Q3 2014
ECONOMIC OUTLOOK

BY ROBERT BENSON

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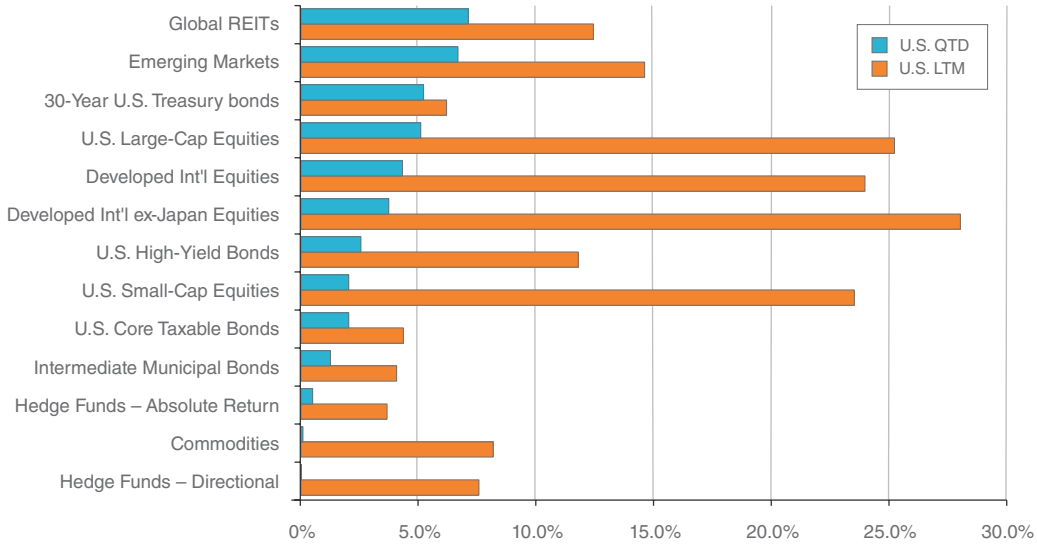
KEEPING A COOL HEAD IN A HOT MARKET

"The Everything Boom." This is how a *New York Times* columnist recently described the current market environment. Indeed, virtually all asset classes have continued to gain ground so far this year, from stocks and bonds (see chart below) to collectible art.

The result is that no one asset class now appears to be significantly undervalued. So caution is warranted: this is not the time to be chasing returns, shifting money into the best-performing asset classes in hopes that the bull will continue to run. Instead, we are adhering to our long-term asset allocations, which are geared to benefit from continued market gains while offering protection on the downside.

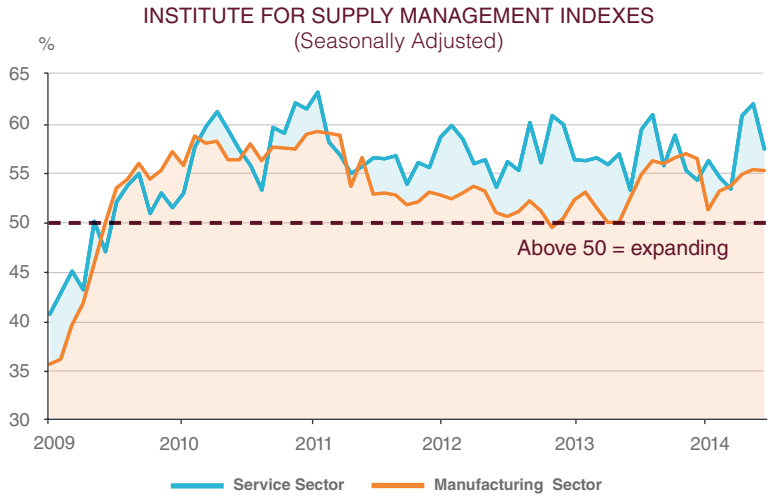
UP AND AWAY: PERFORMANCE OF ASSET CLASSES
Quarter-to-Date (QTD) and Last 12 Months (LTM)
As of June 30, 2014



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: BACK ON TRACK

The good news: The U.S. economy is returning to growth, after shrinking nearly 3% annualized in first-quarter 2014, partly due to the severe winter weather. Not surprisingly, the first-quarter numbers scared some into thinking another recession might be in the offing. We don't share this view. We are encouraged by the recent monthly data, which provide more of a "real-time" perspective on how the economy is functioning. Leading economic indicators, released on a monthly basis, are signaling the U.S. economy is expanding, albeit more modestly than many economists expected.



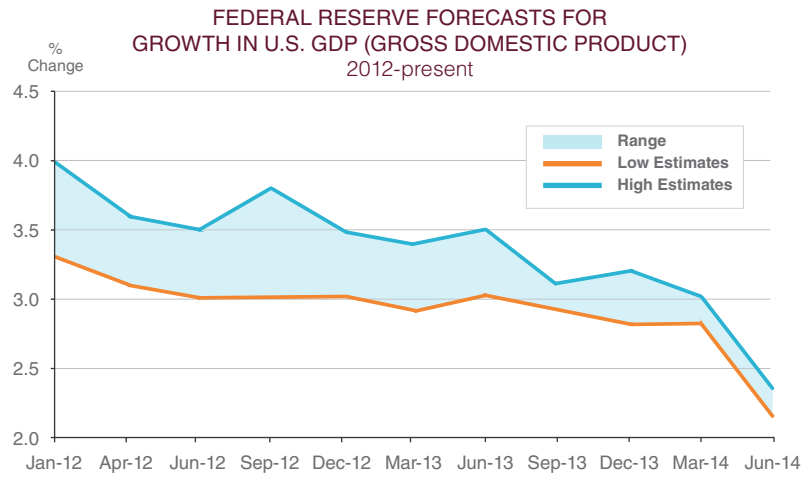
SOURCE OF DATA: Institute for Supply Management

Two indicators we look at closely are the Purchasing Managers' indexes for the services and manufacturing sectors (chart at left). The services sector, which is 70% of the U.S. economy, had a pro-growth Index reading of 58 for June 2014 and manufacturing came in at 55.

Just as important, U.S. job growth is finally trending higher, with the U.S. adding more than 200,000 jobs in each of the previous five months (January – May). This is roughly the figure needed to indicate net new job creation, taking into account population growth.

TWO STEPS FORWARD, ONE STEP BACK

The not-so-good news: The U.S. economy is not likely to approach 3% annualized growth until next year – at the earliest. We're not alone in this view. So far this year, the Federal Reserve (Fed), the International Monetary Fund and the World Bank have each lowered their growth expectations for both the U.S. and global economies. The Fed, which had been forecasting that the U.S. economy would grow nearly 3% this year, revised this downward to just above 2% – in line with LNWM's expectations since last year.



SOURCE OF DATA: Federal Reserve, Federal Open Market Committee.

Indeed, the drivers needed to propel the U.S. to a 3% annualized growth rate – the long-term average for our economy – are not yet in place. U.S. businesses are not yet investing in plant and equipment at a rate that can drive growth upward; corporate

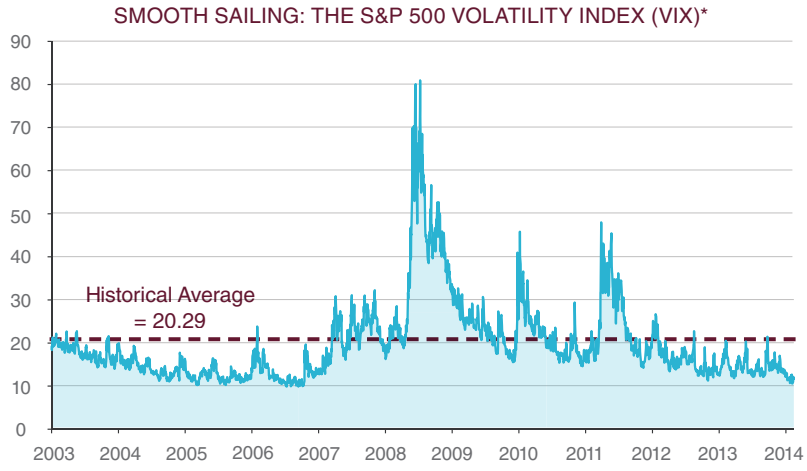
profits are already just off record highs and therefore not likely to move higher without a catalyst; we have a high number of part-time and discouraged workers in the U.S. labor force that can't find full time jobs; and other developed economies are struggling.

INDICATOR	TREND	LNWM COMMENTS
U.S. business spending	Flat	Business spending has trended below consumer spending
U.S. corporate profits	Off peak/High Level	Corporate profits continue to fuel stock price gains and remain near cyclical highs
U.S. employment	Improving	Job growth has improved but needs to continue at 200,000 new jobs added per month to surpass population growth
European economies	Flat	Stagnant GDP for the region; European equities still attractive due to revenue generated outside of region

EQUITIES: STAYING PUT

Despite lower economic growth forecasts, large U.S. stocks were up 7% through June, in line with our expectations for a moderately good year. This sort of "front-running" is not unusual. Investors buy and sell based on their expectations for the future. Therefore, stock prices typically recover from recessions, well before the broad economy returns to its long-term average growth rate (3% for the U.S.).

However, the level of front-running during this recovery has been exceptional. Large U.S. stocks have nearly tripled in value since June 2009, when the recession officially ended, even though the U.S. has struggled to maintain even a 2% growth rate, and Europe is stagnating.



*VIX reflects the pricing of stock options on the S&P 500 index that mature within 30 days.

SOURCE OF DATA: Chicago Board Options Exchange.

Investor complacency is evident in the historically low level of stock-market volatility. Take a look at the chart at left, which shows the VIX, an Index that tracks the price of futures contracts on the S&P 500 and is a common proxy for stock-market volatility. We believe the VIX (which is forward looking by 30 days) is running low because investors expect the good times to keep on rolling. Many seem to believe that the factors that led to the current sweet spot of historically high corporate earnings, historically low interest rates, and few attractive investment options relative to equities will continue indefinitely.

Clearly, the rebound in stock prices has very significantly outstripped the rebound in employment and economic growth, both here and in most developed economies. This begs the question: how long can this trend last? Just as the driver of a car can accelerate faster than the car ahead for only so long, so too equity prices can significantly outpace economic growth only so long. Eventually, one of two outcomes will occur: either U.S. economic growth will pick up to around 3% annualized, supporting the current stock valuations; or stock prices will adjust downward to reflect a lower growth rate closer to 2%.

For a while, stocks could continue gaining, since they are not priced at outrageously high levels. U.S. large caps, for one, are trading at around 16 times forecasted earnings for the next 12 months, which is right around the long-term average.

But the gains are likely to be more muted here out and the risks are higher. At current valuations, we think much of the likely increase in corporate earnings has been priced in, particularly considering weak corporate investment in plant, equipment and hiring. The other major driver of stock prices is a significant drop in interest rates, but this is unlikely given that rates are near historical lows.

As a result, we are maintaining our long-term asset allocations and not shifting more into U.S. stocks. Not only would such a shift entail transaction costs and gains taxes, but it would increase risk at what we think is an inopportune time. Maintaining a long-term allocation (after extensive valuation research) often makes sense, as it did earlier this year for Emerging Market (EM) equities. Our review of EMs pointed to solid fundamentals that are still in place in many developing economies, although certainly not all. And so we were positioned to benefit from the EM rebound this year.

The only change we did make in the second quarter was an incremental shift in our natural esources allocation, affecting around 1.5% of client porfolio assets. For specifics on the shift, please contact your LNWM advisor.

FIXED INCOME: NEW STRATEGY IS WORKING WELL

LNWM's Fixed-Income Strategy, launched in October 2013, continues to perform well, despite the slight drop in bond yields so far this year. For specifics on the results for your own portfolio, please contact your LNWM advisor.

We believe that U.S. interest rates will eventually head higher, albeit in fits and starts due to the uneven economic recovery. The strategy we have in place is designed to buffer client portfolios from the impact of rising interest rates, while maintaining a competitive rate of return should interest rates trend flat or moderately lower.

Real Estate Investment Trusts (REITs). REITs, which lease or rent all sorts of properties, are especially sensitive to interest rates moving higher, since this affects their project-financing costs. If the U.S. economy were growing faster—closer to 3%—REITs would have more leeway to increase rents and expand operations to offset higher borrowing costs. But since we have a slower-growing economy coupled with the possibility for higher rates, we find more downside than upside in REITs. Also, REITs are one of the most volatile asset classes, with a price volatility higher than U.S. stocks, which means price drops are likely to be pronounced.

ALTERNATIVE ASSETS: DOWNSIDE PROTECTION

Alternative assets ("alts"), such as hedge funds and managed futures, use a wide variety of strategies to benefit from falling prices and down markets. By contrast, traditional assets like stock and bond funds can't do much except sell and move into cash when markets are down. While the addition of alts can lower portfolio returns when markets are booming, as they are now, we believe alts have the potential to mitigate losses in the long run. Our modeling suggests the probability of a large loss is significantly lower when client portfolios include both alternative and traditional assets.

A major reason why is enhanced diversification. As trading has become faster, cheaper and globalized during the last 20 years, traditional asset classes have exhibited a higher degree of price correlation. This reduces our ability to manage risk through asset class diversification alone. During the market correction of 2007 - 2009, for example, nearly all major asset classes moved in the same direction – down. Since the alts we select tend to behave very differently than traditional funds, they provide a powerful diversification tool.

IN SUM

We look for renewed economic growth in the U.S. this year, despite the first quarter's downturn. Positive economic signs, and continued loose monetary policy, allow us to maintain our forecast that stock prices will finish the year with gains in the upper-single digits to the low-double digits.

Future gains in equities are not available without higher risk. Stock prices have already moved up dramatically in anticipation of economic growth and "easy money." Should the economy fail to live up to investors' expectations, or central bankers feel the need to hit the brakes, or geopolitical turmoil take center stage, the stock market can pull back suddenly and sharply.

The unpredictable nature of trouble keeps us focused on managing risk in our clients' portfolios. (Please also see Dana Rekow's article on risk in this issue of the *Navigator)*. Although we can point out the types of events that could trigger a market sell-off, we cannot accurately predict how probable these events are, or when they might occur. We therefore opt to maintain multi-faceted diversification so we can build wealth methodically and win by not losing.

ABOUT THE AUTHOR

ROBERT BENSON is chief investment officer at Laird Norton Wealth Management. He is responsible for setting and implementing investment strategy at the firm, as well as selecting managers for our client portfolios. Bob has more than 20 years of experience in the financial industry, most recently at Russell Investments, primarily in investment strategy, asset allocation and risk management. He received his CFA designation in 1997, and he's a member of the CFA Institute as well as the CFA Society of Seattle. He has an MBA from Northwestern University. Bob has served on the boards of both startup firms and non-profit organizations.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With more than $4 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.