ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

Kick the kid while he is trying to get off the ground. Perfect analogy for today's naysayers about the U.S. stock market. From early 1997 to early 2009, a twelve-year time period, the Dow Jones Industrial Average (DJIA) ended about where it began, at a level close to 7000. Adding insult to injury, the market rose like a phoenix twice during those twelve years, in 2000 and 2007. Just like it is rising again today. No wonder pundits don't believe the market's ascent is sustainable. Post traumatic stress has entered the world of investing. Given the roller coaster of the prior two decades and the complex world that we live in, it is so easy to be frightened, nervous and cautious. In fact, only recently have individual investors begun to tiptoe back into the market.

	DJIA
January 1997	6824
January 2000	10941
March 2003	7992
November 2007	13372
February 2009	7063
March 2013	14579

End of month levels for the Dow Jones Industrial Average

So why would the market not retreat yet again from these levels? Let's briefly compare the psychology of these time periods to where we are today.

INDEX PERFORMANCE *3/31/13*

	CURRENT QUARTER	TRAILING 12 MONTHS
Barclays 10-Year Municipal Bond Index	0.35%	5.45%
Barclays Aggregate Bond Index	–0.12%	3.77%
Barclays High Yield Index	2.89%	13.13%
Dow Jones Industrial Average	11.93%	13.37%
S&P 500 Index	10.61%	13.96%
Russell 2000 Index	12.39%	16.30%
NASDAQ Composite	8.52%	7.14%

The year 2000 marked the height of the dot-com euphoria. The new way of communicating supposedly brought unlimited opportunities. It was not unusual for company stock prices to reach significant multiples of SALES, not earnings. Then in September

Continued on inside

FIRST QUARTER 2013 MARKET OVERVIEW

ECONOMY

- Though fiscal policy turned more restrictive due to the payroll tax hike and sequestration, economic data appeared to be on an upward trend.
- The employment picture continued to improve and the unemployment rate moved slightly lower to 7.7%. Weekly unemployment claims also declined ending the quarter near post crisis lows.
- Manufacturing activity continued to recover as the ISM national manufacturing survey has reported four consecutive months of expansion.
- Low mortgage rates continued to support an increase in housing activity evidenced by a pickup in new home sales and modest increases in housing prices.

FED ACTION

- The FOMC left the target range for federal funds at 0–0.25% and committed to keeping short-term rates at exceptionally low levels at least as long as unemployment remains above 6.5% and inflation below 2.5%.
- Bernanke emphasized the targeted unemployment and inflation levels are thresholds and not triggers and that crossing a threshold would not automatically lead to an increase in the federal funds rate.
- The Committee announced the continued purchase of $40 billion agency mortgage-backed securities and $45 billion Treasuries per month.
- The FOMC did not provide specific thresholds for the end of its purchase program, however, they emphasized that the flow of purchases may be adjusted as employment progress is achieved.

BOND MARKETS

- The Treasury yield curve steepened as 5, 10 and 30 year yields moved 4, 9, and 15 basis points higher, respectively. However, Treasury yields moved lower during the final weeks of the quarter when political uncertainty in Italy and the standoff in Cyprus reminded investors of lingering macro risks.
- High yield corporate bonds continued to perform well and spreads tightened due to low default rates and investors' continued search for yield. High grade corporate bond performance was essentially flat for the quarter as spreads were largely unchanged.
- The municipal curve steepened as 5 year yields were unchanged while 10 and 30 year yields moved 15 and 25 basis points higher, respectively. Municipals ended the quarter relatively cheap as weak market technicals in March left ratios against Treasuries above 100% across the curve.

EQUITY MARKETS

- Equities rocketed out of the gate in January and increased gains in March to end the quarter with double-digit returns and with several equity indexes hitting all time highs.
- Flows into equities were strong during the quarter as investor sentiment shifted away from caution and uncertainty. It appears investors were loath to miss another strong year of equity returns parked in cash or other low yielding asset classes.
- Small and mid cap stocks outpaced large caps, and growth stocks within the small cap market segment were strong performers, indicating that investors were willing to take on more risk.
- Fourth quarter earnings season was better than expected and U.S. economic data has met or surprised to the upside.

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2001, the world changed in ways that were unimaginable, and war, fear and social awareness were thrust upon us. In 2007, we were overleveraged and in the throes of a housing boom with real estate speculation at levels never before seen in this country, resulting in bankruptcies at industrial, institutional and personal levels, and reducing wealth across a wide spectrum.

Today, with the economy recovering, albeit slowly, the pundits' main worry is the unwinding of the Federal Reserve's (Fed) monetary policy. How and when will the Fed reverse direction? Will there be hell to pay? Will the economy suffer from inflation and higher interest rates leading to recession? Is this the time to build the fallout shelter?

We know that by keeping short-term interest rates near zero, the Fed has successfully driven money from safe assets earning nothing to higher risk assets which have delivered excellent returns. This may sound dangerous but in fact the system needed to be primed. Low interest rates have provided cheap capital which has helped to stabilize the banks and the economy. We now see housing starts increasing, housing values rising, consumer debt declining, unemployment decreasing, and business profits rising.

Businesses, by far the strongest element of our economy, have increased profit margins by leveraging technology, shuttering marginal businesses and factories and employing a leaner labor force. The pessimistic argue that even the corporate sector's outsized liquidity and access to capital is not sustainable because top line growth (i.e., sales) has been disappointing and the willingness to rehire people has been greatly dampened. The fear of weak top line growth may be incorrect as the global economy grows. In addition, as the banking industry recovers and capital is made available, we may well see a major increase in mergers and acquisitions (both horizontal and vertical) to further reduce overhead.

How will the U.S. provide jobs so that we have a robust domestic economy? My criticism is that Washington has failed to encourage a partnership between business and government, through tax incentives, to train the *un*employed, the *under*employed, and the *un*employ*able*. In today's world, the ability of the uneducated to keep pace with job opportunities is impossible without such cooperation. Look no further than the last war, when even the army was against the draft because they needed educated soldiers to support the military's use of technology. Therefore, we will not see a dramatic decline in the unemployed which will keep this Fed holding interest rates near zero and supporting a slow growth noninflationary economy.

So with the market selling at 14–15 times earnings, and with many stocks now carrying attractive dividend yields, why do so many pundits believe there will be yet another roundtrip from these price levels? How, they say, will the Fed unwind their zero interest rate policies as the economy recovers without creating high inflation, a spike in rates and a resulting recession? In other words: tech bubble in 2000, debt bubble in 2008, and Federal policy bubble 20__?

Inflation is a tax burden to all, including to the U.S. government. With trillions of dollars of debt, even a 1% increase in the cost of money would eventually add billions to the budget each year. The average maturity of the U.S. government's debt is five years, so as rates rise a huge burden would be placed on the budget. The other victim of inflation is the "middle class," the very group President Obama wants to protect. The middle class cannot absorb the cost increases that inflation would bring. Ironically, the poor would not suffer because all government transfer payments are indexed to inflation. The rich would obviously do okay and may even prosper as tangible assets would rise with inflationary premiums.

Inflation is not the answer—the Fed knows that, the government knows that, and we know that. So what is the solution and result of unwinding the Fed's monetary policy? Is Bernanke in a no-win situation with no clear exit strategy, or do we underestimate him? I believe that when the unwinding begins—and that could be years away given the economy's structural malaise—that Bernanke or his successor will succeed in restoring discipline to the Fed's policies without huge disruptions to either the bond or stock markets.

In the end, the Fed's exit strategy is only the latest fear of this cycle. After being held hostage to Europe, China, elections, tax policies, sequester, tsunamis and hurricane Sandy, it is no wonder so many are guarded and reluctant to invest. The fears of the past are on our minds constantly. But we are not in a 2000 or a 2007 world, so don't invest like we are. As I have often said, looking back a year from now some will wonder why they did not invest in our markets, and those who did may be well rewarded as has been the case for the last few years.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE	*3/31/13*
TOTAL ASSETS UNDER MANAGEMENT	$18.1 Billion
TOTAL EMPLOYEES	97
TOTAL INVESTMENT PROFESSIONALS	31

NEW PRINCIPALS OF GW&K

We are pleased to announce the promotions of two long-term GW&K employees to Principal.

Robert L. Gray, *Principal, National Accounts Director*
Brian T. Moreland, CFA, *Principal, Municipal Bond Portfolio Manager*

This recognition reflects their significant contributions to our business, as well as our continued commitment to building and maintaining a strong team dedicated to excellence in investment management and client service. We congratulate them on all of their accomplishments.

MUNICIPAL BOND STRATEGIES

INVESTMENT TEAM

Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Martin R. Touringy, CFA	Partner, Portfolio Manager
Brian T. Moreland, CFA	Principal, Portfolio Manager

21 Fixed Income Investment Professionals	**17** Average Years Experience	**11** Average Years with Firm

GW&K MUNICIPAL BOND STRATEGIES

SHORT-TERM MUNICIPAL BOND	Seeks to earn higher after-tax returns than money market funds while managing risk
FIVE-YEAR MUNICIPAL BOND	High-quality active approach aims to preserve and enhance capital and targets an average maturity of 5 years
MUNICIPAL BOND	High-quality intermediate approach with goal to preserve and enhance capital emphasizes research and active management
MUNICIPAL ENHANCED YIELD	Long-term approach that includes an allocation to higher yielding bonds with a goal to produce high after-tax income

"Our style of active management allows us to be patient, positioning portfolios to reap the benefits of the Fed's go-slow approach, knowing that if rates start to rise, we will act accordingly."

Municipals generated modest gains in the first quarter as return from income and spread tightening exceeded the negative price performance of rising yields. Municipal bonds opened the year relatively strong, outperforming a sharp selloff in Treasuries due to low tax-exempt supply, outsized demand, and a suddenly more attractive return profile thanks to a year-end hike in the federal income tax. Not surprisingly, those strong technicals did not last. By mid-February, the bid-side for municipal bonds was fading while the new issue calendar was picking up. The 10-year municipal/Treasury ratio, an important measure of relative value, began to climb. From just below 90% on January 10, the ratio rose to 96% by the end of February on its way to 103% to close March. At their high point in March, 10-year tax-exempt rates reached 2.00%, 24 basis points above year-end levels and 53 basis points above their November lows. A broader flight-to-quality trade triggered by the Cyprus crisis, however, helped pare those losses, pushing the yield on the 10-year down to 1.9% by quarter-end, salvaging positive returns.

While technicals generally worked against municipal bonds in the first quarter, fundamentals continue to provide more of a tailwind. States' tax revenues have recorded twelve consecutive quarters of growth, budget gaps have been closed with greater ease and states have done a good job controlling spending growth. Rainy day funds are being built back towards the levels that existed prior to the recession. Meanwhile, employment is picking up, income levels are growing and the housing market appears to be emerging from a bottom. All this provided a strong enough backdrop to encourage investors to reach for yield in the first quarter, driving credit spreads tighter.

As we head into April, the municipal bond market is still relatively cheap. Triple-A tax-exempt yields begin the quarter at or higher than comparable Treasury yields at all major points on the curve. This should encourage crossover participation and provide a needed cushion should broader rates move higher. Having said that, the Fed appears committed to keeping a lid on rates even as they've signaled they may recalibrate accommodation in response to changes in the job market. If they are successful, the critical components of return should come from carry and bond roll, especially considering the historically steep nature of the yield curve. Our style of active management allows us to be patient, positioning portfolios to reap the benefits of the Fed's go-slow approach, knowing that if rates start to rise, we will act accordingly. While the worst of the seasonal technicals should be behind us, we remain alert to any changes in sentiment and will take advantage of any trading opportunities that arise.

We entered 2013 with a healthy cash cushion that we established late last year. We sold aggressively at the end of November when rates hit historic lows, the yield curve flattened, and muni/Treasury ratios hit cyclical lows. The result was our shortest duration in ten years and the flexibility of a relatively high cash position. As these conditions reversed during the quarter we began to opportunistically redeploy the cash. By mid-March, rates had risen 50 basis points off the low and we stepped up our purchases. Not only were we able to buy back at cheaper levels, but the curve had also steepened approximately 25 basis points off the low, making bonds in the 10-year area of the curve much more attractive. By the end of the quarter, we brought cash below 3% and are more or less fully invested heading into the second quarter. While this tactical move has been completed, we still hold a strategic allocation of bonds shorter than the index that we can readily sell and reinvest in longer-term bonds if and when rates rise going forward.

"While technicals generally worked against municipal bonds in the first quarter, fundamentals continue to provide more of a tailwind."

TAXABLE BOND STRATEGIES

INVESTMENT TEAM

Mary F. Kane, CFA	Partner, Lead Portfolio Manager
Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Schuyler S. Reece, CFA	Vice President, Portfolio Manager

21 Fixed Income Investment Professionals	**17** Average Years Experience	**11** Average Years with Firm

GW&K TAXABLE BOND STRATEGIES

SHORT-TERM TAXABLE BOND	Through research and diversification, seeks to outperform money market funds while managing portfolio volatility
CORE BOND	A core multi-sector bond strategy that offers a more conservative profile by selecting only investment grade securities
ENHANCED CORE BOND	Offers broad market exposure across multiple bond sectors, including high yield bonds, while seeking to provide strong income
TOTAL RETURN BOND	This multi-sector approach takes advantage of relative valuation among distinct bond sectors and seeks to generate high income and capital gain
CORPORATE BOND OPPORTUNITIES	Seeks to maximize current income and longer-term capital appreciation by focusing on both high grade and high yield corporate bonds

At first glance, the first quarter of 2013 might appear to be an exact microcosm of the entire post-crisis period, as accommodative monetary policy again overwhelmed Washington gridlock and both political and financial turmoil in Europe. With equity returns already in double digits, the high yield market already up nearly 3%, domestic economic data still resilient and global central banks continuing to mitigate fiscal drag, one might expect a building of momentum in the bull market. Yet, digging a little deeper reveals important changes to sentiment. Already this year, we have seen the canonization of the term “Great Rotation,” as fixed income investors grapple with the grim realities of historically low yields and a potentially less-accommodative Fed. Additionally, credit investors have been reminded of idiosyncratic risk, as several public shareholder battles and leveraged buyouts have signaled a more equal balance of power between bondholders and shareholders. Lastly, while muted market reaction to the Cypriot bank recapitalization plan suggests that the credibility established by the European Central Bank (ECB) during the past fifteen months remains intact, the European periphery and its banking system still merit monitoring for signs of distress.

The rally in risk assets began as soon as markets opened following the New Year, as a last-minute deal to avoid the fiscal cliff set the stage. Given broad-based fears of higher interest rates, investors showed an aversion to duration, preferring to take credit risk rather than interest rate risk. As such, high yield was the best performing taxable bond sector, returning 2.9% in the first quarter.

As the economy continued to show signs of impressive resiliency during the quarter, several Fed Board members intimated that prudence might dictate an early moderation of the current asset purchase program prior to year end. With consensus views broadly expecting the current program to last well into 2014, this forced market participants to rationalize their outlook for interest rates. The prospect of the Fed absorbing less duration supply led to a steeper Treasury curve. In the end the Treasury Index returned –0.2% for the quarter. The Barclays Aggregate Index also suffered, returning –0.1%, and marking only the second time since 2006 that this index witnessed a negative quarterly return to begin the year. Though there were distinct pockets of strength, investment grade credits were hurt by their duration, as this sector returned –0.1%. With concerns about an early end to the Fed’s asset purchases weighing on sentiment, spreads on agency mortgage-backed securities widened and this sector returned –0.1%.

> “…it is our belief that strength in our domestic economy, broad global stimulus, and the ECB’s commitment to preserving the Eurozone should keep volatility in check and continue to support risk markets.”

Our rationale for owning spread product remains unchanged: Fed policy continues to be supportive of risk assets, improving housing and labor markets keep the domestic consumer resilient, inflation remains contained, and volatility remains subdued. While potential changes to Fed policy remain a key variable, increased transparency to the Fed’s decision-making process should allow the eventual withdrawal of stimulus to be well-telegraphed and manageable.

As we enter the second quarter, we are cognizant that European-driven volatility seems to have resurfaced at this time in each of the past two years and we will be monitoring the European periphery for any signs of weakness following the Cypriot bail-in. With that said, it is our belief that strength in our domestic economy, broad global stimulus, and the ECB’s commitment to preserving the Eurozone should keep volatility in check and continue to support risk markets.

Following our efforts to shorten portfolio duration in the fourth quarter, we remain neutral duration relative to our benchmark and biased to a steeper curve by year end. Given our confidence in the Fed’s ability to continue to manufacture our domestic recovery and expectations for manageable volatility, we believe that high yield continues to offer attractive prospects for total return. Within investment grade, money center banks and triple-B industrials leveraged to an improving domestic economy remain our highest conviction calls. Though our neutral positioning in agency mortgage-backed securities remains unchanged, we continue to overweight premium coupon collateral, as we believe it offers attractive yields and spreads with limited duration risk.

EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Edward B. White, CFA, CIC	First Senior Vice President, Portfolio Manager
Jeffrey W. Thibault, CFA	Partner, Portfolio Manager
Joseph C. Craigen, CFA	Vice President, Portfolio Manager

10 Equity Investment Professionals	**23** Average Years Experience	**13** Average Years with Firm

GW&K EQUITY STRATEGIES

EQUITY DIVIDEND PLUS	Income oriented strategy that invests in companies paying above-average dividends and with the required balance sheet strength needed to sustain dividend payouts
DIVERSIFIED EQUITY	Combines growth & value disciplines and diversifies across large, mid, and small capitalization stocks
SMALL/MID CAP EQUITY	A core strategy that invests in both small and medium sized companies that offer sustainable earnings growth
SMALL CAP EQUITY	Focuses on small companies with sustainable earnings growth in niche markets with lasting growth potential
SMALL CAP GROWTH	Utilizes fundamental research and quantitative screening to identify small companies with sustainable, above-average earnings growth in niche markets

The tone was set right out of the blocks in 2013, with the quarter's best one-day gain coming on the first trading day of the year. From there, stocks advanced steadily throughout the quarter, with only one meaningful downdraft in late February. By quarter's end stocks had advanced in the low double digits. It is difficult to attribute the gain to any new economic or financial developments. The troubled areas remain the same. Europe is still on the verge of crisis, with the problem area this quarter shifting from Greece to Cyprus. Domestically, economic data continues to show modest-to-moderate improvement in areas ranging from housing to jobs to manufacturing, while the Fed remains determined to keep interest rates low until unemployment shows much more improvement. While markets surely do not go up forever, and a correction would indeed be viewed as healthy, our bias is still toward higher markets by year end.

Large cap stocks, as measured by the S&P 500 Index, registered a double-digit gain of 10.6% in the quarter. The rally on the last day of the quarter propelled the S&P to a record high, finally eclipsing its prior mark set in September 2007. Market strength was fairly broad based, as most sectors were up in the double digits. Technology was a notable exception, showing only modest appreciation due primarily to weakness among computer hardware stocks. The best performance was registered by the more defensive sectors including Consumer Staples and Health Care. In the small cap world, the Russell 2000 Index posted a solid return of 12.4% with consistent and strong gains across all of the small cap market sectors.

Naysayers continue to get their share of air time. Europe remains in recession with unemployment still at intolerable levels in many countries. The Cypriot banking system has moved into the headlines. Domestically, the Federal sequester has begun. Lack of fiscal discipline and gridlock in Congress remains a concern. Despite these stresses investors have chosen to look past them because evidence of U.S. economic recovery and growth remains too strong to ignore. Housing continues to improve. Pricing, new home starts, and home sales all continue to improve meaningfully. The unemployment rate continues its modest decline. Consumer spending continues to grow, and consumer confidence indicators remain solid. And despite slowing somewhat in March, manufacturing indicators remain at expansionary levels.

Perhaps more important in the near term, the Fed has signaled its intent to keep interest rates very low as long as unemployment remains above 6.5%. The Fed has indicated it is exploring ways to eventually unwind Quantitative Easing, but such action would only come after a continued period of economic growth. Commodity prices have not participated in the market rally, suggesting inflation should remain under control and well under the Fed's tolerance level of 2.5%.

Corporate earnings remain strong, with good profit margins and strong cash flow. We expect share buybacks and dividends to be the main uses of excess corporate cash, but we also see a pickup in merger and acquisition activity as management teams put their cash to better use.

Valuation levels have increased given the rise in the stock market, but at 15 times projected 2013 earnings stocks remain only slightly above long-term averages and remain attractive in comparison to fixed income alternatives. Investors have finally started to realize the relative attractiveness of stocks as well, as we have finally seen steady inflows into equities this quarter following several years of outflows despite the rising stock market.

We will of course watch carefully for signs of a market slowdown; in particular any frothy market behavior, a slowdown in economic activity here or abroad, or renewed concerns about Washington's inability to solve its fiscal problems. And we will be watching for erratic behavior out of the world's typical hot spots for other geo-political risk. But most important, our focus remains on investing in quality companies that we feel confident can maneuver well in any economic environment, and will provide you with solid returns over time.

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