Focus on Areas of Strength

Selective market opportunities exist, even as the Federal Reserve embarks on raising interest rates and global growth is subdued.

Investors who have looked for a sustained trend in the quarterly U.S. GDP reports in recent years have been left frustrated. Quarterly GDP readings have fluctuated significantly over the past few years, including a 2.1% decline and a 5.0% increase in 2014. The start of 2015 looks like it will continue this pattern of inconsistent readings with the 0.2% decline in Q1 likely to be followed by 2.0% or better growth in Q2. Despite this year's continued swings in quarterly GDP, growth for the full year is likely to remain in an unimpressive 2.0% to 2.5% range.

Recent economic growth in the U.S. certainly has been sluggish, and the stock market's performance this year has been equally uninspiring. The S&P 500 Index was up just 0.28% in Q2 2015, and the Index returned 1.23% through the first half of the year. There were, however, some noteworthy divergences in performance by sector in Q2 despite the muted returns for the overall S&P 500. The Health Care Sector was the best performing sector last quarter on strong earnings results and the U.S. Supreme Court's decision to uphold insurance subsidies for lower income consumers utilizing the federally run insurance exchange. At the other end of the spectrum, the Utilities Sector was the worst performing sector in Q2 as investors anticipated higher interest rates. The Industrials Sector also underperformed as manufacturing-oriented businesses faced headwinds including a 4.4% year-over-year decline in U.S. exports.

The major stock market moves in Q2 came from outside the United States. Chinese A Shares, which are mainly owned by Chinese nationals, rose over 35% quarter-to-date through mid-June, but declined just over 17% in the last few weeks of the quarter. Chinese stocks still led global equity markets in Q2 as millions of individual investors opened brokerage accounts for the first time. Chinese stocks have continued to be volatile to start the third quarter. European stocks, which led global equity markets in Q1, fell in Q2 on continued soft economic data and a reemergence of concerns about Greece. Germany's DAX Index, for example, declined 8.53% last quarter.

Lackluster All Around

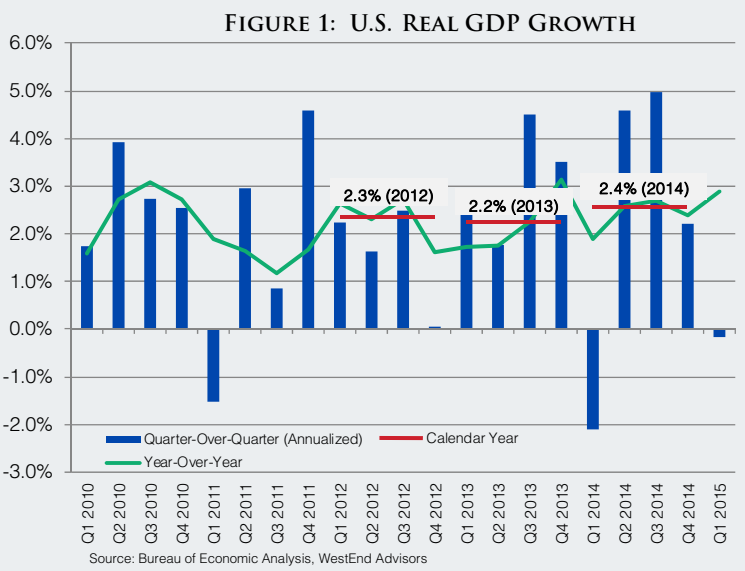
The global economic situation remains challenged, and the weakness in European stocks in Q2 in part reflected the lack of economic traction in that part of the world. European economic growth continues to be subdued, and Greece's move back into the headlines highlights the structural challenges in that region.

We have been concerned about these challenges for some time. Japan, like Europe, continues to deliver anemic economic growth and uncomfortably low inflation even after aggressive monetary policy action by the Bank of Japan. China remains the standout among the major economies in terms of absolute level of growth, but the pace of growth has decelerated, and risks there have grown.

U.S. economic growth, on the other hand, has been steadier and stronger on an *annual* basis compared to other major global economic powers. Annual GDP growth in the U.S. has been between 2.2% and 2.4% over the last three years, as illustrated in Figure 1, despite a wide range in quarterly GDP readings. We expect this steady, moderate annual growth will persist, and that outlook is one of the key reasons we see U.S. equities as attractive compared to overseas opportunities.

Cumulative Headway

There has been significant progress across the U.S. economy since the financial crisis, despite the unimpressive annual GDP growth rates. Q1 2015 real GDP was 8.6% above the previous peak in Q4 2007. Nominal personal income is up 21.7% from its May 2008 high. The unemployment rate has fallen 4.7 percentage points since October 2009 to 5.3% as of June, and the U.S. economy added 3.1 million jobs in 2014 alone.



The collective progress in the U.S. economy has set the table for the Federal Reserve (Fed) to raise short-term interest rates. We do not anticipate that short-term or long-term interest rates will move up sharply given Fed officials' concerns about the durability of the recovery, international risks and modest inflation readings. In fact, it is likely that the yield curve flattens as short-term interest rates increase faster than long-term rates.

Market prognosticators, nevertheless, have spent a great deal of time trying to predict the timing and the pace of interest rate hikes. In our view, the question of exactly when and how quickly rates will go up is less important than where the *areas of economic strength will be in the environment ahead.* Investors will ultimately seek out businesses that can deliver outsized earnings growth in an environment with rising interest rates and less-than-dynamic economic growth.

Areas of Strength

Health care spending should remain strong even as the Fed moves into a new phase of monetary policy. Health care spending has picked up in the U.S. in recent quarters. This acceleration was driven, in part, by the increased number of individuals covered by insurance due to both the Affordable Care Act and steady hiring. Real health care spending grew by 5.5% year-over-year as of Q1 2015. That was the strongest annual growth in over twelve years, as highlighted in Figure 2.

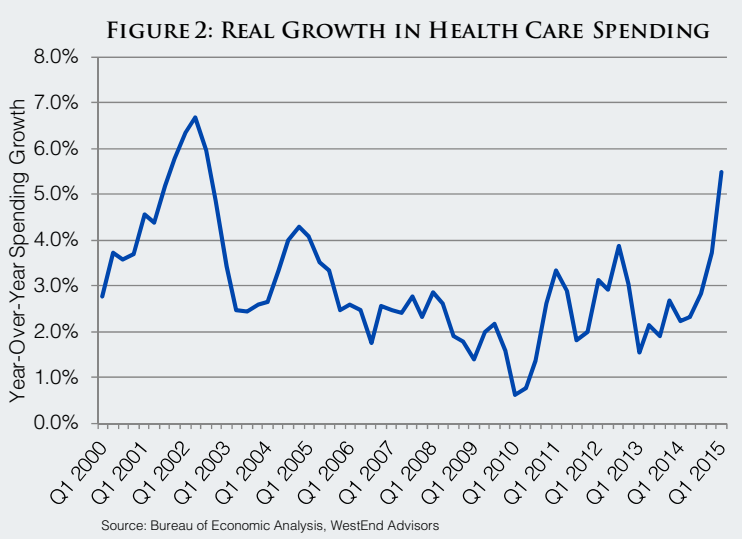
The number of insured individuals should continue to grow. The U.S. Supreme Court's decision in June to uphold insurance subsidies on the federally run insurance exchange will support that growth and also reduce the likelihood of further major legal challenges to the Federal government's expanded role in the health care system. In addition, the shift of indigent care costs from businesses that provide that free care, to the Federal government, will help corporate profitability. These trends, together with new product launches, should drive above-market earnings growth for companies in the U.S. Health Care Sector.

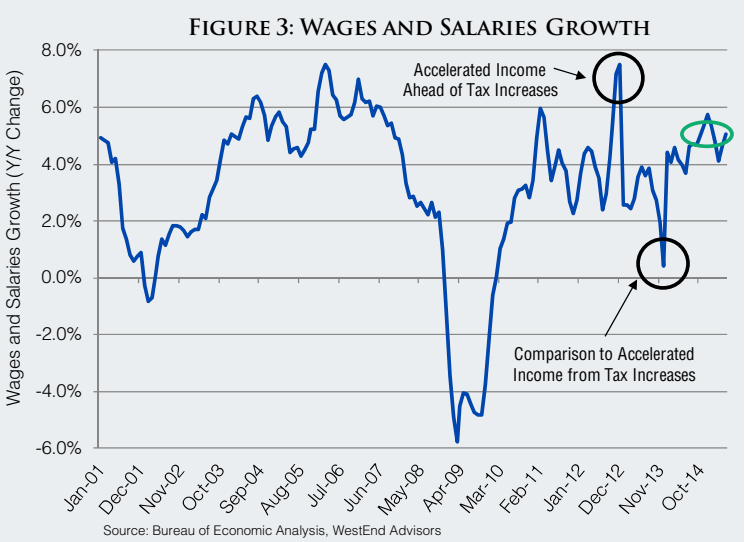
We see U.S. consumer spending as another area of strength in the environment ahead, despite the lackluster growth in consumer spending thus far this year. Temporary factors, like bad weather and the West Coast port strike, led to some of the weakness in Q1. However, the fundamentals that drive spending remained sound, and have continued to improve. Layoffs have trended lower and are essentially at a 15-year low, while consumers have seen a pickup in income growth. Wages and salaries, the largest portion of personal income, recently recorded its strongest period of growth since the financial crisis (Figure 3). These strong fundamentals should endure in the environment ahead, which will likely spur consumer spending and benefit consumer-oriented stocks.

Evolving Landscape

The Federal Reserve has moved away from several of the extraordinary monetary policy programs that were established during the financial crisis. The next step in that progression will be the move to raise short-term interest rates off zero, where they have been for over six years. That action, along with eventual additional rate hikes, will contribute to a shift in the investing landscape for both fixed income and equity investors.

We see longer duration fixed-income securities as susceptible to weak performance as interest rates normalize. This started to play out last quarter as the 10-Year Treasury's yield increased over 0.4 percentage points to a yield of 2.35%, which made for a negative return for the 10-Year Note in the quarter. In addition,





the prospect of higher interest rates will make the slow-growth, but higher-yielding areas of the U.S stock market, like the Utilities Sector and the Telecommunications Sector, unappealing. There was also evidence of this trend last quarter as the Utilities Sector declined 5.80%. The Utilities Sector was down 10.67% through the first half of the year, but that is still less than half of the sector's 2014 gain of 28.98% when the yield on the 10-Year Treasury fell from 3.04% to 2.17%.

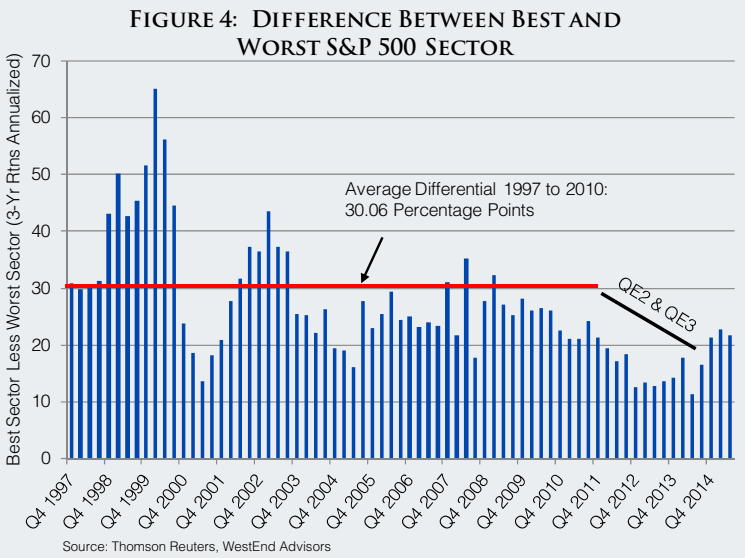
U.S. bank stocks, alternatively, are seen by some investors as a beneficiary of this shifting interest rate landscape. Higher interest rates have the potential to benefit banks' earnings through increases to their net interest margin – the difference between what banks earn on loans and what they pay to depositors. However, that is not the whole story. Higher interest rates will also cut the value of assets held in banks' loan and investment portfolios, particularly mortgages with long-term maturities that make up a significant portion of bank assets.

Investors may have limited visibility into shifts in the loan and investment portfolios and, in turn, the hits to banks' balance sheets from higher interest rates. It is even more difficult for investors to quantify the impact of increased rates on loan demand. Higher interest rates will impact banks' traditional lending businesses as the cost of borrowing goes up. Money center banks' challenges will be compounded in a raising rate environment because their debt capital markets businesses are also likely experience weaker demand. Overall, even if there is a net benefit with higher interest rates for banks, we believe that the benefit will be recognized slowly over a period of years, which will likely disappoint many investors.

Portfolio Positioning

The Federal Reserve's shifting monetary policy not only impacts the economic backdrop, but it also influences financial markets. And these market shifts can create opportunities for investors. We see one such opportunity in sector selection. The Fed's roll back of its unconventional monetary policy programs has contributed to an increased range of returns for S&P sectors in recent quarters, as illustrated in Figure 4. We expect this trend to continue, which should make investors' current sector allocation decisions more important than they were a few years ago during a period dominated by the Fed's quantitative easing (QE) programs.

We continue to favor U.S. stocks over international stocks given our outlook for stronger and steadier economic growth in the U.S. compared with the rest of the world. But we also believe investors should emphasize stocks of companies in sectors of



the U.S. stock market that can deliver above-market earnings increases in this moderate growth environment, like the Consumer Discretionary, Health Care and Information Technology Sectors. At the same time, investors should avoid stocks in economically sensitive sectors such as Energy, Materials, Financials and Industrials, which perform best when there is more dynamic economic growth. Stocks in these sectors continue to face headwinds, especially as a strong dollar applies downward pressure on commodity prices and non-U.S. earnings. We also believe that elevated valuations for stocks in the Telecommunications and Utilities Sectors, along with the prospect of higher long-term interest rates, warrant no allocation to stocks in these sectors.

Higher interest rates also pose a risk to longer duration fixed income securities. We believe that investors should emphasize short-duration fixed income over long-duration fixed income.

We continue to see slow-to-moderate economic growth around the globe, and we continue to position investor portfolios to capitalize on areas of strength within that modest growth environment.

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July 15, 2015