Q2 2015
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

THE DOLLAR & DIVERGENCE

We've entered a Brave New World indeed in 2015, as the markets react to diverging monetary policies and economic growth rates across the globe. The biggest change so far this year? The fast and furious rise in the dollar, which for example, gained 13% against the euro in the first quarter and nearly 25% in the past 12 months.

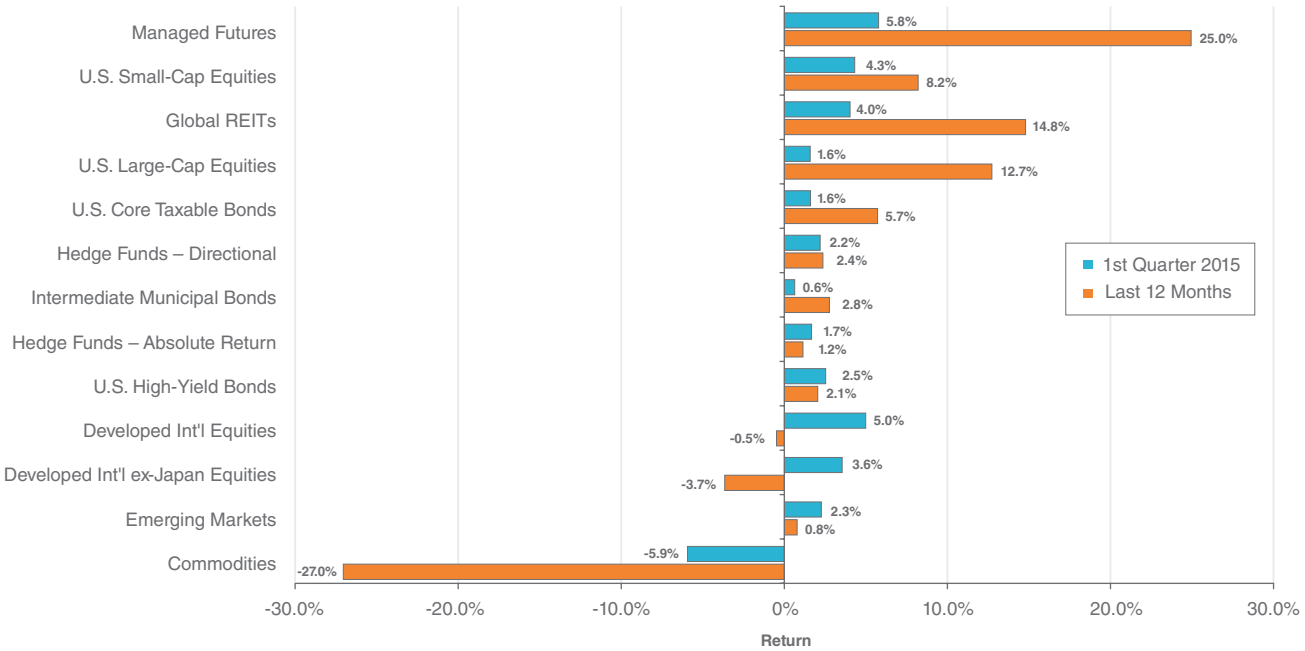
A stronger dollar affects the pricing of assets and transactions worldwide, and we've already started to see the impact. Americans can now buy more sushi in Japan or a bigger condo in Spain. But a stronger dollar also hurts the earnings of U.S. companies selling abroad or trying to compete with imports here at home. Boeing, Amazon and Costco, for example, are some of the local companies whose earnings are being affected.

Generally, a stronger dollar is not bad news. It's an indication the U.S. economy is strong enough to grow on its own, and that there is increasing demand from foreigners for dollar-denominated assets – from bonds and stocks to real estate. It also motivates U.S. companies to invest and streamline in order to offer better pricing.

We think the dollar could strengthen even more, especially if the Federal Reserve starts to raise interest rates later this year, as we expect. The dollar's current strength is not abnormally high relative to the past, and the drivers pushing the dollar higher are still in place.

In the following pages, we discuss our outlook for the economy and corporate profits given a stronger dollar, and why we're not making changes to our global allocations.

PERFORMANCE OF ASSET CLASSES: Mostly Positive
1st Quarter 2015 and Last 12 Months, (As of March 31, 2015)

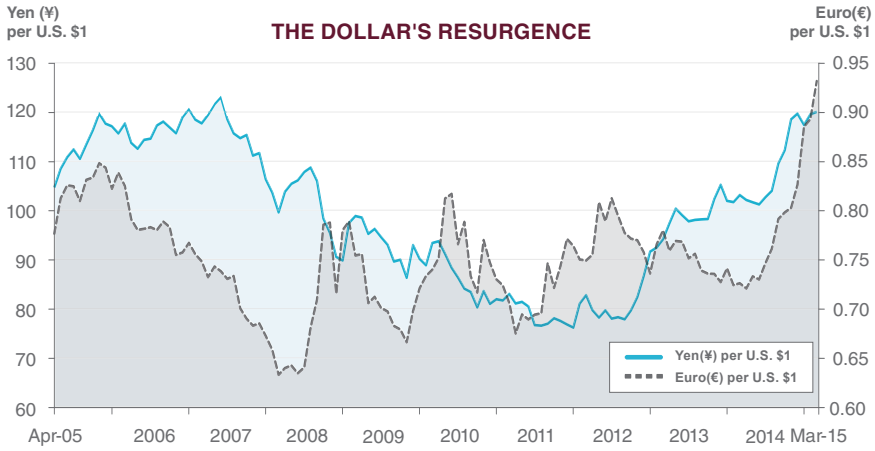


SOURCE OF DATA: Morgan Stanley, Barclays Capital, Russell Indices, and Bank of America Merrill Lynch, Dow Jones UBS, Bloomberg, U.S. Treasury.

U.S. ECONOMY & EQUITIES: Growth Slows but Fundamentals Good

The U.S. economy is likely to grow less than expected for all of 2015 – closer to 2.5% than to 3%, as the strong dollar takes a toll on U.S. corporate profits in general, and the energy sector in particular struggles with low oil prices.

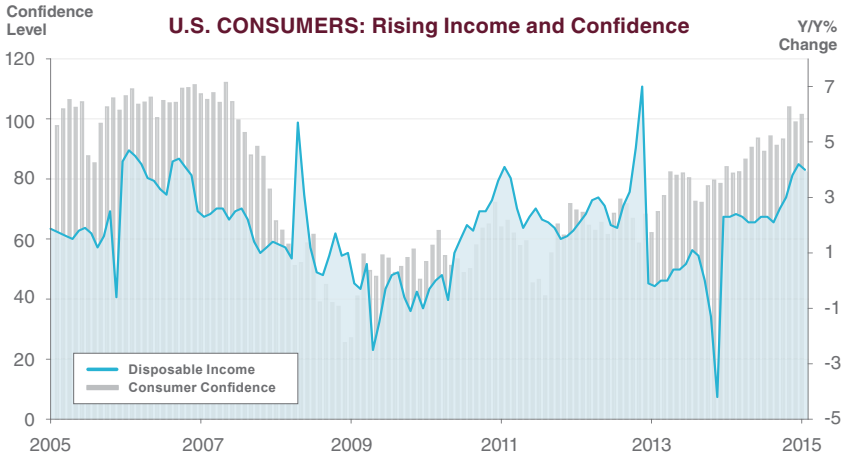
Growth for the first quarter of 2015 could be a lot less than that, partly due to the port workers strike on the West Coast and bad winter weather in the East. But going forward, we think the improving U.S. jobs market coupled with higher consumer confidence and disposable income should drive the U.S. growth rate to between 2.5% and 3% for this year.



SOURCE OF DATA: Bloomberg.

Americans are benefiting from a rebounding real estate market, lower interest rates on consumer debt, lower gasoline prices and the prospect of wage increases.

Take a look at the chart to the right. As you see, BOTH U.S. consumer confidence and disposable income are rising and are not too far off from where they were pre-2008. Mortgage payments, which were 28% of U.S. household income in 2006 were down to 18% recently.



SOURCE OF DATA: Conference Board, Bureau of Economic Analysis.

In the past, sustainable economic recoveries have been coupled with rising productivity. After the 2008 financial crisis, productivity actually spiked due to massive layoffs (when fewer workers produce the same amount, productivity rises). But since then, productivity has been flat or down.

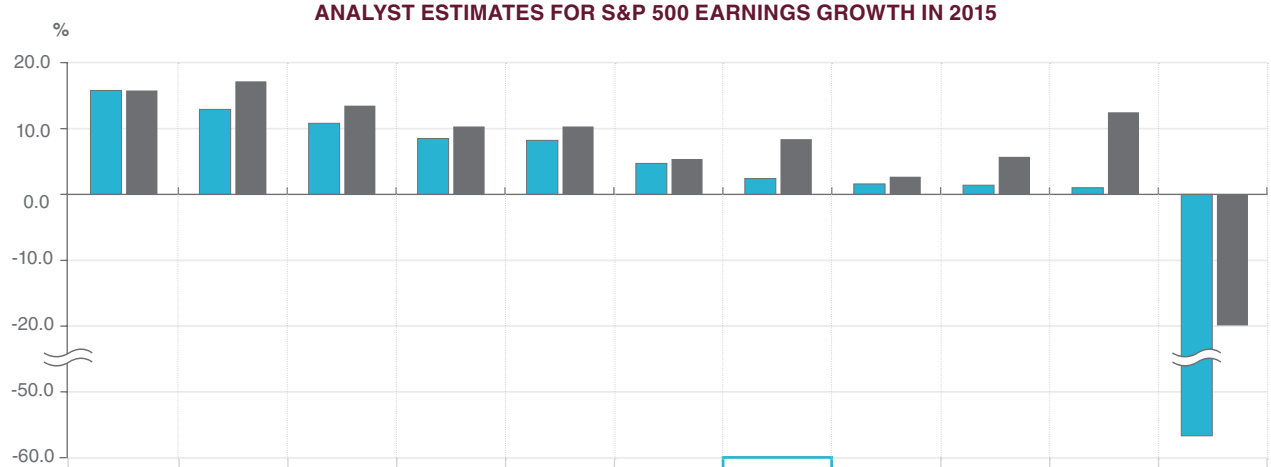
The healthy way for productivity to increase from here would be through higher output to meet rising demand. That demand is most likely to come from U.S. consumers, since global growth remains tepid.

LARGE/MID-CAP U.S. STOCKS: Still Our Favorite Asset Class

Since the end of last year, analysts have lowered their 2015 corporate earnings estimates significantly. A lot of this is due to the stronger dollar, which affects many different sectors, as well as lower oil prices, which are primarily hurting the energy sector.

Take a look at the next chart, which shows earnings growth estimates for the large S&P 500 companies as of Dec. 31, 2014 and April 3, 2015. In just three months, there has been a significant down shift. Still, most sectors are expected to post higher earnings, with the big exception being energy, which is reeling from the nearly 50% drop in oil prices.

ANALYST ESTIMATES FOR S&P 500 EARNINGS GROWTH IN 2015



	Financials	Consumer Disc.	Health Care	Industrials	Info Technology	Telecom Services	S&P 500	Utilities	Consumer Staples	Materials	Energy
Apr-03-2015	15.8%	12.9%	10.8%	8.5%	8.2%	4.7%	2.4%	1.6%	1.4%	1.0%	-56.0%
Dec-31-2014	15.8%	17.2%	13.5%	10.3%	10.3%	5.4%	8.4%	2.7%	5.7%	12.5%	-19.9%

SOURCE OF DATA: FactSet.

On first look, a stronger dollar seems devastating for U.S. multinationals: about 40% of the profits of S&P 500 companies come from abroad (and 33% of sales). But there's a big caveat here: only about 25% of foreign profits are actually in foreign currencies. So a 10% rise in the dollar reduces S&P 500 foreign-currency profits by 2.5%, on average. While this doesn't account for sales lost within the U.S. to cheaper imports, it is an indication that the dollar is a headwind from which companies can recover.

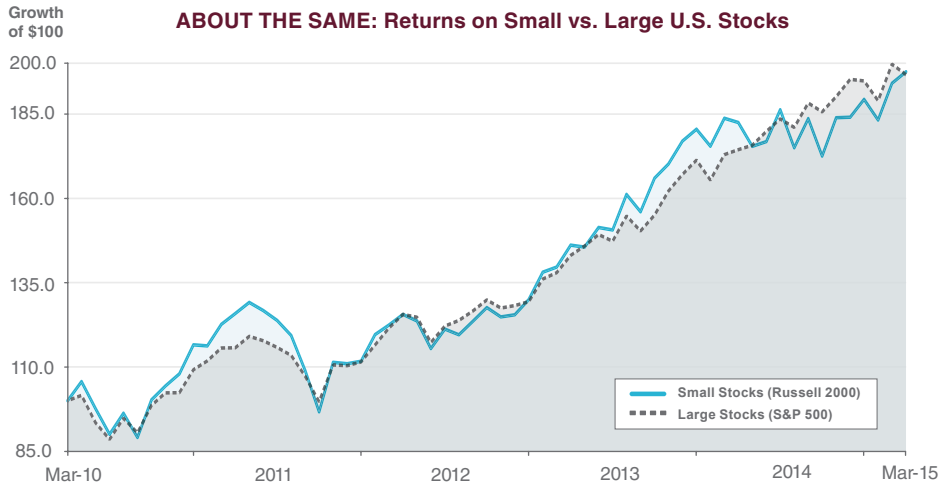
It's also worth noting that about 60% of the funds used in international trade are in U.S. dollars, with key commodities, including oil, priced in dollars. So when the dollar fluctuates against foreign currencies, the impact on international trade is less than it may seem.

Overall, the S&P 500 companies are expected to earn just 2.4% more this year vs. a nearly 5% increase in 2014. At this point, we don't think 2015 earnings estimates are likely to come down much more. And there's a chance earnings estimates could be revised upwards, especially if the U.S. economy picks up later this year.

In addition, large stock valuations are high but not extreme. The S&P 500 companies are priced at 17 times their earnings estimates for the next 12 months, moderately higher than the 10-year average of 14 times. Finally, investor sentiment is relatively muted compared to the peaks of past bull markets.

We continue to be less keen on small U.S. stocks because they're not likely to deliver returns that compensate for their risk. Our analysis indicates that small stock valuations are higher than those

of large stocks relative to historical averages, and that's been the case during the past several years. Additionally, small stocks offer little in terms of diversification. Take a look at the chart. It shows that returns on large stocks (S&P 500) and small stocks (Russell 2000 Index) have been the same during the past five years: 14.5% annualized. But the price volatility of small stocks has been about 33% higher.



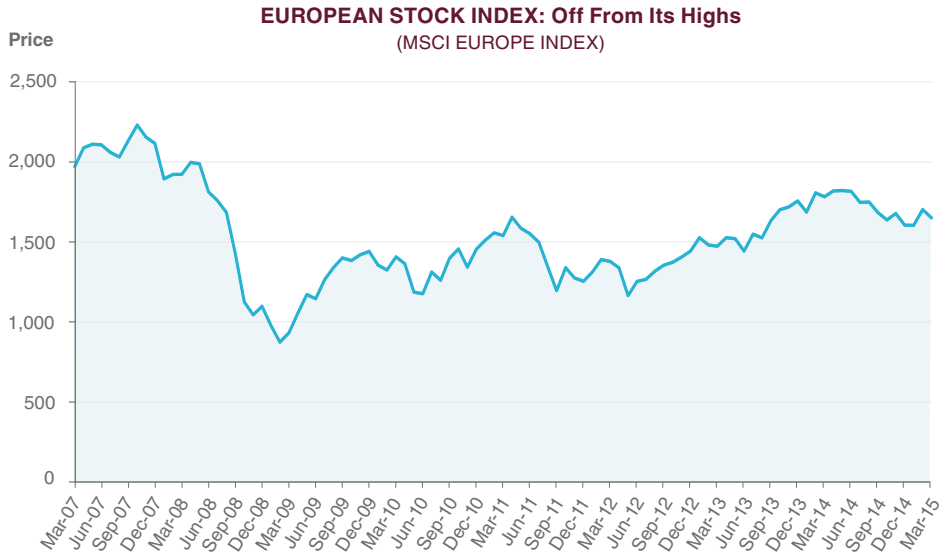
SOURCE OF DATA: Bloomberg.

INTERNATIONAL DEVELOPED EQUITIES: A Boost from Stimulus & Weaker Currencies

Europe, Japan and other major international markets could pleasantly surprise in the coming quarters, as foreign central banks are doing all they can to get growth going and low oil prices decrease costs for businesses and consumers.

At the same time, a weaker euro and yen are boosting exports, which are key to these economies. Consider that exports are about 26% of the Eurozone's GDP vs. 14% for the U.S.

Estimates for European corporate profits are starting to rise and consumer retail sales have been up for the past four months. Plus, European stocks have yet to return to their pre-2008 highs.



SOURCE OF DATA: MSCI.

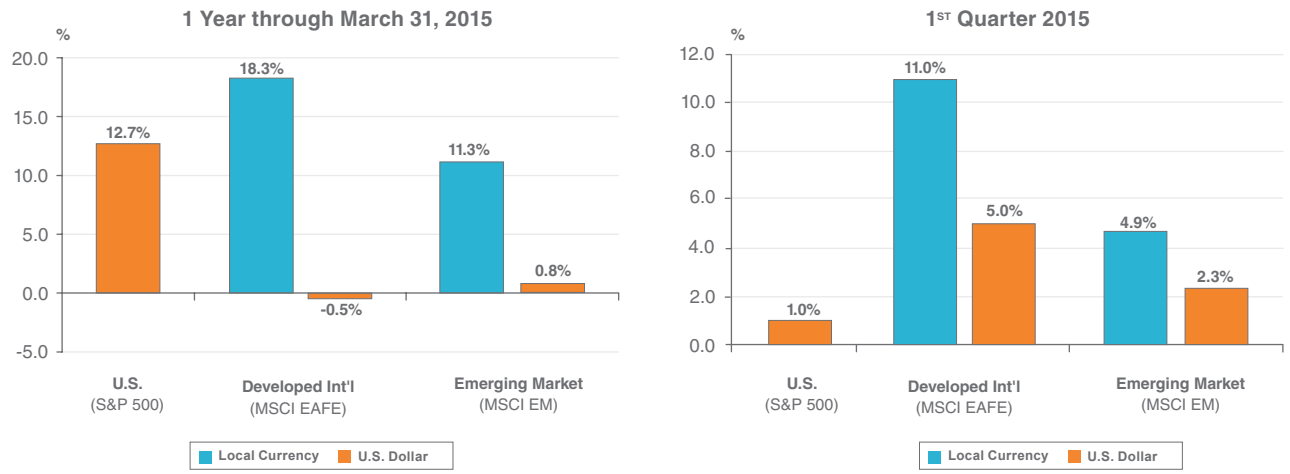
But there are major headwinds. For one, the Eurozone (67% of developed international stock indices) has structural issues likely to make monetary stimulus less effective, such as very high unemployment in the peripheral countries and a greater reliance by corporations on bank lending rather than bond issuance.

Even if the Eurozone and Japan do hit their growth targets for 2015 (around 1.5% for Eurozone; 0.6% for Japan), these growth rates will still be lower than what we're expecting for the U.S.

Just as important, a stronger dollar is hobbling foreign market returns, which have generally been strong in local currency terms, as investors anticipate the benefits of monetary stimulus.

As the chart below indicates, when those foreign returns are converted into U.S. dollars, the results are dramatically lower.

EQUITY RETURNS IN U.S. DOLLARS VS. LOCAL FOREIGN CURRENCIES



SOURCE OF DATA: Bloomberg.

We are therefore comfortable maintaining our slight underweight to international developed equities. Note that LNWM equity portfolios have about a 16% exposure to euro-denominated assets, which we do not hedge because of cost and the fact that currency fluctuations tend to even out over time.

EMERGING MARKETS: Diverging Results

PURCHASING MANAGERS INDEX
(Q1 2015 AVERAGE)

Expanding	
Mexico	54.9
India	52.1
Taiwan	51.6
Neutral	
S. Korea	50.5
China	50.0
Not Expanding	
Brazil	48.8
Russia	48.5
Indonesia	47.5

SOURCE OF DATA: J.P Morgan.

Divergence is also the name of the game when it comes to emerging markets (EM). While the U.S. economy and dollar are strengthening, the growth rates of emerging markets, including China, have been coming down, although they're still expected to grow 4.3%, on average, in 2015 (per the IMF). In response, China, South Korea and other EM countries have started to lower interest rates and provide other types of monetary stimulus, which is fueling EM stock market gains.

Greater care is warranted when investing in the emerging markets today because there are growing differences in economic health, structural reforms and growth rates.

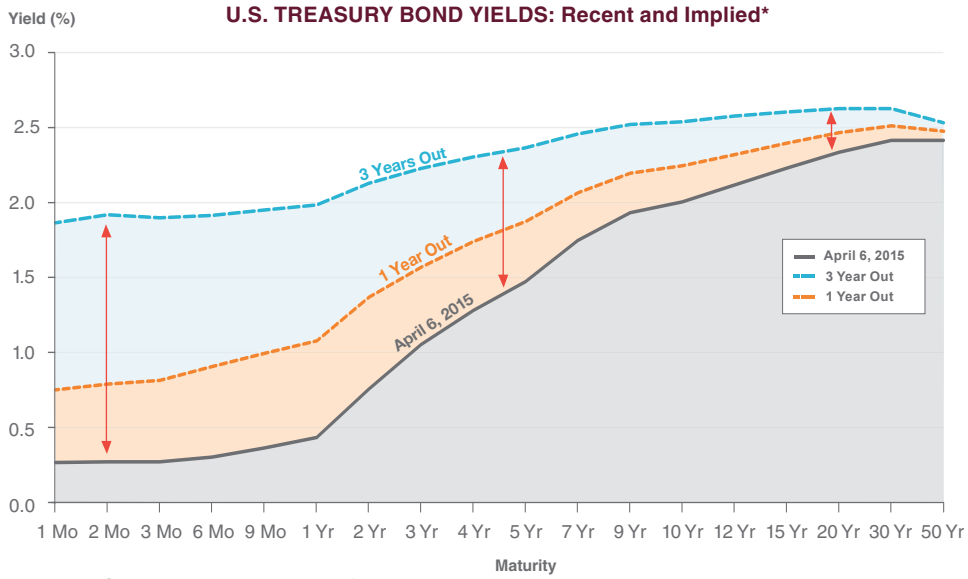
One indicator we look at is the monthly Purchasing Managers Index (PMI). The PMI is an indication of a country's manufacturing health and includes such things as new orders, inventory levels, production, supplier deliveries and employment. A reading above 50 indicates a manufacturing sector that is expanding. As a point of comparison, the U.S. PMI average was just under 55 for first quarter 2015 and just over 51 for the Eurozone.

Selectivity is key in the EM space. We are maintaining our slight overweight to emerging markets because of their higher potential growth rates, especially given the likelihood of further interest rate cuts, monetary stimulus efforts and structural reforms. However, our allocation to EM equities is not through index funds but actively managed EM funds whose investments are based on comparative analysis among EM companies and countries.

FIXED INCOME: A Flattening Yield Curve?

We anticipate the Federal Reserve will increase short-term interest rates later this year, but in a muted, gradual way. If the Fed does increase, U.S. shorter-term rates are likely to rise more than longer-term rates. That's partly because of the growing global demand for U.S. debt. Consider that 10-year German government bonds are yielding a paltry 0.2%, Japanese bonds 0.3%, and Italian bonds 1.3%. In comparison, the nearly 2% yield on 10-year Treasuries seems quite substantial.

The chart shows what's known as the "yield curve": U.S. Treasury bond yields for various maturities as of April 6, 2015, as well as for one year out and three years out. The "implied" bond yields are what bond traders expect yields to be, based on forward contracts on Treasury debt. As you can see, the yield curve is expected to get flatter, with the biggest interest rate increases happening in the shorter maturities.



*Yields on U.S. Treasury bonds, actual and on forward contracts.

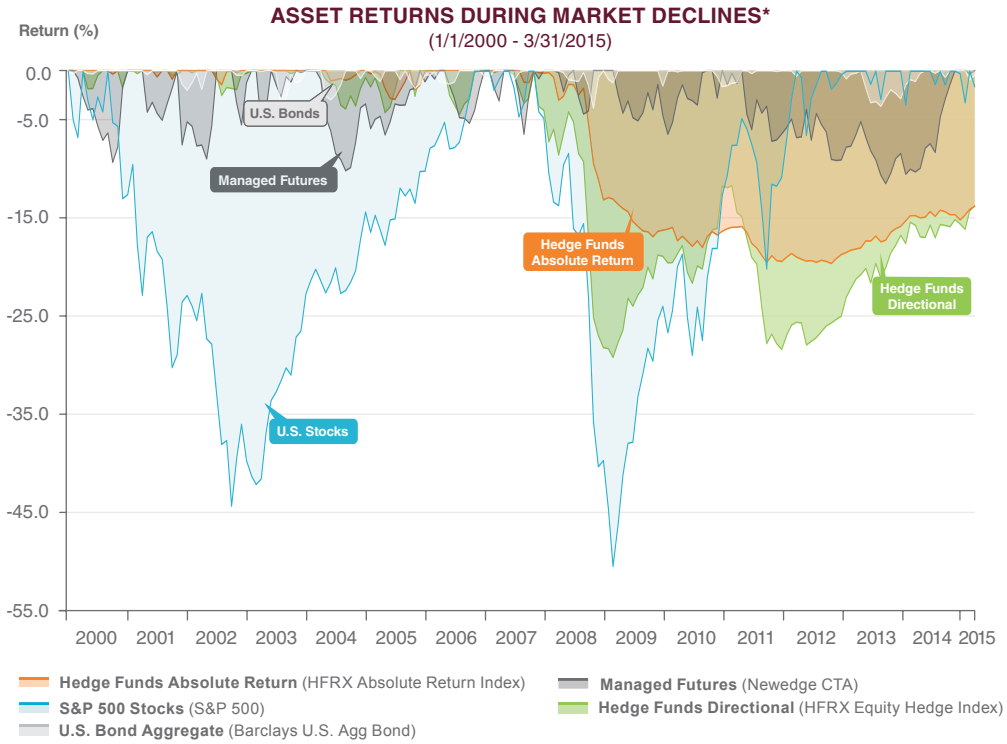
SOURCE OF DATA: Bloomberg.

Regardless of how much and when interest rates rise, we think LNWM portfolios are well-positioned. In the past year, our 50% allocation to multi-strategy fixed income funds has reduced the interest-rate sensitivity of our bond holdings by roughly half while moderately increasing credit risk. Since we made these changes, rates have bounced around a lot. When rates rose, the portfolios performed very well – as anticipated. When rates moved lower, we gave up these gains and were glad to have maintained a 50% position in high-quality, intermediate-term bonds. Given the difficulty in timing the Fed's actions, we will maintain our allocation to intermediate bonds to provide protection should the Fed delay raising rates.

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 rise in the dollar, for example, has benefited managed futures funds, because they have the ability to sell short foreign currencies.

The chart at right shows how various asset classes have performed during market downturns (from peak to trough). As you can see, U.S. stocks (S&P 500) have had dramatic drops, while U.S. bonds have held fairly steady. In between are the hedge funds and managed futures funds. Each asset class has its own risk and return characteristics. By making the most of these differences, we strive to lower overall portfolio risk while not sacrificing too much in return.



SOURCE OF DATA: Morningstar.

IN SUM

We have lowered our outlook for U.S. economic growth slightly (closer to 2.5% than 3%), although this could prove too pessimistic if the expected increase in U.S. consumer spending occurs. At the same time, the Eurozone and Japanese economies could pleasantly surprise due to their stimulus efforts.

We will continue to keep a close watch for signs of stalled growth here and abroad. A stock market pullback in 2015 would not surprise us, although we think it likely to be temporary. We remain 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 our outlook changes.

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.