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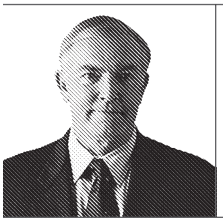
MARKET REVIEW



John Goode
Senior Portfolio Manager
ClearBridge Investments

- What can the history of credit expansion teach us about the economy and financial markets today?
- How long can central banks replace the role of markets and the private sector?
- What are the signs of an aging equity bull market and are we near an inflection point for the U.S. bond market?
- How much more can the US$ rise and is Europe poised for better growth?
- These are just a few of the topics discussed in this latest commentary from ClearBridge's John Goode.

ClearBridge Investments

Market Review

John Goode
Managing Director, Portfolio Manager

"Were it left to me to decide whether we should have a government without newspapers, or newspapers without a government, I should not hesitate a moment to prefer the latter." ***-Thomas Jefferson***

"Where inner city education is concerned, there are those who say vouchers are not the answer. I ask what they would provide as an alternative to vouchers that offers the same level of hope in the next school year, not at some distant educational horizon? The silence at this point from the other side is deafening!" I then ask them how their children are doing at Sidwell Friends School. (Sidwell Friends School is a private school in Washington D.C. which is only a few miles from some of the worst schools in the country.) ***-Richard Henry Davenhill***

"The highly abnormal is becoming uncomfortably normal. Central banks and markets have been pushing sovereign yields to extraordinary lows-unimaginable just a few years back. There is something troubling when the unthinkable becomes routine." ***-Claudio Borio***

Where there's a will, I want to be in it.
Since light travels faster than sound, some people appear bright until you hear them speak.
I used to be indecisive, now I'm not so sure.
Change is inevitable, except from a vending machine.
I'm not arguing with you, I am explaining why you are wrong.
Knowledge is knowing a tomato is a fruit-wisdom is not putting it in a fruit salad.
If I agreed with you, we'd both be wrong.

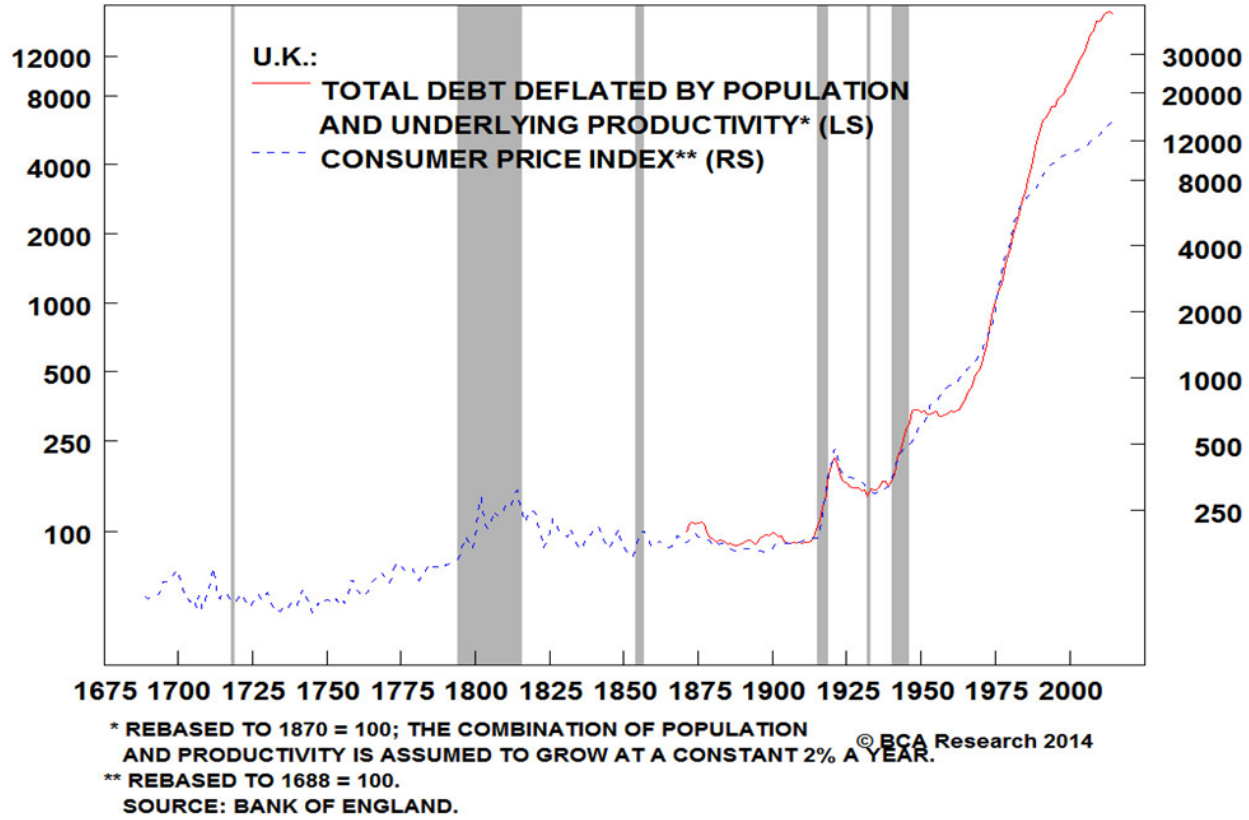
-Paraprosdokians (Figures of speech in which the latter part of a sentence is often unexpected.)

Tales from the Past and the Future

Perspective about the future requires speculation about developments over a time period which often is not helpful for near and intermediate term investment decisions. However, there are times in history when it is necessary to step out on a thin intellectual limb and try to make sense of some of the very big developments that may be especially important over the next 7-10 years. In doing this, it is necessary to look back in time to understand how we got here and where we might be going.

We begin in Great Britain in 1675 and come forward to the present to show how unusual the last 70 years have been relative to the previous 270 years. For most of the time since 1675, credit grew broadly in line with the economy's (England-Britain-United Kingdom) productive potential, structural inflation was limited or non-existent

and real interest rates rarely strayed far from zero. In the period up to the early 1900s, two things acted as a brake on unfettered credit expansion. The gold standard was in force in Great Britain (until 1931) which prevented the explosive creation of money and credit. Only during periods of war was the link between Britain's currency and gold broken, such as when it fought the Napoleonic Wars or World War I. During periods such as these, the government could create and borrow money to fund the war effort, which created temporary bursts of inflation. When the wars ended, inflation reversed and the adherence to the gold standard returned which once again disciplined money and credit creation.



Source: BCA Research, as of 2014. **Past performance is no guarantee of future results**. Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. **Consumer Price Indexes (CPI)** measure the average change in consumer prices over time in a fixed market basket of goods and services.

A second important brake on inflation was the ownership structure of banks. Until the late nineteenth century, most banks were partnerships. Due to the unlimited liability of a partnership, the bank owners' personal wealth was literally on the line which guaranteed prudence in both the quantity and quality of lending. The equivalent of sub-prime mortgages or junk bond[1] lending did not exist until very recently. As a result of the discipline which came with the partnership form of bank ownership, asset leverage was very low, often just two times equity capital. With the transition to joint-stock companies, owners' liability became limited and there was a massive increase in bank leverage ratios. In Europe and America today commercial bank assets are often 20 times capital and in the last decade leverage ratios were even higher. In the U.S. in 2007-2008 capital ratios exceeded 30-to-1 in some cases.

The influence of John Maynard Keynes' publication, *The General Theory of Employment* in 1936, also played a role in driving debt and leverage ratios much higher. Keynes' work stated that governments could and should take steps to smooth out the business cycle by running deficits during recessions and depressions. Especially in Europe, this forged a cozy alliance between governments and banks with the latter often underwriting government debt and then placing large amounts of it on their own balance sheets which supported loan growth. As the chart above shows, there has been an explosion of debt and higher prices (inflation) since the end of World War II which begs the question *"are the decades since the end of World War II the new normal or are they a historical anomaly?* "The short answer is that it is unlikely we will go back to the gold standard and it is even less likely that the partnership form of ownership returns to the UK or the world's banking sector.

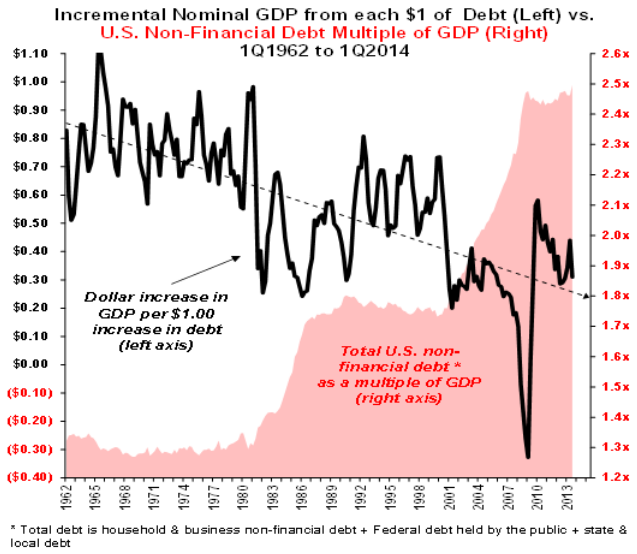
To emphasize just how significant inflation has been over the last 50+ years, consider the following prices from 1962 in the U.S., the year I went off to college.

New House	$12,500
Average Income	$5,556/Year
New Car	$2,924
Average Rent	$110/Month
Tuition to Harvard (Stanford)	$1,560 ($1,260)
Movie Ticket	$1.00 each
Gasoline	$0.28 per gallon
United States Postage Stamp	$0.04
Eggs	$0.32 dozen
Fresh Baked Bread	$0.21 per loaf

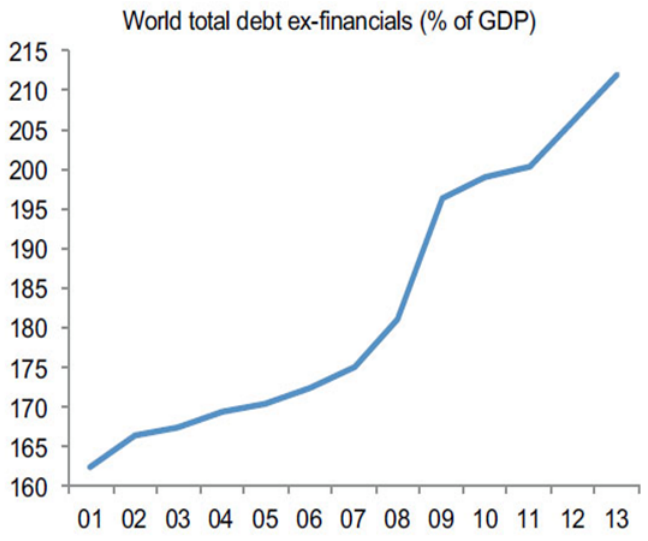
It is a generalization but today's prices for many things are on the order of ten times those a little over 50 years ago. The inflation trend since 1945 also is unique in the experience of the United States since 1776 with the exception of short bursts of inflation which occurred during the Civil War (1861-1865) and World War I (1914-1918).

The Debt Supercycle

The Bank Credit Analyst has analyzed business cycles for many decades and the period from 1945-2008 has been described as one in which the Debt Supercycle was a primary driver of each succeeding business cycle. Expanding credit and debt characterized the period of time from the end of World War II to 2008 as consumers and the private sector took on increasing amounts of debt to launch successive positive business cycles (real GDP[2] growth) in the decades after World War II. This pattern of diminishing returns from the use of debt was suggestive that the process would eventually end, and it did, in 2008.



Source: US Federal Reserve Flow of Funds data, Stifel, March 31, 2014.



Source: ICMB Geneva Report 16, as of September 2014.

At this point in time, the private sector and consumers were unwilling or unable to take on additional debt in sufficient quantities to support another positive business cycle because of increased personal balance sheet leverage and the trauma associated with the unwinding of the housing bubble. For many households, the value of their home constituted a large part of their net worth and the large decline in home prices in 2008-2009 had a chilling effect on consumer spending and the willingness to leverage personal balance sheets. Because of this, central banks in the U.S. and elsewhere, including in the United Kingdom (Great Britain/England), took over the primary role for engineering the next positive business cycle. As a result, world debt has continued to increase with much of it now resting on government rather than on private sector balance sheets.

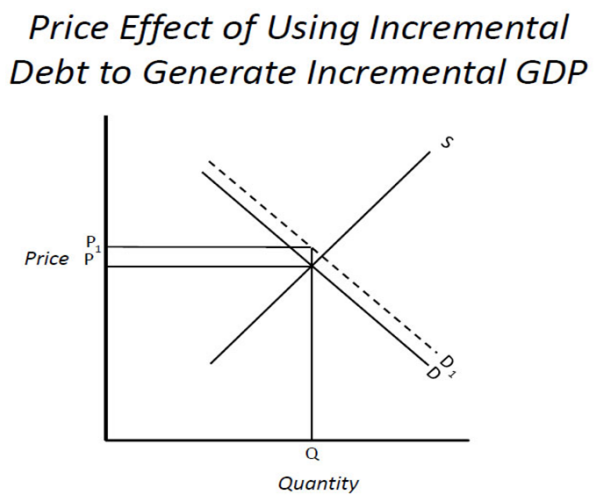
For example, U.S. debt was $10.6 trillion when President Obama took office and it is now $18.5 trillion, an increase of about 75%! When the President's eight year term in office ends in January, 2017 it is possible that our national debt may have doubled the level it took 233 years for the previous 43 presidents and their administrations to accumulate.

A more complete description of the Debt Supercycle is included at the end of this Market Review.

A Dinner Conversation in the early 1950s

I grew up on a small farm one-half mile north of the town of Fowler in California's Central Valley. At dinner when I was quite young I heard my parents discuss the need for a new car because our 1938 Chevrolet was on its last "legs." I remember wondering when a bright, shiny new car would make its appearance but it took several years for this to happen. Think of the time period from dinner conversation to new car as representing "deferred gratification." Across the United States, many families also experienced deferred gratification because widespread use of credit cards lay in the future and banks were not in the habit of knocking down doors to extend credit.

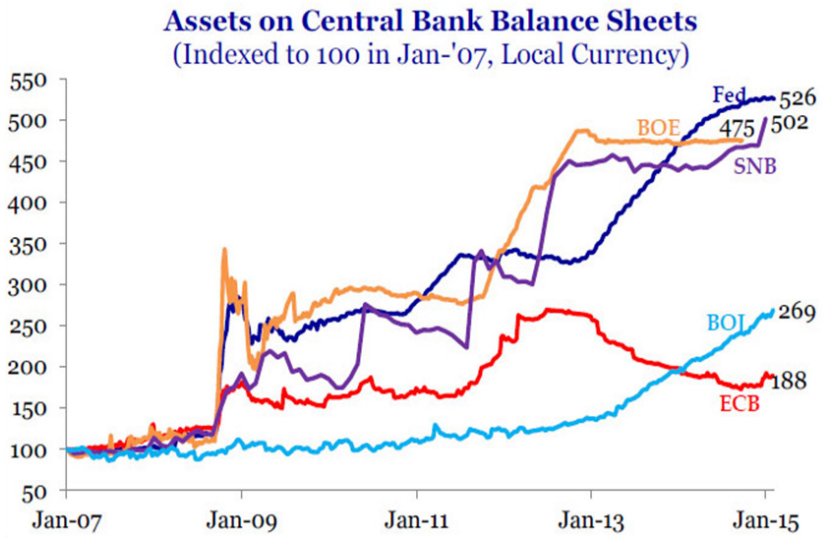
Things began to change as credit and credit cards (debt) came into greater use. As the chart below shows, increasing use of debt in all forms had the effect of advancing consumption from the future to the present. "Later" increasingly became "now."



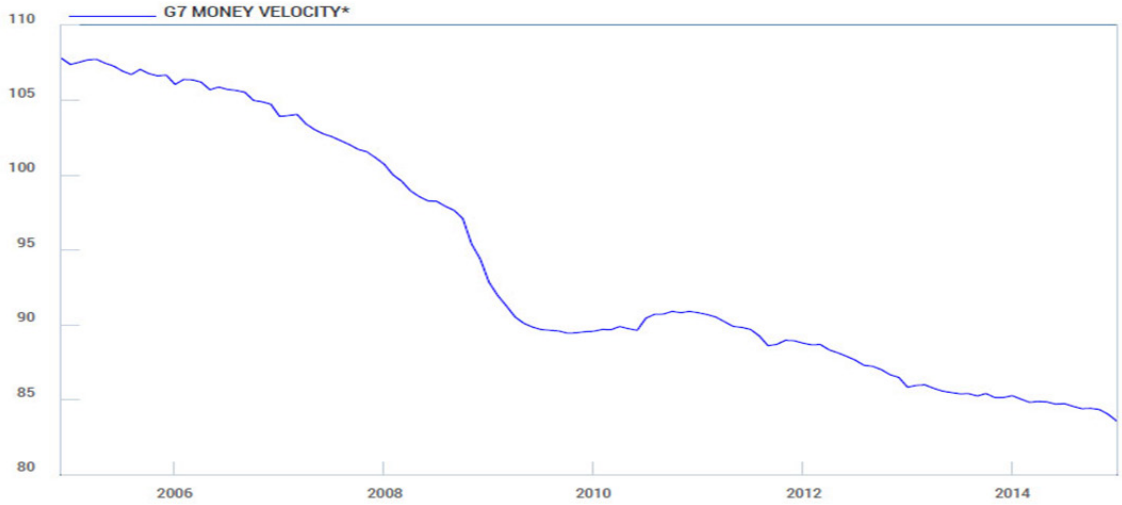
Source: Internal.

This process not only increased spending and consumption somewhat in any one year, it also introduced an incremental amount of inflation because in the short run the quantity of goods was fixed. However, it was very difficult to measure this in any one year but clearly an inflationary bias was built into the U.S. economy over the decades after World War II. It became clear that the inflationary consequences of compressing aggregate deferred gratification in the direction of "now" were historically large as indicated in the chart on page 2 showing the British experience since the end of World War II. The effects were not limited to the British but were repeated in the U.S. and many other countries as well.

What happened when 2008 arrived and the private sector and consumers were no longer willing or able to underwrite another positive (real GDP growth) business cycle? As the housing bubble showed, if sufficient sales are borrowed from the future, when the future actually arrives there may be insufficient aggregate demand to replace what has been brought forward in time. Robbing the future eventually has consequences. Even with the central bankers stimulating the economy and trying to generate the necessary demand, the accumulated debt load, which had been inflationary between 1945 and 2008 because of its extraordinarily large size, instead became deflationary.[3] Contributing to this outcome was a sharp downturn in the velocity of money.[4] Government inspired stimulus and debt creation were being offset by a sharply declining velocity of money which meant that its efforts had to be even more heroic to have the desired economic effects.



Source: Strategas Research Partners, as of January 2015. BOE = Bank of England; SNB = Swiss National Bank; BOJ = Bank of Japan; ECB = European Central Bank; Fed - US Federal Reserve.



* GDP DIVIDED BY BROAD MONEY. SERIES REBASED TO JAN. 2008 = 100. BROAD MONEY BASED ON M3 MONEY SUPPLY, EXCEPT FOR U.S. WHICH IS BASED ON M2 MONEY SUPPLY.

Source: BCA Research, as of December 2014.

It became more difficult to summon a sufficient expansion of debt to jump-start the U.S. economy and the sharp decline in the velocity of money almost guaranteed that the mention of "deflation" in recent years would grow exponentially. Because of this, the inflationary process which characterized the decades leading up to 2008 carried the seeds of its own destruction which is why we're hearing so much about deflationary forces these days.

Important Questions Facing Investors

In our opinion, central banks, including our own Federal Reserve (Fed)[5], can't replace the role of markets and the private sector for very long because their policies bring excesses which multiply the longer they are in place. Suppressing interest rates drives speculation and our capital markets today are more representative of a "casino" than a mechanism for allocating resources efficiently. Low interest rates also "justify" many investments that probably should never have been made. Low interest rates "beggar" many of our senior citizens and retired people who have more conservative portfolios which over the years have relied on interest income from certificates of

deposit (CDs) at banks and other financial institutions and from bonds to augment their incomes. Income from short-term bonds and CDs is down 90% over the last six years! Suppressed interest rates have been very effective in driving asset prices higher, including the stock market, but one can only ask *"how much of the 2009-2015 bull market is based on historically low interest rates?"* No one really knows but the answer probably is "material." ZIRP (zero interest rate policy[6]) has been much less effective in elevating incomes as the decline in median incomes since 2009 indicates. Since 2009, U.S. equity prices have increased 122% while U.S. nominal GDP has only grown 18%. What comes next, currency wars to jump start jobs and incomes?

One of today's most important questions is *"when will central banks hand back the responsibility for creating positive new business cycles to the private sector and what will the U.S. economy and stock market look like at that point in time?"* Any answer would be speculative in nature but it gets to the heart of so many things that are important in constructing a portfolio and diversifying one's assets. Given the massive increase in central bank balance sheets around the world in recent years and the suppression of interest rates at historically low, even negative levels in some countries, how many policy initiatives remain for use in the future to combat recessionary tendencies? Haven't we reached the point where the Federal Reserve and other central banks are part of the problem? What happens if the Federal Reserve, in our own country, stays the course and the velocity of money picks up substantially?

Technical Market Considerations

In previous Market Reviews we have referenced Lowry Research's analysis of late stage stock markets and the "thinning process" which characterizes them. The following table shows figures for 15 stock market peaks (for the Dow Jones Industrials[7]) beginning with 1929. The percentages relate to companies (current number is 1,400) in Lowry's operating-only-company (OCO) database.

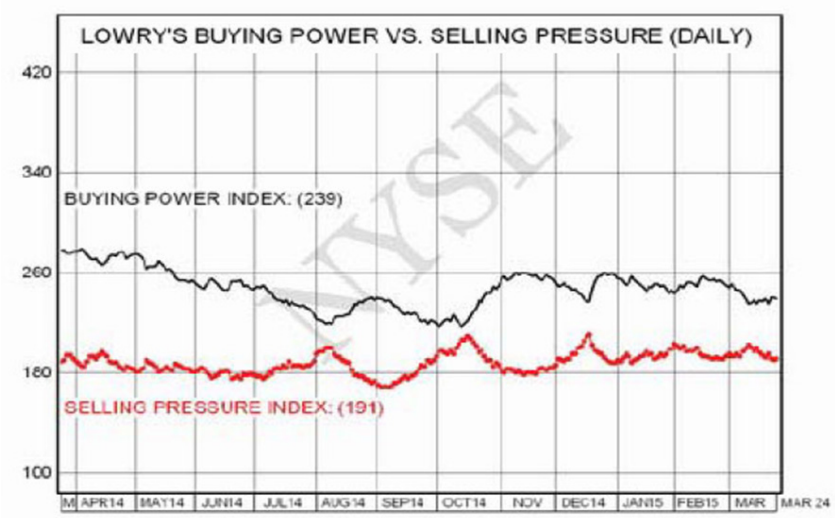
BULL MKT TOP DAY	% STOCKS @ NEW HIGHS	% AT OR < 2% OF NEW HIGHS	% OFF 20% OR MORE	% OFF 30% OR MORE
09/03/1929	2.30%	15.62%	31.84%	18.77%
03/10/1937	6.05%	21.34%	5.94%	1.06%
05/29/1946	8.59%	30.44%	6.30%	0.86%
04/06/1956	5.32%	23.36%	1.92%	0.42%
01/05/1960	1.60%	5.83%	23.25%	7.67%
12/13/1961	3.56%	11.83%	25.29%	11.60%
02/09/1966	9.66%	19.04%	9.52%	2.68%
12/03/1968	9.43%	20.12%	9.51%	2.36%
01/11/1973	5.30%	11.82%	34.22%	20.51%
09/21/1976	10.97%	22.88%	21.65%	10.09%
04/27/1981	7.09%	15.18%	28.01%	9.39%
08/25/1987	6.23%	15.23%	17.37%	7.44%
07/16/1990	5.35%	18.11%	37.31%	22.74%
01/14/2000	3.54%	6.31%	55.33%	32.45%
10/09/2007	10.77%	11.03%	26.51%	16.51%
AVERAGE	6.38%	16.54%	22.26%	10.97%

Source: Lowry's Research, as of March 31, 2015. **Past performance is no guarantee of future results.**

In the last 40 years, generally speaking, new highs at market peaks were 10% or less of all OCO stocks whereas those "confirming" a market peak (less than 2% below their 52-week peaks) were 20% or less. The percentage of companies in their own bear markets (down 20% or more) often were well over 20% but the figures vary widely with the 55% figure in 2000 being most extreme ever recorded. The Lowry's data shows that the topping process for the stock market takes time and trying to pinpoint a market peak often misses an important point namely that many portfolios begin declining well before the eventual peak.

What is Lowry's saying today? Lowry's studies of demand for stocks (buying) and supply (selling pressure) are both restrained at this time. The lack of short-term demand, according to Lowry's, has historically warned of possible short-term market weakness but not an imminent major market top.

Lowry's also feels that divergences between its 1,400 OCO Advance — Decline line and a continuing trend of stock market new highs has been an important warning signal. In the past, this divergence has often showed up 4-6 months prior to a major market peak. However, the recent new high for the S&P 500[8] found the OCO Adv-Dec line also was at a new bull market high (confirming). The S&P 400 Mid Cap Index[9] also was at new highs suggesting a rally that is still relatively broad-based. Only the S&P 600 Small Cap Index[10] showed a lag (divergence) which is consistent with the selective strength in the small cap universe over the last 12 months.



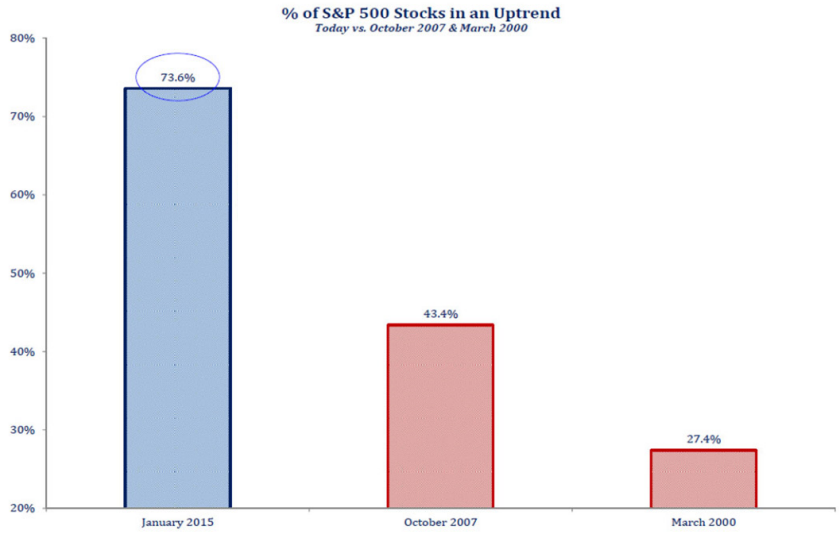
Source: Lowry's Research. Data as of March 24, 2015. **Past performance is no guarantee of future results.** Lowry's Buying Power Index is a proprietary measurement of demand based on upside volume. The Selling Pressure Index is a proprietary measure of the amount of selling activity present in the market.

Lowry's summarizes as follows, *"with many of the stock market indexes at new bull market highs this week, there are still few signs of an imminent market top. However, there are signs of an aging bull market and of increasingly selective strength."*

The chart below shows that 74% of S&P 500 stocks remain in uptrends, a level that is well above those which occurred at the October 2007 and March 2000 market peaks.

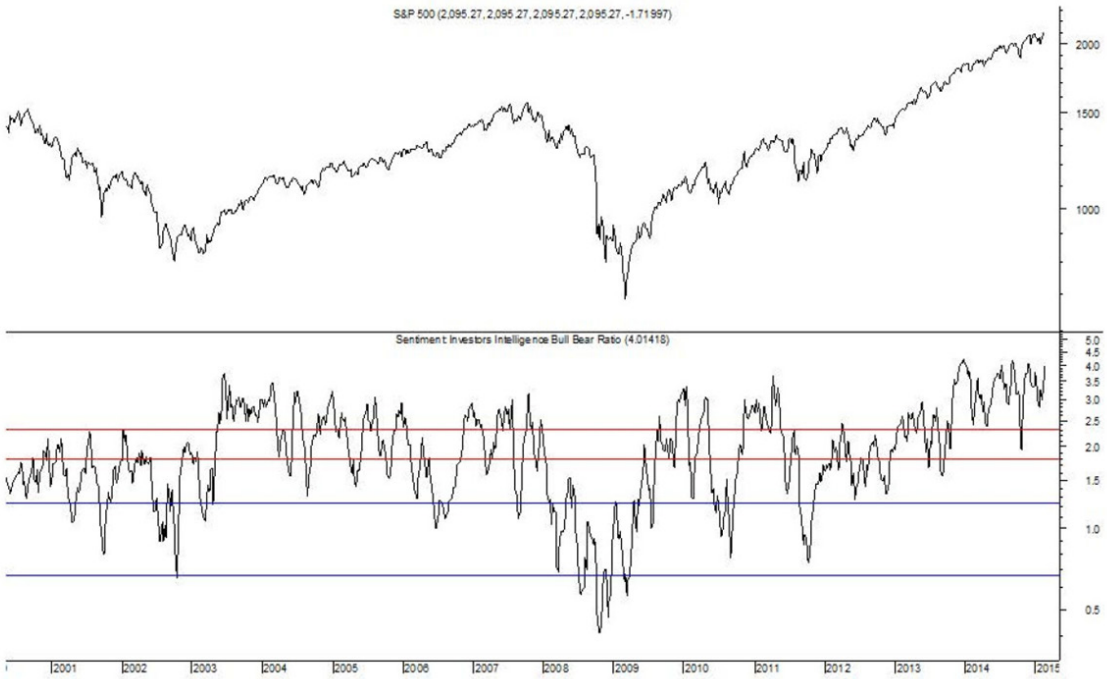
This chart's message seems consistent with Lowry's analysis, namely that the "thinning process" has not yet reached "danger" levels.

Looking at the short term, Jeff deGraaf's investors' sentiment chart shows that today there are four bulls for every bear. Investors are very optimistic about 2015.



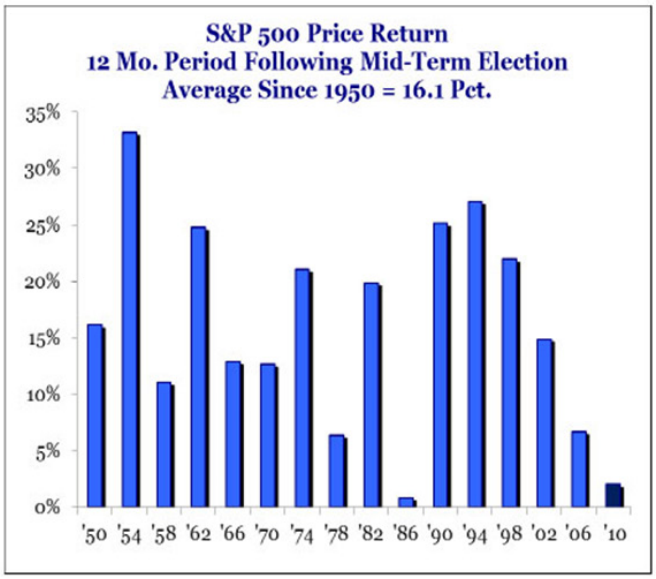
Source: Strategas Research. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Investor Sentiment



Source: Renaissance Macro Research. Data as of February 24, 2015. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Many publications (including this one at the end of last year) showed that the single best period of time for stocks during the four-year presidential cycle begins late in the mid-term year (2014) and extends through the first four months of the ensuing year (2015). deGraaf's chart above suggests the stock market may need to consolidate or correct before advancing on a more consistent basis.



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Common Stocks

Although we remain positive on stocks, we believe equities are no longer cheap and market risks are greater than perceived, just as they were overestimated near the market lows in early 2009. The charts below show various valuation measures for the S&P 500 including the Shiller P/E[11] ratio, which is based on inflation-adjusted last 10 year earnings and the price to sales[12] ratio. The Shiller P/E is 26.5X which is historically high but well below the record high in 2000 when many companies in the technology area sold for extraordinary multiples of earnings. Also included is a chart showing the enterprise value[13] for the U.S. stock market vs. GDP. This is consistent with our "no longer cheap" conclusion.

Note: Horizontal dashed line indicates median (1960-Present).
Source: BCA Research. Data as of March 2015. Price-To Earnings Ratio is defined as an equity valuation multiple. It is defined as market price per share divided by annual earnings per share. **Past performance is no guarantee of future results.**

Note: Horizontal dashed line indicates median (1960-Present).
Source: BCA Research. Data as of March 2015. Price-To-Sales Ratio is defined as a valuation metric for stocks. It is calculated by dividing the company's market cap by the revenue in the most recent year. **Past performance is no guarantee of future results.**

Source: Macro Mavens. Data as of January 2015. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. **Market capitalization (market cap)** is the total dollar market value of all of a company's (indexes) outstanding shares; it is calculated by multiplying a company's (indexes) shares outstanding by the current market price of one share.

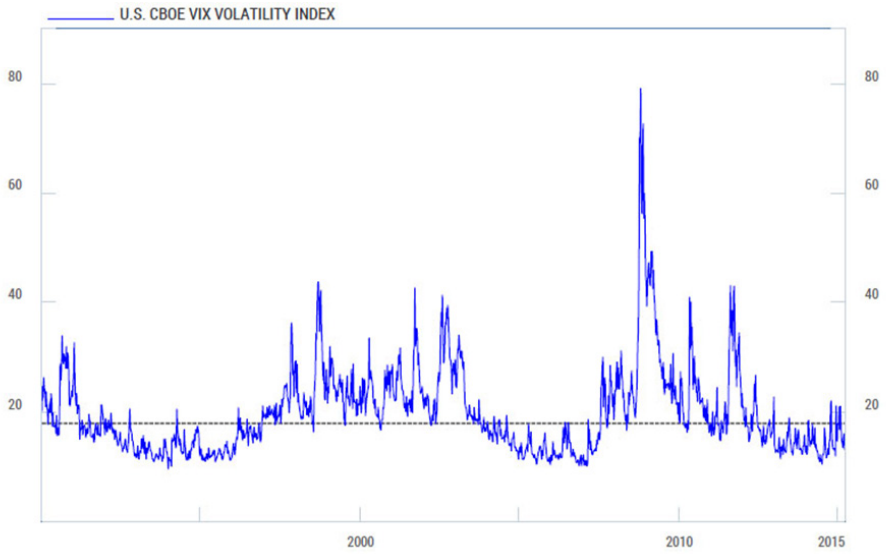
These indicators are in the "warning" range but represent very poor timing tools where identifying a potential market peak is concerned.

We understand that cash yields very little but we believe that cash may be the ultimate contrarian asset at this time.

Market Volatility

We believe stock market volatility, which has been quite low in recent years, could be substantially greater in 2015. Smaller equity exposure and an increase in cash balances might provide some hedge against an increase in volatility.

If a high volatility event were to happen, cash balances also might be used to pick up bargains which might develop at that time.

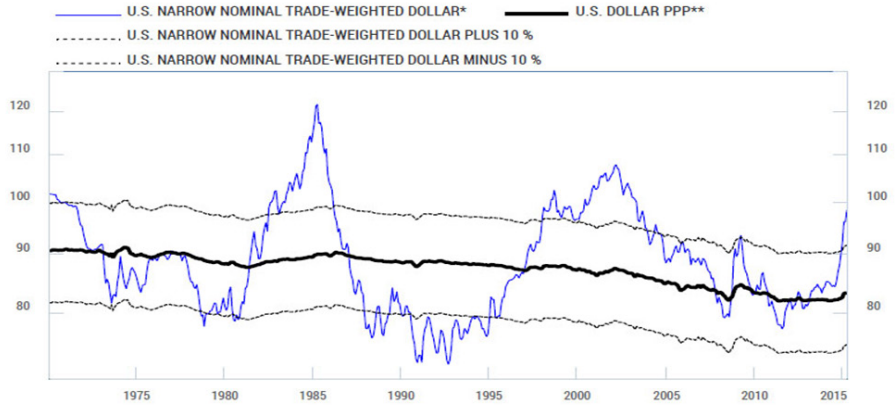


Note: Horizontal dashed line indicates median (1960-Present).
Source: BCA Research. Data as of March 2015. **Past performance is no guarantee of future results.** The VIX is a popular measure of the implied volatility of S&P 500 index options. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Almost Everyone is Bullish on the U.S. Dollar

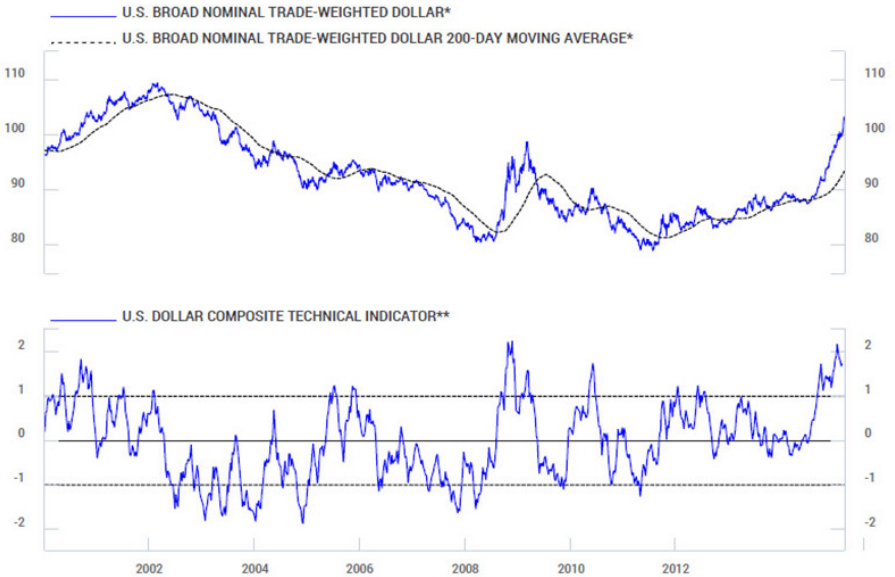
We also believe it is important to comment on the strength of the U.S. dollar. The dollar at this time is a "crowded trade" which is reflected in sentiment readings of 85-90% bullish and the dollar being more than two standard deviations[14] above trend.

U.S. Dollar and PPP



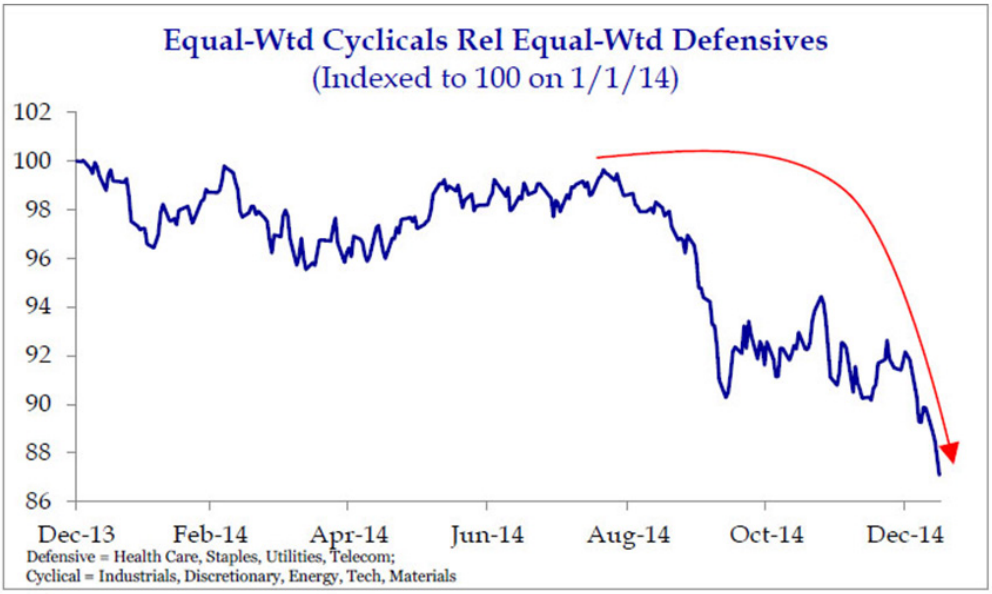
Source: BCA Research. Data as of March 2015. ****Purchasing Power Parity (PPP)** is an economic theory that estimates the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to each currency's purchasing power. **Past performance is no guarantee of future results.**

U.S. Dollar and Indicator



Source: BCA Research. Data as of March 2015. **Based on Momentum, Breadth, Sentiment and Trader Positioning. **Past performance is no guarantee of future results.**

The dollar has gone from being undervalued in recent years to overvalued on a trade-weighted-dollar basis. Although U.S. interest rates are higher than in most other developed economies, which is supportive of a strong dollar, continued dollar strength would adversely affect our exports, worsening our trade balance, and reducing GDP, all of which would be negatives. Our feeling is that bullish sentiment towards the dollar may have reached an extreme. If we are correct, the strong relative strength of defensive sectors, so pronounced as 2015 began, may give way to sectors of the market which are more economically sensitive.



Source: Strategas Research. Data as of January 2015. **Past performance is no guarantee of future results.**

S&P 500 Current and Historical Valuations

Sector	NTM P/E	15-Year Avg	Ratio	Relative P/E	15-Year Avg	Ratio (sorted)
Utilities	17.9x	13.8x	1.30	1.115	0.917	1.216
Energy	15.9x	13.2x	1.20	0.990	0.856	1.156
Staples	19.4x	16.5x	1.17	1.209	1.087	1.113
Health Care	17.6x	16.6x	1.06	1.097	1.055	1.039
Financials	13.6x	12.5x	1.08	0.845	0.823	1.027
S&P 500	*16.0x*	*15.5x*	*1.03*	*1.000*	*1.000*	*1.000*
Materials	15.7x	15.4x	1.02	0.982	1.008	0.974
Discretionary	17.8x	17.9x	0.99	1.109	1.166	0.951
Industrials	15.6x	16.0x	0.98	0.975	1.039	0.939
Telecom	13.6x	16.3x	0.83	0.848	1.063	0.797
Technology	15.4x	20.5x	0.75	0.958	1.283	0.747

Source: Strategas Research. Data as of January 2015. **Past performance is no guarantee of future results.** NTM = Next Twelve Months. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

The table below, from the Bank Credit Analyst, shows why we continue to prefer economically sensitive sectors and the health care sector, which often is lumped in with other defensive sectors (staples, utilities, telecommunications).

SECTOR	12-MONTH FORWARD EARNINGS GROWTH EXPECTATIONS (%)	FORWARD P/E RATIO*	
		CURRENT	HISTORICAL MEAN**
Financials	14.7	14.1	12.7
Consumer Discretionary	13.7	19.1	17.9
Technology	10.3	16.3	21.3
Health Care	8.8	17.9	18.1
Industrials	7.3	16.7	16.3
Materials	6.9	17.9	15.5
Telecom Services	5.3	13.9	16.9
S&P Total	4.2	17.3	14.9
Consumer Staples	4.0	20.0	17.5
Utilities	1.1	17.0	13.6
Energy	-45.2	27.0	14.9

SOURCE: THOMSON REUTERS / IBES
*BASED ON 12-MONTH FORWARD EARNINGS
**SINCE 1996

Source: BCA Research. Data as of March 2015. **Past performance is no guarantee of future results.**

The energy sector is a special situation because of the approximately 50% decline in oil in the last six months. A PEG (P/E-to-growth)[15] ratio relates the projected growth rate of earnings in the next 12 months to the current P/E ratio. In an early cycle stock market, sometimes the PEG ratio can be "1" or better but during late cycle stock markets, earnings growth is likely to be meaningfully below the sector P/E. We feel the defensive areas of the market like utilities, staples, and telecommunications have projected earnings growth rates that are only a small fraction of their sector P/Es. If the stock market improves, as we expect in 2015, the disparity between their P/E ratios and growth rates suggests rather substantial underperformance. Even if we are wrong and the stock market does poorly in the future, correlations increase dramatically in this type of environment and the defensive nature of these sectors is much less than expected. In the 2008-2009 bear market, defensive sectors were hammered right along with most other stocks.

Market Prospects Between Now & 2022

The quantitative types at Grantham Mayo Van Otterloo (GMO) released projections, in January 2015, for various asset classes seven years into the future. Over the years, U.S. common stocks have generated annualized real (inflation adjusted) returns averaging 6.5%. The GMO estimates for U.S. large-cap, small-cap, and high-quality companies out to 2022 are well below this historical norm. In addition international large-cap and small-cap projected returns are also well below the 6.5% figure. Of the asset classes mentioned above, GMO believes negative returns are
in prospect for several of them. The people at GMO are not sanguine about the return potential for bonds either.

If the GMO projections are anywhere near the mark several conclusions follow. First, income and income growth will be more prized in an environment where it is more difficult to generate capital gains, in our opinion. If market volatility is higher in coming years, market approaches may need to be more tactical and the use of options may be appropriate. Finally, we suspect that deflationary forces will give way to at least moderate inflation in the next two years. After all, for the first time in history our Federal Reserve actually wants higher inflation and we see no reason why they won't eventually get it! We note that inflation beneficiaries are among the cheapest and least appreciated areas of the stock market at this time.

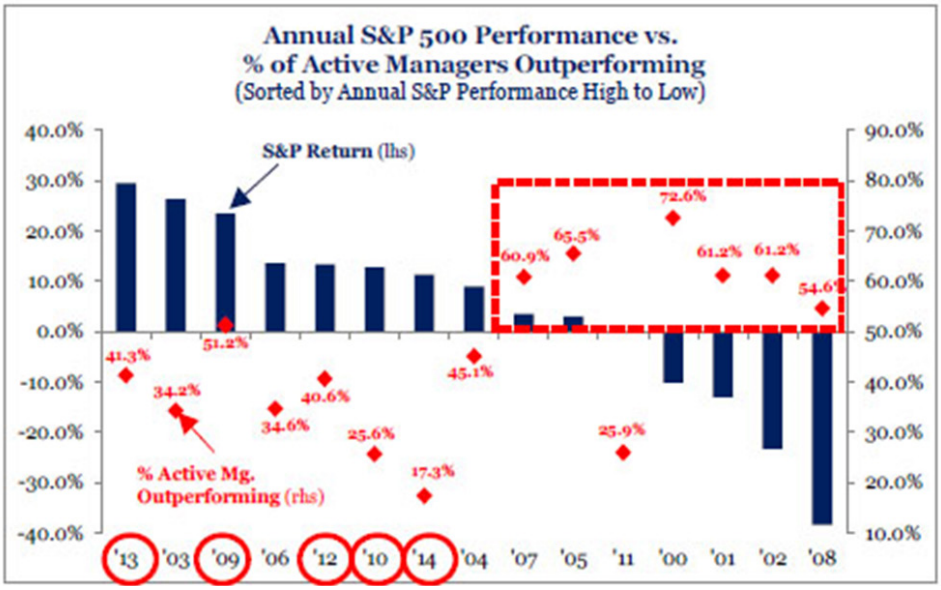
There are reasons why stocks might do better than the people at GMO project. Meaningful tax and entitlement reform and repatriation of stranded corporate capital in excess of $2 trillion from abroad would be among them. Unfortunately, progress on these fronts currently is taking a backseat to the emphasis on social justice and reducing income inequality. We've mentioned many times in recent Market Reviews that income inequality is a legitimate issue for debate but making it the centerpiece of efforts to turn the "economic battleship" known as the U.S. economy in the space of a two-term presidency is misguided. Income inequality can't be cured by raising taxes and making this the primary policy initiative can do harm to the economy. Taxes have been raised in the last

few years and income inequality actually has worsened.

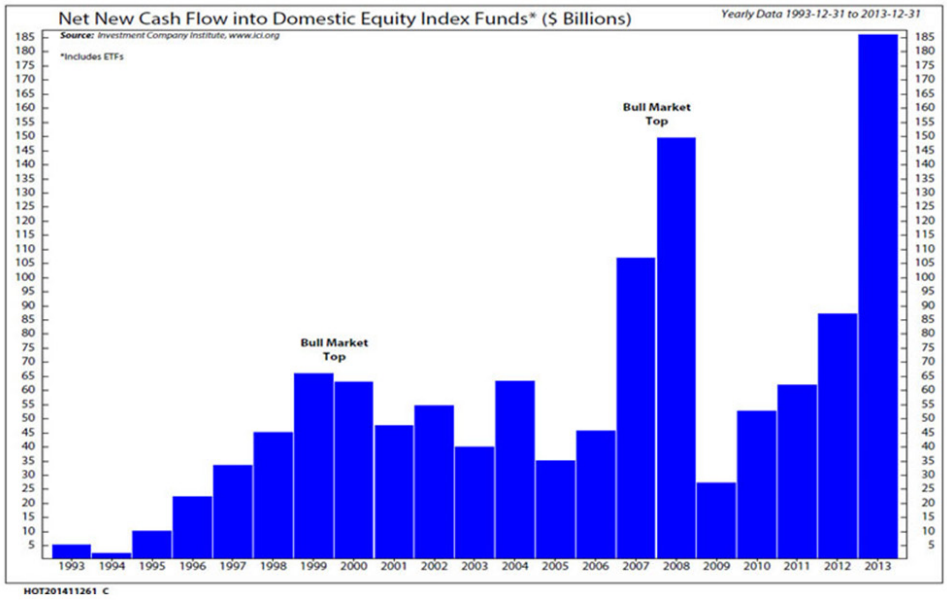
Here is food for thought. In 1960, 6% of babies were born out of wedlock and today the figure is 40% with some segments of the population experiencing rates above 70%. Children born into single parent households are not the only reason for adverse trends in income inequality but they certainly are important. Changing this in a more favorable direction will be a multi-decade challenge.

The Love Affair with Indexing: Cyclical or Secular?

The popularity of indexing has been increasing recently, no doubt a reaction to the fact that so many active managers have underperformed in recent years. The chart below is busy but shows that 2010-2014 have been years in which an index approach to the market triumphed over stock picking approaches.



Source: Strategas Research. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.



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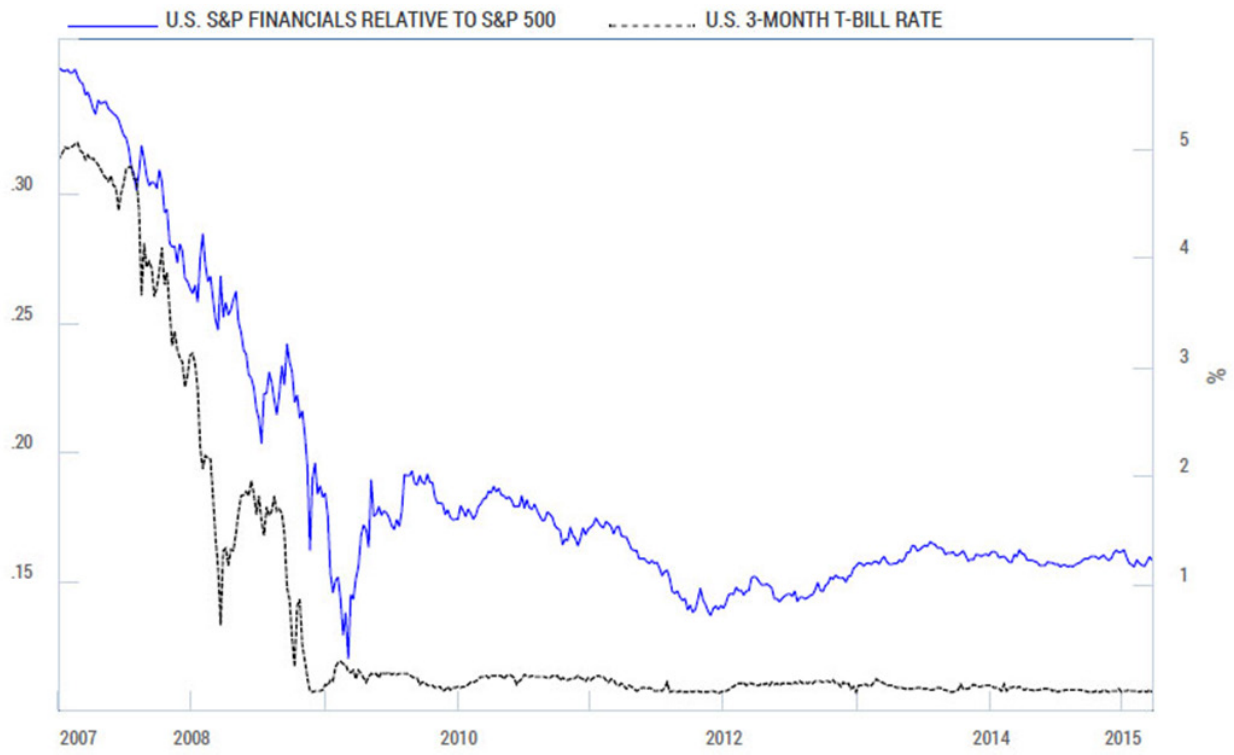
However, if the GMO and Bank Credit Analyst projections are at all valid, indexing in a low equity return environment would seem to guarantee very low returns. Might this not be an environment where stock-picking would be rewarded? The enthusiasm for indexing portfolios seems to be cyclical as evidenced by the chart above.

Low Hanging Fruit?

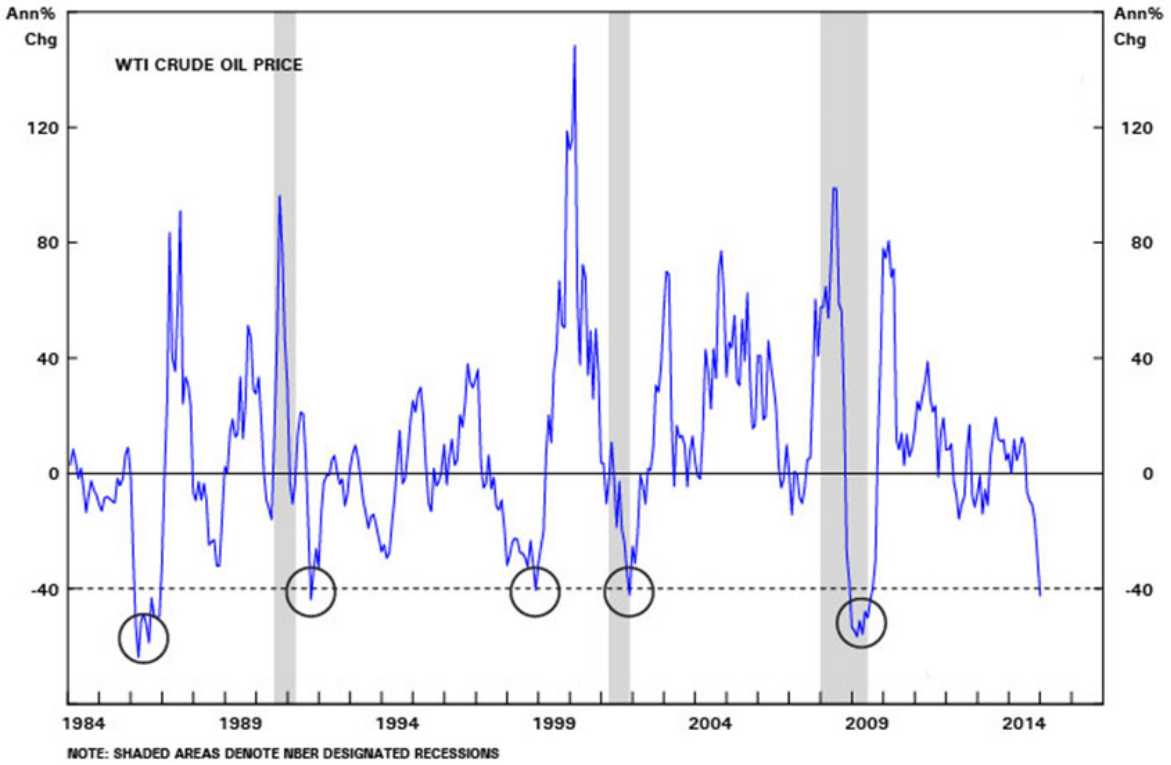
By definition many if not most stocks have performed well over the last five or six years which means there are fewer compelling values available today. However, the following are some of the areas where we feel there coud still be opportunity.

- In our opinion there could be positive implications for the financial sector if the spread between short-term and long-term interest rates expands. We believe the Federal Reserve will begin the normalization process, where interest rates are concerned, in 2015. Initial changes will be modest but stock market valuations are driven by change at the margin. Stocks of interest often have P/E ratios of 10X-12X, well below the 16X-17X for the stock market as a whole. Because of this, it is possible that earnings growth in 2015 might be enhanced by expanding P/E ratios in the direction of a market multiple.

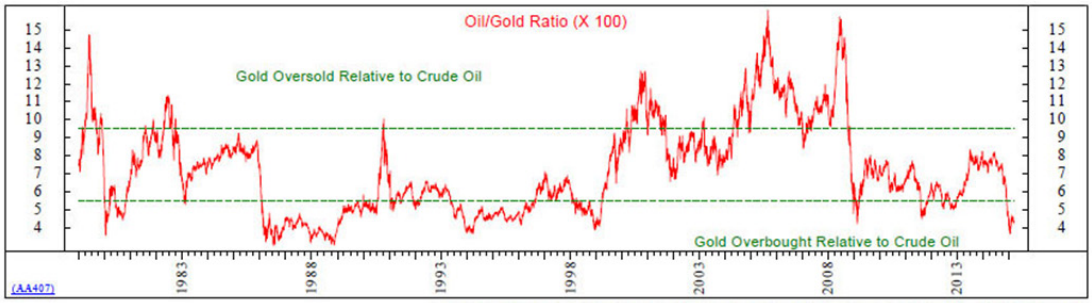


Source: BCA Research. Data as of February 2015. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

- Recently oil prices have fallen more than 40% for the sixth time in the last 30 years. With the damage to share prices having already occurred, history suggests that energy stocks, including some oil services names, might do quite well over the next 6-9 months. Drilling rig activity is falling faster than in any previous cycle and with decline curves of 60% or more for shale oil or natural gas production, a supply effect may occur sooner than many expect. In addition, comparing 2015 to 1986, there is far less excess capacity in OPEC[16] today than 30 years ago. In the mid-1980s, excess capacity in OPEC was 20% whereas today it is more like 3%. The market today may rebalance faster than in the past because of this. A chart we find interesting is the one that relates the price of 100 barrels of crude oil to the price of gold. Given this relationship, we think oil is now much more attractive than gold.



Source: BCA Research. Data as of December 2014. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. **West Texas Intermediate (WTI)**, also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing. This grade is described as light because of its relatively low density, and sweet because of its low sulfur content. It is the underlying commodity of Chicago Mercantile Exchange's oil futures contracts.



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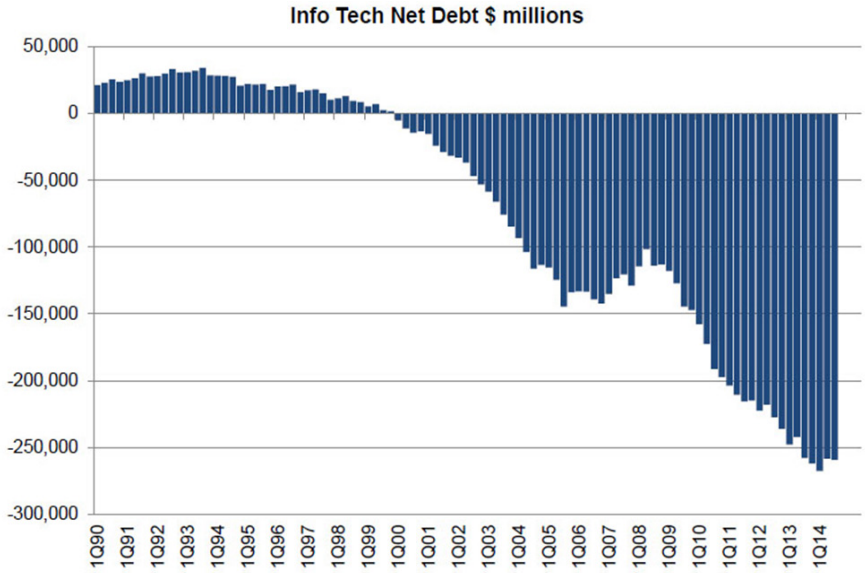
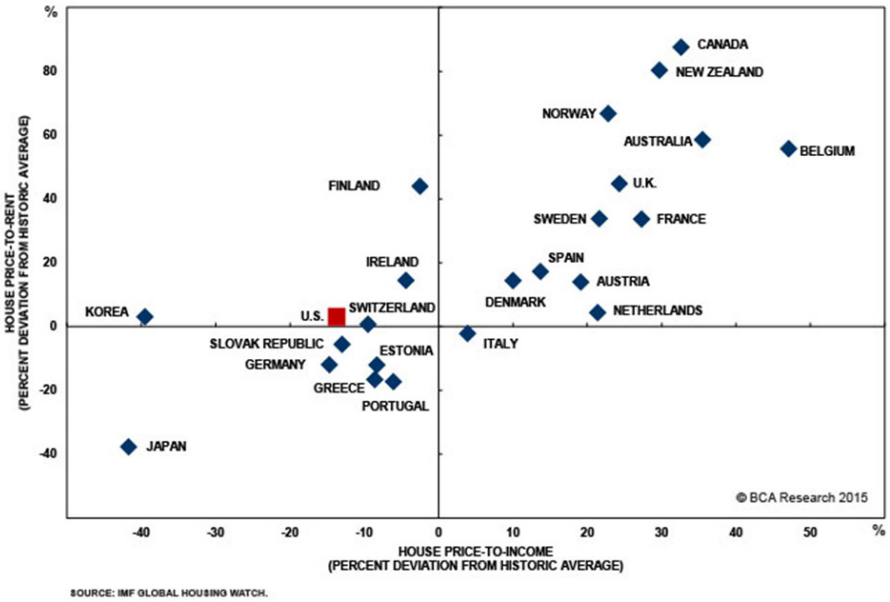
- Infrastructure spending in the U.S. has fallen substantially in recent years. We believe this will begin to change in the next 12-24 months. Efforts to repatriate cash assets from overseas might target domestic infrastructure investments as a quid pro quo. One of the leading specialty steel companies is available today at the same price it sold for five years ago and it provides an above average dividend yield[17]. This area of the economy has been hurt by the strong U.S. dollar but as indicated above, this may moderate in the period ahead.

- One of the things that usually happens later in the stock market cycle is that balance sheets deteriorate and industries and sectors of the stock market become more illiquid[18]. This can't be said of technology which has consistently improved its aggregate balance sheet over time as reflected in large net cash (cash minus all debt is positive or as is shown below, debt-cash is in deeply negative territory) accumulations. We continue to believe technology companies are positioned to benefit from an improving U.S. economy and the large cash positions at many companies suggest great flexibility to buy back shares, increase dividends or make accretive acquisitions.



Source: FactSet.

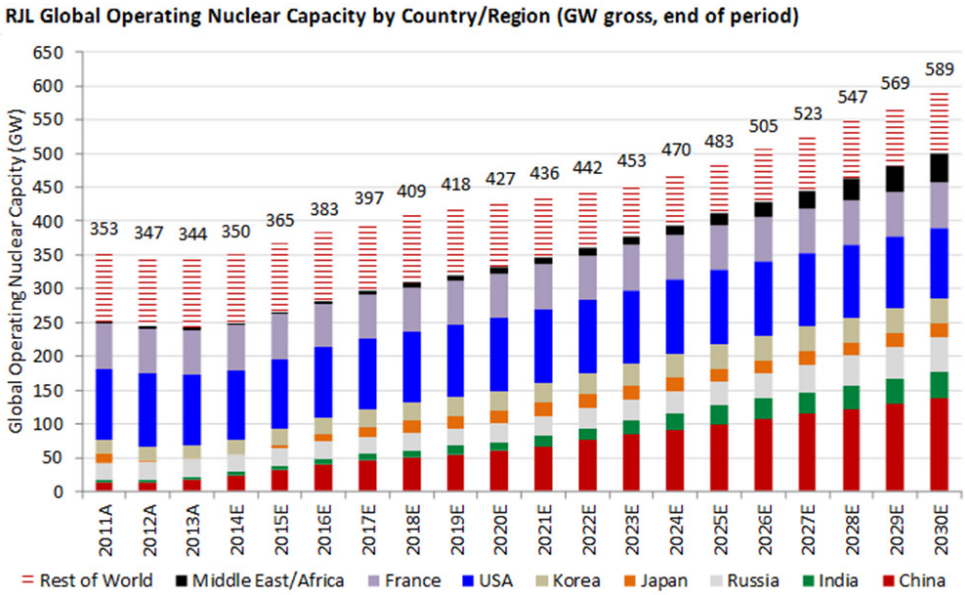
- Our approach to homebuilding is to focus on companies with low cost land inventories and whose products target the upscale homebuyer. The chart to the right shows that overall, the U.S. housing market is attractive on a global basis and there are other variables which suggest 2015 should be a banner year. However, family formations are down and the first time buyer continues to be challenged to buy a home unless virtually all of the purchase price can be financed. We've seen this movie before and it seems we're going to see a replay of sub-prime and other lending assists to the middle class and first time buyers.



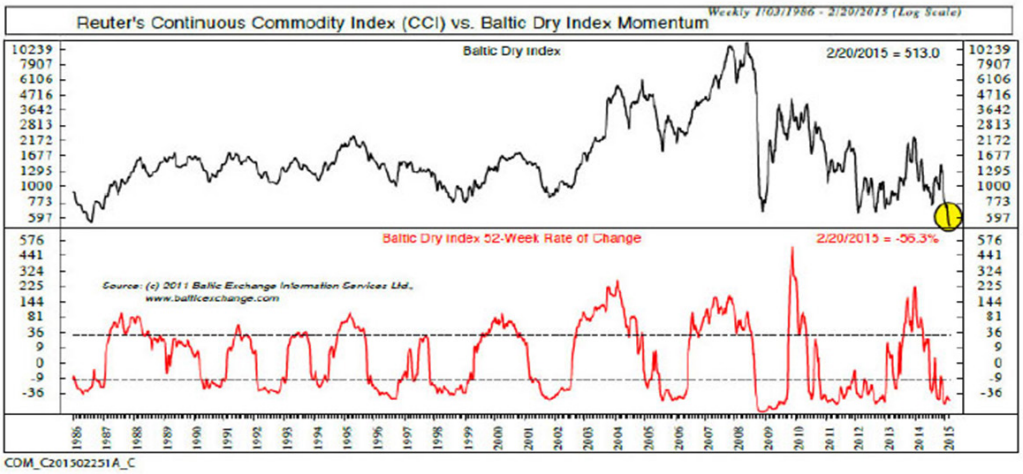
Source: BCA Research. Data as of February 2015.

- In the consumer discretionary area we favor a leading consumer electronics retailer as well as a leading retailer of imported goods. Over the last decade, wages and labor incomes have lagged far behind the returns to capital. Skill shortages and economic growth are beginning to have a favorable effect on wages which, in turn, should benefit specialty retailers.
- We have been early with regard to a more speculative investment, namely uranium. Nevertheless, we think this area of the stock market outperforms over the next 3-5 years. Large new reactor builds in China and India and elsewhere indicate demand may begin to outstrip supply in 2017-2018. However, most nuclear reactors begin to contract for necessary uranium supplies 18-24 months prior to completion. We are now in the early innings of this "window." Another factor that may be important is the fact that Kazakhstan now generates 40% of world supplies of uranium. This country is closely associated with Russia and it seems likely, given the situation in Ukraine, that buyers of enriched uranium will diversify to limit exposure to Kazakhstan.

- There is value, there is deep value, and then there is subterranean value. The chart below shows the Baltic Dry Index (BDIY)[19] over the last 30 years. Dry bulk shippers transport things such as iron ore and grains and of course these have been depressed in price in recent years. In addition, the dry bulk shipping industry has faced overcapacity due in part to dramatic new-build programs in 2007-2008. The suppression of interest rates at historically low levels has allowed marginal players in dry bulk shipping to hang on much longer than in previous cycles. In 2015-2016, scrappage will be increasing and it is likely new capacity additions will moderate. Most publicly traded dry bulk shippers have large amounts of debt so even if they are cheap they don't provide much "optionality" because pesky debt holders may insist on highly dilutive offerings, among other things, to shore up their balance sheets. However, there is one publicly traded dry bulk shipper whose debt is offset by cash balances (an uncharacteristically strong industry balance sheet) and which we believe could be an outstanding stock market performer over the next few years. This company does in fact provide the "optionality" that is essential when considering "deep value" plays. We note that iron ore prices have fallen more than oil prices in the last year. A leading customer of the dry bulk shipping industry is a low cost producer of iron ore. In the last month, this company increased its dividend 12% and it now yields 4.5%. Sometimes interesting opportunities can be found in troubled waters!



Source: Raymond James Ltd , as of December 2013. Forecasts are inherently limited and should not be relied upon as indicators of actual or future performance.



Source: Ned Davis Research. Copyright 2015 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/. Continuous Commodity Index (CCI) is comprised of 17 commodity futures that are continuously rebalanced, recognized as a major barometer of commodity prices. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

International

Earlier we showed that the Federal Reserve has been far out ahead of other central banks in stimulating the economy by growing its balance sheet. In this regard, the Eurozone has been a laggard and only now are we beginning to witness meaningful stimulation from this source. Europe is in the early "innings" of its own quantitative easing[20] whereas the U.S. is much closer to completing its efforts in this regard.

*Based on MSCI Inc. Data (See Copyright Declaration).
Source: BCA Research. Data as of February 2015. **Past performance is no guarantee of fuure results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

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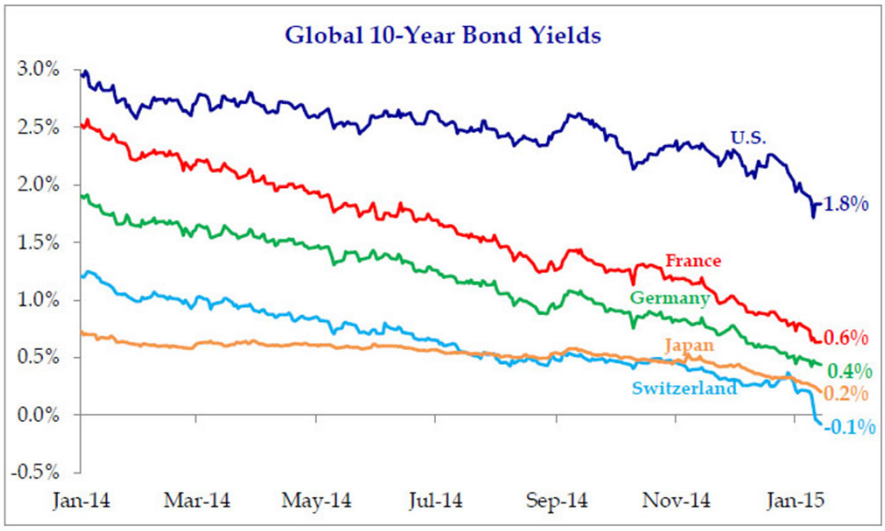
Source: BCA Research. Data as of February 2015. **Past performance is no guarantee of fuure results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

As the chart above shows, the Shiller P/E ratio for Europe is about 15X compared to 26.5X for the U.S. Some of this reflects the moribund European GDP growth in recent years but the valuation spread is large enough that it may make sense to consider some European stocks. It is important to note that Europe relies on exports for about 40% of its GDP-Germany is even higher-compared to 15-16% for the U.S. The combination of quantitative easing, a weaker Euro, and the importance of exports, which should benefit from a weaker currency, indicates more growth may develop in 2015-2016 in this area of the world.

Bonds

Almost certainly the next year will see the inflection point for U.S. interest rates as the Federal Reserve begins the normalization process. A continuation of ZIRP would allow even more significant imbalances to develop. It is curious to see just how "elevated" U.S. interest rates are relative to countries in Europe but this reflects problems there and the very real threat of deflation. If Europe's growth picks up, as we expect, it is likely the current exceedingly depressed rates (including negative interest rates) will begin to increase.



Source: Strategas Research. Data as of January 2015. **Past performance is no guarantee of future return.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

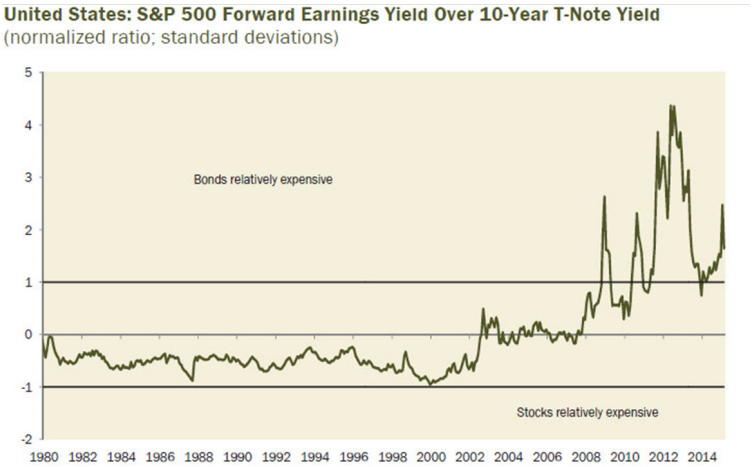
Has anything like current Federal Reserve policy occurred before, where interest rates are concerned? For example, what happened in the Great Depression? We looked at the first years of the Great Depression (1930-1934) and found that 10-year U.S. Treasury yields were in the 3%+ area during this period of time. Some have argued that the Federal Reserve back then should have emulated recent policy initiatives where interest rates are concerned. We present 10-year Treasury interest rates from the early 1930s to show just how aggressive the Federal Reserve has been this time around.

Included below is the Fed Model which relates the S&P 500 forward earnings yield (reciprocal of the P/E ratio) to the yield on the 10-year U.S. Treasury note. Currently, bonds are more than two standard deviations above fair value! We believe bond values today are where Internet and technology stock valuations were in March 2000.

LONG TERM GOVERNMENT BONDS
(20-year average maturity)

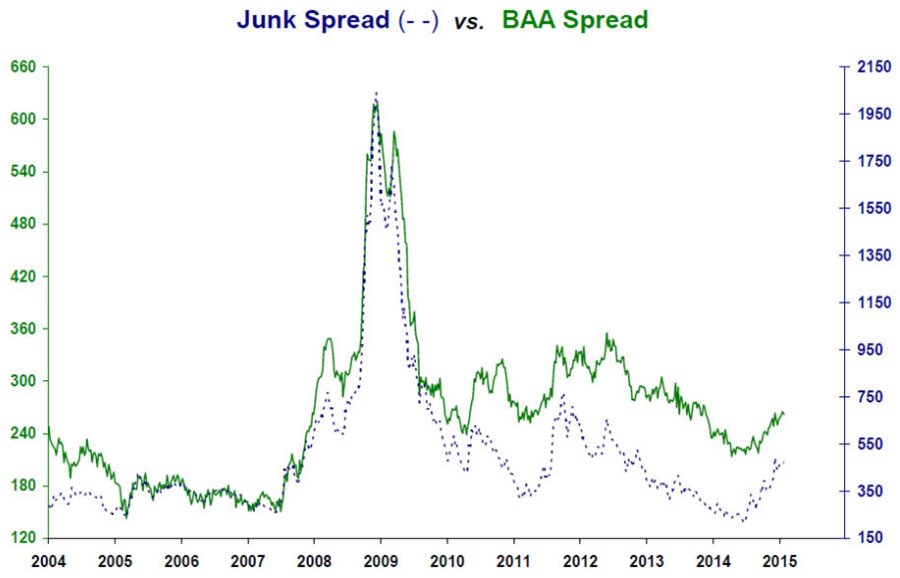
Year	Total Return	Income Return	Income as % Total Return
1930	4.66%	3.32%	71.24%
1931	-5.31%	3.33%	100%+
1932	16.84%	3.69%	21.91%
1933	-0.07%	3.12%	100%+
1934	10.03%	3.18%	31.70%
Annualized	4.82%	3.33%	69.10%

Source: Morningstar Ibbotson SBBI 2014 Classic Yearbook.
Past performance is no guarantee of future return.



Source: Morningstar Ibbotson SBBI 2014 Classic Yearbook.
Past performance is no guarantee of fuure results. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

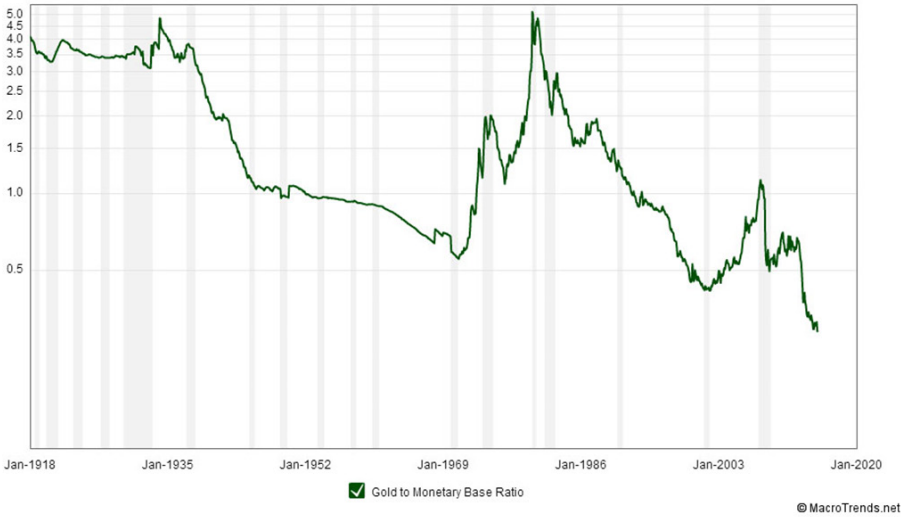
We also believe the recent widening in junk[21] (high yield) and BAA[22] spreads[23] are cautionary as well. These are the most "equity-like" bonds and deterioration (widening) in spreads often has been suggestive of greater stock market risks in the past.



Source: Macro Mavens. Data as of February 2015. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Gold

We continue to believe "insurance positions" in gold are justified. Although interest rates continue to be suppressed at historically low levels, a positive for gold, it is likely the next significant change will be for rates to increase. In addition, recent dollar strength has been a negative for gold. We also believe the sharp drop in the velocity of money in this country limits how much inflation is likely in the first half of 2015. As pointed out in the Common Stock section above, the relative value of 100 barrels of oil to gold strongly favors the former at this time. Depressed oil prices are very strong competition for gold.



Source: MacroTrends. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Gold has done especially well during inflationary times. If we look at the late 1970s and the year 1980 in particular, rising inflation drove gold prices higher even though interest rates were on a trajectory well into double digits. We remain believers that for gold to outperform in dollar terms, the dollar itself must stop appreciating and inflation must become more of a problem. The seeds for this to happen have been planted but as is usually the case, timing the inflection point will be the issue. We believe gold prices may eventually bottom in the $900-$1100 per ounce range.

The chart above shows the St. Louis Federal Reserve's calculation of the monetary base, essentially a broad definition of money supply. From a ratio of $39:1 in 1945 the U.S. monetary base now is approaching $5000 for each ounce of gold held by our government. Certainly this trend represents inflationary potential but as shown earlier, a declining velocity of money tends to neutralize inflationary tendencies, at least for a while.

Earlier we discussed the large increases in the Federal Reserve balance sheet as well as the balance sheets of most central banks around the world. Central banks can't remain the prime mover behind business cycles very long because if they do so, eventually they run out of good policy options. What would our Federal Reserve do if recessionary forces began to appear in the next few years, lower interest rates? This policy tool has already been utilized. When a central bank arrives at the point where there are few good policy options, increasing the money supply and debasing the currency are some of the few remaining ones. If the Federal Reserve overstays its current role in the economy, this could be reflected in higher gold prices but as indicated above, this will need an assist from the velocity of money.

Things That Make You Go Hmmmmmmm……..

In a recent article in Investor's Business Daily, Thomas Sowell expands on the concept of inequality in an article titled "*Wide World of Unavoidable Inequality*." Some of the most interesting inequalities have to do with geography. Africa encompasses 30 million square kilometers, three times the size of Europe at just over 10 million square kilometers. However, Europe has a longer shoreline than Africa because its fractal geometry is such that there are more harbors, islands and inlets. Sowell believes this is one reason why the level of trading and economic activity in Europe is likely to be so much greater than that for Africa, no matter what the income disparities between the continents might be.

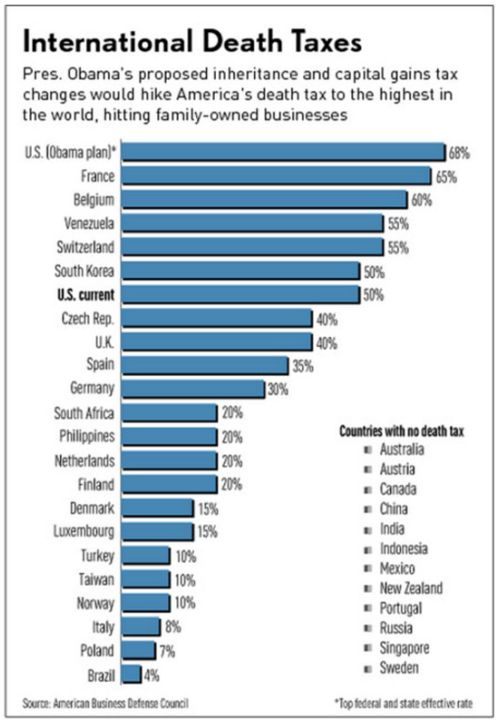
Another inequality cited by Sowell is the difference between the Zaire (Congo) and Mississippi Rivers. Both are major rivers but their economic value is very different. The Zaire River, in the space of 150 miles, has 30 cataracts adding up to a drop of 1000 feet. The Mississippi, by contrast, drops by four inches a mile so over the same 150 miles, it has a drop of only about 50 feet. Because of this the Mississippi is a much more useful river for trade and transit.

<u>International Death (Estate) Taxes</u>

Currently, the U.S. death tax is 50% once the current exemptions ($5.3MM or $10.6MM for a couple) have been fully utilized. The President has made proposals that would elevate the death tax to as high as 68% in some circumstances. If state death taxes were added in, the U.S. would have the highest death tax in the world. The President's major proposals include elimination of the "step up in basis at death" and the payment of capital gains taxes of 28% on appreciated assets at death. Changes such as these would devastate privately held businesses and would amount to wealth confiscation. In recent Market Reviews, we have indicated that the effort to reduce "inequality" is not just an income battlefield. The real battlefield is "wealth" and the death tax proposals are but one of several recent wealth confiscation salvos. Recently a government study group proposed limits on IRA, 401k and other retirement accounts, for example.

Let's compare the President's proposals with those in other countries. In Scandinavian welfare states such as Norway and Denmark, the death tax rates are 10% and 15% respectively. Sweden has no death tax-the rate is 0%! China and India have 35% of the world's population and their death tax rates also are 0%. So what is happening in our own hemisphere? The U.S. with a current death tax rate of 50% is flanked by Mexico and Canada, which, you guessed it, have death tax rates of zero!

Source: Kai Krause.

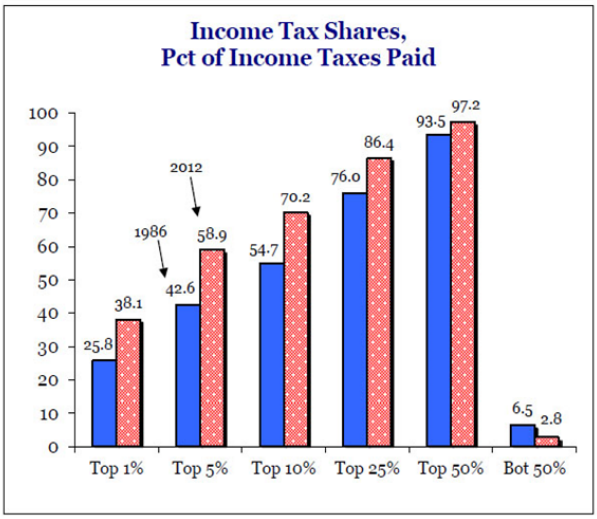


Source: American Business Defense Council, as of February 2015.

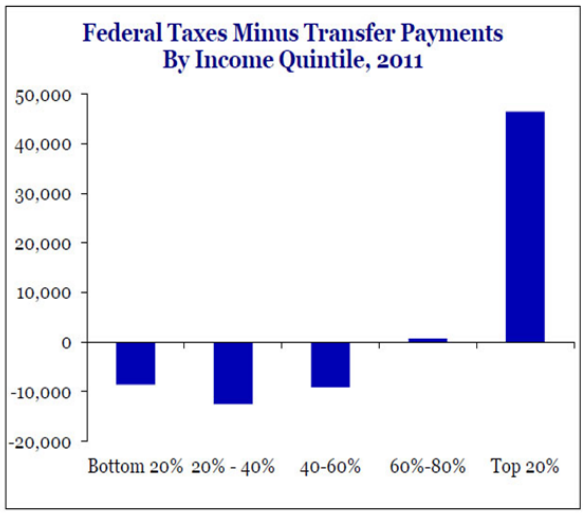
The President tried to soften the blow of his death tax proposals by telling widows or surviving spouses that they would not be taxed on the first death….however, if any bequests were made to children they would be fully taxable.

Please Define "Fair Share"

The chart below shows how the U.S. federal income tax has become significantly more progressive since 1986.



Source: Strategas Research Partners, as of December 2012.



Source: Strategas Research Partners, as of December 2011.

In fact, if things keep trending the way they have in the last 29 years, soon the top 50% of taxpayers will be paying more than 100% of income taxes. Possibly this is the political goal of some so that it will be easier to increase tax rates on the tax paying minority! The only definition we can think of for "fair share" is "more!"

The Debt Supercycle-A More Detailed Description From the Bank Credit Analyst

"The pain of the Great Depression led governments to intervene to smooth out the business cycle, and their actions were given legitimacy by the economic theories of John Maynard Keynes. Fiscal and monetary reflation, together with the introduction of automatic stabilizers such as unemployment insurance, were successful in preventing frequent depressions that plagued the pre-WWII economy, but the downside was that balance-sheet imbalances and financial excesses built up during each expansion phase were never fully unwound. Although liquidity was rebuilt during recessions in recent decades it did not return to its previous cyclical high. Meanwhile the liquidity rundown during the next expansion phase usually established new lows. Individual balance sheets at the end of World War II were extremely liquid, in part, because rationing during the war years limited consumption so that food and many other things would be available to the military.

The trends inherent in the Debt Supercycle led to growing illiquidity and vulnerability in the financial markets. The greater the degree of illiquidity in the economy, the greater is the threat of deflation. Thus, the bigger the balance sheet excesses become, the more painful the corrective process would be. So, the stakes became higher in each cycle, putting ever-increasing pressure on the authorities to reflate demand by whatever means are available. The Supercycle process was characterized over time by the building tension between rising underlying deflationary risks in the economy, and the ability of policy makers to create inflation.

The Supercycle reached an important inflection point in the recent economic and financial meltdown (2008), with the authorities reaching the limit of their ability to get consumers to take on more leverage. This forced the government to leverage itself up instead, representing the Debt Supercycle's final inning."

John G. Goode
March/April 2015

Investment Risks

The opinions and views expressed herein are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, or investment advice.

Common stocks generally provide an opportunity for more capital appreciation than fixed-income investments but are subject to greater market fluctuations.

Investments in small-cap and mid-cap companies involve a higher degree of risk and volatility than investments in larger, more established companies.

Fixed-income securities are subject to interest rate and credit risk, which is a possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. As interest rates rise, the price of fixed income securities falls.

High yield bonds are subject to increased risk of default and greater volatility due to the lower credit quality of the issues.

Asset-backed, mortgage-backed or mortgage-related securities have greater exposure to prepayment and extension risks than investments in other fixed income securities.

International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

Commodities and currencies contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

Real Estate Investment Trusts (REITs) invest in real estate or loans secured by real estate and issue shares in such investments, which can be illiquid.

U.S. Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

A credit rating is a measure of an issuer's ability to repay interest and principal in a timely manner. The credit ratings provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd. typically range from AAA (highest) to D (lowest). Please see www.standardandpoors.com, www.moodys.com, or www.fitchratings.com for details.

Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses and have a potentially large impact on Fund performance.

Hedge funds are considered to be complex investment products which have specific risks associated with them, and may not be suitable for all investors.

Leverage increases the volatility of investment returns and subjects investments to magnified losses and decline in value.

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Dividends and Yields represent past performance and there is no assurance they will continue to be paid in the future.

Diversification and asset allocation do not guarantee a profit or protect against market loss.

Outperformance does not imply positive results.

Active Management does not ensure gains or protect against market declines.

Endnotes

[1] **Junk bond** is a colloquial term for a high-yield or non-investment grade bond.

[2] **Gross Domestic Product ("GDP")** is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time. **Real GDP** is a nation's total output of goods and services in constant dollar, or inflation-adjusted terms.

[3] **Deflation** refers to a persistent decrease in the level of consumer prices or a persistent increase in the purchasing power of money.

[4] The **velocity of money** is the rate at which money is exchanged from one transaction to another, and how much a unit of currency is used in a given period of time. Velocity of money is usually measured as a ratio of GNP to a country's total supply of money.

[5] The **Federal Reserve Board ("Fed")** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

[6] A **Zero Interest Rate Policy (ZIRP)** is a monetary policy that attempts to stimulate economic activity by keeping interest rates close to zero.

[7] The **Dow Jones Industrial Average (DJIA)** is an unmanaged index composed of 30 blue-chip stocks. The DJIA is price-weighted, reflects large-cap companies representative of U.S. industry, and historically has moved in tandem with other major market indexes such as the S&P 500.

[8] The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

[9] The **S&P MidCap 400 Index** is a market-value weighted index which consists of 400 domestic stocks chosen for market size, liquidity, and industry group representation.

[10] The **S&P SmallCap 600 Index** is a market-value weighted index, which consists of 600 domestic stocks chosen for market size, liquidity, and industry group representation.

[11] The **price-to-earnings (P/E)** ratio is a stock's (or index's) price divided by its earnings per share (or index earnings).

[12] The **price-to-sales (P/S)** ratio is a stock's price divided by its sales per share.

[13] **Enterprise value (EV)** refers to the entire value of a company after taking into account both holders of debt and equity.

[14] **Standard deviation** is a statistic used as a measure of the dispersion or variation in a distribution, or dataset, from its mean, or average; it measures the volatility of an investment's return over a particular time period; the greater the number, the greater the volatility.

[15] **Price/Earnings to Growth (PEG)** is a valuation metric for determining the relative trade-off between the price of a stock, the earnings generated per share (EPS), and the company's expected growth.

[16] The **Organization of the Petroleum Exporting Countries (OPEC)** is a permanent intergovernmental organization of 12 oil-exporting developing nations that coordinates and unifies the petroleum policies of its member countries.

[17] **Dividend yield** is a financial ratio that shows how much a company pays out in dividends each year relative to its share price.

[18] **Liquidity** refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price.

[19] The **Baltic Dry Index** measures dry bulk shipping rates – the demand for shipping capacity versus the supply of dry bulk carriers. Since the demand for shipping varies with the amount of cargo that is being traded in the market and the supply of ships is much less elastic than the demand for them, the index indirectly measures global supply and demand for the commodities shipped aboard dry bulk carriers, such as cement, coal, iron ore, and grain.

[20] **Quantitative easing (QE)** refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

[21] **Junk** is a colloquial term for a high-yield or non-investment grade bond.

[22] **BAA** is a credit rating denoting a medium grade, moderate risk security.

[23] A **spread** is the difference in yield between two different types of fixed income securities.

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* As of March 31, 2015.