COHO PARTNERS, LTD.

Q1 2015 Commentary

"I will have a very clear answer in hindsight"

Lloyd Blankfein-Goldman Sachs

UNITED STATES

Following the weather-induced contraction in economic activity in 1Q 2014, the U.S. economy accelerated over the balance of the year at an annualized rate of 3.8%. If maintained in 2015, this would represent the fastest pace of annual growth since 2004. Declines in energy costs, import prices and inflation coupled with gains in employment and wages framed our initial thesis for stronger consumer spending in 2015.

As consumer spending accounts for almost 70% of real GDP calculations, it is considered one of the most important barometers of the health of domestic economic activity. Anticipating an increase in consumption might add as much as 0.5% to overall Gross Domestic Product (GDP), we pegged 2015 growth at an improved 2.75%, albeit still below consensus. This would represent the best growth rate of the economic recovery, but so far in 2015, the U.S. consumer has been missing in action.

In 4Q 2014 consumer spending growth (30% of which was for health care services) reached 4.4%, the strongest pace since 1Q 2006. However, for 1Q 2015, real consumer spending is looking closer to 1%, far below our expectations. As a result, we now expect 1Q GDP to come in around 1%. We are maintaining our full year target but acknowledging the potential for downside risk.

In late March, Federal Reserve Chairperson Janet Yellen shared her current views on the economy at a research conference at the Federal Reserve Bank of San Francisco:

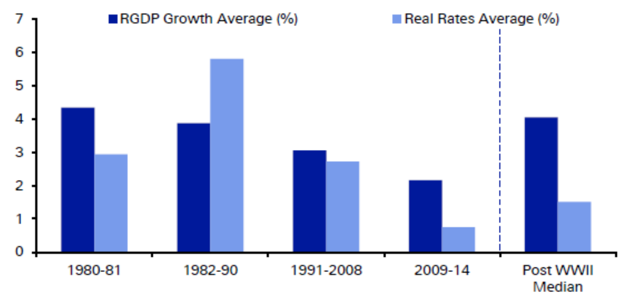
> "*In assessing the actual strength of the labor market and the broader economy, we must bear in mind that these very welcome improvements have been achieved in the context of extraordinary monetary accommodation. While the overall level of real activity now appears to be much closer to its potential than it was a year or two ago, the economy in an "underlying" sense remains quite weak by historical standards, for the simple reason that the increases in hiring and output that have been achieved thus far have required exceptionally low levels of short- and longer-term interest rates, reflecting a highly accommodative stance of monetary policy. Interest rates have been, and remain, very low, and if*

underlying conditions had truly returned to normal, the economy should be booming……"

We agree with Yellen's assessment and wonder what has happened to the U.S. consumer. Have 15 years of multiple stock market collapses combined with a housing market where prices are still 16% lower than their pre-recession peak finally forced the average consumer to repair personal balance sheets and rebuild wealth? While this may be partially correct, the reality may be our faulty perception of the growth potential of the economy where an aging demography, income inequality and excess debt levels have all contributed to a stagnation of secular economic gains.

In actuality, the U.S. has been in a decelerating period of economic growth since long before the Great Recession. Since World War II, inflation-adjusted GDP has averaged around 3.2% per year with over 37 years from 1949-2000 above 3% and 27 occurrences greater than 4%. Since 2000, annual GDP growth has not achieved a level of 4% and only exceeded 3% in 2004 & 2005. Overall, between 1949 and 2000, the economy enjoyed average annual growth in excess of 3.6%. Since 2000, that rate is only 1.8%. The most recent post-recession period has averaged just 2.2% despite following the largest economic contraction since the Depression.

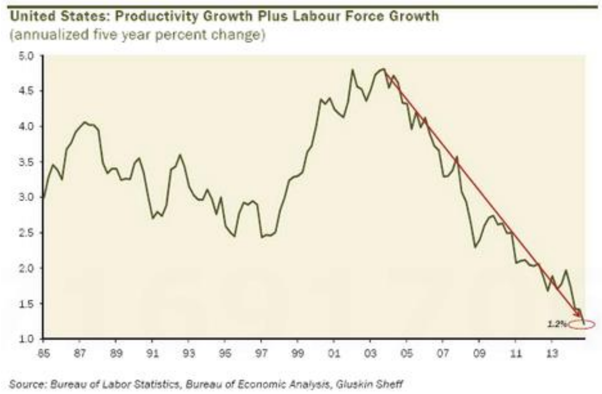
US Expansion Cycles* - Falling Growth, Falling Real 10Y Rates



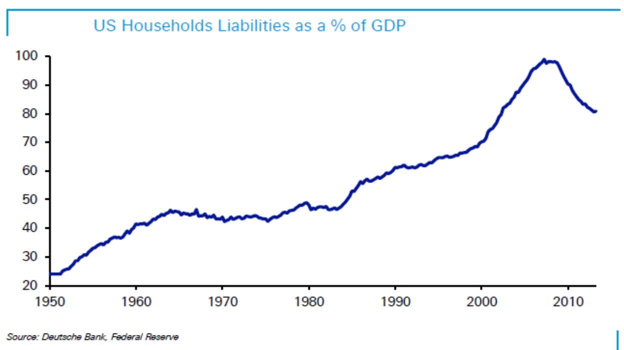
Source: Deutsche Bank, GFD / *Note – Here we define a recession as two quarters of negative real GDP growth

Many have struggled to square the circle of a strong job market not correlating to stronger economic growth, but remember, a country's potential GDP growth rate is a product of both productivity and labor force growth. The U.S. labor force grew 0.5% over the last year and the 10-year average is 0.6%. That is less than half the rate of the prior three decades. Ours is an aging demography and fewer people being added to the work force will limit potential economic gains absent major increases in productivity. On that front, a similar shortfall emerges.

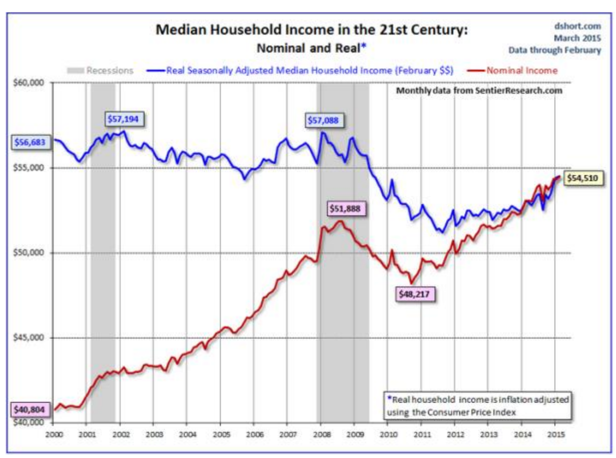
Following an outright contraction at a -2.2% an annual rate in 4Q, productivity growth (defined as output per hour of all employed people) for full year 2014 was 0%. Solid 1Q 2015 job growth combined with the prospect of a 1% 1Q GDP indicate a further decline in this period. The 10-year average for productivity has slowed to 1.5% (and about 1% during this cycle) compared with an average for the prior two decades closer to 2.2%. A look at the chart on the following page goes a long way to explaining the multi-decade deceleration in economic growth.



Despite major credit expansion (see chart below) and multiple asset bubbles in equities and housing, the median U.S. household has fared even more poorly with only a few periods of robust growth succeeding in raising wages and household incomes. The increased use of credit that started in the early 80's that accelerated after the millennium was a major tailwind for growth and appears to now be unwinding if not ending.



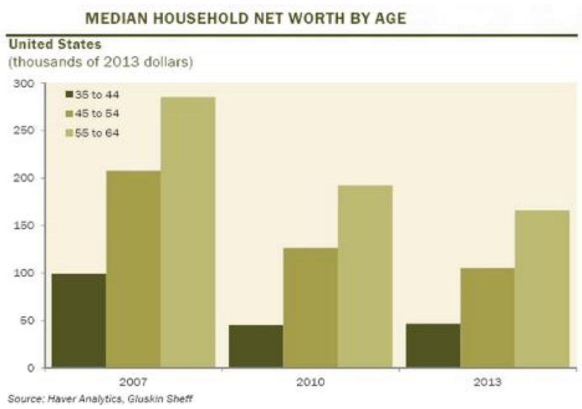
According to Sentier Research, median household income adjusted for inflation (see blue line in chart below) is now on an upward trend (+2.7% year-over year and +6.4% from the 2009 trough). However, at $54,510 this income level is still 4.7% below levels observed in 2002.



Household Net Worth for the period ending 4Q 2014 has recently been reported at an all-time high of $89.2T, up 5.2% in the last year. This is a level that is 50.9% above the trough in 2009 and 22.2% above the prior peak in 2007. However, this data which is extracted from the Flow of Funds released by the

Federal Reserve is aggregate data and does not reflect the typical or median individual. The median tells a different story and is consistent with the income plight of the average worker.

For the median household led by an individual between the ages of 45-54, net worth has plunged from $207,600 at the 2007 peak to $105,300 at the end of 2014. For an older cohort between the ages of 55-64, it has declined from $285,300 to $165,900 during the same time period. A similar though less immediately alarming story applies to the younger 35-44 year cohort as shown in the chart below.



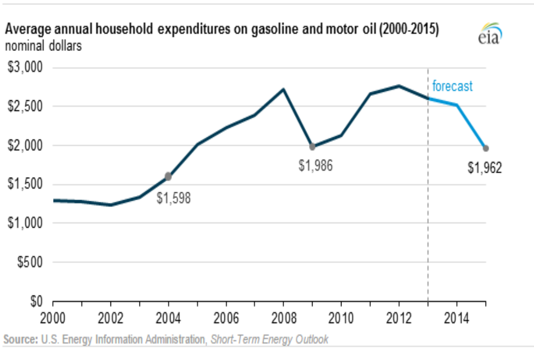
Without a return to economic growth rates of the second half of the 20th century, the median U.S. household will struggle to regain the ground lost during the last 2 decades. Recently we have seen the personal savings rate jump from 4.4% in November of last year to 5.8% as of February. Viewed through the prism of declining net worth, perhaps recent consumer frugality is more understandable.

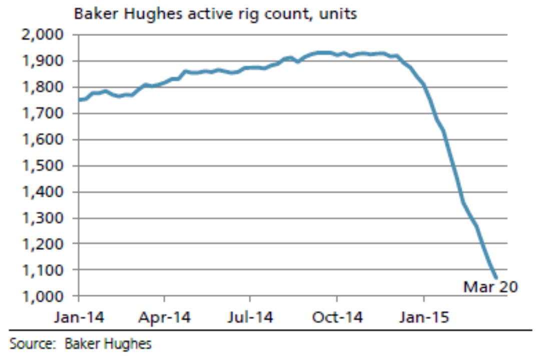
OIL & U.S. DOLLAR

Perhaps the two most impactful events of the last few quarters have been the major collapse in oil prices and the meteoric rise of the U.S. dollar against most global currencies. Since peaking in June of 2014 around $107 per barrel, crude oil prices dropped over 50% to end 2014 at $53/barrel and declined another 10% to $47 at the end of 1Q of 2015. The positive supply shock to global markets is mostly due to increased production via the hydraulic fracking revolution (shale oil) combined with a behavioral shift in production to greater uses of natural gas. OPEC has defended its market share via continued production putting further pressure on prices. Shale oil is expensive to extract (and more cheaply turned on and off) thus this price decline benefits the low cost production of conventional oil fields and the United States may be viewed as the marginal producer.

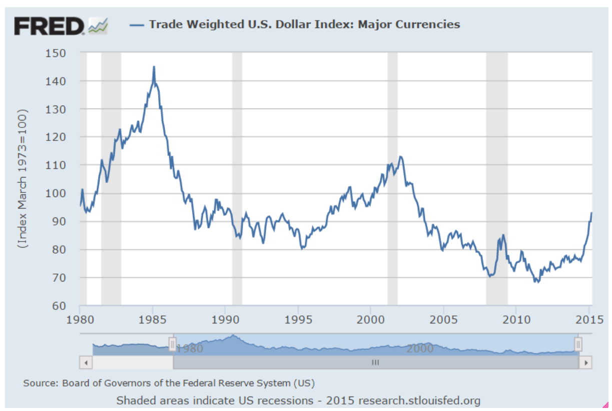
According to data released by the U.S. Energy Information Administration (EIA), the average U.S. household in 2015 should spend almost $700 less on gasoline and motor oil than in 2014 (chart below left) the lowest levels in over 11 years. This savings also inures disproportionately to the benefit of lower income households. According to Bank of America Merrill Lynch, households earning less than $50,000 per year spend over 21% of after-tax income on energy compared with less than 9% for those earning more.

Though we had forecast an immediate benefit to consumer spending based on these savings, this has yet to occur. Meanwhile, the tumbling weekly rig count issued by Baker Hughes (chart below right) is indicative of the steep decline in domestic drilling activity. Though the oil & gas industry is a relatively small part of total payrolls and GDP it is declining rapidly enough to impact quarterly GDP numbers.





The trade-weighted U.S. dollar has risen about 25% over the last three quarters. In the 1st quarter of 2015 alone, the trade-weighted dollar appreciated over 11%, the largest single quarter move in history (see chart below). A strong domestic currency restrains economic growth via the headwind of reduced export growth (as a rising dollar makes our goods more expensive overseas) and the curtailing of our manufacturing sector (the Institute for Supply Management index of manufacturing has declined for five straight months and is nearing contractionary levels). In our annual commentary, we suggested that as the U.S. imports greater than 20% more than it exports, the benefit to the consumer of lower inflation via lower import costs would mostly offset the trade decline. This has yet to materialize. It also bears noting that the nascent manufacturing renaissance that has benefitted our economy in recent years has been against the backdrop of a major tailwind of a 35% decline in the U.S. dollar since 2002. We may be in the early stages of a reversal.



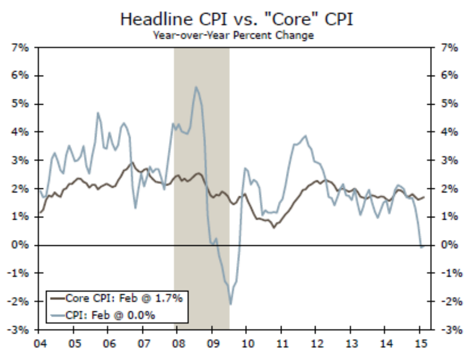
There is increasing concern that although the U.S. is not an export-driven economy, many of its largest companies are. Between 45%-50% of S&P 500 earnings are derived from outside the U.S. and a strong and rising currency has the impact of eroding the earnings of many multi-national companies and the confidence of their managements thus impacting investment decisions and potentially domestic growth.

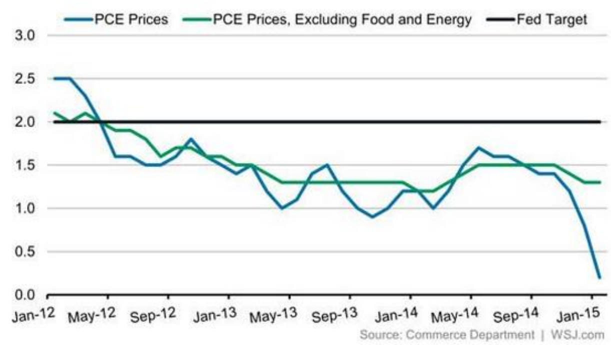
The main driver behind the powerful rise in the dollar may be traced to the monetary policy divergence between the U.S. and foreign central banks. The former has raised the specter of rising rates while the latter have launched their own versions of QE. A stronger dollar creates a major policy dilemma for the Federal Reserve as it seeks to increase levels of inflation and continue to grow employment. The dollar increase makes U.S. exports more expensive which in turn forces domestic producers who sell internationally to lower prices and potentially reduce wage costs (employees) to stay competitive.

INFLATION & INTEREST RATES

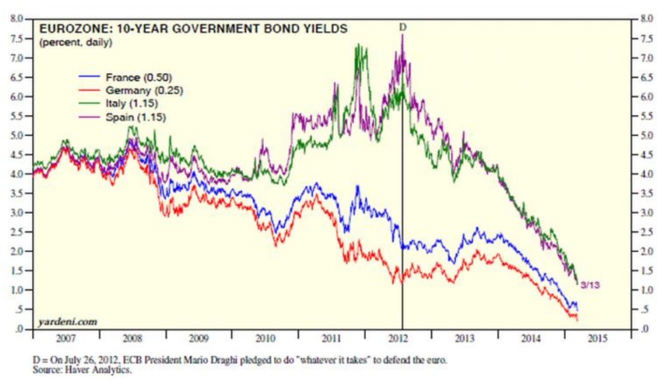
With declining commodity inputs, the Consumer Price Index moderated in 2014 to a 1.3% y/y level down from over 3% in 2011 and 2.1% in 2012. We noted in our annual commentary that it was very possible that early in 2015 we would see a headline reading in the CPI below 0% as the influence of the decline in input prices continued to work its way through the pipeline. This occurred during the first quarter.

The Personal Consumption Expenditure (PCE) price index remains the preferred inflation gauge for the Federal Reserve as it has a much lower weighting given to shelter and allows for changing preferences or substitution effects. This measure has now been below the Fed target of 2% for 34 months. Despite this, we see no deflationary concerns as the services components (85% of our economy) continue to exhibit pricing power. There may be wide latitude for the Fed before inflationary concerns force their hand.

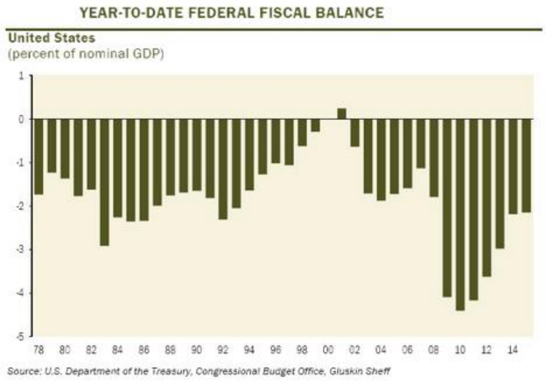


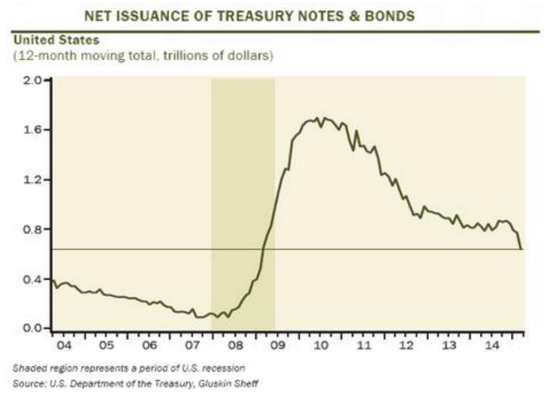


With deflation not appearing as a viable concern to the U.S., it appears to some that our government bond market has become disconnected from a modestly growing economy. Rather we feel interest rates will remain low as there remains a global dearth of high quality debt while demand for such secure yield continues to grow. Our domestic bond market continues to exhibit rising foreign demand and declining domestic supply. While our 10-Year bond may only yield 1.92% as of the end of the 1st quarter, this level is extremely attractive when compared with other sovereign debt (Eurozone 10-Year bond yields on the chart below) and is of much higher quality.



Government deficits are financed through the issuance of additional Treasury notes and bonds. With the U.S. government enjoying a declining deficit, the budget shortfall for fiscal year 2015 is expected to have declined to $386B or 2.1% of GDP, the lowest since 2008. New issuance has declined by over 50% in four years amidst a growing global demand for our debt.





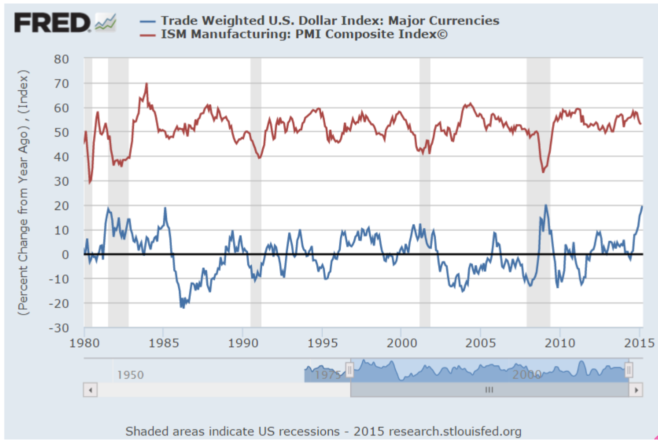
FEDERAL RESERVE

The large majority of economists have anticipated the Federal Reserve raising rates for much of the last two years with consensus now favoring the first rate hike to occur between June and September of this year. We have long noted our minority view that the Federal Reserve will end up deferring rate increases until 2016. There may be such hints in Janet Yellen's speech noted above.

Despite the recent soft patch, the economy is clearly improving but is certainly not at escape velocity and is still highly dependent upon monetary accomodation. The noted contraction in productivity has negated the improving employment fundamentals and acted as a major drag on growth. Whether it be a further dramatic appreciation of the U.S. dollar, additional oil shocks, foreign growth disappointments or some other dislocation, we are still quite vulnerable to an exogenous event that might push the economy back towards the stall speed that has characterized much of the recovery.

For the Federal Reserve to act by September, we believe you would need the 2Q GDP numbers to reflect a very strong bounce back confirming the weak 1Q growth as another weather-induced aberration. Though we do expect a modestly better 2Q, we would anticipate more trend-like growth and the bar for a rate increase may have been raised higher than that. If the dollar were to continue to rise, we can expect U.S. economic activity to soften and inflation to moderate further and the Fed to actually become more dovish. Dollar strength may reflect our relative economic strength but at a point it does not just act as a brake on growth but rather a major headwind.

On the follwing page is a graph depicting in blue the year over year change in the value of the trade-weighted U.S. dollar. It is up over 20%, a level only broached three other times in the 35 year period reflected and two of those occurred during recessions. In red on the chart is the ISM Manufacturing index that we had noted above is in steep decline from prior strong levels. As this is a diffusion index of the state of manufacturing, it stands to reason that this index will continue to weaken with a lag from the impact of this currency move. We find it difficult to envision Yellen raising rates at a point in time when manufacturing is actually contracting (as we expect to see in the ISM reading shortly) and inflation is running near 0%.

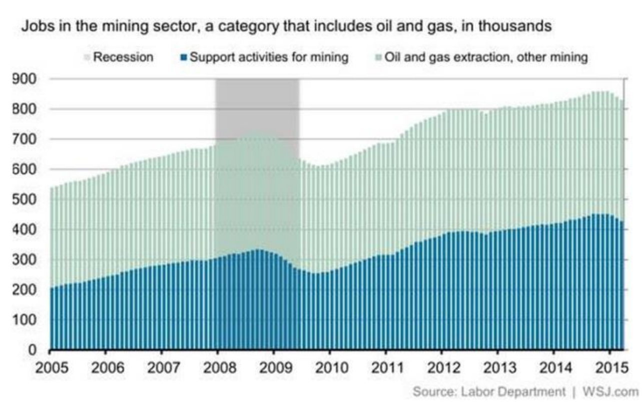


EMPLOYMENT & WAGES

Has the acceleration in job gains enjoyed over the last four years come to an end? Following an average monthly gain in nonfarm payroll job growth of over 185K per month from 2011-2013, job growth exploded in 2014 to a monthly average of 260K jobs per month, the highest average growth since 1999. Indeed, we finished the year with the best quarter of gains during the recovery at 324K new jobs per month. March job data depicts a dampening in the rate of employment gains with 126K for March and a 1st quarter average of 197K, and we anticipate a similarly slower pace for the balance of the year. With productivity stagnating, corporations may be more circumspect in hiring decisions to protect margins. There are additional and not surprising energy related concerns.

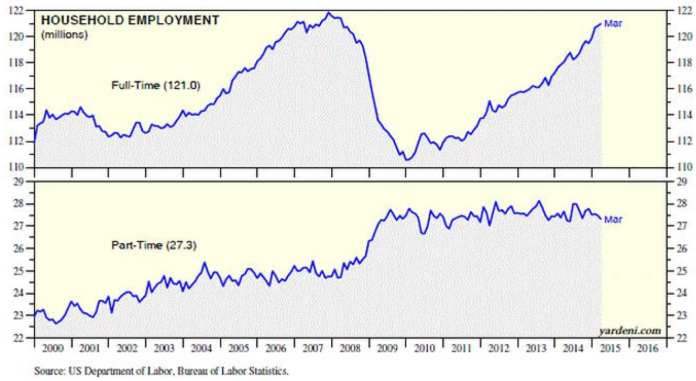
The benefits to the dramatic decline in energy costs inure to consumer cash flows with additional advantages of lower shipping and production costs for many businesses but constraining budgets at oil and gas companies. The shale oil & gas industries have been the nation's largest single creator of solid-paying, middle-class jobs during the economic recovery. But the fall in oil prices has led to big cuts in capital spending and layoffs.

The Wall Street Journal recently noted that the latest Labor Department release indicated that employment in mining, a category that includes oil and gas, fell by 11,000 in March. So far this year, the industry has lost 30,000 jobs, after adding 41,000 in 2014. Employment losses in the first quarter of this year have been concentrated in support activities. Unfortunately, these areas are also among the highest-paying, middle class positions thus amplifying wage concerns.

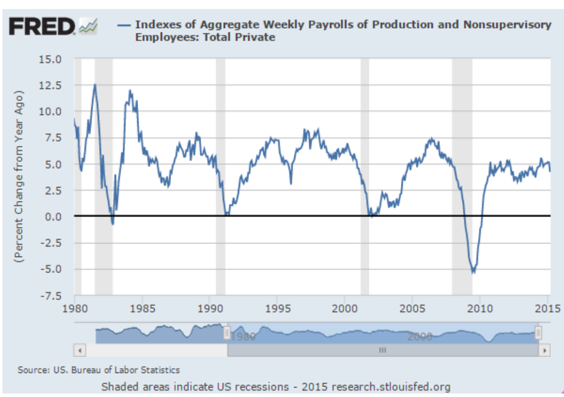


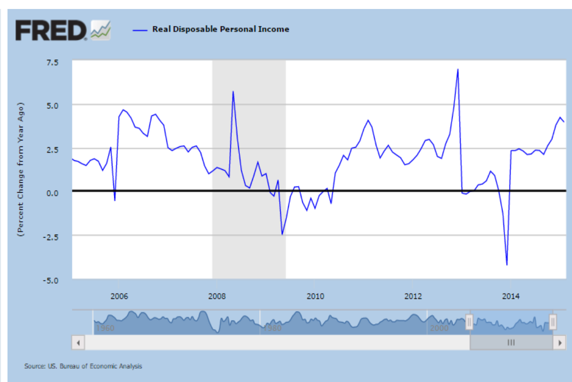
The common narrative in conflict with the improving job numbers (and partly borne out by the tepid hourly earnings growth) remains the struggle of good paying full time positions. During the recession, total employment declined by over 8.7 million jobs from the peak of January 2008 to the trough of February

2010. However, full-time jobs fell by a much larger 11.3 million, as weak demand led employers to slash hours and relegate many workers to part-time status. Though part-time jobs remain elevated and problematic, virtually all job gains since 2010 have been full time.



Despite the best annual job growth since 1999, average hourly earnings are still mired in the 2.1% y/y range. To more effectively gauge the labor situation, one needs to look at aggregate data as that is what actually moves the economy. Total hours worked are rising at a 2.2% annual rate. With more employees working longer hours, total aggregate payrolls are rising 4.2% per year (though a drop from 5% in the last quarter). With lower inflation, real incomes are growing. Real disposable personal income adjusts for inflation and subtracts current taxes from personal income data. It is now increasing at a rate of 3.95% y/y (chart below right).





HOUSING

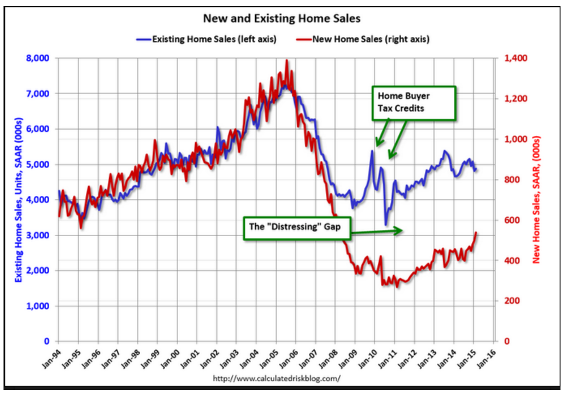
Over the last year, we have continued to stress that home price gains would slow and even flat line as the market transitioned to dependence on the traditional drivers of housing demand including household formation, employment and wage growth. This transition is in the embryonic stages and the 1Q arrest of price moderation may be perversely working against this goal.

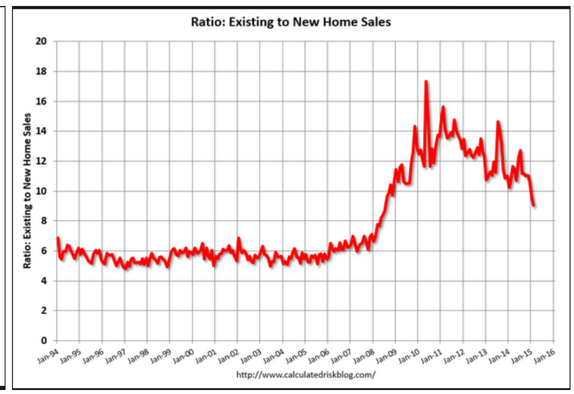
Nationwide housing prices have risen 5.9% over the last year, according to Zillow. Other housing price measures such as Case Shiller and Core Logic also indicate year-over-year price gains of 4.5% & 5.6% respectively to the highest levels since 2008 though still about 15% below pre-recession peaks. All of this data is a continued positive for current home owners. However, it may counterintuitively retard what we have long noted is the Achilles heel for a normal and functioning housing market, the first-time home buyer. With annual wage gains below the level of housing increases, this cohort is both losing ground on affordability and suffering with a lack of inventory.

On one hand, moderating and even declining prices is a positive toward maintaining affordability. However, a lack of continued price gains may constrain supply in some areas of the market. According to

Zillow, about 16.9% of all mortgaged homes nationwide were underwater in Q4, down 0.1% from Q3. Zillow notes that the normal share of underwater borrowers is generally thought to be around 5%. More than 27% of homes with values in the bottom third of their market were underwater in Q4.These homeowners are often unable to place their homes up for sale and this potential inventory is generally the marketplace for the first time buyers.

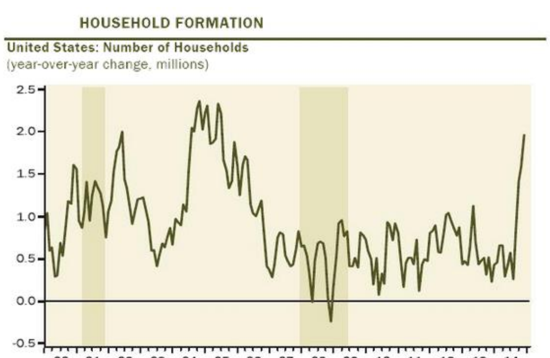
The chart below (left) illustrates the recovery in existing home sales (blue line left hand scale) to levels consistent with pre-bubble periods. New home sales continue to lag at levels 40% below even pre-bubble periods. The concerns above could be alleviated with the building of more of these entry level new homes. There remains a clear reluctance on the part of builders to build new homes in these lower price points as rising costs and greater demand for higher priced homes crowd out this market.

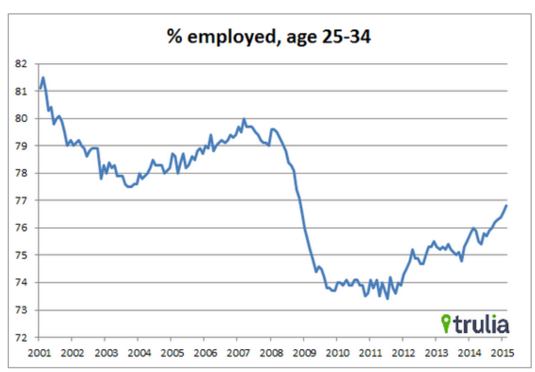




Homeownership for under 35 has declined from 43.6% in 2004 to just 36% in 4Q 2014. Much of this may be laid at the doorstep of a generation that came of age during the financial crisis and housing collapse into an incredibly weak job market. Many also carry large burdens of student debt.

However, we feel we are seeing the early stages of this cohort moving off the futon and out of the basement and into a rental (necessary pre-cursor). While 4Q Homeownership dropped to lows of 1994 at 63.9%, the implied houshold formation rate (based off the Housing Vacancy Survey from the Census) increased by 1.337MM in the quarter. However, the total increase in the number of new households of 1.665MM in 2014 is much less than the increase in renter-occupied housing units of 2.008MM. With improvement in the job market for this group, we are optimistic that housing starts and sales will continue to gain ground over the next year provided continued low mortgage rates and decelerating price gains aid affordability.





INTERNATIONAL

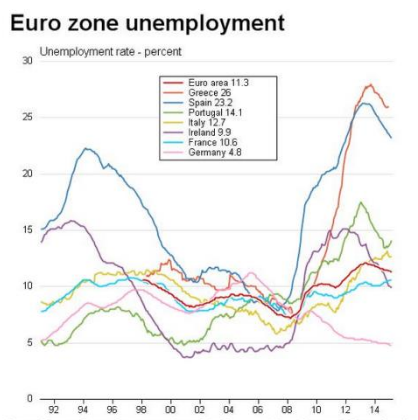
The major decline in oil prices should act as a sizable tax cut for much of the global economy with wealth and power potentially shifting from many of the autocratic oil states to the benefit of consumers. There are many winners and losers. While many higher cost of production economies are experiencing major headwinds, the U.S., China and India are experiencing the greatest benefits of this stimulus for consumption. Europe and other countries that have experienced major currency devaluation have seen some of these gains muted but still stand to benefit. While more shocks may still be expected, in total lower energy prices stand to be a net positive for the global economy.

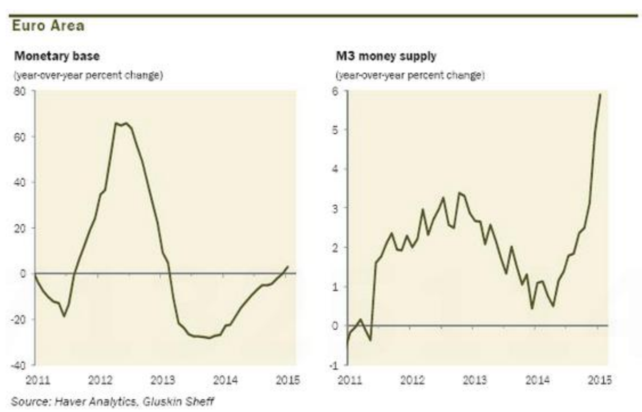
As often occurs in a global economy, many of the headwinds faced by one country act as tailwinds for another and that appears to now be the case for Europe. The decline of the Euro from an exchange of almost $1.40/€ to a level below $1.10/€ has occurred in only the last year. The lower Euro is benefitting export competitiveness and reducing somewhat the deflationary pressures which have plagued the union for much of the last 3 years. Additionally, the introduction by the European Central Bank (ECB) of a large QE program is providing the impetus to improving consumer demand and business confidence. The ECB launched its version of QE (public sector purchase program) on March 9, with the objective of buying €60 billion of assets each month at least until September 2016.

With the ECB keeping rates so low and promising to buy government bonds, the weaker peripheral countries will find it easier to stabilize their overwhelming debts. Keeping rates below the level of growth (in nominal terms) allows debt-to-GDP levels to fall and this is what we have witnessed with the modestly improving economies in Spain, Ireland and Portugal.

Though still plagued with many structural concerns, the Eurozone (EZ) economy appears to be in the early stages of a cyclical recovery. GDP growth has improved to about 1% on an annual basis with unemployment levels declining from recent highs of 11.6% to 11.3% and year-over-year deflation levels moving from -0.6% to -0.1% in March. Ben Bernanke would call these "green shoots".

Most importantly is the expansion in the ECB balance sheet and money supply (now expanding near double digits) and growth in bank loans indicating demand is clearly picking up and the extreme austerity is further in the rear view mirror. The impact of the dramatic currency declines is very powerful in making exports much more competitive and allowing wage growth to spur increased demand. Within this backdrop of improving momentum, we have raised our estimates for Eurozone GDP growth in 2015 to 1.5%.

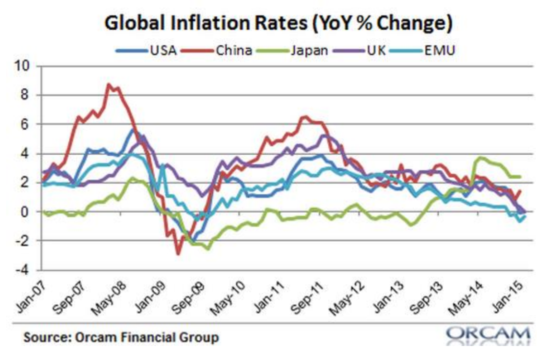




While valuations of markets in Europe are not as cheap as last year, they are still at a discount to those in the United States where we are also facing potentially peak margins and earnings. As EZ earnings growth on a year-over-year basis has finally turned positive, profit margins and earnings trends are still below historic averages and the current 3% dividend yield is more than twice the level of bond yields.

Japan is obviously the other major market that is undergoing an extremely aggressively monetary stimulus with a policy mix (unlike the Eurozone) that is at least attempting to enact growth-oriented reforms to inject energy into a moribund economy. Japan has moved past another mini-recession with an annualized 4Q growth rate of 1.5% (though full year GDP for 2014 was -0.8%). That may prove to be an optimistic target for the full year of 2015 and, for reasons noted below, we foresee a high probability of another downturn.

The Yen is already down over 50% from the levels of just a few years ago (in red on chart below left). This decline has improved export competitiveness but has not benefitted consumer spending. The Japanese consumer has experienced a major increase in their food and energy costs due to the currency decline (what would be viewed as bad inflation). This along with the increase in the consumption tax to 8% last April has held back consumer spending and restrained the achievement of the inflationary targets of the Bank of Japan and Prime Minister Shinzo Abe. As private consumption in Japan accounts for about 60% of the economy, we do not yet see a clear path for growth. Though inflation has risen (in green on chart below right), Japan needs nominal GDP growth of near 4% to arrest the debt-to-GDP levels from continuing to crowd out investment.



China has not been exempt from the global debt binge. According to the McKinsey Institute, since 2007 through the 2nd quarter of 2014, total debt in China (including debt of the financial sector) has nearly quadrupled, increasing from \$7.4 trillion to \$28.2 trillion. This increases the debt ratio in China from 158 percent of GDP to 282 percent. Of growing concern is that nearly 50% of this debt is related to real estate, an area where property prices have ballooned over 60% since the financial crisis. Recently the volume of home sales has turned down and home prices have followed declining almost 4% y/y in February. This is a primary area of concern as there remains an abundance of excess capacity in the housing-related industries that have long been the major exports helping drive the China growth engine.

Compounding this volume decline in exports is that, unlike other major markets, China links the yuan to the value of the dollar. Therefore, in just the last year the Yuan has risen over 25% versus the euro (China's largest trading partner) and 35% versus the yen further crimping exports and moving us to lower growth expectations from the targeted 7% to 6% GDP growth in 2015. To achieve these targets we expect the People's Bank of China (PBOC) to defend its markets via additional rate cuts and even allowing the yuan to decline.

The policies of the Federal Reserve during the height of the financial crisis of lowering interst rates to near zero levels and multiple programs of QE have flooded the emerging economies with dollars. For these emerging markets, borrowing could be done more cheaply in dollars than if they took out loans in their local currencies as interest rates in the U.S were much lower. This was during a period of extended dollar weakness and most of these loans were not hedged as countries expected to benefit from the continued fall of the dollar. According to the Bank of International Settlements (BIS), emerging markets have borrowed over \$9T in dollar-denominated debt up from about \$2T at the turn of the century. As the dollar has risen over 25% versus many of these currencies, these debts are more expensive to repay and the next five years represent periods of heavy scheduled redemptions.

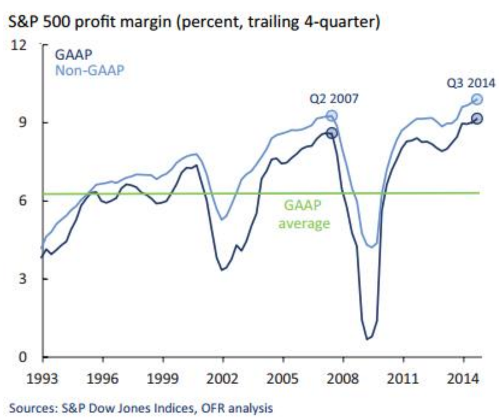
The rising dollar does work both ways for many of these economies as these falling local currencies make exporters more competitive in global markets. Thus, emerging markets that are more export driven will weather this period much better. As much of this debt has been incurred by private companies and not governments, major financial stability risk is not elevated at this time though internal economic issues may be heightened.

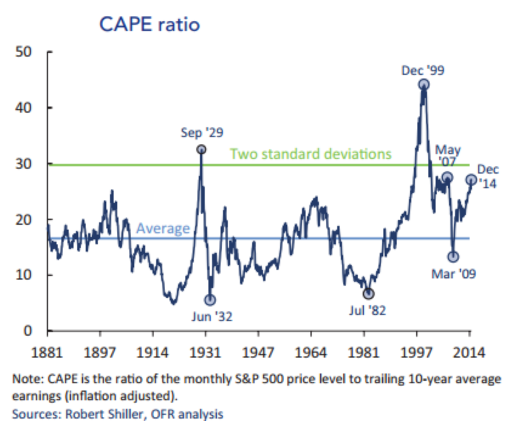
The International Monetary Fund projects that economic growth for emerging economies worldwide should approximate 4.3% this year. Though this still dwarfs the estimate of 2.4% for advanced economies it is a major slowdown from economies that grew as much as 8% collectively as recently as 2007. We anticipate a more pronounced slowing to levels below 4% as we note these transitions rarely occur so seamlessly.

MARKETS

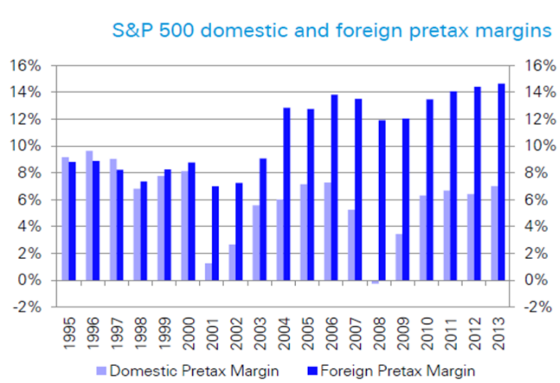
For much of the last two years, we have pointed to historically high profit margins as being unsustainable in the long term and inflating earnings from historic trend growth. The impact of margins on understanding valuation can be dramatic and is best exhibited in the alchemy that has allowed a 2.6% revenue growth rate in the S&P 500 since January 2011 to generate 5.4% in earnings per share growth over the same time period according to data supplied by Thomson Reuters.

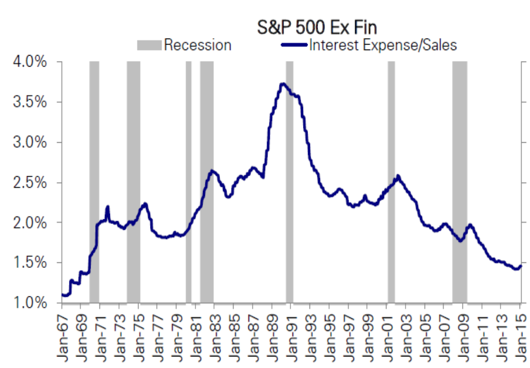
If companies are "over-earning" it has the effect of reducing current price/earnings ratios giving the illusion of value. It is one of the reasons that the cyclically adjusted price-earnings ratio (CAPE developed by Robert Shiller) continues to flash signals of elevated valuations that are now higher than 2007



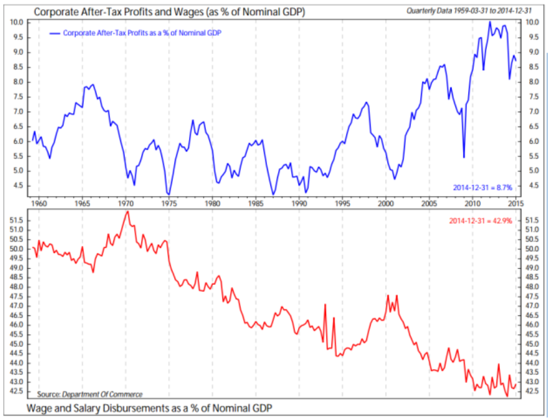


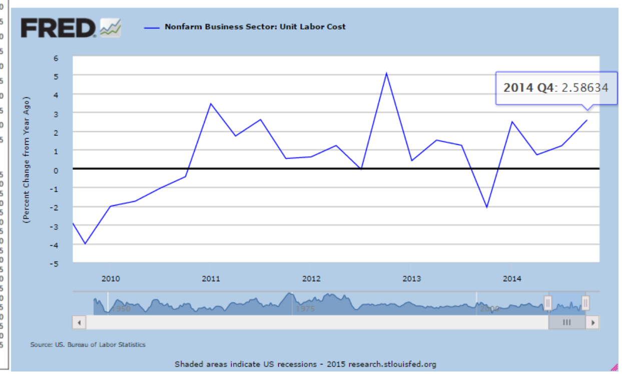
The arguments against the anticipation of a regression to the mean of today's high profit margins include reduced tax rates and lower interest rates. An increasing portion of the profits of larger companies has come from overseas where taxes are generally lower and multi-national companies in the S&P 500 have seen margins widen. Also, in the wake of the credit crisis and commensurate collapse in interest rates, companies have refinanced debt at lower rates, resulting in lower interest expenses. Many view this as a structural rather than cyclical change in margins.





The chart below on the left shows the dramatic decline (bottom pane) in wages & salaries as a percentage of GDP juxtaposed to the top pane depicting the percentage of profits to GDP. This is the essence of "Wall Street over Main Street". Historically profit margins compress in the more mature phase of the economic cycle as labor markets tighten and we believe we may be in the early stages of a rolling over of these margins in aggregate. The rising trend in unit labor costs (below right) appears to support this thesis as labor costs are the biggest expense on the corporate income statement.





Despite the price of oil having already collapsed 50% in the second half of 2014 and the commensurate reduction in earnings estimates of the Energy sector, consensus estimates for the S&P 500 (Factset) as we entered the new year were for an increase of 8.4% to a level over $127. Anticipating additional headwinds from a stronger currency, our estimate was for a modest increase to about $120. As we enter earnings season, current estimates for 1Q earnings now indicate a decline of -4.6% from a year ago representing the largest quarterly decline since the third quarter of 2009. Full year consensus estimates have declined to our unchanged projection of $120.

As earnings for 2Q are also expected to drop, this mini profits recession is fomenting concerns that an economic recession may be close behind. Since 1945, all 10 recessions have coincided with a decline in earnings. Only three times have we experienced negative earnings over a full year outside of a recession. As long as the odds of a recession remain low (and we continue to believe that they are), the likelihood of a large earnings decline that coincides with big market drawdown remain low.

These profit concerns manifested themselves in a much more volatile market during the 1st quarter. The S&P 500 closed up or down by more than 1% on 19 days which was the most since 2Q 2012. In the face of this volatility, the S&P 500 managed to eke out a small positive return of 0.95% while the Russell 2000 index of smaller (and more domestically-oriented) companies gained 4.3%.

Despite major currency headwinds which dramatically reduced total returns when exchanged into dollars, the MSCI EAFE of developed markets was up 4.9% with the MSCI Emerging Markets index gaining 2.24%. We continue to find international markets attractive as relative valuations, accommodative monetary policy, and currency declines should all act as major tailwinds.

Sincerely,

Rick Wayne

Rick S. Wayne, CFA