Q3 2015
ECONOMIC OUTLOOK

By the LNWM Investment Strategy & Research Group

A STEEPER WALL OF WORRY

There's an old Wall Street saying that "rising markets climb a wall of worry." Recently, that wall has become steeper, thanks to the Greek crisis, China's stock-market rout, and a U.S. economy whose growth sputtered in the first half of 2015. Most asset classes were down or barely up in the second quarter. And the big question is: more of the same – or worse – for the rest of 2015?

While we continue to monitor the situation in Greece and China closely, we don't think the outcomes for these countries will outweigh positive developments, which include: U.S. economic growth picking up in the second half of 2015; improving economies in Japan and the Eurozone (except for Greece); and the Chinese government doing all it can to keep the country growing close to 7% this year.

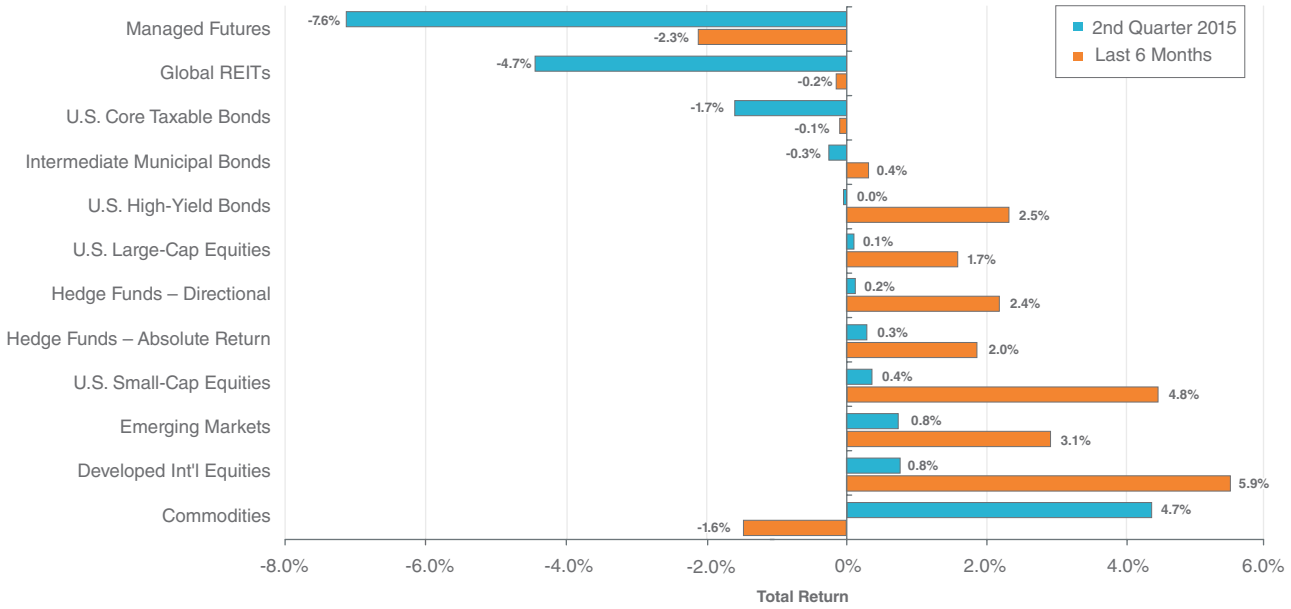
We do think the Federal Reserve will raise interest rates in 2015, barring an unexpected crisis. Already, the bond markets are pricing in this likelihood, as investments that are the most sensitive to interest-rate increases – including bonds and REITs – are losing ground.

This autumn could be especially trying, given slowing U.S. corporate earnings growth, high valuations on equities worldwide, a U.S. interest rate increase, and potentially more geopolitical turmoil abroad. So it's time for caution.

We have prepared our portfolios accordingly. In fixed income, we have added assets that tend to perform well when interest rates rise. In equities, we have a sizable allocation to foreign markets, where stimulus programs are reviving growth, as well as to large U.S. stocks due to their strong finances and global diversification. And we have a significant allocation to alternative assets, which as expected, performed relatively well during recent market turbulence.

PERFORMANCE OF ASSET CLASSES

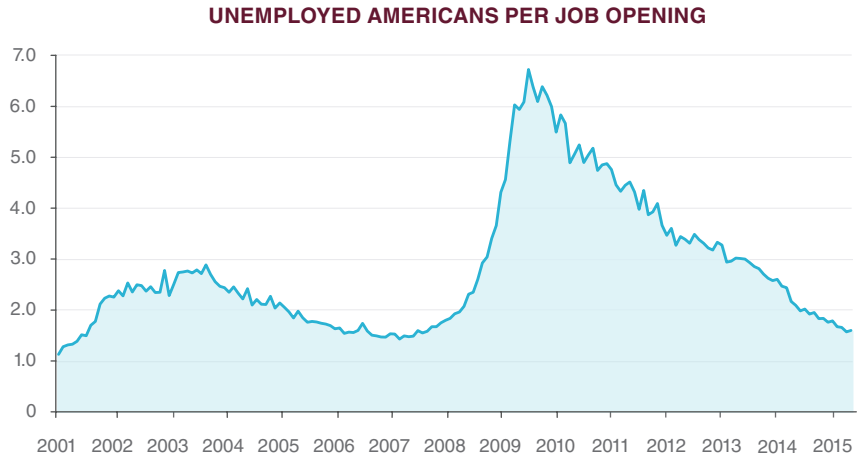
2nd Quarter 2015 and Last 6 Months, (As of June 30, 2015)



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: Optimism for Second Half

We expect U.S. economic growth to rebound in the second half of 2015, after a weak start of the year mainly due to a historically fierce winter out East and a long port strike out West. We are encouraged by these recent developments: a stabilizing exchange rate for the U.S. dollar, whose strength in the past year has made U.S. products less price competitive; and a 20% rebound in oil prices from the lows hit earlier this year, which has helped the U.S. energy sector.



SOURCE OF DATA: Bureau of Labor Statistics.

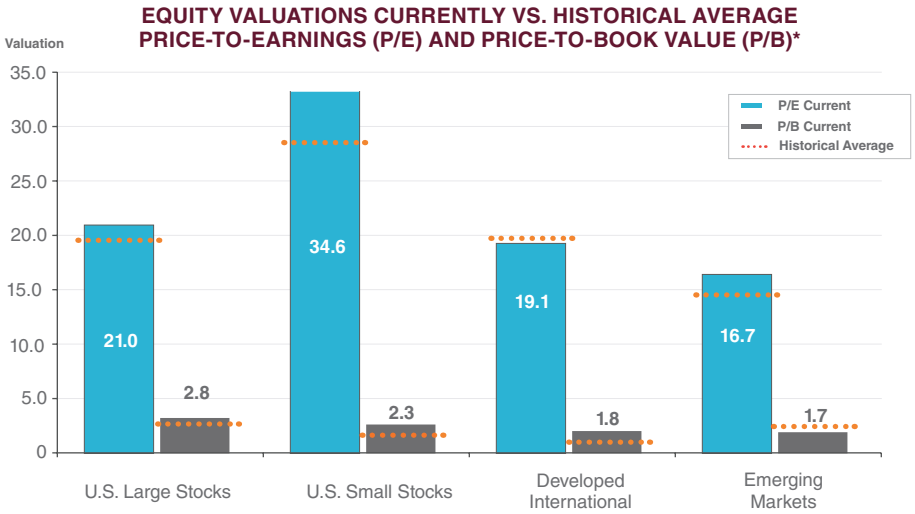
At the same time, U.S. consumers continue to benefit from a strengthening real estate market, lower interest rates on consumer debt, and an improving job market with the prospect of wage increases. Wage increases are especially important at this point in the economic recovery because they allow for broader and more sustainable increases in consumer spending.

U.S. wages and salaries rose 2.8% for the 12 months ended March 2015, much more than the 1.6% increase the previous year. Other signs point to continued wage gains. For May 2015, key numbers for the labor market were near or above 2007 pre-recession levels: U.S. job openings (around 5 million), new hires (4.7 million), and the number of people feeling confident enough to quit jobs (2.5 million).

In the past five years, we have seen a steady drop in the number of unemployed Americans available for each job opening (see chart above). Granted, this ratio does not count discouraged job seekers or those who are underemployed, but it does indicate we're in a tighter job market in which employers will have to compete more in terms of pay and benefits to keep and attract workers.

LARGE/MID-CAP U.S. STOCKS: Favored for Now

Worldwide, equity valuations in terms of earnings and book value are near or above historical averages (the past 25 or so years), as the chart at right indicates. Of course, stock valuations can rise above the historical averages, but when this has happened in the past, the above-average levels have not lasted for long.



*Through June 30, 2015 based on earnings for previous 12 months.

SOURCE OF DATA: FTSE Russell.

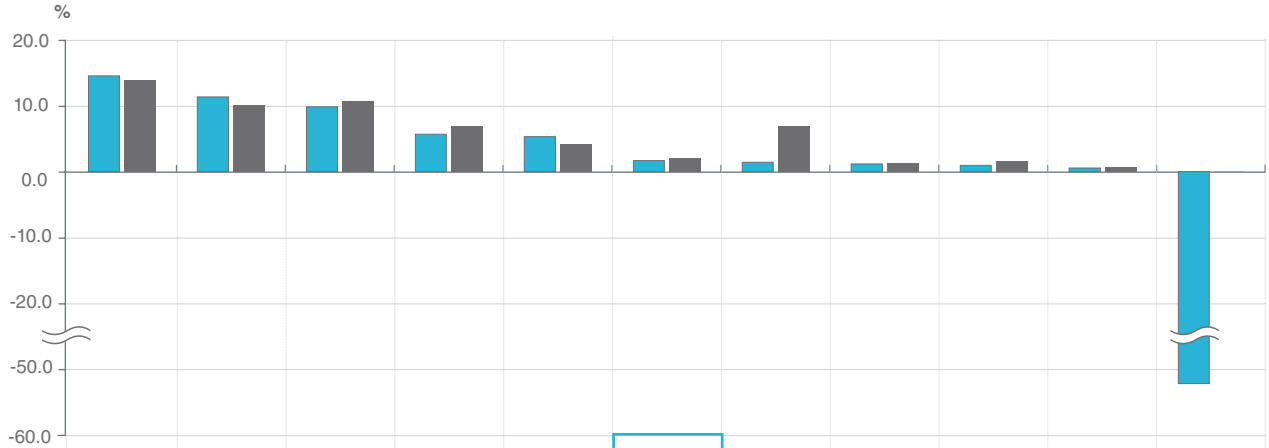
For the past five years, the markets have supported rising valuations because U.S. inflation and interest rates have been falling, and corporate earnings rising mostly due to cost-cutting and restructuring. Falling rates make stocks appear much more attractive than low-yielding bonds, and lower inflation means each $1 in corporate earnings is worth more.

But we're at a point now when the reverse is likely to happen: U.S. corporate earnings are growing more slowly, and inflation and interest rates are likely to rise. So it is time for caution. It is also a time when stock selection is likely to become increasingly important relative to momentum investing through index funds.

In this environment, we continue to favor the U.S. market because it's the farthest along in recovering from the Great Recession, is politically stable and has fewer structural imbalances that hinder growth. Within the U.S., we continue to favor large and mid-size U.S. stocks because they're more likely to benefit from recent stabilization in the value of the U.S. dollar, and the recent rebound in oil prices. Also, small U.S. stocks are priced considerably higher than large stocks relative to historical averages (see chart bottom of previous page).

U.S. corporate earnings, relative to 2014, are likely to disappoint in the near term as the stronger dollar and lower oil prices make comparisons difficult. The consensus among analysts is that earnings for the S&P 500 stocks will, on average, decline for the second and third quarters (-4.5% and -1.5%, respectively) but rebound in the fourth (+4.2%) to end the year slightly up from 2014.

S&P 500 ESTIMATED EARNINGS GROWTH FOR 2015: Lower Than Before



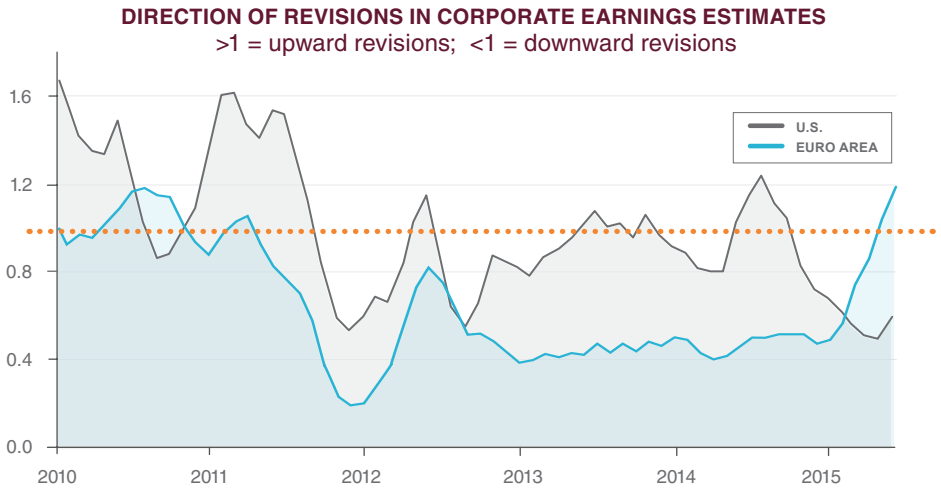
	Financials	Health Care	Consumer Disc.	Info Technology	Telecom Services	S&P 500	Industrials	Utilities	Consumer Staples	Materials	Energy
Jun-02-2015	16.3%	12.7%	11.0%	6.5%	6.5%	1.5%	1.5%	1.3%	0.9%	0.7%	-55.1%
Mar-31-2015	15.9%	11.3%	12.1%	7.7%	4.1%	2.2%	7.7%	1.4%	1.6%	0.6%	-56.3%

SOURCE OF DATA: FactSet.

INTERNATIONAL DEVELOPED EQUITIES: Danger and Opportunity

Despite the ongoing Greek debt crisis, things are improving in Europe. The Eurozone is 67% of developed foreign equity market valuations, so it's the main driver of performance in this arena.

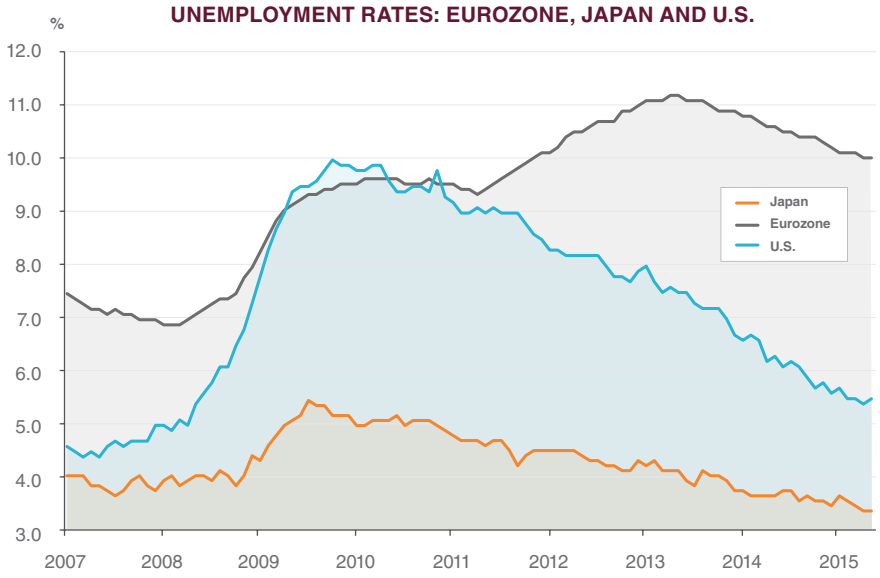
Earnings estimates for Eurozone companies have turned positive for the first time in four years (see chart at right). Except for Greece, Eurozone companies are benefiting from the European Central Bank's stimulus program, a weaker euro, low oil prices, and a pick-up in consumer demand.



SOURCE OF DATA: JP Morgan Asset Management.

The turmoil in Greece holds geopolitical dangers for Europe, but financially, Greece is less than 2% of the Eurozone's GDP, so its economic impact is likely to be contained. Still, there is great potential for market turbulence as the Eurozone continues to grapple with the Greek crisis, and this is a major reason we're not increasing our allocation to what is a rebounding Eurozone economy.

The other major developed foreign economy – Japan – is also showing strong improvement, thanks to the stimulus policies of Shinzo Abe, who became prime minister in 2012. In the past three years, Japanese corporate earnings have doubled and dividends are up 60%. Inflation-adjusted wages are rising for the first time in over 20 years, along with corporate spending, as Japanese multinationals set up domestic operations to benefit from a weaker yen.



SOURCE OF DATA: BLS, Eurostat, Bloomberg.

EMERGING MARKETS: Putting China in Context

Emerging markets (EM) continue to be dragged down by potentially higher interest rates in the U.S. and a slowdown in China's economy. As China's real estate market continues to cool, and infrastructure spending slows, the country is attempting a shift toward a consumer driven economy. Currently, about 33% of China's GDP is consumer spending vs. close to 70% in the U.S.

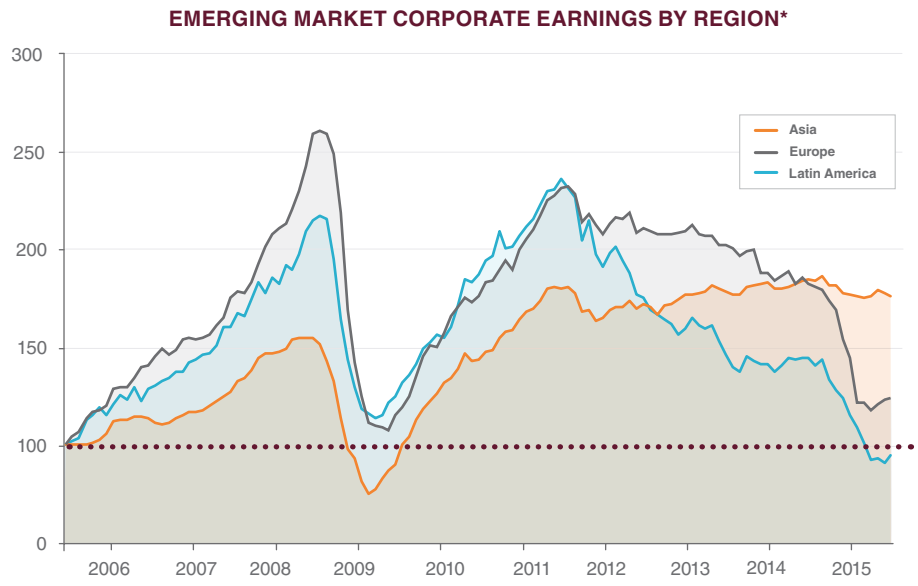
With the Chinese government doing all it can to revive economic growth – including four interest rate cuts since last November – we think a growth rate of just under 7% is quite possible for this year. While substantially lower than before, this is still among the fastest growth rates worldwide.

On average, the EM funds we have selected for investment have an allocation to China that is much lower than that of the major EM stock indexes (25%). And all our EM funds' China allocation is to Hong Kong-listed shares, which haven't been nearly as volatile as stocks listed on China's mainland exchanges.

It's important to note that virtually all foreign investment in Chinese stocks is through shares listed on the Hong Kong stock exchange, up 9.3% so far this year.

By contrast, the Shanghai stock exchange is virtually all domestic Chinese investors. It is on the Shanghai exchange that a speculative buying spree occurred up until mid-June 2015, followed by massive selling. Despite government efforts to stop the sell-off, Shanghai Exchange shares are down close to 30% since mid-June with many analysts projecting they have more to fall.

Overall, we continue to think that emerging markets offer significant growth opportunities as corporate earnings growth in many EM countries is holding up, and more people are joining the middle class. However, as we've said in the past, selectivity is key since growth prospects differ greatly depending on the country and region.



*Consensus estimates for earnings per share for the next 12 months, in local currencies, rebased to 100 in mid-2005.

SOURCE OF DATA: JP Morgan.

As the U.S. raises interest rates, the borrowing costs in emerging markets will rise, temporarily dampening growth and making individual stock selection more important. This is why most of our allocation to emerging markets is through actively managed funds instead of EM indexes.

FIXED INCOME: Positioned for Rising Rates

As we have been anticipating, U.S. bond yields have started to climb, hurting bond returns. Ten-year Treasury bonds are now yielding close to 2.4% vs. 1.9% at the end of March. Yields are likely to rise even more should the Federal Reserve stick to its plan of two interest rate hikes this year, and four rate hikes in 2016.

LNWM's fixed-income strategy aims to protect portfolios from rising interest rates through shorter bond maturities and slightly increased credit risk. So far in 2015, this approach has performed very well. It's worth noting that both high-yield bonds (lower credit quality) and equities tend to outperform during periods of rising interest rates, as the chart on the next page indicates.

PERFORMANCE* DURING PAST PERIODS OF RISING RATES (1993 - 2013)

When 10-Yr T-bonds yields rose more than 1 percentage point

PERIOD	TREASURY BONDS	MUNICIPAL BONDS	INVESTMENT GRADE CORPORATES	FLOATING RATE LOANS	HIGH YIELD BONDS	LARGE U.S. STOCKS
Aug. 1, 2012 — Dec. 31, 2013	-3.3%	-1.2%	0.4%	10.1%	13.8%	38.3%
Sept. 1, 2010 — Mar. 31, 2011	-2.8%	-3.8%	-0.1%	7.4%	10.5%	27.8%
Jan. 1, 2009 — Dec. 31, 2009	-3.6%	12.9%	18.7%	44.9%	58.2%	26.5%
Jul. 1, 2005 — Jun. 30, 2006	-1.7%	0.9%	-2.2%	6.7%	4.8%	8.6%
Oct. 1, 1998 — Jan. 31, 2000	-2.5%	-1.9%	-1.7%	6.6%	4.1%	39.4%
Feb. 1, 1996 — Aug. 31, 1996	-2.4%	-0.3%	-2.9%	4.8%	3.3%	3.9%
Oct. 1, 1993 — Nov. 30, 1994	-4.3%	-5.9%	-4.9%	13.4%	2.0%	2.2%

*Index returns for each category.
Indexes: Barclays U.S. Treasury, Barclays Municipal, Barclays U.S. Corporate Investment Grade, Credit Suisse Leveraged Loan, Barclays U.S. Corporate High Yield, S&P 500.

SOURCE OF DATA: Lord Abbett, Morningstar.

In the municipal bond market, Puerto Rico set off alarms after the Governor suggested that the island's debts are unpayable and that the municipality was locked into a "death spiral."

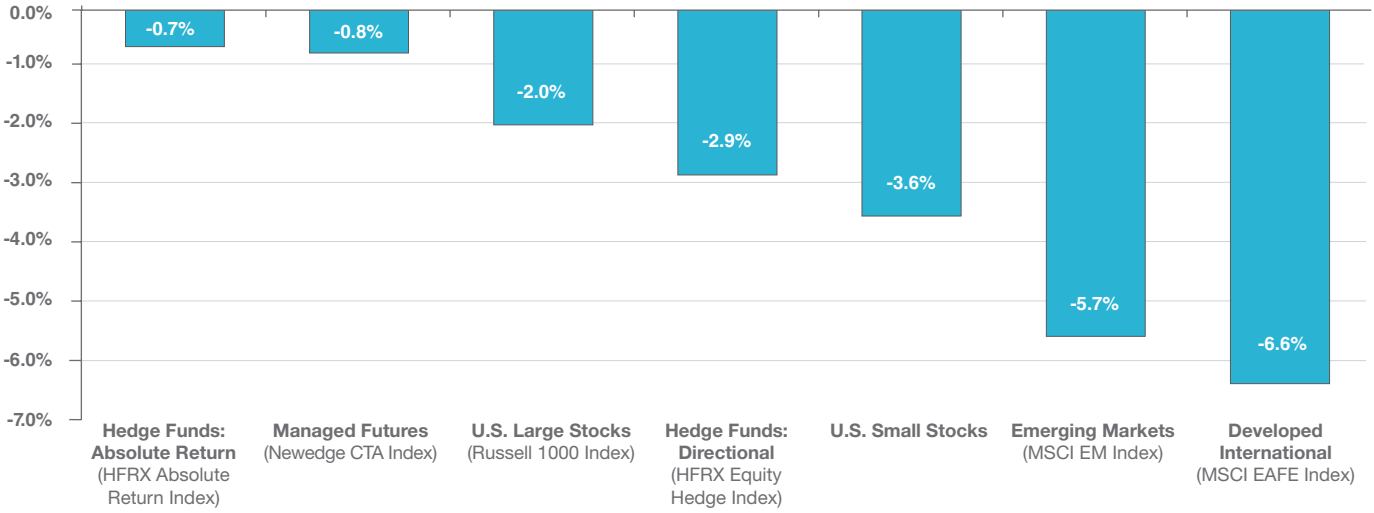
LNWM's municipal bond portfolios have nearly zero Puerto Rico debt. We continue to think Puerto Rico's crisis is not indicative of the health of the municipal bond market, which remains strong.

ALTERNATIVE ASSETS: Performing as Expected

We continue to think carefully selected alternative assets are providing necessary diversification to client portfolios and will bolster returns during market pullbacks. In the recent market turbulence due to Greece's debt crisis and China's stock-market losses, alternative asset indexes generally performed better than traditional ones, as the chart below indicates.

PERFORMANCE DURING RECENT MARKET TURBULENCE

June 23 - July 7, 2015



SOURCE OF DATA: Bloomberg.

IN SUM

We would not be surprised by higher market volatility between now and year-end, due to a temporary slowdown in U.S. corporate earnings growth, relatively high valuations, and rising interest rates. A stock market correction – drop of at least 10% – is increasingly possible since we have not had such a pullback in nearly four years.

However, we think the positives in the U.S. economy and most major foreign markets continue to outweigh the negatives. Should near-term turbulence pick up, LNWM clients are well-positioned. We remain globally diversified across high-quality assets in a way that's geared to keep portfolio volatility within specific targets. And we stand ready to make adjustments should we see indications of stalled growth here and abroad.

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.