sometimes cyclical issues can evolve into structural ones. The Great Recession elevated several employment measures to historic highs in 2009 and 2010, and because these measures remained well above historical averages for extended durations, some economists began to postulate these measures may no longer be cyclical, but structural issues.

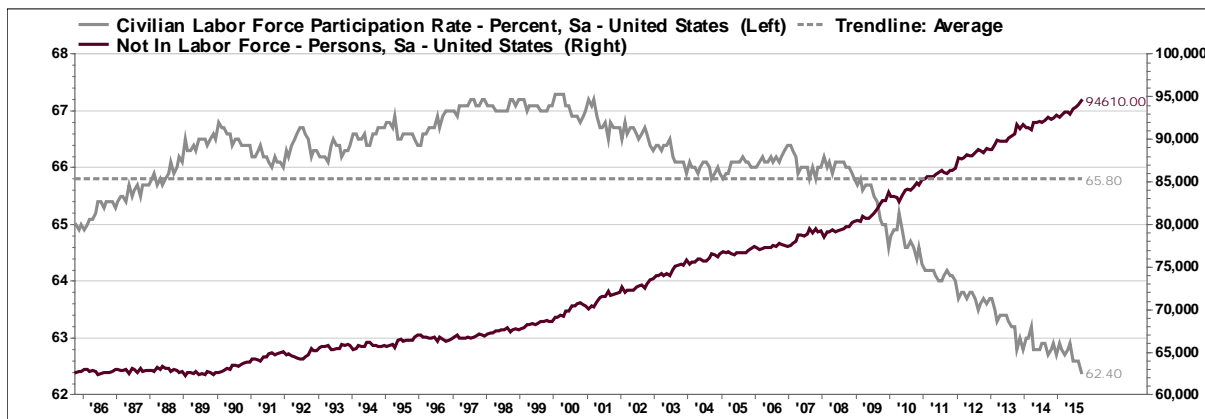


More specifically, two cyclical labor issues include the level of involuntary part-time workers due to economic reasons (they want to work full-time) and the number of people unemployed greater than 27 weeks (they want to work, period). The number of involuntary part-time workers peaked at 9.2 million in September 2009 and presently stands at 6.0 million, remaining above its 30-year average of 5.5 million. People unemployed greater than 27 weeks peaked at 6.8

October 2015

million in April 2010 and now stands at 2.1 million, which is slightly above its 30-year average of 2.0 million. Another measure, the underemployment rate (or U-6), which adds involuntary part-time workers and active job seekers to the unemployment rate, peaked at 17.1% in October 2009, and has since fallen to 10.0% in September, which is below its 30-year average of 10.7%.

One primary structural issue, which has not improved, is the labor force participation rate (LPR). As of September, LPR was 62.4%, a level not seen since October 1977. According to the Bureau of Labor Statistics, for a civilian labor population of 251.3 million, a total of 156.7 million are considered in the labor force and 94.6 million are considered not in the labor force. The 30-year LPR average is 65.8%. If the LPR rate were to move to the historical average, that would equate roughly to an additional 8.5 million workers in the labor force. From the early 1960s to late 1980s, the labor participation rate rose from 59% to 67% due to women and baby boomers entering the labor force. The recent decline in the LPR is largely attributable to an aging demographic, i.e., the retirement of the baby boomers. Fiscal policy likely plays a significant role as well.



As detailed above, while some weakness remains, cyclical labor issues have improved significantly over the past few years, although structural issues such as the LPR have not. These are some of the reasons the Fed has held off on raising the short-term target rate.

THE FEDERAL RESERVE

The Federal Reserve's last tightening phase began in June 2004, over eleven years ago. At that time, the target rate was at 1.00% and, over the course of the next two years, the Fed raised the target rate seventeen times, in quarter-point increments, to settle at 5.25% in June 2006. Unbeknownst to the Fed, their aggressive moves set the stage for the largest financial and economic collapse since the Great Depression.

October 2015

In response to the 2008 financial crisis, the Fed aggressively lowered the target rate down to 0.25% in December 2008, where it still stands. This monetary policy action, along with quantitative easing programs, was taken to stimulate consumer spending, business borrowing and capital investment in order to boost overall economic growth, and it has worked.

It has been almost seven years since the Fed last moved. Since 1970, the longest period between target rate actions had been eighteen months and the average target rate was 5.50%. As always with monetary policy decisions, there is the tug of war between perceived strengths and weaknesses and their potential effect on the economy. There will always be some reason not to increase interest rates. To say the Fed is cautious is an understatement, and even when they do finally raise the target rate, they have stated that any subsequent rate hikes will be at a measured pace. Do they mean in another three years?

In our opinion, the Fed needs to show some conviction in the strength of the U.S. economy and raise rates. The markets and the economy can handle it.

CAPITAL MARKETS

In the third quarter of 2015, the scale of risk tolerance tilted in favor of risk aversion as stock markets experienced their first correction in four years. Several headline events increased investor uncertainty, elevating stock market volatility and driving treasury yields lower.

For the first half of the year, the stock market was in a tight trading range and market participants were expecting some sort of directional catalyst to break the range gridlock. The renewed Greek saga had some effect on market volatility, but the real catalyst came with the surprise devaluations of the Chinese yuan in August. While Chinese officials claimed it was in response to recent dollar gains, investors thought otherwise, concluding it was in response to weakening economic conditions, and sent the market sharply lower. Material, energy, and mining related industries were hit particularly hard.

Subsequent to China growth concerns, the never ending question of the timing of Fed liftoff for the target rate and policy normalization took center stage with the September 17 Federal Open Market Committee (FOMC) monetary policy meeting. The primary focus that week was whether or not the FOMC was going to raise the target rate, which they did not. Prior to the 17th that week, the stock market staged a nice rally and bond yields rose significantly, as evidenced by the 10-year treasury rising from 2.10% to 2.30%. It appeared as though markets were expecting a rate increase. On Thursday, the Fed announced rates would remain unchanged, bonds rallied and the stock market came under renewed pressure, evident with the increase in market volatility. The VIX, which measures expected near-term volatility, rose 18.4% to 22.28 from 18.81. Much investor attention and scrutiny has been given to the Fed's recent decision and keeping rates unchanged leaves the dark cloud of uncertainty as to the timing and pace policy normalization, and will likely keep volatility levels elevated near-term.

October 2015

These were the main events that led the S&P 500 to its worst quarterly performance since 2011 and drove up investment grade bond returns.

Index Total Returns as of September 30, 2015

<i>Index</i>	<i>3-Month</i>	<i>Year-to Date</i>	<i>1-Year</i>	<i>3-Year</i>	<i>5-Year</i>
Barclays Municipal	1.65%	1.77%	3.16%	2.88%	4.14%
Barclays Aggregate	1.23%	1.13%	2.94%	1.71%	3.10%
Barclay Int. Gov't/Credit	0.95%	1.77%	2.68%	1.45%	2.42%
Barclays High Yield	-4.86%	-2.45%	-3.43%	3.51%	6.15%
S&P 500	-6.44%	-5.29%	-0.61%	12.40%	13.34%
Dow Jones	-6.98%	-6.95%	-2.11%	9.26%	11.38%
NASDAQ	-7.09%	-1.61%	4.00%	15.48%	15.66%
S&P 400	-8.50%	-4.66%	1.40%	13.12%	12.93%
MSCI EAFE	-10.23%	-5.28%	-8.66%	5.63%	3.98%
Russell 2000	-11.92%	-7.73%	1.25%	11.02%	11.73%

Sources: FactSet, Federal Reserve, U.S. Department of Labor