Fourth Quarter 2015

In A Holding Pattern

Following an impressive second quarter which saw U.S. GDP grow at a robust rate of 3.7 percent, domestic economic data during the third quarter failed to show the decisive strength that many economists were expecting. In addition to sluggish manufacturing activity, which has been weighed down by a strong U.S. dollar, and persistent worries about slowing global growth, recent broad increases in the inventory levels of U.S. companies could provide a headwind to near-term growth as many firms may choose to reduce inventory investment in an uncertain global environment. The first estimate of domestic economic growth for the third quarter will not be released until October 29, but it appears the bourgeoning momentum evident in the U.S. economy during the second quarter has moderated.

The U.S. Federal Reserve held its latest policy meeting on September 16 – 17, and, for the first time in more than 8 years, there was some genuine expectation that an interest rate increase might be announced. The members of the Federal Open Market Committee (FOMC) have been weighing the strength in labor market indicators, solid housing numbers, and firm activity in the service sector against falling inflation expectations, signs of stalling global growth, continued weakness in the commodity complex, and heightened financial market volatility. Ultimately, the FOMC decided to postpone beginning its tightening cycle. Despite the apparent dovish implications of the policy statement, Fed Chair Janet Yellen reiterated at her subsequent press conference that the majority of Committee members continue to expect the first rate hike to occur in 2015. Although the concerns that kept the Fed on hold warrant close watching, our view remains that solid job growth, momentum in the housing market, and robust service sector data should keep the U.S. economy on solid footing in the coming months.

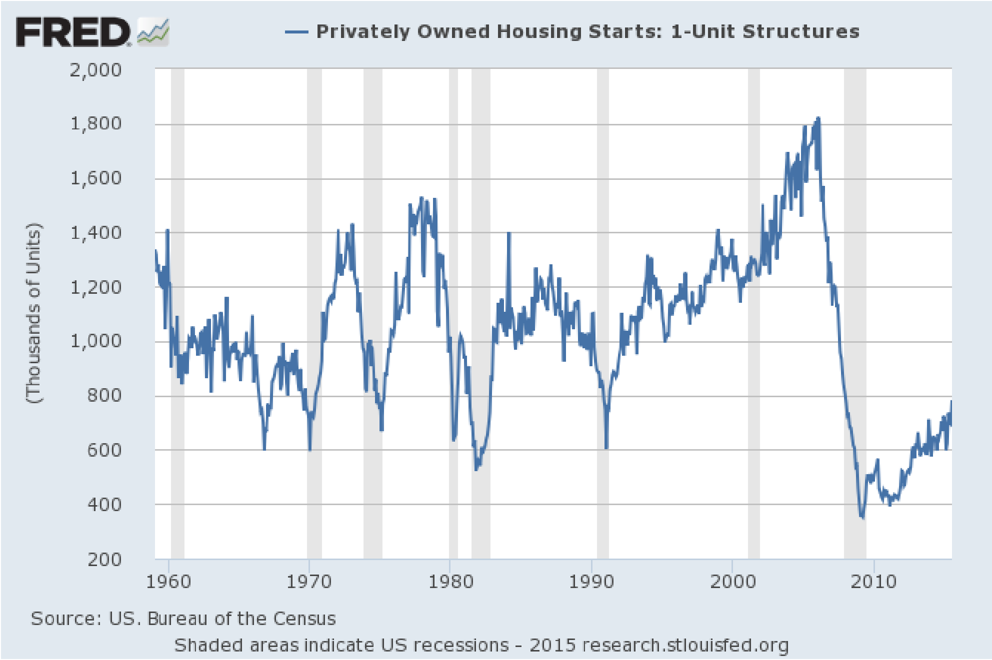
Even with the headline number of jobs created in the August employment report coming in below expectations, broad evidence suggests the U.S. labor market remains firm and continues to tighten. The unemployment rate is down to 5.1 percent and still dropping at a 1 percent rate year-over-year, an indication that slack is rapidly declining. The payrolls figures for June and July were also revised up by a net 38,000 jobs, which offset the weaker than expected August job gains. Meanwhile, the Conference Board's Employment Trends Index increased 0.9 percent in August, the biggest gain in ten months. The number of unemployed workers per job opening also recently plunged to a new cycle low of 1.4, down from a peak of nearly 7 unemployed workers for every job opening in 2009.

Figure 1. Number of Unemployed Workers per Job Opening from 2009-2015

Source: DB Global Markets Research

Recent solid trends in the housing sector could also provide a tailwind for the U.S. economy well into 2016 and beyond. As shown in Figure 2, despite significant improvement since 2009, single-family housing starts remain near the trough levels of prior downturns and would need to rise nearly 50 percent from current levels to return to historical norms. At the same time, inventories of new and existing homes are near 15-year lows. This suggests that housing is one area of the U.S. economy where significant pent-up demand remains in place even six years into the economic expansion. The solid employment backdrop and an improving trend in household formation also suggest that housing starts are likely to continue improving from current levels, barring a substantial move higher in mortgage rates.

Figure 2. Privately Owned Housing Starts



Household debt service payments as a percentage of disposable income remains near 40-year lows and an increased appetite for consumer borrowing could also support U.S. economic growth. Even without the big jump in borrowing that typically accompanies economic expansions, auto sales are at 10-year highs, mortgage applications are up 20 percent year-over-year, and construction spending is rising at the fastest year-over-year pace since 2006. Aided by low gasoline prices, vehicle miles traveled have recently surged to an all-time high and at least temporarily reversed what many analysts have identified as a secular decline in the propensity of Americans to drive.

Offsetting the aforementioned signs of strength, the Organisation for Economic Co-operation and Development (OECD) U.S. Composite Leading Indicator (CLI) recently fell to its lowest level since November 2011 as sluggish manufacturing data, falling stock prices, and tightening financial conditions weigh on near-term growth prospects. These headwinds call into question the reacceleration of the economy that many economists expected for the second half of 2015. Viewed together, the latest evidence suggests the U.S. economy is struggling to sustain above-trend growth but remains on reasonably solid ground.

Global Economy

Outside the U.S., the global manufacturing PMI fell to 50.7 in August—its lowest level in over two years. While the recent weakness is a concern, the new orders component actually increased to its best level in three months during August and the new orders-to-inventories ratio rose to a 5 month high. The breadth of PMIs was also somewhat encouraging, with 61% of countries in expansionary territory. A majority of countries reporting contraction in their manufacturing sectors would suggest heightened risk that the global economy was sinking into recession.

Most indicators suggest the Eurozone remains in the midst of an economic recovery. Consumer spending, manufacturing, construction, and international trade trends all suggest Europe's economy is growing at a solid clip. Bank lending remains depressed by historical standards, but has improved markedly from the lows seen in recent years. Real GDP growth in the region is now running slightly above its potential growth rate of 1.0 percent based on productivity and labor force growth. While the Eurozone's current 1.0 percent – 1.5 percent growth rate is still low, relative to its recent history and investor expectations at the beginning of the year, the European economy is doing well.

We continue to monitor how positive the effects of a weaker Yen and monetary easing policies will be on the Japanese economy. Cheap oil has kept prices low, but if Japan is able to achieve inflation and growth, that should provide a boost for the country's markets. Longer term, there is increasing pressure on Japanese companies to improve corporate governance, increase return on equity, and be better stewards of investors' capital. Should these changes occur, such structural improvements, along with the highly-accommodative attitude of the Bank of Japan, could provide further tailwinds for this market.

Emerging market turmoil led by continued disappointing growth figures from China is concerning and the primary risk to the global economic outlook in our view. While credit markets at this point do not yet seem to be signaling a full-blown financial crisis, further weakness in emerging market currencies, spiking of credit spreads, and a greater number of large emerging economies joining Russia and Brazil in recession would heighten the risk of a global downturn. In spite of the growing risk associated with the emerging market growth outlook, continued slow growth appears to be the most likely path for the global economy heading into the fourth quarter.

Equity Markets

A prolonged period of suppressed volatility in equity markets came to a sudden end during the third quarter as the S&P 500 experienced its first 10 percent correction in nearly four years. The third quarter plunge in equities was global in nature, with eroding confidence in China's economic outlook and concern over a repeat of the 1998-style financial crisis in the emerging world providing downside catalysts. The rout in the value of many emerging market currencies has also been exacerbated by the potential for forthcoming rate hikes in the U.S., creating a very volatile market backdrop. At its closing low on August 25, the benchmark S&P 500 was down more than 12 percent from its all-time high reached in the spring.

Figure 3. Third Quarter Equity Market Performance

Asset Class	Index	Quarter-to-Date	Year-to-Date
Large Cap US Equities	Russell 1000	-4.67%	-3.04%
Mid Cap US Equities	Russell Mid Cap	-4.84%	-2.60%
Small Cap US Equities	Russell 2000	-6.99%	-2.56%
International Equities	MSCI EAFE	-6.60%	-1.44%
Emerging Markets Equities	MSCI Emerging Mkts	-14.03%	-11.49%
Global Equities	MSCI World	-5.71%	-3.23%

Source: Morningstar; as of 09/18/2015

Stocks remain on the defensive heading into the fourth quarter as concerns over Fed policy, slower global growth, and the outlook for corporate earnings continue to weigh on investor sentiment. However, the macro backdrop remains generally supportive for developed market equities, and, in our view, the odds favor the current correction's running its course by year-end. In the U.S., a generally-healthy labor market, growth in bank lending, improving home construction activity, and broad strength in the service sector are likely to continue to offset weakness in manufacturing. Absent a recession, which we see as unlikely, the current environment of extremely low interest rates and minimal inflation is likely to support renewed equity market strength in the coming months.

A weakening trend in the earnings of U.S. corporations has been one fundamental element of the recent market instability. While decelerating earnings growth is a concern, particularly with profit margins still near record highs and some valuation measures already above historical norms, it is also important to note the degree to which the recent earnings weakness has been driven by a plunge in energy sector earnings. As shown in Figure 4, second quarter aggregate earnings for the S&P 500 rose only 1.5 percent, year-over-year (based on Thomson Reuters' methodology for calculating operating earnings). However, when the 56.2 percent plunge in energy sector earnings is excluded, operating earnings rose to a far more respectable 9.0 percent. Although slower relative to the double-digit gains experienced early in the bull market, earnings growth in the second quarter did not show a deeply-concerning degree of broad-based deterioration.

Figure 4. Comparison of Second Quarter S&P 500 Earnings

Sector	Earnings $B 2Q15	Earnings $B 2Q14	Growth $B 2Q15	Growth % 2Q15
Consumer Discretionary	30.2	27.0	3.3	12.2%
Consumer Staples	25.0	25.0	0.0	-0.2%
Energy	13.7	31.4	-17.7	-56.2%
Financials	58.7	49.6	9.2	18.5%
Health Care	40.7	36.5	4.3	11.7%
Industrials	30.6	30.5	0.1	0.2%
Materials	9.6	8.8	0.7	8.3%
Technology	51.0	47.8	3.2	6.6%
Telecom Services	8.8	8.1	0.8	9.3%
Utilities	7.3	7.0	0.3	4.3%
S&P 500	275.6	271.6	4.0	1.5%

Source: Thomson Reuters I/B/E/S

There is also a silver lining to the recent pessimism concerning the outlook for corporate earnings. Median expected earnings growth based on consensus analyst estimates has fallen to a cycle low of 5.2 percent. Perhaps counter intuitively, as shown in Figure 5, the earnings growth rate forecasted by analysts has had an inverse relationship with S&P 500 returns over the past 30 years and periods of relative pessimism concerning the earnings have been associated with above average returns. Should the U.S. economy prove resilient in the coming months, some rebound in earnings expectations could provide a catalyst for a year-end rally in equity markets.

Figure 5. Inverse Relationship between Earnings Growth Forecasted by Analysts and Market Returns

S&P 500 Gain/Annum When:		
Expected EPS Growth Is:	**Gain/Annum**	**Percent of Time**
Above 14.2%	-2.4	14.1
Between 3.4% and 14.2%	9.5	71.7
3.4% and Below	14.0	14.1

Source: Ned Davis Research; as of 06/30/2015; Gray shading indicates current environment.

Despite the bruising declines already experienced by emerging market equities, we believe a cautious stance on the group is still warranted. Although extremely negative investor sentiment and depressed relative valuations have created the potential for a near-term countertrend rally, structural changes appear to be needed for a lasting bull market to take hold. Specifically, a glut of manufacturing capacity in China and a looming threat of bad debts, as well as longstanding concerns over corruption and poor corporate governance standards, have yet to be addressed and present significant headwinds to the intermediate-term outlook. Near-term growth is also likely to be impeded by a recent rise in short and long-term interest rates in many emerging countries.

The diverse mix of positives and negatives impacting equity markets are summarized in Figure 6. Despite rising risks of a global economic downturn, the weight of the evidence still favors a backdrop of sluggish global growth led by a relatively stable U.S. economy. In this environment, domestic equities remain the proverbial best house in a bad global neighborhood. Aside from the U.S., the near-term outlook for European equities has turned more favorable while the outlook for emerging markets remains highly uncertain.

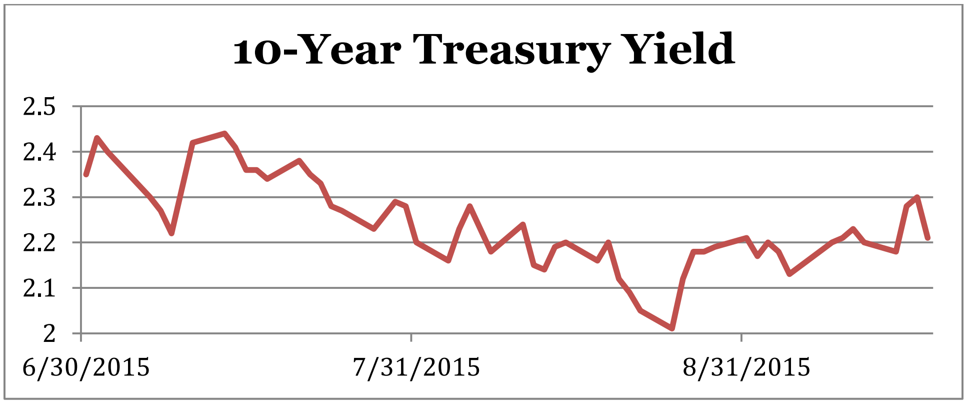
Figure 6. Diverse Mix of Positives and Negatives Impacting Equity Markets

Positives	Negatives
Minimal signs of inflationary pressures	Emerging market growth still slowing despite China stimulus
Extremely low global interest rates	Global trade softening at concerning rate
Labor market strength	Tightening global financial conditions
Housing sector activity has room to improve	Excessive debt in emerging world
Services industries showing broad strength	Risk of emerging market currency crisis
European economic data more robust than forecasts	U.S. Fed has little ammunition to combat downturn
Improving Eurozone bank lending	Global deflationary pressures persist
Valuations not irrational given low inflation/interest rates	Demographic headwinds throughout the developed world
Global monetary policy still accommodative	Benefits of lower oil on consumer spending muted thus far
Merger & acquisition activity still strong	Majority of global markets in apparent long-term downtrends
Extremely pessimistic sentiment readings	Broad nature of correction is a concern

Fixed Income Markets

Long-term rates were volatile during the third quarter, trending upward in the beginning as many were anticipating a Fed rate hike in September. The 10- year Treasury yield started the quarter at 2.34 percent and peaked at 2.44 percent in July before falling to 2.01 percent in August due to concerns over the growth of China's GDP and its impact on global economic growth. Those concerns eventually eased, pushing the yield back up to the 2.3 percent level. Finally, the FOMC's decision not to raise interest rates pushed the yield back down to 2.19 percent (as of 9/17/2015).

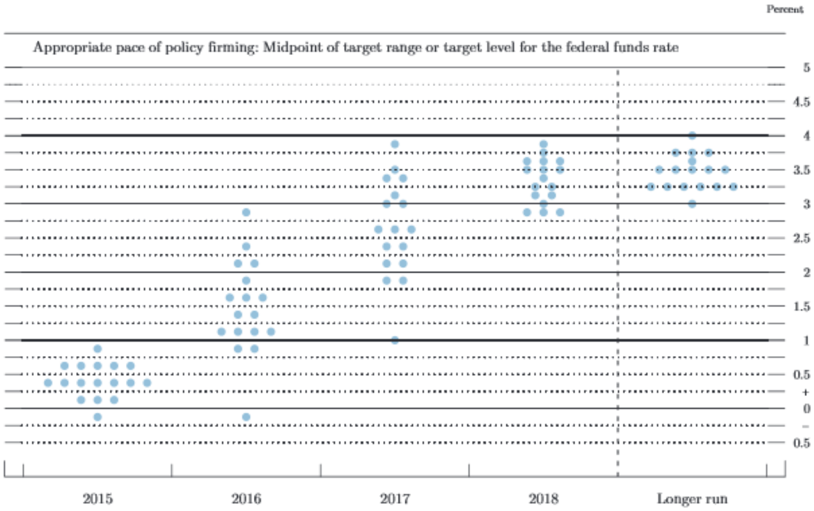
Figure 7. 10-Year Treasury Yield



Source: U.S. Department of the Treasury; Data as of 9/17/2015

In September, the FOMC voted to leave rates unchanged but the committee also mentioned that while its current 0 percent to 0.25 percent target range for the federal funds rate remains appropriate, it will continue to review new information to determine when a rate rise may be reasonable. The FOMC lowered its expectations for the long term Fed Funds Rate by 0.25 percent for the end of 2016. However, the updated "dot plot," which indicates rate expectations, still suggests one Fed Funds rate hike later this year. In Figure 8, each shaded circle indicates the expectation of an individual FOMC participant's judgment of the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. For example, seven FOMC participants feel the appropriate target range for the federal fund rate at the end of 2015 should be between 0.25 and 0.50 percent.

Figure 8. Federal Reserve Dot Plot



Source: Federal Reserve

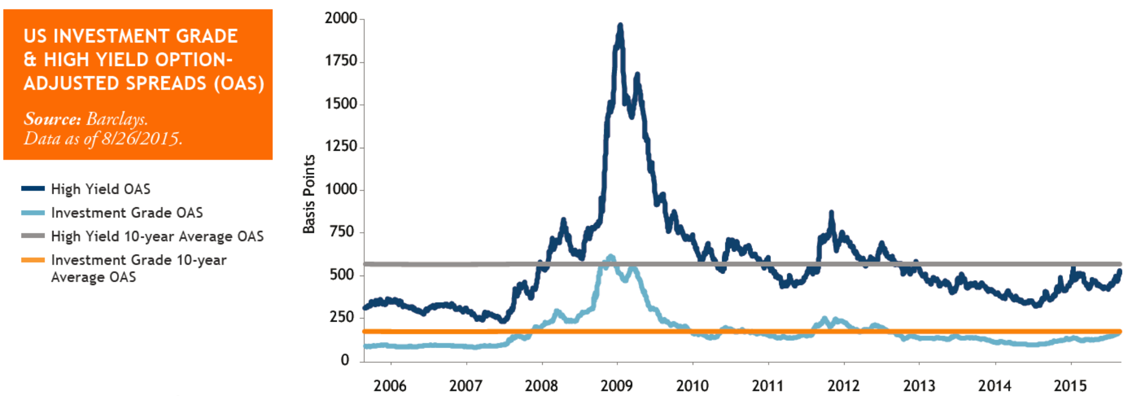
Looking forward, we expect the higher volatility levels we observed in fixed income will remain elevated. The uncertainty surrounding the timing and pace of rate normalization—and its possible impact on the economy—is likely to contribute to more frequent rate variability than seen in recent history. We continue to believe that, over the longer term, rates should settle a bit higher and the yield curve may flatten as shorter-term rates rise faster than long-term rates. In our opinion, predicting the exact time the Fed will start to raise rates may not be as important as the pace of rate increases. Our expectation is that the Fed will remain cautious and data-dependent given slow economic growth prospects and subdued inflation. This stance suggests a slow and gradual upward path for short-term rates. On the other hand, demand factors are likely to continue to keep long-term rates in check as the need for safe assets from domestic pension and insurance buyers remains. Foreign demand for U.S. Treasuries is also likely to persist given U.S. dollar strength and the possibility of higher real rates in the U.S.

In our view, investment-grade credit still offers greater value relative to Treasury bonds. Spreads in investment-grade credit increased in late August but have since subsided to a level consistent with 10-year averages. We believe that the U.S. economy is on a solid footing and default rates in investment grade bonds are likely to remain low. For this reason, we believe that the additional yield offered by investment-grade bonds may offer an additional cushion to protect portfolios against the risk of rising rates.

High yield spreads widened dramatically in mid-August as equities sold off, but some calm has returned to the markets since. As shown in Figure 9, at current levels, high yield spreads are close to 10-year averages, and are mildly attractive. One caution point is the continued weakness in oil prices – if current or lower levels persist, it may cause an earnings drag on the high yield sector, possibly causing downward pressure on the price of energy-related high-yield bonds.

The chart below shows the current option adjusted spreads (OAS) for investment-grade and high-yield bonds, compared to their 10 year averages. The OAS is a commonly used measure for the level of credit spreads, after the effects on yield of optional bond features such as call protection and convertibility are removed.

Figure 9. U.S. Investment-Grade and High-Yield Option-Adjusted Spreads



Foreign bonds are suffering from two major headwinds at present. A stronger U.S. dollar could hurt emerging markets as they see capital flows reverse out of their nations and back to the United States. International trade is also less profitable in dollar terms. This situation worsens the current accounts of many emerging markets nations and may endanger the debt coverage levels of dollar denominated debt. Local currency debt may not face this risk, but as international currencies weaken, bonds denominated in such currencies are worth less. In our view, declining commodity prices should continue to put pressure on commodity exporting countries. The impact may be felt by countries in Latin America such as Brazil, which was recently downgraded to below-investment-grade status by Standard & Poor's. On the other side of the equation, emerging markets that are energy importers, such as India, should benefit from lower oil prices.

Municipal bond returns have been relatively flat on both a year-to-date and a quarter-to-date basis. Most of the headlines coming from this sector over the quarter have been from weaker issuers, such as Puerto Rico and the city of Chicago. In Puerto Rico, the Governor of the Commonwealth has stated that the island's debt situation may become untenable. Under current rules, Puerto Rico cannot declare bankruptcy or restructure, but the market has already priced in many of these risks, and Puerto Rico bonds have been declining in price. We feel, however, that the developments coming out of Puerto Rico will not be a downside risk to the entire municipal bond market. In Chicago, a pension reform bill was ruled unconstitutional, but it was widely anticipated by the market, and we expect Chicago will eventually find a solution. Bonds are also trading accordingly.

Risks to Our Outlook

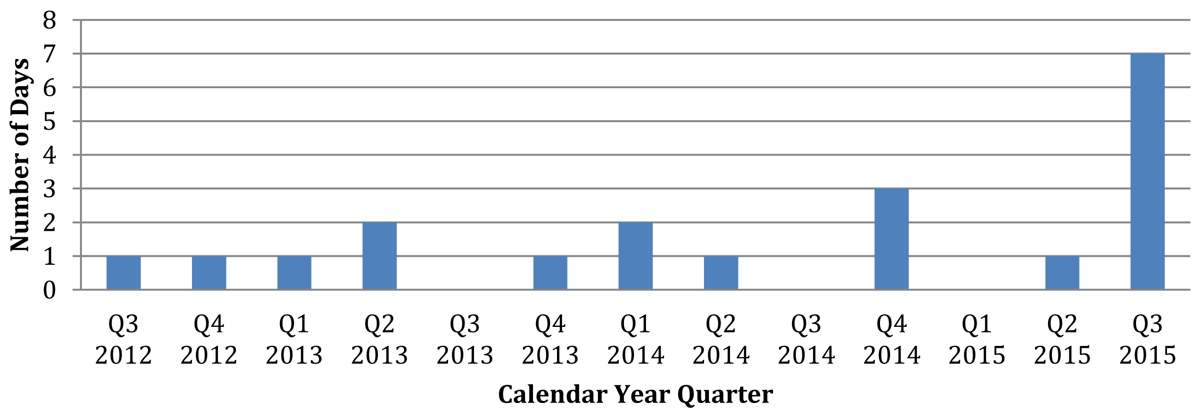
For the balance of 2015, we have a baseline optimistic view for developed economies and equity markets. Positive trends in consumer spending, unemployment and housing, combined with low inflation and accommodative monetary policy, provide the right environment to support positive year-end returns for the major indices. Despite this tempered optimism, there are risks that we need to monitor, including increasing market volatility, a hard landing in China potentially hurting global growth over the longer term, a U.S. government shutdown in October, and an emerging-market currency shock that could result from tightening monetary conditions.

Increasing Market Volatility

As we have noted in prior market commentaries, we anticipate higher levels of market volatility through year end and beyond. The combination of investor concerns regarding Fed monetary policy, an uneven global economy, and the fact that we have been in a nearly seven-year equity bull market have helped increased some investor anxiety and, consequently, market volatility.

In Figure 10, for the three years ending 6/30/15, there were just thirteen days when the S&P 500 either rose or fell more than two percent. With just two weeks left in the third quarter, the S&P 500 has already experienced seven of these days. Increased market volatility may make investors more nervous.

Figure 10. Number of Days S&P 500 Rose or Fell 2 Percent or More



Source: S&P, eSignal, Tower Square Investment Management
Data as of 9/16/2015

Hard Landing in China

Weakening economic data out of China was a driving force behind the global equity selloff this past August. As indicated in Fed Chair Janet Yellen's press conference after the recent FOMC meeting, the continued slowdown in China, and its ramifications for the global economy, has the attention of the policy makers. Chinese officials have telegraphed well their intended transition from an export-driven economy to a more consumer-driven one accompanied by an expected marginally lower GDP. However, there is increasing worry that things might be worse than suggested by the People's Bank of China and the data they released. Estimates point to China expanding debt faster than growth, a debt-to-GDP ratio approaching 300 percent (up from 150 percent in 2008) and nonperforming loans nearing $23 billion. If the People's Bank of China is unable to interrupt the cycle of excessive debt and overcapacity and ultimately stabilize growth, a deleveraging cycle could have far-reaching negative implications for the global economy over the longer term.

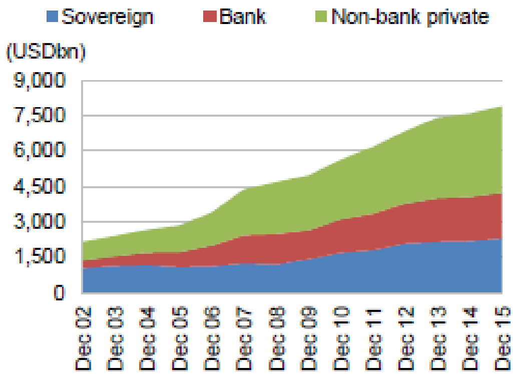
U.S. Government Shutdown

There is growing concern that Congress will not pass a new spending bill before expiration on September 30 if it includes the $500 million in annual government assistance to Planned Parenthood. Not passing this bill will likely result in a "funding gap" and possibly a subsequent government shutdown similar to the events of October 2013. Rating agency Standard & Poor's estimated the 16-day break in 2013 took $24 billion out of the U.S. economy and 0.6 percentage points of GDP growth in the fourth quarter of 2013. In addition, there was a reduction of over 120,000 private sector jobs in those two weeks of 2013. If a bill cannot be passed, each passing day will exacerbate the problem, throwing off annual growth estimates, increasing market volatility and affecting corporate earnings.

Emerging Market Currency Shock

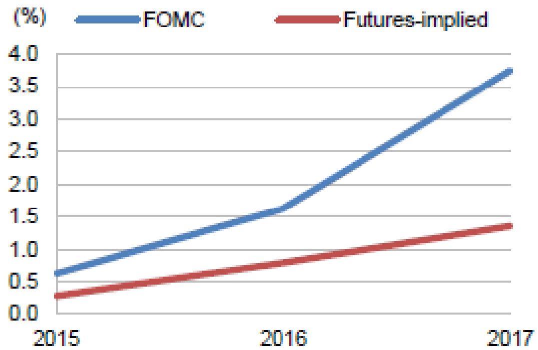
External debt levels for emerging market economies have swelled to $7.5 trillion since 2008 (shown below). Many of these economies will find themselves in an especially difficult situation once the Fed begins to raise interest rates. A rising concern is what might happen if the Fed tightens more rapidly than expected. As displayed in Figure 12, there is an increasing gap between what the FOMC is signaling for target rates and what the futures market implies. Fitch Ratings cautioned that international markets are pricing in a slower pace of rate increases than the Fed. Since many emerging market nations have significant amounts of debt priced in US dollars, a strong U.S. dollar would make debt repayment more expensive for these nations in terms of their local currencies. A faster-than-expected tightening could force interest rates higher, most likely strengthening the dollar against the already tumbling emerging market currencies. If this were to occur, it might prompt a large, sudden capital outflow from emerging economies and possibly create a credit crunch, making it even more difficult for these nations to pay off their debt.

Figure 11. Emerging Markets Gross External Debt



Source: Fitch Sovereign Comparator

Figure 12. Growing Disparity Between FOMC Rate Expectations vs. Market Expectations



(Futures-implied rate as at 4 September 2015)
Source: CBoT, FOMC, Fitch

Investment Implications

For some time now, we have maintained our current investment thesis, that the United States economy will continue to grow modestly, perhaps below trend, but likely better than elsewhere in the developed world. This growth may serve as evidence to suggest the economy is finally ready for the Fed to raise rates as it attempts to coax us out of its zero interest rate policy into a new regime without upsetting the current recovery's delicate balance. The Fed's intimation that the economy is not yet ready for this transition was a disappointment to investors, but we remain moderately bullish and prefer the U.S. over international. We also prefer developed over emerging markets.

In this environment, we continue to maintain an allocation to equities based on long-term objectives, skewing neither aggressive nor conservative in equity allocation. Within the United States, and in light of the strength of the dollar and increasing geopolitical risk, we still favor more domestically-oriented companies, which translates to a greater allocation to small-cap stocks. The prospects of small cap stocks look brighter given their recent relative underperformance to large caps (especially in 2014), their greater economic sensitivity, and, because they tend to derive less of their revenues from foreign economies, their decreased vulnerability to the effects of a strengthening dollar. Additionally, companies that are able to grow despite an anemic economic backdrop are likely to command a premium. As such, we continue to favor growth over value across the market cap spectrum.

As the likelihood of Fed rate hikes increases, we recommend a defensive interest rate positioning in fixed income, which translates to keeping duration short and overweighting bonds that offer a yield spread over Treasuries (such as corporate and international bonds).

In an increasingly uncertain environment, we believe it prudent to retain an allocation to alternative investments for mitigating unforeseen volatility through their low correlation to traditional investments. We are slightly underweight commodities, which could come off their lows if the global economy picks up, but which still face tough headwinds from a stronger dollar and excess supply. Finally, from a portfolio implementation standpoint, we prefer managers with flexible investment styles that provide the discretion and ability to move nimbly within their mandates in the face of the changing circumstances that we anticipate going forward.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Commodities markets have historically been extremely volatile.

Small-cap stocks may be subject to a higher degree of market risk than large-cap stocks, or more established companies' securities. Furthermore, the illiquidity of the small-cap market may adversely affect the value of an investment so that shares, when redeemed, may be worth more or less than their original cost.

A High Yield Fund yield is high due, in part, to the volatility and risk of the high securities market. High yield funds are also known as "junk bonds."

Employment Trends Index (ETI)™, *is produced by the Conference board and is a leading composite index for employment which aggregates eight labor market indicators from different sources, each of which has proven accurate in its own area.*

MSCI EAFE Index *(Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.*

MSCI Emerging Markets Index *is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.*

MSCI World Index *is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.*

Russell 1000 Index *measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.*

Russell 2000 Index *measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

Russell Midcap Index *measures the performance of the mid-cap segment of the U.S. equity universe and is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies.*

The ***S&P 500*** *is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*