Q1 2015
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

2015: A BRAVE NEW WORLD

The U.S. economy is looking better than it has since the Great Recession. But we're also entering a Brave New World in 2015, in which the financial markets are likely to be more volatile and challenging than they have been in recent years.

Toward the end of 2014, major changes occurred in the global economy. We saw: the Federal Reserve easing its monetary stimulus and hinting it will start to raise interest rates in 2015; confirmation that China's growth rate is slowing to around 7% (from 10% during the previous decade); a 50% drop in oil prices; and both Europe and Japan struggling to avoid not only a recession but deflation.

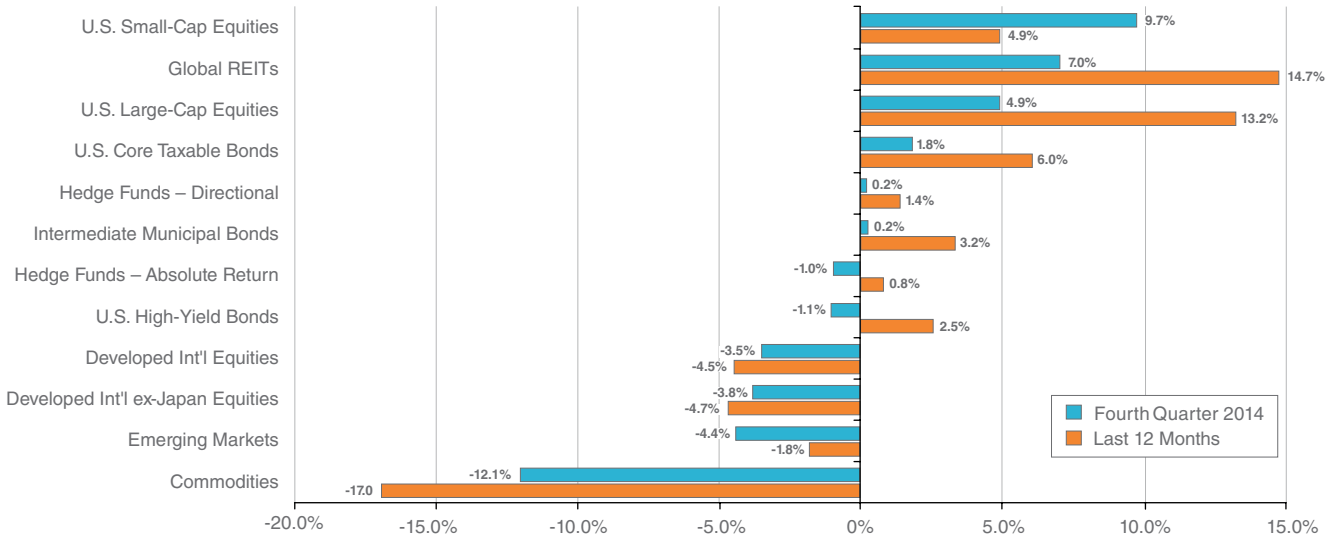
The above developments are changing the investment landscape, causing valuations to diverge. Complacency has evaporated, as investors shift away from assets perceived to be the most vulnerable to an economic slowdown. Add geopolitical risk to the mix, and asset class returns in 2015 aren't likely to be as strong as in 2014 (see chart below), despite the U.S. economy's recent momentum.

Still, we think 2015 could well be another positive year for U.S. equities, although not as strong as 2014, and with considerably higher volatility.

LNWM client portfolios are structured to mitigate risk through diversification, an emphasis on high-quality holdings, and select alternative assets. As we enter 2015, we think we are well-positioned to weather both the higher price volatility and divergence in asset class returns that we envision, while benefiting from moves on the upside.

On the following pages, we discuss the key market trends for 2015 and their likely impact.

PERFORMANCE OF ASSET CLASSES: Diverging
Fourth Quarter and Last 12 Months (As of December 31, 2014)



SOURCE OF DATA: Morgan Stanley, Barclays Capital, Russell Indices, and Bank of America Merrill Lynch, Dow Jones UBS, Bloomberg, U.S. Treasury.

GLOBAL EQUITIES: U.S. Likely to Retain Its Lead

We are seeing diverging growth rates among the world's economies, as well as in central bank policies. The U.S. is expanding at a faster rate than other developed nations, with 2015 growth expected to be 2.5% to 3%, a significant bump up from the 2.2% averaged since the Great Recession.

The growth forecasts we use in our analysis are from Oxford Economics (see chart) and are slightly lower than the World Bank and IMF forecasts.

2015 ECONOMIC GROWTH FORECAST

Region	2015 GDP GROWTH
United States	3.0%
Advanced Economies	2.2%
Asia Pacific	4.2%
Emerging Markets	4.0%
European Union (EU)	1.7%
World	2.8%

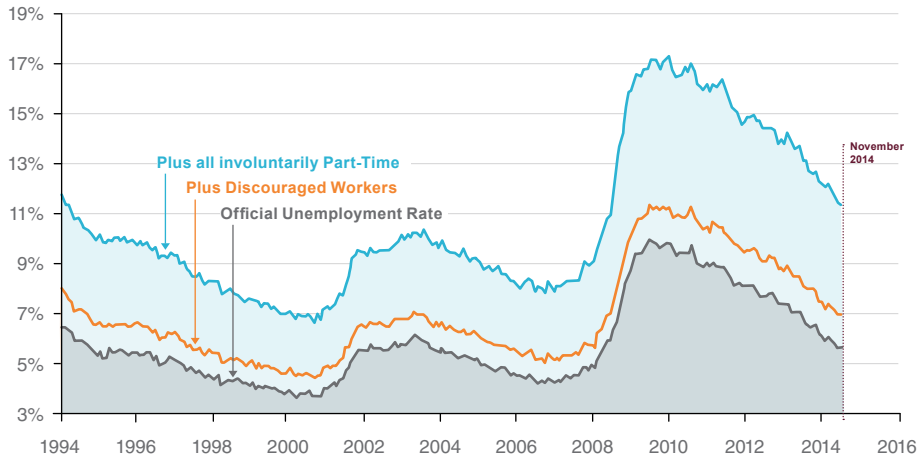
SOURCE OF DATA: Oxford Economics.

For the U.S., we think the main driver will continue to be higher consumer spending (70% of the economy), as Americans benefit from a rebounding real estate market, lower interest rates on consumer debt, more job creation and dramatically lower gasoline prices.

In this environment, we are maintaining our overweight to large U.S. equities. At the same time, we continue to underweight stocks in foreign developed markets mainly due to the murky economic outlook, while keeping our slight overweight to emerging markets.

In 2014, the U.S. added an average of 240,000 new jobs each month, the healthiest pace in 15 years. Not since the boom times of 1999 have we seen this type of job growth, although significant wage increases have yet to materialize. All major measures of U.S. unemployment are falling, with the official unemployment rate dropping to 5.6% in December 2014.

U.S. UNEMPLOYMENT



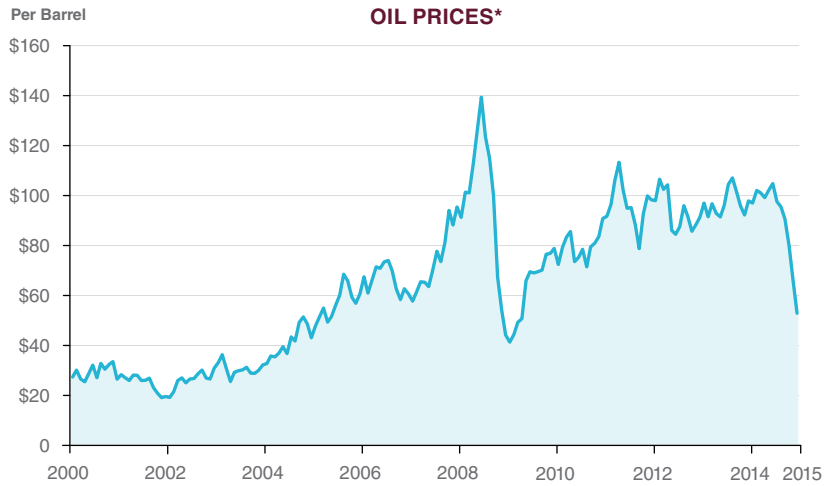
SOURCE OF DATA: Bureau of Labor Statistics via Haver Analytics.

The drop in oil prices is likely to be a positive overall. Countries that are net importers of oil will benefit from cheaper prices, which are down more than 50% since last June. The world's largest economies – U.S., China, and most of Europe are poised to add 0.25 to 1 percentage point to their GDP growth due to cheaper oil. By contrast, major oil exporters such as Saudi Arabia and Russia will be hard-hit – with an estimated 4 percentage point drop in their GDP (per Oxford Economics modeling $40/barrel oil).

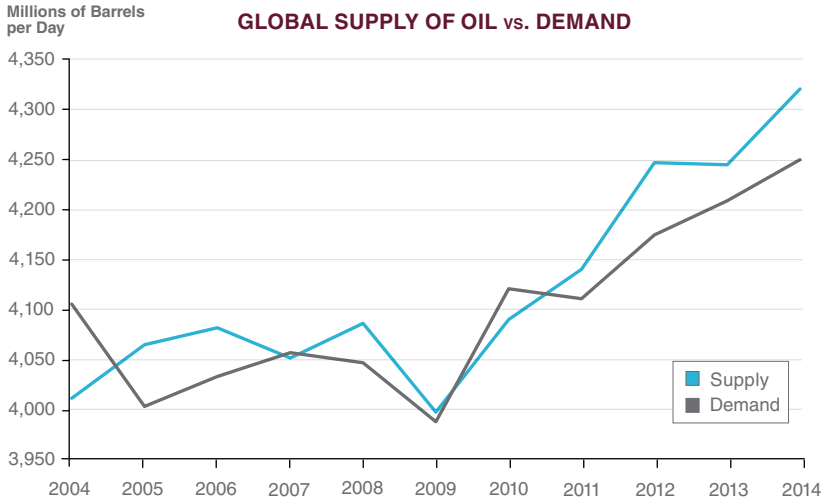
Major industries such as trucking, shipping, the airlines, and the automakers typically get a boost from cheaper oil, as do retailers. Clear losers are the oil companies, whose stocks are down more than 20% since June 2014 (S&P Energy Index).

Eventually, the price of oil is expected to stabilize at higher levels ($60 to $80/barrel), as global growth and the forcing out of marginal producers reduce the mismatch between supply and demand (see charts).

In the interim, we are maintaining our small allocation to North American energy funds, focused on "midstream" service providers (pipelines, processing and transport), which are not directly affected by moves in oil prices, as well as midsized oil and gas producers with solid finances. This level of diversification has cushioned the impact of low oil prices, while allowing us to participate in the long-term resurgence of U.S. oil and gas production.



*West Texas Intermediate (WTI) crude.
SOURCE OF DATA: Bloomberg.



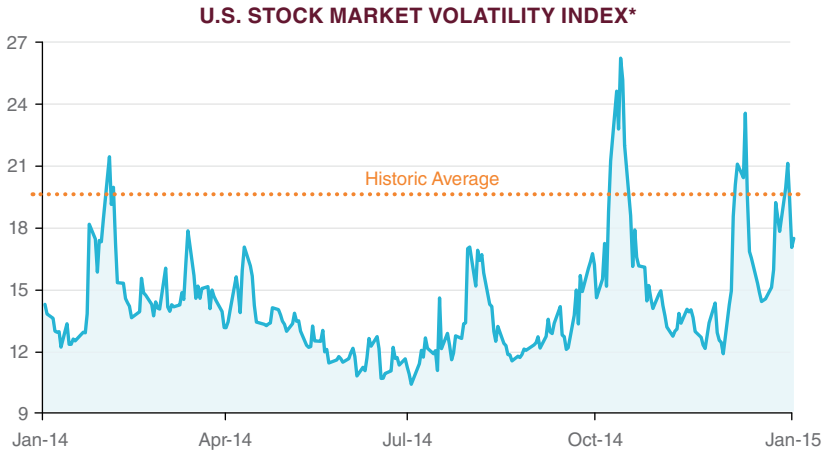
SOURCE OF DATA: Energy Information Administration.

LARGE/MID-CAP U.S. STOCKS:
Our Favorite Equity Sector

Large U.S. equities are close to fair value, although further gains are possible due to: (1) corporate earnings rising again in 2015; and (2) investors paying more for each dollar of corporate earnings (the so-called price/earnings ratio), as is typical during times of low interest rates. Historically, U.S. stock prices have tended to rise when the economy is both growing and the 10-year Treasury is yielding less than 5% (around 2% now).

For all of 2015, the S&P 500 companies are expected to earn 7.7% more, on average, after an estimated 4.9% gain in 2014. (Based on analyst estimates, Jan. 2015, in *FactSet Earnings Insight*.) Earnings estimates have been coming down since last quarter, and this has contributed to stock market volatility.

We wouldn't be surprised to see stock market volatility return to its historical average of around 20 (see chart), after being unusually low for most of 2014. There is increasing uncertainty about the level of 2015 corporate earnings as the energy and materials sectors suffer from low oil prices and a stronger dollar hurts U.S. exports. We will be keeping a close watch on whether these headwinds are causing S&P 500 earnings growth to stall.



*CBOE VIX Index, based on the pricing of short-term stock options on the S&P 500.
SOURCE OF DATA: Bloomberg.

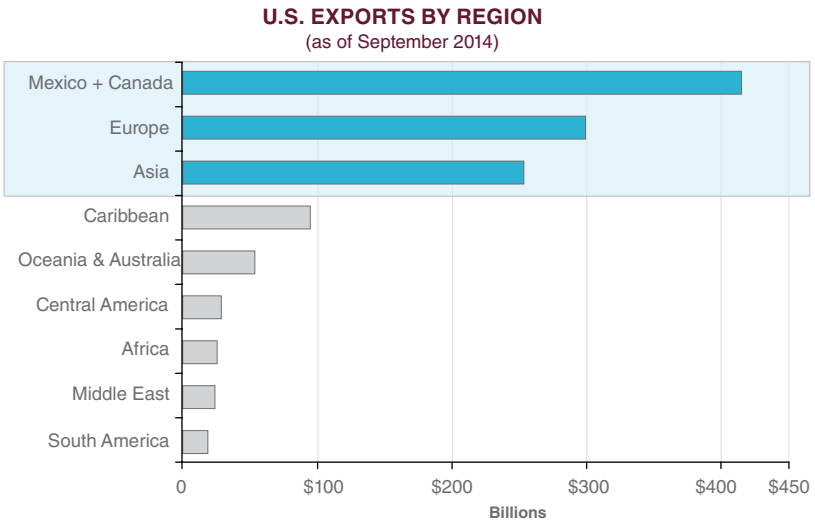
We think U.S. small-cap stocks will underperform again in 2015. As a group, they're priced at nearly 19 times 2015 earnings estimates vs. the historical average of 16 times. Also, smaller companies don't tend to benefit as much as large ones from lower oil prices, and they're more vulnerable to rising interest rates should that occur.

INTERNATIONAL DEVELOPED EQUITIES: Digging Out of Deflation

We envision some improvement in both the Eurozone and Japanese economies in 2015, and equities in these regions could get a lift from monetary stimulus programs. In 2014, virtually all foreign markets dramatically underperformed the U.S., due to economic weakness and the strength of the dollar (which lowers local-currency returns).

Returns in foreign markets are likely to continue suffering from a stronger dollar, which could continue gaining strength in starts and fits in 2015 if the Fed – as expected – raises interest rates, while Europe and Japan keep rates at less than zero.

Recovery in Europe, one of our largest export markets, is very important for the U.S. With prices actually starting to fall in the Eurozone (the first time since 2009), the European Central Bank is now actively advocating for a massive stimulus program (up to $590 billion) in early 2015. A tailwind is also being provided by a weaker euro (helps with exports) and cheaper oil. But uncertainty abounds in Europe, including a critical Greek election on January 25.



SOURCE OF DATA: Bloomberg.

Japan. The Japanese economy has less of an impact on the U.S. than does Europe. So while Japan is officially in recession, we don't think this has to be contagious, especially given the Bank of Japan's ongoing efforts to revive the economy.

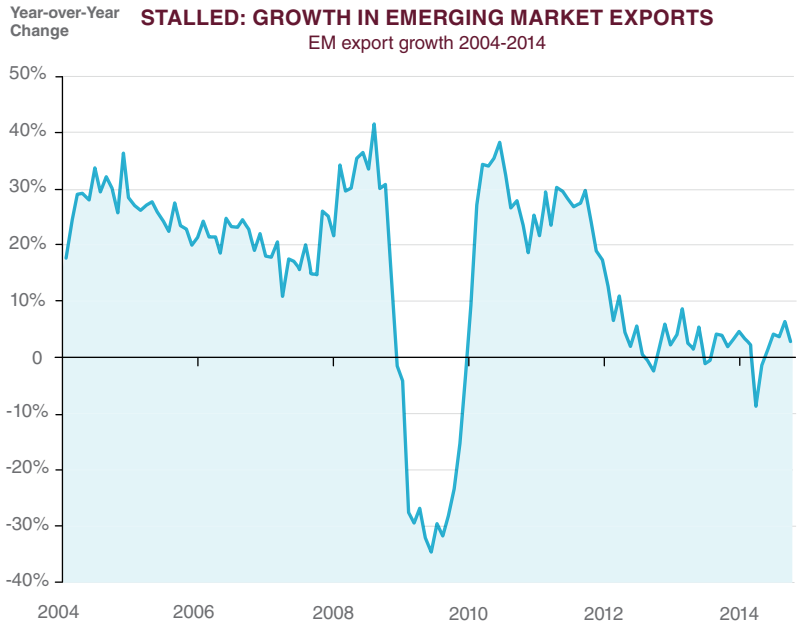
EMERGING MARKETS: Selectivity Is Key

We envision another challenging year for Emerging Markets (EM), with country results likely to vary widely. A stronger U.S. dollar and potentially higher U.S. interest rates are generally not good for emerging markets. As EM currencies weaken, investors tend to shift money away from emerging markets; at the same time, consumers in those countries are hit with rising prices for imported goods.

Commodity exports are a major economic driver for most developing markets. The big drop in oil and other commodity prices has stalled export growth for some countries, including Russia, Brazil and Venezuela, while helping out others such as China.

Despite lower growth rates overall, quite a few emerging markets are in good financial shape, with budget surpluses that should allow them to weather investment outflows and weaker currencies. In addition, some of the major EM countries are implementing structural reforms to boost domestic growth.

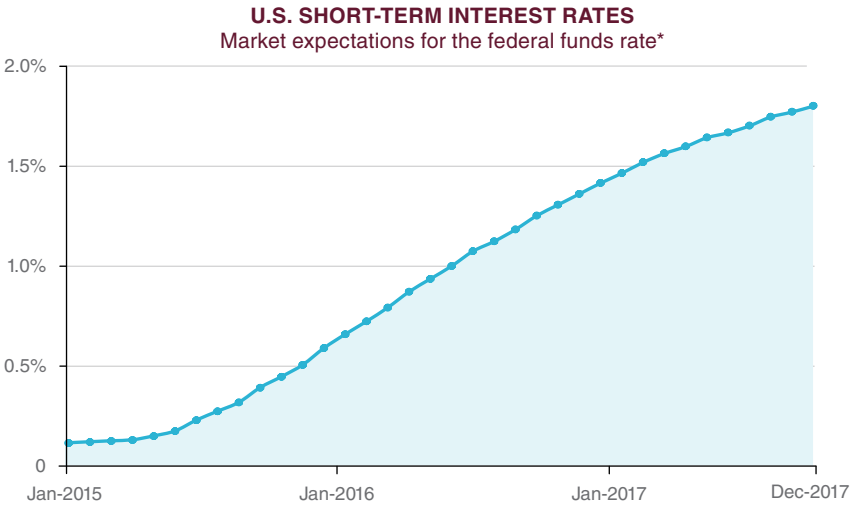
As we've said before, selectivity is key in the EM space. And that's especially true in 2015. LNWM's portfolios, which have a slight overweight to emerging markets, are in actively managed EM funds that seek out the most promising investments in the developing world.



SOURCE OF DATA: BlackRock Investment Institute and IMF, November 2014.

FIXED INCOME: 2015 Is a Transition Year

The fixed-income sector performed better than expected in 2014. None of the scary forecasts came true about bonds. Still, we do think it will be harder for bonds to earn a lot more than their coupons during 2015. This is why we continue to position client portfolios for the eventual increase in rates while not giving up too much in total return.
In general, we remain 50% in traditional fixed-income investments and 50% in multi-strategy and floating-rate funds, which have more leeway to benefit from rising rates.



*Based on the pricing of futures contracts on the federal funds rate, a short-term rate controlled by the Fed.

SOURCE OF DATA: Bloomberg.

By the end of 2015, we expect U.S. interest rates to be higher. The Federal Reserve has implied it will raise short-term rates sometime this year. And rates aren't likely to drop much farther, given a U.S. economy approaching full employment and a still-expanding (although sluggish) world economy.

However, we are not likely to see U.S. interest rates rise to the "normal" levels typical of past economic recoveries, during this year. Normalized rates would put the 10-year Treasury bond yield at least 1 percentage higher than where it is today – at over 3.5% vs. 1.8% recently.

ALTERNATIVE ASSETS

We continue to think carefully selected alternative assets are providing necessary diversification to client portfolios and will bolster returns during market pullbacks. The drop in oil prices, for example, has benefited our managed futures funds, because they have the ability to sell short all sorts of commodities, including oil.

IN SUM

A more challenging investment climate is likely in 2015, as we face a bevy of variables: less Federal Reserve stimulus and possibly higher interest rates in the U.S., iffy growth abroad, and the pros and cons of cheap oil and a stronger dollar. Any one of the geopolitical conflicts could also flare. The result could well be higher volatility and more divergence in asset pricing.

LNWM portfolios are well-prepared for higher market turbulence, should that develop. We are diversified across high-quality assets in a way that's geared to keep price volatility within specific targets. And we stand ready to make adjustments if the outlook changes.

As 2015 unfolds, we will be keeping a close watch for signs of a slowdown in growth here and abroad. A stock market correction in 2015 would not surprise us. But unless current growth forecasts deteriorate substantially, we think pullbacks should prove to be temporary.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $5 billion in assets under management, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 425 individuals, families, business leaders, private foundations and nonprofit organizations.