

2014 Fourth Quarter Update and 2015 Outlook

Review: Stocks finished the year strongly, up 4.9% in the quarter and 13.7% for the year. The U.S. economic recovery continued to gain momentum, aided by falling energy prices. Bonds also had a good quarter, rising 1.8%, as global investors looked upon the U.S. as a safe haven. International equity markets had a poor quarter as economic growth prospects for both Europe and emerging markets faded.

Period	4Q14	3Q14	2014	2013
S&P 500	4.9%	1.1%	13.7%	32.4%
EAFE*	-3.6%	-5.9%	-3.6%	22.8%
Emerging Markets	-4.5%	-3.5%	-4.5%	-2.6%
Barclays U.S. Aggregate Bond	1.8%	0.2%	6.0%	-2.0%

* Europe, Australia, Far East

Domestic Economy: The economy continued to improve. GDP in the third quarter (the most recent number available) accelerated to 5.0%, up from the already healthy 4.6% rate of the second quarter. The job market showed persistent strength, adding 252,000 to payrolls in December. Energy prices have declined sharply, increasing consumers' purchasing power and boosting corporate profits. There are some areas of concern: While the job market has improved, wages have been stagnant for five years. Rising wages are a key factor in building consumer confidence. We expect wages to begin to improve in the coming months as competition for workers grows. The housing market recovery has been subdued as mortgage requirements are more stringent than before the financial crisis. If the job market tightens and wages begin to rise, housing is likely to improve because more buyers will become creditworthy.

Looking ahead, we expect the economy, boosted by higher employment and lower energy prices, to continue on the path of moderate growth. Our early estimate for GDP growth in 2015 is about 3.0%, a healthy but sustainable rate.

International Economies: The concern we expressed last quarter about the economic trends in both developed and developing economies proved to be justified. In Europe, the ECB has held back on supplying needed stimulus for political reasons. As a result, the economies are



stagnating. Emerging economies are burdened by the excesses of the boom years, notably in real estate and infrastructure spending. The adjustment process may take several years. International investments are therefore less appealing.

In fact, international economies are our most significant concern. In our interdependent world, we will need to have at least stabilization, if not a return to economic growth, of our major trading partners to continue our current growth trends. A mitigating factor is that in the past year, the dollar has risen by about 15% against the euro and yen. Exports from Europe and Japan have become more attractive, thus aiding their recoveries.

Strategy: Despite the strong performance of the past two years, we believe that equity investments, particularly in the U.S., will be among the best-performing asset classes over the next year. We do not expect returns to match recent years because valuations have risen and are no longer at depressed levels and earnings gains will be more moderate. However, the recovery appears to be durable, inflation remains benign, and there is little sign of economic or financial excesses that could cause the cycle to end. These factors provide a favorable environment for equities. We expect bonds to lag as the Fed begins to increase interest rates by mid-year and the improving economy lessens demand for U. S. Treasury securities by investors seeking safety.

Our positive economic forecast leads us to believe that consumer stocks will be good performers. If the consumer sector strengthens, resulting in higher business profits, we expect increased capital spending by corporations, particularly on technology. Healthcare stocks should benefit from a high level of innovation and the increasing need for healthcare as the population ages.