ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

During the Cold War, Americans lived in constant fear of a nuclear confrontation with the Soviet Union. I remember Khrushchev's defiance at the United Nations General Assembly. The Bay of Pigs invasion and the Cuban Missile Crisis pushed tensions to the brink of nuclear war. It all seems like yesterday. But as threatening and difficult as those years were, our country's enemies were at least definable and, to the extent possible, government officials created policies that provided protection for the citizenry.

After September 11, our government saw another definable enemy and aggressively pursued them. I am not going to get bogged down in policy discussions because the U.S. government's response and use of military intervention in Iraq and Afghanistan, like in Korea and Vietnam before them, will be debated forever.

Continued on inside

INDEX PERFORMANCE *12/31/14*	CURRENT QUARTER	YEAR TO DATE
Barclays 10-Year Municipal Bond Index	1.38%	8.72%
Barclays Aggregate Bond Index	1.79%	5.97%
Barclays High Yield Index	–1.00%	2.45%
Dow Jones Industrial Average	5.20%	10.04%
S&P 500 Index	4.93%	13.69%
Russell 2000 Index	9.73%	4.89%
NASDAQ Composite	5.70%	14.75%

FOURTH QUARTER 2014 MARKET OVERVIEW

ECONOMY

- The U.S. economy posted 5% GDP growth in its most recent quarter, the highest level in over 10 years.
- Job growth continued strong in the fourth quarter. Nonfarm payrolls saw an increase of 321,000 in November, the most since January 2012. The unemployment rate fell to 5.8% from 6.7% at the end of 2013. Concerns remain regarding the labor force participation rate and soft wage growth, although both have seen slight improvements from the previous quarter.
- The ISM Manufacturing and Non-Manufacturing reports indicate economic activity in these sectors remained in expansion territory. Housing prices continued to rise, but some building and sales data signal moderation in the sector.
- Inflation indicators are running below the Fed's target of 2%.

FED ACTION

- As expected, the Fed ended its monthly bond purchase program in October. The Fed continues to reinvest principal payments from its mortgage holdings.
- The federal funds target rate remains unchanged at 0–0.25%. In their December meeting, the FOMC replaced "considerable time" with language suggesting the Fed would be "patient" in normalizing policy. Market participants are anticipating the first rate hike to be in the middle of 2015 or later.
- The FOMC is forecasting more aggressive rate hikes than the market is pricing in.

BOND MARKETS

- U.S. Treasury markets saw strong performance in the fourth quarter amid concerns about anemic global growth, the rising threat of deflation, and the implications of falling energy prices. The 10-year and 30-year Treasury rates dropped 32 bps and 45 bps, respectively.
- Investment grade corporates added to their strong year-to-date performance, returning 1.77% in the quarter, while the high yield sector ended with its second negative quarter in a row with a –1.00% return.
- Continuing a year-long trend, the municipal yield curve flattened substantially in the fourth quarter with 5-year rates rising 15 bps while 10-year and 30-year rates fell by 13 bps and 23 bps, respectively.

EQUITY MARKETS

- After a difficult start to the quarter, the equity market found its bearings and resumed its upward climb notching its sixth consecutive year of gains. Small caps led the way, outperforming large caps for the first time in five quarters. Despite the rebound, large cap stocks finished the year 9% ahead of small caps, more than reversing last year's small cap performance advantage.
- The Utilities sector posted the strongest quarterly returns followed by Consumer Discretionary and Consumer Staples. In a continuation of third quarter trends, Energy was the worst performing sector as oil prices plummeted to five-year lows and the dollar further strengthened.
- In this low interest rate environment, fund flows into equities turned positive driven by improved valuations, stronger than expected corporate earnings, low inflation, and steady U.S. economic growth.

ECONOMIC COMMENTARY, continued from page 1

Today, however, it has become more difficult to identify enemies, to discover their staging grounds and determine their methods. At best, they give us cause for deep concern; at worst, they may wreak havoc on our country. I am not talking about ISIS or Al Qaeda, but about cyber terrorism and economic destabilization.

While it's tempting to dismiss North Korea's cyber-attack on Sony as a one-off situation, it is alarming that this "backward" country was able to use blackmail to temporarily shut down the distribution of a movie. The ultimate decision to show or not show the film is immaterial. The fact that North Korea could go so deep into the cyber world to provoke such reaction is the problem. If North Korea can do it over a foolish movie, imagine the threat posed by more sophisticated countries with more sinister motives. These new enemies can hide in the shadows making it more difficult to immobilize the threat.

Another concern is the sharp drop in oil prices, from roughly $100 a barrel in June to the $50 range today. Many analysts emphasize the economic benefits to lower energy costs, others the disruptive shift it causes in the energy industry and still others the potential ramifications for alternative fuel sources. My foremost concern is the event itself—the simple fact that a commodity so fundamental to our way of life can be so susceptible to dramatic price changes. I work in an industry that takes pride in its ability to forecast fundamentals in the oil and gas industries: corporate profits, capital spending, exploration technologies, etc. And yet, not one analyst forecasted a drop in the price of oil. The talking heads give us plenty of after-the-fact reasons: U.S. production has increased by 90% over the last six years, Iraq is producing more than forecast, China's economy is growing more slowly, etc. But a 50% reduction in price?

I believe Saudi Arabia, whose policies can significantly affect the price of oil, has an external enemy that creates real fear for the Kingdom—Iran. Saudi Arabia wants to avoid a nuclear Iran as much as or even more than Israel does. Hatred between the Sunnis and Shiites dates back long before the state of Israel was founded. A nuclear Iran is not acceptable to the Saudis. The probability of war between the two countries is unlikely but we see what intimidation can result from attainment of such capabilities. North Korea without nuclear weapons would be a non-entity. As I wrote in one of my previous letters, Gadhafi created his downfall by giving up his nuclear weapons program. Had he maintained his weapons program, the West would not have dared to enter his airspace.

The Saudis distrust the ability and/or desire of the U.S. and its European allies to negotiate a tough nuclear disarmament agreement with Iran. The distrust between the U.S. and the Kingdom has many roots, but the most recent one is the Obama administration's recognition of the Muslim Brotherhood and President Morsi in Egypt. The Brotherhood was, and in many ways still is, a sworn enemy of the Saudis. To make matters even worse, when Morsi and the Brotherhood were overthrown and General Sisi took over, to the relief of Saudi Arabia and Israel, Obama was critical of the coup and slow to recognize the new government.

As important, the U.S. and Iran are cooperating in Iraq fighting ISIS, so the Kingdom's two mortal enemies, the Brotherhood to the west and Iran to the east, have created an overwhelming problem. Saudi Arabia had one weapon at their disposal—the price of oil. Since the Arab oil embargo in 1973, the producing nations and consuming nations have found common ground and the understanding of mutual interdependence. Price the product too high and the consuming nations have a recession or worse; price the product too low and exploration is dramatically reduced and the producing nations have major economic problems. This unstated economic contract has been superseded by Saudi Arabia's need to force the U.S., Europe and Iran to do what they have all been reluctant to do: ensure a nuclear-free Iran.

So we live in a world where new world problems (cyber wars) or old world problems (driving down the price of a commodity by 50%) can destabilize the status quo. While we enjoy the benefits of a growing global market, we need to realize that the world is getting smaller and ever more complicated. Having said that, the world's economies will still continue to grow and provide investment opportunities here and abroad. Proper diversification is required as a shock absorber in these volatile times.

Enjoy 2015 with health, happiness and prosperity.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

GW&K UPDATE	*12/31/14*
TOTAL ASSETS UNDER MANAGEMENT	$22.8 Billion
TOTAL EMPLOYEES	108
TOTAL INVESTMENT PROFESSIONALS	34

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

"Entering the potentially choppy waters of 2015, much of what makes municipals so secure and predictable, from the steady tax-free income stream to the miniscule default rates to the domestic nature of the purchasing base, should reassure those looking for a portfolio anchor."

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 mixed returns in the fourth quarter—the long end rallied hard amid signs of a deepening global slowdown while the short end barely broke even, held back by the prospect of Fed rate hikes in 2015. The results continued a year-long trend that rewarded duration risk and punished those who sought to hide in shorter maturities. Tax-exempt yields inside five years entered the fourth quarter essentially unchanged on the year and rose as much as 18 basis points over the final three months. Meanwhile, 10-year municipal bond yields began October already down 64 basis points for the year and dropped an additional 13 basis points. The yield on 30-year municipal bonds dropped 23 basis points over the final quarter to end 2014 down a whopping 134 basis points.

Results in the municipal bond market were driven mainly by broader events, the behavior of municipal yields simply mirroring the massive flattening of the Treasury curve. Short rates drifted higher as nonfarm payrolls continued to expand and U.S. GDP growth rebounded from a weather-induced contraction in the first quarter. Meanwhile, with growth and inflation still uncomfortably low in Europe and Japan, global capital poured into U.S. government securities looking for an alternative to the depressed yields available on other high-quality sovereign bonds. Buying was also fueled by geopolitical tensions, the severe drop in oil prices, and concerns of a possible Ebola pandemic. Volatility peaked on October 15, when a mix of these factors triggered a brief market panic.

To the extent that rate moves in the municipal market diverged from those in the Treasury market, supply was usually the culprit. For most of the year, tax-exempt issuance was running well behind 2013's pace, causing municipal bonds to outperform Treasuries along the entire curve. But a surge in fourth quarter supply, which pushed total volume for 2014 in line with 2013, caused municipal bonds to underperform Treasuries over the final three months of the year. Still, demand for tax-exempt paper remained strong in the face of the issuance pickup.

Throughout the year, our trading activity centered on selling five-year maturities and reinvesting in 10-year bonds. With the yield curve historically steep through the majority of the year, these swaps provided a significant pickup in carry from both higher yield and increased roll potential. While any bonds shorter than the benchmark proved a drag on performance in 2014, we still maintain a healthy exposure to such positions as a hedge against rising interest rates heading into the new year.

Away from structural considerations, we deliberately upgraded credit quality toward the latter half of 2014 as investors chased yield in a declining rate environment. As spreads tightened during the year, the risk/reward calculus changed, prompting us to shed risk that we believe will become more vulnerable to repricing going forward.

Looking ahead, the broader markets will be hyper-focused on Fed policy. As investors try to decipher the maddening language of forward guidance, volatility is likely to increase. The fourth quarter gave us a taste of that. In this environment, municipals should offer a relative haven, one that has historically avoided the sharp swings of the Treasury market. Credit fundamentals in the municipal bond space remain solid. Tax revenues have been on the upswing for five years at the same time the states have implemented austerity measures that have modestly shrunk the level of municipal debt outstanding. Rainy Day funds have been replenished and states are benefiting from the national recovery that typically trickles down with a lag. Technicals in the market are favorable as well. The fourth quarter surge in supply is giving way to the typically slow issuance months of January and February. Pent up demand promises to curtail any yield spike as many investors lie in wait to leg in at more attractive levels. And yields versus Treasuries are historically cheap, particularly in the ten-year range and out longer, where nominal yields even surpass their taxable counterparts. Entering the potentially choppy waters of 2015, much of what makes municipals so secure and predictable, from the steady tax-free income stream to the miniscule default rates to the domestic nature of the purchasing base, should reassure those looking for a portfolio anchor.

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

10 Taxable Investment Professionals	17 Average Years Experience	9 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

Fixed income markets saw mixed performance in the fourth quarter amid concerns about anemic global growth, the rising threat of deflation, and the implications of falling energy prices. Economic data in the U.S. offered further evidence that a meaningful domestic recovery is finally taking hold, with GDP growing at its fastest pace in more than ten years. This proved to be little comfort to bond investors, however, who focused instead on weakness internationally. The U.S. stood apart from the rest of the world with respect to monetary policy as well. The Fed brought QE3 to an end and adopted increasingly hawkish language, while the European Central Bank and Bank of Japan ramped up asset purchases and hinted at further easing. And so, interest rates extended their year-to-date rally on the back of both a flight-to-quality and demand for the relative attractiveness of U.S. debt, ultimately ending the year near historic lows.

The Treasury yield curve flattened dramatically during the quarter, reaching levels last seen six years ago. The short end rose to a three-year high in response to language from the Fed implying a significant likelihood that the first rate hike was on schedule for the second quarter. The long end, meanwhile, extended its year-long rally amid worries of weak global growth and falling worldwide inflation, hitting its lowest level in more than two years and coming within 30 basis points of its all-time low. The Treasury sector returned 1.93% in the fourth quarter, outperforming the 1.79% return of the Barclays Aggregate Index.

Investment grade corporates added to their strong year-to-date performance by returning 1.77% in the quarter. The high yield corporate sector, on the other hand, saw its second negative quarter in a row, posting a loss of -1.00%. The most significant driver of high yield performance, particularly among the lower-rated bonds, was the Energy sector, which comprises 14.5% of the Barclays High Yield Index. The 42% decline in the price of crude oil led to a 10.6% sell-off in high yield energy credits.

We expect the recent uptick in volatility to persist in 2015. Despite a U.S. economy that continues to show strength, the impending rate hike from the Fed and the implications of falling energy prices will ensure that uncertainty persists in both the interest rate and credit markets. We also anticipate further flattening of the yield curve as we approach the first rate hike. Additionally, the unique strength of the U.S. amid a global economy characterized by the threat of deflation, slow growth, and geopolitical uncertainty will continue to limit upside in rates, as the U.S. offers both safety and attractive valuations. Finally, we remain constructive on high quality spread product, which we expect to benefit from improving economic fundamentals in the U.S. and a worldwide search for yield.

We continue to see value in corporate bonds relative to Treasuries, particularly following recent spread widening, given that profitability remains near peak levels and balance sheets remain solid. Corporates also provide a defensive hedge in a rising rate environment. Within investment grade, we still prefer BBB-rated credits for the incremental spread over A-rated credits for acceptable levels of additional risk. We also continue to favor the more cyclical sectors, which should benefit from the ongoing U.S. recovery and which offer the best reward for careful security selection.

We remain overweight high yield in eligible Strategies as well. While we recognize that a prolonged decline in oil prices could lead to an increase in the overall default rate over the next several years, credit fundamentals more broadly remain strong and support a benign default outlook outside of the energy space. High yield spreads reached their highest level in more than two years during the quarter and remain 160 basis points above their recent lows, offering not only carry and the potential for spread compression but also protection against rising rates. We remain neutral on mortgages, despite limited room for spread compression, because they offer downside protection in a rising rate environment as well as a defensive alternative to credit markets.

"We continue to see value in corporate bonds relative to Treasuries, particularly following recent spread widening, given that profitability remains near peak levels and balance sheets remain solid. Corporates also provide a defensive hedge in a rising rate environment."

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	17	8
Equity Investment Professionals	Average Years Experience	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

After a sluggish third quarter and a difficult start to the fourth quarter, the market found its bearings and once again resumed the year's upward climb. Stocks of all sizes posted gains in the mid to high single digits. Smaller cap stocks led the way this quarter, but managed to only slightly close their full-year under-performance gap versus larger caps. By the time the books had closed on the year, the market had registered its sixth consecutive annual gain, a feat not experienced since 1999. While the record decline in oil prices garnered the majority of the headlines, there were many other economic and market developments worthy of note. On the negative side we have the continued economic malaise in Europe, reduced growth expectations in China, and a slowdown in most emerging markets; especially those suffering from declining oil and commodity prices. On the positive side, our domestic economy is proving to be very resilient, with lower energy prices helping to raise consumer confidence and lower manufacturing costs. When combined with the low interest rate environment, it is no surprise that money continues to flow into equities, pushing nearly all market indexes to all-time highs.

Large cap stocks, as measured by the S&P 500 Index, advanced 4.9% in the quarter. Energy declined by more than 10%, weighed down by the nearly 50% decline in oil prices. The Utility sector was the winner with a 13% gain. Investors flooded to these high dividend paying stocks as long-term interest rates continued their decline. Among small cap stocks, the quarter was more kind, with the Russell 2000 Index posting a 9.7% gain. Small cap energy stocks, a group comprised of many domestic exploration and production companies most impacted by falling oil prices, posted a whopping 31% decline. All other sectors of size posted gains of 9% or more, led by Health Care (+18%) and Utilities (+17%).

For the year, large cap stocks finished 9% ahead of small caps, more than reversing last year's small cap performance advantage. But as long-term investors, perhaps the most important statistic shows that large and small stocks had almost equivalent performance gains over the past five years, each compounding at about 15.5% per year.

Looking ahead, we are aware that all the economic news is not positive. The Energy sector has been an important part of U.S. economic growth, but cuts in capital spending by energy companies will have some impact on overall growth. Housing also remains a key sector not showing growth, although rising consumer confidence and lower mortgage rates could result in a surprising improvement in this sector as the year progresses. Economic weakness around the globe also bears watching. Europe remains in a funk, China's growth engine is also sputtering, and emerging economies clearly have been impacted by the decline in oil and other commodity prices so important to their economies.

"Corporate earnings growth has been strong in 2014, and we expect it to continue into 2015.…Corporate health is also supportive of the stock market, as companies continue to repurchase stock, pay out more of their cash flow in dividends, and use their cash and borrowing capacity for acquisitions."

So with this list of concerns on the heels of a six-year bull market, does it make sense to still express a positive market outlook? We think it does. The U.S. economy continues its slow, steady, and sustainable growth. There is enough growth to generate jobs, increase consumer confidence and enhance profits, but not too much that inflation or interest rates tick up in any meaningful way. Employment statistics and U.S. business surveys remain solid. The Consumer Confidence Index continues to signal favorable spending indications. The meaningful decline in oil, gasoline and natural gas prices has put a lot of dollars back in consumers' pockets and has cut costs for most manufacturing and many services businesses, suggesting these favorable growth trends will continue.

Corporate earnings growth has been strong in 2014, and we expect it to continue into 2015. Earnings growth is likely to remain in the upper single digits this year. Corporate health is also supportive of the stock market, as companies continue to repurchase stock, pay out more of their cash flow in dividends, and use their cash and borrowing capacity for acquisitions.

While we maintain a positive market outlook, we also understand that our forte is in stock selection rather than in economic or market forecasting. As such we remain committed to finding reasonably valued companies that we can hold for the long term. We believe such companies have strong management teams and strong market positions that can generate consistent and sustainable growth over time.

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