ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

Interest rates will not rise significantly from here. In fact, they might not rise at all. In the last 25 years, there have been four periods of rising rates that alarmed markets and inspired pundits to call the end to what has now been a thirty-year secular decline in yields.

To listen to the crowd on CNBC or the talking heads mesmerized by every communique out of the Federal Reserve, you'd think the bull market was officially declared over. Again. For the last twenty years, I have written about the dangers of progressively lower rates and have taken action to protect clients' portfolios from a trend that has been in place now for the better part of my career. Now the question becomes: so you were right, but what now? Rates are so low, they cannot possibly go lower. Wrong! Of course they can go lower. No one thought short-term rates could go below the 1% Greenspan engineered in the wake of 9/11 and yet, ten years later, there they are—next to zero.

Continued on inside

PERIODS OF RISING INTEREST RATES

Ten-Year U.S. Treasury Yield	1994	1998–00	2008–09	2012–13
High	8.03%	6.79%	3.95%	3.03%
Low	5.57%	4.16%	2.06%	1.39%
Change	2.46%	2.63%	1.89%	1.64%

Source: Bloomberg

INDEX PERFORMANCE *12/31/13*

	CURRENT QUARTER	YTD
Barclays 10-Year Municipal Bond Index	–0.10%	–2.17%
Barclays Aggregate Bond Index	–0.14%	–2.02%
Barclays High Yield Index	3.58%	7.44%
Dow Jones Industrial Average	10.22%	29.65%
S&P 500 Index	10.51%	32.39%
Russell 2000 Index	8.72%	38.82%
NASDAQ Composite	11.10%	40.12%

FOURTH QUARTER 2013 MARKET OVERVIEW

ECONOMY

- Economic momentum continued as improving consumption, business investment and a declining fiscal drag contributed to better than expected growth.
- Employment improved as non-farm payrolls were higher than anticipated and the unemployment rate declined to 7.0%. However, slack in the labor market persisted as the number of discouraged and part-time workers remained elevated.
- Manufacturing activity increased over the quarter, and inflation remained contained due to declining commodity prices and an absence of labor cost pressures.
- Consumer confidence rebounded in December as rising faith in the labor market and income growth outweighed negative sentiment from the government shutdown.

FED ACTION

- The FOMC left the federal funds rate unchanged at 0–0.25% and strengthened its guidance by committing to maintain this range well past the time the unemployment rate declines below 6.5%, particularly if inflation continues to run below its 2% target.
- The Committee announced a tapering of its monthly purchases due to the decline in the unemployment rate and improvement in the labor market outlook. Beginning in January, the Committee will purchase $35bn agency MBS securities and $40bn Treasuries per month down from $40bn and $45bn, respectively.
- Virtually all members of the FOMC expect the first increase in the fed funds rate to occur in 2015.

BOND MARKETS

- Treasury yields moved higher across the curve as improving economic data and a budget compromise in Washington served as catalysts for the Fed's tapering announcement.
- Despite the sharp rise in rates, the Barclays Aggregate Index posted only a modestly negative return for the quarter thanks to strong results from the corporate sector. High yield was the star performer, returning 3.58%, representing nearly 50% of the sector's total return for the year.
- Municipals outperformed Treasuries due to low tax-exempt supply. The slope of the curve between five and ten years finished the year at 153bps, 61bps steeper on the year. Despite the hype over Detroit and Puerto Rico the vast majority of municipal credits were stable in 2013.

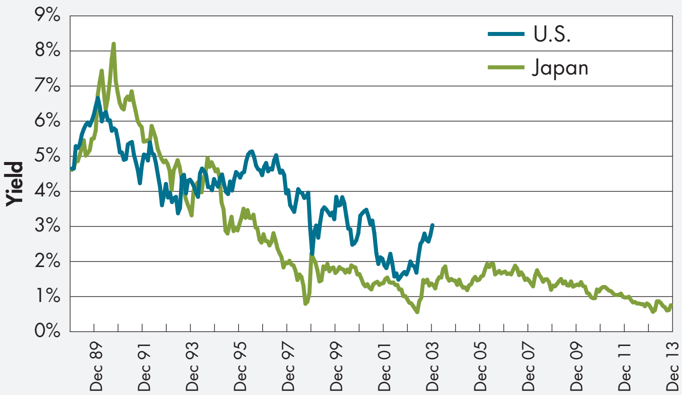
EQUITY MARKETS

- Stocks continued their march higher with major indices closing the year at record nominal highs. Market strength was driven primarily by positive U.S. policy developments, namely the successful budget resolution, improving economic data, and a moderate start to the long-awaited taper.
- Large caps slightly outperformed small and mid-cap stocks, a shift from the third quarter and a trend that bears watching in 2014.
- Generally, the more economically sensitive sectors such as Industrials, Consumer Discretionary, and Materials outperformed while the more defensive and highest dividend-yielding sectors such as Utilities and Telecommunication Services lagged.
- Strong corporate profits, improved consumer confidence, and continued positive fund flows into equities were hallmarks of the quarter.

ECONOMIC COMMENTARY, continued from page 1

JAPAN/U.S. 10-YEAR GOVT BOND YIELDS

Time scale: U.S. lagged by 120 months



Source: Ministry of Finance Japan, Bloomberg

So with the Fed now scaling back their bond buying program (tapering), the world believes that rates will find a natural level, much higher than what now exists. No—not necessarily. There are plenty of reasons for rates to stabilize where they are (or even go lower), none of which get a mention in conventional wisdom. Start with the level of inflation, which is approaching zero as the global economy and advances in technology rapidly drive down prices. Consider the huge amount of debt that has been paid down, refinanced or written off these last five years, a trend still firmly in place. Look abroad for examples of other developed economies experiencing similar issues and take note of how things have turned out there. Appreciate the pain of money market investors, sitting around waiting for rates to rise while earning zero on their "investment," only to hear that the Fed is determined to hold rates lower for longer. What do you suppose their response will be? A steep yield curve must look awfully enticing by now. The world is awash in liquidity which needs to find a home. Who's to say the bond market won't be one of those destinations?

I have written about the Japanese deflation experience of the last twenty years. Above is a chart of Japanese and U.S. Treasury bonds with a ten-year maturity. These are actual numbers and not predictions. I have dropped the U.S. trend lines back by ten years to see if the Japanese experience is a leading indicator for us.

Our fathers and grandfathers worried about the Depression returning after World War II, and many could never leave that terrible time behind. This generation risks making the same mistake in terms of the fear of inflation. In 1973, OPEC turned the world upside down by taking control of their oil fields. In many ways, it was the birth of modern inflation. Today, serious observers are talking about U.S. energy independence and even exporting liquefied natural gas if the government lets go of 1973 policies. Additionally, conservation policies have effectively reduced the level of energy as a percentage of our gross domestic product (GDP), meaning the 1973 crisis should stay where it belongs—in the history books.

If you're looking for inflation in wages, there is little chance you'll find it. Mercedes Benz employees in Germany recently petitioned the company to unionize their counterparts in North America so that the pay scale of U.S. workers would be in line with that of the German workers. The Germans were motivated by the company's decision to move production of the C-Class sedan to a factory in Alabama. But efforts to organize in the U.S. have met continued roadblocks and attitudes toward unions seem to be getting more adversarial and not less. Part of that is the collective bargaining protocols written into U.S. labor laws and part of that is a recognition of the long hidden burden of guaranteeing future benefits. Suffice to say, the cost-push wage inflation cycles of the past won't be resurfacing anytime soon.

The world is changing fast. The most obvious advances are in technology and medicine. But there is also a real evolution occurring in almost every area of our society. We have seen states move dramatically to adjust pension liabilities formerly viewed as sacrosanct. We have witnessed companies aggressively scouring the far corners of the world, once closed to them ten or twenty years ago, looking for new markets for their products. And we have observed a marked shift toward the use of capital rather than that of labor. This trend has been hidden somewhat by corporate uncertainty, stemming from fiscal dysfunction and monetary innovation. But as Washington achieves some semblance of stability by passing a budget deal and the Fed winds down some of its more ground-breaking programs, capital investment should follow in short order.

The financial crisis was a scary milestone and many still live with these fears. But we are in a new and growing economic world where globalization will keep inflation very low and investment opportunities will expand as the world's population moves to a more sustainable lifestyle. Don't continue to live looking into the rearview mirror. OPEC was forty years ago, 9/11 was twelve years ago, and the financial meltdown was five years ago. The world will never be perfect, but even with these difficult times we recover, move on and improve.

Enjoy the stability of interest rates and the rise of risk assets around the world. Stay the course and look forward, not back.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE

TOTAL ASSETS UNDER MANAGEMENT	$19.0 Billion
TOTAL EMPLOYEES	100
TOTAL INVESTMENT PROFESSIONALS	33

EDWARD B. WHITE, CFA, CIC, RETIRES FROM GW&K

Ed joined GW&K 25 years ago to build and lead the firm's equity investment effort. He laid the foundation for the investment philosophy that continues to guide each of our equity strategies today—investing in companies with ethical, committed management, and in quality businesses capable of sustained earnings growth. Ed has been a steady and confident advisor to his clients through many market ups and downs, and also a trusted colleague, mentor and friend. We are grateful to Ed for his lasting contributions to our business.

Through the years we have increased our commitment to equity investing by expanding our equity style options and building a team with deep talent. Daniel L. Miller, CFA, Director of Equities, has led this team since 2008. Dan has shared management responsibility for our Diversified Equity and Equity Dividend Plus Strategies with Ed, and will continue to manage these strategies, with no change to their investment philosophy or process.

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

13 Municipal Investment Professionals	18 Average Years Experience	13 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

"We methodically extended duration in 2013 as a significant rise in interest rates created opportunities along the yield curve. Throughout the year, we focused on selling our shortest maturities, which were our best performers. The entire front end of the curve was in high demand this past year as retail investors sought the security of shorter bonds in a period of increasing yields."

The municipal market posted mixed returns in the fourth quarter amid a significant steepening of the yield curve. Months of speculation regarding an eventual tapering of the Federal Reserve's quantitative easing program, officially announced in December, caused retail investors to seek shelter in shorter duration paper. Tax-exempt yields from five years and in actually declined over the quarter while rates longer than five years moved higher. The hardest hit area of the curve was the ten year, where rates increased 23 basis points. Yields out long rose less than half that amount, benefiting from low supply and extremely cheap valuations versus Treasuries coming into the quarter.

While much was made of Detroit's bankruptcy filing and Puerto Rico's possible descent to junk status, it was the Fed's May and June comments about reducing its asset purchase program that led to calendar year losses for just the third time since Reagan reformed the tax code in the early 1980s. The taper discussion triggered a stampede out of tax-exempt mutual funds that exceeded in magnitude even the 2010–11 period of outflows that was sparked by the infamous 60 Minutes Meredith Whitney episode. The heavy selling pressure was met by a buy side that lacked much conviction, as a year-long drop in new issue supply often sapped the market of necessary price guidance. This dynamic disrupted the usual seasonal patterns of supply and demand. Gone was the typical summer rally, September and October experienced rare rate declines and the usual year-end firming was not to be.

With the Fed approaching a historic transition from an emphasis on quantitative easing to a focus on forward guidance, volatility is probably inevitable. But underneath the broader swings in interest rates lies a municipal market that is remarkably healthy considering all the headlines touting the difficult nature of 2013. Credit fundamentals are as solid as they have been in some time. Tax revenues are on the upswing and now exceed pre-recession highs, even after inflation. Expenses have been reined in, due to balanced budget requirements, and rainy day funds are being replenished nationwide.

While a 1% rise in rates over the course of a year was unnerving for many, the value it created is compelling. Remember, we are less than 18 months removed from a ten-year Treasury rate of 1.39% and a ten-year municipal yield of 1.47%, both all-time lows in their respective markets. Now, not only are intermediate yields finally within shouting distance of their ten-year average level, but a significantly higher tax burden, with the expiration of the Bush-era tax cuts and the new Medicare surcharge, increases the importance of the tax-exemption. When you consider that municipals are also trading historically cheap to Treasuries, in some cases even nominally out-yielding them, it is easy to get excited about where we start the year. Investors don't even need to extend maturities to 20 years to lock in a 7% taxable-equivalent yield on a double-A municipal bond. Even supposing rates drift higher in 2014, which is far from certain, the value proposition offered by municipal bonds demands attention.

We methodically extended duration in 2013 as a significant rise in interest rates created opportunities along the yield curve. Throughout the year, we focused on selling our shortest maturities, which were our best performers. The entire front end of the curve was in high demand this past year as retail investors sought the security of shorter bonds in a period of increasing yields. We concentrated our purchases on maturities between 8 and 12 years that we felt offered more relative value.

In the end, we lengthened duration approximately half a year, a move consistent with our strategy of locking in higher rates during rising rate periods. In the meantime, we will keep harvesting carry and roll while making sure we retain the appropriate flexibility should an actionable catalyst materialize.

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

11 Taxable Investment Professionals	15 Average Years Experience	8 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

Economic conditions improved throughout the fourth quarter as a host of indicators, including employment, consumer confidence, durable goods, and new home sales reports, surprised to the upside. In light of the improved outlook for growth, the highlight of the quarter was the Fed's much anticipated mid-December announcement that it would begin to modestly reduce the pace of its asset purchase program beginning in January. At the same time, the Fed went out of its way to reinforce its forward rate guidance and reassure investors that interest rates would remain exceptionally low for a long period of time.

The steady stream of relatively good news coupled with investors' growing expectations for tapering in early 2014 resulted in a significant backup in longer-term interest rates. By year end the ten-year Treasury yield stood at its highest level since mid-2011. Given the Fed's commitment to the front end of the curve, short rates remained relatively anchored and two-year Treasuries essentially broke even on a total return basis during the quarter.

Despite the sharp rise in rates, the Barclays Aggregate Index posted only a modestly negative fourth quarter return of –0.14%. Strong relative performance from the investment grade corporate sector of 1.11% helped support these results, as a quarter-long rally saw spreads tighten to a post-crisis low. The high yield sector was the star performer, returning 3.58%. A brisk rally in the equity market, strong fundamentals, and continued support from the Fed drove investors to seek higher yielding securities. Treasuries posted a modest loss of –0.75%, while government-related securities broke even and returned a marginally positive 0.04%. Mortgage-backed securities delivered a slightly negative return of –0.42%.

For the year, every sector of the taxable bond market had negative returns except high yield. The sharp rise in interest rates drove a negative return for the Barclays Aggregate Index of –2.02%, its worst annual showing since 1999. In a year of many records, this represented only the third calendar year since the inception of the Aggregate Index in 1976 that total returns were negative.

In 2014, we expect to see slightly higher rates and modestly tighter spreads based upon a steady winding down of the Fed's massive quantitative easing program, an adequately improving economy, and low defaults. A major caveat for the market will be whether the Fed's "qualitative" approach to strengthening rate guidance will be sufficient to anchor rates as quantitative easing tapering begins. Any string of economic data that surprises to the upside could cause the market to re-price expectations quickly.

We remain approximately one-half year underweight duration relative to our benchmarks. While we expect rates to grind marginally higher next year, we believe we are approaching the upper bound for the ten-year Treasury (3.25%–3.50%) given the tenuous nature of this recovery, the lack of inflationary pressures, and the Fed's commitment to keep rates lower for longer.

Against this backdrop, the carry trade environment will persist, and credit should perform well. We remain overweight the intermediate part of the curve and continue to favor credit risk over duration risk. While we recognize that return opportunities from here are limited in corporate bonds, excess returns should be better than the alternatives. Fundamentals are solid and valuations are not yet at extreme levels. Higher yields should keep flows coming into the sector. We expect modest spread tightening as the economy continues to improve. In our opinion, the risks to corporate bonds would come from an unexpected monetary tightening, a spike in default rates, or sharply higher interest rates. None of these are likely in 2014.

In high grade corporates, we continue to focus on some of the widest spread industrial sectors, which should benefit the most from stronger global growth. Within the high yield sector, we remain invested in the higher quality BB/B-rated segment of the market. The limited interest rate sensitivity and low embedded default risk inherent to single-B rated bonds make them particularly attractive in an environment of heightened macro risks and the ongoing quest for income.

We continue to be relatively neutral in mortgage-backed securities. As interest rates rise, our primary concern shifts from prepayment risk to extension risk. We continue to emphasize higher-coupon, seasoned, specified-pools that should help protect us from any serious duration spikes.

"We remain overweight the intermediate part of the curve and continue to favor credit risk over duration risk. While we recognize that return opportunities from here are limited in corporate bonds, excess returns should be better than the alternatives."

EQUITY STRATEGIES

INVESTMENT TEAM

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

10 Equity Investment Professionals	16 Average Years Experience	7 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 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

Another quarter of solid performance caps off an exceptional year for equities! While the market experienced a few brief and shallow corrections, the direction was consistently positive throughout the quarter and the year. Unlike last quarter when smaller stocks dominated, returns for large cap stocks were up in the double digits while smaller caps were up "only" in the high single digits. Once fears of Fed tapering waned and the government shutdown was resolved, stocks attracted new interest from investors who had missed the rally, helping push markets to new highs. The fact that the economy continues to grow, corporate profits are still increasing, inflation remains tame, and equity flows remain positive only further helped the market along. We suspect these factors will remain in play for 2014 as well.

Large cap stocks posted a solid gain in the quarter, with the S&P 500 Index increasing by 10.5%. All sectors showed positive returns. As one would expect in a growing economy, the leaders were among the more economically sensitive sectors such as Information Technology, Industrials, Consumer Discretionary, Materials and Financials. For the year the S&P 500 Index gained 32.4%, the best calendar year return for this index in over 15 years.

Small cap stocks also posted solid returns in the quarter, with the Russell 2000 Index gaining 8.7%. As with larger caps, all sectors posted positive returns, with the economically sensitive sectors leading the way. Full year results for the Russell 2000 Index showed an impressive gain of 38.8%, well ahead of the large cap benchmark, and the fourth best year on record for this Index.

We are a bit hesitant in continuing to voice a positive market outlook after a five-year bull market and the completion of one of the strongest years on record for stocks, but the positive factors remain too overwhelming to ignore. The issues that gave us concern a quarter ago have largely been resolved: a new bi-partisan budget has been signed, and the Fed has begun tapering with little apparent impact on equities. The economy continues to grow, with signs of improvement evident in all economic sectors. We have seen acceleration in several economic measures such as GDP, consumer confidence and manufacturing. Unemployment has ticked down to 7% for the first time since the financial crisis in 2008. Home prices continue to rise. Inflation remains tame, with commodity prices still in decline, and the CPI and PPI registering only modest increases. Yet overall signs of improvement are still rather moderate, with the level of job growth and unemployment not yet good enough to suggest Fed policy is likely to change from its accommodative stance.

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Corporate earnings remain strong, driven by both revenue growth and cost containment. It is likely that corporate profit growth will be greater in 2014 than it was in 2013. Consensus estimates among Wall Street strategists suggest the stock market is selling at a reasonable valuation level of 15½–16 times 2014 earnings. This valuation level is only slightly above long-term averages and, despite the uptick in interest rates, remains relatively attractive as compared to other investment alternatives. Corporate cash flows and cash balances remain high, suggesting continued use of cash to pay dividends, repurchase shares and make accretive acquisitions.

So what can go wrong with this positive outlook? Interest rates could continue their climb despite few signs of inflation. Tapering does remove some amount of demand from the bond market, and its ultimate impact on rates is difficult to forecast. Higher rates could impact the price investors are willing to pay for stocks, and could slow interest rate-sensitive economic activity such as housing. Tapering itself has its inherent risks, as the Fed must walk the fine line between the proper amount of tapering and its impact on the economy and interest rates. Lastly, market volatility remains low; a sign that there is some degree of complacency in the market. In such times, a short and perhaps sharp correction cannot be ruled out.

We expect to participate in up markets and, just as importantly, protect in down markets. Whether the market continues its winning ways or not, we remain committed to investing in the highest quality companies at reasonable valuation levels, using our investment expertise to find and hold onto these stocks for the long term.

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