ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

One would think the sudden and dramatic decline in commodity prices would be a windfall for industrialized countries. If OPEC had never been created and oil stayed at the pre-OPEC price of under $2 per barrel, the world would look very different today. Beginning with the Arab oil embargo of 1973, the oil producing countries forced a dramatic change in all aspects of life for those who lived in the oil dependent industrialized world. Reflecting back on these 42 years, so much has changed in how businesses operate and how oil and its by-products are employed in everyday activities. Today we have been taught to be mindful of our energy use. Businesses have spent billions to become energy efficient. And now industry will need to reset priorities and rethink capital investments to adjust to the recent plunge in oil prices.

In the 1970s, the world suffered through two energy crises, both brought on by supply shocks from OPEC producing nations. During the Arab oil embargo, the price of crude quadrupled in less than six months and then held more or less steady until the Iranian revolution of 1979, when oil then tripled in price. And so from 1973 to 1980, a barrel of oil went from under $3 to over $30.

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INDEX PERFORMANCE *9/30/15*

	CURRENT QUARTER	YEAR TO DATE
Barclays 10-Year Municipal Bond Index	2.01%	2.12%
Barclays Aggregate Bond Index	1.23%	1.13%
Barclays High Yield Index	–4.86%	–2.45%
Dow Jones Industrial Average	–6.98%	–6.95%
S&P 500 Index	–6.44%	–5.29%
Russell 2000 Index	–11.92%	–7.73%
NASDAQ Composite	–7.09%	–1.61%

THIRD QUARTER 2015

ECONOMY

- The second quarter's 3.9% GDP increase was a welcome surprise compared to the anemic growth we saw in Q1. GDP for Q3, however, is expected to moderate and overall continues to run at a pace below its long-run average of over 3%.
- Economic indicators were mixed during the third quarter. Nonfarm payrolls were below forecasts but the unemployment rate remains low. Housing continued to recover, the service sector reported expansion, but manufacturing data was soft.
- Oil prices are down from Q2 and are approximately 50% lower than a year ago.
- Inflation appears contained, continuing to run below the Fed's target of 2%.

FED ACTION

- The federal funds target rate remained unchanged at 0–0.25%. At the highly-anticipated September meeting, the FOMC revised down its overall forecasts for growth and inflation.
- Chair Yellen and other Fed members have since said that the base-case is to raise rates by year end. This would imply a December hike even though October is still considered a "live" meeting by the FOMC.
- On average, market participants pushed back their anticipation of the first rate hike into 2016. At quarter end, the odds of a 25 bp hike by year end was less than 50%, indicating the market expects the Fed to be on hold for longer.

BOND MARKETS

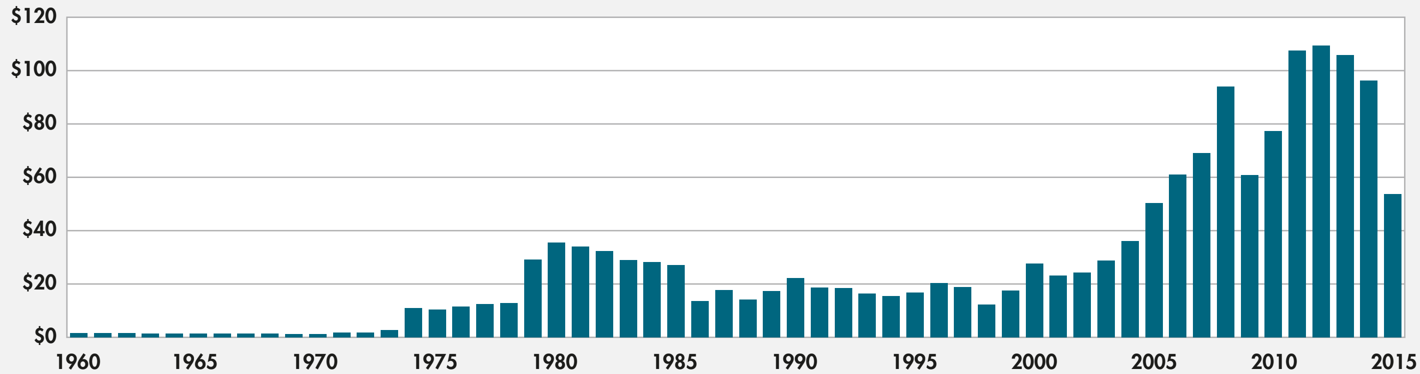
- The 10-year and 30-year Treasury rates sank 32 bps and 27 bps, respectively. Inflation expectations fell to a five-year low on concerns over China's deteriorating growth, rapidly falling commodity prices, and a slowdown in global demand.
- High yield was the worst performing sector, returning –4.86% on 154 bps of spread widening. Due to the rally in Treasuries, investment grade corporates gained 0.83% despite 24 bps of spread widening.
- Municipals posted impressive returns in the quarter, riding the coattails of the rally in Treasuries. A sharp slowdown in tax-exempt supply kept municipals well bid and insulated from the volatility of the broader markets.

EQUITY MARKETS

- The equity markets suffered significant declines and heightened volatility in the third quarter, driven by concerns around a slowdown in global growth and uncertainty about the Fed's policy path. Riskier assets, such as small cap stocks, underperformed large caps and now lag on a year-to-date basis.
- In a reversal of second quarter trends, the defensive Utilities and Consumer Staples sectors notched the strongest returns. The Energy, Materials, and Health Care sectors posted the steepest losses with oil and commodity prices testing new lows.
- Growth stocks outpaced value in large caps though the reverse was true for small caps. The sell-off in shares of previously high-flying Biopharma stocks was a key driver of the shift in the small cap market. Growth continues to lead across market segments year to date.

ECONOMIC COMMENTARY, continued from page 1

OPEC CRUDE OIL AVERAGE PRICE: 1960–2015
U.S. DOLLARS PER BARREL



Source: Statista.com

The spike in crude oil created dramatic incentives for individuals and businesses to change behavior. The opportunities for technology to improve our usage and develop other sources of energy became paramount. As a result, industrialized countries became more and more efficient while the threat of alternative energy sources kept crude prices largely in check. You can see in the chart, the price of a barrel of oil stayed within a $15 range from 1980 through 2004. But as the West was becoming more successful at keeping demand under control, a new player emerged on the global stage: China. China's seemingly unstoppable growth and investment-driven thirst for resources offset the declining demand in Western countries and rekindled the upward spiral for oil as well as other commodities. Starting in the mid-2000s, the price of crude resumed its steady climb, spiking to $140 in May 2008 amid a speculative fury but holding north of $100 a barrel as recently as July of last year.

So now with China growing at half the rate it was experiencing only a few years ago, the commodity sector feels like the plug was pulled from the bottom of the boat. The price of oil has dropped by 60%, as have the prices of other commodities. Another period of economic disruption is upon us. In 2000, the technology bubble damaged the economy with unsustainable stock valuations. In 2008, the credit bubble did the same with easy money and unsustainable leverage. Now we have to deal with a major change in commodity prices and what that means for the economy. And just like the bubbles of 2000 and 2008 disrupted markets but eventually made industrialized nations more resilient, the commodity slide of 2015 will ultimately benefit the developed world.

As we come to grips with the reality of today's commodity prices, many are obsessed with their near-term direction. Will prices continue to decline as exporters compete for revenue or have prices bottomed and are they possibly poised to rebound? In either case, unlike 2000 or 2008, our current domestic economy is quite stable and our private sector relatively strong. Like the decades following the oil crises of the 1970s, the world will adapt. Commodity prices must be viewed from a longer-term perspective, one that places China's slower growth in proper context. Only then can one conduct a rational examination of asset allocation and investment return expectations.

In a slow growth economy, there will always be traders looking to create uncomfortable swings in asset values to skim a net return. We saw it with the Technology sector, we saw it with structured finance, we see it with commodities. This too shall pass. If you stay committed to a quality portfolio, today's volatility will eventually be viewed as one more notable but ultimately harmless event. Had you stayed invested from 2000 to the present, whether in bonds, stocks, real estate or most any asset class, the returns in most cases would have been excellent. Fear should not drive you from the market.

U.S. growth will continue to be in the 2%–3% range. Interest rates will stay low and business will continue to find opportunities in the world markets. 2015 will be seen as a transitional year. Stay confident and don't let this turmoil affect your well-thought-out investment approach.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE	*9/30/15*
TOTAL ASSETS UNDER MANAGEMENT	$25.8 Billion
TOTAL EMPLOYEES	115
TOTAL INVESTMENT PROFESSIONALS	39

Visit **www.gwkinvest.com** for more information.

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. Tourigny, CFA	Partner, Portfolio Manager
Brian T. Moreland, CFA	Principal, Portfolio Manager

14 Municipal Investment Professionals	**18** Average Years Experience	**13** Average Years with Firm

"As an asset class, municipals have always had the quality and stability to act as an ideal portfolio counterweight. We look to enhance that inherent advantage by applying a disciplined approach to unpredictable events."

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 five 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

Municipals posted impressive returns in the third quarter, riding the coattails of a powerful rally in Treasuries. A sharp slowdown in tax-exempt supply kept municipal bonds well bid and well insulated from the volatility of the broader markets. Even the fallout from Puerto Rico's first payment default was minimal, as the island is viewed as an outlier in an otherwise healthy space. As the quarter came to a close, municipals remained attractive with historically cheap valuations versus Treasuries, a normalized yield curve that rewards sensible duration positioning and a still improving credit profile that bodes well for stable, dependable and tax-efficient returns.

Ironically, the third quarter opened with many worried about the bond market. In May, Janet Yellen herself warned that the first Fed rate hike could spark a "sharp jump in long-term rates." But anxiety over a slowdown in China and its spillover effects to the global economy turned out to be the greater concern. China's surprise currency devaluation ignited a worldwide equity rout that pushed investors to the relative safety of bonds. The turmoil broadened the slide in global commodities, weighing on growth and inflation, and was cited by the Fed as a deciding factor in leaving rates unchanged in September. By the end of the quarter, a more gloomy outlook for global growth had taken root. Futures markets were pricing in only a 40% chance of liftoff in December despite comments from Yellen and other Fed officials that the economy is strong enough to handle a rate hike before year end.

The disconnect between Wall Street and the Fed is nothing new. The market has long questioned policymakers' more optimistic assumptions on growth and inflation. In the third quarter, this led to wild swings in market prices when investors feared the Fed would add a rate hike on top of slowing global growth and financial instability. And yet, municipals were largely unaffected. While seasonally strong technicals helped, the nature of the asset class was as important. The municipal bond space is a domestic, long-only market where hedging is difficult and shorting impossible. Most investors are simply locking in a stream of tax-exempt income rather than speculating on the direction of rates. This doesn't make municipal bonds immune to secular moves in interest rates, but it does dampen the short-term fluctuations common to asset classes dominated by institutional and program trading.

And so as we head into the final quarter of the year, plenty of uncertainties still exist. Will the U.S. economy continue to add jobs at a healthy clip or be dragged down by a decelerating global environment? Will confusion regarding Fed action lead to more episodes of spiking volatility? Will rhetoric from the election cycle affect the markets in the coming months? As active managers, we focus not on the answers to these questions, but on the range of outcomes that could develop from them. Our strategy positioning emphasizes diversity, liquidity and flexibility with an eye toward avoiding the worst of the downside risks while preparing to take advantage of overreactions that may arise. As an asset class, municipals have always had the quality and stability to act as an ideal portfolio counterweight. We look to enhance that inherent advantage by applying a disciplined approach to unpredictable events.

Our trading this quarter consisted mainly of selling bonds that had rolled into the five-year area of the curve and reinvesting in bonds maturing between eight and twelve years. Due to the relatively steep yield curve and wider credit spreads available in ten years, we were able to pick up over 100 basis points on average for the trade. This is a process we execute constantly in order to prevent our overall duration from shortening due simply to the passage of time. We control duration by changing the amount and speed of these transactions. With rates declining over the quarter, we allowed duration to come in a bit by slowing the pace of this trade from the second quarter. As a result, our duration finished the quarter modestly shorter than the benchmark. Accordingly, we are well positioned to take advantage of the opportunity to lock in a higher income stream should interest rates rise from here.

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

12 Taxable Investment Professionals	**17** Average Years Experience	**8** Average Years with Firm

> "Demand for safe haven assets and the relative attractiveness of yields on U.S. debt are likely to keep a lid on interest rates, while aversion to all but the safest corners of the corporate market is likely to keep pressure on spreads."

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

Investor sentiment turned decisively negative in the third quarter. Anxiety over deteriorating growth prospects in China, rapidly falling commodity prices, and the possibility of the first rate hike in nine years led to an intense risk-off environment. For fixed income markets this was a double-edged sword: safe haven assets rallied while credit spreads widened to levels not seen since 2012. In the end, the Fed left interest rates unchanged, but caused a further sell off by offering surprisingly negative commentary that highlighted the downside risks from slowing global growth and low inflation.

The deteriorating global outlook caused a sharp decline for intermediate and longer dated Treasury rates. Meanwhile, two-year yields finished the quarter essentially unchanged, reflecting the Fed's decision to delay liftoff. The rally in rates drove a 1.76% return in the Treasury sector, outperforming the Barclays Aggregate's return of 1.23%. Mortgaged-backed securities (MBS) returned 1.30% as spreads remained relatively stable. The sector benefited from Fed commentary that indicated a strong likelihood that reinvestments in MBS would continue through the end of 2016. Taxable municipals also posted strong returns, up 1.63%, benefiting from their long duration.

Investment grade corporates saw continued spread widening, but managed to post a positive 0.83% return on the back of strong Treasury performance. The yield premium investors demand over Treasuries reached its highest level in three years amid record new issuance and increasing concerns over the state of the global economy. High yield bonds, which entered the quarter as the best performing sector, posted a total return of –4.86% and exited the quarter as the worst performing sector. It was particularly hit hard by the Fed's message of concern about the potential impact of weakening offshore economies. Despite the market volatility, it is notable that this is a market deeply divided into winners and losers, not one that is collapsing across the board.

We expect elevated volatility to persist for the rest of the year and into 2016. Uncertainty surrounding the first rate hike, concerns about global growth, and worries about deflation will continue to dominate headlines and rule sentiment. We expect U.S. economic growth to slow, but remain solid due primarily to an improving jobs outlook. Demand for safe haven assets and the relative attractiveness of yields on U.S. debt are likely to keep a lid on interest rates, while aversion to all but the safest corners of the corporate market is likely to keep pressure on spreads.

Our Strategies are neutral-weight with respect to duration, but are slightly underweight the short and long ends of the curve in favor of intermediate maturities. While we anticipate modest upward pressure on rates in advance of the first rate hike, we ultimately expect macroeconomic uncertainty and worries about global deflation to limit upside. We see the greatest value in intermediate maturities on both the Treasury and credit curves, given the attractive carry and roll for the interest rate risk being assumed.

We have turned more cautious on corporate bonds in recent months. While margins and interest coverage remain near peak levels, leverage has recently ticked up, new issue volumes are at record levels, and central bank policy remains highly uncertain. Market stress has been a fixture in the energy and commodity-related sectors, but as we approach the late innings of the credit cycle this stress may spill over into other areas of the market. In high yield we do not expect risk appetite to return until energy prices stabilize and/or investors have more conviction around the China story.

We upgraded the quality of our portfolios over the course of the quarter and we assumed a more defensive posture with respect to sector allocation, credit quality, and exposure to commodity prices and global growth. Our allocation to corporates is the lowest it has been since 2011, while our allocation to Treasuries is now at its highest level in more than seven years. Within the corporate space we have reduced our exposure to BBB-rated bonds on the investment grade side and single-Bs in high yield. We will continue to look for opportunities to upgrade the portfolios as economic and credit conditions evolve.

EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Jeffrey W. Thibault, CFA	Partner, Portfolio Manager
Jeffrey O. Whitney, CFA	Principal, Portfolio Manager
Aaron C. Clark, CFA	Vice President, Portfolio Manager
Joseph C. Craigen, CFA	Vice President, Portfolio Manager

11 Equity Investment Professionals	**18** Average Years Experience	**8** 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 CORE	A core strategy that invests in both small and medium sized companies that offer sustainable earnings growth
SMALL CAP VALUE	Employs fundamental research and proprietary screening methods to identify well-managed small cap value companies with attractive valuations and improving fundamentals.
SMALL CAP CORE	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

After trading sideways into mid-August on mixed economic data, the market reacted quickly and violently to the Fed's inaction on raising rates, falling within a week's time into correction territory. Stocks of all sizes and styles were impacted. The Fed's decision not to raise rates reflected its concern over global growth, with particular focus on the slowdown in China and emerging markets. While domestic GDP growth remains positive despite global growth issues, U.S. corporate profits will likely decline in the third quarter. Yet the tug of war regarding domestic economic growth prospects continues, with data still supporting those with both bullish and bearish outlooks. We remain in the positive camp as the market correction and the low inflation/low interest rate environment make stocks attractive at current levels.

Large cap stocks, as measured by the S&P 500 Index, declined –6.44% in the quarter and the correction from the peak has exceeded –12%. In the small cap arena, the Russell 2000 Index declined –11.92% in the quarter. From its June peak to its third quarter low in late September the Russell 2000 had corrected by over 16%. Almost all market sectors suffered losses this quarter. Energy and Materials stocks performed the worst as falling global commodity prices hurt sales and earnings of companies in these sectors. Energy's –33% decline in the small cap index was rather mind boggling considering investors have had nearly a year to react to low oil prices! Health Care also fell in the double digits, with the volatile Biopharma stocks finally falling to earth, and the entire sector trading down on increased political rhetoric regarding healthcare pricing. The only group of stocks to manage a positive return was Utilities in the large cap index.

The global economy continues to struggle, with China's growth slowing, and emerging market economies suffering from a steep decline in commodity prices. The question for U.S. investors is whether these global issues will ultimately spill over to our domestic economy. The Fed was sufficiently concerned about this scenario that it signaled it was in no particular hurry to raise rates. This of course spooked investors, sending us into the market correction that we are now in the midst of. Corporate profitability is surely not immune to these issues, especially multinationals with a meaningful portion of their business coming from overseas, and companies in the Energy, Materials and Industrials sectors where commodity headwinds weigh on earnings. As such, corporate profits will be down in the third quarter, and expectations for the full year are now for more modest growth.

Recent job creation data was also disappointing, although still positive, as companies react to this slower growth environment. Low energy prices put dollars back into the pockets of consumers and are likely responsible for the continued strength we are seeing in new home sales and auto sales. Survey work in Consumer Confidence, Manufacturing and Services remain in expansionary territory. Inflation remains nonexistent and interest rates remain low. This quarter's earnings comparison is likely to be the trough, as we cycle through last year's fourth quarter meltdown in Energy. And of course stocks are already off double digits from their highs, resulting in valuation levels that are quite reasonable in this low rate environment.

Corporations remain aggressive in using their strong balance sheets and excess cash to repurchase shares, pay dividends and make acquisitions. M&A activity remains near record levels. These factors also provide good support for stocks.

While the market did not agree with our favorable outlook last quarter, we were correct in our expectation that more speculative investments such as Biotech would fall out of favor, and there would be a return to our style of investing in high quality companies. Ultimately, that is all we can really do in this type of environment; use our research talent to identify companies that can achieve sustainable and consistent growth through better management and a superior business model. Over time, we expect these companies to outperform their peers, and contribute to above-average stock returns.

"While the market did not agree with our favorable outlook last quarter, we were correct in our expectation that more speculative investments such as Biotech would fall out of favor, and there would be a return to our style of investing in high quality companies."

GW&K Investment Management

222 Berkeley Street
Boston, Massachusetts 02116
617 236 8900
www.gwkinvest.com

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