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STATEMENT OF INVESTMENT POLICY

Not surprisingly, the US economy grew at a subpar 1.4% rate in the first half of this year as restrictive tax and government spending policies created a significant drag on the gradually improving private sector. Undoubtedly, the lack of leadership in Washington, the growing web of business-depressing regulation and new taxes contributed to the malaise. Now, recently released coincident and forward–looking economic data show the pace of business activity has quickened a bit and that we may be entering the long-awaited acceleration phase of the recovery which began in mid 2009. For example:

- Both the August manufacturing and non-manufacturing Institute for Supply Management (ISM) indices are at or near their post-recession highs.
- Weekly jobless claims for the last several weeks have shown further declines with the four week average now at a post-recession low.
- Business activity abroad is improving. The euro zone has emerged from recession. Japan’s new fiscal and monetary policies are bearing fruit, and China’s economy appears to have stabilized with 2013 GDP growth expected to be above 7.5%. The possibility of an eventual synchronous global expansion has increased.
- Broader measures of spending and confidence suggest consumers were unfazed by early 2013 obstacles such as higher taxes and gas prices, and federal budget cuts due to the sequester.
- US auto sales and service-sector activity continued to strengthen in August with auto sales exceeding a 16 million annualized pace for the first time in five years, surpassing their pre-recession levels.

Meanwhile, the jobs market, while steady, has failed to meaningfully accelerate over the past two years. Labor Department figures showed 169,000 jobs were

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added last month. But beneath this number, there is evidence employment growth remains tepid - - stuck in second gear. The government revised down its estimates for June and July hiring by a total of 74,000 jobs and a disproportionate share of the jobs being added are in low paying sectors such as restaurants and retail. At the recent pace of hiring, the economy will not get back to pre-recession levels of employment, adjusting for population growth, for more than eight years.

OUTLOOK

Despite the weak jobs report, we continue to believe the economy is on a firmer footing than it was six months ago. Continued declines in weekly jobless claims, prospects of sustained growth in home construction and auto sales, and reduced uncertainty portend better growth. Second half GDP is likely to exceed 2.0% as the private sector will continue to advance at about a 3.0% rate led by housing, auto sales and exports, and as the dampening effect of restrictive fiscal policies runs off.

Beyond year-end, we expect business activity to continue to improve gradually with housing set to continue its expansion, firms beginning to spend more of their cash hoards, and consumers dipping further into savings to make purchases they had previously postponed. The combination of these trends should result in GDP growth of about 3.0% next year. Indeed, our firm's proprietary Economic Model, as well as the Leading Economic Indicators (LEI), continue to signal expansion ahead.

Clearly, the recent tightening in financial conditions, particularly in the mortgage market, presents a risk to growth. Already, we have seen a sharp slowdown in mortgage refinancing due to higher interest rates. However, with inflation stubbornly below the Fed's 2.0% target and unemployment still unacceptably high, the Fed is unlikely to deviate from its highly accommodative monetary policy any time soon as improving residential construction, dependent upon low and predictable interest rates, remains an important underpinning to the recovery. Despite the rise in mortgage rates, with borrowing costs still low by historical standards and affordability high, surveys indicate prospective buyers see current rates as a good reason to buy.

THE FED

Following five years of unconventional measures and policies aimed at supporting the economy, first through a severe financial crisis and more recently during a sluggish recovery, Federal Reserve officials in late May signaled that, depending upon data to be released this summer and fall, they may begin to scale back their $85 billion-per-month bond-buying program later this year and conclude it by mid-2014. However, scaling back the bond-buying does not imply the Fed believes the economy has reached "escape velocity" where it is able to expand completely on its own. Fed officials, hoping to clarify their intentions, have repeatedly stressed that reducing their bond purchases (referred to as QE) does not mean they intend to raise short term rates anytime soon. In fact, Fed members indicated at their June meeting they expect to implement the first interest rate hikes no earlier than 2015.

As to tapering their bond purchases, the Fed has made it clear that if the economy proceeds, as it expects, they will consider reducing their bond purchases when the unemployment rate, currently 7.3%, reaches 7.0%. The next unemployment rate marker is 6.5% at which point the Fed will consider raising short term rates. The 7.0% and 6.5% targets are not triggers but thresholds which will occasion a review of Fed policy. Further guidance from the Fed regarding tapering is expected following next week's FOMC meeting when many Fed watchers expect a tapering announcement coupled with strong assurances of a continuation of low rates for an extended period.

POLICY

Corporate profits, often referred to as the "mother's milk" of stock prices, have risen beyond their pre-recession peak. For 2013, we expect the S&P 500 companies to earn about $112 per share, rising to $120 in 2014. At its current level of about 1690, the S&P 500 is priced at 14.9 times 2013 earnings and 14.1 times earnings expected for next year - - well below the average valuation of 15.5 times earnings over the past 20 years. And, valuations of developed and emerging market equities at 11 and 9 times forward earnings are also attractive.

Open market indicators point to higher stock prices. Metrics such as the upward trend in stock prices, the steepening yield curve, falling gold and silver prices, and the resurgent Baltic Freight Index confirm the favorable outlook for equities.

Indeed, *asset class forecasts* suggest low double digit total annual returns for equities over the next two years compared with flat returns for government bonds and 2.0% for corporate bonds.

With corporate profits expected to continue to rise next year, inflation well-contained, and the lack of quality alternatives offering competitive returns, "animal spirits", of which we have frequently written, are stirring. Investors are turning their attention to companies able to deliver superior earnings and dividend growth and avoiding higher yielding equities which performed well earlier in this cycle. Portfolios under our supervision are overweighed stocks whose businesses are economically sensitive, including industrials, technology and financials. Client's equity portfolios remain fully invested despite the likelihood of corrections along the way.

The *supply and demand* situation for equities remains favorable. We expect individual and institutional investors who are under-committed to equities to raise their allocations over time providing an underpinning to share prices. Corporate share repurchases, merger and acquisition activity, purchases by foreigners seeking the perceived safety of the US dollar and the US financial markets, purchases by foreign central banks and sovereign wealth funds will also add to the demand for US equities lending credence to the view equities could become *scarce* as the bull market plays out.

As for investments abroad, which we are targeting at 15%+ of the overall equity portfolio, holdings remain tilted toward companies domiciled in the emerging markets where we believe valuations remain extremely attractive on both an absolute and relative basis.

FIXED INCOME

Finally, we remain in the early stages of a secular rise in interest rates and falling bond prices. Over time, rates will normalize with yields on 10 year US Treasury notes, now at 2.9%, returning to the 4.0% to 5.0%+ range. While there will inevitably be brief periods during which longer-term rates retreat, the risk of owning longer-dated securities at this time outweighs the possible short term rewards that may accrue during counter-rallies. Bond portfolios under our supervision are, therefore, structured with protection of principal as the overriding objective. Durations of clients' corporate and municipal bond portfolios remain at all-time lows approaching 1 year. The "great rotation" out of bonds is underway.

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